



U.S. CHAMBER
Institute for Legal Reform

Containing the Contagion

*Proposals to Reform the Broken
Securities Class Action System*

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U.S. CHAMBER
Institute for Legal Reform

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Executive Summary

The Institute for Legal Reform's October 2018 report, "A Rising Threat: The New Class Action Racket That Harms Investors and the Economy,"¹ explained in detail the serious problems plaguing the securities class action system:

- The number of cases has exploded, reaching levels not seen since before the enactment of the Private Securities Litigation Reform Act (PSLRA) in 1995.
- Federal courts have been hit by an avalanche of cases alleging misstatements in connection with a public company's merger or acquisition—virtually every deal valued at over \$100 million is hit by a lawsuit. These cases formerly were brought in state courts under state law, but they moved *en masse* to federal court after the Delaware Court of Chancery, and other state courts, cracked down on abusive settlements that provide no benefits to investors and substantial payments to plaintiffs' lawyers. Those illegitimate settlements have resumed now that the cases are brought in federal court.
- A second wave of securities class actions rests on a different theory. These claims are triggered by adverse events in a company's underlying business, such as a product liability lawsuit, data breach, environmental disaster, or other similar negative occurrence. They assert that the company defrauded investors by failing to warn that the adverse event might occur, even though these events are—by definition—unexpected. (Harm from the underlying event is addressed through other types of lawsuits, not securities claims.) Legal experts are skeptical about the merits of these securities claims, but they are powerful weapons for coercing settlements because of the costs of defense and the reputational harm from ongoing litigation focused on such adverse events.
- Data confirm that these new waves of lawsuits are characterized by unjustified, abusive claims. Federal securities cases are being dismissed at a greater rate, and those cases not dismissed are settled, most for an amount less than or equal to the cost of defending the lawsuit. But the costs of litigation are significant and ultimately are borne by investors. And the principal beneficiaries are lawyers—both plaintiffs' and defense lawyers—who reap large fees. That is particularly true of merger and acquisition lawsuits, where lawyers get two-thirds of the payments.

/// Indeed, the number of filings in 2018 set a new record and public companies are more likely than ever before to be sued in a securities class action. ///

- Congress enacted securities class action reform in 1995—the Private Securities Litigation Reform Act (PSLRA)—in large part because it found these cases were plagued by abusive practices, principally driven by lawyers rather than investors. The very same abuses are recurring today. Plaintiffs’ lawyers are again relying on “professional plaintiffs” to bring multiple cases. And in a number of instances the pension funds that are serving as plaintiffs have relationships with the lawyers they hire—often in the form of campaign contributions from lawyers to public officials. Despite the strong congressional purpose to cure the problem of lawyer-controlled litigation, the 1995 reforms have not been fully successful—and the evidence shows that lawyer control is marked by higher fees and lower settlement payments to investors.

New information regarding these cases provides further confirmation of the urgency of the problem and the need for reform.

To begin with, data regarding 2018 securities class action filings shows that the unprecedented rate of filings continued unabated. Indeed, the number of filings

in 2018 set a new record, and public companies are more likely than ever before to be sued in a securities class action. Importantly, 2018’s cases are larger than before and therefore threaten much higher litigation and settlement costs than cases filed in prior years—nearly three times larger than the average for 1997 to 2017.

Merger and acquisition cases continue to be filed in federal court at a breathtaking rate. But the federal courts—in contrast to the Delaware Chancery Court—have not yet identified effective tools for deterring the filing of unjustified claims leading to “settlements” that reward the plaintiffs’ lawyers with fees but provide only meaningless disclosures to investors, who of course pay the bills for the plaintiffs’ lawyers and the defense lawyers and for wasted management time.

Event-driven claims—the second growth category of securities cases—also continue to be filed, notwithstanding skepticism about the legitimacy of a large number of these lawsuits. Again, courts do not appear to have recognized the differences between these suits and traditional securities fraud claims or to have developed tools for quickly weeding out unjustified claims.

