ARTICLES

Rethinking Damages in Securities Class Actions

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In this article, Professor Alexander proposes alternative reforms to securities litigation. Professor Alexander makes the insightful observation that many of the current problems in securities class action litigation result from the size and uncertainty of the potential class-wide compensatory damages, and that these damages are misaligned with the goals of securities litigation. The primary goal of securities litigation is to protect the public interest in the integrity of the capital markets. To this end, Professor Alexander argues that current damage awards are both inefficient because the uncertainty in estimating potential damages awards impedes efficient settlement and ineffective because the size of the damage award is not correlated to the true social cost of the violation. Professor Alexander proposes two alternative reforms to better align damage awards with securities litigation goals. First, she proposes shifting to a regime of civil penalties for superior fraud deterrence, enforced through a bounty system for successful private plaintiffs. Alternatively, if reforms to class-wide damages are not accepted, she proposes procedural reforms to improve monitoring of the class counsel's performance and to better align class counsel's incentives with the interests of the class.

Securities litigation is no longer like the weather. Everybody still complains about it, but now many people are also eager to do something about it—not only law professors, who are always wanting to change things, but also judges[1] and those with real power to reform securities litigation, Members of Congress. Securities litigation reform was an important element of the Republican Contract with America, and in 1995, legislation comprehensively over-

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1. *See, e.g.*, *In re* California Micro Devices Sec. Litig., No C-94-2817-VRW, 1995 U.S. Dist. LEXIS 11587, at *18 (N.D. Cal. Aug. 8, 1995) (requiring plaintiffs to poll class members as to proposed settlement and demonstrate that the settlement "enjoys affirmative support, as opposed to silent toleration, of a significant portion of the prospective class"); *In re* Wells Fargo Sec. Litig., 157 F.R.D. 467 (N.D. Cal. 1994) (establishing auction procedure for determining lead counsel for the class); *In re* Oracle Sec. Litig., 131 F.R.D. 688 (N.D. Cal. 1990) (same).

hauling the rules governing securities litigation was enacted over a presidential veto.[2]

In view of the sweeping changes that won approval in one or both houses, it is remarkable that none of the proposed or enacted reforms addressed the measure of damages. Indeed, neither the popular nor the academic debate over securities litigation reform has paid much attention to damages as a possible contributing factor to the problems that seem so widely perceived.[3] Yet the issue of damages is one of the most significant problem areas of securities litigation from both a practical and a theoretical standpoint.

There is much to be gained from rethinking class-based compensatory damages as a sanction for violations of the securities laws involving publicly traded securities. Securities class action litigation today has little in common with suits over the common law torts of fraud and misrepresentation from which the compensatory remedy was derived. Rather, it is a primary enforcement mechanism for a regulatory regime whose purpose is to protect the public interest in the integrity of the capital markets. Rethinking damages in securities class actions means considering what sanction would be optimal for achieving the regulatory purposes. From this perspective, class-based compensatory damages are a relatively ineffective and inefficient sanction.

The potential damages in securities class actions involving publicly traded securities are very large, commonly amounting to tens and even hundreds of millions of dollars. It is difficult for the parties to estimate the size of the potential jury award with any degree of confidence, because the amount of damages is a complex and intractable issue at trial. Expert testimony is required to calculate damages, and that testimony is contradictory even when the experts purport to be using the same methodology.[4] The size and uncertainty of potential awards impedes efficient settlement[5] by making it difficult for the parties to estimate accurately the size of the expected verdict if liability is found, by decreasing the likelihood that the parties' estimated value calculations will converge, by increasing the effects of risk aversion, and by making it

2. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

3. A notable exception is Easterbrook and Fischel's important article on optimal damages, which argued powerfully against the rationale for class-based compensatory damages but concluded, somewhat surprisingly, that they were probably sufficiently optimal to meet deterrent goals. Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985). An important recent contribution is Donald C. Langevoort, Capping Damages for Open-Market Securities Frauds (1995) (working paper, on file with the *Stanford Law Review*), which criticizes the compensatory damages regime on many of the grounds stated in this article, though proposing a different solution. In the 1970s, the American Law Institute proposed to limit damages in certain cases, *see* FED. SEC. CODE § 1708(c) (Am. Law Inst. 1978), but the proposal never achieved the necessary political support for enactment. For an extensive review of the ALI proposal, and a proposal for an alternative compensatory damages approach based on it, see Langevoort, *supra*.

4. *See* Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421 (1994) [hereinafter Alexander, *Value*]; Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883 (1990); Jon Koslow, Note, *Estimating Aggregate Damages in Class-Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 FORDHAM L. REV. 811 (1991); Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7 (1994).

5. Settlements are efficient, in this sense, if they approximate the rational present expected value of an adjudicated resolution and do not include excessive transactions costs.

more likely that a settlement will be based on factors other than the present expected value of a trial. If outcomes do not reflect the expected value of trial, the efficacy of class action litigation as a primary means of enforcing the securities laws is drawn into question.[6]

The practical difficulty of measuring damages is only one of the problems under current law. From an analytical perspective, class-based compensatory damages are not a well-designed remedy for securities violations. As a means of delivering compensation to investors, securities class actions do a rather poor job even on their own terms. And as a deterrent, class-based compensatory damages in the securities context are analytically incoherent. Classical economic analysis demonstrates that compensatory damages can in some circumstances be an efficient deterrent, but this model does not fit the open-market securities context. The legal measure of damages is not commensurate with (or even related to) the true social costs of the violation; the defendant does not internalize the benefits of the activity; and there is too much uncertainty associated with the process of calculating damages for a compensatory damages rule to achieve optimum deterrence.

In this article, I argue that a regulatory sanction—in effect, a schedule of civil penalties enforceable by private litigation—would provide superior deterrence at lower cost for claims involving publicly traded securities. A pure regulatory approach, however, has certain practical and doctrinal difficulties. I therefore propose—though not without reservations—a regime of regulatory sanctions for violations involving publicly traded securities that would be enforced through suits by the SEC or private plaintiffs. Successful private plaintiffs would receive a statutory bounty roughly equivalent to the present measure of compensatory damages plus attorneys' fees.

Should such an approach prove analytically unacceptable or politically impracticable, I also propose an alternative, exclusively procedural reform within the existing context of class-based compensatory damages. This alternative proposal would require large investors to opt in to the class in order to participate in the class recovery. Those who opt in could be required to participate in managing the litigation. Settlements and judgments would also be required to be stated in per-share amounts rather than aggregate sums, and the procedures for awarding attorneys' fees to the class lawyers would be substantially reformed. These reforms would address many of the problems created by class-based compensatory damages, as well as problems of perverse incentives that characterize securities class actions, without requiring radical changes in the substantive law.

Part I of this article is a brief discussion of the law of damages in class actions brought under Rule 10b-5, and the methodology of calculating damages at trial, pointing out some of the theoretical and practical difficulties in calculating damages. Part II explains the unsatisfactory nature of class-based com-

6. For a fuller discussion of this point, see Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991) [hereinafter Alexander, *Merits*].

pensatory damages with respect to the goal of deterrence, and Part III addresses the goal of compensation. Part IV argues that a regulatory sanction, in the nature of a fine payable to the government but enforceable through private litigation, is superior to class-based compensatory damages as a sanction for securities violations involving publicly traded stock. After exploring the practical and constitutional obstacles to replacing compensatory damages with a regulatory sanction, this Part concludes that a hybrid regime, as described above, would be the most practical method of achieving the goals of the securities laws. Finally, Part V proposes an alternative, exclusively procedural reform within the existing compensatory damages regime.

My inquiry in this article focuses exclusively on damages. It takes as given the present state of the substantive law, the desirability of enforcing Rule 10b-5 against nontrading defendants, the application of the Rule to omissions as well as misrepresentations, and the need for a private litigation remedy as a supplement to SEC enforcement. All of these assumptions are debatable on their own terms, of course, but it is not necessary to debate them in order to consider whether compensatory class-based damages hinder rather than advance the goals of the securities laws. The analysis, moreover, is limited to class action suits, publicly traded securities, and nontrading defendants. Although full class-based compensatory damages are probably inappropriate against trading defendants in many situations, the analysis would have to be modified to apply to such cases. More significantly, the problems of securities class actions, and particularly the problems associated with the measure of damages, do not arise in individual (nonclass) suits; I do not advocate changing the law with respect to these more traditional suits.

I. THE MEASURE OF DAMAGES IN RULE 10B-5 CLASS ACTIONS

In cases brought under Rule 10b-5,[7] the generally accepted rule is that damages are calculated by the out-of-pocket method used in fraud cases. Purchasers are entitled to recover the difference between the price paid for the shares and the "true value" of the shares at the time of purchase.[8] The "true value" or

7. 17 C.F.R. § 240.10b-5 (1995). The discussion in this article is limited to Rule 10b-5 actions involving secondary market transactions. Many securities class actions also include claims under sections 11 and 12 of the 1933 Act. The measure of damages under section 11 is similar to that in Rule 10b-5 cases: plaintiffs can recover the difference between the price paid (up to the original offering price) and the value (or price) when the suit was filed, minus any amount that the defendants prove was not attributable to the fraud. 15 U.S.C. § 77k(e) (1995). Section 12 permits rescission or rescissory damages. 15 U.S.C. § 77l (1995). However, unlike section 11 or Rule 10b-5 cases, section 12 does not require plaintiffs to show that the misrepresentations or omissions caused the economic harm. *See, e.g.*, Casella v. Webb, 883 F.2d 805 (9th Cir. 1989); Rousseff v. E.F. Hutton Co., 867 F.2d 1281 (11th Cir. 1989); *see also* LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 887-92 (1988) (stating that a plaintiff "does not have to prove 'reliance' on the misstatement or omission"). The significant distinction with respect to the analysis in this article is not between claims under the 1933 Act and the 1934 Act, but between cases in which the defendants were in privity with the plaintiffs. *See* text accompanying notes 85-88 *infra*.

8. The securities laws require the disclosure of material information, whether good news or bad. Although some cases have involved the nondisclosure of good news, *see* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), most litigated cases are brought by purchasers who allege that material adverse information was not disclosed. For the sake of

"intrinsic value" of the securities is taken to mean the price at which they would have traded in the absence of the fraud—i.e., if the true information had been disclosed.

In individual (nonclass) actions, the calculation of damages is relatively straightforward. The number of shares and the date of the transaction are known with certainty, and the amount of the loss attributable to the violation, while not free from doubt, does not pose unusual problems of proof.

The problems of determining damages in class actions are different not just in degree, but in kind. The class damages are supposed to consist of the sum of the individual damages of each member of the class. Calculating the total class damages is a two-step process. The first step is to determine the "per-share damages," the amount of the actual market price attributable to the nondisclosure on each day of the class period. The second step is to determine the aggregate damages of the class. To determine per-share damages, an expert economic witness constructs a "value line" which represents the "true value" of the stock—what purchasers would have been willing to pay if they had known the undisclosed information—on each day of the class period. The damages sustained by any particular member of the class can then, in theory, be determined by comparing the price actually paid with the value line for the date of the transaction.

The value line is a hypothetical construct. The most common method of estimating per-share damages is to start with the share price after disclosure of the relevant information, and then, through an event study,[9] to isolate the effects of the withheld information from other factors, unrelated to the litigation, that may have affected the stock price between the time of the purchase and the time of the disclosure. Determining the value line is the least problematic aspect of the class action damages calculation, but it is subject to serious difficulties. The event study methodology depends on various debatable factual assumptions.[10] As a result, the value line calculations of the experts for the two sides can differ greatly, even when they are using the same methodology.[11] Moreover, even at its best the event study methodology can only calculate the

clarity, this discussion assumes that the nondisclosures involve bad news and that the class is composed of purchasers and not sellers of the shares.

9. Event studies begin with the change in the share price on the day of disclosure. Using regression analysis, the study eliminates events that are not firm specific (for example, an across the board fall in market prices) and isolates the extent to which the price change can be attributed to the disclosure. Working backwards, the study then establishes a hypothetical price for each day from the date of actual disclosure to the date that the information should have been disclosed. RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 185-228 (2d ed. 1995); Cornell & Morgan, *supra* note 4, at 899-900; Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 17-19 (1982).

10. *See* Cornell & Morgan, *supra* note 4, at 894-97; *see also* Alexander, *Value*, *supra* note 4, at 1454-58.

11. *See* Alexander, *Value*, *supra* note 4, at 1456-57 (discussing a trial in which the plaintiffs' expert testified that per-share damages were $3.25, with aggregate class damages of approximately $120 million, while the defendants' expert testified that, assuming liability, per-share damages were zero).

price effect of the disclosure, which is not necessarily the same as the price effect of the information that was withheld.[12]

From the value line, one can determine each class member's damages. A member of the class who bought shares during the class period and held them until the close of the class period (typically the date when the bad news was finally disclosed) suffered damages of the difference between the price paid and the value line, multiplied by the number of shares purchased. If a plaintiff resold the shares during the class period, however, both the purchase price and the selling price were inflated by the nondisclosure. The windfall the plaintiff received on the sale must therefore be offset against the loss incurred on the purchase. If the value of the undisclosed information remained constant during the class period, these amounts would cancel each other out, and those who bought and sold during the class period ("in-and-out traders") would have no damages. If the value of the information fluctuated during the class period, in-and-out investors' damages would depend on the dates of their transactions.

Related to this issue is the question of the number of shares in the class. Because some shares are bought and sold, often repeatedly, within the class period, the number of shares in the class is not simply the sum of the daily volume of trading during the class period. Indeed, the total daily trading volume may exceed the total number of shares outstanding. The methodology for calculating aggregate class damages must therefore include a procedure to account for in-and-out traders and to net out their windfalls against their losses.[13] This step, however, introduces a fatal amount of uncertainty. The parties cannot reconstruct a share-by-share trading history of the shares traded during the class period, because most shares are held by brokers in street name. Individual buyers are not in fact matched to individual sellers, and individualized records of such transactions are not kept. Therefore, the parties cannot determine directly either the number of shares in the class or the precise damages attributable to each share in the class. Adjusting for in-and-out traders requires the use of a statistical model which estimates how many of the shares that traded on a given day had traded before during the class period, and on what days. The results of such models depend critically on empirical assumptions about trading patterns. Those assumptions, in turn, are subject to considerable doubt.[14] It is possible that the most widely used model overstates actual aggre-

12. For example, the information disclosed in the announcement may differ in important ways from the information that was improperly withheld. Cornell & Morgan, *supra* note 4, at 889-94. The change in the stock price on disclosure may incorporate other components, such as the anticipated litigation costs to the company and the extinguishment of subsequent purchasers' right to sue over the nondisclosure. *See* Alexander, *Value, supra* note 4, at 1435-37, 1440-48. It is also possible that the market may overreact initially to unexpected disclosures of bad news, so that the calculation of per-share damages is skewed upward. *See* Lev & de Villiers, *supra* note 4, at 10, 13-16.

13. For a description of such a statistical model, see Koslow, *supra* note 4, at 834-40; *see also* Alexander, *Value, supra* note 4, at 1458-62.

14. The model most often used assumes that all shares are equally likely to trade. In fact, however, shares that have already traded are more likely to trade again, perhaps as much as four or five times more likely than those that have not been traded. *See* Alexander, *Value, supra* note 4, at 1461; Koslow, *supra* note 4, at 831-34; *see also* Daniel R. Fischel, *The Use of Economics in Securities Fraud Cases, in* 2 SECURITIES LITIGATION: PROSECUTION AND DEFENSE STRATEGIES 455, 468 (PLI Corp. Law

gate class damages by 100 percent or more, even in a relatively short class period.[15]

Thus, while the doctrinal statement of the measure of damages is relatively straightforward, the practical and methodological difficulties of calculating aggregate class damages make the damages inquiry in class actions complex and the ultimate outcome at trial uncertain. The development of more sophisticated models, based on improved information about trading patterns and more detailed consideration of events that may have affected share prices, may remove some of this uncertainty. Considerable uncertainty will remain, however, even in the best of circumstances. Moreover, one cannot be confident that all testifying experts would adopt improved methodologies, so lay factfinders would still have to choose between competing experts. Finally, unless some way is found to encourage a significant number of cases to be adjudicated on the damages issue, lawyers will be unable to make confident predictions of how the trier of fact will resolve the issue.

II. Rethinking the Remedy: The Goal of Deterrence

Economic analysis of tort law has established that compensatory damages can, in certain circumstances, provide effective deterrence by forcing defendants to internalize the costs as well as the benefits of their actions, thus providing incentives to take the appropriate amount of care.[16] This approach in effect uses private market incentives to define as well as to enforce the appropriate standard of behavior. By setting a price for a particular level of conduct equal to the social cost of that conduct and permitting rational, wealth-maximizing potential violators to determine the price they are willing to pay to engage in the conduct, the system theoretically results in a socially optimal level of care.[17]

Such a system will not achieve optimal deterrence, however, unless violators internalize the correct level of costs. For this to happen, violators must be able to predict the amount of a potential judgment against them for a particular level of conduct, and that judgment must be an accurate measure of the social harm caused by the conduct. Neither of these conditions is met under the present system.

& Practice Course Handbook Series No. 492, 1985) (discussing other factors which may influence the amount of inflation of share prices due to fraud).

15. *See* Alexander, *Value*, *supra* note 4, at 1460-62; Koslow, *supra* note 4, at 831-34.

16. *See, e.g.*, Steven Shavell, Economic Analysis of Accident Law 5-31, 127-50 (1987); Robert Cooter, *Prices and Sanctions*, 84 Colum. L. Rev. 1523 (1984).

17. There is, of course, a considerable literature exploring how private tort litigation may not lead to an optimal level of deterrence because of litigation costs and the difference between private benefits and social benefits. *See, e.g.*, Susan Rose-Ackerman & Mark Geistfeld, *The Divergence Between Social and Private Incentives to Sue: A Comment on Shavell, Menell, and Kaplow*, 16 J. Legal Stud. 483 (1987); Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. Legal Stud. 333 (1982).

