Reforming the Securities Class Action: An Essay on Deterrence and its Implementation

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An Essay On Deterrence and Its Implementation

John C. Coffee, Jr.

October 2006
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by John C. Coffee, Jr.

Abstract

The securities class action cannot be justified in terms of compensation, but only in terms of deterrence. Currently, the damages recovered through private enforcement dwarf the financial penalties levied by public enforcement. Yet, the evidence is clear that corporate officers and insiders rarely contribute to securities class action settlements, with the settlement funds coming instead from the corporation and its insurers. As a result, the cost of such actions in the aggregate falls on largely diversified shareholders. Such a system is akin to punishing the victims of burglary for their negligence in suffering a burglary and does little to deter corporate officials who have private motives for engaging in securities fraud. The present structure of securities class actions benefits a trio of interest groups - corporate officials, plaintiff's attorneys, and insurers - but not shareholders.

To reform the securities class action and give it a true deterrent orientation, this article proposes a variety of steps - none requiring legislation or the reversal of well-established precedents - to shift the costs of the securities class action to the culpable. These steps proceed from the twin premises that (1) the settlement of a securities class action is a conflict of interest transaction requiring independent directors to exercise oversight over the allocation process, and (2) enterprise liability is an ineffective approach for misconduct that is privately motivated and easily concealed. To incentivize private enforcers, a basic change in the judicial approach to attorney's fees is proposed.
Critics of the securities class action have advanced virtually every conceivable critique – except the most telling. The standard criticism from the business community, the corporate bar, and some academics has long been that securities class actions disproportionately assert “frivolous” claims and thereby reduce shareholder welfare on average.¹ A related theme has been that securities class actions systematically overcompensate, yielding damages that exceed the societal harm, and therefore should be limited by some form of ceiling on damages.² Courts also have expressed similar doubts, and this term the Supreme Court has again noted the unique “vexatiousness” of securities

¹ The Private Securities Litigation Reform Act of 1995 (PSLRA) was clearly a product of this sense that securities class actions were disproportionately non-meritorious. In enacting the PSLRA, Congress announced this view explicitly, stating in the legislative history that among the PSLRA’s purposes was the desire to end 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 a faint hope that the discovery process might lead eventually to some plausible cause of action….” See H.R. Rep. No. 369, at 31 (1995), reprinted in 1996 U.S. C.C.A.N. 730, 1103. This view that securities class actions were often frivolous was nurtured in part by academic research, much of it still controversial. See Stephen J. Choi, The Evidence on Securities Class Actions, 57 Vand. L. Rev. 1465, 1469-74 (2004) (reviewing prior studies that suggested that securities class actions were frequently or normally non-meritorious); James Bohn & Stephen Choi, Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions, 144 U. Pa. L. Rev. 903 (1996).

² The most recent and unrelentingly critical attack has been sponsored by the U.S. Chamber of Commerce. See e.g., Anjan V. Thakor, The Unintended Consequences of Securities Litigation (U.S. Chamber of Commerce Institute for Legal Reform Research Paper, October 2005) (information-related disclosure litigation “destroys on average approximately 3.5% of the equity value of a company” with the result that “at least $24.7 billion in shareholder wealth was wiped out just due to litigation”); Anjan V. Thakor, Jeffrey Nielsen & David Gulley, The Economic Reality of Securities Class Action Litigation (U.S. Chamber of Commerce Institute for Legal Reform, Research Paper, October 26, 2005) (large institutional investors are overcompensated as a result of securities litigation); Donald C. Langevoort, Capping Damages for Open-Market Securities Fraud, 38 Ariz. L. Rev. 639, 646 (1996) (arguing that there will be “systematic overcompensation” from securities fraud litigation if full compensation is made the goal of securities litigation). This line of argument about excessive damages originates with Frank Easterbrook & Daniel Fischel, Optimal Damages in Securities Cases, 52 U. Chi. L. Rev. 611 (1985), which argued that because for every investor who lost money in a secondary market case, another investor profited, the social harm could not be defined as the sum of all investor losses. Accordingly, they argued that attempts to compensate such losses fully would yield systematically excessive damages.
litigation. In contrast, the plaintiff’s bar (and some academics) protest that the Private Securities Litigation Reform Act of 1995 (PSLRA) has crippled the securities class action and denied it the ability to reach important types of securities fraud, such as fraudulent forward-looking statements. All this rhetoric, however, misses the fundamental problem: as presently constituted, securities class actions produce wealth transfers among shareholders that neither compensate nor deter.

This Essay is equally skeptical of those who claim that securities litigation is vexatious and frivolous and those who claim that it has been seriously chilled. Its basic

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3 See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 2006 U.S. LEXIS 2497 at *18-*19 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738 (1975), for the proposition that securities litigation presents a “danger of vexatiousness different in degree and kind from that which accompanies litigation in general”). To the extent that courts doubt the legitimacy of securities litigation and see little valid purpose being served, this refrain will predictably be repeated. This Essay seeks, however, to ground securities litigation on a stronger rationale.

4 For the strongest recent defense of the securities class action, which defends it on both deterrent and compensatory grounds, see James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 Ariz. L. Rev. 497 (1997). For an earlier defense suggesting that the premises underlying the PSLRA were unfounded, see Joel Seligman, The Merits Do Matter, 108 Harv. L. Rev. 438 (1994). Other academic articles have raised the narrower argument that the PSLRA may chill meritorious actions at least as much as it chills “frivolous” ones. See Hillary Sale, Heightened Pleadings and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ’33 and ’34 Act Claims, 76 Wash. U. L. Q. 537, 537-38 (1998) (meritorious litigation likely to be chilled); Lynn Stout, Type I Error, Type II Error, and the Private Securities Litigation Reform Act, 38 Ariz. L. Rev. 711, 711-15 (1996) (both meritorious and frivolous suits likely to be chilled.) Professor Stephen Choi, long a critic of “frivolous” securities litigation, has also noted that the PSLRA may chill meritorious claims that lack hard evidence of fraud). See Stephen J. Choi, Do the Merits Matter Less After the Private Securities Litigation Reform Act? (working paper 2004), available at http://papers.ssrn.com/abstract id=558285. For the plaintiff’s bar view of recent developments in the securities class action, see Patrick J. Coughlin, Eric Alan Isaacson, and Joseph D. Daley, What’s Brewing in Dura v. Broudo? The Plaintiff’s Attorneys Review the Supreme Court’s Decision and Its Import for Securities-Fraud Litigation, 37 Loy. U. Chi. L. J. 1 (2005).

5 The true “strike suit” nuisance action, which is filed only because it was too expensive to defend, is, in this author’s judgment, a beast like the unicorn, more discussed than directly observed. Although small settlements may have been impelled in part by the high cost of defense, the corresponding observation is that the small damages in these cases also did not justify much effort on the plaintiff’s side. Neither side wanted to invest much effort in them — but this does not make them inherently frivolous. Similarly, the economic evidence that strike suits predominate also seems unpersuasive. A series of event studies have sought to demonstrate that securities class actions are frivolous based on the positive stock price reaction to political developments seeking to curtail such litigation. Compare D. Katherine Spiess & Paula Tkac, The Private Securities Litigation Reform Act of 1955: The Stock Market Casts Its Vote, 18 Mgmt. Dec. Econ. 545 (1997); Marilyn Johnson, Ron Kasanik & Karen Nelson, Shareholder Wealth Effects of the Private Securities Litigation Reform Act of 1995, 5 Rev. of Acct. Stud. 217 (2000). See also Choi, supra note 1, at 1478-83 (analyzing these studies). Although these studies focused on the shareholder wealth effects of the Private Securities Litigation Reform Act of 1995, they do not measure whether such litigation was
diagnosis views compensation as unobtainable and deterrence as deeply compromised by a variety of inconsistent legal doctrines that pull the punch of private enforcement. Deterrence, it will be argued, is the only rationale that can justify the significant costs – both public and private – that securities class actions impose on investors and the judiciary. Potentially, securities class actions could fulfill their deterrent promise. Indeed, private securities class actions currently represent the principal means by which financial penalties are imposed in cases of securities fraud and manipulation; in the aggregate, they impose penalties that overshadow those imposed by federal and state authorities and by self-regulatory organizations. Moreover, the total amount of damages awarded in securities class actions has also soared in recent years.

But do these massive penalties achieve or even approach optimal deterrence? Not necessarily. Deterrence works best when it is focused on the culpable, but there is little evidence that securities class actions today satisfy this standard. Rather, because the costs of securities class actions – both the settlement payments and the litigation expenses of both sides – fall largely on the defendant corporation, its shareholders ultimately bear these costs indirectly and often inequitably. This year, the SEC itself recognized this point in the related context of financial penalties, formally acknowledging in an unusual statement of its intended future policy that large financial penalties should be avoided when they will

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6 See infra notes 19-20 and accompanying text.
7 In 2005, corporations paid a record $9.6 billion in securities class action settlements, as compared with $2.9 billion in 2004. This $9.6 billion does not include the $7.1 billion partial settlement in the Enron litigation, which remains to be judicially approved. See Paul Davies, Class-Action Pay Settlements Soar, Wall St. J., Feb. 7, 2006 at C-3.
fall inequitably on innocent shareholders.\(^8\) The Commission indicated that its future policy, at least in cases where the corporation did not directly benefit from the violation, would be “to seek penalties from culpable individual offenders….”\(^9\) By the same token, imposing the full cost of securities class actions on shareholders can be at least as inequitable. In the typical secondary market case, the corporation is not selling its securities and thus does not receive any “direct benefit” (in the Commission’s phrase) when its managers inflate its earnings and stock price (usually for their own benefit). To punish the corporation and its shareholders in such a case is much like seeking to deter burglary by imposing penalties on the victim for having suffered a burglary. Although such an approach might arguably encourage additional precautions, it will also encounter predictable resistance from those it is ostensibly seeking to protect.

This explanation that the burden of securities legislation falls perversely on the victim also better explains those stock price event studies that report that the subject company’s stock price typically falls when a securities class action is filed and that stock prices generally rise when legislation is passed curtailing securities class actions.\(^10\)

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“A key question for the Commission is whether the issuer’s violation has provided an improper benefit to shareholders, or conversely whether the violation has resulted in harm to the shareholders. Where shareholders have been victimized by the violative conduct, or by the resulting negative effect on the entity following its discovery, the Commission is expected to seek penalties from culpable individual offenders acting for a corporation.”

The Commission then added that two principles would guide it in the future imposing penalties on a corporation:

1. “The presence or absence of a direct benefit to the corporation as a result of the violation;” and
2. “The degree to which the penalty will recompense or further harm the injured shareholders.” Id.

This Essay submits that these same policies logically apply well and should be consistently followed in designing the securities class action as a tool of private enforcement.

\(^9\) See supra note 8.

\(^10\) See studies discussed supra note 5.
Although these studies are often cited as proof that such litigation is frivolous, they show no such thing, but only that the costs of such litigation tend to fall more on the innocent than the guilty. As a result, the market reacts adversely to the action’s filing because it expects that the eventual settlement of the action will be borne by the shareholders as a group.

So what should be done? Unlike those authors who have called for ceilings on liability or the transformation of the securities class action into a form of civil penalty,\(^{11}\) this Essay maintains that the goal of deterrence requires the imposition of significant financial damages, but argues that to the extent possible the incidence of such damages should be shifted so that they fall more on the culpable (and less on the innocent). To be sure, any such re-allocation can only be marginal, but even a modest change could be sufficient to deter.

Obvious as the goal of imposing penalties on the culpable may seem, it is easier said than done. Practical difficulties abound, which this Essay will address in four stages. Part I will begin with some basic public policy cost accounting that is intended to place the securities class action in context as the principal enforcement mechanism for policing the equity capital markets. Part II will then turn to the central problem: securities class actions essentially impose costs on public shareholders in order to compensate public shareholders. This is an essentially circular process whose perverse effects are compounded by the twin facts that (a) public shareholders tend to be diversified (and thus are on both sides of the wealth transfer) and (b) on each such transfer a significant percentage of the transfer payment goes to lawyers and other agents. Those who defend this system proclaim that it is no different from the system of entity liability that tort law

\(^{11}\) See sources cited supra note 2.
scholarship has long endorsed, but Part II will draw some basic distinctions. Unlike tort litigation that forces shareholders to bear the costs that their corporation imposes on others, securities litigation imposes costs on investors because of harm done to investors—without recognizing that the victim is again bearing the costs of its own injury. Equally important, the corporation may not be the best “cost avoider” of financial fraud that is engaged in primarily to benefit corporate managers (a category into which most securities fraud, it will be argued, falls). Part III will then assess why the losses suffered by injured investors are today seldom imposed on the responsible officers and agents of the corporation whose misbehavior caused those losses. Then, it will explore the practical problems, including insurance and indemnification, that interfere with achieving such an allocation. Finally, Part IV will propose some practical remedies toward such a reallocation.

I. PLACING THE SECURITIES CLASS ACTION IN CONTEXT

From a policy perspective, the securities class action has two potential rationales: compensation and deterrence. This section will explain the shortcomings of each rationale as measured against the current reality. Before examining either rationale, however, it is useful to understand the significant costs that securities class actions impose on both the judiciary and shareholders.

A. The Public Role of the Securities Class Action

The first myth to dispel is that securities class actions are simply one of many varieties of class action, no different in principle from antitrust or civil rights class actions. In fact, as the following data from the Administrative Office of the U.S. Courts reveals, securities class actions are unique at least from a quantitative perspective; in
effect, they are the 800-pound gorilla that dominates and overshadows other forms of class actions:

Total Class Actions Pending In Federal Courts as of September 30, 2002, 2003 and 2004

<table>
<thead>
<tr>
<th>Type of Case</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract</td>
<td>282</td>
<td>290</td>
<td>289</td>
</tr>
<tr>
<td>Real Property</td>
<td>33</td>
<td>38</td>
<td>34</td>
</tr>
<tr>
<td>Tort Actions</td>
<td>529</td>
<td>604</td>
<td>600</td>
</tr>
<tr>
<td>Antitrust</td>
<td>249</td>
<td>231</td>
<td>202</td>
</tr>
<tr>
<td>Employment Rights</td>
<td>164</td>
<td>159</td>
<td>173</td>
</tr>
<tr>
<td>Other Civil Rights</td>
<td>298</td>
<td>274</td>
<td>266</td>
</tr>
<tr>
<td>Prisons, Prisoners</td>
<td>66</td>
<td>64</td>
<td>82</td>
</tr>
<tr>
<td>RICO</td>
<td>53</td>
<td>76</td>
<td>46</td>
</tr>
<tr>
<td>ERISA</td>
<td>134</td>
<td>183</td>
<td>216</td>
</tr>
<tr>
<td>Other Labor Suits</td>
<td>180</td>
<td>204</td>
<td>262</td>
</tr>
<tr>
<td>Securities/Commodities/Exchange</td>
<td>2,325</td>
<td>2,339</td>
<td>2,480</td>
</tr>
<tr>
<td>Others</td>
<td>522</td>
<td>514</td>
<td>529</td>
</tr>
<tr>
<td>Total</td>
<td>4,835</td>
<td>4,977</td>
<td>5,179</td>
</tr>
</tbody>
</table>

Securities Class Actions as a percentage of total

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities Class Actions as a percentage of total</td>
<td>47.5%</td>
<td>47%</td>
<td>47.9%</td>
</tr>
</tbody>
</table>

Because securities class actions have averaged between 47% and 48% of all class actions pending in federal court, they necessarily consume significant judicial resources. Viewed in this light, securities class actions are essentially subsidized by the U.S. taxpayer, and thus, they raise the question of whether society is receiving an adequate return on its investment.

12 This data is taken from Table X4 to the Annual Reports on the Judicial Business of the United States Courts, 2002, 2003, 2004. See, The Administrative Office of the United States Courts, Annual Reports on the Judicial Business of the United States Courts 2002, 2003, 2004 [hereinafter “U.S. Courts Annual Reports”]. It must be acknowledged that these statistics showing the total number of securities class actions may overstate the judicial burden to the extent that most securities class actions are consolidated for purposes of discovery by the Judicial Panel on Multidistrict Litigation. See 28 U.S.C. § 1407(a). Few are also ever tried. However, even cases consolidated under this provision must be remanded back to the original district court at the conclusion of the pretrial proceedings. See Lexecon Inc. v. Milberg Weiss Bershad Hynes & Lerach, 523 U.S. 26 (1998). Hence, it seems legitimate to count individual class actions.
Beyond the sheer weight of their numbers, securities class actions disproportionately claim judicial time and attention for several additional reasons. First, they take longer to resolve than most other class actions, and this tendency is increasing. Second, they require the court to play a more active monitoring role. Under the unique provisions of the PLSRA, the Court must select the “lead plaintiff” who will represent the class. Initially, this requires the court to determine which potential plaintiff suffered the largest losses and thus has the greatest stake in the action. Recent experience has shown that competition often arises for the position of lead plaintiff, and administering these disputes, which are essentially contests among competing teams of plaintiffs’ attorneys, consumes significant judicial time. Third, the plaintiff in a securities class action is disadvantaged in comparison to plaintiffs in other forms of class actions in that it cannot obtain discovery until the plaintiff has first satisfied a heightened pleading test that normally requires it to plead, with particularity, facts giving rise to a strong inference of fraud. Often, this process will involve multiple motions in which the

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13 In 2001-2002, 2002-2003, and 2003-2004, securities class actions constituted 42.4%, 33.5%, and 38.7% of all class actions filed during those years, but amounted to 47.5%, 47% and 47.9% of all class actions pending on September 30, 2002, 2003, and 2004. Thus, although the percentage commenced went down, the percentage pending stayed relatively constant, showing that securities class actions have a longer duration. Compare Table X5 (showing actions commenced) with Table X4 (showing cases pending on September 30) of the U.S. Courts Annual Reports for 2002, 2003, and 2004.