Another new category of securities class action has emerged, resulting from the Supreme Court's holding in the *Cyan* case that class actions under the federal Securities Act—including claims under Section 11 of that Act, which is the principal basis for alleging misrepresentations or omissions in connection with initial public offerings—may be brought in state court. The first study quantifying the effect of that decision found a significant number of state court cases filed in 2018, which means that many companies will face securities class action claims in both state and federal court arising out of the same alleged misstatement or omission. That in turn increases the leverage of plaintiffs' lawyers to force settlements regardless of the merits, because of the increased cost of defending in two courts and the

risk that state court judges unfamiliar with these complex cases will deny meritorious motions to dismiss.

Also continuing into 2018 is the evidence of continuing, significant abusive practices by some plaintiffs' lawyers in connection with these cases. In particular, the resurgence of actions brought only by individuals means that lawyers are able to assert the very control over these cases that the PSLRA was designed to prevent.

Action is urgently needed to stop the harm to investors and our capital markets resulting from our out-of-control securities litigation system. Multiple parts of our federal government—the Securities and Exchange Commission, the federal courts, and Congress—can and should take steps to correct today's serious imbalances, steps that are described in detail below.

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The Litigation Explosion Continues

2017 was, at the time, a record year for securities class action filings. That trend continued in 2018—making clear that 2017’s 50 percent increase in filings was not a one-off event but rather the new normal for securities class actions.

Several analysts issued reports on these filings. The numbers differ depending on the study, but the key points are clear.

Another Record Number of Filings

NERA Economic Consulting reported 441 new cases—“the highest [filing rate] since passage of” the Private Securities Litigation Reform Act in 1995 and “a near doubling of filings since 2015.”²

Cornerstone reported 403 federal filings and an additional 17 new cases filed in state court asserting federal securities law claims.³ The 420 total exceeds Cornerstone’s combined state and federal total for 2017. That means, as one experienced observer put it, that “2018 arguably represents the most significant year of securities litigation filing activity since the end of the dot-com era.”⁴

2018 is the second year in a row in which federal class action securities filings doubled the average annual filings over the prior 20 years.⁵

Public Companies are More Likely to be Sued Than Ever Before

“[A] record 8.4 percent of U.S. exchange-listed companies were subject to filings in 2018, slightly above the rate in 2017,” Cornerstone found.⁶ 2018 marks the sixth consecutive year in which the likelihood of securities litigation has increased.⁷

“That means, as one experienced observer put it, that ‘2018 arguably represents the most significant year of securities litigation filing activity since the end of the dot-com era.’”

The D&O Diary reached the same conclusion, finding a “litigation rate of 8.7%, which is not only higher than the rate in 2017 but is in fact the highest rate since at least 1996. In other words, the chances of a U.S.-listed company getting hit with a securities suit arguably were higher in 2018 than [they have] ever been.”⁸

2018 Cases are Larger Than Ever

Estimating the size of securities class actions is difficult, but analysts have developed several measures for assessing cases’ relative size. One is the dollar-value change in a defendant company’s outstanding shares before and after the class period—

and it reached a record \$330 billion in 2018.⁹ That is more than 2.5 times greater than the amount for 2017 and nearly triple the 1997 to 2017 average of \$115 billion.¹⁰

In sum, there can be no doubt that, as Columbia Law School Professor John Coffee, Jr. recently put it, “[s]ecurities litigation is growing at a prodigious rate.”¹¹

The primary drivers behind this explosion continue to be two fundamental changes in the nature of federal securities lawsuits: M&A claims and event-driven litigation. Additionally, there is a new “*Cyan Effect*” at issue after the Supreme Court’s 2018 ruling, all of which are described in the following sections.

