

# REFORMING THE SECURITIES CLASS ACTION: AN ESSAY ON DETERRENCE AND ITS IMPLEMENTATION

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*Securities class actions impose enormous penalties, but they achieve little compensation and only limited deterrence. This is because of a basic circularity underlying the securities class action: When damages are imposed on the corporation, they essentially fall on diversified shareholders, thereby producing mainly pocket-shifting wealth transfers among shareholders. The current equilibrium benefits corporate insiders, insurers, and plaintiffs' attorneys, but not investors. The appropriate answer to this problem is not to abandon securities litigation, but to shift the incidence of its penalties so that, in the secondary market context, they fall less on the corporation and more on those actors who are truly culpable. This Essay proposes a variety of means to this end involving the settlement process, insurance, and attorneys' fees.*

## INTRODUCTION

Critics of the securities class action have advanced virtually every conceivable critique—except the most telling. The standard criticism from the business community, the corporate bar, and some academics has long been that securities class actions disproportionately assert “frivolous” claims and thereby reduce shareholder welfare on average.<sup>1</sup> A related theme has been that securities class actions systematically overcompensate, yielding damages that exceed the societal harm, and therefore should be limited by some form of ceiling on damages.<sup>2</sup> Courts also have

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1. The Private Securities Litigation Reform Act of 1995 (PSLRA) was clearly a product of this sense that securities class actions were disproportionately nonmeritorious. See Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.). In enacting the PSLRA, Congress announced this view explicitly, stating in the legislative history that among the PSLRA's purposes was the desire to end the “routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action.” H.R. Rep. No. 104-369, at 31 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 730. This view that securities class actions were often frivolous was nurtured in part by academic research, much of it still controversial. See James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. Pa. L. Rev. 903, 979 (1996) (“[E]mpirical results show that most securities-fraud class actions are, in fact, frivolous.”); Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 Vand. L. Rev. 1465, 1477–98 (2004) [hereinafter Choi, *Evidence*] (reviewing prior studies suggesting securities class actions were frequently or normally nonmeritorious).

2. The most recent and unrelentingly critical attack has been sponsored by the U.S. Chamber of Commerce. See, e.g., Anjan V. Thakor with Jeffrey S. Nielsen & David A. Gulley, U.S. Chamber Inst. for Legal Reform, *The Economic Reality of Securities Class Action Litigation* 5 (2005), available at <http://www.instituteforlegalreform.com/pdfs/>

expressed similar doubts, and this Term the Supreme Court has again noted the unique “vexatiousness” of securities litigation.<sup>3</sup> In contrast, the plaintiffs’ bar (and some academics) protest that the Private Securities Litigation Reform Act of 1995 (PSLRA) has crippled the securities class action and denied it the ability to reach important types of securities fraud, such as fraudulent forward-looking statements.<sup>4</sup> All this rhetoric, however, misses the fundamental problem: As presently constituted, se-

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EconomicRealityNavigant.pdf (on file with the *Columbia Law Review*) [hereinafter Thakor, Economic Reality] (arguing that large institutional investors are overcompensated as a result of securities litigation); Anjan V. Thakor, U.S. Chamber Inst. for Legal Reform, The Unintended Consequences of Securities Litigation 14 (2005), available at <http://www.instituteforlegalreform.com/pdfs/UnintendedConsequencesThakor.pdf> (on file with the *Columbia Law Review*) (stating that information-related disclosure litigation “destroys on average approximately 3.5% of the equity value of a company” with result that “at least \$24.7 billion in shareholder wealth was wiped out just due to litigation”); see also Donald C. Langevoort, Capping Damages for Open-Market Securities Fraud, 38 Ariz. L. Rev. 639, 646 (1996) (arguing that there will be “systematic overcompensation” from securities fraud litigation if full compensation becomes goal of securities litigation). This line of argument about excessive damages originates with Frank H. Easterbrook & Daniel R. Fischel, Optimal Damages in Securities Cases, 52 U. Chi. L. Rev. 611, 639–40 (1985), which argued that because for every investor who lost money in a secondary market case, another investor profited, the social harm could not be defined as the sum of all investor losses. Accordingly, they argued that attempts to compensate such losses fully would yield systematically excessive damages. *Id.*

3. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510 (2006) (arguing that securities litigation presents “danger of vexatiousness different in degree and in kind from that which accompanies litigation in general” (internal quotation marks omitted) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975))). To the extent that courts doubt the legitimacy of securities litigation and see little valid purpose being served, this refrain will predictably be repeated. This Essay seeks, however, to ground securities litigation on a stronger rationale.

4. For the strongest recent defense of the securities class action, which defends it on both deterrent and compensatory grounds, see James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 Ariz. L. Rev. 497, 509–15 (1997). For an earlier defense written at the time of the passage of the PSLRA suggesting that the premises underlying the PSLRA were unfounded, see Joel Seligman, Commentary, 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, 439 (1994). Other academic articles have raised the narrower argument that the PSLRA may chill meritorious actions at least as much as it chills “frivolous” ones. See, e.g., Hillary A. Sale, Heightened Pleadings and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ’33 and ’34 Act Claims, 76 Wash. U. L.Q. 537, 562–65 (1998); Lynn A. Stout, Commentary, Type I Error, Type II Error, and the Private Securities Litigation Reform Act, 38 Ariz. L. Rev. 711, 714–15 (1996). Professor Stephen J. Choi, long a critic of “frivolous” securities litigation, has also noted that the PSLRA may chill meritorious claims that lack hard evidence of fraud. Stephen J. Choi, Do the Merits Matter Less After the Private Securities Litigation Reform Act? 22–27 (N.Y. Univ. Law & Econ. Res. Paper Series, Paper No. 03-04, 2005), available at [http://papers.ssrn.com/abstract\\_id=558285](http://papers.ssrn.com/abstract_id=558285) (on file with the *Columbia Law Review*). For the plaintiffs’ bar’s view of recent developments in the securities class action, see, e.g., Patrick J. Coughlin, Eric Alan Isaacson & Joseph D. Daley, What’s Brewing in *Dura v. Broudo*? The Plaintiffs’ Attorneys Review the Supreme Court’s Opinion and Its Import for Securities-Fraud Litigation, 37 Loy. U. Chi. L.J. 1, 31–41 (2005).

curities class actions produce wealth transfers among shareholders that neither compensate nor deter.