A. *Uncertainty About the Sanction*

To the extent that potential violators encounter uncertainty, the costs of their conduct will be more difficult to predict.[18] John Calfee and Richard Craswell have identified four common forms of uncertainty in the legal context: uncertainty about what conduct meets the legal standard; uncertainty about whether, assuming defendants have met that legal standard, they will be able to convince the judge or jury; uncertainty about whether an individual who does violate the legal standard will be sued; and uncertainty about the amount of damages that the defendant will have to pay if found liable.[19] All of these sources of uncertainty are present in securities class action litigation.

There is some uncertainty about the content of the legal standard. For example, a corporation will have difficulty weighing the costs and benefits of failing to disclose information if it is unsure about whether a court would consider that information "material." It is not easy to state a clear standard whose factual application can be readily understood, particularly when applied to omissions. Because most securities class actions do not go to trial,[20] reported cases tend to concern motions to dismiss or for summary judgment, where facts are assumed or undisputed and the standard of review is weighted heavily toward the plaintiff. Additionally, there are few unreported but adjudicated cases to form the basis of legal lore.[21] Thus, there is little opportunity to judge how courts would apply the articulated legal standards to a rich factual context in which the defendant's version of disputed facts is permitted to be taken into account.[22] In recent years, however, district courts have shown a greater readiness to grant summary judgment on issues such as materiality and scienter which formerly were generally viewed as inappropriate for pretrial adjudication.[23] Consequently, this potential source of uncertainty may be decreasing in importance.

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18. *See* John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965 (1984).

19. *Id.* at 968-69.

20. *See* FREDERICK C. DUNBAR, VINITA M. JUNEJA & DENISE N. MARTIN, SHAREHOLDER LITIGATION: DETERRENT VALUE, MERITS AND LITIGANTS' OPTIONS 33 & tbl. 1 (Nat'l Economic Research Assocs., Working Paper No. BLE-95-07-a, 1995) (finding that less than 3% of securities class actions filed from 1991 to 1994 were resolved by judgment, including default judgments); Alexander, *Value*, *supra* note 4, at 1422 n.2 and authorities cited therein.

21. Cases that are tried to a jury verdict but that do not generate a published judicial opinion can add significantly to lawyers' understanding of the standard of liability, as well as other relevant legal issues, such as the appropriate model for proving damages. These results are available to practicing lawyers even though they are not in the official reporters. Significant verdicts and summaries of the evidence are widely, though not systematically, reported in legal journals and specialized publications. In fields such as securities law where there is a small and highly specialized bar on both plaintiffs' and defendants' sides, considerable information is shared through word of mouth.

22. In some cases, different courts have adopted conflicting standards. *Compare In re* Wells Fargo Sec. Litig., 12 F.3d 922, 931 (9th Cir. 1993), *cert. denied*, 115 S. Ct. 295 (1994) (stating that allegations of motive and opportunity in plaintiffs' complaint were "sufficient to establish a basis for inferring [defendant's] fraudulent intent") *with* Shields v. Citytrust Bancorp, 25 F.3d 1124, 1129 (2d Cir. 1994) (finding that "coupl[ing] a factual statement with a conclusory allegation of fraudulent intent" does not establish that defendants acted with scienter).

23. *See, e.g.*, Kaplan v. Rose, 49 F.3d 1363 (9th Cir. 1994) (affirming in part a grant of summary judgment on the issue of scienter in a 10-b action), *cert. denied*, 116 S. Ct. 58 (1995); *In re* Worlds of

There is also significant uncertainty over whether one who has met the legal standard will be sued, and if so, whether the factfinder will incorrectly find liability. Academic studies seeking to identify variables that are statistically significant predictors of whether companies whose stock value declines are sued suggest that complex relationships of factors are associated with the incidence of lawsuits.[24] There is evidence suggesting that corporate managers overestimate the probability of being sued,[25] and that they believe that juries will not decide rationally. They tend, therefore, to believe that the probability of being found liable is both random to a significant degree and larger than the legal standard would dictate. These beliefs, however erroneous, may lead to overdeterrence.[26]

From another perspective, if expected trial outcomes are not the primary factor determining settlement behavior in securities class actions, and if parties are self-aware on this point, uncertainty over the legal standard and the likelihood that the fact-finder will "get it right" may not be very important in influencing potential defendants' behavior. In that event, potential wrongdoers would not price their behavior as the tort model posits, so a compensatory damages remedy would not assure a socially optimal level of precaution.

As discussed in Part I, the most significant source of uncertainty in securities class actions is the inability to predict the amount of the judgment if the

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Wonder Sec. Litig., 35 F.3d 1407 (9th Cir. 1994) (affirming a grant of summary judgment on the grounds that a prospectus was not materially misleading, and that the plaintiffs did not establish the requisite scienter for a 10(b) claim), *cert. denied*, 116 S. Ct. 277, *and cert. denied*, 116 S. Ct. 185 (1995); *In re* Apple Computer Sec. Litig., 886 F.2d 1109, 1114-19 (9th Cir. 1989) (affirming in part summary judgment on materiality, falsity, and scienter grounds), *cert. denied*, 496 U.S. 943 (1990); Zaltzman v. Clark, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,603 (N.D. Cal. Mar. 23, 1992) (dismissing complaint for lack of alleged basis to infer scienter); *see also* Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 HARV. L. REV. 438, 445-46 (1994) (providing data on dismissal of securities cases).

24. *See, e.g.*, Jennifer Francis, Donna Philbrick & Katherine Schipper, Determinants and Outcomes in Class Action Securities Litigation (September 1993) (unpublished manuscript, on file with author) [hereinafter Francis et al., Determinants and Outcomes]; Jennifer Francis, Donna Philbrick & Katherine Schipper, Shareholder Litigation Based on Earnings-Related Announcements (March 1993) (unpublished manuscript, on file with author) [hereinafter Francis et al., Shareholder Litigation].

25. *See, e.g.*, *Common Sense Legal Reform Act, 1995: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Commerce*, 104th Cong., 1st Sess. 222, 223 (1995) [hereinafter *1995 Hearings*] (statement of Richard C. Breeden, partner, Coopers & Lybrand) (claiming that "canned" class action complaints are often filed within a few hours of a stock price falling significantly); *id.* at 233-34 (statement of Saul S. Cohen, Rosenman & Colin) (asserting that plaintiffs' firms merely observe large drops in the price of a particular stock and file a suit without investigating); *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs*, 103d Cong., 1st Sess. (1993) (statement of Edward R. McCracken, CEO, Silicon Graphics, Inc.) (criticizing "the current practice of filing off-the-shelf legal complaints when a company announces a downturn in performance" and stating, "[u]nder today's system, companies can be exposed to potential litigation whenever their stock price falls by more than a few percent, even if there was absolutely no violation of securities laws or fiduciary responsibility"). *But see* John C. Coffee, Jr., *Securities Class Actions: Myth, Reality and Reform*, N.Y. L.J., July 28, 1994, at 5, 5 (arguing against the "myth" that there has been "an epidemic of securities litigation").

26. One could also argue that if defendants actually believe the chances of liability to be essentially random, underdeterrence might result, as defendants might conclude that there is no point in obeying the law.

violator is found liable.[27] Currently available methodologies for measuring damages incorporate losses not properly recoverable as damages and seriously overstate the number of shares in the class. The damages calculations of experts who are nominally using the same methodology vary greatly, and the small number of jury verdicts makes it difficult to predict how juries will resolve such competing expert testimony. In these conditions, parties cannot estimate damages with any degree of confidence. This uncertainty, in turn, may contribute to the willingness of parties to incur amazingly high litigation costs, even in cases that are settled.[28]

B. *The Social Costs of the Violation*

Unquestionably, the nondisclosure of material adverse information that inflates the price of a stock harms the investor who purchases the stock. Unlike the paradigm of common law fraud, however, in securities class actions the aggregate amount by which class members overpaid does not represent the true social cost of the violation.[29] The class members' transactions take place in an open market. For every buyer who pays too much, and thereby acquires a cause of action to recover the excess, there is a seller—just as innocent of the fraud—who reaps a windfall in an equal amount.[30] We make no effort to recover these windfalls and restore them to the purchasers. Moreover, in calculating "compensatory" damages we do not apply traditional remedies doctrines, such as the duty to mitigate, and we do not restrict class plaintiffs to their actual losses, but permit plaintiffs who continued to hold the stock to recover their unrealized losses at the end of the class period even if the price later rose.[31] Thus, when securities violations occur, wealth is redistributed among investors but the net effect is a transfer from one group of investors to another. The net social cost, *as measured solely by trading gains and losses,* arguably is zero.[32]

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27. *See* Calfee & Craswell, *supra* note 18, at 969.

28. *See* Frederick C. Dunbar & Vinita M. Juneja, Recent Trends II: What Explains Settlements in Shareholder Class Actions? tbl. 4 (Nat'l Economic Research Assocs., Inc. 1993) (attorneys' fees averaged 31.32% of settlements in a sample of 135 cases, from July 1991 through June 1993); Frederick C. Dunbar, Todd S. Foster, Vinita M. Juneja & Denise N. Martin, Recent Trends III: What Explains Settlements in Shareholder Class Actions? ii (Nat'l Economic Research Assocs., Inc. 1995) [hereinafter Dunbar et al., Recent Trends III] (Although average settlements fell between 1993 and 1994, plaintiffs' attorneys' fees remained constant, averaging one-third of the settlement awards. Plaintiffs' attorneys' fees averaged $1.96 million in 1993 and $2.03 million in 1994.); *see also* Alexander, *Merits, supra* note 6, at 539, tbl. 6, 573, tbl. 8 (plaintiffs requested an average of $3.2 million and were awarded an average of $2.5 million in fees and expenses); Alexander, *Value, supra* note 4, at 1435 n.41 (plaintiffs' lawyers were awarded $9 million of the $16 million settlement in *Apple*). Assuming conservatively that defendants' legal costs equal those of the plaintiffs, the administrative costs of securities class litigation may exceed the amounts delivered to the investors.

29. *See* Easterbrook & Fischel, *supra* note 3; *see also* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. Ill. L. Rev. 691 (1993); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 Va. L. Rev. 623 (1992); Langevoort, *supra* note 3.

30. This analysis assumes that the defendants are not selling in the market.

31. *See* Lev & de Villiers, *supra* note 4, at 35 (reporting that prices characteristically rebound somewhat after a disclosure-related drop because the market initially overreacts to the disclosure).

32. *See* Easterbrook & Fischel, *supra* note 3, at 635; Langevoort, *supra* note 3, at 13-14.

Of course, securities violations do impose social costs. Fraud and misrepresentation in capital markets threaten investors' security, impair the ability of business to raise capital, raise the cost of capital, and undermine the integrity and well-being of the economy.[33] These harms, however, are systemic. They are not measured by counting up the aggregate market losses of all buyers during a particular time frame.

If this is true, perhaps the way to achieve optimal deterrence is to make the measure of damages the net cost of these systemic social harms. But this approach is impractical, if not impossible. It would be hard to specify the systemic harms a particular securities violation caused, or to measure them if they could be specified. And even if we could measure accurately the net systemic social costs of the violation, we could not identify particular plaintiffs who were harmed or measure their share of the net social cost. In short, attempting to define damages as the net systemic social costs of the violation would render the inquiry even more uncertain, speculative and subject to abuse than under current law.

Since we cannot accurately measure the true net social costs of the violation, it follows that we cannot compare that number with the class-wide compensatory damages recoverable under present law. It seems likely that the true social costs of any particular violation are significantly less than the tens or hundreds of millions of dollars represented by potential class-based damages.[34] Thus, the measure of damages under current law appears significantly higher than that needed to achieve optimal deterrence.[35] This intuition is reinforced by the fact that actual settlements in securities class actions average only about nine percent of market losses.[36]

The fact that damages under the securities laws do not measure the true social costs of the violation is not the only problem with transplanting the tort model of deterrence to the securities context. That model is based on requiring the violator to internalize both the costs and the benefits of the violation. The defendants in securities class actions, however, do not receive the benefit of

33. *See, e.g.*, DUNBAR ET AL., *supra* note 20, at 11-12 (arguing that indirect costs of securities fraud include overinvestment in safe securities and underinvestment in risky securities that are free of fraud, increased information costs to investors, and overinvestment in public offerings of safe securities, resulting in social costs of "the reduction in the present value of projects that would be funded with the risky securities minus the present value of projects that will be funded with the safe securities").

34. *See* Easterbrook & Fischel, *supra* note 3, at 621-24, 634; Langevoort, *supra* note 3, at 14-15. *But see* DUNBAR ET AL., *supra* note 20, at 12 (asserting that "[t]here is no reason to believe that [systemic social costs are] a small number relative to total shareholder litigation damages in aftermarket cases").

35. The effective cost to defendants is even higher than the potential damage award, for it includes litigation costs, which are very high in securities class suits. By raising the amount defendants have to pay above the plaintiffs' losses, high litigation costs decrease the accuracy of the deterrent, and at the same time decrease the compensation to plaintiffs by siphoning off a significant portion of the plaintiffs' recovery to pay their lawyers. This effect is, of course, characteristic of any system in which parties bear their own litigation costs.

36. DUNBAR ET AL., *supra* note 20, at tbl. 3. Of course, if, as I have argued, settlement amounts do not sufficiently reflect the merits of the plaintiffs' liability case, they are not a reliable signal of the real social costs or even the size of the transfer.

class members' overpayments.[37] Those overpayments go to other investors, third parties who are not required to refund their windfalls. To be sure, defendants usually receive some benefit from their violations, but these benefits (for example, job advancement, increased value of stock options, and enhanced reputation and prestige for individuals, and lower cost of capital, protection from hostile takeovers, and temporary business advantage for the firm) are more speculative and difficult to measure. Their value is probably less than the total market losses of all open-market purchases during the class period.[38]

Thus, even though individual class members have been harmed, compensating them for their market losses does not produce optimal deterrence. If defendants actually had to pay such gigantic damages, there would seem to be overdeterrence in virtually every case. Aggregate class trading losses are probably greater than either the true net social cost of the violation or the benefits received by the violator, both of which are speculative in nature and difficult to calculate.[39]

Deterrence is further complicated by the fact that the individuals responsible for the violation hardly ever have to contribute to any payment made to the class.[40] Half or more of the settlement payment typically comes from insurance, and thus is not borne directly by either individual or entity defendants.[41]

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37. This point does not fully apply if defendants are themselves trading during the period of nondisclosure, although even then the defendants do not receive the full aggregate overpayments of the class.

38. Daniel Fischel has proposed that damages in aftermarket cases be based on the violator's profit rather than investors' aggregate losses. *1995 Hearings*, *supra* note 25, at 102 (statement of Daniel R. Fischel, Professor, University of Chicago Law School); *see also* A. Mitchell Polinsky & Steven Shavell, *Should Liability Be Based on the Harm to the Victim or the Gain to the Injurer?*, 10 J.L. ECON. & ORG. 427 (1994) (arguing that "gain-based liability [is] seriously flawed in the presence of legal error because it fails to deter many socially undesirable acts"). Such a reform would be more likely to produce optimal deterrence, but the substantial uncertainties that would be associated with determining the value of such benefits would tend to undermine the usefulness of such a pricing model.

39. The meaning of "overdeterrence" in this context is somewhat opaque. To be sure, potential defendants can surely refrain from deliberate lies. But projections or statements about the future can turn out to be wrong through bad luck or bad judgment as well as fraud. Before discovery, plaintiffs cannot always distinguish losses caused by bad luck from losses caused by fraud, so some percentage of suits will be filed where no violation actually occurred. Because cases are not adjudicated, these cases may not be treated any differently from cases of actual fraud. Defendants have limited ability to prevent these plausible but factually nonmeritorious suits through due diligence procedures and disclosure policies, because future events may still differ materially from defendants' previous honest statements, particularly when the statements concern projections or predictions about the future. The behavioral effects of "overdeterrence" might include limiting disclosure, not going public, foregoing risky ventures that would otherwise be in the firm's interest, overinvestment in legal services, and, of course, overcompensation of plaintiffs and their attorneys. *See* Langevoort, *supra* note 3, at 25 (discussing effects of overdeterrence). Payments in settlement of securities class actions are normally much smaller than either market losses or the legal measure of damages. *See* text accompanying notes 40-50 *infra*. The correct level of deterrence might be achieved through the settlement process, but if so, it would be no more than happenstance.

40. *See* DUNBAR ET AL., *supra* note 20, at 12 n.22; Arlen & Carney, *supra* note 29, at 699, 727. Commentators have argued that individual managers should bear at least part of the risk of loss, and not the enterprise or the investors. *See, e.g.*, A. Mitchell Polinsky & Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability?*, 13 INT'L REV. L. & ECON. 239 (1993).

41. A study of shareholder class actions between January 1991 and December 1994 found that where officers and directors were named as defendants, an average of 68.2% of the settlement amount

Individual defendants almost never contribute personally to settlements.[42] To be sure, directors' and officers' liability policies provide the primary source of insurance funding, but these policies are paid for by the corporation and their proceeds do not in any sense represent a direct payment by the individual defendants. While individuals sometimes lose their jobs and companies suffer additional economic losses,[43] these costs are incidental, unintended, and unremarked byproducts of the litigation, not bargained-for terms of the settlement.[44] Indeed, it is rare for a settlement of a securities class action to include any acknowledgement of wrongdoing. According to Roberta Romano, shareholder class actions have little deterrent effect on managers.[45]

Thus, in securities class actions involving secondary open-market trading, the tort model of deterrence through compensatory damages seems inapposite. Defendants do not receive the benefits of the violation, and damages do not accurately measure the net social costs.[46]

Moreover, it is not clear that securities violations are a type of behavior similar to accidents, in which there is an optimal level of care defined as the level at which the costs and benefits of the conduct are in balance. The costs of taking care might include the measures the firm must take to discover and disclose information and to avoid misleading the public, the competitive disadvantage of making corporate information public, the risk that the firm will become overly cautious in providing information to investors or in conducting its busi-

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was paid by their liability insurance. The defendant company paid 31.4%. No more than 0.4%, therefore, was paid by the officers and directors themselves (and the study does not indicate whether any of this amount came from previous disgorgements to resolve SEC enforcement actions). DUNBAR ET AL., RECENT TRENDS III, *supra* note 28, at 9.