No Let-Up in Merger & Acquisition Claims

While rare just a few years ago, suits challenging public company mergers and acquisitions (M&A) comprised approximately half of 2018's filings.¹² This was the case in 2017 as well. These M&A cases, which allege that disclosures to shareholders relating to the transaction were false and deceptive, largely migrated to federal court after some state courts—notably Delaware's Court of Chancery—cracked down on such cases.¹³

It is not clear whether federal courts can or will arrive at a similarly effective response. Professor Coffee recently explained the problem:

The Delaware Chancery Court is a concentrated group of sophisticated judges who collectively bore the impact of a multitude of merger objection cases. Ultimately, they realized their time was being wasted — and they responded collectively. In contrast, federal judges are dispersed, and each federal district judge sees only a few such cases. Moreover, with all respect to federal judges, they can be characterized as “Lone Rangers” who do not typically act collectively. Hence, a joint response is less likely.¹⁴

And even if federal judges are willing, there are a number of significant obstacles.

Plaintiffs may be able to choose where to file based on the court's willingness to process abusive M&A settlements.

First, generous venue rules may allow an M&A claim against a particular company to be brought in any of a number of different federal courts. Plaintiffs may be able to choose where to file based on the court's willingness to process abusive M&A settlements. Indeed, the adoption by the U.S. Court of Appeals for the Seventh Circuit of a tough standard similar to Delaware's Court of Chancery led to a more than 60 percent reduction in the proportion of merger objections filed in that Circuit.¹⁵

Second, plaintiffs seek to avoid any federal court oversight by using the tactic of an out-of-court settlement—in which the defendant agrees to insignificant additional disclosures, the plaintiffs’ lawyers are paid a “mootness fee,” and the case is dismissed. There is no clear answer to the question of whether courts may intervene to stop, or at least oversee the legitimacy of that practice.

One federal court stated that it “will exercise its inherent powers to police potential abuse of the judicial process—and abuse of the class mechanism in particular—and require plaintiffs’ counsel to demonstrate that the disclosures for which they claim credit” are “plainly material.”¹⁶ That is so, the court explained, because “disclosure suits like this are generally ‘no better than a racket’ that ‘should be dismissed out of hand,’” absent a demonstration that the disclosures are “‘plainly material.’”¹⁷ It emphasized that “courts should not permit plaintiffs’ counsel to file cases purely to exact attorneys’ fees from corporate defendants under any circumstances.”¹⁸

But another court found that it lacked the power to intervene.¹⁹

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Professor Coffee suggests that federal courts use the tools set forth in the PSLRA, which include mandatory evaluation of dismissed cases to determine whether the claim was frivolous and standards for attorneys’ fees.²⁰ It is not clear, however, whether courts will take those steps—and plaintiffs’ lawyers might begin to bring M&A suits as individual cases rather than class actions in order to avoid that risk.

// The fact is that the plaintiffs' lawyers are continuing to file federal court merger objection lawsuits. //

Another source of relief could be the U.S. Supreme Court, which will hear argument in mid-April 2019 in *Emulex Corp. v. Varjabedian*,²¹ a case involving a claim under Section 14 of the Securities Exchange Act, which is the provision of federal law invoked in M&A cases. The question before the Court is whether the U.S. Court of Appeals for the Ninth Circuit was correct in holding that a negligent misstatement or omission is sufficient to establish liability, or whether the higher “scienter” standard—which requires intentional wrongdoing or a high degree of recklessness—is required. Adopting the tougher standard, and rejecting the Ninth Circuit’s rule, will at least prevent the expansion of M&A lawsuits, but it is not likely to reduce them.

And in any event, plaintiffs’ lawyers almost certainly would adapt by invoking other sections of the federal securities laws to justify their lawsuits.

The bottom line: M&A claims continue to plague the federal courts in record numbers.

[F]ederal court merger objection lawsuits continued to be filed at significant levels, apparently unabated. To be sure, the way these suits are being resolved now may have changed (with plaintiffs’ attorneys now agreeing to dismiss the suits in exchange for the defendants’ agreement to pay a mootness fee), but that is a different issue. The fact is that the plaintiffs’ lawyers are continuing to file federal court merger objection lawsuits.²²

Unfortunately, there is no reason to believe this phenomenon will change without a focused effort to address the problem.