14 One study finds that the percentage of securities class actions settling within four years of the action’s filing dropped from 57.59% pre-PSLRA to only 26.06% after the PSLRA. See Mukesh Bajaj, Sumon C. Mazumdar, Atulya Sarin, Securities Class Action Settlements, 43 Santa Clara L. Rev. 1001, 1010 (2003). This slower settlement may imply a lower rate of frivolous actions, as these authors surmise, but it certainly suggests an increased judicial burden.

15 For representative cases showing the issues that emerge, see, e.g., In re Cavanaugh, 306 F.3d 726 (9th Cir. 2002); In re Cendant Corp. Sec. Litig., 404 F.3d 173 (3d Cir. 2005); In re Fannie Mae Secs. Litig., 355 F. Supp. 2d 261 (D.C. 2005). Many (but not all) courts now use a “last-in, first-out” (“lifo”) accounting method to calculate the lead plaintiffs’ losses and reject a “first-in, first-out” (“fifo”) accounting method. See In re Espeed Inc. Sec. Litig., 232 F.R.D. 95, 101 (S.D.N.Y. 2005); In re Cable & Wireless PLC Sec. Litig., 217 F.R.D. 372, 378-79 (E.D. Va. 2002). But, symptomatically, this point continues to be litigated.

16 Section 21D(b)(3)(B) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4(b)(3)(B), stays discovery during the pendency of any motion by a defendant challenging the adequacy of the pleadings. This produces something of a “Catch 22” problem for the plaintiff: namely, the plaintiff cannot obtain
parties contest whether this heightened pleading standard has been satisfied (with the plaintiffs typically receiving at least one leave to replead their complaint if their initial pleadings fail this test). Discovery disputes are also common, in large part because the plaintiff may be seeking to take the deposition of senior corporate officials, directors, and agents, who would all have their own counsel, who predictably will object that their time is being wasted.

Finally, the settlement process in securities class actions has become more complicated, as a growing number of sophisticated class members may decide to opt out of the class or may object to the settlement’s fairness or the reasonableness of the attorney’s fees. Although this could also happen in other types of class actions, the increasingly predominant role of institutional investors among U.S. shareholders implies that the class in a securities class action will include many sophisticated and well-informed members who will make their own decisions and will often contest class counsel’s decisions. The bottom line then is that a greater burden is placed on the court by a securities class action, and this burden tends to be concentrated in a few federal

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17 In the past, class action plaintiffs attorneys competed to be named class counsel. Today, however, the choice of class counsel is only the first round in their competition. The unsuccessful competitor may then seek to induce institutional investors in the class to “opt out” and sue with this firm as their counsel in state court. William Lerach, probably the best known plaintiff’s attorney in the securities field, has recently utilized this strategy, inducing a large number of funds to opt out of both the WorldCom settlement and the more recent AOL Time Warner Settlement. See Lorraine Woellert, Fractured Class Actions: ‘Opt-Outs’ Are A Growing Problem for Companies, Business Week February 27, 2006 at 31. Opt outs force the defendant to fight a two front war and increase the uncertainty about the ultimate cost of settlement. Also, litigation can arise between the federal and state actions, when the federal court seeks to stay the state action. See Ret. Sys. v. J.P. Morgan Chase & Co., 386 F.3d 419 (2d Cir. 2004) (stay by WorldCom federal trial court of state proceedings reversed as unauthorized by the All Writs Act).
Courts of Appeals – most notably the Second and the Ninth – where these cases tend to cluster disproportionately.\(^{18}\)

The public policy significance of securities class actions becomes even clearer when we turn from the cost to the benefit side of the ledger. Professor Howell Jackson has recently estimated the total effort made to enforce the securities laws in the United States and several other major jurisdictions.\(^{19}\) Although his focus is on the relative “regulatory intensity” of these various jurisdictions, he found that the majority of the total monetary sanctions recently imposed in the United States were obtained through private, not public, enforcement. Looking at the years 2000 to 2002, he estimated the average annual financial sanctions imposed over these three years to break down as follows:

\begin{center}
\begin{tabular}{lcc}

\textbf{Public Monetary Sanctions} & \textbf{Private Monetary Sanctions} & \\
State Monetary Sanctions: & $931,212,489 & Class Action Trial Awards: $17,626,000 \\
NASD Disciplinary Sanctions: $126,110,622 & NASD Arbitration Awards: $104,000,000 \\
NYSE Disciplinary Sanctions: $5,752,833 & NYSE Arbitration Awards: (not available) \\
\end{tabular}
\end{center}

$1,864,409,277 $2,027,959,333

The statistic that virtually leaps out from this data is that securities class action settlements averaged an annual aggregate amount (i.e., $1,906,333,333) exceeding the sum of all public monetary sanctions. To be sure, the federal securities laws are also

\(^{18}\) The Second Circuit and the Ninth Circuit have long been the principal Circuits in which securities class actions are filed. In 2005, when the number of securities class actions fell to 176, 44 were filed in the Second Circuit; 38 in the Ninth Circuit, and only 18 in the Third Circuit, which had the next highest number. See Stephen Taub, Securities fraud lawsuits decline, CFO.com, January 3, 2006.


\(^{20}\) Id. at 27.
enforced by criminal penalties (chiefly, incarceration) and by SEC suspensions, expulsions, cease and desist orders, and other non-monetary relief. Nonetheless, plaintiffs’ attorneys appear to extract more funds from corporate pocketbooks than do all federal and state regulators.

Another way to understand the significant role played by private enforcement is to focus on individual cases and contrast the penalties imposed on corporate defendants by public and private enforcers. Cornerstone Research has prepared an illustrative table that contrasts the relative size of SEC and private settlements in recent notable cases:21

Private Versus Public Settlements

*(Dollars in Millions)*

<table>
<thead>
<tr>
<th>Case</th>
<th>Settlement Fund in SEC Action</th>
<th>Settlement Fund in Related Class Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>WorldCom, Inc.</td>
<td>$750.0</td>
<td>$6,156.1</td>
</tr>
<tr>
<td>Computer Associates International, Inc.</td>
<td>$225.0</td>
<td>$128.6</td>
</tr>
<tr>
<td>Bristol-Meyers Squibb Company</td>
<td>$150.0</td>
<td>$300.0</td>
</tr>
<tr>
<td>Symbol Technologies</td>
<td>$37.0</td>
<td>$102.0</td>
</tr>
<tr>
<td>Lucent Technologies, Inc.</td>
<td>$25.0</td>
<td>$517.2</td>
</tr>
<tr>
<td>i2 Technologies, Inc.</td>
<td>$10.0</td>
<td>$87.8</td>
</tr>
<tr>
<td>Gemstar-TV Guide International, Inc.</td>
<td>$10.0</td>
<td>$92.5</td>
</tr>
<tr>
<td>Homestore Inc.</td>
<td>$5.0</td>
<td>$78.0</td>
</tr>
<tr>
<td>Measurement Specialties, Inc.</td>
<td>$1.5</td>
<td>$8.1</td>
</tr>
</tbody>
</table>

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Clearly, even in major scandals where the SEC has brought its own action, the damages paid in securities class actions are usually (but not always) a multiple of those paid to the SEC.

That private enforcement seems to dwarf public enforcement does not mean, however, that the securities class action generates an adequate deterrent threat. Here several basic limitations need to be understood.

First, research suggests that there are some kinds of companies and some kinds of frauds that are largely immune from the reach of securities class actions. Because the plaintiff’s attorney must advance the expenses of the class action and will not be reimbursed if the action is unsuccessful, the plaintiff’s attorney must estimate in advance the expected fee award, discounting it both for the prospect of a loss and for the time value of money over the period until payment is made, in order to determine if the action justifies the risks being undertaken. Because the fee award tends to be a function of the recovery, this, in turn, implies that a small recovery will mean at best a small fee award. As a result, the conventional wisdom has long been that companies with small market capitalizations are less likely to be sued in securities class actions. Where this arguable threshold of immunity begins has long been the subject of debate. Using data from the early 1980s, Professor Janet Alexander found that all the IPOs in her sample with market losses over $20 million elicited a class action, while none of the IPOs with losses under that amount resulted in litigation. Another study, examining the period from 1976 to 1986, found that less than 1 percent of IPOs with an offering amount of less than $5

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22 See sources cited infra at notes 24-28.
23 See Choi, supra note 1, at 1473-74, 1480-81.
million resulted in a securities class action. These authors concluded that “smaller sized offerings hardly ever experience a securities-fraud suit.”

Ultimately, the threshold below which a corporation becomes seemingly exempt from securities class actions as a “smaller sized” company depends upon the costs (and risks) of bringing a securities class action. Again, the conventional wisdom is that the passage of the PSLRA has driven these costs up and thus raised the threshold at which a securities class action can be justified by the expected fee award to the plaintiff’s attorney. For present purposes, it is unnecessary to locate where this zone of immunity begins, but only to recognize that there is a cutoff level in terms of market capitalization below which private enforcement appears not to work.

Similarly, there may also be species of fraud for which private enforcement may no longer work well. Several researchers have reported a shift in the type of claim litigated in the post-PSLRA time period, with allegations of accounting irregularities becoming the predominant claim in class actions filed after the passage of the PSLRA and allegations of false forward-looking statements declining as a percentage. In

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25 See Bohn & Choi, supra note 1, at 927-36
26 Id. at 936.
27 Corroborating this view, Professors Grundfest and Perino found an increase in the average stock price decline experienced by corporations that were sued after the effective date of the PSLRA, suggesting that PSLRA raised the threshold at which a securities class action became cost justified to plaintiffs’ attorneys. See Joseph Grundfest & Michael Perino, Securities Litigation Reform: The First Year’s Experience, 1015 PLI/Corp. 955, 957 (1997). Grundfest and Perino did not, however, find an increase in the market capitalization of the typical post-PSLRA defendant, which actually declined. Id. at 969. Their explanation was that large market capitalization firms experienced a lower rate of accounting irregularities. Id. at 970.
28 Professor Alexander hypothesized that a minimum of $20 million in damages was necessary to make the class action economically attractive to plaintiff’s attorneys. In IPOs with damages above $20 million, all defendants in her sample were sued; below that level, none were sued. See Alexander, supra note 20, at 511.
29 Grundfest and Perino estimated that the mean market capitalization of a post-PSLRA defendant was $529.3 million. Grundfest, supra note 27, at 969.
addition, cases involving accounting allegations and restatements appear to have a higher settlement value than cases lacking these factors.31 The PSLRA’s “safe harbor” for forward-looking statements is the most likely (but not the exclusive) cause of this transition because it requires the plaintiff to prove the defendant’s actual knowledge of the falsity of the forward-looking statement.32 A 2004 study by PricewaterhouseCoopers summarizes the empirical evidence and reports that:

“Cases alleging ‘accounting’-related securities fraud versus cases alleging ‘non-accounting’-related disclosure fraud divide roughly 60/40; this has been a relatively constant statistic since 1996.”33

Thus, although it would be an overstatement to say that the securities class action exclusively polices fraud in financial reporting, this seems to be its primary role.

B. The Compensatory Rationale

From a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly. Settlements recover only a very small share of investor losses. NERA Economic Consulting annually prepares a table showing the ratio of settlements to investor losses, and between 1991 and 2004, this ratio has never

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32 See Section 21E of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-5. Not all authorities agree on this point. Pritchard and Sale find, at least in the Second Circuit, that allegations of false forward-looking statements are less likely to be dismissed. See Pritchard & Sale, supra note 31. But this finding was limited to the Second Circuit.

33 See PricewaterhouseCoopers LLP 2004 Securities Litigation Study at 11 (2004). A significant percentage of these “accounting-related” cases involve a financial statement restatement. The percentage of “accounting-related” cases involving a restatement was formerly over 50%, but has recently declined noticeably: 1999: 50%; 2000: 51%; 2001: 56%; 2002: 51%; 2003: 33%; 2004: 35%. Id.
exceeded 7.2% (which it hit in 1996). Over the most recent three years for which data is available, (i.e., 2002, 2003 and 2004), this ratio fell to 2.7%, 2.9%, and 2.3%, respectively. To be sure, these ratios represent the relation between the settlement and overall investor losses based on the decline in stock price, not the smaller loss directly attributable to fraud. But the market decline is the only loss that investors experience or that can be reliably measured.

Not only is the trend downward in terms of the percentage of damages recovered, but NERA’s prediction is that the ratio will continue to decline as “mega settlements” in the multi-billion dollar range increase, because settlement size cannot keep pace with the increasing scale of investor losses. Moreover, these low percentages in the 2 to 3% range are before the subtraction of the full costs that investors bear: plaintiffs’ attorneys’ fees and expenses, defense counsels’ fees and expenses, D&O insurance premiums, and the possible costs of disruption, stigma, and adverse publicity – all of which inevitably also fall on the corporation’s shareholders.

The sum of these costs approaches and could exceed the aggregate recovery. For example, during at least the 1990s, plaintiff’s attorneys in securities class actions received fee awards equal on average to 32% of the recovery. Less is known about the costs of defense counsel, but senior insurance industry experts have estimated that defense costs

35 Id.
36 NERA Economic Consulting estimates that, on average, “a 1.0% increase in investor losses results in a 0.4% increase in the size of the expected settlement.” Id. at 6. Thus, as investors losses in recent “mega” cases have increased, it is predictable that settlement size will decline as a percentage of these losses. Among the reasons for this declining relationship are both the inevitable limits on corporate solvency and the ceilings on insurance coverage.
37 See Denise Martin, et al., Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions, 5 Stan. J. L. Bus. & Fin. 121, 141 (1999). With the advent of the lead plaintiff, and with larger recoveries, this percentage may have more recently declined.
in securities litigation are often in the range of 25% to 35% of the settlement, and sometimes run to 50% or even 100% of the settlement. The primary reason for the high level of defense costs in securities litigation is that Directors and Officers liability insurance (D&O insurance), which all public corporations carry, is unique. Unlike most forms of liability insurance, where the insurer provides and controls the defense, thereby reduce the insurer’s loss ex post, D&O insurance gives no control over the defense to the insurer, but simply reimburses the policyholders’ defense costs up to the dollar limit of the policy, subject to the requirement that the defense costs be reasonable. As a result, D&O insurers have little ability to control defense costs. Indeed, one recent study reports a case in which defense counsel billed “$75 million in the course of 18 months.” High defense costs in turn imply a higher insurance premium, as the insurer passes its costs back to the corporation and its shareholders. As a result, it is an open question as to

38 In their study of D&O insurers, Professors Baker and Griffith quote “one senior underwriter” speaking at a D&O industry conference estimating that “defense costs were commonly twenty-five to thirty-five percent of the settlement amount” and sometimes as high as “50% or 100% of the settlement.” See Thomas Baker and Sean Griffith, The Missing Monitor in Corporate Governance: The Directors’ & Officers’ Liability Insurer, (Working Paper 6/28/2006) at p. 22 n. 91. Other data, however, suggests that defense costs are lower. The Tillinghast survey reports that the median and mean defense costs were $538,150 and $1,965,079 per claim. Id. at 22. (citing Tillinghast, 2005 Directors and Officers Liability Survey at 112, Table 107). On this basis, Baker and Griffith place defense costs around 11% of the settlement costs. Id. at 22. This seems a very low estimate, possibly because the Tillinghast survey includes claims (such as derivative actions) that on average settle more cheaply than the typical securities class actions or possibly because many D&O policies covering the corporation have deductibles and thus the full defense cost would not be known to the issuer.

39 Id. at 21. D&O insurance contracts give the insured the right to choose their own counsel and manage their defense. Although the policy does not cover “unreasonable” litigation expenses, very little that experienced defense counsel does can be called unreasonable, even if it involves using highly paid expert witnesses. Such insurance is obviously more expensive, but insurers have found that corporate managers want, and will pay for, policies that maximize corporate managers’ autonomy and allow them to hire the most expensive defense counsel.