This Essay is equally skeptical of those who claim that securities litigation is vexatious and frivolous and those who claim that it has been seriously chilled.<sup>5</sup> Its basic diagnosis views compensation as unobtainable and deterrence as deeply compromised by a variety of inconsistent legal doctrines that pull the punch of private enforcement. Deterrence, it will be argued, is the only rationale that can justify the significant costs—both public and private—that securities class actions impose on investors and the judiciary. Potentially, securities class actions could fulfill their deterrent promise. Indeed, private securities class actions currently represent the principal means by which financial penalties are imposed in cases of securities fraud and manipulation. In the aggregate, they impose penalties that overshadow those imposed by federal and state authorities and by self-regulatory organizations.<sup>6</sup> Moreover, the total amount of damages awarded in securities class actions has soared in recent years.<sup>7</sup>

But do these massive penalties achieve much of value—let alone approach optimal deterrence? Not necessarily. Deterrence works best when it is focused on the culpable, but there is little evidence that securities class actions today satisfy this standard. Rather, because the costs of securities class actions—both the settlement payments and the litigation expenses of both sides—fall largely on the defendant corporation, its shareholders ultimately bear these costs indirectly and often inequitably.

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5. The true “strike suit” nuisance action, filed only because it was too expensive to defend, is, in this author’s judgment, a beast like the unicorn, more discussed than directly observed. Although small settlements may have been impelled in part by the high cost of defense, the corresponding observation is that the small damages in these cases also did not justify much effort on the plaintiff’s side. Neither side wanted to invest much effort in them—but this does not make them inherently frivolous. Similarly, the economic evidence that strike suits predominate also seems unpersuasive. A series of event studies have sought to demonstrate that securities class actions are frivolous based on the positive stock price reaction to political developments seeking to curtail such litigation. Compare D. Katherine Spiess & Paula A. Tkac, *The Private Securities Litigation Reform Act of 1995: The Stock Market Casts Its Vote . . .*, 18 *Managerial & Decision Econ.* 545, 553–55 (1997) (analyzing market impact of PSLRA presidential veto threat and of subsequent congressional veto override), and Marilyn F. Johnson, Ron Kasznik & Karen K. Nelson, *Shareholder Wealth Effects of the Private Securities Litigation Reform Act of 1995*, 5 *Rev. Acct. Stud.* 217, 226–29 (2000) (same, using different industry sample), with Choi, *Evidence*, *supra* note 1, at 1477–83 (analyzing these two studies). Although these studies focused on the shareholder wealth effects of the PSLRA, they do not measure whether such litigation was frivolous, but only that it ultimately imposed costs on shareholders. This negative market reaction seems more fairly attributed to what this Essay will term the “circularity problem”—namely, that the costs of the action fall principally on innocent shareholders.

6. See *infra* notes 19–20 and accompanying text.

7. In 2005, corporations paid a record \$9.6 billion in securities class action settlements, as compared with \$2.9 billion in 2004. This \$9.6 billion does not include the \$7.1 billion partial settlement in the Enron litigation, which remains to be judicially approved. Paul Davies, *Class-Action Pay Settlements Soar*, *Wall St. J.*, Feb. 7, 2006, at C3.

This year, the Securities and Exchange Commission itself recognized this point in the related context of financial penalties, formally acknowledging in a statement of its intended future policy that large financial penalties should be avoided when they will fall inequitably on innocent shareholders.<sup>8</sup> The Commission indicated that its future policy, at least in cases where the corporation did not directly benefit from the violation, would be “to seek penalties from culpable individual offenders.”<sup>9</sup> By the same logic, imposing the full cost of securities class actions on shareholders can be at least as inequitable. In the typical secondary market case, the corporation is not selling its securities and thus does not receive any “direct benefit” (in the Commission’s phrase) when its managers inflate its earnings and stock price (usually for their own benefit). To punish the corporation and its shareholders in such a case is much like seeking to deter burglary by imposing penalties on the victim for having suffered a burglary. Although such an approach might arguably encourage additional precautions, it will also encounter predictable resistance from those it is ostensibly seeking to protect.

This explanation, that the burden of securities legislation falls perversely on the victim, also better explains those stock price event studies that report that the subject company’s stock price typically falls when a securities class action is filed and that stock prices generally rise when legislation is passed curtailing securities class actions.<sup>10</sup> These studies are often cited as proof that such litigation is frivolous, but they show no such thing. Rather, whether the action is meritorious or frivolous, the costs of such litigation fall on innocent shareholders, not the responsible parties. As a result, the market reacts adversely to the filing of the action because it expects that the eventual settlement of the action will be borne by the shareholders as a group.

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8. On January 4, 2006, the SEC issued this formal statement of future policy regarding financial penalties by the unusual means of a press release, which stated that exemplary penalties should be visited upon the corporate issuer only in special cases:

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

Press Release, U.S. Sec. & Exch. Comm’n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), at <http://www.sec.gov/news/press/2006-4.htm> (on file with the *Columbia Law Review*). The Commission then added that two principles would guide it in the future imposing penalties on a corporation:

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

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

9. Id.

10. See studies discussed *supra* note 5.

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

Obvious as the goal of imposing penalties on the culpable may seem, it is easier said than done. Practical difficulties abound, which this Essay will address in four stages. Part I will begin with some basic public policy cost accounting that is intended to place the securities class action in context as the principal enforcement mechanism for policing the equity capital markets. Part II will then turn to the central problem: Securities class actions essentially impose costs on public shareholders in order to compensate public shareholders. This is a circular process whose perverse effects are compounded by the twin facts that (a) public shareholders tend to be diversified (and thus are on both sides of the wealth transfer), and (b) on each such transfer a significant percentage of the transfer payment goes to lawyers and other agents. Those who defend this system proclaim that it is no different from the system of entity liability that tort law scholarship has long endorsed, but Part II will draw some basic distinctions. Unlike most tort litigation, which seeks to force shareholders to bear the costs that their corporation imposes on others, securities litigation imposes costs on investors because of harm done to investors—without recognizing that the victim is again bearing the costs of its own injury. Equally important, the corporation may not be the best “cost avoider” of financial fraud that is engaged in primarily to benefit corporate managers (a category into which most securities fraud, it will be argued, falls). Part III will then assess why the losses suffered by injured investors today are seldom imposed on the responsible officers and agents of the corporation whose misbehavior caused those losses. Then, it will explore the practical problems, including insurance and indemnification, that interfere with achieving such an allocation. Finally, Part IV will propose some practical remedies toward such a reallocation.

## I. PLACING THE SECURITIES CLASS ACTION IN CONTEXT

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

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11. See sources cited *supra* note 2.