42. *See id.* In cases where there was insider trading, disgorgements obtained by the SEC in its own separate proceedings are sometimes credited to the recovery. *See, e.g., In re* Warner Comm. Sec. Litig., 618 F. Supp. 735, 740 (S.D.N.Y. 1985), *aff'd,* 798 F.2d 35 (2d Cir. 1986).

43. Such effects may include harm to relations with customers, suppliers or creditors because of uncertainty over the firm's potential liability or its effect on the firm's stability or solvency, reputational effects resulting from the allegations, and inability to conclude transactions such as mergers or joint ventures because of the existence of a large contingent liability that might be assumed by the prospective business partner. One might argue that these effects should be minimal because cases settle for less than 10% of market losses and are paid largely by insurance. *See* notes 36 & 41 *supra* and accompanying texts. It does not seem to work that way, though. The explanation may lie in the lack of widely available, reliable information about litigation and settlement outcomes, or in the difficulty people have in correctly assessing the significance of low-probability but greatly adverse outcomes. *See generally* Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability, in* JUDGEMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 163 (Daniel Kahneman, Paul Slovic & Amos Tversky eds., 1982).

44. *See* Arlen & Carney, *supra* note 29, at 702-03 (finding that most fraud-on-the-market occurs when companies are facing imminent trouble, and arguing that in such circumstances managers have nothing to lose because of fraud, since if the firm does not turn around, they will lose their jobs in any event).

45. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?,* 7 J.L. ECON. & ORG. 55, 84 (1991).

46. This analysis is less often true in cases alleging violations in face-to-face or private placement transactions, particularly where the circumstances resemble traditional fraud. In such cases, defendants do reap a benefit approximately equal to the plaintiff's losses, and the tort analogy is a better fit. This observation suggests that compensatory damages may be an appropriate remedy for securities violations not involving open-market transactions.

ness,[47] and the possibility that firms will be reluctant to use the public equity markets at all. These costs would be balanced against the particular and systemic benefits to investors of additional disclosure.[48] Even if this model applies in the securities class action context, the aggregate market losses of purchasers during the period of nondisclosure bear no logical relation to the model. Therefore, imposing those costs on defendants is unlikely to produce the optimal level of care.

The present measure of class-based compensatory damages thus is not well-supported by the traditional deterrence rationale for compensatory damages in tort law. Moreover, setting the sanction equal to aggregate trading losses makes the amount of the sanction depend on the length of the class period plaintiffs choose to allege[49] and the number of shares that happened to trade during that time—not to mention the difficulty of calculating the latter number with any degree of certainty. The size of the damage award is related only tenuously to the defendants' conduct.

III. The Goal of Compensation

Surprisingly, the present system does not even do a good job of compensating class members. This is not simply a question of whether settlements are too small, though that is a possibility. Rather, the problem is that the amounts paid by defendants are not delivered fairly and efficiently to class members.

There is considerable controversy over whether securities class actions settle too cheaply. Indeed, substantial doubt surrounds the basic empirical question of what portion of the class's alleged losses is recovered through litigation. The most careful analysis finds that settlements average around nine percent of investor losses and twelve percent of the class's claimed damages.[50] Whether such settlements are too small depends on additional factors, such as the

47. If liability depends in the first instance (though not solely) on a significant price drop, then there is an incentive to favor lower risk (variance) investments. *See* Philip D. Drake & Michael R. Vetsuypens, *IPO Underpricing and Insurance Against Legal Liability*, 22 FIN. MGMT. 64 (1993); *cf.* Francis et al., Determinants and Outcomes, *supra* note 24, at 34-35 (finding that firms subject to lawsuits have lower market returns compared to nonlawsuit firms).

48. *Cf.* Richard Craswell, *Interpreting Deceptive Advertising*, 65 B.U. L. REV. 657 (1985) (applying a similar analysis to precautions against misleading statements to ordinary consumers).

49. For example, a complaint filed against Televideo Corporation over its initial public offering alleged a class period of nearly three years (the length of the statute of limitations). *See* Alexander, *Merits*, *supra* note 6, at 516 n.62.

50. *See* DUNBAR ET AL., *supra* note 20, at 23 & tbl. 3; *see also* DUNBAR ET AL., RECENT TRENDS III, *supra* note 28, at 4 (finding that settlements averaged 12.25% of plaintiffs' claimed damages in 30 cases); Vincent E. O'Brien & Richard W. Hodges, A Study of Class Action Securities Fraud Cases II-3 (June 1991) (unpublished study, on file with the *Stanford Law Review*) (finding that plaintiffs recover 5.9% of estimated damages). Others have argued that settlements represent a much higher percentage recovery, perhaps as much as 60%. *See* William S. Lerach, *Prevalence and Economic Impact of Securities Class Actions: Is Reform Necessary?*, *in* AVOIDING AND MANAGING SECURITIES LITIGATION AND SEC ENFORCEMENT INQUIRIES FOR IN-HOUSE COUNSEL 20 (PLI Corp. No. 888, 1995). The methodology of this higher estimate is discussed and criticized in Alexander, *Value*, *supra* note 4, at 1464.

probability of a plaintiff's verdict on both liability and damages,[51] the costs of litigating to a judgment,[52] and the collectability of the judgment.[53]

Present techniques do not determine accurately either per-share damages or the number of shares in the class. Because we have no reliable way of calculating what the appropriate amount of compensation should be, we are unable to judge whether class action litigation does a good job of delivering it. As the rationale of the present system is to compensate class members for their actual losses, the inability to determine those losses accurately seems in itself a telling point against the system.

An equally serious argument, in my view, is that even assuming that the aggregate amount recovered by securities class action litigation is not unfairly small, the current system fails to deliver it efficiently and fairly to class members. There is presently no reasonably practical way to identify individually the members of the class—the persons who bought (or sold) shares during the class period. Payments are made, therefore, only to those class members who file claims. Though reliable empirical information is difficult to obtain, it appears that a significant number of class members—representing as many as forty percent of the shares in the class—do not file claims.[54] Striking evidence of this phenomenon appeared in a recent competitive-bid proceeding to select class counsel. One experienced plaintiffs' firm submitted two proposals: one in which attorneys' fees were determined as a percentage of a lump-sum settlement, the other in which attorneys' fees were based on claims actually filed. The firm sought a *50 percent higher percentage fee* for the claims-made bid.[55] Moreover, administrative costs, in the form of attorneys' fees, litigation expenses, and expenses of administering the settlement, are large.[56] Finally, a high proportion—perhaps a disproportionate number—of claims are filed by institutional investors.[57]

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51. To determine the expected value of the case after trial, the potential damages must be discounted by the probability of a plaintiffs' verdict. If the recovery rate of 12% of potential damages, see text accompanying note 50 *supra*, means that the probability of winning is only one in eight, perhaps too many weak cases are being filed.

52. In this connection, it is significant that securities class actions historically have settled late, after most of the trial preparation work has been done. *See* Alexander, *Merits*, *supra* note 4, at 519, 543-44; *see also* James Bohn & Stephen Choi, *Fraud in the New-Issues Markets: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 907, 935-37 (1996) (finding a correlation between the size of the offer and the likelihood of a lawsuit from a study of 122 lawsuits resulting from 3519 initial public offerings: "plaintiffs' attorneys will only file suit where their expected fee award exceeds their fixed costs of litigation").

53. In some cases, by the time the lawsuit is settled, the defendant company has essentially gone under. In any event, a large judgment may be difficult and expensive to collect even if it is less than the defendants' net worth. On factors that may lead to low-value settlements of meritorious actions, see DUNBAR ET AL., *supra* note 20, at 23-24.

54. *See* Alexander, *Value*, *supra* note 4, at 1448-49.

55. *In re* California Micro Devices Sec. Litig., No. C-94-2817-VRW 1995 U.S. Dist. LEXIS 11587, at *12 (N.D. Cal. Aug. 4, 1995).

56. *See* note 28 *supra*.

57. *See* Alexander, *Merits*, *supra* note 6, at 575; O'Brien & Hodges, *supra* note 50; Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2088-94 (1995). Moreover, dollar-value recoveries by noninstitutional investors are quite small. *See* Alexander, *Merits*, *supra* note 6, at 574-77 (examining distributions in two cases: in the first case, the 86 institutional investors among the top 100

One might argue that even a small payment is better for class members than no recovery at all. It is possible, however, that an alternative that provides no direct payments to class members would better serve many class members' economic interests than the present compensatory damages system.

In the first place, many investors may not really need compensation from litigation, because they have diversified against the risk of securities violations. Most market transactions involve persons who have traded before and will do so in the future. Institutional investors, in particular, hold diversified portfolios and trade frequently. The chance of being on the losing or winning side of a transaction when the stock price is distorted by a securities violation can be assumed to be random. The more trades investors make, the more likely that, in the aggregate, their gains from trading while material facts are withheld will equal their losses.[58] In this sense, investors are quite different from traditional tort plaintiffs, who cannot diversify against the risk of injury.

An investor who is completely diversified will be fully compensated for its trading losses that are due to securities fraud by windfalls on other transactions. Such investors have no need for further compensation obtained through litigation. The investors who are the most likely to be compensated through class action litigation—large institutional investors—are precisely those who are most diversified and thus are the least in need of compensation.[59] From this perspective, recoveries from class action litigation represent a windfall to large investors. These superfluous litigation recoveries entail very high transaction costs, while diversification has no transaction costs.

To the extent that investors are diversified against the risk of securities fraud, they have no need for additional compensation. The justification for damages must then be stated purely in terms of deterrence or retribution, not compensation.[60] Some other sanctions regime almost certainly could be better calibrated to achieve those goals, with substantially lower administrative costs.

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claimants (out of over 5000 total claims) accounted for over half of the recovery, while over one-quarter of the class received less than $250; in the second case, one percent of the claimants received over half of the recovery, and 48% of the class received less than $250).

Of course, as institutions hold over half of the voting stock of U.S. publicly traded securities, this pattern does not necessarily reflect a disproportionate rate of claim filing by institutions.

58. *See* Easterbrook & Fischel, *supra* note 3, at 640-41; Langevoort, *supra* note 3, at 14. Of course, the offsetting of gains against losses reflects statistical probabilities; some individual investors will be net gainers or losers. The more trades that are made and the more diversified the investments, however, the more an individual's experience is likely to approach the statistical mean.

Because the incidence of litigation appears to be at least in part a function of price changes, firms whose stock has greater variance will be more likely to be sued than those with lower variance. A well diversified but conservative portfolio will not be subject to as much litigation risk as a fund that seeks investments with higher variance. At whatever level of litigation risk an investor selects, however, the chance of incurring a windfall or a loss should be random, barring systematic informational advantage.

59. The point is often made in response that institutional investors, such as pension plans and mutual funds, represent beneficiaries who are not wealthy. The fund itself, however, is a large, sophisticated, and diversified investor. My point is not whether claimants are morally deserving; I simply observe that compensation goes to large, sophisticated investors (and indirectly to their beneficiaries) who have already diversified against the risk which is being compensated.

60. This point was recognized in Judge Vaughn Walker's thoughtful opinion in *In re* California Micro Devices Sec. Litig., No. C-94-2817-VRW, 1996 U.S. Dist. LEXIS 1361, at *47 (N.D. Cal. Feb. 2, 1996) ("A rational institutional investor would . . . be interested in pursuing securities class actions

In the second place, a compensatory regime that requires the issuer to pay damages equal to the market losses of all purchasers during the class period may not be in the economic interest of many class members, particularly continuing shareholders and institutional investors.[61] It is often said that settlements are, in large part, a transfer of wealth from current shareholders to former shareholders.[62] In fact, a significant number of class members may still own their shares when the suit is brought or settled, either because they have not sold the shares they bought during the class period or because they own other shares purchased before or after the class period. Institutional investors, particularly index funds, may continue to hold large amounts of the company's stock. In *In re Apple Computer Securities Litigation*,[63] for example, the plaintiffs' expert on damages testified that at the beginning of the class period, over half of the publicly owned shares were held by institutional investors.[64] At least 318 institutional investors who each bought 100,000 shares of stock or more during the class period, accounting for over 4.5 million shares out of a class consisting of up to 36.5 million shares, still held shares as of one week after the close of the class period.[65] Indeed, at the time of trial, eight-and-one-half years later, 107 of those same institutional investors still owned Apple stock.[66]

To the extent that shareholders continue to hold their shares, payments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up.[67] Such transfers are not in the economic interests of continuing share-

only when they generate a genuine deterrent effect."). In fact, two institutional investors—the Colorado Public Employees' Retirement Association, which was ultimately named class representative, and Bank of America—objected to the proposed settlement for its lack of deterrent effect. *Id.* at *47-48. Judge Walker ultimately rejected the proposed settlement and named one of the objectors the representative for the class.

61. *See id.* at *44-45 (recognizing distinction between interests of continuing shareholders and institutional investors, as contrasted with individual, in-and-out traders).

62. *See, e.g.*, DUNBAR ET AL., *supra* note 20, at 18-19; Arlen & Carney, *supra* note 29, at 698-700; Easterbrook & Fischel, *supra* note 3, at 638-39; Lerach, *supra* note 50, at 22.

63. No. C-84-20148 (N.D. Cal. May 13, 1991).

64. Transcript of Trial Proceedings at 1430-31, *In re* Apple Computer Sec. Litig., No. C-84-20148 (N.D. Cal. May 13, 1991) (testimony of John B. Torkelsen).

65. *Id.* The number of shares bought by the institutional investors is a "hard" number, obtained from reports filed by the institutions. The number of shares potentially in the class is a "soft" number derived from a statistical model that, as discussed in the text accompanying notes 13-15 *supra*, probably significantly overstates the size of the class. Thus the proportion of shares in the class held by continuing shareholders may have been even greater than 4.5 million out of 36.5 million, and the total number of shares held by these continuing investors was probably greater than the 4.5 million shares they bought during the class period.

66. *Id.* at 2145 (comments of plaintiffs' lead trial attorney, Patrick J. Coughlin, during oral argument on jury instructions).

67. Between January 1991 and December 1994, securities litigation settlements, 90% of which were class action settlements, amounted to $2.0 billion, of which plaintiffs' lawyers received one-third. DUNBAR ET AL., RECENT TRENDS III, *supra* note 28, at 7 & tbl. 5. Legal fees for the defendants are not made public, but are probably of the same approximate magnitude (perhaps more when multiple defendants require multiple representation and when litigation is protracted). Thus, it is reasonable to infer that attorneys for both sides received about $1.6 billion out of $3.3 billion paid in connection with the settlements.

holders.[68] In the recent *California Micro Devices* case, Judge Vaughn Walker took the highly unusual step of rejecting a proposed settlement for just these reasons.[69] The proposed settlement consisted of a $1 million cash payment by the issuer, plus 1.5 million newly issued shares of stock (equal to 17 percent of the outstanding shares). The outside directors and corporate officers were not required to contribute to the settlement, though the company had sued its former CEO on essentially the same allegations as the class complaint and the former chief accounting officer had settled a civil action brought by the SEC arising out of the same misstatements.[70] The court noted that "in a worst case situation," members of the class who were continuing shareholders " 'may discover that the proposed settlement dilutes their current holding by 17 percent only to compensate them by precisely the same amount . . . as members of the plaintiff class . . . . and with respect to such shareholders the proposed settlement will charge a fee of 20.5 percent for shifting economic value from one pocket to the other.' "[71]

Continuing shareholders might rationally prefer monetary or other sanctions against the individuals responsible for the violation,[72] or changes in the firm's management or controls,[73] to substantial payments by the firm to themselves and other shareholders. Institutional investors might prefer such an approach even if they are not continuing shareholders in the particular case. As diversified and frequent investors, their primary interest in litigation should be deterrence rather than compensation, and deterrence might be better served by more focused sanctions including sanctions directed against the responsible individuals. In *California Micro Devices*, for example, institutional investors who were continuing-shareholder members of the class objected to the settlement on the

68. In addition to legal fees, lengthy litigation may divert managers' attention, deprive the company of funds necessary to operate the business, disrupt supplier and distributor relationships, cause a loss of customer confidence in the firm's long-term staying power, and prevent the firm from entering into desirable business relationships and combinations such as mergers, because potential acquires do not want to take on a large contingent liability in the form of a class action lawsuit. All of these factors decrease the value of the continuing shareholders' shares.

69. *In re* California Micro Devices Sec. Litig., No. C-94-2817-VRW, 1996 U.S. Dist. LEXIS 1361 (N.D. Cal. Feb. 2, 1996).

70. *Id.* at *34-48.

71. *Id.* at *42 (quoting at length from a letter by Professor Joseph Grundfest submitted on behalf of class members Bank of America and Wells Fargo Bank).

72. The question whether the goal of deterrence is better served by individual or entity sanctions has been the subject of much academic discussion. *See, e.g.*, Arlen & Carney, *supra* note 29; William F. Baxter, *Enterprise Liability, Public & Private*, 42 LAW & CONTEMP. PROBS. 45, 49 (1978); Easterbrook & Fischel, *supra* note 3, at 640; Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345 (1982); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984); Reinier H. Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733 (1994); Polinsky & Shavell, *supra* note 40.

73. Nonmonetary sanctions against the firm, however, are subject to abuse in collusive settlements and should be regarded with skepticism. *See* Anthony Borden, *The Shareholder Suit Charade: The Wilmington Filers Shake Down Corporations in Delaware and No One Seems to Mind*, AM. LAW., Dec. 1989, at 67 (citing examples including a proposed settlement, ultimately rejected by the court, in which the plaintiffs' attorneys would receive monetary compensation while the class members would receive video cassettes of defendant's films, and an approved settlement that provided plaintiffs with coupons redeemable only at defendant's restaurant); Romano, *supra* note 45, at 63-65.

ground, among others, that it called for no contribution by individual officers or directors. A separate group of institutions who were not class members also wrote to the court to stress the interest of institutional investors in deterrence, in particular in appropriate sanctions of responsible individuals.[74]

Furthermore, the risk of litigation, unlike the risk of securities fraud, cannot be diversified against because the legal fees of both sides constitute a deadweight loss. Therefore, to the extent litigation is meritless it will result in higher cost of capital.