40 Id. at 23 (quoting unnamed D&O product manager at a leading D&O insurance company).

41 By definition, insurance premiums equal the actuarially determined probability of loss plus a “loading” fee to compensate the insurer for its costs and provide it a profit. This loading fee is generally estimated to be in the range of twenty to thirty percent. Id. at 31 n. 123. Baker and Griffith argue that the existing form of D&O insurance “does not simply distribute the risk of legally compensable insurance losses” but rather “likely increases those losses.” Id. at 29.
whether the typical securities class action settlement actually produces any net recovery, particularly to diversified shareholders.\footnote{The diversified shareholder will bear on a pro-rata basis the litigation costs of the overall corporate community. By definition, these costs must exceed the payout by insurers by a margin sufficient to earn insurers a risk-adjusted profit. See infra notes 38 to 41 and accompanying text. This raises the puzzle as to why public corporations insure their own liability, almost uniquely, in this context. See infra notes 126-133 and accompanying text.}

Equally inconsistent with the compensatory rationale for the securities class action is the disquieting fact that the majority of institutional investors who have provable losses appear not to submit claims in securities class actions.\footnote{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 (2005) (estimating that less than 30% of institutional investors with provable losses filed claims); see also James D. Cox & Randall S. Thomas, Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions, 80 Wash. U. L. Rev. 855 (2002).} By some estimates, as much as $1 billion annually is forfeited in this fashion by institutional investors who seem indifferent to relatively small recoveries.\footnote{See Adam Pritchard, Who Cares? 80 Wash. U. L. Rev. 883 (2002) (analyzing Cox and Thomas data).} At the least, this evidence suggests indifference by many investors to the compensatory role of the securities class action.

C. The Deterrence Rationale

But if the securities class action fails as a mechanism for compensation, it could still perform admirably as a form of deterrence. Indeed, its deficiencies from a compensatory perspective may even be virtues from a deterrent perspective. That the securities class action recovers only a small percentage of investor losses presents less of a problem from a deterrent perspective because the corporate decisionmakers who caused the corporation to violate the securities law will also only receive a gain equal to a small portion of the investors’ losses. Typically, in the context of the standard secondary market “stock drop” case in which the defendant corporation is not selling its shares, the corporation receives no direct gain, and its officers and other insiders profit only to the
extent that they sell their shares or otherwise benefit from the corporation’s inflated stock price. In principle, if insiders face an expected penalty that exceeds their expected gain, this should be sufficient to remove any incentive for them to inflate the corporation’s stock price. Indeed, if the typical securities class action settlement vastly exceeded the insiders’ expected gains, a danger of overdeterrence would arise that might make insiders excessively risk averse in their decisionmaking about accounting, forecasting and investment policies for their corporation.

But this theoretical answer that the securities class action can deter, even if it cannot compensate effectively, encounters serious problems once we examine the reality of actual securities litigation. On the positive side of the ledger, securities class actions do seem sufficiently pervasive to constitute a deterrent threat for most public corporations. In fact, the incidence of securities class actions has increased over the last several decades.45 Between 1996 and 2004, an average of 195 securities class actions were filed each year – hardly a trivial number.46 Alternatively, if one looks simply at the universe of listed public companies – i.e., issuers listed on the NYSE, Nasdaq or the Amex – then between 2.1% and 2.8% of these companies have been defendants in securities class actions at the start of each year since 1998.47 One recent study concludes that “the average public corporation faces at least a 10% probability that it will face at least one

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45 Over the period of 1971 to 1978, one early study identified some 228 shareholder suits brought against a sample of 190 firms, for a mean of 1.2 lawsuits per firm over this seven year interval. See Thomas M. Jones, An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Suits, 1971-78, 60 Bill. L. Rev. 306, 207-08 (1980). Bohn and Choi found that in the case of initial public offerings between 1976 and 1986, less than 1 percent of small offerings (under $1.79 million) resulted in litigation, but 12 percent of those over $40 million did. See Bohn & Choi, supra note 1, at 936.

46 See Cornerstone Research, Securities Class Actions Case Filings, 2005: A Year in Review (2005) at 3. In 2005, the number of securities class actions filed fell to 176, down from 213 in 2004. Id.

47 Id. at 4. This percentage was 2.8% in 2004, but fell to 2.4% in 2005.
shareholder class action lawsuit” over a five year period. In short, although securities litigation is not an inevitable fact of corporate life, it is sufficiently common that corporate planners must anticipate and prepare for it. Whether an individual corporation will be sued in a securities class action is likely to depend principally on three factors: (1) its stock price volatility; (2) its industry classification, with consumer goods, technology, communications, and finance companies being the recent preferred targets, and (3) its market capitalization. Larger firms are sued more often and can suffer greater damages.

From a deterrent perspective, the critical question is who gets sued and who actually bears the costs of a securities class action. As will be seen, the answers to these two questions differ. Initially, the evidence is clear that members of senior management are highly likely to be named as co-defendants in any securities litigation. PricewaterhouseCoopers LLP has concisely summarized this data for corporate officers for the years 2001-2004.

<table>
<thead>
<tr>
<th>Title</th>
<th>2002</th>
<th>2003</th>
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<tr>
<td>CEO</td>
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<td>CFO</td>
<td>76</td>
<td>88</td>
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</tr>
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48 See E. Buckberg, T. Foster & R. Miller, Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard? (NERA Monograph 2005) at 2. This study was based on the 2004 case filing rate. As the number of class actions filed in 2005 declined, this estimated 10% probability may prove somewhat high.

49 Cornerstone Research, supra note 46, at 14. These were the four leading categories in 2005. The lowest filings rates were in the Basic Materials, Utilities and Energy Companies, possibly reflecting either greater recent economic success in those industries or lower price volatility.


51 For the data on corporate officers, see PricewaterhouseCoopers LLP, supra note 33, at 16.

52 See PricewaterhouseCoopers LLP, supra note 33, at 16.
In sharp contrast, however, outside directors are rarely sued in securities fraud class actions\(^53\) and are held liable even more rarely.\(^54\) Why are insiders frequently sued and outside directors not? The answer probably lies in the pleading requirements of the PSLRA, which require the complaint to raise a strong inference of fraud against any defendant named.\(^55\) This can be done, possibly with some difficulty, in the case of insiders, but satisfying this pleading standard is extremely difficult in the case of the outside director. Because the outside director is typically remote from the corporation and not cognizant of the facts known to management on a day-to-day basis, fraud cannot easily be attributed to such a person, particularly before the plaintiff obtains discovery.

This same pattern of virtual immunity carries over to the case of the corporation’s principal agents or gatekeepers. Auditors and underwriters appear to be named as defendants in only a very low percentage of securities class actions. According to Cornerstone Research, auditors were named as defendants in only five cases (or 3\%) out of all securities class actions filed in 2005 and similarly were named in only eight cases (or 4\%) out of all such actions filed in 2004.\(^56\) Correspondingly, underwriters were

\(^{53}\) For the finding that in a sample that included approximately half of the securities class actions filed in 1999, outside directors were named in only 21 cases, see Robert Thompson & Hillary Sale, Securities Fraud as Corporate Governance: Reflections Upon Federalism, 56 Vand. L. Rev. 859, 896-97 (2003).

\(^{54}\) See infra notes 64-65 and accompanying text.


\(^{56}\) Cornerstone Research, supra note 46, at 16. This data, which covers only the initial complaint, does not mean that auditors are sued in only 3 or 4\% of all securities class actions, because the class action may be amended later to add the auditor as defendant after the plaintiff obtains discovery. But this is difficult to do because of the short statute of limitations on most securities law causes of action and the fact that the plaintiff can only obtain discovery under the PSLRA if it has first satisfied that statute: particularized pleading standard (which often requires multiple efforts).
named in only seven cases (or 4%) in 2005 and three cases (or 1%) in 2004.\footnote{Id.} Previously, secondary participants faced a higher likelihood of securities litigation, but this pattern shifted in the mid-1990s when the combined impact of the PSLRA and the Supreme Court’s 1994 decision in \textit{Central Bank of Denver},\footnote{See \textit{Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.}, 511 U.S. 164 (1994).} which held that Rule 10b-5 did not reach those “aiding and abetting” a securities fraud, caused litigation against secondary participants to drop off sharply. Because the majority of securities class actions contain at least some allegations of accounting fraud,\footnote{See supra notes 30-33. In particular, PricewaterhouseCoopers estimates that 60% of securities fraud cases are “accounting” related. See PricewaterhouseCoopers, supra note 33, at 11.} this striking omission of auditors and other secondary defendants as defendants suggests that they have been well insulated against securities fraud liability. Although large settlements involving accounting firms do occur, these often involve the insolvency of the corporate defendant (as in Enron and WorldCom) so that the auditor becomes the defendant of last resort – namely, the remaining defendant with a deep pocket.

The strangest aspect of this pattern involves corporate insiders – executive officers and controlling shareholders. Although they are regularly sued, they rarely appear to contribute to the settlement. Rather, the corporate defendant and its insurer typically advance the entire settlement amount. For example, one study of securities class actions in the mid-1990s found that, even in cases in which officers and directors were named as defendants, liability insurers paid on average 68.2% of the settlement, and the defendant corporation paid 31.4% -- leaving at most 0.4% to be paid by individual defendants.\footnote{See Frederick C. Dunbar, et al., \textit{Recent Trends III: What Explains Settlements in Shareholder Class Actions?} (Nat’l Economic Research Associates 1995) at 9. This 0.4% that remains is not necessarily paid by officers and other insiders, but could be paid by other secondary defendants or could be payments that
settlements are within the typical insurance coverage, with insurance proceeds often being the sole source of settlement funds.”61 Professor Janet Alexander, a knowledgeable observer, has concluded concisely that “[i]ndividual defendants almost never contribute personally to settlements.”62 The reality is that corporate insiders are sued in order for the plaintiffs to gain access to their insurance, but their personal liability appears not to be seriously pursued.

To the extent that there are exceptions to this generalization, they usually involve special facts, typically that either: (1) the defendant corporation had become insolvent and hence was judgment-proof63 (Enron and WorldCom fall within this category); (2) individual defendants were facing criminal liability and agreed to make partial restitution either to gain a reduced sentence or to avoid indictment; or (3) Directors’ and Officers’ (D&O) insurance was either inadequate or the policy was rescinded for fraud in the application. In these cases, where there is no deep-pocketed corporate defendant to in effect bail out its officers, plaintiffs can and do obtain recoveries from individuals. But the rarity of these individual settlements is striking. Studying litigation against outside directors, Professors Bernard Black, Brian Cheffins and Michael Klausner investigated

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61 See Cox, supra note 3, at 512 (citing Securities Litigation Reform, Hearings Before the House Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, 103rd Cong., 2nd Session (July 22 and August 10, 1994) at 139 (Statement of Vincent E. O’Brien). For the estimate that “from 50% to 80% of the typical settlement … is paid by insurance,” see Janet Cooper Alexander, The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced, 41 UCLA L. Rev. 17, 46 (1993).


63 Securities class actions tend less frequently to be filed in the wake of bankruptcy because the usually deep pocketed corporate defendant can no longer be sued once it has entered bankruptcy. Examining the class actions filed in 2004 and 2005, Cornerstone Research found only eight class actions (out of the 176 filed in 2005 – or 5%) that were filed subsequent to a corporation’s bankruptcy and only four class actions (out of the 213 filed in 2004 – or 2%) that similarly followed a bankruptcy. Cornerstone Research, supra note 46, at 16. Hence, although insiders and secondary participants are the only parties that can be sued once bankruptcy has been filed, few such suits are brought.
the 3,239 federal securities class actions that were filed between 1991 and 2004, of which 1,754 had settled by the end of 2004. Contacting counsel for both sides, other leading law firms, D&O insurers and D&O brokers, they were able to identify only thirteen settlements “since 1980 in which outside directors made out-of-pocket payments.”64 Three of these cases involved famous frauds – WorldCom, Enron and Tyco – but the remainder chiefly involved “insolvent companies with serious D&O coverage problems.”65 Their conclusion that outside directors with “state of the art” D&O liability insurance face little risk may or may not be correct, but it does not necessarily apply to insiders and controlling shareholders.

Within the context of “insiders” (a term that will be used to include both senior executives, founders, and controlling shareholders), the largest payment by an individual in a securities class action is believed to have been that made by Gary Winnick, the former chairman of Global Crossing Ltd., which filed for bankruptcy in January 2002, not long after Enron, with $12.4 billion in debt outstanding.66 Winnick paid a reported $55 million, $30 million toward a settlement fund for investors and another $25 million to compensate employees for their lost retirement savings.67 This settlement came only a month before Winnick reached a settlement with the SEC, and Winnick may well have received (or at least anticipated) concessions in his SEC settlement because of his contribution to the class settlement. In any event, the remainder of the Global Crossing

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65 See Black, Cheffins & Klausner, supra note 64, at 1069.
66 For the conclusion that $55 million was the largest payment made by an individual out of his own pocket, see The Plaintiff’s Hit List, National L. J., Oct. 10, 2005 at 56 (citing plaintiff’s counsel, Grant & Eisenhofer, for this estimate).
class action settlement came from the company’s insurers, which paid some $261 million, and from the company’s former law firm, which paid some $19 million. Given that Winnick’s payment is apparently the largest individual payment on record, does even it demonstrate a sanction sufficient to deter? Symptomatically, the facts show that Winnick sold $734 million in company stock shortly before Global Crossing’s bankruptcy, so that his $55 million contribution to these settlements represented well under 10% of the alleged gains that he personally received.

Other cases in which personal liability was imposed on insiders fit the same general pattern. Both Bernard Ebbers, the WorldCom CEO, and the family of John Rigas, the founder of Adelphia, contributed personal funds to class action settlements, but at the time they did so, their firms were bankrupt and they were facing sentencing following a felony conviction (and thus had every incentive to appear contrite and repentant). Similarly, the WorldCom directors were required to contribute 20% of their net worth to a settlement fund, but this was both because their corporation was insolvent and their potential liability vastly exceeded their insurance resources.

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68 Id.
69 Id. See also Gretchen Morgenson, Ebbers to Shed Assets, N. Y. Times, July 1, 2005 at C-1 (also discussing Winnick’s case).
70 Following his conviction in 2005 and before his sentencing, Bernard Ebbers, the founder of WorldCom, contributed some $40 million to the WorldCom class action settlement, which at the time represented “nearly all of his personal fortune.” See Morgenson, supra note 69, at C-1. In the case of Adelphia, the entire Rigas family, including certain family members who were not charged with any crime, consented to the forfeiture of designated assets, including cable television systems and nearly all their Adelphia securities, in return for the Government’s waiver of criminal fines and/or forfeiture against John and Timothy Rigas at their criminal sentencing; this property was then to be transferred by the Government to Adelphia in return for Adelphia’s transfer of $715 million in value to the Government. See Peter Morgenstern & Eric B. Fisher, Outside Counsel: New Clout for Victims in Criminal Proceedings, N.Y.L.J., July 20, 2005 at 4. In substance then, the civil contribution by the Rigas family was coerced by the prospect of the criminal sentencing. For a fuller description of the entire transaction (and a decision upholding it), see In re W. R. Huff Asset Management Co., 409 F.3d 555 (2d Cir. 2005).
71 The ten independent directors of WorldCom paid some $18 [S25] million based on a requirement that they contribute 20% of their net worth. The ten directors of Enron paid some $13 million to settle. See David Marcus, “Taking Liability Seriously,” Corporate Control Alert, April 11, 2003. [Note to editors: I
In the more typical case of the solvent corporation, however, the likelihood is that
the insurer will cover everything – i.e., the settlement plus litigation expenses – up to its
policy limits, and the corporation will pick up the balance.\textsuperscript{72} Even if one assumes that the
market for “D&O” insurance is efficient and tailors premiums to the individual issuer’s
risk level, an assumption that has long been debated,\textsuperscript{73} the cost of insurance still falls on
shareholders, and this cost becomes heavier as the company becomes riskier. As a result,
if the insiders who are most culpable can apparently escape personal liability in securities
class actions, the deterrent rationale for that action seems largely undercut. At best, the
efficacy of deterrence, under the current system, rests on the validity of enterprise
liability: that is, on the claim that by imposing large penalties on the corporation, society
induces increased monitoring of the corporate officials who benefit from securities
fraud.\textsuperscript{74}

Before reaching any bottom line assessment, however, fairness requires the
observation that non-financial consequences of a securities class action could conceivably

\textsuperscript{72} Sometimes, particularly when the corporation is insolvent, the insurer will seek to rescind its policy
based on its claim that fraudulent misrepresentations were made to it. See discussion infra notes 135 to 136
and accompanying text.