Event-Driven Claims Continue to Grow

The second dramatic change in securities lawsuits has been the growth in event-driven claims. As Professor Coffee explains,

Once, securities class actions were largely about financial disclosures (e.g., earnings, revenues, liabilities, etc.). In this world, the biggest disaster was an accounting restatement. Now, the biggest disaster may be a literal disaster: an airplane crash, a major fire, or a medical calamity that is attributed to your product... The expectation of major losses from the disaster sends the issuer's stock price down, which in turn triggers securities litigation that essentially alleges that the issuer failed to disclose its potential vulnerability to such a disaster.²³

Event-driven litigation differs fundamentally from traditional securities cases, as "traditional securities litigation is not filed in the immediate wake of a stock drop; rather, plaintiff's counsel spends months interviewing potential witnesses and gathering evidence in order to be able to plead an intent to defraud with the degree of particularity that the Private Securities Litigation Reform Act (PSLRA) demands."²⁴

But "[a] different pattern prevails...in the case of event-driven securities litigation, which regularly follows in the immediate wake of a stock drop"—and that may be

“ [T]he inherent problem in all event-driven securities litigation is that just because something bad happened does not mean that the company or its directors and officers committed fraud. ”

because “some plaintiff’s counsel are less concerned about surviving a motion to dismiss because they expect an early (and cheap) settlement.”²⁵ As another experienced observer of securities class actions commented with respect to event-driven claims, “[f]irst comes the event, then comes the lawsuit.”²⁶

The legitimacy of these lawsuits remains suspect. As two experienced securities litigators have explained, “[t]he inherent problem in all event-driven securities litigation is that just because something bad happened does not mean that the company or its directors and officers committed

fraud. Because many of these events relate to business or operational risks that are known or already subject to a company's risk disclosures, many of the event-driven suits are based on the tenuous theory that the occurrence or the event upon which the case is based was the materialization of an under-disclosed or downplayed risk."²⁷

It has been pointed out that "[w]hen the risk seemed remote at the time the corporate issuer made its disclosures, both the materiality of the issuer's omission and its alleged scienter"—key elements of the federal securities claim—"would seem open to serious challenge."²⁸ But obtaining dismissal on materiality grounds can be difficult under current precedent: "although many cases should and will be dismissed, this category of cases may remain viable because the potential damages are often very high."²⁹

It is not surprising, therefore, that even in the past several months, new event-driven claims have continued to be filed—and have continued to meet the pattern of "file first, investigate later."

For example, on November 30, 2018, Marriott issued a press release informing customers of a breach of its guest reservation system.³⁰ The very next day, plaintiffs' lawyers filed a securities class action in the Eastern District of New York,³¹ alleging that Marriott and its executives made false and misleading statements and failed to disclose the database's security issues.³² The complaint devoted one paragraph to

alleging that Marriott and its executives acted with scienter.³³ As *The D&O Diary's* Kevin LaCroix put it, "the scienter allegations in the new Marriott lawsuit are not extensive (to say the least)."³⁴

Another case followed a tragic plane crash, which killed everyone on board.³⁵ The crash marked the Boeing 737 Max 8's first accident.³⁶ The following month, a shareholder sued Boeing in a securities class action.³⁷ The complaint relied on press reports that the company withheld information about its new flight-control system from airlines or pilots.³⁸ But citing the information contained in those reports, of course, is "a different thing from saying the information was withheld from investors in violation of the federal securities laws."³⁹ According to Kevin LaCroix, "[t]he allegations of scienter in the complaint are not, shall we say, extensive."⁴⁰

After wildfires in California, a utilities company shareholder filed a securities class action.⁴¹ The complaint alleged that the company made false and misleading statements regarding its policies, which heightened the risk of wildfires in California.⁴² But the complaint devoted little space to establishing how the defendants acted with scienter, especially in view of the defendants' prior disclosures stating that "wildfires...can disrupt the generation and transmission of electricity, and can seriously damage the infrastructure necessary to deliver power," which can lead to "lost revenues and increased expenses," "regulatory penalties and disallowances,"

and “damage [to] the business reputation” of the defendants.⁴³ The case was filed “[j]ust eight days after the fire started and while the embers were still smoldering.”⁴⁴

Other event-driven securities cases involve the collapse of a dam in Brazil,⁴⁵ alleged price-fixing of a company’s products,⁴⁶ and alleged sexual misconduct by an executive⁴⁷—among other claims.