A. *The Public Role of the Securities Class Action*

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

TABLE 1: TOTAL CLASS ACTIONS PENDING IN FEDERAL COURTS AS OF SEPTEMBER 30, 2002, 2003, AND 2004<sup>12</sup>

Type of Case	2002	2003	2004
Contract	282	290	289
Real Property	33	38	34
Tort Actions	529	604	600
Antitrust	249	231	202
Employment Rights	164	159	173
Other Civil Rights	298	274	266
Prisons, Prisoners	66	64	82
RICO	53	76	46
ERISA	134	183	216
Other Labor Suits	180	204	262
Securities/Commodities/Exchange	2325	2339	2480
Others	522	515	529
Total	4835	4977	5179
Securities Class Actions as a Percentage of Total	47.5%	47%	47.9%

12. These data are taken from Table X-4 to the annual Judicial Business of the United States Courts reports for the years 2002, 2003, and 2004, respectively. See Admin. Office of the U.S. Courts, *Judicial Business of the United States Courts* 395–97 tbl.X-4 (2002), available at <http://www.uscourts.gov/judbus2002/appendices/x04sep02.pdf> (on file with the *Columbia Law Review*) [hereinafter 2002 Annual Report]; Admin. Office of the U.S. Courts, *Judicial Business of the United States Courts* 393–97 tbl.X-4 (2003), available at <http://www.uscourts.gov/judbus2003/appendices/x4.pdf> (on file with the *Columbia Law Review*) [hereinafter 2003 Annual Report]; Admin. Office of the U.S. Courts, *Judicial Business of the United States Courts* 400–03 tbl.X-4 (2004), available at <http://www.uscourts.gov/judbus2004/appendices/x4.pdf> (on file with the *Columbia Law Review*) [hereinafter 2004 Annual Report]. It must be acknowledged that these statistics may overstate the judicial burden of securities class actions for two reasons: First, most securities class actions are consolidated for purposes of discovery by the Judicial Panel on Multidistrict Litigation. See 28 U.S.C. § 1407(a) (2000). Also, few class actions are ever tried. Still, even cases consolidated under this provision must be remanded back to the original district court at the conclusion of the pretrial proceedings. See *Lexecon Inc. v. Milberg Weiss Bershad Hynes & Lerach*, 523 U.S. 26, 34–40 (1998). Hence, it seems legitimate to count individual class actions. Second, in 2005 and 2006, there has been a marked decline in the number of new filings of securities class actions. See Paul Davies, *Class Inaction: Plaintiffs' Lawsuits Against Companies Sharply Decline*, *Wall St. J.*, Aug. 26, 2006, at A1 [hereinafter Davies, *Class Inaction*] (noting 45% decline in securities class action filings in first half of 2006). This is a brief period, and thus it is premature to reach judgments about whether this decline will persist.

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

Beyond the sheer weight of their numbers, securities class actions disproportionately claim judicial time and attention for several additional reasons. First, they take longer to resolve than most other class actions,<sup>13</sup> and this tendency is increasing.<sup>14</sup> Second, they require the court to play a more active monitoring role. Under the unique provisions of the PSLRA, the court must select the “lead plaintiff” who will represent the class. Initially, this requires the court to determine which potential plaintiff suffered the largest losses and thus has the greatest stake in the action. Recent experience has shown that competition often arises for the position of lead plaintiff, and administering these disputes, which are essentially contests among competing teams of plaintiffs’ attorneys, consumes significant judicial time.<sup>15</sup> Third, the plaintiff in a securities class action is disadvantaged in comparison to plaintiffs in other forms of class actions in that it cannot obtain discovery until the plaintiff has first satisfied a

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13. During fiscal years ending September 30, 2002, 2003, and 2004, securities class actions constituted 42.4%, 33.5%, and 38.7%, respectively, of all class actions filed during those years, but amounted to 47.5%, 47%, and 47.9% of all class actions pending on September 30, 2002, 2003, and 2004. Thus, although the percentage commenced went down, the percentage pending stayed relatively constant, showing that securities class actions have a longer duration. Compare Table X-5 (showing actions commenced during the twelve-month period ending September 30 of each year) with Table X-4 (showing cases pending on September 30 of each year) of the annual Judicial Business of the United States Courts reports for 2002, 2003, and 2004. See 2002 Annual Report, *supra* note 12, at 395–400 tbls.X-4 & X-5; 2003 Annual Report, *supra* note 12, at 393–400 tbls.X-4 & X-5; 2004 Annual Report, *supra* note 12, at 400–07 tbls.X-4 & X-5.

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

15. For representative cases showing the issues that emerge, see, e.g., *In re Cendant Corp. Sec. Litig.*, 404 F.3d 173, 197–99 (3d Cir. 2005) (holding that once lead plaintiff is appointed, primary responsibility for compensation shifts to lead plaintiff, and its decisions are entitled to presumption of correctness); *In re Cavanaugh*, 306 F.3d 726, 731 (9th Cir. 2002) (holding that shareholders with largest financial stake, not shareholders with most advantageous fee arrangements with lawyers, were presumptively most capable lead plaintiffs under PSLRA); *In re Fannie Mae Sec. Litig.*, 355 F. Supp. 2d 261, 263–64 (D.D.C. 2005) (holding that investor sustaining largest loss was “prima facie” lead plaintiff and was not disqualified due to having lead plaintiff status in too many other suits). Many (but not all) courts now use a “last-in, first-out” (“lifo”) accounting method to calculate the lead plaintiff’s losses and reject a “first-in, first-out” (“fif”) accounting method. See *In re eSpeed, Inc. Sec. Litig.*, 232 F.R.D. 95, 101 (S.D.N.Y. 2005); *In re Cable & Wireless, PLC, Sec. Litig.*, 217 F.R.D. 372, 378–79 (E.D. Va. 2003). But, symptomatically, this point continues to be litigated.

heightened pleading test that normally requires it to plead, with particularity, facts giving rise to a strong inference of fraud.<sup>16</sup> Often, this process will involve multiple motions in which the parties contest whether this heightened pleading standard has been satisfied (with the plaintiffs typically receiving at least one leave to replead their complaint if their initial pleadings fail this test). Discovery disputes are also common, in large part because the plaintiff may be seeking to take the deposition of senior corporate officials, directors, and agents, who would all have their own counsel, who predictably will object that their time is being wasted.