\textsuperscript{73} The nature of the market for D&O liability insurance has long been debated. Over a decade ago, Kent
Syverud argued that the demand for liability insurance was inelastic and thus insurers can expect to be able
to pass along fully the liability costs that they bear to their corporate clients in the form of increased
insurance premiums. See Kent D. Syverud, On the Demand for Liability Insurance, 72 Tex. L. Rev. 1629
(1994). This thesis is controversial, but even if demand is not inelastic and even if insurers do evaluate the
corporation’s risk level ex ante, the market may still be one in which corporate managers prefer to pay high
premiums, rather than limit their autonomy, either in the choice or monitoring of defense counsel, or
commit to loss prevention measures, because the potential cost savings on D&O insurance are not
important to them. This appears to be the conclusion of Baker and Griffith. See Baker & Griffith, supra
note 38, at 5, 12-26. They conclude, as does this Essay, that “D&O insurance seems likely to increase the
amount of shareholder losses due to securities law violations.” Id. at 4.

\textsuperscript{74} For a general overview of this issue, see Alan O. Sykes, The Boundaries of Vicarious Liability: An
Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines, 101 Harv. L. Rev. 563
(1988), Professor Sykes argues that placing vicarious liability on the employer (or principal) for the
employee’s (or agent’s) misconduct tends to be inefficient if (a) the enterprise did not cause the wrong, and
(b) the enterprise cannot effectively reduce the probability of the wrong through contracting with its
employee or agent. This topic is discussed infra at notes 101 and accompanying text.
also deter. For example, some research has found that securities class actions tend to lead to a CEO turnover in the wake of the class action. In one study, the filing of a securities class action was found to cause the likelihood of a CEO turnover to more than double, increasing from 9.8% before the filing to 23.4% afterwards. Realistically, however, even if the risk of ouster for the insider were to move up to well above 25%, this risk, by itself, would seldom constitute a deterrent threat capable of offsetting the potentially enormous financial gains to insiders from inflating the firm’s stock price. The problem is that corporate officer who faces the greatest exposure to ouster also probably has the greatest incentive to inflate the firm’s financial results; this is a classic “final-period problem” for which market and private sanctions rarely work.

The policy prescription that flows from this analysis may seem obvious: the law should attempt to impose a greater share of the securities class action’s costs on the more culpable insiders. But a counter-argument also deserves attention: the scale of the change that would be necessary is so great and the financial resources of insiders so limited that

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76 Id. at 22.
77 Again, the example of Gary Winnick, the CEO of Global Crossing, illustrates the problem. He did resign under pressure and contributed $55 million to the settlement of class actions, but he sold $784 million in Global Crossing stock shortly before his firm’s bankruptcy. See supra note 53. Similarly, in the case of Enron, the top three executives “earned more than $100 million each in 2000,” and Enron’s total compensation to its top 200 executives soared from $193 million in 1998 to $1.4 billion in 2000,” a sevenfold increase. See Alan Murray, Twelve Angry CEOs – the Ideal Enron Jury, Wall St. J., Feb. 15, 2006 at A-2.
78 “Final-period” problems classically arise as the corporation approaches bankruptcy or as the manager faces the prospect of job loss. The more that the manager expects ouster, the more that the manager’s incentives are no longer aligned with those of the shareholders, and the manager cannot be as easily deterred by future private sanctions or reputational loss. For descriptions of this problem, see Robert Prentice, Whither Securities Regulation? Some Behavioral Observations Regarding Prospects For Its Future, 51 Duke L. Rev. 1397, 1496 n.132 (2002) (describing conflicts of interest between managers and shareholders during final period); Mitu Gulati, When Corporate Managers Fear a Good Thing is Coming to an End: The Case of Interim Nondisclosure, 46 UCLA L. Rev. 675, 694 (1999). Here, the manager who realizes that current earnings cannot be sustained and that the corporation’s stock price will eventually fall has a powerful incentive to delay the market’s recognition of this decline until after the manager’s options have vested and the manager has sold his stock.
meaningful change is infeasible. Even at first glance, it is evident that securities class actions often result in enormous settlements to which insiders could conceivably contribute no more than a modest percentage. For example, the Stanford Law School Securities Class Action Clearinghouse lists the ten largest securities class action settlements since the passage of the PSLRA, and, as of early 2006, the cases on this list settled for amounts ranging from $7.1 billion down to $574 million:

<table>
<thead>
<tr>
<th>Rank</th>
<th>Issuer</th>
<th>Maximum Asserted Valuation</th>
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<tr>
<td>1</td>
<td>Enron</td>
<td>$7,160.5 Million</td>
</tr>
<tr>
<td>2</td>
<td>WorldCom</td>
<td>$6,156.3 Million</td>
</tr>
<tr>
<td>3</td>
<td>Cendant</td>
<td>$3,528.0 Million</td>
</tr>
<tr>
<td>4</td>
<td>AOL Time Warner</td>
<td>$2,500.0 Million</td>
</tr>
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<td>5</td>
<td>Nortel Networks</td>
<td>$2,473.6 Million</td>
</tr>
<tr>
<td>6</td>
<td>Royal Ahold</td>
<td>$1,091.0 Million</td>
</tr>
<tr>
<td>7</td>
<td>IPO Allocation Litigation</td>
<td>$1,000.0 Million</td>
</tr>
<tr>
<td>8</td>
<td>McKesson HBOC</td>
<td>$960.0 Million</td>
</tr>
<tr>
<td>9</td>
<td>Lucent Technologies</td>
<td>$673.4 Million</td>
</tr>
<tr>
<td>10</td>
<td>Bristol-Meyers Squibb</td>
<td>$574.0 Million</td>
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Obviously, officers and other insiders lack the assets to contribute more than a small fraction to such “mega settlements.” But this is less of an obstacle to deterrence than it may initially appear, for three reasons: First, the mean and median settlements in

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79 For the Stanford Law School Securities Fraud ‘Top Ten Mega-Settlements’ List, see http://securities.stanford.edu/top_ten_list.html. (examined on February 13, 2006).
securities class actions are much smaller. Second, a full transfer of the costs to the more culpable insiders is not necessary to achieve deterrence. All that is needed is that the expected penalty, which would include both the financial and non-financial costs of a securities class action settlement, exceed the expected gain. Third, D&O insurance provides far less protection to insiders than it does to outside directors. Insurance companies can seek to rescind the policies applicable to insiders for fraud in the application (and are currently seeking to do so) or can assert the traditional exclusions to coverage in such cases. In addition, as the foregoing list shows, many settlements are now exceeding the ceiling on insurance coverage. No corporation can afford to insure its board for $1 billion; nor are insurers willing to offer coverage in such amounts (indeed, insurance at such a level might even invite litigation). As a result, at least the insider defendant can no longer confidently rely on liability insurance in all cases.

II. THE CIRCULARITY PROBLEM: WHEN DO WEALTH TRANSFERS AMONG SHAREHOLDERS MAKE SENSE?

At the outset, a basic distinction must be drawn between two types of securities class actions: (1) those that challenge actual sales of securities by an issuer, and (2) those in

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80 NERA Economic Consulting and Cornerstone Research both report mean and median data on securities class action settlements. In 2004, NERA reports that the mean settlement rose by 33% to $27.1 million, while the median settlement fell to $5.3 million from $5.5 million in 2003. See Elaine Bucksberg, Todd Foster, Ronald Miller & Stephanie Plancich, Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements (NERA Monograph, Feb. 2005), at 4. Cornerstone Research found the median settlement to be $6.0 million (down from $6.2 million over the period from 1995 to 2003) and the average settlement to be $24.6 million (up from $19.2 million over the 1995 to 2003 period). See Laura Simmons & Ellen M. Ryan, Post-Reform Act Securities Settlements (Updated through December, 2004)” at 2. In common, this data shows that most securities class actions settle for amounts that are well within the personal assets of insiders, but there is a long tail to the right on the dispersion curve of settlements, with an increasing number of very large mega-settlements.

81 With respect to attempts to rescind for fraud in the application, see infra notes 160 and 163 and accompanying text. Also, the typical D&O policy contains exclusions on coverage that are more likely to apply to insiders than to outside directors. Typically, the D&O policy excludes claims based on “criminal or deliberately fraudulent misconduct” or based on transactions in which the insured received “any personal profit or advantage to which he is not legally entitled.” See 2 William E. Kneipper & Dan A. Bailey, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS §25.03 (7th ed. 2005).

82 Currently, D&O insurers appear to be placing a ceiling of $300 million on the insurance that they will offer. See Baker & Griffith, supra note 38, at 10 (citing interviews with industry officials).
which the plaintiff purchases instead from another shareholder, but asserts that the issuer’s materially misleading statements or omissions caused the plaintiffs to purchase the company’s stock at an inflated price in the secondary market. In the former “primary market” case, there is at least some privity between the plaintiffs and the corporate issuer, and the plaintiff class is effectively asserting that the other shareholders profited at its expense because of the inflated price of the issuer’s stock. But in the latter “secondary market” case, neither the defendant corporation nor its continuing shareholders ordinarily benefit from the plaintiffs’ purchases. Typically, the shareholders who will bear the recovery are innocent of any wrongdoing. Moreover, the plaintiffs and defendants tend to overlap heavily, because many shareholders are in both classes, having bought stock at different times. The key distinction here is that, in the first case, the existing shareholders benefit when their corporation sells stock at an inflated price to the plaintiffs, but, in the second case, the continuing shareholders seldom receive any benefit – direct or indirect – from the sales by former shareholders at inflated prices to the plaintiff class members. As a result, the moral entitlement of the plaintiff class to seek their recovery from the equally non-culpable continuing shareholders seems debatable at least.

That much may seem obvious. But the circularity problem is subtler still, as the real costs do not fall on all shareholders equally, but are borne differently by different

83 This primary/secondary distinction is a standard one that is made in virtually all securities regulation casebooks. See John Coffee & Joel Seligman, Securities Regulation: Cases & Materials (9th ed. 2003) at 21. (“It is conventional to distinguish the primary market (i.e., issuer transactions in which shares are sold to investors) from the secondary market (trading transactions between investors”).

84 If an investor – individual or institutional – wishes to remain diversified, it will be necessary for it to make continuing purchases as its portfolio increases. Thus, even a passive and indexed mutual or pension fund will be buying the same stocks on a continuing basis. Because the typical class period is under one year, see infra at note 93, it is likely that such an investor will have purchased some of its holdings in the defendant corporation before the class period commenced, and thus it will straddle the class period’s boundary line.
classes of shareholders. This section will examine the differential impact of securities class litigation on diversified and undiversified shareholders and then examine whether the deterrent benefits can justify these costs.

A. Case One: The Simple Wealth Transfer

Because of the long-established separation of ownership and control in the United States, the vast majority of the stock in “public” companies is owned by dispersed shareholders, all holding relatively small percentage stakes. When a “secondary market” securities class action is brought against a public corporation that has not, itself, sold or purchased its own securities, the action is essentially brought on behalf of shareholders (and former shareholders) who purchased the stock during the “class period” (i.e., the time period during which the market was allegedly affected by material misinformation). Typically, this class period will end on the date that corrective disclosure is made (and the market price of the stock declines in response). Any judgment or settlement in this action will be borne by the corporation (and thus indirectly by all its current shareholders). As a result, securities litigation in this context inherently results in a wealth transfer between two classes of public shareholders – those in the class

85 The dispersed character of U.S. stock ownership was first recognized by Berle and Means over seventy years ago. See Adolf A. Berle, Jr. & Gardner C. Means, The Modern Corporation and Private Property (1933). The distribution of stock between individual and retail ownership has continually changed, with institutions now owning roughly 50%, but the separation of ownership and control has been constant. See Coffee and Seligman, supra note 83, at 43-46 (showing breakdown of share ownership by ownership categories in public corporations).
86 That is, the class will typically be defined as all persons who bought the stock of the issuer beginning on date x and ending on date y, excluding any of the defendants.
87 Once corrective disclosure is made, the alleged fraud is at an end. Even if individual shareholders might remain deceived when they later purchase the stock, the premise of the securities class action is that the market will incorporate into price immediately both the original fraudulent disclosure and the corrective disclosure. See Basic Inc. v. Levinson, 485 U.S. 224 (1988). Thus, they are not injured by a post-corrective disclosure purchase.
88 See supra notes 60-64 and accompanying text (indicating that insurers and corporation bear entire cost of securities class action settlements). Costs borne by the corporation are by definition indirectly borne by its shareholders.
period and those outside it —, and typically neither class is culpable. Worse still, the most likely beneficiaries of the fraud will be the insiders who sold at inflated prices. Because they bailed out at an inflated price, they will escape without bearing any cost when liability is later imposed exclusively on their former corporation.

B. Case Two: Wealth Transfers Under the Assumption of Diversification

Often shareholders will belong to both the plaintiff class that sues and the residual shareholder class that bears the cost of the litigation. This can result because they purchased stock at times that are both inside and outside the class period, so that they are on both sides of the litigation. Thus, they are effectively making wealth transfers to themselves, in effect shifting money from one pocket to another, minus the high transaction costs of securities litigation.

But from a broader-angled perspective, this is also the position of the diversified shareholder who holds stock in many corporations. That is, if one assumes that most shareholders are diversified, the key implication of this premise is that, on an aggregate basis, diversified investors will be shareholders on both sides of the class period divide, sometimes being a shareholder within the class period and sometimes a shareholder outside the class period. As a result, at least in the aggregate, diversified investors are largely making wealth transfers among themselves as the result of contemporary securities litigation. To illustrate, assume a pension fund that holds a portfolio of 1,000 stocks, and that, over a several year period, 100 of these stocks become defendants in securities litigation. Assume further that the pension fund is in the plaintiff class in 50 cases and in the defendant class in the other 50 cases (and maybe in both classes in 25 of these cases). However large the recoveries, such an investor cannot gain from this
pocket-shifting of wealth, unless third parties are compelled to contribute to the settlement.

Worse yet, on each such wealth transfer, the continuing shareholders will be taxed the transaction costs of the litigation, which includes the legal fees paid to both plaintiff’s and defendant’s counsel, the increased insurance premiums in the wake of the litigation, and the possible costs of business disruption and adverse publicity to the subject company. In addition, hidden costs are also borne by the corporation, including the cost of diverted managerial time, possible stigma and damage to reputation. When all those costs are aggregated, the sum may often exceed the net recovery to the class. Absent high deterrent benefits, the result seems to be a dead weight loss to investors as a class.

C. Case Three: The Conflict Between “Buy and Hold” Investors Versus “In and Out” Traders

Of course, not all investors are diversified. Clearly, most retail investors do diversify, because they invest through mutual funds and pension funds, which are required by law to diversify.90 Large, sophisticated investors also understand the wisdom

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89 As noted earlier, plaintiffs attorneys charged fees in securities class actions amounting to 32% of the settlement during the 1990s and some estimate the cost of defense counsel as amounting to between 25-35% of the settlement. See supra notes 37-38 and accompanying text. Insurance premiums will cover these expenses (up to their ceilings and minus any deductible), but the pricing of D&O insurance involves estimating the probability of the loss and then adding a “loading fee” to assure a profit for the insurer. See supra note 41 and accompanying text. Thus, from the perspective of the diversified investor, it is clear that across all public corporations the cost of D&O insurance to all corporations must exceed the loss experienced by all corporations (or the insurers, losing money, would cease to write insurance). From this perspective, the diversified shareholder loses wealth when the corporation decides to buy D&O insurance covering its own liability (as opposed to that of its officers and directors). See Baker and Griffith, supra note 38, at 30-34.

90 As of 2005, nearly three-fourths of Americans’ liquid financial resources were invested in securities-related products, with mutual funds being the fastest growing category. In contrast, in 1975, slightly more than half of American financial assets were in bank deposits (55%). See The Securities Industry Association, Key Trends in the Securities Industry (last updated on 1/13/05), at 5, available at http://www.sia.com/research. Savings then have moved from banks to mutual funds. Mutual funds are clearly the fastest growing sector of the financial marketplace, now holding 23% of all equities. See Alan Palminter, U.S. Mutual Funds: The Awakening Behemoth (Working Paper, May, 2006). Mutual funds are basically required to diversify their investments if they wish to classify themselves as a “diversified” fund (as most do). See Investment Company Act, Section 5(b)(1), 15 U.S.C. § 80a-5(b)(1). For an overview of
of diversification. Nonetheless, let’s make the assumption that many investors are undiversified. Undiversified investors could benefit from the securities class action (if they are lucky enough to be in the plaintiff class and not in the class of existing shareholders). But in reality, small undiversified investors are seldom likely to receive a monetary benefit from the securities class action. Indeed, their position is even more exposed than the diversified investor. This is because the typical small, undiversified investor is likely to be a “buy and hold” investor who does not trade frequently. Such investors do trade less actively because (1) they pay higher brokerage commission rates than do larger investors; (2) they receive less current information than do larger investors with closer ties to securities analysts; and (3) they are not professionals who can watch their investments constantly. As a result, because of their typically longer holding

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these diversification requirements, see Roberta Karmel, The SEC at 70: Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility – What Regulation by the Securities and Exchange Commission Is Appropriate?, 80 Notre Dame L. Rev. 909 (2005). Hence, if individual investors are moving their retirement savings to mutual funds, they are at the same time likely becoming diversified.