These cases are only examples of what has become a significant trend. Fueled by event-driven claims, non-M&A securities suits are increasing over past levels. For example, one study of 2018 cases found that—after ignoring the M&A cases that constitute 50 percent of the total—“[t]he likelihood of an S&P 500 company being sued was the highest since 2002”—one in every eleven companies was sued, amounting to 9.4 percent of such companies.⁴⁸

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The *Cyan* Effect

The Supreme Court altered securities class action practices with its March 2018 ruling in *Cyan, Inc. v. Beaver County Employees Retirement Fund*.⁴⁹ That decision held that class actions under the federal Securities Act—including claims under Section 11 of that Act, which is the principal basis for alleging misrepresentations or omissions in connection with initial public offerings—may be brought in state court.

Prior to 2015, only a few such claims were filed. But since then, the numbers have grown with 33 cases filed in 2018.⁵⁰ Seventeen of those cases did not have parallel actions in federal court, but in the others there were parallel actions in federal court involving the same or very similar allegations.⁵¹

“The advent of a parallel track of securities class action litigation in state court creates a number of significant problems...”

The advent of a parallel track of securities class action litigation in state court creates a number of significant problems, as securities litigation veteran Kevin LaCroix has explained:

- “[i]t increases the likelihood that a company defendant might have to fight a multi-front war, in the event of parallel state court and federal court lawsuits”;⁵²
- “state court securities class action lawsuits are less likely than federal court lawsuits to be dismissed”⁵³—48 percent of federal court Section 11 claims are dismissed, compared to 33 percent of state court claims;⁵⁴ and
- “IPO companies now face a measurably more significant risk of getting hit with a securities lawsuit than may have been the case before *Cyan*.”⁵⁵

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Plaintiffs' lawyers will be able to exploit these dual forums to pressure defendants to settle regardless of the merits of the cases—and to litigate complex claims before state court judges with little or no experience in applying the federal securities laws.

When Congress enacted the Securities Litigation Uniform Standards Act in 1998,⁵⁶ it recognized the adverse consequences

of fragmenting claims regarding alleged misrepresentations or omissions by public companies. The Supreme Court held in *Cyan* that the text of the Act did not divest state courts of their pre-existing jurisdiction over 1933 Act claims, even if that result would serve Congress's purpose. The initial data indicates that the precise harms Congress sought to prevent are likely to result from the *Cyan* decision.

Abusive Conduct by Plaintiffs' Lawyers

Recent developments also highlight the need to curb the plaintiffs' bar's ongoing abusive litigation practices.

Professional Plaintiffs

First, individual plaintiffs—rather than institutional investors—are increasingly being appointed as lead plaintiffs. That is exactly the opposite of Congress's goal in enacting the 1995 reforms, which sought to put institutional investors in control of these cases in order to check the power of the plaintiffs' bar.

Those reforms worked for the first 15 years following enactment of the PSLRA: although individuals initially were appointed lead plaintiff more often than institutional investors, by 2004, institutional investors were as likely or more likely to serve as lead plaintiffs—and that continued through 2010.⁵⁷ But starting in 2013, individuals more frequently served as lead plaintiffs—and they were named as the sole lead plaintiffs in 60 percent of the cases filed in 2017 and 2018.⁵⁸

This change is strong additional evidence that claims brought in recent years are less meritorious than in the past. Institutional investors simply are not willing to endorse them. Plaintiffs' lawyers therefore are forced to turn to their pet "professional plaintiffs," which results in the very lawyer-driven litigation that the PSLRA sought to eliminate.