With respect to the desirability of large payments of compensatory damages, the interests of continuing shareholders will thus generally conflict with those of class members who have sold their shares and who, consequently, have no interest in the continued health of the business. Indeed, continuing shareholders themselves may find it difficult to determine where their economic interests lie, for the firm's settlement payment reduces the value of all outstanding shares pro rata, but a different (and usually smaller) class of present and former shareholders receives this money. Whether a particular settlement is desirable for the continuing shareholder thus depends on several factors: how many shares the shareholder still owns and how much their value will decrease because of the settlement payment; how many shares the shareholder owns or previously owned that are eligible to participate in the class recovery; how many other shares are entitled to share in the recovery and how many of those are likely to file claims; how much of the settlement payment will come from outside sources such as insurance or other defendants; how much will be deducted from the settlement fund for attorneys' fees and other administrative expenses; and the effect of the settlement on the company's future operations and cash flow. In sum, filing and pursuing litigation may not always be in the best economic interest of class members who are continuing shareholders.

Under the present system, none of these factors is considered even slightly relevant to determining the fairness and adequacy of a securities class action settlement.[75] We pretend, throughout the settlement process, that all class members sold their shares on the day after the close of the class period, that the only relevant interest of class members is in maximizing the dollars they and their lawyers will receive in the aggregate from the litigation, that class members are entirely indifferent to the source of the money used to fund the settlement and to the effect of the settlement on the company's future health, and that they have no interest in preventing individuals who have committed securities fraud from continuing in positions of corporate trust. We accept these premises even though we know that large institutional investors receive the lion's share of settlements, and that many class members are continuing shareholders.

The continuing-shareholder argument has been attacked on two grounds: First, that most shareholders sell their stock upon disclosure of bad news and the class therefore consists primarily of former, rather than continuing, share-

74. *In re* California Micro Devices Sec. Litig., No. C-94-2817-VRW, 1996 U.S. Dist. LEXIS 1361, at *47-48 (N.D. Cal. Feb. 2, 1996).

75. A notable exception is the court's analysis in *In re California Micro Devices*. *Id.*

holders; second, that the costs of settling the suit are not borne by current shareholders, but have already been reflected in the lower post-announcement stock price the current shareholders paid when they bought their shares.[76] The first claim is implausible. Over half of the publicly held shares in this country are held by institutional investors. Many of these, especially index funds, follow a buy and hold strategy, as exemplified in the *Apple Computer* case.[77] Share ownership is unlikely to turn over completely following disclosure of bad news. And even if it did, a large proportion of former shareholders would be institutions whose primary interest, as we have seen, is in deterrence rather than compensation. The second claim, that the costs of settlement have already been reflected in the stock price, proves too much. This argument is based on the premise that the anticipated future costs of litigation are a component of the initial stock price decline following the announcement of bad news. As such, they form a part of the price decline that is measured by event-study methodology to determine the per-share damages. But future litigation costs are not a proper component of the legal measure of damages. They should not be included in class damages at all.[78] Some have also argued that current shareholders are not the primary source of settlement payments, because insurers[79] and other defendants[80] contribute significant amounts to settlements. Insurance payments are not truly external, however, for shareholders bear the cost of insurance premiums. And payments by the issuer and insurers account for 99.6 percent of settlement payments.[81] So the significance of other external sources is minimal.

The fact that the goal of the lawsuit is a compensatory remedy also skews the decision whether to bring suit at all. In individual, nonclass securities litigation, plaintiffs engage in a litigation-as-investment calculus before filing suit. That is, plaintiffs determine the expected value of the lawsuit by estimating the probable amount of a judgment in their favor, discounting that amount by the probability of success, and subtracting the expected costs of litigation. If the present value of this equation is positive, the litigation has positive investment value. Continuing shareholders trying to decide whether to undertake litigation would rationally consider their interests both as shareholders and as class members. They would consider not only the amount of the judgment they might eventually win, but whether it would be paid by the company or by external sources, how much the litigation and settlement would cost them both as plaintiffs and as shareholders of the defendant, and the likely effect of the litigation on the value of their remaining investment.

76. *See* Lerach, *supra* note 50, at 22.

77. *See* text accompanying notes 63-66 *supra*.

78. *See* Alexander, *Value*, *supra* note 4.

79. *See* DUNBAR ET AL., RECENT TRENDS III, *supra* note 28, at v (68.2% of settlements are paid by directors' and officers' liability insurance).

80. *See* Lerach, *supra* note 50, at 23.

81. *See* DUNBAR ET AL., RECENT TRENDS III, *supra* note 28, at 9.

In class actions, however, the decision to sue is made not by members of the investor class, but by entrepreneurial plaintiffs' lawyers[82] whose economic interest is in the size of their potential fee, which is determined primarily by the amount of the recovery. Unlike continuing shareholders, the lawyers' interests are not affected by who pays for the settlement or which investors are eligible to receive payment. There is no opportunity for class members to assess whether they will ultimately be better off in economic terms if the suit is brought. And, of course, no one asks whether the benefit to class members will outweigh the economic costs to other, equally innocent, shareholders. In a similar vein, there is no meaningful opportunity to judge whether a proposed settlement has a higher expected value than going to trial.[83]

By isolating the transactions in which members of the class purchased shares during the class period and considering only their interest in receiving compensation for the inflated price they paid, the compensatory damages model ignores divergent interests within the plaintiff class itself. The interests of shareholders who are not members of the class, the aggregate social harm done by the violation, and the effects of the violation on the capital markets and the investing public at large also are not considered.[84]

To summarize, the compensation rationale does not persuasively justify the present measure of damages. First, class losses cannot be measured accurately. Second, the system does not distribute the compensation equitably or efficiently. Third, many if not most investors do not need to be compensated through litigation, because in a diversified portfolio gains and losses from securities violations will tend to average out over time. Fourth, the investors whom we do the best job of compensating are precisely the repeat players who need it least. Fifth, compensation by the issuer for market losses may not be in the best economic interests of a substantial number of the class members. Nor can the present system be justified as providing optimal deterrence by requiring defendants to internalize the social costs of violations, because the definition of class damages does not correspond to the social costs of the violation and is disproportionate to the benefits internalized by the defendants, and because those who commit the violations rarely have to contribute to the litigation or settlement costs, and thus do not internalize those costs.

82. *See* John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 Md. L. Rev. 215, 229-34 (1983) [hereinafter Coffee, *Rescuing the Private Attorney General*]; John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669, 677-78 (1986) [hereinafter Coffee, *Understanding the Plaintiff's Attorney*]; Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chi. L. Rev. 1, 71 (1991).

83. *See In re* California Micro Devices Sec. Litig., No. C-94-2817-VRW, 1996 U.S. Dist. LEXIS 1361, at *28-29 (N.D. Cal. Feb. 2, 1996) (discussing pressure on class members to agree to a proposed settlement even if it may be inadequate).

84. It is not an answer to say that public policy precludes taking other class-member interests into account, because our analysis presently concerns only the *compensatory* function of class damages. It is certainly relevant to this analysis if a significant number of class members would be economically better off without such "compensation," particularly when another significant set of class members do not file claims and thus receive no compensation at all.

IV. Toward an Alternative Sanction

A. *The Case for a Regulatory Remedy*

Requiring violators to compensate investors for their market losses is not the only possible sanction that could be administered through private enforcement. It is a remedy that seems natural to us now because the securities laws developed by analogy to the common law torts of fraud and misrepresentation. Individual (nonclass) securities actions, and cases that do not involve open market transactions (such as private placements), preserve more of the attributes of these common law torts, with more or less direct dealings between the plaintiff and defendant, reliance by the plaintiff on the misrepresentation or omission, direct benefit to the defendant, and relatively ascertainable losses. In such cases, the compensatory remedy seems appropriate to further both compensatory and deterrence goals. Any reform designed to correct defects observed in class actions involving publicly traded securities should be carefully designed so as to avoid unintended adverse effects on nonclass suits, which should remain unchanged.

Class actions involving open-market transactions in the secondary market do not, however, fit the common law model. The defendants in these cases were not parties to plaintiffs' transactions.[85] They had no face-to-face dealings with plaintiffs. Plaintiffs need not have relied on or even been aware of defendants' statements.[86] State-of-mind requirements are relaxed or absent.[87] Mitigation is not an issue, for damages are measured by the unrealized loss at the close of the class period, regardless of whether plaintiffs actually suffered such a loss.[88] Plaintiffs' damages are not reduced even if they continued to hold their shares after the close of the class period and the price rose.

The wrongful act in these open-market cases is not a species of common law tort.[89] Rather, it is the violation of a regulatory statute enacted for the benefit of the public at large. Permitting investors to recover compensation for their market losses and allowing such claims to be aggregated through the class action device encourages private enforcement of the securities laws by entrepreneurial plaintiffs' attorneys as a supplement to the government's enforcement activity.[90] But compensatory damages are not the only sanction that could be administered through private enforcement.

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85. For a discussion of the abandonment of the privity doctrine in the securities litigation context and its implications for compensatory damages, see Langevoort, *supra* note 3, at 11-12.

86. Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (endorsing the fraud on the market theory as substitute for requiring proof of direct reliance by each plaintiff); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (allowing presumption of reliance upon a showing that a reasonable investor would have considered the withheld facts material).

87. *See* Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 728-36 (1989).

88. *See* Lev & de Villiers, *supra* note 4, at 35 (reporting that stock prices often rebound after an initial "crash").

89. In some, but by no means all, cases the behavior alleged as a securities violation might also constitute a common law tort, although the elements of the claim differ substantially. Pendent state tort claims are frequently found in securities class action complaints.

90. *See* Coffee, *Rescuing the Private Attorney General*, *supra* note 82, at 215-30; Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 82, at 684-90.

In fact, sanctions for regulatory violations are not usually measured by the harm done to individual members of the public, nor are compensatory remedies imposed.[91] The more common remedy is a fine, whose amount is typically scaled according to the culpability of the act. I will call such noncompensatory sanctions regulatory remedies.

Regulatory remedies may also be enforced through private lawsuits. This is the case in private litigation under certain environmental laws.[92] Many such statutes permit citizens to obtain injunctive relief against ongoing violations; some also allow citizens to recover monetary penalties. Under the Clean Water Act, for example, citizens may sue for violations of the statute.[93] The statutory remedy for violations is a civil fine of up to $25,000 per day for each violation.[94] If the remedy is ordered by a court, the civil penalty is generally paid to the United States Treasury.[95] When a case is settled, the government may authorize the defendant to use all or part of the penalty to pay for an environmentally beneficial project, such as cleaning up the area harmed by the violation.[96] In addition, the private plaintiff is entitled to recover reasonable attorneys' fees.[97] The Clean Air Act Amendments of 1990 also allow private plaintiffs to sue for civil penalties.[98] These funds are also paid to the United States Treasury for use by the Environmental Protection Agency, but a court may order that up to $100,000 be used for a specified environmentally beneficial project.[99] In addition, the Resource Conservation and Recovery Act (RCRA),[100] the Comprehensive Environmental Response, Compensation and Liability Act of 1980

91. *See, e.g.*, Jeannette L. Austin, Comment, *The Rise of Citizen-Suit Enforcement in Environmental Law: Reconciling Private and Public Attorneys General*, 81 Nw. U. L. Rev. 220, 237-40 (1987) (explaining that penalties are paid to the Federal Treasury or a special fund in order to reimburse the public, not citizen plaintiffs, for harm done to the environment).

92. *See* Harold Feld, *Saving the Citizen Suit: The Effect of* Lujan v. Defenders of Wildlife *and the Role of Citizen Suits in Environmental Enforcement*, 19 Colum. J. Envtl. L. 141, 144 n.16 (1994) (listing statutes with citizen suit provisions); Marcia R. Gelpe & Janis L. Barnes, *Penalties in Settlements of Citizen Suit Enforcement Actions Under the Clean Water Act*, 16 Wm. Mitchell L. Rev. 1025, 1025 n.1 (1990) (listing federal environmental statutes that provide for citizen suits).

93. 33 U.S.C. § 1365 (1994); *see also* Reed D. Benson, *Clean Water Act Citizen Suits After* Gwaltney: *Applying Mootness Principles in Private Enforcement Actions*, 4 J. Land Use & Envtl. L. 143, 143-51 (1988) (providing an overview of citizen suits under the Clean Water Act); Gelpe & Barnes, *supra* note 92, at 1025-27. Unlike the government, however, which can sue for past violations, citizens can sue only for ongoing violations. Gwaltney of Smithfield, Ltd. v. Chesapeake Bay Found., 484 U.S. 49 (1987) (holding that citizen suits over emissions violations require allegations of continuous or at least intermittent violations).

94. 33 U.S.C. § 1319(c)-(d) (1994). The statute also provides for criminal penalties.

95. Gelpe & Barnes, *supra* note 92, at 1028.

96. *Id.* at 1028-32.

97. 33 U.S.C. § 1365(d) (1994). Attorneys' fees provisions are included in all of the federal environmental statutes. Austin, *supra* note 91, at 221, 231 & n.68 (listing some statutes that allow recovery of expert witness and attorneys' fees).

98. 42 U.S.C. § 7604(a) (1994). Citizen suits may seek penalties for past violations as well. *Id.*; *see also* Michael S. Alushin, *Enforcement of the Clean Air Act Amendments of 1990*, 21 Envtl. L. 2217, 2226-29 (1991); David T. Buente, *Citizen Suits and the Clean Air Act Amendments of 1990: Closing the Enforcement Loop*, 21 Envtl. L. 2233, 2237-39 (1991).

99. 42 U.S.C. § 7604(g)(2) (1994); Alushin, *supra* note 98, at 2228.

100. 42 U.S.C. § 6972 (1994).

(CERCLA),[101] and the Surface Mining Control and Reclamation Act of 1977[102] also allow for civil penalties in citizen suits.[103]

A regulatory sanction may provide effective deterrence. Robert Cooter suggests a useful distinction between prices and sanctions.[104] In this terminology, a law requiring the injurer to pay the external costs caused by its conduct is a price. In a price regime, socially desirable behavior is induced by charging a price that exactly internalizes costs.[105] The behavioral standard is not set externally. Rather, the price charged causes the injurer to choose the socially efficient level of conduct. The purest example of a price system is strict liability. In a sanction regime, by contrast, the standard of behavior is set externally by a law which articulates the desirable legal standard of behavior. The standard is backed by a sanction, or penalty, severe enough to induce conformity.[106] So long as the injurer meets or exceeds the legal standard of care, it incurs only its own costs of taking precautions. As soon as it drops below that standard it must pay the sanction as well.[107] Securities class actions are basically a pricing regime which attempts to measure damages by the external costs of nondisclosure—though, as we have seen, it adopts an artificial and inaccurate proxy for such external costs.[108]

In Cooter's analysis, people change their behavior in response to even small changes in prices,[109] so it is crucial to set the price correctly to reflect the external harm caused by the behavior. So long as the price is chosen correctly, it is not necessary to define the standard of socially optimal behavior. If costs are fully internalized, individual wealth-maximization by the injurer will automatically produce a socially optimal level of conduct. On the other hand, most people will obey a reasonable obligation backed by a reasonable sanction.[110] When sanctions are employed, it is critical to define the legal standard of behavior correctly, but mistakes in setting the sanction will not reduce compliance, and the sanction need not be related to the external harm caused by the conduct.[111]

Cooter concludes that "lawmakers ought to price an activity when it is easy for them to determine its external costs[, and] . . . ought to sanction an activity when they can easily determine its optimal level."[112] Under this analysis, pricing (measuring damages by the external costs of the behavior) is a poor en-

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101. *Id.* § 9659.

102. 30 U.S.C. § 1270(f) (1994).

103. The examples of environmental statutes containing private enforcement provisions are now so numerous that it is no exaggeration to say that since 1970, "citizen suit provisions have become a standard feature of federal environmental laws." Benson, *supra* note 93, at 150.

104. Cooter, *supra* note 16, at 1524-31.

105. *Id.* at 1532.

106. *Id.*

107. *Id.* at 1527.

108. The strict liability provisions of section 11 of the 1933 Act establish a pure pricing regime.

109. This phenomenon occurs because with prices, unlike sanctions, benefits, and costs are in equipoise, such that a small change in either results in a change in behavior. *Id.* at 1528-29.

110. *Id.* at 1532.

111. *Id.* at 1527-29.

112. *Id.* at 1546.

forcement mechanism in securities class actions because the price set under current law (aggregate class-wide trading losses) does not correspond to the actual external costs of the behavior, and because calculating that price is subject to so much uncertainty. Pricing regimes require accuracy in setting the price in order to achieve optimal deterrence. Therefore, attempting to price securities violations by measuring aggregate class-wide damages will not induce the socially desirable level of conduct.

In contrast, a clear standard of conduct backed by a reasonable schedule of sanctions could dramatically lower the transactions costs that are now incurred in securities class litigation, without sacrificing deterrence. Moreover, a sanctions regime could distinguish between injurers with different states of mind, punishing intentional violations more severely than negligent or unintentional violations. The precise amount of the sanction would not be critical, so long as the least severe sanction is set high enough to exceed the reasonable costs of the desired level of precautions. Higher sanctions could be imposed for intentional violations in order to deter those who would otherwise treat the minimum sanction as the price of intentionally violating the obligation.[113]

A regulatory sanction would have the additional benefit of making trials a more realistic option for litigants, thereby increasing the accuracy of settlements.[114] The class-based compensatory damages regime in theory imposes remedies that are so catastrophically large that defendants are unwilling to go to trial even if they believe the chance of being found liable is small.[115] Such judgments are rarely, if ever, entered against issuers of publicly traded common stock; but the possibility that they could be is a powerful settlement incentive. If, on the other hand, a regulatory sanction were set at fifty percent to one hundred percent above the present average settlement of about $5 million,[116] defendants would probably wind up paying at least as much as they do under the present system, but the trial rate would be increased because defendants would not face such a large downside risk. Reducing uncertainty at trial achieves a number of benefits. Settlements would not be discounted as steeply off the potential judgment as they are today, because the variance of the potential judgment would be reduced. Issues and proof regarding both damages and class issues would be streamlined decreasing litigation costs. Trial would be a realistic option, so settlements would begin to approximate the expected value of going to trial, as postulated by conventional economic models of settlement behavior.[117] Increasing the trial rate would give more certain content to the

113. *See id.* at 1543-44 (discussing punitive damages for those tempted to violate the standard and pay the compensation); *see also id.* at 1548-50 (discussing the superiority of sanctions over prices in deterring crime).