91 A 2005 study jointly conducted by the Investment Company Institute and the Securities Industry Association reports that the typical U.S household did not trade securities in the average year. Specifically, it found:

“Because the majority of equity investors are saving for retirement and have long-term investment horizons, most are not frequent traders. As a group, these investors do not have a pattern of buying or selling equities in response to stock market conditions. The share of equity investors who conducted equity transactions in 1998, 2001, and 2004 ... remained steady at about 40 percent....”

See Investment Company Institute and the Securities Industry Association, Equity Ownership in America, 2005 (2005) at 24. In short, slightly more than 60% of individual shareholders do not trade in any given year and thus could not be members of a class that reached back less than one year from the date of corrective disclosure. As noted below, the typical class period is less than one year. See infra note 93.

92 There is a vast empirical literature on trading intensity which finds that different classes of investors have vastly different proclivities to trade. For a brief overview, see John Finnerty & George Pushner, An Improved Two-Trader Model for Measuring Damages in Securities Fraud Class Actions, 8 Stan. J. L. Bus. & Fin. 213, 230-33 (2003); see also Michael Barclay & Frank C. Torchio, Complex Litigation at the Millennium: A Comparison of Trading Models Used for Calculating Aggregate Damages in Securities Litigation, 64 Law and Contemporary Problems 105 (Spring/Summer 2001). As a result, most contemporary empirical models of damages in securities litigation use a “two trader model” which distinguishes between “traders” and “investors.” I do not assert that all retail investors follow a “buy and hold” philosophy (indeed, some were “day traders” in the late 1990s) or that all institutional investors are active traders (many are in fact indexed). But on average, the small investor has a lower trading intensity than the institutional investor, in part because the former faces much higher trading costs on a per share basis. A common heuristic used by the modelers of securities damages is that 20% of the shareholders are
period, individual “buy and hold” investors are more likely to have purchased their stock before the class period commenced.93

As a result, securities class actions seem likely to systematically transfer wealth from “buy and hold” investors (who bought on average outside the class period) to more rapidly trading investors (who purchase on average within the class period). Ironically, the clear winner under such a system is the more rapidly trading, undiversified investor – which is the profile of the contemporary hedge fund. The clearest loser is the small investor who buys and holds for retirement – exactly the profile of the American retail investor. The other major category of clear losers is populated by the corporation’s own employees, including its managers, who hold stock as the result of equity compensation and stock option plans. Not only do these groups lose, but there is decreased likelihood today that their interests will be given serious consideration in securities litigation, because control of the securities class action was presumptively assigned by the PSLRA to large diversified investors, who often have highly contrary interests.94

D. The Policy Debate

active “traders” and 80% are passive “investors." If securities litigation does largely cause wealth transfers, those transfers should systematically flow from investors to traders.

93 One empirical study has found that the mean length of the class period in securities litigation was 358 days, with a median of 257 days. See William T. Carleton, Michael S. Weisbach & Elliott J. Weiss, Securities Class Action Lawsuits: A Descriptive Study, 38 Ariz. L. Rev. 491, 497 (1996). Thus, unless the investor bought the majority of the investor’s stock interest in the company during this period of less than a year, the investor will on average bear the proportionate cost of the recovery and the litigation, but not share in any portion of the recovery. It seems a fair assumption that the typical small investor has not purchased his or her shares within the 257 or 358 days preceding the date of corrective disclosure.

94 Although the lead plaintiff provision in the PSLRA may be an important and successful reform, its hidden consequence is to ensure that undiversified small shareholders will have their interests slighted in the organization of the class action. The PSLRA assigns control of the class action to a class member who is likely to be highly diversified. See Section 21D(a)(3) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4(a)(3) (making the volunteering class member with the “largest financial interest in the relief sought by the class” the presumptive lead plaintiff). Experience with this provision has shown that the lead plaintiff will typically be a large public pension fund (which must by law diversify) or at least another financial institution that is likely to be a diversified investor. Hence, even if one is sympathetic to the position of the undiversified investor, the securities class action is no longer designed to be a remedy for protecting the interests of such persons.
The essential circularity of the securities class action in the secondary market context has not escaped the attention of legal academics. But their responses have diverged radically. One school – best typified by Professor James Cox – argues that placing the liability to defrauded investors on the non-trading corporation is justifiable because it is consistent with the standard rule of enterprise liability that prevails across tort law generally. In sharp contrast, another school maintains that, once the inevitable circularity of the wealth transfers in securities class actions is recognized, the logical policy response should be to convert the securities class action into a form of civil penalty. Thus, Professor Donald Langevoort has suggested capping the damages at a low level, pointing to the American Law Institute’s Federal Securities Code as a relevant model; and Professor Janet Cooper Alexander has similarly proposed a civil penalty that could be enforced both by the SEC and/or plaintiff’s attorneys.

95 See, e.g., Langevoort, supra note 2, at 642 (“[w]hatever compensation comes via class actions in open market cases is funded directly or indirectly by other innocent investors, creating a system of pocket-shifting that takes little money out of the hands of those natural persons who contrived the fraud.”); see also Jenifer Arlen & William Carney, Vicarious Liability for Fraud on Securities Markets, 1992 U. Ill. L. Rev. 691, 698-700 (1992); Paul Mahoney, Precaution Costs and the Law of Fraud in Impersonal Markets, 78 Va. L. Rev. 623, 635 (1992).

96 See Cox, supra note 3, at 509-512. Professor Cox argues broadly that “[t]he financial burdens of a securities fraud settlement borne by the innocent shareholders of the corporate violator is indistinguishable from the burden borne by the shareholders of the corporation that produces a defective product or violates the environmental laws.” Id. at 511.

97 This is Professor Langevoort’s position. See Langevoort, supra note 2, at 660 (favoring the “use of the civil penalty model in defining the maximum amount of recovery”).

98 Id. at 657-58. The ALI’s Federal Securities Code would limit damages for the issuer corporation in the case of an open market fraud where the corporation was not contemporaneously selling its securities to the greater of one percent of the issuer’s gross income (to a maximum of $1,000,000) or any profits received, unless the fraud was a “knowing” one. See Fed. Sec. Code, Section 1708(c), (e) (American Law Institute 1980).

99 See Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 Stan. L. Rev. 1487 (1996). As she points out, such civil penalties are sometimes enforced by private litigation under which the successful plaintiff’s attorney receives attorney’s fees. Id. at 1509 (citing Clean Water Act, Clean Air Act, Resource Conservation and Recovery Act (RCRA) and other environmental statutes). Under her proposal, the SEC would receive the first option to sue and, if it did not, then private plaintiffs could then sue. Obviously, this approach significantly erodes the incentive to search for legal violations as the private plaintiff (or plaintiff’s attorney) who incurs costs to identify a violation would not profit unless and until the SEC declined to sue.
But there are problems with both lines of argument. Those who point to tort law’s general preference for enterprise liability as a justification for the status quo miss what is most distinctive about the securities class action. When a corporation is fined or incurs liability in a class action because of a defective product or environmental emissions, society is imposing a cost on the corporation (and indirectly its shareholders) to induce it to monitor the behavior of its managers more diligently. Shareholders are not, themselves, the primary victims of the offense. Instead, a negative externality is being internalized (at least partially) by shifting costs from the victims of the tort to the corporation and its shareholders. But in the case of at least the “secondary market” securities class action, the victims and the shareholders are largely the same (at least if we assume the shareholders to be diversified). Thus, enterprise liability in this context is a strategy akin to that of punishing the victims of burglary for their failure to take greater precautions. Although this strategy might produce some enhanced monitoring, it offends both social norms and the public’s sense of fairness to punish the victim. Thus, the more this strategy becomes transparent, the more it will predictably encounter both political and judicial resistance. Nor is punishing the victim terribly effective, as victims are generally not the best suited persons to detect and prevent the offense (which is ultimately why they became victims).

Defenders of the current system of enterprise liability tend to assume that the corporation’s agents and employees are engaging in legal violations to maximize profits for the corporation. But again securities litigation is distinctive. Although this assumption is generally valid when the corporation sells a defective product or pollutes the environment, the corporate manager usually has more self-interested reasons for inflating
the firm’s earnings. Except in the case where the corporation is itself issuing shares, securities fraud appears to be primarily motivated by the manager’s own personal interests. Typically, managers hide bad news because they fear loss of their jobs (either from a dismissal or a hostile takeover), and they overstate favorable developments or inflate earnings in order to maximize the value of their stock options and other equity compensation. After analyzing a large sample of class actions, Professors Arlen and Carney report that managerial self-interest seems to be the dominant motivation underlying securities fraud,100 with managers frequently engaging in behavior that closely resembles insider trading.101 If so, enterprise liability may work less well than a strategy that focuses directly on the managers, themselves.102

On the other hand, use of a civil penalty system (as Professors Langevoort and Alexander have each independently proposed) could well underdeter. The $1 million ceiling proposed by the A.L.I.’s Federal Securities Code now seems dwarfed by the

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100 See Arlen & Carney, supra note 95, at 702-03.
101 Id. at 720-40.
102 Professors Arlen & Carney argue that “enterprise liability for Fraud on the Market is not better able to deter Fraud on the Market than is agent liability” and that “agent liability probably achieves superior deterrence.” Id. at 694. This Essay generally agrees with their analysis, but doubts that private enforcers will be motivated to pursue cases under an agent liability system involving inherently smaller damages (and thus smaller attorneys’ fees). Thus, a combined or hybrid system of agent and enterprise liability (with the agent’s liability being increased and the enterprise’s liability being decreased) seems likely to better deter. Also, some of their critique of enterprise liability now seems dated. For example, they argue that monitoring by the corporation of its managers will not work well, both because the board has limited time and incentives to monitor, because of structural bias in the boardroom, and because of the ability of managers to conceal their self-interested actions. See Arlen & Carney, supra note 95, at 710-712. But their analysis, written over a decade ago, may underestimate the monitoring capacity of the modern board and its gatekeepers. Particularly in light of the Sarbanes-Oxley Act, independent audit committees are in a position to monitor for abuses, such as premature revenue recognition, and thus enterprise liability cannot be as easily dismissed as a futile strategy today in the manner that Arlen and Carney did in their article of fifteen years ago. In addition, they give little attention to the possibility that enterprise liability coupled with incentive contracting between the enterprise and its agent can produce superior deterrence to a simple rule of agent liability. See Sykes, supra note 74, at 577-578. Professor Sykes concludes that enterprise liability is generally superior whenever the use of incentive devices can reduce the probability of the wrong. Id. In an era when stock options are the basic currency of senior executive compensation, such incentive contracting is certainly possible. Thus, enterprise liability probably works to a considerable degree, but at high cost to shareholders. A hybrid system that combines agent liability with enterprise liability should reduce those costs.
potential gains in recent securities frauds.\textsuperscript{103} Worse yet, even if a civil penalty system were to be enforced by private litigation, the incentive for plaintiff’s attorneys to bring such actions would be modest in comparison to their current incentive to prosecute securities class actions. Assume for the sake of simplicity that the plaintiff’s attorney will receive on average a fee award of around 25\% of a class action settlement.\textsuperscript{104} Mega-settlements of over $100 million in securities class actions are now common, and thus the plaintiff’s attorney is motivated to bring and pursue securities class actions by the prospect of receiving a sizable percentage of such a recovery. But if we reduce the damages significantly, we correspondingly reduce the plaintiff’s attorney’s expected recovery and thus its incentive to seek out and prosecute securities fraud. For example, a $10 million civil penalty would probably not justify the costs, expenses and risks that the plaintiff’s attorney today incurs to prosecute a securities class action\textsuperscript{105} – even if the civil penalty went exclusively to the plaintiff’s attorneys who brought the action (which seems politically unacceptable in any event).\textsuperscript{106} Moreover, low penalty levels would encourage

\textsuperscript{103} As noted earlier, the CEO of Global Crossing sold over $784 million in his company’s stock, and Enron executives were in a position to profit similarly by hiding Enron’s problems. See supra note 77.

\textsuperscript{104} Research shows that the actual fee award in securities class actions during the 1990s was approximately 32\% of the recovery. See Martin et al., supra note 37, at 141. More recent research finds somewhat lower percentages today (possibly because of the impact of the lead plaintiff) and that the fee award is a declining percentage of the recovery. See Theodore Eisenberg & Geoffrey P. Miller, Attorney Fees in Class Action Settlements: An Empirical Study, 1 J. Empirical Legal Stud. 27, 51-54 (2004). Thus, as the recovery surpasses the $100 million level, the 32\% figure for the average fee award may overstate. Hence, this article is using the more conservative estimate of 25\% is used in the illustration in the text.

\textsuperscript{105} Over a decade ago, Professor Alexander suggested that market losses of over $20 million appeared to be necessary to elicit a securities class action. See Alexander, supra note 24, at 511-12. While this estimate was challenged at the time because of her small sample of cases, the combined impact of both the PSLRA and inflation over the subsequent interval has probably made this estimate overly conservative today.

\textsuperscript{106} Although the public may accept the payment of attorneys fees to the private enforcer in the field of environmental regulation, the idea of paying the entire penalty to the plaintiff’s attorneys is far more radical. Payment of a $25 to $50 million penalty to a law firm in a securities case would likely shock the public (even though such a payment no more than matches the attorney’s fees paid in many securities class actions today). Even more importantly, political and judicial distaste for awarding such a penalty to a bounty-hunting law firm might cripple enforcement.
defendants to stretch out the litigation interminably and wage a war of attrition in order to erode the expected value of the payoff to the plaintiff’s attorney.

In short, although a system of managerial liability seems likely to yield greater deterrence than enterprise liability, one cannot safely eliminate corporate liability in securities class actions without radically reducing the likelihood of private enforcement. As noted earlier, the federal securities laws rely on private enforcement (even if its effectiveness may often seem questionable). Thus, the most sensible policy approach is a substitutionary one: to seek to shift the incidence of the liability so that it falls more substantially on managers and other insiders, but not to abolish corporate liability, which would continue to play a residual role. Shaky as the case for corporate liability may be, economic theory suggests that vicarious liability is efficient so long as the principal and agent can enter into contracts that reduce the probability of the wrong that is to be deterred. Even given the “final period” problem, there are conceivable means by which the corporation could write such contracts with its managers, for example, by restricting stock options and other incentive compensation. That they have done so only to a modest degree to date probably evidences the difficulty in forcing the principal to monitor its agents in this context.

A deeper question also lurks here that this Essay will not attempt to resolve: how much deterrence is needed? The simplest answer is that modest penalties will produce little, if any, deterrence because private enforcement will be non-existent unless the

107 See supra notes 19-20.
108 See Sykes, supra note 74, at __.
109 For example, if the driving force behind managerial financial misconduct is stock options, as many believe, the corporation could substitute restricted stock contracts under which the manager would not be able to sell for an extended period – thus preventing to simple bailout. There has been some modest movement in this direction since Enron, and the securities class action could have been one of the forces driving the corporation marginally in this direction.
expected recovery to the private enforcer will exceed its expected costs and yield a return commensurate with the risk assumed.  \footnote{But this is only the first step. To achieve deterrence, the expected penalty must also cancel out the expected gain to the wrongdoer, who may often face a low probability of detection. But even this further step may still be insufficient because the private enforcer may not be motivated to search diligently enough to detect hidden violations. Thus, some economists argue that, to truly deter, the expected penalty should equal the expected social harm. Yet, this in turn raises an even more perplexing question: what is the overall social harm in securities fraud? How should it be measured?}

Here, one school of thought tends to view the harm as simply the loss to the victimized investors, which loss is more or less counterbalanced by the gains received by the usually equally innocent investors on the other side of these transactions.  \footnote{But this is overly narrow and myopic accounting. The deeper problem in securities fraud is the impact of fraud on investor confidence and thus the cost of equity capital. Here, it is impossible to quantify the impact of any individual scandal, but clearly the cumulative impact of Enron, WorldCom and a host of other scandals in the 2000 to 2002 era made stockholders wary, chilled the initial public offering market, and caused investors to demand a higher return based on the perceived higher risks – in short, the cost of capital went up. When the cost of capital rises, the economy as a whole suffers, as Gross National Product declines or stagnates and unemployment may increase. As a result, not only investors, but citizens throughout society experience a loss. In addition, fundamental change}

110 “Expected recovery” here means the civil penalty discounted by the action’s likelihood of success. Thus, if the penalty is $1 million and the odds are 50/50, the expected recovery is $500,000.