Frequent Filers

Second, one study found that three plaintiffs' law firms appear as counsel of record on more than half of the initially-filed complaints in non-M&A cases.⁵⁹ These firms' activity has coincided with an increase in the appointment of individuals, rather than institutional investors, as lead plaintiffs.⁶⁰ And the three firms' cases were dismissed at a rate of a staggering 51 percent, compared to the already-high 43 percent for all other firms.⁶¹

The concentration of so much litigation activity in a few firms—especially activity that has characteristics consistent with unjustified

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claims—raises serious questions. That is especially true because these firms' cases involve small damages exposure,⁶² which means that the settlement that companies can be pressured to pay will likely be less than the costs of defending the lawsuit through trial. In that situation, what rational company would decide not to settle?

Excessive Fees

Third, the continuing saga of the *State Street Bank* case provides a window into abusive practices by plaintiffs' firms. (The case arises under a different federal statute, but the law firms involved frequently file securities class actions.)

The parties to the case, which involved alleged unfair and deceptive practices in conducting complex foreign exchange transactions, reached a \$300 million settlement.⁶³ Plaintiffs' counsel were awarded more than \$74 million in attorneys' fees, on top of another \$1.25 million for expenses.⁶⁴

Questions arose regarding some of the attorneys' fee requests, and the district court appointed a Special Master to investigate. After a 14-month investigation and a painstaking review of hundreds of thousands of pages of documents, the Special Master found that the fee award was undermined by serious mistakes that were only "compounded by a troubling disdain for candor and transparency that at times crossed the line into outright concealment of important material facts, including the payment of an enormous amount of money from class funds to a lawyer who never appeared in the case, did no work on the case, and whose identity was intentionally hidden from the clients, the class, co-counsel and the Court."⁶⁵ He

determined that the plaintiffs' "lawyering... became tainted and entangled in a web of concealment and highly questionable ethical practices by experienced attorneys who should have known better."⁶⁶

These questionable practices included payment to a lawyer in Texas of an undisclosed "finder's fee," amounting to a full "20 percent of the attorneys' fee it received in the litigation."⁶⁷ Professor John Coffee observed that the Special Master's report "shed an important light on the 'rather sordid market of buying and selling plaintiffs' in securities class actions"—an arrangement perceived as both "'under the table and dubious."⁶⁸

Although the plaintiffs' firm initially objected to the Special Master's findings, it subsequently "acknowledge[d] that its conduct in [the] case did not meet emerging best practices of transparency, candor, and reliability."⁶⁹ The firm offered its "sincere acceptance of responsibility and expression of regret," and it agreed to undertake a multitude of remedial actions.⁷⁰ It "discontinued," for instance, "its practice of allowing another firm to pay for the costs of [its] staff attorneys working at [its] office, and of allowing its staff attorneys to be included on another Firm's lodestar petition"—which resulted in a fee award for the staff attorneys' work far in excess of their cost to the firm.⁷¹ And the firm agreed to return \$4.8 million in attorneys' fees to the class and to other law firms.⁷²

This case study—in which a fee petition was subject to close review that virtually never occurs in securities litigation—provides a strong indication that there may be serious problems lurking beneath the surface in other cases.

Proposals for Reform

The securities class action system is plainly broken, harming investors and our capital markets. Reforms are urgently needed—and multiple parts of the federal government have important roles to play in remedying this serious problem.

The Securities and Exchange Commission

The Securities and Exchange Commission is responsible for protecting our nation's capital markets and enforcing the federal securities laws. It has the ability to collect relevant information and identify threats to the capital markets and investors. And it can promote appropriate solutions to eliminate those threats.

The Commission should therefore undertake a project to evaluate the current state of private securities class action litigation, with a focus on identifying abuses that are harming investors and suggesting practical ways to address those abuses. For example, M&A lawsuits are nothing less than a transaction tax diverting resources away from productive uses and into the pockets of lawyers.