Finally, the settlement process in securities class actions has become more complicated, as a growing number of sophisticated class members may decide to opt out of the class or may object to the settlement's fairness or the reasonableness of the attorney's fees.<sup>17</sup> Although this could also happen in other types of class actions, the increasingly predominant role of institutional investors among U.S. shareholders implies that the class in a securities class action will include many sophisticated and well-informed members who will make their own decisions and will often contest class counsel's decisions. The bottom line then is that a greater burden is placed on the court by a securities class action, and this burden tends to be concentrated in a few federal Courts of Appeals—most notably the Second Circuit and the Ninth Circuit—where these cases tend to cluster disproportionately.<sup>18</sup>

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16. Section 21D(b)(3)(B) of the Securities Exchange Act of 1934 stays discovery during the pendency of any motion by a defendant challenging the adequacy of the pleadings. 15 U.S.C. § 78u-4(b)(3)(B) (2000). This produces something of a "Catch-22" problem for the plaintiff: Namely, the plaintiff cannot obtain discovery until the plaintiff has adequately pled a particularized complaint, but to plead such a complaint plaintiffs traditionally rely on discovery.

17. In the past, class action plaintiffs' attorneys competed to be named class counsel. Today, however, the choice of class counsel is only the first round in their competition. The unsuccessful competitor may then seek to induce institutional investors in the class to "opt out" and sue with this firm as their counsel in state court. William Lerach, probably the best known plaintiff's attorney in the securities field, has recently utilized this strategy, inducing a large number of funds to opt out of both the WorldCom settlement and the more recent AOL Time Warner settlement. See Lorraine Woellert, *Fractured Class Actions: "Opt-Outs" Are a Growing Headache for Companies*, *Bus. Wk.*, Feb. 27, 2006, at 31, 31. Opt-outs force the defendant to fight a two-front war and increase the uncertainty about the ultimate cost of settlement. Also, as seen by the recent example of the WorldCom litigation, litigation can arise between the federal and state actions when the federal court seeks to stay the state action. See *Ret. Sys. v. J.P. Morgan Chase & Co.*, 386 F.3d 419, 431 (2d Cir. 2004) (holding federal trial court injunction ordering stay of state court proceedings unauthorized by All Writs Act and Anti-Injunction Act).

18. The Second Circuit and the Ninth Circuit have long been the principal circuits in which securities class actions are filed. In 2005, when the number of securities class actions fell to 176, forty-four were filed in the Second Circuit, thirty-eight in the Ninth Circuit, and only eighteen in the Third Circuit, which had the next highest number. See Stephen Taub, *Securities-Fraud Lawsuits Decline*, *CFO.com*, Jan. 3, 2006, at <http://www.cfo.com/article.cfm/5353420?f=search> (on file with the *Columbia Law Review*).

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

TABLE 2: AVERAGE PAYMENTS 2000–2002<sup>20</sup>

Public Monetary Sanctions	Private Monetary Sanctions
SEC Monetary Sanctions: \$801,333,333	Class Action Settlements: \$1,906,333,333
State Monetary Sanctions: \$931,212,489	Class Action Trial Awards: \$17,626,000
NASD Disciplinary Sanctions: \$126,110,622	NASD Arbitration Awards: \$104,000,000
NYSE Disciplinary Sanctions: \$5,752,833	NYSE Arbitration Awards: (not available)
Total: \$1,864,409,277	Total: \$2,027,959,333

The statistic that virtually leaps out from this data is that securities class action settlements averaged an annual aggregate amount (i.e., \$1,906,333,333) exceeding the sum of all public monetary sanctions. To be sure, the federal securities laws are also enforced by criminal penalties (chiefly, incarceration) and by SEC suspensions, expulsions, cease and desist orders, and other nonmonetary relief. Nonetheless, plaintiffs’ attorneys appear to extract more funds from corporate pocketbooks than do all federal and state regulators.

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

19. See Howell E. Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications 15–29 (Harvard Law Sch. John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 521, 2005), available at <http://ssrn.com/abstract=839250> (on file with the *Columbia Law Review*).

20. *Id.* at 27.

21. See Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, Post-Reform Act Securities Settlements: 2005 Review and Analysis 13 (2005), available at [http://securities.cornerstone.com/pdfs/settlements\\_2005.pdf](http://securities.cornerstone.com/pdfs/settlements_2005.pdf) (on file with the *Columbia Law Review*).

TABLE 3: PRIVATE VERSUS PUBLIC SETTLEMENTS (DOLLARS IN MILLIONS)

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

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

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

First, research suggests that there are some categories of companies and fraud that are largely beyond the reach of securities class actions.<sup>22</sup> Because the plaintiff's attorney must advance the expenses of the class action and will not be reimbursed if the action is unsuccessful, the plaintiff's attorney must estimate in advance the expected fee award, discounting it both for the prospect of a loss and for the time value of money over the period until payment is made, in order to determine if the action justifies the risks being undertaken. Because the fee award tends to be a function of the recovery, this, in turn, implies that a small recovery will mean at best a small fee award. As a result, the conventional wisdom has long been that companies with small market capitalizations are less likely to be sued in securities class actions.<sup>23</sup> Where this arguable threshold of immunity begins has long been the subject of debate. Using data from the early 1980s, Professor Janet Alexander found that all the initial public offerings (IPOs) in her sample with market losses over \$20 million elicited a class action, while none of the IPOs with losses under that amount resulted in litigation.<sup>24</sup> Another study, examining the period from 1975 to 1986, found that less than 1% of IPOs with an offering amount of less than \$5 million resulted in a securities class action.<sup>25</sup> These authors concluded that "smaller sized offerings hardly ever experience a securities-fraud suit."<sup>26</sup>

22. See sources cited *infra* notes 24–28.

23. See Choi, Evidence, *supra* note 1, at 1473–74, 1480–81.

24. Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 *Stan. L. Rev.* 497, 511–13 (1991) [hereinafter Alexander, Merits].

25. See Bohn & Choi, *supra* note 1, at 926–37.

26. *Id.* at 936.

Ultimately, the threshold below which a corporation becomes seemingly exempt from securities class actions as a “smaller sized” company depends upon the costs (and risks) of bringing a securities class action. Again, the conventional wisdom is that the passage of the PSLRA has driven these costs up and thus raised the threshold at which a securities class action can be justified by the expected fee award to the plaintiff’s attorney.<sup>27</sup> For present purposes, it is unnecessary to locate where this zone of immunity begins,<sup>28</sup> but only to recognize that there is a cutoff level in terms of market capitalization below which private enforcement appears not to work.<sup>29</sup>

Similarly, there may also be species of fraud for which private enforcement no longer works well. Several researchers have reported a shift in the type of claim litigated in the post-PSLRA time period, with allegations of accounting irregularities becoming the predominant claim in class actions filed after the passage of the PSLRA and allegations of false forward-looking statements declining as a percentage.<sup>30</sup> In addition, cases involving accounting allegations and restatements appear to have a higher settlement value than cases lacking these factors.<sup>31</sup> The PSLRA’s “safe harbor” for forward-looking statements is the most likely (but not the exclusive) cause of this transition because it requires the plaintiff to

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27. Corroborating this view, Professors Grundfest and Perino found an increase in the average stock price decline experienced by corporations that were sued after the effective date of the PSLRA, suggesting that PSLRA raised the threshold at which a securities class action became cost justified to plaintiffs’ attorneys. Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year’s Experience 971–72* (1997), at Westlaw, 1015 PLI/Corp 955 (on file with the *Columbia Law Review*). Grundfest and Perino did not, however, find an increase in the market capitalization of the typical post-PSLRA defendant, which actually declined. *Id.* at 969. Their explanation was that large market capitalization firms experienced a lower rate of accounting irregularities. *Id.* at 970.