114. *See* Alexander, *Merits, supra* note 6, at 566-68.

115. This tendency will be more pronounced if defendants are risk-averse. Securities plaintiffs' practice of naming directors and top managers as individual defendants probably results in even entity defendants behaving in a risk-adverse manner, because individuals who are in a position to affect the entity's decisions face personal liability in the suit. *See id.* at 530.

116. *See* text accompanying note 127 *infra.*

117. *See, e.g.,* Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution,* 27 J. ECON. LITERATURE 1067, 1075-82 (1989); William M. Landes, *An Economic*

substantive standard of conduct, and would increase the accuracy of settlements by providing a benchmark for parties' expected value calculations in settlement negotiations.[118] These developments would lead to improved enforcement of the securities laws. Moreover, defendants who engaged in knowing or fraudulent behavior would be more likely to have judgments entered against them, rather than settling without an admission of liability, as is now customary. Individual wrongdoers might thus be prevented from engaging in the same behavior again with the same or a different company. These developments would improve enforcement of the securities laws.

A regulatory remedy could also ameliorate some of the distorting effects of insurance on the settlement process, by reducing the risk that a trial would result in a catastrophic, uninsured loss.[119] These distorting effects could be eliminated completely by making such sanctions uninsurable. (In that event, the amount of the regulatory sanction could be reduced, perhaps to the $5 million range.[120]) Under the current compensatory damages system, it is often argued that eliminating insurance for securities class actions would have a disastrous effect, drastically reducing the willingness of qualified managers to serve. A schedule of regulatory remedies that distinguished between corporate and individual sanctions and that was scaled according to the actor's state of mind might not have such an effect, even if the sanctions were made uninsurable.

A regulatory regime could also address a frequent criticism of the present compensatory damages regime, that the individuals responsible for violations escape without penalty.[121] A regulatory remedy could impose meaningful monetary and employment sanctions on individuals responsible for violations. A relatively small penalty to be paid personally (and by law made uninsurable and not indemnifiable) could have a larger deterrent effect on individuals than a much larger compensatory judgment to be paid by the corporation and its insurers.

Finally, a system of regulatory sanctions could allocate private enforcement efforts more appropriately for deterrence purposes. Under the present system, plaintiffs' attorneys' fees are either explicitly or implicitly a fraction of the

Analysis of the Courts, 14 J.L. & ECON. 61, 66-68 (1971); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399, 417-20 (1973).

118. *See* Kevin C. McMunigal, *The Costs of Settlement: The Impact of Scarcity of Adjudication on Litigating Lawyers*, 37 UCLA L. Rev. 833, 860-72 (1990) (describing how the lack of trial experience by individual attorneys impairs their ability to value cases for settlement).

119. For a discussion of the effect of insurance on securities class action settlements, see Alexander, *Merits*, *supra* note 6, at 550-57.

120. Issuers presently pay directly only about 30% of settlements, plus an unknown proportion of their costs of litigation, and individual defendants almost nothing. The rest is paid by insurance, principally directors' and officers' liability insurance whose premiums are paid by the issuer. DUNBAR ET AL., RECENT TRENDS III, *supra* note 28, at 9. Thus, setting the sanction at about the current average settlement range would actually make the potential sanction larger than current settlement payments by the issuer, and thus would not reduce the amount of deterrence resulting from litigation payments (though it would reduce some deterrence from defendants' risk-averse over reaction to the threat of extremely large judgments).

121. On the debate over the desirability of individual versus enterprise sanctions, see authorities cited in note 72 *supra*.

amount of the settlement. The settlement in turn reflects the potential damages. Because a case that survives a motion to dismiss is virtually assured of settlement,[122] the size of a potential damage claim exerts a hydraulic pressure on the selection of cases. A lawsuit over a factually weak case involving large potential damages may be more profitable for a plaintiffs' lawyer, and thus more likely to attract a suit, than one where the liability case is stronger but market losses are smaller. This result is desirable if the goal is compensation, but probably less so if the goal is deterrence. (Scrutiny by large investors, market professionals, and government regulators provides an additional deterrent, and this scrutiny is more complete for larger companies.) For a variety of reasons, then, a regulatory sanction should provide better deterrence than the compensatory damages rule.

There is at least one serious objection to applying Cooter's sanction theory to the securities context. Some would argue that the standard of conduct cannot be made sufficiently clear to support a sanctions regime. Under this view, the substantive standards of "materiality" and "scienter" (defined to include some species of recklessness), particularly as applied to omissions and statements involving projections and opinions, are more akin to the negligence standard of reasonableness (the classic case for enforcement by prices) than to the criminal law model of sanctions.

This is a powerful objection, and possibly an insuperable one. There are several responses, however. First, the standard may not be as unclear as its critics believe. The applicability of any standard is most uncertain at the margins. The present private compensatory damages enforcement regime, which provides strong incentives to bring cases characterized by high trading volume, high share price, and large price changes, may encourage the filing of marginal suits where it is difficult to determine whether the defendants actually violated the standard. A regime focused on deterrence rather than on investor compensation and with a fixed sanction, would encourage the filing of suits where the evidence of liability, and thus the case for materiality and scienter, was strongest. A sanctions regime that imposed higher sanctions for intentional misrepresentations or actual fraud would encourage plaintiffs to seek out suits where there was strong evidence of intent. And if the class-based compensatory damages remedy were abandoned, all reliance issues, including the fraud on the market doctrine, would be obsolete, thus eliminating a large source of uncertainty.

122. As recently as ten years ago, summary judgments and dismissals with prejudice were extremely rare. *See* Barbara Ann Banoff & Benjamin S. Duval, Jr., *The Class Action as a Mechanism for Enforcing the Federal Securities Laws: An Empirical Study of the Burdens Imposed*, 31 WAYNE L. REV. 1, 44-72 (1984) (reporting that in a study of 1,479 individual and class action securities litigations in the Southern District of New York from 1967 to 1973, only approximately 1.2% were terminated by adjudication prior to trial). In recent years, courts have been more willing to grant motions to dismiss and motions for summary judgment. *See* DUNBAR ET AL., *supra* note 20, at tbl. 1 (noting that of 656 total dispositions of securities class actions between 1991 and 1994, 86 were by dismissal—including voluntary dismissals, which could include settlements—and 17 were by judgments). It is not clear whether summary judgments were included in the "dismissals" category or the "judgments" category. Even when summary judgment has been granted, however, settlement remains an option to avoid the expense, delay and uncertainty of an appeal.

Second, it may be possible to agree on clearer standards. For example, a well-crafted safe harbor for forward-looking statements, a concept included in the recent securities reform legislation, could answer some of the objections to the indeterminacy of the present standard. Third, no standard expressed in language can be perfectly clear, and statutory standards are often made clearer and more definite through judicial interpretation and adjudication. It is true that the statutory standards expressed in the securities laws have been around for a long time and are still not clear. But very few cases involving publicly traded securities have actually been adjudicated on the merits with a fully developed factual record.[123] Such adjudications on the merits would provide more practical guidance than the present literature of opinions based on motions to dismiss and for summary judgment, where the legal standards require the court to assume a version of the facts favorable to the plaintiff.[124]

Finally, even if the standard of conduct is not as clear as one would wish, a regulatory regime applying a definite and reasonable sanction to violations of a moderately unclear standard would still be preferable to a pricing regime that exacts an indeterminate, logically irrelevant, and hugely disproportionate price for violations of the same unclear standard, through an enforcement mechanism in which there is almost never a factual determination of whether a defendant violated the standard.

B. *The Contours of a Regulatory Remedy*

Replacing the compensatory damages rule with a regulatory sanction would require legislation. The sanction should be tailored to the rationale sketched above, which applies most strongly to class action suits by open-market traders when the defendants are not themselves trading. The present remedies for nonrepresentative actions over face-to-face transactions are not subject to the same problems and should remain unchanged. In initial public offerings, unlike secondary market cases, companies do receive money from investors' purchases and thus can benefit directly from disclosure violations that affect the stock price.[125] To that extent, the analysis concerning the inappropriateness of compensatory remedies does not apply.[126] For suits against nontrading defendants for violations concerning publicly traded securities, however, a system built on

123. A recent comprehensive study of 656 securities class actions from 1991 through 1994 reports only 17 were resolved by "judgments," including default judgments (it is unclear whether summary judgments, which are not decided on the basis of a full factual record, were classified as "judgments" or "dismissals"). DUNBAR ET AL., RECENT TRENDS III, *supra* note 28, at tbl. 1.

124. The statement in the text assumes, as is usually the case in securities cases, that summary judgment motions are brought by defendants.

125. Technically, the company does not receive the money "directly," as most initial public offerings in this country are firm commitment underwritings in which the underwriter is the direct seller. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 343, 350-51 (4th ed. 1991). Insider trading cases share some of the characteristics of these cases, although there is still no face-to-face relationship between the insider and contemporaneous purchasers. Disgorgement seems a preferable solution to a damages remedy in these cases, even if damages are confined to closely contemporaneous traders.

126. Some changes in the substantive law, such as eliminating strict liability, may be warranted. *See, e.g.*, Langevoort, *supra* note 3, at 44-45.

regulatory sanctions would, I believe, be preferable to the existing class-based compensatory damages system.

1. *The statutory penalty.*

The proposed statute would apply to violations of Rule 10b-5 involving publicly traded securities. It would abolish the private right of action for damages for such violations in any but face-to-face transactions between plaintiff and defendants. In its place, the statute would set forth a schedule of civil penalties, payable to the United States Treasury (possibly for the benefit of the SEC). The federal courts would have exclusive jurisdiction of such suits. The amount of the penalty should vary according to relevant circumstances. For example, the penalty should be substantially enhanced if intentional fraud is proved. Penalties should be greater for cases involving larger firms, both because the systemic harm caused by fraud involving such securities is likely to be greater and because a penalty that is devastatingly large to a small firm may be inconsequential to a large one. Penalties for individuals should be scaled differently from those for issuers.

The penalties should be substantial, reflecting the seriousness of the harms inflicted by securities violations and the strong temptations to commit them. There should be no possibility that changing to a regulatory sanction would provide less effective enforcement than the present system. As a guideline for setting the sanction, a study of 319 settlements from 1991 through 1994 found that the average settlement was $7.7 million; the median settlement was $4 million.[127] Penalties for issuers might be set in the range of five to fifteen million dollars, based on the size of the issuer, and might be doubled on a finding of intentional fraud. Penalties for individuals might be in the $100,000 to $300,000 range.[128] Because the presence of insurance, particularly directors and officers liability insurance, appears to be a major factor in producing nonmerits-related settlements under current law,[129] these penalties should be made uninsurable. Defendants should be able to purchase insurance to cover their own legal expenses in private enforcement actions. No proceeds of those policies should be available to finance settlements or judgments, however.

2. *Disgorgement.*

The statute could require, in addition, the disgorgement of any benefits defendants received from the violation, such as proceeds from any transactions they engaged in during the period of nondisclosure, increases in the value of stock options, or other compensation tied to the misleading statements or to the stock price during the period of nondisclosure. Adding the remedy of disgorgement would combine the pure regulatory remedy which I have proposed for

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127. Dunbar et al., Recent Trends III, *supra* note 28, at tbl. 2.

128. *Cf.* Va. Code Ann. § 13.1-692.1 (Michie 1989) (limiting director and officer liability for violations of the duty of due care to the greater of $100,000 or the annual compensation from the firm); Deborah De Mott, *Limiting Director's Liability*, 66 Wash. U. L.Q. 295 (1988) (describing state law limitations on director and officer liability).

129. *See* Alexander, *Merits*, *supra* note 6, at 550-54.

nontrading defendants with proposals that sanctions be based on the defendants' gains rather than the plaintiffs' losses.[130] This refinement would make the statute applicable to cases involving publicly traded securities where insider trading occurred. Because most corporate managers own stock in their corporations and such stock forms an important part of their compensation and net worth, trading by individual defendants during the period of nondisclosure is not an uncommon occurrence. It is important that the regulatory remedy be applicable to these cases. Assuming that any transactions by insiders occurred through a brokered exchange rather than in face-to-face dealing, individuals who happened unknowingly to have purchased shares owned by insiders are in no different position from any other purchasers and have no special claim to compensation. The regulatory remedy is the appropriate sanction for all violations involving publicly traded securities where the corporation is not issuing securities.

The disgorgement alternative would also be applicable, in theory, to cases in which the issuer is trading in the market by issuing securities. In these cases there is a stronger argument that investors should be able to recover compensation. Counterarguments can also be made. In the case of secondary offerings, purchasers of the newly issued stock do not appear to be differently situated than persons who are simultaneously trading existing shares of the same class. High turnover during the initial post-offer period and dramatic increases in price in the first few trading days mean that an initial public offering case may rapidly come to look more like a secondary market case. The factors to be considered in deciding whether a regulatory remedy is preferable to a compensatory remedy when the corporation is issuing securities are complex. Resolution of this issue is beyond the scope of this article. However, adding a disgorgement remedy provides a promising approach to generalizing the regulatory remedy to cover a broader range of offenses. Making the remedies for initial offering and secondary market cases as consistent as possible would be desirable.

3. *Standing to sue.*

For purposes of this analysis, I assume that private plaintiffs as well as the SEC should enforce any regulatory remedy designed to replace the class-wide compensatory damages remedy. The SEC has emphasized repeatedly that it views private enforcement efforts as an essential supplement to its own enforcement activities.[131] Moreover, private litigation can contribute to a consistent level of enforcement, recognizing that the SEC's enforcement policies vary according to administration priorities at any given time, and the limited resources available to the SEC.

The simplest mechanism for private enforcement would be to authorize "any person" to sue to enforce the provisions of the statute. This is the ap-

130. *See 1995 Hearings*, *supra* note 25, at 102 (statement of Daniel R. Fischel).

131. *See, e.g.*, *id.* at 196 (statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission) (noting that private actions are crucial to the integrity of securities disclosure system).

proach adopted by the Clean Air Act and the Clear Water Act.[132] Successful plaintiffs would be entitled to recover their reasonable attorneys' fees and costs. Plaintiffs would also be required to give notice of the action to the SEC, which would have the option to take over the action and, in any event, to appear at any settlement hearing.[133]

Citizen-suit enforcement may not satisfy the constitutional requirements for standing, however. The Supreme Court cast substantial doubt on the constitutionality of citizen standing under the case or controversy requirement of Article III in *Lujan v. Defenders of Wildlife*,[134] a case brought against the Secretary of the Interior under the Endangered Species Act of 1973. In that case, the Court held that despite a statutory provision authorizing "any person" to sue to enjoin a violation of the Act,[135] plaintiffs must show a particularized, individual injury-in-fact in order to satisfy Article III.[136] The case has been persuasively criticized,[137] but it stands as a potential obstacle to citizen-suit enforcement of the securities laws.[138] Any private plaintiff would have to show a particularized injury-in-fact.

There are several ways to assure that the private plaintiff meets the standing requirements. One is to grant the successful plaintiff a percentage of the recovery—a statutory bounty similar to that allowed under the False Claims Act[139] or the traditional qui tam action.[140] The qui tam provision of the False Claims Act authorizes private individuals to sue on behalf of the United States for civil damages and penalties against any entity that knowingly presents a fraudulent

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132. *See* text accompanying notes 92-103 *supra.*

133. A provision permitting SEC oversight might reduce the possibility that the statute would contravene Article II's "take Care" Clause by interfering with the unitary executive's ability to make enforcement decisions. *See* Lujan v. Defenders of Wildlife, 504 U.S. 555, 576-78 (1992); United States *ex rel.* Kelley v. Boeing Co., 9 F.3d 743, 749-56 (9th Cir. 1993) (holding that False Claims Act provides "control mechanisms" giving the executive branch sufficient control over qui tam actions to satisfy Article II); United States *ex rel.* Newsham v. Lockheed Missiles & Space Co., 722 F. Supp. 607, 610-12 (N.D. Cal. 1989) (same); Feld, *supra* note 92, at 169; Harold J. Kent & Ethan G. Shenkman, *Of Citizen Suits and Citizen Sunstein*, 91 MICH. L. REV. 1793 (1993).

134. 504 U.S. 555 (1992).

135. 16 U.S.C. § 1540(g)(1) (1994).

136. *Defenders*, 504 U.S. at 573-77. The decision was also based on a concern that citizen suits to enjoin actions (or failures to act) of administrative agencies would violate the "take Care" clause of Article II. *Id.* at 576-78. This aspect of the opinion would be unlikely to hinder private enforcement suits against private parties, particularly if the SEC were given the opportunity to take over the suit if it wished.

137. *See* Cass R. Sunstein, *What's Standing After* Lujan? *Of Citizen Suits, "Injuries," and Article III*, 91 MICH. L. REV. 163 (1992).

138. It is also possible to distinguish *Defenders* as a suit against the government, whereas securities cases involve suits by private parties against other private parties. This distinction may make a difference for the Article II rationale, but does not seem significant on the standing issue.

139. 31 U.S.C. § 3730(d) (1994).