The Commission should issue a policy paper describing the problem and then institute a program of amicus brief filings to inform federal courts of the pervasiveness of the M&A lawsuit problem and its

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adverse consequences, and urging them to intervene early to prevent the use of these cases to extort unjustified attorneys' fees. It could suggest that courts assert authority to review any out-of-court resolutions of these cases and order a Rule 11 proceeding to assess whether the complaint was sanctionable, particularly when—as is often the case—the same plaintiff has filed multiple M&A claims.

// Congress therefore should plug the loophole identified by the Supreme Court in *Cyan* and require all federal securities class actions to be brought in federal court. //

Another area appropriate for the Commission's attention is event-driven litigation. Numerous securities law experts have explained how difficult it can be for a plaintiff to plausibly allege the materiality, scienter, and loss causation elements of a federal securities claim. The Commission could issue a policy paper addressing those issues and use that analysis as the basis for submitting amicus briefs in appropriate cases to assist courts in analyzing these issues.

Federal Courts

Federal courts should take account of the successful approach adopted by the Delaware Chancery Court to address the M&A litigation avalanche. That means recognizing that the cases before them are not isolated one-off filings but instead part of a significant trend, and using available tools to detect and sanction abusive filings in order to deter future filings that will add to the flow of unjustified lawsuits.

Congress

Congress should enact targeted statutory changes that will eliminate the well-documented abuses of securities class actions.

OVERTURN *CYAN*

First, Congress should overturn the *Cyan* decision to ensure that federal securities class actions are heard in federal court. Allowing plaintiffs' lawyers to bring federal securities class actions in state and federal courts opens the door to multiple types of abuse. Companies can be forced to defend in two courts at the same time, multiplying litigation costs and creating added pressure to settle regardless of the merits. And state court judges are much less experienced in handling complex securities litigation. Congress therefore should plug the loophole identified by the Supreme Court in *Cyan* and require all federal securities class actions to be brought in federal court.

CENTRALIZE M&A LAWSUITS

Second, if courts are not able to deter abusive M&A claims, Congress should take action. Hopefully, federal courts will be able to use existing tools to deter unjustified M&A lawsuits. But if they cannot, Congress should act to centralize these claims so that they will be filed in a limited number of federal courts that will be able to establish standards to deter the abusive claims that are now flooding the courts. Congress could accomplish this goal by requiring M&A lawsuits to be brought in the state of incorporation of the company whose disclosures are challenged in the lawsuit.

ENACT INVESTORS' BILL OF RIGHTS

Third, Congress should prohibit abusive practices used by plaintiffs' lawyers to exercise the very control over these lawsuits that the PSLRA sought to eliminate. Congress in 1995 recognized that the fundamental problem underlying the broken securities class action system was that cases were controlled by plaintiffs' lawyers rather than by investors. But the lead plaintiff system that Congress enacted has not solved the problem. Once again, the same "professional plaintiffs" are used by plaintiffs' lawyers to file dozens of lawsuits. Once again, financial connections between plaintiffs' lawyers and their clients enable the lawyers to control the litigation. Once again, fees for plaintiffs' lawyers do not bear a reasonable relationship to the benefit conferred on investors.

Congress should therefore enact a bill of rights for securities investors that gives courts the information they need to stop these abuses once and for all. It should:

- Require disclosure of all relationships between plaintiffs' lawyers and plaintiffs—personal, professional, economic (including campaign contributions), and otherwise (including any referral arrangements entered into with other lawyers with such relationships with the plaintiffs). And direct courts to assess these relationships in determining whether the case may continue.
- Presumptively bar any individual or entity from serving as a plaintiff in more than five cases in 36 months, requiring a reviewing court to find a compelling justification before allowing an additional case to proceed.
- Require federal courts to more closely scrutinize fee requests. This could include requiring the appointment of an independent monitor in all cases, or at least all cases involving fee requests over a specified threshold. Alternatively, Congress could specify a set of presumptive ceilings on fee awards, requiring the court to make findings that a case is unusual to exceed those ceilings. Finally, courts assessing fee applications should be required to take account of the extent to which the alleged fraud, and the factual contentions relied on by the plaintiff, were uncovered first by government investigators, journalists, or others and simply incorporated into the complaint by the plaintiffs' lawyers. Compensation should be reduced when the key information was not the product of the lawyers' work.