28. Professor Alexander hypothesized that a minimum of \$20 million in damages was necessary to make the class action economically attractive to plaintiffs’ attorneys. In IPOs with market losses above \$20 million, all defendants in her sample were sued; below that level, none were sued. See Alexander, *Merits*, supra note 24, at 511–13.

29. Grundfest and Perino estimated that the mean market capitalization of a post-PSLRA defendant was \$529.3 million. Grundfest & Perino, supra note 27, at 969.

30. See, e.g., Bajaj, Mazumdar & Sarin, supra note 14, at 1006–07; Grundfest & Perino, supra note 27, at 973–74; cf. Marilyn F. Johnson, Ron Kasznik & Karen K. Nelson, *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms*, 39 *J. Acct. Res.* 297, 312–18 (2001) (noting increase in voluntary forward-looking disclosures after PSLRA).

31. See Laura E. Simmons, Cornerstone Research, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2001*, at 6–7 (2002), available at [http://securities.stanford.edu/Settlements/REVIEW\\_1995-2001/Settlements.pdf](http://securities.stanford.edu/Settlements/REVIEW_1995-2001/Settlements.pdf) (on file with the *Columbia Law Review*). In addition, Professors Adam Pritchard and Hillary Sale find that allegations of violations of accounting principles, other than those relating to revenue recognition, correlate negatively with dismissal, particularly in the Second Circuit. See A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act 24–25* (Univ. of Iowa Coll. of Law Legal Studies, Research Paper No. 05-12, 2003), available at <http://ssrn.com/abstract=439503> (on file with the *Columbia Law Review*).

prove the defendant's actual knowledge of the falsity of the forward-looking statement.<sup>32</sup> A 2004 study by PricewaterhouseCoopers summarizes the empirical evidence and reports that: "Cases alleging 'accounting'-related securities fraud versus cases alleging 'non-accounting'-related disclosure fraud divide roughly 60/40 percent; this has been a relatively constant statistic since 1996."<sup>33</sup> Thus, although it would be an overstatement to say that the securities class action exclusively polices fraud in financial reporting, this seems to be its primary role.

### B. *The Compensatory Rationale*

From a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly. Settlements recover only a very small share of investor losses. NERA Economic Consulting annually prepares a table showing the ratio of settlements to investor losses, and between 1991 and 2004, this ratio has never exceeded 7.2% (which it hit in 1996).<sup>34</sup> Over the most recent three years for which data are available (i.e., 2002, 2003, and 2004), this ratio fell to 2.7%, 2.9%, and 2.3%, respectively.<sup>35</sup> To be sure, these ratios represent the relation between the settlement and overall investor losses based on the decline in stock price, not the smaller loss directly attributable to fraud. But the market decline is the only loss that investors experience or that can be reliably measured.

Not only is the trend downward in terms of the percentage of damages recovered, but NERA's prediction is that the ratio will continue to decline as "mega-settlements" in the multibillion dollar range increase, because settlement size cannot keep pace with the increasing scale of investor losses.<sup>36</sup> Moreover, these low percentages in the 2% to 3% range

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32. See Securities Exchange Act of 1934 § 21E, 15 U.S.C. § 78u-5(c)(1)(B) (2000). Not all authorities agree on this point. Pritchard and Sale find, at least in the Second Circuit, that allegations of false forward-looking statements are less likely to be dismissed. Pritchard & Sale, *supra* note 31, at 25–26. But this finding was limited to the Second Circuit.

33. See PricewaterhouseCoopers LLP, 2004 Securities Litigation Study 11 (2004), available at [http://www.pwc.com/gx/eng/cfr/gecs/pwc\\_2004\\_seclit\\_study.pdf](http://www.pwc.com/gx/eng/cfr/gecs/pwc_2004_seclit_study.pdf) (on file with the *Columbia Law Review*). A significant percentage of these "accounting-related" cases involve a financial statement restatement. The percentage of "accounting-related" cases involving a restatement was formerly over 50%, but has recently declined noticeably: 50% in 1999; 51% in 2000; 56% in 2001; 51% in 2002; 33% in 2003; and 35% in 2004. *Id.*

34. See Elaine Buckberg et al., NERA Econ. Consulting, Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard? 6 (2005), available at [http://www.nera.com/Publication.asp?p\\_ID=2544](http://www.nera.com/Publication.asp?p_ID=2544) (on file with the *Columbia Law Review*) [hereinafter Buckberg et al., *New Standard*].

35. *Id.*

36. NERA Economic Consulting estimates that, on average, "a 1.0% increase in investor losses results in a 0.4% increase in the size of the expected settlement." *Id.* Thus, as investors' losses in recent "mega" cases have increased, it is predictable that settlement size will decline as a percentage of these losses. Among the reasons for this declining relationship are both the inevitable limits on corporate solvency and the ceilings on insurance coverage.

are before the subtraction of the full costs that investors bear: plaintiffs' attorneys' fees and expenses, defense counsels' fees and expenses, Directors' and Officers' (D&O) insurance premiums, and the possible costs of disruption, stigma, and adverse publicity—all of which inevitably also fall on the corporation's shareholders.

The sum of these costs approaches and may exceed the aggregate recovery. For example, during at least the 1990s, plaintiffs' attorneys in securities class actions received fee awards on average equal to 32% of the recovery.<sup>37</sup> Less is known about the costs of defense counsel, but senior insurance industry experts have estimated that defense costs in securities litigation are often in the range of 25% to 35% of the settlement, and sometimes reach 50% or even 100% of the settlement.<sup>38</sup> The primary reason for the high level of defense costs in securities litigation is that D&O insurance, which all public corporations carry, is unique. Unlike most forms of liability insurance, where the insurer provides and controls the defense, thereby reducing the insurer's loss *ex post*, D&O insurance gives no control over the defense to the insurer, but simply reimburses the policyholders' defense costs up to the dollar limit of the policy, subject to the requirement that the defense costs be reasonable.<sup>39</sup> As a result, D&O insurers have little ability to control defense costs. Indeed, one recent study reports a case in which defense counsel billed "\$75 million

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37. See Denise N. Martin et al., *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 *Stan. J.L. Bus. & Fin.* 121, 141 (1999). With the advent of the lead plaintiff, and with larger recoveries, this percentage may have declined more recently.