140. Literally, a qui tam action is one in which the plaintiff "sues on behalf of the king as well as for himself." In such suits, an informer brings an action under a statute that awards him part of any assessed penalty, the remainder usually going to the state. BLACK'S LAW DICTIONARY 1251 (6th ed. 1990). The most familiar contemporary application of the qui tam action is under the False Claims Act. The Supreme Court has historically accepted such suits if statutory language authorizes an action on behalf of the government and a bounty payment. George R. Rogers, Comment, *Legislative Intent Versus Executive Non-Enforcement: A New Bounty Statute as a Solution to Executive Usurpation of Congressional Power*, 69 IND. L.J. 1257, 1267-69 (1994).

claim to the government. Under the Act, the qui tam plaintiffs (or "relators") receive a bounty of up to thirty percent of the damages award or settlement, plus expenses, attorneys' fees, and costs of suit.[141] Several writers have proposed such an approach as a way of avoiding the impact of *Defenders* in the environmental area.[142]

The qui tam approach may not solve the standing problem, however. Though qui tam plaintiffs[143] have a *stake* in the litigation, they do not have a discrete and palpable *injury* at the outset of the suit, but only a promise of a future benefit at its conclusion.[144] The qui tam plaintiff's position appears analogous to that of the contingent fee plaintiff's lawyer, whose interest in a potential fee surely is not sufficient to confer constitutional standing. On the other hand, private plaintiffs in a regulatory remedy securities action, like qui tam relators under the False Claims Act, are suing to enforce an obligation owed to the government. The statutory bounty could be deemed an assignment of the government's interest.[145] For purposes of standing, the qui tam plaintiff would avoid the problematic citizen-suit approach and would step into the government's shoes.

Another approach to the standing problem is to require that the plaintiff have suffered a particularized injury. The statute could adopt the purchaser-seller rule of *Blue Chip Stamps* and require the plaintiff to have purchased or sold securities of the defendant firm during the period of nondisclosure.[146] Such a provision might not satisfy the injury-in-fact requirement if the plaintiff's individual right to compensation for that injury were repealed. The rationale for eliminating compensatory damages, however, is not a factual claim that there was no actual injury, but a policy decision that investors who suffered an actual injury should not be permitted to recover because the class of investors taken as a whole suffered no net injury and investors could diversify against the risk. Individual investors still suffer a particularized injury on individual transactions, and that injury should satisfy the constitutional test.

That injury might not meet the redressability requirement, however.[147] The remedy afforded in the lawsuit—a fine to be paid to the government, plus reimbursement of the plaintiff's attorneys' fees—would not redress the injury that

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141. 31 U.S.C. § 3730(d) (1994).

142. *See, e.g.*, Feld, *supra* note 92, at 146, 149-50, 164-84; Rogers, *supra* note 140, at 1267-69; Sunstein, *supra* note 137, at 232-34. Justice Scalia indicated in dicta that qui tam actions are not invalidated by the constitutional analysis in *Defenders*. *Defenders*, 504 U.S. at 572-73.

143. Technically, the correct term is "relator"; I will use the less accurate but more familiar "plaintiff."

144. *See* Thomas R. Lee, *The Standing of Qui Tam Relators Under the False Claims Act*, 57 U. CHI. L. REV. 543, 555-56 (1990).

145. *See* United States *ex rel.* Kelley v. Boeing Co., 9 F.3d 743, 748 (9th Cir. 1993); United States *ex rel.* Stillwell v. Hughes Helicopters Inc., 714 F. Supp. 1084, 1096 (C.D. Cal. 1989); Lee, *supra* note 144.

146. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731-49 (1975).

147. For cases discussing the redressability requirement see, for example, Northeastern Florida Chapter of Associate General Contractors v. Jacksonville, 508 U.S. 656, 663-64 (1993); Lujan v. Defenders of Wildlife, 504 U.S. 555, 561 (1993); Warth v. Seldin, 422 U.S. 490, 505 (1975); United States v. Boeing Co., 9 F.3d 743, 748 (9th Cir. 1993); *Ex rel.* Stillwell v. Hughes Helicopters Inc., 714 F. Supp. 1084 (C.D. Cal. 1989). *See also* Lee, note 144, *supra* at 555-56.

serves as the basis for standing.[148] It is difficult to predict how strictly courts would interpret the redressability requirement in this type of case.[149] If the statute authorized a partial assignment of the government's claim, however, redressability should not be a problem. Both the government's injury and the private plaintiff's would be redressed by the action. The safest approach from the standing perspective would be to combine both approaches, authorizing one who purchased during the class period to sue on behalf of the government and to receive a share of the recovery sufficient to redress the loss.

4. *Recovery of litigation costs.*

The statute should authorize successful plaintiffs to recover at least their reasonable costs of suit. To accomplish this objective, the statute could either set the statutory bounty high enough to cover such costs and leave plaintiffs responsible for their own fees, direct the court to award reasonable attorneys' fees and costs to be paid out of the recovery (as is presently done under the common fund doctrine), or incorporate a fee-shifting provision requiring defendants to pay successful plaintiffs' reasonable attorneys' fees and costs in addition to the statutory sanction. In the first two methods, the amount of the defendant's sanction remains fixed.[150] To the extent that the deterrent effect of the sanction depends on its amount, these methods would avoid undesirable uncertainty in the amount of the remedy. Additionally, these methods encourage plaintiffs to litigate efficiently because litigation costs would reduce their net recovery.[151] But meritorious suits with high litigation costs (for example, where records are voluminous, evidence is technical in nature, or plaintiff's attorneys are not already knowledgeable about the industry) would be less attractive, and private enforcement might tend to concentrate in particular industries.[152]

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148. This problem might not be fatal. In *Larson v. Valente*, 456 U.S. 228 (1982), for example, the Court held that plaintiff had standing to challenge a statute providing an exemption from charitable organization reporting requirements for religious organizations that received at least 50% of their contributions from members, despite the state's argument that plaintiff was not a religious organization and would have to register anyway. *Id.* at 242. The Court held that the plaintiff's status was uncertain and that it was "substantial and meaningful relief" to make clear that if it is a religious organization it cannot be compelled to register. *Id.* at 243. "[A] plaintiff satisfies the redressability requirement when he shows that a favorable decision will relieve a discrete injury to himself. He need not show that a favorable decision will relieve his every injury." *Id.* at 244 n.15.

149. The Supreme Court's redressability jurisprudence has been obscure if not unprincipled. *Compare* Warth v. Seldin, 422 U.S. 490, 493 (1975) (would-be residents and home builders lacked standing to challenge exclusionary zoning practices) *with* Village of Arlington Heights v. Metropolitan Housing Dev. Corp., 429 U.S. 252, 252-53 (1977) (would-be resident had standing to challenge exclusionary zoning); *compare* Linda R.S. v. Richard D., 410 U.S. 614, 614 (1973) (unwed mother lacked standing to challenge state's nonenforcement of statute criminalizing failure to pay child support) *with* Orr v. Orr, 440 U.S. 268, 268-69 (1979) (man permitted to challenge statute authorizing courts to award alimony to women but not to men).

150. Defendants would also have to pay their own attorneys' fees.

151. The statement assumes that the named plaintiffs, rather than their lawyers, control the litigation.

152. Concentration is already a fact. It may be explained by a higher incidence of securities fraud in certain industries, by more volatile stock prices in certain industries, or by plaintiffs' lawyers capitalizing on expertise developed in previous lawsuits. *See* Bohn & Choi, *supra* note 52, at 950-51 (discuss-

By contrast, a fee-shifting provision would make the amount of the plaintiff's recovery constant, with any uncertainty borne by the defendant.[153] The fee-shifting approach would also promote efficiency and lower costs of litigation because the defendant would have an incentive to monitor the plaintiff's attorney's fee request, assuring an adversary presentation on the reasonableness of the fee.[154]

C. *A Hybrid Approach*

The regulatory sanction should be designed to minimize the problem of agency costs—that is, the costs of the conflict of economic interests between the class members and the attorneys for the class. This conflict is a pervasive problem under the present system.

The usual rationale for the class action procedure is that by permitting the aggregation of individual claims, each too small to support the costs of litigation, it enables the vindication of legal rights that otherwise would go unredressed. The aggregate claim is large enough to pay reasonable litigation costs, allowing the class to attract the services of a competent lawyer. While an agency problem lurks in every lawyer-client relationship, it is more severe in class actions because too often, no one is available to supervise and monitor the lawyer for the class as in the traditional lawyer-client relationship. The very characteristic that dictates using a class action, individual claims that are too small to justify the costs of litigation, means that no member of the class has a sufficient incentive to monitor the activities of class counsel or to make decisions about litigation and settlement that are normally assigned to clients. Instead, it is the lawyer for the class who makes litigation and settlement decisions. Indeed, in many cases it is the lawyer who first identifies a potential claim and then seeks out some member of the potential class to serve as a named plaintiff.[155] The named plaintiffs are essentially figureheads, merely the "key to the courthouse door," in Judge Friendly's arresting phrase,[156] who play no real role in directing the litigation. The lawyers for the class thus are effectively unsupervised in their conduct of the litigation, and even for the most honest and well-intentioned lawyers, conflicts of interest can lead to decisions that are not in the class' best interest.[157] The lack of meaningful monitoring and control of plaintiffs' lawyers is a significant source of problems in securities class actions.[158]

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ing value of concentrating litigation); Francis et al., Determinants and Outcomes, *supra* note 24, at 10-11 (noting 46% of lawsuit firms are in computer related industries).

153. According to Cooter's theory of prices and sanctions, however, uncertainty as to the exact amount of a sanction does not seriously affect deterrence, so long as it is sufficient to keep defendants from pricing the conduct.

154. *See* text accompanying note 193 *infra*.

155. *See, e.g.*, Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 82, at 682 n.38.

156. Saylor v. Lindsley, 456 F.2d 896, 900 (2d Cir. 1972).

157. *See In re* California Micro Devices Sec. Litig., No. C-94-2817-VRW, 1995 U.S. Dist. LEXIS 11587, at *4 (N.D. Cal. Aug. 8, 1995).

158. *See* Alexander, *Merits*, *supra* note 6, at 535-36; Weiss & Beckerman, *supra* note 57; Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 82, at 677-84; Macey & Miller, *supra* note 82, at 3, 6, 12-18.

The proposed regulatory sanction would eliminate class actions for compensatory damages in securities cases involving publicly traded securities and the secondary market, but agency problems could still arise. The plaintiff would still represent the interests of another (in this case, the government), and—depending on the mechanism for paying attorneys' fees and the size of the fee compared to the total recovery—might not have sufficient incentive to supervise the lawyer's conduct during the litigation. Cheap and collusive settlements would still be a potential problem, and it is not clear that the mechanisms discussed above would make them significantly less likely than under the present system.[159]

Therefore, the statutory regulatory sanction should include safeguards against the agency costs problem. One strategy would be to provide incentives to attract institutional investors to serve as plaintiffs. The notion of enlisting institutional investors to monitor shareholder litigation has attracted considerable support among academics and legislators.[160] Institutional investors have many characteristics that recommend them for such a role. They are frequent market participants, buying, selling, and holding a large and diversified portfolio of stocks. Fund managers (except for index funds) make their living from analyzing information about firms and their securities. Institutional investors' economic interests, therefore, are closely aligned with the public interest in honest capital markets, efficient enforcement of the securities laws, and avoidance of nonmeritorious litigation. If private securities enforcement were in the hands of institutional investors as a class, one would expect the amount and focus of such enforcement efforts to be close to optimal.[161] Moreover, institutions may be more competent to monitor the class' lawyers than the small investors who presently bring almost all securities class actions. Though institutional investors do not engage in much litigation, they do hire and supervise lawyers, they are familiar with competent law firms that do not presently specialize in securities class actions (and thus might introduce competition into

159. The possibility of nonmeritorious litigation is also present, but one purpose of decreasing the upper end of the defendants' potential liability is to increase the incentives to go to trial should a settlement not reflect the merits. Eliminating insurance for settlements as well as for judgments would also reduce defendants' incentives to settle nonmeritorious litigation.

160. Commentators have suggested encouraging institutions to participate actively in securities class actions. *See* Weiss & Beckerman, *supra* note 57, at 2095; Coffee, *Understanding the Plaintiffs' Attorney*, *supra* note 82. A similar approach was reflected in S. 1976, 103d Cong., 2d Sess. § 103 (1994), which would have required the appointment of a "plaintiff steering committee" of shareholders holding, cumulatively, 5% or $10 million of the shares in the class. The legislation ultimately enacted did not include this provision, but mandated a preference for selecting the lawyer for the plaintiff who held the largest number of shares as lead counsel for the class. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 101, 109 Stat. 737 (1995). I suggest a variation on this theme in the alternative remedy discussed in text accompanying notes 181-199 *infra*.

161. By contrast, the recent public debate over securities litigation reform has been dominated by two contending teams of self-interested parties. The proponents of "reform" have been led by members of the plaintiffs' securities bar, whose economic interests in class action fee awards could bias them toward "too much" litigation. The most prominent opponents have been CEOs of high-technology corporations and representatives of the securities and accounting industries; as potential defendants their economic self-interest could bias them toward "too little" litigation.

the market for plaintiffs' counsel[162]), and they are unlikely to be captives of particular plaintiffs' firms, a frequent criticism of the present system.

Finally, in most cases there would be a number of institutional investors with large enough stakes in the litigation to justify the costs of monitoring. Studies of claims filed in securities class action settlements show that a relatively small number of claimants, usually institutional investors, typically account for a large fraction of the class' losses.[163] One study found that the ten largest claimants accounted for an average of 34.49 percent of the total claims.[164] Thus, securities cases differ from much other class action litigation in that the paradigm of a multitude of individual claims, each too small to make litigation economically feasible, does not apply. A relatively small number of investors would typically have a large enough stake to sue under the traditional rules of joinder, even without the class action device.[165] A few investors could be found in almost every case with a large enough stake to justify the costs of monitoring the class counsel.

For commentators concerned about the agency costs problem, institutional investors may seem to be an answer to their prayers. Yet institutional investors seldom initiate or participate in securities class actions.[166] Evidently they do not regard such participation as cost-effective. Litigation recoveries represent a very small fraction of most institutions' income. Monitoring litigation would entail costs, including adding staff to perform functions the institutions do not presently undertake. As class representatives, institutions might have to assume fiduciary obligations to class members that could conflict with their fiduciary obligations to their beneficiaries; and if they intervened rather than seeking to be named class representatives, their litigation expenses might not be reimbursed from the class recovery. They would also be subject to discovery and cross-examination on issues relating to their trading practices and information sources.[167] Finally, institutions, especially those that take an activist role in corporate governance, might conclude that it would be inappropriate to sue companies in which they hold (or formerly held) stock.

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162. *Cf. In re* Oracle Sec. Litig., 131 F.R.D. 688, 689-90 (N.D. Cal. 1990) (discussing the benefits of competition in the market for class counsel).

163. *See* O'Brien & Hodges, *supra* note 50, at III-3; *see also* Alexander, *Merits, supra* note 6, at 575-76.

164. *See* O'Brien & Hodges, *supra* note 50, at III-3 (reporting that the top five claimants in a class action study accounted for an average of 25% of the total claims filed; the top 10 claimants accounted for 34.49%).

165. A clearinghouse procedure would be needed to assemble groups of plaintiffs in particular cases, but this coordination function should not be too difficult.

166. An exception is *In re* California Micro Devices Sec. Litig., No. C-94-2817-VRW, 1996 U.S. Dist. LEXIS 1361 (N.D. Cal. Feb. 2, 1996), discussed at text accompanying notes 69-75, *supra*. Even then, the institutions did not initiate their participation in the litigation. Their actions were prompted by an unusual survey of class members' opinion on a proposed settlement which was undertaken at the district judge's instigation.

167. The Ninth Circuit recently held that sophisticated investors are entitled to the fraud-on-the-market presumption of reliance. Knapp v. Ernst & Whinney, 96 C.D.O.S. 5415 (July 23, 1996); *see* Robert Ablon, *Ruling Eases Burden on Securities Fraud Plaintiffs*, RECORDER, July 24, 1996, at 3. If widely adopted, this rule could eliminate the "sophisticated-investor defense."

Under the present system, institutions do not have to worry about any of these problems. They can simply ride on the coattails of the named plaintiffs and file claims in the settlement. Although active monitoring by large investors would probably make litigation more efficient and lower the effective cost of the recovery to the class, such efforts might not increase the institutions' own net recovery, as the savings would be spread over the entire class. Moreover, if institutional investors are more likely to file claims than smaller investors and thus garner a disproportionate share of recoveries, this would partially offset the inefficiencies of unmonitored litigation.

Nevertheless, additional incentives may succeed in prompting greater participation by institutions. The Private Securities Litigation Reform Act of 1995 aimed to increase participation by institutional investors by giving them preference in the selection of lead plaintiff. The State of Wisconsin Investment Board recently moved to take over as lead plaintiff (represented by its own law firm) in a suit filed against Cellstar by the largest plaintiffs' securities firm.[168]

To encourage institutions to bring and monitor litigation under the regulatory remedy, the statute could adopt a hybrid approach in which the compensatory damages remedy is abolished and replaced by a statutory sanction, but the plaintiff in a successful statutory action is permitted to recover a bounty equivalent to the present measure of compensatory damages plus attorneys' fees. Repealing the right to recover compensatory damages through class action litigation would eliminate the free-rider option for large investors, and the bounty would encourage their participation by allowing them to recover their losses through litigation.

The statute would prescribe a schedule of sanctions, as described in Part IV-B, and would abolish the right to recover compensatory damages for violations involving publicly traded securities. The SEC would be authorized to enforce the statute. Persons who traded to their disadvantage during the period of nondisclosure would also be authorized to bring suit on behalf of the government to recover the statutory sanction. Private plaintiffs would be required to notify the SEC of the commencement of the suit, and the SEC would have the right at any time to take over the suit or to appear and be heard on the government's behalf, including at trial or any settlement hearing. If multiple suits were filed over the same events, they would be consolidated and a lead plaintiff chosen.

As the first claim on the judgment or settlement, successful plaintiffs would be entitled to recover their reasonable attorneys' fees and costs plus a statutory bounty.[169] The amount of the bounty would be equal to the portion of plaintiff's market losses caused by the nondisclosure.[170] (To avoid reintroducing

168. *See Pension Fund Seeks to Control Suit Under New Law*, WALL ST. J., Aug. 8, 1996, at B2.