112 For essentially such a position, see Thakor, supra note 2.
misallocations of resources may result because of what might best be termed a “contagion effect.” That is, companies in the same industry may feel compelled to copy the accounting tricks of an industry leader, lest their stock price fall far behind and they become a takeover target. Other firms may simply abandon a market or industry in the belief that they cannot effectively compete with the seemingly dominant competitor (who is in fact using crooked accounting). Considerable evidence suggests that Enron and WorldCom had this impact on other firms within their respective industries.\footnote{For example, AT&T appears to have responded to the accounting manipulations practiced by WorldCom, including its artificially low ratio of line costs to revenues, by deciding to abandon the field on the false premise that it could not compete effectively with WorldCom. Initially, it laid off tens of thousands of workers in the late 1990s, “as it tried frantically to match WorldCom’s infuriatingly low costs.” See Geoffrey Colvin, The Other Victims of Bernie Ebber’s Fraud, Fortune, August 8, 2005 at 32. See also John J. Keller, AT&T’s Armstrong Is Expected to Cut as Much as 15% of Staff – Reduction Could Be Deepest in a Decade, The Wall St. J., Jan. 22, 1998 at A3 (noting that 19,000 appeared likely to be laid off in order to match “lean trend setters such as WorldCom, Inc.”). Unlike AT&T, Qwest and Global Crossing appear to have emulated WorldCom’s accounting fraud, and the latter went into bankruptcy. Colvin, supra, at p. 32. Ultimately, in 2000, AT&T split itself into four separate businesses based on its mistaken belief that it could not compete with WorldCom in the long distance business. See Adam Cohen, Ma Bell Calls it Splits, Time, Nov. 6, 2000, at 96-98. Similarly, Dynergy appears to have copied many of Enron’s accounting tricks and as a result entered into a major settlements with the SEC and class action plaintiffs. For a description of Dynergy’s structured finance transactions, see Nathan Koppel, Wearing Blinders, The American Lawyer, July 1, 2004 at 26. See also, United States v. Olis, 429 F.3d 540 (5th Cir. 2005) (affirming securities fraud conviction of Dynergy executive with respect to these transactions).}

Given this possibility of broader social harm and economic misallocation, the radical reform of abolishing corporate liability seems an overly risky step, but the cost of enterprise liability to shareholders can be reduced by shifting the incidence of damages to agent/managers, while leaving the corporation liable for the residual amount.

Part III. WHY DON’T INSIDERS PAY MORE?

One cannot shift the incidence of the damages in securities class actions without first understanding better why these costs today fall so heavily on the issuer corporation. Here, the basic story involves the combination of agency costs, the legal rules regarding indemnification, and recent changes in insurance practices.
A. *Agency costs.*

When corporate executives are sued alongside the corporation as co-defendants in securities litigation (as they almost always are\(^{114}\)), a clear conflict of interest arises: the executives will naturally want to settle their own liability with funds advanced by the corporation. In principle, the board should recognize the conflict of interest inherent here, but boards of directors have little capacity (and perhaps even less incentive) to monitor the complex details and complicated procedures of securities litigation. Even more importantly, the directors may themselves also be sued. Or, they may have been so sued in the past, giving them a closer identification with the interests of the officer-defendants than with those of the shareholders. “Structural bias” is always a possible explanation for lax monitoring, but seldom is it more legitimately applicable than in the context of litigation against corporate officials, which seems to trigger a “circle-the-wagons” defensive response from directors eager to protect their colleagues in management.

Also, if the settlement is fully covered by corporation’s own liability insurance (as it usually is\(^{115}\)), the board has little reason to resist a settlement that involves no contribution by the individual defendants. Even when the settlement requires individual defendants to pay some amount out of their own funds, counsel may advise the board that the corporation is legally required to indemnify its officers and employees under its by-laws.\(^{116}\) If so, it can be plausibly argued that requiring the individual defendants to contribute would only produce a pointless circularity. If this advice is accepted (as it

\(^{114}\) See supra at notes 51-52 and accompanying text.

\(^{115}\) See supra notes 60-61 and accompanying text.

\(^{116}\) As discussed below, this conclusion is not necessarily correct, even if all the other defendants settle. See infra notes 155-156 and accompanying text. Also, it would be clearly incorrect if the manager/defendants went to trial and were held liable. See infra notes 117-118 and accompanying text. Counsel can still argue, however, that, if the corporation wants a settlement and an end to the controversy, it may be necessary to pay the settlement costs of officers and defendants because the plaintiff may want a global settlement and the corporation will likely want an end to the adverse publicity and disruption.
normally appears to be), the net result is both that the corporation bears virtually the entire cost of the settlement and that actual indemnification is seldom paid because few payments by individual defendants are ever made.

B. Indemnification and the Settlement Approval Process

Although state corporate law broadly authorizes indemnification of corporate officials, the SEC partially withdraws that protection by precluding indemnification of liabilities arising under the federal securities laws. But the practical impact of the SEC’s position has been modest, because although courts have largely agreed that indemnification of securities law liabilities is inconsistent with the policies underlying the federal securities laws, neither courts nor the SEC have extended this policy to apply to settlement payments or defense costs where the defendants do not admit liability.

Even more importantly, federal courts have repeatedly asserted that they have no responsibility for supervising how the multiple defendants in a securities class action apportion liability among themselves, so long as the aggregate settlement is fair to the class. An illustrative case is In re Cendant Corp. Litig., which at the time it settled

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117 The leading decision is Globus v. Law Research Service, 418 F.2d 1276 (2d. Cir. 1969), which found that actual knowledge of material misstatements barred recovery because indemnification would be contrary to public policy as the federal securities laws were intended to be a deterrent. Later cases have said that even liability based on recklessness may not be indemnified. See Heizer v. Ross, 601 F.2d 330 (7th Cir. 1979). Indeed, “mere negligence” on the part of an underwriter, which is actionable under Sections 11 and 12(a)(2) of the Securities Act of 1933, has been held to bar indemnification under this deterrent rationale. See Eichenholtz v. Brennan, 52 F.3d 478 (3d Cir. 1995); First Golden Bancorporation v. Weiszmamn, 942 F.2d 726 (10th Cir. 1991) (indemnification barred even under strict liability provisions of Section 16(b)); Stewart v. American Oil & Gas, 845 F.2d 196 (9th Cir. 1988). The SEC enforces this position by requiring companies seeking to register their securities to give an undertaking that if a director seeks indemnification for damages, the company “will … submit to a court of appropriate jurisdiction the question whether such indemnification … is against public policy as expressed in the Act.” Reg. S-K, 17 C.F.R. § 229.512(h)(3) (2006). But this language requires court approval only for indemnification of damages, not settlements.


119 See, e.g., In re Warner Communications Sec. Litig., 798 F.2d 35 (2d Cir. 1986).

120 264 F.3d 286 (3rd Cir. 2001).
was the largest class action settlement on record\textsuperscript{121} – but also one in which the entire $2.85 billion settlement came from the defendant corporation, with no contributions being made by Cendant’s defendant officers and directors, even though numerous officers and directors received releases from all claims under the settlement.

Understandably, a shareholder objected to this settlement, pointing out that 13 out of the 14 Cendant directors had been sued in the action and yet none had made any contribution to the settlement.\textsuperscript{122} On this basis, the objector claimed that the settlement amounted to an illegal indemnification of the individual defendants. The District Court dismissed these claims\textsuperscript{123} and was upheld by the Third Circuit, which agreed that (1) the District Court need only be concerned as to whether the settlement was adequate and reasonable to the class,\textsuperscript{124} and (2) the settlement did not amount to indemnification because no reimbursement was made by the corporation to its directors.\textsuperscript{125}

\textbf{C. D&O Insurance}

The latest relevant development involves a change in the coverage of D&O insurance. Traditionally, public companies insured their directors, paying the premiums on their D&O policies.\textsuperscript{126} This closed a hole that indemnification left open, because indemnification is not available in bankruptcy and certain other contexts.\textsuperscript{127} Over time,

\footnotesize{\begin{itemize}
\item \textsuperscript{121} Cendant paid $2,851,500 billion and Ernst and Young, its auditor, paid $335 million for a grand total of $3.185 billion. Id. at 288, 291.
\item \textsuperscript{122} Id. at 292.
\item \textsuperscript{123} In re Cendant Corp. Sec. Litig., 109 F. Supp. 2d 273, 280 (D.N.J. 2000) (rejecting objection filed by Martin Deutch).
\item \textsuperscript{124} In re Cendant Corp. Litig., 264 F.3d at 293-296. The Third Circuit basically held that claims that the contributions made by the individual defendants were inadequate should be resolved in a derivative action filed in Delaware.
\item \textsuperscript{125} Id. at 301.
\item \textsuperscript{126} For concise histories of the law on corporate indemnification of officers and directors, see Joseph Johnston, Jr., Corporate Indemnification and Liability Insurance for Directors and Officers, 33 Bus. Law. 1993 (1978) and United States v. Stein, 2006 U.S. Dist. LEXIS 42915 (July 20, 2006) at *59 to *66.
\item \textsuperscript{127} In bankruptcy, any executory obligation, such as the contractual obligation to pay indemnification, can be rejected. As a practical matter, directors rely on their individual insurance policies only when the
\end{itemize}}
corporations came also to insure their own obligation to pay indemnification, but they did not ensure their own direct liability as defendants. Typically, the two policies were written in tandem by the insurance company because the insurer knew it would not have to pay twice and could thus sell the joint policies at a cheaper rate.\textsuperscript{128}

But a problem in coverage still remained. Insurers writing D&O policies would resist paying all defense costs in a securities class action where the corporation was also a defendant and would demand an allocation of the defense costs between their clients and the corporation.\textsuperscript{129} Barring such an allocation agreement, they would threaten not to pay any expenses, thereby placing the individual defendants at risk for these payments.

To end these uncertainties, insurers began to write “corporate entity coverage,” which directly reimbursed the corporation for its own litigation expenses and its own settlement payments in securities cases and certain other forms of litigation.\textsuperscript{130} This form of insurance appears to have first been offered in 1996, and thus is a relatively new development.\textsuperscript{131} Despite its recent appearance, entity insurance caught on quickly, and

\begin{flushleft}corporation becomes insolvent. See Baker & Griffith, supra note 38, at 11. Otherwise, all payments are made by the insurer under its other policies. See infra at notes 128 and 130. Another problem with traditional indemnification was that the obligation to pay indemnification arose only “after the defense to the legal proceedings has been ‘successful on the merits or otherwise.” See Homestore, Inc. v. Tafeen, 888 A.2d 204, at 211 (Del. 2005). This left open the question of advances of legal expenses.  
\textsuperscript{128} Most D&O policies came to include two basic types of insurance coverage: “Side A” coverage which protected the individual officers and directors against covered losses, and “Side B” coverage, which insures the corporation itself from losses resulting from its indemnification obligations. See Baker and Griffith, supra note 38, at 10-11.  
\textsuperscript{129} Because they were not insuring the corporation for its own liability, the insurers did not want to pick up that portion of the defense effort attributable to the corporation’s defense. For an example of such a dispute, see Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424 (9th Cir. 1994). Also, if there were another defendant, such as an auditor or investment bank or law firm, an allocation would again obviously be necessary. Alternatively, some officers or directors might be insured by a different insurance company, again causing the insurance company representing the company to want an allocation of expenses. See Ernest Martin, Jr., D&O Insurance Coverage: Surviving the Turmoil (Lessons We Are Learning from Enron) (2002) (7th Annual Insurance Law Institute, University of Texas Law School) at 2-3.  
\textsuperscript{130} Id. In the industry parlance, this is known as “Side C” coverage, as it insures the corporation’s own direct liability, not its liability to officers or directors. See Baker and Griffith, supra note 38, at 10-11.  
\textsuperscript{131} See Lawrence A. Cunningham, Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability, 52 U.C.L.A L. Rev. 413, 445 (2004).\end{flushleft}
over 90% of D&O insureds had entity coverage as of 2002. In the wake of its appearance, D&O insurance now protects both the individual’s assets and those of the corporation. As a result, allocation seemingly became unnecessary, because one insurer covers the exposure of virtually everyone. If the insurer had an overall policy limit of, say, $50 million on all three coverages (the individual’s policy, the corporate indemnification policy, and the corporation’s own coverage), it could simply write a single check, and neither it nor the corporation needed to allocate the payment among the three policies.

D. Analysis

The combination of these three developments means that the process has been simplified so that all costs typically flow back to a single insurance company – until its policy limit is exceeded. But as a result, the deterrent value of the securities class action has again been eclipsed. In addition, the sharp disparity between the corporation’s ability to indemnify settlement costs and its inability to indemnify judgments established at trial in securities class actions places overwhelming pressure on defendants to settle, and this in turn may invite frivolous or at least low merit litigation. Finally, with the advent of entity insurance, the corporation has much less incentive than in the past to resist the plaintiff – if it can settle within the policy’s limits. In the past, it shared liability with the individual defendants, and its own exposure was reduced if the individual defendants (or their insurers) contributed to the settlement fund. Today, it is rationally indifferent to the allocation, because its insurance covers everything.

132 See Michael W. Early, Another Glimpse into the Current State of Directors and Officers Insurance, 17 Committee on Corporate Counsel Newsletter No. 3 at 29 (2003). This was up from only 50% in 1997. Id.

133 This can be viewed as a classic “moral hazard” problem, as the availability of insurance reduces the corporation’s otherwise rational desire to shift some of the liability to others (such as responsible officers).
What can be done to restore that deterrent role? The most obvious solution might be to preclude the indemnification of settlement costs in securities class actions. But, absent legislation, the doctrinal obstacles to this position are immense. If the SEC took the position that the federal securities laws barred indemnification of settlement costs, it would likely be stretching its own uncertain authority to preclude indemnification beyond the breaking point. At a time when Supreme Court decisions regularly show a fervent concern for the preservation of federalism and state’s powers, any attempt by the SEC to encroach through rule-making on the traditional powers of the states to regulate corporate governance invites strong judicial resistance. Precisely because a right to indemnification is clearly established under state law and because courts to date have not seen the indemnification of settlement costs to conflict with the policies underlying the federal securities laws, a new SEC initiative seeking to bar indemnification of settlement costs would appear highly vulnerable. This does not mean that the SEC is powerless, but it may have to proceed by requiring greater disclosure about the settlement process, rather than by framing a broader prophylactic rule.

The better hope therefore lies in encouraging greater judicial scrutiny of the settlement allocation in securities class actions. Although, in the relatively few decisions on point, courts have so far been unwilling to supervise the apportionment of liability among the defendants in a securities class action, the case for greater scrutiny is strong.

Of course, its future insurance premiums will rise if it incurs recurrent litigation or settles too generously, but these payments appear to be either too small or too invisible to motivate managers. To economists, the real puzzle is not the ex post behavior of a corporation that has insurance, but the reasoning that leads corporations to ensure themselves, as opposed to only their agents. See Baker & Griffith, supra notes 38, at 30-40.


135 Indeed, the SEC has been repeatedly rebuffed in this context. See Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (vacating SEC’s one-share, one-vote rule as in excess of SEC’s authority because subject matter was entrusted to state regulation).
Second Circuit Judge Jon O. Newman wrote a powerful concurring opinion in *Warner Communications*, arguing that occasions can arise in which such a review is justified.136

In that case, he first noted the importance of a fair apportionment of liability to the plaintiffs in a securities class action who remained shareholders:

“Every dollar contributed to the settlement by the individual defendants is a dollar of gain to appellant and those in his circumstances. Every dollar contributed by the corporate defendants is partially offset by the prorata decrease in the value of appellant’s stock due to the payment.”137

On this basis, he opined that an overly generous corporate contribution could imply an unfair settlement:

“[I]n a case such as this, where apportionment between corporate and individual defendants can have economic significance for a shareholder-claimant, some scrutiny of the portion contributed by a corporate defendant normally should be appropriate. In such circumstances, a settlement might well be shown to be unreasonable to a shareholder if the corporate defendant contributed so much more than a fair share as to cause a discernible incremental pro rata decline in the value of the shareholder’s stock below the reduction attributable to a fair contribution.”138

In the contemporary environment where individual defendants make no contribution and the corporation bears the entire burden, Judge Newman’s concerns about the settlements’ fairness might be particularly hard to satisfy.139 But the question remains: how does one induce courts to consider an issue that they seem to prefer to duck? Part IV will approach this question.