38. In their study of D&O insurers, Professors Baker and Griffith quote "one senior underwriter" speaking at a D&O industry conference estimating that "defense costs were commonly twenty five to thirty five percent of the settlement amount" and sometimes as high as "50% or 100% of the settlement." See Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 *Geo. L.J.* (forthcoming June 2007) (manuscript at 22 n.91, on file with the *Columbia Law Review*) [hereinafter Baker & Griffith, *Missing Monitor*]. Other data, however, suggest that defense costs are lower. The Tillinghast survey reports that the median and mean defense costs were \$538,150 and \$1,965,079 per claim. *Id.* (manuscript at 22) (citing Tillinghast-Towers Perrin, *Directors and Officers Liability Survey: 2005 Survey on Claims and Insurance Purchasing Trends* 112 tbl.107 (2005)). On this basis, Baker and Griffith place defense costs at around 11% of the settlement costs. *Id.* This seems a very low estimate, possibly because the Tillinghast survey includes claims (such as derivative actions) that on average settle more cheaply than the typical securities class actions or possibly because many D&O policies covering the corporation have deductibles, and thus the full defense cost would not be known to the issuer.

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

in the course of 18 months.”<sup>40</sup> High defense costs in turn imply a higher insurance premium, as the insurer passes its costs back to the corporation and its shareholders.<sup>41</sup> As a result, it is an open question as to whether the typical securities class action settlement actually produces any net recovery, particularly to diversified shareholders.<sup>42</sup>

Equally inconsistent with the compensatory rationale for the securities class action is the disquieting fact that the majority of institutional investors who have provable losses appear not to submit claims in securities class actions.<sup>43</sup> By some estimates, as much as \$1.05 billion annually is forfeited in this fashion by institutional investors who seem indifferent to relatively small recoveries.<sup>44</sup> At the least, this evidence suggests indifference by many investors to the compensatory role of the securities class action.

### C. *The Deterrence Rationale*

But if the securities class action fails as a mechanism for compensation, it can still perform admirably as a form of deterrence. Indeed, its deficiencies from a compensatory perspective may even be virtues from a deterrent perspective. That the securities class action recovers only a small percentage of investor losses presents less of a problem from a deterrent perspective because the corporate decisionmakers who caused the corporation to violate the securities law will also only receive a gain equal to a small portion of the investors' losses. Typically, in the context of the standard secondary market “stock drop” case in which the defendant corporation is not selling its shares, the corporation receives no direct gain, and its officers and other insiders profit only to the extent that they sell

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40. *Id.* (manuscript at 23) (internal quotation marks omitted) (quoting unnamed D&O product manager at leading D&O insurance company).

41. By definition, insurance premiums equal the “actuarially determined probability of loss plus a loading fee to compensate the insurer” for its costs and provide it with a profit. *Id.* (manuscript at 30). This loading fee is generally estimated to be in the range of 20% to 30%. *Id.* at 31 (manuscript at n.123). Baker and Griffith argue that the existing form of D&O insurance “does not simply distribute the risk of legally compensable investment losses” but rather “likely increases those losses.” *Id.* (manuscript at 29).

42. The diversified shareholder will bear on a pro rata basis the litigation costs of the overall corporate community. By definition, these costs must exceed the payout by insurers by a margin sufficient to earn insurers a risk-adjusted profit. See *supra* notes 38–41 and accompanying text. This raises the puzzle as to why public corporations insure their own liability, almost uniquely, in this context. See *infra* notes 127–133 and accompanying text.

43. See James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 *Stan. L. Rev.* 411, 413 (2005) (estimating that less than 30% of institutional investors with provable losses filed claims); see also James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 *Wash. U. L.Q.* 855, 879 (2002) (finding that many institutional investors are failing to file securities class action claims).

44. See A.C. Pritchard, *Who Cares?*, 80 *Wash. U. L.Q.* 883, 883–84 (2002) (analyzing Cox and Thomas's data).

their shares or otherwise benefit from the corporation's inflated stock price. In principle, if insiders face an expected penalty that exceeds their expected gain, this should be sufficient to remove any incentive for them to inflate the corporation's stock price. Indeed, if the typical securities class action settlement vastly exceeded the insiders' expected gains, a danger of overdeterrence would arise that might make insiders excessively risk averse in their decisionmaking about accounting, forecasting, and investment policies for their corporation.

But this theoretical answer that the securities class action can deter, even if it cannot compensate effectively, encounters serious problems once we examine the reality of actual securities litigation. On the positive side of the ledger, securities class actions do seem sufficiently pervasive to constitute a deterrent threat for most public corporations. In fact, the incidence of securities class actions has increased over the last several decades.<sup>45</sup> Between 1996 and 2004, an average of 195 securities class actions were filed each year—hardly a trivial number.<sup>46</sup> Alternatively, if one looks simply at the universe of listed public companies—i.e., issuers listed on the NYSE, Nasdaq, or AMEX—then between 2.1% and 2.8% of these companies have been defendants in securities class actions at the start of each year since 1998.<sup>47</sup> One recent study concludes that “the average public corporation faces a 10% probability that it will face at least one shareholder class action lawsuit” over a five-year period.<sup>48</sup> In short, although securities litigation is not an inevitable fact of corporate life, it is sufficiently common that corporate planners must anticipate and prepare for it. Whether an individual corporation will be sued in a securities class action is likely to depend principally on three factors: (1) its stock price volatility; (2) its industry classification, with consumer goods, technology, communications, and finance companies being the recent preferred

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45. Over the period of 1971 to 1978, one early study identified some 228 shareholder suits brought against a sample of 190 firms, for a mean of 1.2 lawsuits per firm over this seven-year interval. Thomas M. Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971–1978*, 60 B.U. L. Rev. 306, 312 (1980). Bohn and Choi found that in the case of initial public offerings between 1975 and 1986, less than 1% of small offerings (under \$1.79 million) resulted in litigation, but 12% of those over approximately \$40 million did. See Bohn & Choi, *supra* note 1, at 936.