169. Alternatively, attorneys' fees could be imposed separately on defendants under a fee-shifting proposal, with a corresponding reduction in the amount of the statutory sanction. The alternative would maximize the government's receipts; the proposal in the text would maximize the predictability of the defendant's payment.

170. A rise in the stock price in the period following the corrective disclosure and the initial price drop should be offset against the recovery of plaintiffs who continued to hold their stock.

difficult proof problems, plaintiffs could be permitted to recover the full amount of their market losses, adjusted by a relevant market index.) In effect, the successful plaintiff would be permitted to recover the amount of its compensatory damages under present law, up to the amount of the statutory sanction.

This proposal would give large investors a greater incentive to sue than small investors, and with the elimination of a general right to compensatory damages, the incentive might be effective. This approach would also eliminate the potential conflict of interest between institutional investors' fiduciary duties to their own beneficiaries and the duties of class representatives to the class, as the beneficiaries could recover only if the fund brought suit and there would be no class to represent. Moreover, there would be no discovery into the institutions' trading practices, as those would be irrelevant to the government's claim.[171] Additionally, the statute would be immune to standing objections, because the plaintiff would have suffered an injury-in-fact which would be redressable through the lawsuit.

Why not just retain the substantive right to compensatory damages, but make the class action procedural device unavailable?[172] First, that approach would make the applicability of a Federal Rule of Civil Procedure depend on the substantive claim being asserted. The principle of trans-substantivity is one of the fundamental tenets of the Federal Rules.[173] It may, as some have asserted, be time to relax that principle.[174] But such a step should only be taken when it is clearly necessary. If the same result can be obtained through the substantive law, that is the preferable path.

Second, there is at least a theoretical possibility that the incentive of receiving compensatory damages would be so attractive that many investors would join in the suit, either by initiating their own suits that would be consolidated into one action, by traditional voluntary joinder, or through intervention. Alternatively, they could wait for a judgment in the regulatory sanction case and then seek to use it preclusively in subsequent suits for compensatory damages. Such actions by a relatively small number of large-stakes plaintiffs could result in aggregate claims that would exceed the statutory sanction.[175] In effect, the existence of large-stakes claimants could reintroduce the problems of excessive damages even if class actions were prohibited. Retaining an individual right to

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171. The statute should expressly provide that plaintiff's reliance is not an element, nor lack of reliance a defense, to the government's claim. This is because the rationale of the sanction is to punish and deter the violator, not to compensate the plaintiff for losses. Compensation is merely a convenient measure for an incentive to encourage enforcement.

172. I proposed that approach in testimony on an earlier version of the securities reform bill. Janet Cooper Alexander, On the Subject of Securities Fraud Litigation, Testimony before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (Aug. 10, 1994) (on file with author).

173. For a discussion of trans-substantivity as a fundamental tenet of the Federal Rules, and an elegant argument for applying the Rules flexibly in response to substantive considerations, see Robert M. Cover, *For James Wm. Moore: Some Reflections on a Reading of the Rules*, 84 YALE L.J. 718 (1975).

174. *Id.* at 736-40.

175. *See* note 164 *supra*.

compensatory damages would thus throw the deterrence calculation underlying the statute out of kilter.

Awarding a statutory bounty consisting of the plaintiffs' market losses caused by the violation plus reasonable attorneys' fees should attract two kinds of plaintiffs: large investors motivated by the desire to recover substantial losses, and small investors recruited, as in the present system, by attorneys motivated by the desire to recover substantial fees. The procedure for handling the cases should be designed to encourage suits by large investors, in order to minimize the agency costs problem.

All suits over the same basic conduct would be consolidated in a single court.[176] The court would hold a hearing at the earliest opportunity to select the lead plaintiff or plaintiffs. This determination would be based on the plaintiff's ability to represent the public interest and to monitor the litigation effectively; a statutory preference would be given to investors with substantial compensatory claims.[177] The court would have discretion to permit the lead plaintiff to choose the lawyer to prosecute the claim, or to conduct a competitive bidding auction or other court-supervised procedure to select counsel.[178]

The lead plaintiff would have the right to recover its market losses, as defined, and court-approved attorneys' fees as the first claim on any judgment or court-approved settlement. Any amount remaining would be paid pro rata to the other plaintiffs in satisfaction of their compensatory claims, with any remaining amounts going to the U.S. Treasury.[179] Because of the potential for collusive settlements limited to the amount of the lead plaintiff's claim and attorneys' fees, judicial approval of settlements would be required. A hearing would be required on the fairness and adequacy of any proposed settlement for less than the full statutory sanction. A plaintiff seeking approval of a settlement for less than the statutory sanction would have an affirmative burden to justify the adequacy of the settlement in terms of the probability of success on the merits or the collectability of the judgment. Notice of the proposed settlement would be given to all other plaintiffs, who would have full access to discovery materials for purposes of determining whether to object to the settlement. Successful objectors would be reimbursed their costs from the eventual

176. Needless to say, no more than one regulatory sanction could be imposed for any single violation of the statute. Consolidation should prevent needless duplication of litigation.

177. A preference for large shareholders in the selection of lead counsel for the class is contained in the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995); an earlier Senate version of the bill would have required the appointment of a plaintiffs' steering committee representing a defined level of shares in the class, S. 1976, 103d Cong., 2d Sess. § 103 (1994). *See* note 160 *supra*.

178. *See In re* California Micro Devices Sec. Litig., No. C-94-2817-VRW, 1996 U.S. Dist. LEXIS 1361, at *12-13 (N.D. Cal. Feb. 2, 1996) (describing a competitive bidding process); *In re* Wells Fargo Sec. Litig., 157 F.R.D. 467, 470-77 (N.D. Cal. 1994) (same); *In re* Oracle Sec. Litig., 131 F.R.D. 688, 690 (N.D. Cal. 1990) (same).

179. Permitting all plaintiffs, rather than only the lead plaintiff, to recover their market losses would encourage large investors to make the effort to file even if they were not assured of becoming lead plaintiffs. This would promote competition in the market for bringing suit, and would bring into the case other interested parties who could monitor the lead plaintiff at the settlement stage by objecting to the settlement. Compensating additional plaintiffs in all cases rather than only when they filed objections to the settlement is necessary to discourage groundless objections.

recovery. This procedure would replicate the fairness hearing in present class actions, and the other plaintiffs would be likely to have a large enough stake in the outcome to motivate them to monitor settlements.

Another possibility would be to prohibit settlements for less than the statutory sanction. A government agency might adopt such an enforcement policy, and the SEC has, at least at times, attempted to adhere to such a policy, for example in insider trading cases. A no-settlement policy could decrease the number of collusive settlements and increase the accuracy of law enforcement by, in essence, requiring seriously contested cases to be adjudicated. Such an enforcement policy cannot be voluntarily adopted in a private-enforcement system, as there is no way to force compliance. Nevertheless, it should not be imposed through statute. For one thing, settlement has become too deeply ingrained in our concept of litigation to make this option realistic. For another, a rigid, invariable rule would surely lead to excessive litigation costs and nonmerits-based settlements. A meaningful fairness hearing is probably the best alternative.

Despite the added incentives for institutional investors to participate in the litigation and the elimination of any other opportunity to recover their market losses, institutional investors might choose not to become plaintiffs. The disadvantages of participating in litigation against companies in which they held investments might outweigh the potential economic benefits, particularly in light of the fact that such benefits would represent a windfall if the institution were diversified against the risk of losses due to securities violations.[180] Should that be the case, the statutory bounty and the ability to recover attorneys' fees should assure that a sufficient number of plaintiffs would still be available. These would be small investors, "figurehead" plaintiffs as under the present system, who probably would not be effective monitors of the lawyers for the class. In that sense, however, the regulatory regime would be no worse than the present system. The requirement for court approval of settlements and attorneys' fees would assure at least as much judicial supervision as the present system, and the reduction of the size and uncertainty of a potential judgment should increase the number of cases that are resolved by trial, providing a further check on the accuracy of settlements.

180. There is evidence, however, of increasing interest by institutional investors in participating in securities litigation, either as plaintiffs or to monitor the conduct of class action litigation. *See In re* California Micro Devices Sec. Litig., 1996 U.S. Dist. LEXIS 1361, at *2-3 (The district court ordered plaintiffs' counsel to survey class members to demonstrate their support for a proposed settlement that the court suspected was collusive; several institutions objected to the proposed settlement, one of which was later, with its consent, named lead plaintiff.); Karen Donovan, *Institutional Investors Ready for Role in Class Action Securities Suits,* NAT'L L.J., Mar. 13, 1995, at A6 (discussing action of the Council of Institutional Investors, which represents 100 pension funds that manage about $800 billion in investments, to investigate ways to play a more active role in class litigation, and institutions' objections to suit against Intel); Mark Walsh, *BIG Investors Speaking Out on Securities Suits,* RECORDER, Feb. 23, 1995, at 3 (California Public Employees Retirement System and other pension funds wrote to plaintiffs' lawyers and the SEC urging that class action and derivative suits against Intel be dropped). For a cogent discussion from an insider's perspective of factors institutional investors consider in deciding whether to become activist shareholders, see Robert C. Pozen, *Institutional Investors: The Reluctant Activists,* HARV. BUS. REV., Jan.-Feb. 1994, at 140.

One objection to such a statute is that it would effectively discriminate in favor of large or wealthy investors. Only one (or at most a few) investors could become lead plaintiffs, however. Most investors, both large and small, would be treated equally (that is, they would have no right to compensation). Small investors would still be permitted to bring suit, and the preference for investors with sufficient economic stakes to make them effective monitors of the lawyers litigating the government's claim has a compelling rationale. In any event, the most important benefit to small investors under either system is deterrence of unlawful conduct and the resulting improvement in the honesty and efficiency of the capital markets—benefits that accrue to all members of the investing public.

V. AN ALTERNATIVE PROPOSAL

The case for replacing compensatory damages with a regulatory remedy is not free from doubt from a theoretical point of view, and the political obstacles to such a far-reaching change would be formidable. If a regulatory sanction could not be implemented, many of the problems of the current damages regime could be significantly ameliorated with a simple set of procedural reforms. Indeed, most of these reforms could be implemented today by individual trial judges, without the need for implementing litigation. This alternative procedural reform, which I discuss in detail below, is less radical and more practical than the set of reforms that were enacted in the Private Securities Litigation Reform Act of 1995,[181] and it targets the real dysfunctions of securities class action litigation more precisely. Moreover, the proposal concerns aspects of securities class action litigation that were not significantly affected by the recent legislation. Thus, it could still be adopted as a supplement to that legislation. Finally, most of the provisions of this proposal, unlike the 1995 Act, would not require extensive litigation or the promulgation of agency regulations to determine their contours. The proposal is exclusively procedural, and its terms can be specified relatively completely.

A. *The Provisions of the Reform*

The provisions of the proposal can be simply stated. They would apply only to class actions involving claims of securities violations for publicly traded securities.[182] They provide a mechanism for obtaining a functioning client to monitor the class counsel, coupled with a truth-in-advertising law for the settlement and provisions to assure an adversary presentation on the fee request. The elements of the proposal are as follows:

181. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

182. Cases involving initial public offerings would not be excluded from the reach of this proposal, as it would not alter the present compensatory measure of damages.

(1) All class members who during the class period held shares in the class valued at $250,000 or more must affirmatively opt in to the class in order to participate in any class recovery.[183]

(2) Lead counsel for the class will be selected only after all of the opt-ins have been surveyed as to their views on this issue. All opt-ins may propose lead counsel. The court must take the results of the survey into account in making the lead counsel determination, and may order an advisory or binding vote on the issue.

The firms selected as lead counsel will be the only firms representing the class. Individual plaintiffs, including named plaintiffs, may continue to retain their own counsel for their individual claims at their own expense, but they shall not be reimbursed for these expenses from the class recovery.

(3) A plaintiffs' steering committee (PSC) shall be selected by the court from among the opt-ins and named plaintiffs. The statute could establish a preference for larger shareholders, some form of proportional representation between opt-ins and named plaintiffs, or an elected PSC, with each share being entitled to one vote. The PSC monitors the conduct of the litigation, and lead counsel for the class must report regularly to the committee. The PSC must be informed of all settlement discussions and performs the traditional role of the client with respect to settlement negotiations and decisions (including the right to participate in settlement negotiations). Any settlement agreement must be approved by the PSC unless the court orders otherwise after motion and hearing.

(4) All proposed settlements and trial judgments in class actions must be stated in terms of the per-share recovery, not the aggregate total amount to be paid. The total amount to be paid to the class shall be determined by the number of shares that file claims.

(5) Fee awards to the attorneys for the class must be computed separately from the amounts to be paid to the class and must be paid by the defendant as part of the settlement or judgment.

(6) No negotiations or agreements involving plaintiffs' attorneys' fees may take place until after the settlement has been approved by the court. Attorneys' fees and expenses may not be a subject of the settlement agreement.

(7) The application for, briefing, and hearing on the plaintiffs' attorneys' fee request must occur after the time for filing claims pursuant to the settlement has expired.

(8) In determining the fee award, the court must consider the benefit conferred on the class by the lawyers' efforts. The court in its order

183. The $250,000 figure is illustrative. The amount should be determined based on empirical data about the size of claims filed in litigation under the present law. *See* text accompanying note 187 *infra*.

must specifically address the numerical relationship of the fee award to the value of the actual claims filed.

B. *The Opt-In Procedure*

As discussed above, the active participation of institutional investors could solve many of the agency problems that beset securities class action litigation. The opt-in proposal is a mechanism for giving institutions an incentive to participate. Large-stakes investors would have to opt in to the class—that is, would have to affirmatively indicate their desire to be in the class—in order to be eligible to share in any class recovery. By opting in, these large-stakes investors would agree to be subject to being drafted to serve on the plaintiffs' steering committee, which would supervise class counsel and make those litigation and settlement decisions traditionally reserved to the client.

The opt-in proposal has two purposes. First, it would identify a pool of potential members of an independent plaintiffs' steering committee which would represent the interests of the class in dealing with class counsel. These class members would have sufficiently large stakes to bear the costs of monitoring the class lawyers, and by opting in they would signify their willingness to serve. An important feature of this proposal is that it is coercive. A PSC would be formed in all securities class actions, and institutions with sufficiently large stakes would be required to indicate their willingness to serve in order to become eligible to share in the class recovery.[184] They could not pick and choose whether to become involved or, as in some proposals, perform the monitoring function through comments by an industry association.[185] This is because the goal of this proposal is not simply to assist institutional investors who decide to participate in a particular case; the option of filing suit or intervening is already available under present law. Rather, the proposal is based on the view that *structurally*, the present system is flawed because class members' interests are not adequately represented in monitoring class counsel's conduct of the litigation, and that the public interest requires restructuring securities class litigation to provide such a monitor.

The second purpose of the opt-in procedure is to make the amount of damages more definite and objectively verifiable. The practical effect would be to limit damages claims. When large investors opt in, they will be required to state the number of shares they own (or owned) that were in the putative class, and the dates of purchase or sale. The damages of the opt-in class members may be computed precisely for any given value line. As large claims constitute a substantial portion of the total claims, this will substantially reduce the uncertainty associated with damages calculations. Similarly, if large investors do not opt in, they will not be in the class. Damages calculations will be addressed only to shares belonging to small investors. This will reduce the range of un-

184. If no large-stakes claimants opted in, the PSC would perforce be made up of named plaintiffs and volunteers. The reporting and monitoring requirements of the proposal would continue to apply.

185. *See Securities Fraud Litigation: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 103d Cong., 3d Sess. (1994) (testimony of John C. Coffee, Jr.) [hereinafter Coffee, *Testimony*].

certainty in damage calculations and will provide a check on inflated damages claims. If a larger portion of the most well-informed members of the class conclude that they do not wish to join the class, that fact may suggest that the case is not worth pursuing. On the other hand, to the extent that the apparent failure of a significant portion of the class to file claims[186] is actually the result of statistical methods that overstate the number of shares in the class, limiting the scope for estimating the shares in the class would reduce this important source of error.

Under other provisions of the proposal, the total amount of any judgment or settlement will be determined by the claims actually filed, and the plaintiffs' fee request must be filed after the total value of the claims is known and must be justified in relation to the claims filed. This cluster of reforms is designed to make the amount of damages at stake a more realistic number, and, even more importantly, to prevent class counsel from receiving a disproportionate share of the recovery.

The threshold amount for the opt-in requirement should be large enough to ensure that those affected will have a significant incentive to opt in despite the added burdens of possibly being asked to serve on the PSC (the expenses of which should be reimbursed), while still identifying an adequate pool of potential steering committee members. The threshold amount should be set on the basis of an empirical analysis of settlements. If O'Brien and Hodges' finding that the largest ten claimants account for approximately 35 percent of total claims is generalizable,[187] a cutoff that would separate out about the top ten to fifteen claimants in the average class action should be adequate. The claimant rosters filed in several settlements of suits involving initial public offerings suggest that setting the cutoff at $250,000 of market losses might be about right.

The opt-in threshold should be stated in terms that will be understandable and easily calculated at the outset of the case. For this reason, the cutoff should not be based on the amount of damages that will be claimed, as this calculation is difficult, subject to dispute, and hard to determine until later in the case. The most understandable and easiest to apply standard is the market value of shares held during the class period; investors who met the threshold but did not trade (enough) during the class period to make opting in desirable could simply choose not to opt in. Another possibility, more difficult to calculate but more closely related to the amount of the final damage claim, is the market losses (realized or unrealized) in the stock as of a specified date after the corrective disclosure.