Part IV. A ROADMAP TO DETERRENCE: HOW TO GET THERE FROM HERE

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136 In re Warner Communications Sec. Litig., 798 F.3d 35, 38 (2d Cir. 1986).
137 Id. at 38.
138 Id. Judge Newman went on to note that this condition was not present in *Warner Communications* because the Delaware Chancery Court had specifically determined that the allocation between the corporate and individual defendants was fair. Id.
139 Also, the rare fact present in *Warner Communications* that a state court had approved the liability apportionment as fair will not normally provide a basis for avoiding this issue.
Based on the premise that the securities class action can serve an important deterrent role, but only a minor compensatory role, this article has favored a policy of greater managerial liability. The persons most responsible for the accounting irregularities at Enron, WorldCom and a host of other companies were managers who, beginning in the 1990s, began to be primarily compensated with equity compensation and so had a strong incentive to recognize income prematurely in order to inflate reported income.\footnote{Between 1990 and 2001, the percentage of the total compensation of a chief executive officer of a large public corporation in the United States that was paid in the form of equity (rather than cash) rose from 8% to 66%. See Brian J. Hall, Six Challenges in Designing Equity-Based Pay, 15 Accenture J. Applied Corp. Fin. 21, 23 (2003). For a fuller discussion of the destabilizing impact of this rapid shift from cash to equity compensation, see John Coffee, What Caused Enron? A Capsule Social and Economic History of the 1990s, 89 Cornell L. Rev. 269, 275 (2004).} More than any other factor, this sudden shift in executive compensation from cash to equity best explains the hyperbolic increase in accounting restatements that began in the mid 1990s.\footnote{Coffee, supra note 140, at 282-283. See also U.S. General Accounting Office, Pub. No. 03-138, Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges (2002) 5. (showing increase from 92 restatements in 1997 to an estimated 250 in 2002).} Thus, corporate managers, facing enhanced incentives to engage in fraudulent reporting, are the key actors who most need to be deterred.

But how does one get there from here? This article will begin with the case of a securities fraud action that proceeds to trial and results in a finding of liability – and then work back to the more common case of settlements.

A. Applying Proportionate Liability to the Corporate Defendant

Assume that a jury finds a hypothetical corporate issuer and various individual defendants liable for securities fraud in the amount of $500 million. What happens next? Under Section 21D(f) of the Securities Exchange Act of 1934,\footnote{15 U.S.C. § 78u-4(f).} which establishes a rule of proportionate liability, the factfinder (judge or jury) must now apportion liability among the “covered persons” (a term that covers all the defendants in a securities class
action)143 and assign each defendant that “portion of the judgment that corresponds to the percentage of responsibility of that covered person ….”144 In other words, the factfinder must allocate the judgment among all defendants (and any non-defendants it also considers responsible) based on their relative culpability, with all the percentages so assigned adding up to 100%. This was the PSLRA’s innovation in order to reduce the coercive effect of the former system of “joint and several” liability upon secondary defendants. It was intended to protect auditors, investment bankers, and law firms – all of whom might have only marginal culpability but could end up being held jointly and severally liable for the entire judgment (which amount would clearly be imposed on them alone if the principal defendants were insolvent). Under the PSLRA, “joint and several” liability can only be imposed on a defendant if it has “knowingly committed a violation of the securities laws,”145 and this term is defined rigorously so as to preclude a merely “reckless” defendant from being subjected to “joint and several liability.”146

Presumably, in the normal case, the jury will hear evidence and then answer “special interrogatories” as to the relative culpability of each defendant.147 But what “percentage of responsibility” should apply to the corporate issuer? The PSLRA gives little guidance on this question because its real concern was protecting secondary defendants, such as the accounting firms that lobbied hard for passage of this provision.

146 Section 21D(f)(10)(A), 15 U.S.C. § 78u-4(f)(10)(A) (requiring that the defendant have “actual knowledge that, as a result of the omission, one of the material representations of the covered person is false”).
147 Section 21D(f)(3)(A) requires the jury to be instructed to “answer special interrogatories” as to the “percentage of responsibility” to be assigned to each person alleged to “have caused or contributed to the loss incurred by the plaintiff”. See 15 U.S.C. § 78u-4(f)(3)(A). Section 21D(f)(3)(C) (“Factors for Consideration”) instructs the factfinder as to the criteria to be employed in assessing culpability. These factors can only be awkwardly applied to the corporation, because almost by definition it made the statement that misinformed the market.
Arguably, the defendant corporation should not be seen as having “actual knowledge” of the omission (as Section 21D(f) requires\(^ {148} \)), because it can only have vicarious knowledge through its officers and agents. In determining the corporation’s “percentage of responsibility” under Section 21D(f), it may often also be relevant that the corporate officials who perpetrated the fraud concealed it from their superiors and the corporation’s audit committee because they were pursuing personal ends (i.e., the maximization of the current value of their stock options and other equity compensation).

Thus, it is realistic to expect that the fact-finder (judge or jury) might often assign the highest percentage of responsibility to a corporation’s chief executive officer and/or chief financial officer, with only lesser percentages being assigned to the corporation, itself, and the other secondary defendants. Once such liability is imposed, the corporation could not then indemnify these amounts because this would directly offend Globus and the other decisions restricting indemnification of securities law liabilities.\(^ {149} \) Moreover, in this rare case of a jury verdict, even the defendant’s insurance may be unavailable, because customarily it includes an “actual fraud” exclusion to the insurer’s liability.\(^ {150} \)

Alternatively, the factfinder might find that both the CEO, CFO and the corporation had “actual knowledge” of the material omissions or misstatements and so

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\(^ {149} \) See supra notes 117-118 and accompanying text.

\(^ {150} \) The issue here will be whether there has been a “final adjudication” that satisfied the “actual fraud” language of the typical exclusion, as Rule 10b-5 liability can be based simply on “recklessness,” which may arguably be a level below “actual fraud.” See Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) (defining “reckless conduct” as “highly unreasonable” and involving “an extreme departure from the standards of ordinary care”). Most D&O policies contain an exclusion for “actual fraud” or personal enrichment, but subject this exclusion to a “final adjudication” condition that obligates the insurer to fund the insured’s defense until there is a final adjudication that the officer committed fraud. See Baker & Griffith, supra note 38, at 8-9; see also Little v. MGIC Indem. Corp., 836 F.2d 789, 794 (3d cir. 1987). Because plaintiffs need to resort to the insurance, they will predictably try to avoid triggering this exclusion and will seek to characterize the defendant as “reckless” but not involved in “actual fraud.” Nonetheless, it is the court that frames this interrogatory (although it too has weak incentives to force a “final adjudication” that rendered resort to insurance unavailable).
are jointly and several liable. Here, where both these individuals and the corporation are held 100% liable, it would again seem to offend and frustrate Section 21(f)’s concept of proportionate liability if the corporation paid the entire liability without any contribution from the other defendants (even though no indemnification would be technically paid). In such a case the court would have a responsibility to assure itself that the apportionment of liability did not offend Section 21D(f)’s directions that actual liability be allocated on the basis of relative culpability. To this extent, the old rule of non-review of apportionment should yield to the PSLRA’s explicit policy.

B. Extending Proportionate Liability to the Settlement Context

In a settlement, no such apportionment of liability by the factfinder occurs, and thus it is harder to claim that a corporate payment of the entire settlement offends the PSLRA’s proportionate liability provision. But this defines the problem that needs to be addressed. Given the obvious conflict of interest when the corporation and its senior executives or directors are sued in the same action, the SEC could require that independent directors examine any proposed settlement of a securities class action and evaluate its fairness to the corporation – just as they would normally do in the standard self-dealing context. Specifically, these directors should be expected to assess the apportionment of liability among the corporation and its officers and explain in a public statement if they consider it to be fair to the corporation – and why. This is a disclosure strategy, rather than a prophylactic rule, and it seems much more clearly within the SEC’s jurisdiction than does a ban on indemnification of settlement expenses. This approach of mandating a fairness evaluation and explanation by independent directors has long been

151 Such a finding might, however, amount to a “final adjudication” that the director or officer engaged in actual fraud and so was not covered under his or her D&O policy, which typically contains an exclusion for actual fraud. See Baker & Griffith, supra note 38, at 8-9.
used by the SEC in related contexts involving other sensitive transactions.\textsuperscript{152} By analogy, the independent directors would be required to state their belief that the apportionment was fair or unfair to the shareholders and to discuss in reasonable detail the “material factors upon which the belief … is based.”\textsuperscript{153} Experience in the related contexts where the SEC has used such a technique suggests that it does have real impact – possibly because independent directors tend to be risk averse.

Today, of course, no disclosure is mandated by SEC rules upon the settlement of a securities class action, but there is no apparent reason why this context should be ignored by the SEC, particularly when disclosure of the position and analysis of independent directors is required in the case of other conflict of interest transactions. The simplest way to implement such a requirement would be for the SEC to add a new triggering event to the already lengthy list of events that require an issuer to file a Current Report on Form 8-K\textsuperscript{154}: namely, the entry into a settlement of a securities class action (either by the corporation or any of its present or former officers or directors) under which the corporation is to make any financial payment.

\textsuperscript{152} For example, in a “going private” transaction, a public corporation must comply with Rule 13e-3, 17 C.F.R. § 240.13e-3, and file Schedule 13E-3. Item 8 of that Schedule requires the issuer to evaluate the fairness of the proposed transaction and furnish the information required by Item 1014 of Regulation M-A, 17 C.F.R. § 229.1014. In turn, Item 1014 requires a statement as to why the person filing the schedule “believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders.” This disclosure must then be followed by a discussion “in reasonable detail” of the “material factors upon which the belief … is based.”

\textsuperscript{153} This disclosure would simply parallel the disclosure now required by Item 1014 of Regulation M-A. See supra note 152. That regulation goes even further and also requires an analysis of “the weight assigned to each factor.”

\textsuperscript{154} Form 8-K is the SEC-mandated form for current reports under Section 13 or 15d of the Securities Exchange Act of 1934. A host of events, including even amendments to the corporation’s bylaws, today require the filing of a Form 8-K. Procedurally, the Form 8-K should be filed before the judicial approval of such a settlement, and thus the articulation of this requirement should require its filing after an agreement in principle is reached, but before the settlement is submitted to the court. Ideally, the SEC might comment on these disclosures to the Court in an amicus curiae filing.
Of course, some replies to such a disclosure obligation are predictable. The
directors might, for example, respond that the corporation had no alternative because
corporate bylaws required indemnification of settlement costs. But this is an overbroad
statement of the law. For example, Delaware law provides that a corporation may
indemnify any person who is sued in his or her capacity as “a director, officer, employee,
or agent of the corporation … against … amounts paid in settlement in connection with
such action … if he acted in good faith and in a manner he reasonably believed to be in
or not opposed to the best interests of the corporation….”155 The Delaware statute further
provides that any such indemnification shall be made only “upon a determination that
indemnification of the present or former director, officer, employee or agent is proper in
the circumstances because he has met the applicable standard of conduct….”156; in effect,
the board must specifically determine that the party to be indemnified “acted in good
faith and in a manner he reasonably believes to be in or not opposed to the best interests
of the corporation.”

In light of this requirement that there be a specific determination as to the
propriety of the defendant officer or director’s conduct, this proposal that the SEC require
disclosure by the directors of their evaluation, along with the reason underlying their
decision, creates no conflict between federal and state law. Indeed, the two requirements
dovetail, as Delaware law seems already to require a determination that the party to be
indemnified acted “in good faith,” and the required federal disclosure would simply focus
in detail on how the board reached that judgment.

155 See Delaware General Corporation Law § 145(a). (“Indemnification of Officers, Directors, Employees
and Agents; Insurance”) (emphasis added).
156 See Delaware General Corporation Law § 145(d). This subsection d specifically cross references the
standard of conduct set forth in Section 145(a) and quoted in the text supra at note 128.
As a practical matter, however, such a disclosure requirement would likely
dissuade many independent boards from approving complete assumption by the
corporation of settlement costs where officers or directors are also sued. After all, if the
settlement were for $500 million and if plaintiffs alleged that the corporation inflated its
earnings to maximize its short-term stock price, independent directors are placed in a
ticklish position. They cannot easily claim that they paid $500 million to settle a frivolous
action or simply to avoid disruption of normal business activities. Also, the SEC is
experienced at contesting makeweight or boilerplate justifications, and it can demand
more detailed explanations. Finally, the directors risk liability themselves if they file an
incomplete or misleading Form 8-K with the SEC.157

The net result should be that independent directors would be embarrassed into
requiring greater fairness in securities class action settlements. Even if federal courts
resist examining the apportionment of liability among defendants, that apportionment
would still be altered by the understandable reluctance of independent directors to seek to
justify to the SEC the complete assumption by their corporation of all liability. Nor
should it be assumed that all federal courts will resist consideration of the apportionment
of liability. Judge Newman’s position in *Warner Communications* is convincing.158 Once
a formal corporate evaluation of the apportionment is prepared by the board, objectors to
the settlement could bring it to the attention of the court.

A predictable response to this proposal will be that it ignores the role of
insurance. Even if indemnification were restrained and the corporation itself did not pick

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157 Although private plaintiffs would be unlikely to sue because the damages would generally be modest,
the SEC could itself sue with regard to any false or misleading statement made in a document filed with it.
If the Commission sued under Section 17(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77g, it would not
need to prove scienter. See Aaron v. SEC, 446 U.S. 680 (1980).
158 See supra notes 136-139 and accompanying text.
up the entire settlement cost, those costs would still be covered by D&O insurance paid for by the corporation (and thus its shareholders indirectly). This objection has some merit, but it ignores some important contemporary facts.

First, officers and directors often face liabilities today that exceed their insurance coverage. WorldCom is an illustration of this pattern, because no corporation can ever afford to insure its officers and directors against the billions in potential liabilities that the WorldCom directors faced. Today, D&O insurance coverage depends typically on the corporation’s market capitalization. Coverage limits in 2004 ranged from $4.7 million (for corporations with a market capitalization of up to $100 million) to $122.9 million (for corporations with a market capitalization of over $5 billion). Currently, insurers will not offer insurance anywhere near the billion dollar range; reputedly, the highest coverage now being offered is $300 million. On this basis, officers at a number of companies are subject to potential exposure, particularly if their company files for bankruptcy. Second, insurance coverage has limitations on the conduct covered and can

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159 The WorldCom directors paid some $18[$25] million, or 20% of their net worth each, to settle their liability in that case. See supra note 71 and accompanying text.

160 As noted earlier, a significant number of recent settlements have exceeded the issuer’s insurance resources. See supra notes 80-84 and accompanying text. In WorldCom, the defendant directors were required to contribute 20% of their assets to the settlement fund. See supra note 71 and accompanying text.

161 See The Controller’s Report, Feb. 2005 at p. 9. For the year 2004, this publication reports, relying on a survey by Towers Perrin Tillinghast, that the coverage limits for the typical for-profit corporation were as follows:

<table>
<thead>
<tr>
<th>Average Coverage Limits by Asset Size</th>
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<tbody>
<tr>
<td>Up to $100 million: $4.7 million</td>
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<tr>
<td>$100 million - $400 million: $16.3 million</td>
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<tr>
<td>$400 million - $1 billion: $25.4 million</td>
</tr>
<tr>
<td>$1 billion - $2 billion: $34.3 million</td>
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<tr>
<td>$2 billion - $5 billion: $58.6 million</td>
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<tr>
<td>Over 5 billion: $122.9 million</td>
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Towers Perrin Tillinghast has also reported that the average for-profit U.S. corporation increased its coverage limits in 2005 to $14.3 million (up from $13.6 million in 2004). See Dave Lenkus, Directors study D&O cover limits to protect assets, Business Insurance, Jan. 30, 2006, at 25.

162 See Baker & Griffith, supra note 38, at 10 (citing interviews with corporate risk managers and underwriters).
be rescinded if fraudulent statements were made in the original application.\textsuperscript{163} Typically, when the corporation applies for D&O insurance, the insurer asks the corporation to attach its financial statements to the application, and if these financial statements are overstated, the insurer has at least a colorable basis for denying coverage to culpable insiders.\textsuperscript{164} Hence, removing the corporation as the ultimate backstop who will pay all settlement costs and expenses does have real world consequences and tends to ensure that enough liability will fall on corporate officers to have some deterrent value.

A last objection to this proposal is that it will add to the litigation risk associated with being an outside director. If so, that would be a deficiency. But it should not. Outside directors have virtually no anti-fraud liability,\textsuperscript{165} and negligence on their part is only actionable under the federal securities laws in the case of Section 11 of the Securities Act of 1933.\textsuperscript{166} Further, under the standard here proposed, little problem arises

\textsuperscript{163} In the wake of recent corporate scandals, many insurers are increasingly attempting to rescind their policies based on a claim that a fraudulent misrepresentation was made to the insurance company in the application. State law differs widely as to their ability to deny coverage in this fashion. Under New York law, an insurer can rescind based on a misrepresentation in the application without needing to show that the misrepresentation was made with an intent to deceive the insurer. See Mutual Benefit Life Ins. Co. v. JMR Elect. Corp., 848 F.2d 30, 32 (2d Cir. 1988); Nationwide Mutual Fire Ins. Co. v. Pascarella, 993 F. Supp. 134, 136 (N.D.N.Y. 1988). A number of other jurisdictions also permit coverage to be rescinded based on an innocent misrepresentation so long as it was material. See Nat’l Union Fire Ins. Co. v. Sahlen, 992 F.2d 1532, 1536 (11th Cir. 1993); First Nat’l Bank Holding Co. v. Fid. & Deposit Co. of Ma., 885 F. Supp. 1533, 1535 (N.D. Fla. 1995). In contrast, Texas law requires the misrepresentation to be made with an intent to deceive in order for coverage to be denied. See Union Bankers Ins. Co. v. Shelton, 889 S.W. 2d 278, 283 (Tex. 1994); Continental Cas. Co. v. Allen, 710 F. Supp. 1088, 1092 (N.D. Tex. 1989).