46. See Cornerstone Research, *Securities Class Action Case Filings, 2005: A Year in Review 3* (2005), available at <http://securities.cornerstone.com/pdfs/YIR2005.pdf> (on file with the *Columbia Law Review*). In 2005, the number of securities class actions filed fell to 176, down from 213 in 2004. *Id.* In 2006, the decline has accelerated, with the number of filings of new securities class actions falling by 45% during the first six months of 2006. See Davies, *Class Inaction*, *supra* note 12. Although this is a brief period, it suggests that a continued high rate of securities class actions cannot be automatically assumed.

47. Cornerstone Research, *supra* note 46, at 4. This percentage was 2.8% in 2004, but fell to 2.4% in 2005. *Id.*

48. See Buckberg et al., *New Standard*, *supra* note 34, at 2. This study was based on the 2004 case filing rate. As the number of class actions filed in 2005 declined, this estimated 10% probability may prove somewhat high.

targets;<sup>49</sup> and (3) its market capitalization.<sup>50</sup> Larger firms are sued more often and can suffer greater damages.<sup>51</sup>

From a deterrent perspective, the critical question is who gets sued and who actually bears the costs of a securities class action. As will be seen, the answers to these two questions differ. Initially, the evidence is clear that members of senior management are highly likely to be named as codefendants in any securities litigation.<sup>52</sup> PricewaterhouseCoopers has concisely summarized these data for corporate officers for the years 2001–2004.<sup>53</sup>

TABLE 4: PERCENTAGE OF U.S. SECURITIES CLASS ACTION LAWSUITS NAMING CERTAIN OFFICERS, 2001–2004

Title	2002	2003	2004
CEO	95	98	96
CFO	76	88	83
Chairman	82	69	72
President	68	77	71

In sharp contrast, however, outside directors are rarely sued in securities fraud class actions<sup>54</sup> and are held liable even more rarely.<sup>55</sup> Why are insiders frequently sued and outside directors not? The answer probably lies in the pleading requirements of the PSLRA, which require the complaint to raise a strong inference of fraud against any named defendant.<sup>56</sup> This can be done, possibly with some difficulty, in the case of insiders, but satisfying this pleading standard is extremely difficult in the case of the outside director. Because the outside director is typically remote from the corporation and not cognizant of the facts known to management on a day-to-day basis, fraud cannot easily be attributed to such a person, particularly before the plaintiff obtains discovery.

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

50. D&O insurers consider market capitalization to be strongly correlated with both the frequency and severity of loss. See Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. Chi. L. Rev. (forthcoming March 2007) (manuscript at 29–30, on file with the *Columbia Law Review*).

51. *Id.* (manuscript at 30).

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

53. *Id.*

54. See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 Vand. L. Rev. 859, 896 & tbl.3 (2003) (finding that in sample that included approximately half of securities class actions filed in 1999, outside directors were named in only twenty-one cases).

55. See *infra* notes 65–66 and accompanying text.

56. See Securities Exchange Act of 1934 § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2) (2000).

This same pattern of virtual immunity carries over to the case of the corporation's principal agents or gatekeepers. Auditors and underwriters appear to be named as defendants in only a very low percentage of securities class actions. According to Cornerstone Research, auditors were named as defendants in only five cases (or 3%) out of all securities class actions filed in 2005 and similarly were named in only eight cases (or 4%) out of all such actions filed in 2004.<sup>57</sup> Correspondingly, underwriters were named in only seven cases (or 4%) in 2005 and three cases (or 1%) in 2004.<sup>58</sup> Previously, secondary participants faced a higher likelihood of securities litigation, but this pattern shifted in the mid-1990s when the combined impact of the PSLRA and the Supreme Court's 1994 decision in *Central Bank of Denver*, which held that Rule 10b-5 did not reach those "aiding and abetting" a securities fraud,<sup>59</sup> caused litigation against secondary participants to drop off sharply. Because the majority of securities class actions contain at least some allegations of accounting fraud,<sup>60</sup> this striking omission of auditors and other secondary actors as defendants suggests that they have been well insulated against securities fraud liability. Although large settlements involving accounting firms do occur, these often involve the insolvency of the corporate defendant (as in Enron and WorldCom) so that the auditor becomes the defendant of last resort—namely, the remaining defendant with a deep pocket.

The strangest aspect of this pattern involves corporate insiders—executive officers and controlling shareholders. Although they are regularly sued, they rarely appear to contribute to the settlement. Rather, the corporate defendant and its insurer typically advance the entire settlement amount. For example, one study of securities class actions in the mid-1990s found that, even in cases in which officers and directors were named as defendants, liability insurers paid on average 68.2% of the settlement, and the defendant corporation paid 31.4%—leaving at most 0.4% to be paid by individual defendants.<sup>61</sup> Others have noted "that approximately 96% of securities class action settlements are within the typi-

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57. Cornerstone Research, *supra* note 46, at 16. These data, which cover only the initial complaint, do not mean that auditors are sued in only 3% or 4% of all securities class actions, because the class action may be amended later to add the auditor as a defendant after the plaintiff obtains discovery. But this is difficult to do because of the short statute of limitations on most securities law causes of action and the fact that the plaintiff can only obtain discovery under the PSLRA if it has first satisfied that statute's particularized pleading standard (which often requires multiple efforts).

58. *Id.*

59. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 175–78, 191 (1994).

60. See *supra* notes 31–33 and accompanying text. In particular, PricewaterhouseCoopers estimates that 60% of securities fraud cases are "accounting" related. PricewaterhouseCoopers LLP, *supra* note 33, at 11.

61. See Frederick C. Dunbar et al., NERA Econ. Consulting, *Recent Trends III: What Explains Settlements in Shareholder Class Actions?* 9 (1995). This 0.4% that remains is not necessarily paid by officers and other insiders, but could be paid by other secondary defendants or could be payments that the SEC has compelled these individual defendants

cal insurance coverage, with insurance proceeds often being the sole source of settlement funds.”<sup>62</sup> Professor Janet Alexander, a knowledgeable observer, has concluded concisely that “[i]ndividual defendants almost never contribute personally to settlements.”<sup>63</sup> The reality is that corporate insiders are sued in order for the plaintiffs to gain access to their insurance, but their personal liability appears not to be seriously pursued.

To the extent that there are exceptions to this generalization, they usually involve special facts, typically that either: (1) The defendant corporation has become insolvent and hence is judgment-proof<sup>64</sup> (Enron and WorldCom fall within this category); (2) individual defendants face criminal liability and agree to make partial restitution either to gain a reduced sentence or to avoid indictment; or (3) D&O insurance is either inadequate or the policy has been rescinded for fraud in the application. In these cases, where there is, in effect, no deep-pocketed corporate defendant to bail out its officers, plaintiffs can and do obtain recoveries from individuals. But the rarity of these individual settlements is striking. Studying litigation against outside directors, Professors Bernard Black, Brian Cheffins, and Michael Klausner investigated the 3,239 federal securities class actions that were filed between 1991 and 2004, of which 1,754 had settled by the end of 2004. Contacting counsel for both sides, other leading law firms, D&O insurers, and D&O brokers, they were able to identify only thirteen settlements “since 1980 in which outside directors made out-of-pocket payments.”<sup>65</sup> Three of these cases involved famous frauds—WorldCom, Enron, and Tyco—but the remainder chiefly

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to make to a restitution fund pursuant to an SEC settlement, for which a credit may be given in the class action settlement.