ELIMINATE ABUSIVE LITIGATION TACTICS

Congress should also eliminate abusive litigation tactics, especially those that circumvent protections enacted by Congress in 1995. Over the past 20 years, the plaintiffs' bar has been able to blunt the effect of several key reforms enacted in the PSLRA. Congress should amend the statute to prohibit these unjustified "work-arounds":

- The PSLRA assumed that securities fraud claims would be resolved in class actions, and its reforms therefore apply to that category of lawsuits. In response, some plaintiffs' lawyers have adopted the practice of urging large investors (individuals and entities such as funds) to file individual actions, either in federal court or in state court.

“ Congress should investigate the real-world economic consequences of these cases and adopt an appropriate cap on damages, taking account of any profits by culpable insiders. ”

Those separate cases multiply the defendants’ litigation costs and can be used to coerce the defendant into paying exorbitant settlements to avoid an adverse judgment in an individual case that could be used against the defendant in the class action. In some cases, these settlements can deplete available resources and leave investors in the class action (which will always include small investors) with only a limited chance of recovery. Congress should require that any such claims be stayed until after the class action is resolved.

- The district court’s decision on the motion to dismiss is the critical event in securities class actions: if the motion to dismiss is denied, class certification and settlement virtually always follow—as the data demonstrate. Because this ruling is so critical, Congress should provide for interlocutory appeals of denials of motions to dismiss—either as of right or based on a discretionary standard such as the one governing appeals of class certification decisions under Federal Rule of Civil Procedure 23(f).

- The PSLRA’s pleading standard and its stay of discovery pending resolution of the motion to dismiss were two of its most critical reforms to prevent abusive tactics. Court interpretations have weakened both protections, and Congress should restore the Act’s original meaning.

ADOPT A DAMAGES CAP

Congress should also consider adopting a cap on damages for non-IPO cases, with small investors given priority to collect damages. Numerous commentators have recognized that securities class actions cannot be justified on the theory that they effectively compensate injured investors. As the Institute for Legal Reform’s October 2018 study explained,⁷³ these cases simply shift money from one group of innocent investors (the company’s current shareholders) to another (the plaintiff class), with huge transaction costs paid to lawyers. For that reason, scholars such as John Coffee have advocated a cap on this “pocket-shifting” exercise,⁷⁴ that makes investors systemically worse off. Congress should investigate the real-world economic consequences of these cases and adopt an appropriate cap on damages, taking account of any profits by culpable insiders. Small investors should have priority in the distribution of such recoveries.

Conclusion

Recent data confirms what has been clear for some time: the securities class action system badly needs reform. Cases are at record high levels; the likelihood that a public company will be sued has never been greater; the system is plagued by M&A claims that exhibit every characteristic of classic litigation abuse; and event-driven claims are increasingly used to coerce unjustified settlements. Much of this illegitimate litigation is the product of abusive practices by plaintiffs' lawyers—precisely what led Congress to reform securities class actions 24 years ago.

Multiple parts of the federal government have important roles to play in reforming this broken system. The Securities and Exchange Commission, with its core responsibility of protecting the capital markets and investors, should analyze the current class action system, issue policy papers identifying abusive practices and ways to remedy them, and inform courts—through the filing of *amicus* briefs—of appropriate ways to curtail litigation abuse.

The federal courts should recognize that there has been a change in the nature of securities class actions, which warrants a judicial response that will curtail the systemic abuse now underway. And Congress should enact targeted reforms that will prohibit the abusive practices in use today and give courts the tools they need to stop unjustified lawsuits.

Endnotes

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