Notice of the pendency of the lawsuit and the opportunity to opt in could be given by filing a form with the SEC, which could make such filings readily available electronically. Periodicals such as *Institutional Investor Digest* could

186. *See* text accompanying note 54 *supra*.
187. *See* O'Brien & Hodges, *supra* note 50, at III-3.

provide additional publication notice. These methods should satisfy the constitutional requirement of notice.[188]

The opt-in provision is the most radical aspect of this alternative proposal, as well as the only one whose legality under present law may be open to question. Institutions probably would not favor the opt-in proposal because it conditions their recoveries, which they can obtain with no effort under present law, on taking affirmative steps in advance that expose the institutions to additional burdens. Their opposition should not be determinative, however, as benefits would flow to investors as a whole from independent monitoring of class counsel. These benefits would be best obtained through procedures that operate in all cases, rather than at the option of institutional investors.[189]

C. *The Role of the Opt-Ins*

The large investors who opt in to the class should have a significant voice in the selection of class counsel. They could propose class counsel (as named plaintiffs currently do by filing complaints), and express their views on the selection and performance of class counsel to the court. This participation would promote both responsiveness by class counsel and monitoring of attorney performance, and might well bring new entrants into the market for class counsel and increase competition among the plaintiffs' bar.[190]

In addition, a plaintiffs' steering committee, selected from the opt-ins and named plaintiffs, would be responsible to monitor the ongoing conduct of the litigation, including settlement negotiations, and generally to perform all of the litigation functions that are traditionally allocated to the client rather than the lawyer.[191] This step should significantly reduce the principal-agent problems in securities class action litigation.

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188. Notice by publication is routinely given in consumer class action litigation. *See, e.g.*, New York v. Reebok Int'l, 903 F. Supp. 932 (S.D.N.Y. 1995) (authorizing publication notice); Charles A. Wright, Arthur R. Miller & Mary Kay Kane, Federal Practice and Procedure § 1797 (2d ed. 1986) (collecting cases); *see also* Joseph M. Fisher, *Internet Seen as Means of Providing Legal Notice*, Nat'l L.J., July 1, 1996, at C3 (discussing use of World Wide Web to give notice).

189. An unwilling class representative is generally to be avoided. In this case, however, the large investors may weigh the benefits of joining the class action against the costs of becoming eligible to perform monitoring functions, and decide whether opting in is to their advantage.

190. It is possible to achieve similar results under the present rules. *See* notes 74, 166, & 180, *supra* (discussing *In re* California Micro Devices Sec. Litig.); *see also* notes 160 & 168 *supra*.

191. Provision for a plaintiffs' steering committee was included in the original House and Senate versions of the 1995 Act but was not incorporated in the final bill. H.R. 1058, 104th Cong., 1st Sess. § 103 (1995); S. 240, 104th Cong., 1st Sess. (1995). These provisions were deeply flawed. In the House version, defendants were permitted to nominate members of the PSC and to contribute financially to their expenses, raising the possibility that the PSC would not represent the interests of the class but would be a stalking-horse for the defendants. Another provision would have insulated the members of the PSC from liability for their oversight actions, but the original named plaintiffs, who would have constituted only a minority of the PSC, would apparently have remained liable to the class even though they could not control the litigation. A third provision would have required the named plaintiffs, but not the PSC members, to pay the defendants' attorneys' fees if the defendants won, again despite the fact that the PSC, rather than the named plaintiffs, controlled the case. Furthermore, the criteria for membership in the steering committee were stated in terms of the percentage of shares in the class owned by the members of the committee. Since it is difficult, if not impossible, to determine accurately how many shares are in the class, *see* text accompanying notes 13-15 *supra*, this definitional problem would be virtually insurmountable.

The proposal also seeks to limit the number of law firms representing the class to the one or two firms selected as lead counsel. In practice, the lead counsel firms do the overwhelming bulk of the litigation work. The proposal seeks to eliminate duplicative or unnecessary work by other plaintiffs' firms that is undertaken primarily to justify a fee award to those firms. Such work does not benefit the class, and is condoned by lead counsel to secure the other firms' cooperation in this and future cases, particularly at the stage of selecting lead counsel.[192]

D. *No Aggregate-Damages Settlements or Judgments*

As discussed above, the calculation of aggregate class damages is presently subject to so much uncertainty, dispute, and manipulation that it must be regarded as essentially unreliable in an evidentiary sense. Recognizing the difficulty of proving aggregate damages, trial courts generally permit the jury to determine only per-share damages, and not the aggregate amount of the judgment.[193] The total amount of the defendant's liability is set by the number of claims filed. Thus, as to cases that actually go to trial the reform proposal simply codifies existing practice.

Extending this rule to settlements would eliminate an obstacle to reaching a negotiated agreement. Because the parties disagree so radically on the total amount of the class's losses, a settlement offer that may appear to one side to represent a substantial concession may seem to the other side to be an outrageous demand. Uncertainty about the number of shares in the class can thus make settlement less likely by increasing the parties' perception of injustice. Requiring settlements to be stated in per-share terms would use that uncertainty to promote settlement. Because plaintiffs' estimates of the size of the class are larger than defendants', plaintiffs should view an offer to settle at a particular per-share amount as worth more than defendants' estimate of the cost. For example, if plaintiffs calculate the number of shares in the class at five million and defendants believe it is only two million, plaintiffs would value an agreement to pay $10 per share at $50 million, while defendants would value it at $20 million. An offer to settle at $10 per share would be more likely to result in agreement than a lump-sum offer. The proposal would thus enlarge the "settlement zone," the range of values within which both parties believe they would be better off settling than going to trial. Obviously, if both sides really believe their experts, someone is going to be surprised when the claims are actually totalled up. Experience will show what methodology is more reliable, and the incentive to exaggerate expert testimony will be removed. The parties' real valuations of the amount at stake will tend to converge.

The most important aspect of the per-share requirements, however, is the benefit it will provide to members of the class. When class members evaluate

192. In other types of cases, work by law firms that represent named plaintiffs but are not lead counsel is not necessarily inefficient. For example, in mass tort cases where individual plaintiffs have significant and individualized claims, individually retained counsel can play an important and beneficial role in addition to the role played by class counsel.

193. *See* authorities cited in Alexander, *Value*, *supra* note 4, at 1457 n.130, 1462 n.146.

whether to object to the settlement or to opt out, they will be able to answer the crucial question: How much will I receive under the settlement? Incredibly, at present the class does not receive this essential information. They are only told the aggregate amount of the settlement and usually the maximum amount allocated to attorneys' fees. They do not know the number of shares eligible to claim or the number likely to file claims. Similarly, stating a proposed settlement in per-share terms gives the judge a more meaningful basis for determining whether the settlement is fair and adequate. Presently, the judge knows only the aggregate amount of the settlement and that the plaintiffs' brief supporting the settlement claims that this amount is fair given the risks of litigation. The judge has no objective criteria by which to evaluate the settlement, as she does not know how much of their losses claimants will recover.

Both plaintiffs and defendants may oppose this provision as well as the requirement that all discussions of the plaintiffs' fee request be deferred until after the settlement is approved and all claims are filed. They might argue that defendants cannot settle the case unless they know the exact amount they will have to pay. However, defendants can estimate the total cost of a settlement stated in per-share terms just as well as plaintiffs can estimate the value to individual class members of a lump-sum settlement. Both can estimate the value of a per-share settlement more easily than class members can evaluate the benefits they will receive under a lump-sum settlement. Per-share settlements will not add any uncertainty to the determination of the fee award, because the hearing on the fee request will not take place until the exact value of the settlement is known.

E. *Fee Awards*

The proposal to determine the fee award separately from the class recovery and to have the fee paid directly by the defendant rather than out of the class recovery is simply a truth-in-labelling provision to make it easier for class members to understand what they will receive under the settlement. While scholars may argue that the deterrent effect of litigation is solely a function of how much the defendant pays, members of the class care whether it goes to them or to the attorney appointed to represent them. This part of the proposal is in effect just a change in labels, breaking the settlement up into the portions paid to the class and to the attorneys. Both the court deciding the fairness and adequacy of the settlement and the fee and the class members deciding whether to object or opt out would have accurate and relevant information on the benefit conferred on the class.

Uncoupling the approval of the fee request from the approval of the settlement is the key to eliminating many of the most serious abuses in class action litigation. Prohibiting the parties from negotiating fees as part of the settlement eliminates a significant potential for collusive settlements and other conflicts of interest. Separating the issue of fees from that of the recovery for the class and requiring the defendant to pay a separately adjudicated (not negotiated) fee

award assures an adversary presentation on the fee request and provides an additional incentive for the attorneys to seek the largest recovery for the class.

Under the present system, attorneys' fees are deducted from the settlement amount off the top; the remainder is paid to the class. The class and its lawyers are thus in a direct conflict of interest on the issue of the fee. The fee award reduces, dollar for dollar, the amount that will be paid to the class. At the very time that this conflict of interest arises, the defendants cease to have any interest in opposing the plaintiffs' attorneys, so the fee request is decided without the benefit of an adversary presentation.

The fee request is customarily submitted for court approval together with the proposed settlement. The settlement agreement typically includes a "clear sailing" clause by which the defendants agree not to oppose an attorneys' fee request of up to a specified amount. The hearing on the fee request is usually held on the same day as the final hearing on the proposed settlement. The defendants have no interest in the size of the plaintiffs' attorneys' fee because it comes out of the class recovery and does not affect the amount the defendants will have to pay. Opposing the fee request, in fact, could jeopardize the approval of the settlement, which is the defendants' primary objective at this stage. Therefore, no one knowledgeable about the litigation will make an adversary presentation on the fee issue. In recognition of the potential for harm to the class' interests, the court must make a determination that the fee is fair and reasonable; but the lack of an adversary presentation hampers this task.[194] For example, though only a small proportion of securities class actions fail to produce a class recovery, courts routinely award multipliers of two, three, or four times the value of actual hours worked to compensate plaintiffs' lawyers for the alleged risk of nonrecovery.[195] Rarely does a court restrict the plaintiffs' lawyers' fees to their hourly rate times their actual hours worked.

The current trend in responding to these problems is to set the fee in advance as a percentage of the recovery.[196] This solution is subject to criticism, however, because it may result in extremely high hourly fees and constitutes an incentive to settle early and without adequate investigation. By contrast, the proposed changes in the procedure for awarding fees would assure the presence of a knowledgeable party with an adequate economic interest to give the court the benefit of an adversarial presentation on the fee issues. In class actions where fees are determined separately by the court and assessed directly against the defendant, the defendant has an incentive to oppose an excessive fee request. The resulting adversary presentation provides the court with more complete information to make a more just determination. For example, in a consumer class action over the defective Pentium processor, the court reduced

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194. The judge can appoint a special master to evaluate the fee request, but this is an expensive proceeding, and the costs of the master's inquiry are paid from the class recovery.

195. *See* Alexander, *Merits*, *supra* note 6, at 549 n.171.

196. *See, e.g.*, ALBA CONLE, ATTORNEY FEE AWARDS 45 (2d ed. 1993); Paul, Johnson, Alston & Hunt v. Graulty, 886 F.2d 268, 268 (9th Cir. 1989) (holding that the percentage approach is proper for setting fees in common fund cases, with 25% serving as a benchmark).

plaintiffs' counsel's fee request by thirty percent after an adversary hearing.[197] The proposal to have defendants pay fee awards directly would still permit percentage-of-the-recovery awards, but they would have to be found reasonable in proportion to the amounts actually received by the class. Most importantly, when fee requests are determined separately and after the settlement is approved, and are paid directly by defendants independent of the payment to the class, defendants will have adequate incentives to actively oppose excessive requests.

Under the proposed procedure, the court would be required to justify its fee award explicitly in terms of the benefit conferred on the class. To further that goal, the hearing on the request for attorneys' fees would be held *after* all claims had been filed.[198] At that time, the court knows the exact number of claims filed and the total payments to the class. It need not rely on conjectures by plaintiffs' experts. This procedure would reduce the incentives for exaggerated estimates of the size of the class, and would eliminate the possibility of inflated claims of the total value of the settlement. Such exaggerated estimates are often found in consumer class actions.[199]

Additionally, the proposal prohibits negotiations over the fee prior to the approval of the settlement. This would eliminate "clear sailing" clauses under which defendants agree not to oppose a request for fees up to a specified amount. Such clauses have obvious potential to encourage collusive settlements. Under the proposed reforms, defendants would pay the fee award directly, and would thus have an incentive to oppose unreasonable requests. The fee hearing would take place after the approval of the settlement, eliminating the pressure to keep silent about fees in order not to jeopardize the approval of the settlement. The proposal also eliminates a source of unfairness in the present practice of consolidating the fee request with the request for settlement approval for hearing and decision. Under this practice, the lawyers receive their fee immediately, but the class has to wait an additional year or two for the claims administration process to be complete. Under the proposed procedure, the attorneys would be paid at the same time as the class.

The proposal thus improves the information available to both the court and the members of the class in evaluating the settlement, as well as adding incentives to the plaintiffs' lawyers to act in accordance with the interests of the class.

197. *See* Mark Walsh, *Plaintiffs' Counsel Awarded $4.2M in Pentium Suit*, RECORDER, Jan. 4, 1996, at 3. Even the reduced award, however, was based on a multiplier of three (as compensation for taking the case on contingency and settling it early). The opposition to the fee request was made by a lawyer acting as amicus curiae rather than by the defendants. *Id.*

198. Presently, the fee request is submitted at the same time as the request for final approval of the settlement, and the court normally rules on both at the same time.

199. *See In re* General Motors Corp. Pick-up Truck Fuel Tank Prods. Liab. Litig., 55 F.3d 768 (3d Cir. 1995) (rejecting district court's valuation of a coupon settlement at close to face value); *In re* Domestic Air Transp. Antitrust Litig., 148 F.R.D. 297 (N.D. Ga. 1993) (discussing valuation issues in coupon settlement).

F. *Some Arguments Against the Proposal*

Lawyers on both sides may protest that this proposal is impractical and unfair, because defendants cannot possibly settle cases unless they know precisely how much they will be paying—that is, they must be able to specify a lump sum settlement amount. Although this argument has a superficial appeal because it sounds as though it is based on economics, it is simply illogical. Parties make litigation decisions every day without knowing precisely how much their own legal fees will be. They agree to contracts, including settlement agreements as well as business contracts, that specify mechanisms for determining payments but with the exact amounts to be determined by future events. More broadly, corporations make all kinds of business decisions in which the total costs and future benefits are uncertain; they are nevertheless able to determine whether such agreements are in their economic interest. In fact, most of these everyday decisions involve more uncertainty than would per-share class settlements. The parameters of the settlement are tightly specified; the claims period seldom exceeds six months; defendants have readily available information about the number of potential claimants (they obtain this information routinely in order to put it to a more partisan use under present law); information about the number of claims filed in previous settlements can also be obtained; and defendants and their lawyers can ascertain how courts have ruled on fee requests.

The argument that defendants will not settle unless they can negotiate fees in advance is a knee-jerk reaction to a reform that would thoroughly transform the routine of negotiating securities class action settlements. Though this part of the proposal might make settling a case somewhat harder because it would prevent the parties from financing their agreement by imposing costs on the class, that is the price of protecting the class from its attorneys' potential conflict of interest. Some cases that would have settled under current practice may not settle under this proposal. Those cases will not just go away; they will be tried. This development, too, will not be comfortable for the securities bar, which is composed primarily of "litigators," many of whom have had scant trial experience in large cases. But a few more trials would be good for both securities law and securities lawyers, improving both lawyers' judgment and the accuracy of settlements.[200]

G. *The Principle of Trans-substantive Procedural Rules*

A more theoretical and fundamental objection to the proposal might be that it would violate the principle, implicit in the Federal Rules of Civil Procedure, that rules of procedure for the federal courts should be trans-substantive. That is, the same procedural rules should apply to cases in all areas of substantive law—there should be no substance-specific procedural rules.

200. *See* McMunigal, *supra* note 118, at 837, 857 (contending that adjudication is necessary for effective functioning of lawyers and accurate prediction of settlements); *see also* Alexander, *Merits, supra* note 6, at 567-68 (noting that if all cases are settled, lawyers have no factual grounding to predict trial outcomes).

This is a weighty objection. The proposed reforms need not, however, be substance-specific. They should apply to class actions in any area of substantive law where the structural defects that they are designed to correct are present. The opt-in procedure, for example, could be useful when there are members of the class with large stakes or when the action is actually in the class's best interest. Opt-in classes will always be the exception to the rule, but they may be appropriate in some defendant class actions, some mass tort cases, and other cases in which these conditions are present. The prohibition on lump-sum settlements and judgments is appropriate whenever the number of claimants is uncertain or disputed, such as in many consumer class actions.

The fee award reforms probably have the most general applicability. They should be considered in all sorts of class actions where there may be a conflict of interest between the class and its attorneys at the fee award stage—that is to say, in all common fund cases. These reforms could be especially useful in consumer class actions where there is a danger of illusory in-kind settlements, fee requests supported by inflated estimates of the value of a nonmonetary settlement, or a settlement for a class of indeterminate size.

In summary, the proposed procedural reforms remove the uncertainties of calculating aggregate class damages from the litigation, settlement, and fee award process, and decrease the amounts at stake in securities class actions. They eliminate some conflicts of interest between the class and its attorneys, and provide improved monitoring of the conduct of the litigation by sophisticated class members whose interests are closely aligned with the public interest in enforcement. Finally, they place meaningful and administrable controls on fee requests.

VI. Conclusion

The present sanction for securities violations involving publicly traded securities in the aftermarket—class wide compensatory damages—has proven ineffective and inefficient. It fails on both compensatory and deterrence grounds. A regulatory sanction with a schedule of civil penalties would provide superior deterrence while reducing the costs of litigation. A regulatory remedy could be enforced through private litigation, most likely by a variation on the qui tam action.

This article also presents an alternative proposal, a package of relatively modest procedural reforms directed at many of the most troubling problems of securities class action litigation. This proposal addresses the adequacy of the class representative, conflicts of interest between the class and its lawyers, sources of uncertainty as to the amount of damages, the need for better information to help the class and the judge evaluate proposed settlements, and the need for an adversary presentation in the determination of the fee award. These procedural reforms would not radically alter the substantive law, and hence may be more palatable than the proposal to replace class-wide compensatory damages with a statutory penalty.