\textsuperscript{164} See Martin, supra note 129, at 24-25. For examples of rescission on this basis, see Nat’l Union Fire Ins. Co. v. Sahlen, 999 F.2d 1532 (11th Cir. 1993); Amer. Int’l Specialty Lives Ins. Co. v. Towers Fin. Corp., 1997 WL 906427 (S.D.N.Y. 1997). Innocent outside directors may remain entitled to their coverage even when the corporation makes a misrepresentation to the insurer in its application for D&O insurance, but the law is divided on this point. For example, in INA Underwriters Ins. Co. v. D.H. Forde & Co., P.C., 630 F. Supp. 76, 77 (S.D.N.Y. 1985), the entire policy was declared void, even as to individuals who had not signed the application or committed fraud. Where there is a severability clause, with the result that the D&O policy is to be construed as a separate contract between each insured and the insurer, then an innocent insured will not lose coverage because of fraud committed by another. See Wedtech Corp. v. Federal Ins. Co., 740 F. Supp. 214, 218-19 (S.D.N.Y. 1990). The bottom line here is that culpable insiders may very well lose their insurance coverage in accounting fraud cases, but outside directors are less at risk.

\textsuperscript{165} See Black, Cheffins, Klausner, supra note 64.

\textsuperscript{166} This was the basis for liability in the \textit{WorldCom} case where outside directors did pay $18 million. See text and note supra at note 71. Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, makes every
with indemnification of settlement costs in an action based simply on negligence. Under
the above quoted Delaware statute, a merely negligent director could be found to have
acted “in good faith and in a manner he believed to be in or not opposed to the best
interests of the corporation.” 167 Thus, under the standard corporate bylaws,
indemnification would be mandatory, and the board would have no difficulty explaining
its decision in a Form 8-K, as earlier proposed. Only in cases where the insiders appear to
have been actively engaged in misconduct, such as by inflating revenues or hiding
liabilities in their own interest, do the board’s obligations become more complex and
their explanation more sensitive.

What can be expected of this proposed reform? Clearly in cases where the
liability exceeds $1 billion (or even a considerably lower number), individual defendants
are not likely – even collectively – to fund more than a low percentage of the total
settlement. But that is probably enough to deter. Moreover, the contemporary mean and
median securities class action settlements are for much smaller amounts (currently
around $27 million and $5.3 million, respectively). 168 In these cases, insiders could fund
a significant proportion of the settlement.

C. Activating the Insurer

The recent advent of entity coverage has created a crisis for many D&O insurers,
as securities class actions are now settling at higher levels (at least in part because issuer
defendants have less incentive to resist) and the insurers who resist are facing a growing

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167 See supra note 155 (quoting the language of Delaware General Corporation Law Section 145(a)).
168 See supra note 80 and accompanying text.
backlog of cases.\textsuperscript{169} For every year since 1991, securities class actions filings have outpaced settlements, with the result that the D&O insurance industry faces the “specter of the ‘1,000 claims’ inventory”\textsuperscript{170}—that is, a thousand or more unresolved securities class actions. Against this backdrop, insurers have increased incentive to resist and deny coverage for fraud in the application.

But this does them little good if the corporate client will pay the same amount under its own policy. Although it is customary (and probably cheaper) for one insurance company today to cover both the individual officers and the corporation, the incentives would be quite different if different insurers covered the individual defendants and the corporation. This would create a greater likelihood of a fair allocation of the settlement costs, because the corporate insurer would now have a greater reason to resist an overly generous contribution by its client. Also, the insurer insuring the individual defendants might be more willing to seek to rescind its policies for fraud in the application in the case of the insider defendants.\textsuperscript{171} Again, the SEC probably lacks authority to order this, but could encourage it through disclosure.\textsuperscript{172}

If the corporation were required to undertake a study of the responsibility of its officers, conducted by independent counsel, to establish the fairness of the allocation between the corporation and the individual defendants, this study might well enhance the

\textsuperscript{169} See Michael W. Early, Another Glimpse into the Current State of Directors and Officers Insurance, 17 Committee on Corporate Counsel Newsletter 27 (2003). This author is the assistant general counsel of the Chicago Underwriting Group, Inc.

\textsuperscript{170} Id.

\textsuperscript{171} In the case of the culpable insiders, the insurer has a plausible case for rescinding coverage based on fraud in the application. See supra notes 163-164 and accompanying text. Where the insurer insures the corporation and all defendants, it may be reluctant to do so and lose a client. Where, however, it is only insuring the directors, it may be more willing to seek to rescind the policies covering the culpable insiders.

\textsuperscript{172} For a fuller discussion of the need and potential for greater disclosure about the terms of D&O liability insurance, see Sean Griffith, Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors’ and Officers’ Liability Insurance Policies, 154 U. Penn. L. Rev. 1147 (2006).
ability of the insurer of the corporate officers to rescind its policy for fraud in the application. Even in the case where one insurer writes all the policies, evidence developed by such a study might enable the insurer to rescind the individual officers’ policies, and a properly counseled corporation would not pick up the entire liability. Moreover, if the officers’ insurance were cancelled for fraud, plaintiffs’ attorneys have no necessary reason to accept a payment only from the defendant corporation and not pursue the officers individually. The point is that accurate information, if developed, could change the current dynamics under which a solvent corporation bears virtually the entire cost of the settlement.

D. Attorneys Fees

Reforms work best when they align the interests of the private actors with the enforcement of the desired public policy. Today, the plaintiff’s attorney is the principal enforcer of securities law liabilities, and, put bluntly, the plaintiff’s attorney is indifferent as to who pays the settlement in a securities class action. Today, the plaintiff’s attorney is compensated based on the aggregate size of the settlement, regardless of its source. But this is easily modified. Plaintiff’s attorneys could be rewarded based on the source of the settlement, not simply on its aggregate size. The more that we realize that compensation is not goal of securities litigation (and is not truly achieved in any event), the more that such a change makes sense.

Some modest movement in this direction is already discernable. When public pension funds offered higher fee awards for recoveries from individual defendants, plaintiff’s attorneys responded and obtained recoveries from individual defendants.173

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173 See Sue Reisinger, Investors Offer Bounties to Recover Funds, N.Y.L.J., Sept. 15, 2005, at 5. Both the California State Teachers’ Retirement System (or CalSTRS), the nation’s third largest public pension fund,
Courts could similarly revise their rewards. For example, the court awarding attorneys fees in a securities class action could award substantially higher fees for the portion of the recovery obtained from insiders or third parties than for the portion obtained from the corporation. To illustrate, assume that plaintiffs obtain a $100 million settlement that is paid 50% by the corporation and 50% by individuals and other third parties (both insiders, controlling shareholders, auditors, investment bankers, law firms, etc. but not outside directors). Hypothetically, the fee award on the first 50% paid by the corporation might be set at 10%, while the fee award on the other 50% could be 30% -- for an aggregate fee award of 20% (a fee award that is not in truth above the current norm). This would reflect both the social utility of recoveries from culpable insiders in generating deterrence and the fact that the 50% paid by the corporation ultimately was a cost that fell on diversified shareholders. If the plaintiff’s attorney in securities litigation is a bounty hunter, it is not too much to ask courts to set the bounties intelligently.

E. Exempting the Non-Trading Corporation as a Defendant in Rule 10b-5 Litigation

All the prior proposals in this section pale in comparison to this final recommendation: the SEC can and should exempt the non-trading corporate issuer from private liability for monetary damages under Rule 10b-5. Effectively, this would require plaintiffs’ attorneys to sue the corporate insiders and the corporation’s gatekeepers (e.g., its investment bankers, auditors, and attorneys), not the issuer, in order to obtain their recovery. At a stroke, this would eliminate entity insurance (because the corporation now

\[174\] In principle, the court would, of course, only pay such a bonus on the portion of the individual recovery that was not indemnified or insured. At least on a transitional basis, however, there is a case for paying a higher fee award on even an insured recovery from individual defendants in order to encourage the transition to a fair allocation of the recovery among the defendants.
could not be sued), and it would compel the insider defendants to apply to the corporation for indemnification when they settled (thereby activating the board’s role in monitoring indemnification requests). Today, the board seldom has to face the issue of indemnification because the corporation contributes the entire settlement and then turns to its insurer for repayment.

But does the SEC have the authority to “disimply” Rule 10b-5 – that is, to deny a private cause of action under it? This issue has been elaborately debated in the past.\textsuperscript{175} But whether these earlier advocates were right or wrong is no longer the issue. Following an earlier debate over the Commission’s authority, Congress in 1996 added Section 36 ("General Exemptive Authority") to the Securities Exchange Act of 1934,\textsuperscript{176} which authorizes the SEC to “conditionally or unconditionally exempt any person, security or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”\textsuperscript{177}

Because Rule 10b-5 is a rule under the Securities Exchange Act of 1934, the Commission’s authority to grant an exemption from it seems clear on the face of the statute, so long as the Commission can plausibly make the requisite findings. If this


article’s analysis is correct, Rule 10b-5 litigation in the secondary market “stock drop” context essentially produces pocket-shifting wealth transfers that injure shareholders and does not protect the public interest. Predictably, some will respond that exempting the corporation will create a haven for fraud. But this is a shallow response.178 Because no exemption would be given to those officers, employees or agents who act on the corporation’s behalf or who control it, the real impact of such an exemption would not be to end Rule 10b-5 litigation, but to focus it on the culpable.179 Exempting the non-trading corporation from Rule 10b-5 litigation effectively moves us at least a significant distance from a system of enterprise liability toward a system of managerial liability.

Of course, such a change would also alter the market for D&O insurance. Now threatened, executives would demand more insurance and would re-examine the corporation’s bylaws to make certain they were guaranteed broad indemnification rights. Such insurance would fund sufficiently large recoveries to continue to motivate plaintiffs’ attorneys to bring suit (even if the overall scale of the recoveries might decline). Because of the SEC’s ban on indemnification of securities law liabilities (when they result in judgments),180 executives would remain under strong pressure to settle and to seek indemnification. Outside directors would thus be required to consider carefully

178 As a statutory matter, Section 36 recognizes only one area in which the SEC cannot grant exemptions: namely, Section 15C of the Securities Exchange Act and the rules and regulations thereunder. See Section 36(b), 15 U.S.C. § 78mm(b). Section 15C addresses government securities brokers and dealers. The fact that Congress carved out this lone area undercuts any claim that the SEC was implicitly denied authority to curtail its antifraud rules.

179 Managers would remain indemnified and insured, and to an extent they would be shielded by Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994), which found Rule 10b-5 not to reach aiding and abetting liability. See supra note 58 and accompanying text. But corporate officers are liable for statements that they make to the market, and both the chief executive and the chief financial officer today must certify the corporation’s financial results under Sarbanes-Oxley, which will constitute a statement that triggers Rule 10b-5 liability. See Section 302 of Sarbanes-Oxley. Also, in Rule 10b-5 litigation, plaintiffs almost automatically name the principal corporate executives as defendants. See supra note 52 and accompanying text.

180 See supra notes 117 to 118.
and dispassionately where these defendants acted “in good faith” and in a manner
“reasonably believed to be in or not opposed to the best interests of the corporation.”
Alternatively, insider defendants might forego indemnification and simply rely on their
insurance policies, but now they would face a heightened danger that the insurer would
seek to cancel the policy for fraud in the application. Although plaintiffs’ attorneys will
predictably collude with defendants to resist any attempt to terminate the insurance
policy, these disputes are still likely to be settled on a basis that placed some liability on
the individual defendant. Minimum deductibles on D&O insurance policies might also
come into greater use. At this point, real deterrence would begin to emerge.

Finally, the limited exemption from Rule 10b-5 here contemplated would not
apply when the corporation sold its shares during the class period. In such cases, the
corporation is benefiting from the fraud and should sensibly be made a cost bearer. This
position is consistent with the SEC’s own position on financial penalties.

Some will respond that executives will not bear greater risk without demanding
higher compensation. But the contemporary evidence is that executives already receive
high rents in the form of executive compensation, and the danger that individuals
would be deterred from becoming chief executive seems laughably remote.

Other variations on this proposal are possible, but they carry additional
difficulties. The key idea is that by removing the corporate defendant from most Rule

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181 This is the language of Delaware General Corporation Law Section 145(a). See supra at note 155.
182 The Commission’s new policy on financial penalties focuses on “whether the issuer’s violation has
provided an improper benefit to shareholders.” See supra at note 8 (discussing “Statement of the Securities
and Exchange Commission Concerning Financial Penalties”).
183 For the fullest expression of this view, see Lucian Bebchuk and Jesse Fried, Pay Without Performance:
The Unfulfilled Promise of Executive Compensation (2004). Their powerful critique of the excesses in
executive compensation was written even before the current stock option backdating scandals.
184 Another variant is that any private action against the corporate issuer would be precluded under Section
36 if the SEC brought and settled an action under Rule 10b-5 and deposited the penalties that it collected in
10b-5 cases, we reduce the extent to which it serves as the residual cost bearer and thereby passes the costs of the litigation onto the shareholders.

**Conclusion**

To the extent that contemporary securities litigation imposes its costs almost exclusively on the corporation and its insurers, this system benefits three sets of actors: corporate insiders, plaintiff’s attorneys, and insurance companies – but not shareholders. Viewed in this way, the plaintiff’s attorney is less a champion of shareholders and more a participant in a process by which the parties shift liabilities created by corporate managers onto shareholders through the medium of costly insurance paid for by shareholders. Because the repeat players – managers, attorneys and insurers – all profit from this process, the outcome is usually the same: settlement.

Only by changing the incentives can society encourage private enforcers to move beyond this simple game of collecting the shareholders’ insurance and instead pursue more aggressively the truly culpable. Precisely for this reason, attorney’s fees should be higher with regard to that percentage of the settlement that comes from officers and third parties.

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185 This same point was made over a decade ago by Kent Syverud. See Syverud, supra note 73. Everyone recognizes that a settlement in which the corporation agrees exclusively to non-pecuniary relief but the plaintiff’s attorneys receive a high fee award (paid by the corporation) looks suspiciously like collusion. But a settlement in which the corporation pays a significant financial recovery, while the individual defendants contribute little or nothing, can also be fairly described as collusive in a structural sense, even if the parties litigated intensely, because the real costs are being borne by shareholders who have no effective voice in the settlement process. At bottom, collusion in multi-party litigation involves pushing the costs of the action onto an absent party or at least a party facing high agency costs in the control of its attorney.

186 Although this description will be resented by plaintiff’s attorneys, a distinctive feature of securities litigation is that the corporation has characteristically insured itself against liabilities imposed on it because of the conduct of its own officers. Corporations do not insure against the risk of antitrust or environmental liabilities or virtually any other class of legal liability (with the possible exception of employment liability). In fairness, when plaintiffs attorney pursue third parties, other than the corporation (as they did in Enron and WorldCom), they are serving as the shareholders’ champion.
parties in order to incentivize the plaintiff’s bar to pursue personal liability against such persons. But such a reform would also make securities litigation far more adversarial than it is today and will therefore predictably be resisted by all the players. Still, reforms could be adopted tomorrow by the SEC under its general exemptive authority that would end the current static equilibrium. As a first step, the SEC must recognize that the settlement of a securities class action presents an acute conflict of interest, one requiring independent directors to review it as carefully as they would a management buyout proposal.

For the SEC to go further and curtail Rule 10b-5 litigation, it must first acknowledge an inescapable fact: the securities class action is unlikely to afford significant compensation to shareholders. That realization should lead not to the abolition of the class action (as some critics have proposed), but to its reconfiguration into a mechanism for deterrence. Deterrence through private enforcement is possible, and this Essay has proposed a first step in this direction – perhaps only a modest step, but one that can be taken without legislation or any major reversal of settled precedents.

To be sure, more could be done. Congress, if motivated, could restrict indemnification in securities class actions; insurance practices might also be changed to impose minimum deductibles for corporate insiders (but not for outside directors). But, such changes are unlikely in the short run. Rather than accept the status quo as inevitable, this Essay has proposed some marginal, but feasible, reforms. If its proposed means seem modest, the end that they are attempting to achieve is more significant: real deterrence, not illusory, pocket-shifting wealth transfers.