62. See Cox, *supra* note 4, at 512 (citing Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs, 103d Cong. 139 (1993) (statement of Vincent E. O’Brien)). For an estimate that “from 50% to 80% of the typical settlement . . . is paid by insurance,” see Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 *UCLA L. Rev.* 17, 46 (1993).

63. Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 *Stan. L. Rev.* 1487, 1499 (1996) [hereinafter Alexander, *Rethinking Damages*].

64. Securities class actions tend less frequently to be filed in the wake of bankruptcy because the usually deep-pocketed corporate defendant can no longer be sued once it has entered bankruptcy. Examining the class actions filed in 2004 and 2005, Cornerstone Research found only eight class actions in 2005 (out of the 176 filed—or 5%) that were filed subsequent to a corporation’s bankruptcy and only four class actions in 2004 (out of the 213 filed—or 2%) that similarly followed a bankruptcy. Cornerstone Research, *supra* note 46, at 16. Hence, although insiders and secondary participants are the only parties that can be sued once bankruptcy has been filed, few such suits are brought.

65. Bernard Black et al., *Outside Director Liability*, 58 *Stan. L. Rev.* 1055, 1068 (2006) [hereinafter Black et al., *Director Liability*]; see also Bernard Black et al., *Outside Director Liability* 34–35 (Stanford Law Sch., John M. Olin Program in Law & Econ., Working Paper No. 250, 2003), available at <http://papers.ssrn.com/abstract=382422> (on file with the *Columbia Law Review*) (describing “several downside risks” and “limited upside” for plaintiffs going to trial against directors for out-of-pocket expenses).

involved “insolvent companies with serious D&O coverage problems.”<sup>66</sup> Their conclusion that outside directors with “state of the art” D&O liability insurance face little risk does not necessarily apply, however, to insiders and controlling shareholders.

Within the context of “insiders” (a term that will be used to include senior executives, founders, and controlling shareholders), the largest payment by an individual in a securities class action is believed to have been made by Gary Winnick, the former chairman of Global Crossing Ltd., which filed for bankruptcy in January 2002, not long after Enron, with \$12.4 billion in debt outstanding.<sup>67</sup> Winnick paid a reported \$55 million, \$30 million toward a settlement fund for investors and another \$25 million to compensate employees for their lost retirement savings.<sup>68</sup> This settlement came only a month before Winnick reached a settlement with the SEC, and Winnick may well have received (or at least anticipated) concessions in his SEC settlement because of his contribution to the class settlement. In any event, the remainder of the Global Crossing class action settlement came from the company’s insurers, which paid \$261 million, and from the company’s former law firm, which paid \$19 million.<sup>69</sup> Given that Winnick’s payment is apparently the largest individual payment on record, does even it demonstrate a sanction sufficient to deter? Symptomatically, the facts show that Winnick sold \$734 million in company stock shortly before Global Crossing’s bankruptcy, so that his \$55 million contribution to these settlements represented well under 10% of the alleged gains that he personally received.<sup>70</sup>

Other cases in which personal liability was imposed on insiders fit the same general pattern. Both Bernard Ebbers, the WorldCom CEO, and the family of John Rigas, the founder of Adelphia, contributed personal funds to class action settlements, but at the time they did so, their firms were bankrupt, and they were facing sentencing following a felony conviction (and thus had every incentive to appear contrite and repentant).<sup>71</sup> Similarly, the WorldCom directors were required to contribute

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66. See Black et al., *Director Liability*, *supra* note 65, at 1069.

67. For the conclusion that \$55 million was the largest payment made by an individual out of his own pocket, see *The Plaintiffs’ Hot List*, Nat’l L.J., Oct. 10, 2005, at S8 (citing plaintiff’s counsel, Grant & Eisenhofer, for this estimate).

68. Carrie Johnson, *Global Crossing Case May Be Ending: 3 Former Leaders Reach Tentative Accord with SEC*, Wash. Post, Dec. 7, 2004, at E1.

69. *Id.*

70. See *id.*; see also Gretchen Morgenson, *Ebbers Set to Shed Assets*, N.Y. Times, July 1, 2005, at C1 (stating that Winnick paid out “a fraction” of \$734 million he made).

71. Following his conviction in 2005 and before his sentencing, Bernard Ebbers, the founder of WorldCom, contributed some \$40 million to the WorldCom class action settlement, which at the time represented “nearly all of his personal fortune.” Morgenson, *supra* note 70. In the case of Adelphia, the entire Rigas family, including certain family members who were not charged with any crime, consented to the forfeiture of designated assets, including cable television systems and nearly all their Adelphia securities, in return for the government’s waiver of criminal fines and/or forfeiture against John and Timothy Rigas at their criminal sentencing; this property was then to be transferred by the

20% of their net worth to a settlement fund,<sup>72</sup> but this was both because their corporation was insolvent and their potential liability vastly exceeded their insurance resources.

In the more typical case of the solvent corporation, however, the likelihood is that the insurer will cover everything—i.e., the settlement plus litigation expenses—up to its policy limits, and the corporation will pick up the balance.<sup>73</sup> Even if one assumes that the market for D&O insurance is efficient and tailors premiums to the individual issuer's risk level, an assumption that has long been debated,<sup>74</sup> the cost of insurance still falls on shareholders, and this cost becomes heavier as the company becomes riskier. As a result, if the insiders who are most culpable can apparently escape personal liability in securities class actions, then the deterrent rationale for that action seems largely undercut. At best, the efficacy of deterrence under the current system rests on the validity of enterprise liability: that is, on the claim that by imposing large penalties on the corporation, society induces increased monitoring of the corporate officials who benefit from securities fraud.<sup>75</sup>

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government to Adelpia in return for Adelpia's transfer of \$715 million in value to the government. See Peter D. Morgenstern & Eric B. Fisher, *New Clout for Victims in Criminal Proceedings*, N.Y.L.J., July 20, 2005, at 4. In substance, then, the civil contribution by the Rigas family was coerced by the prospect of the criminal sentencing. For a fuller description of the entire transaction (and a decision upholding it), see *In re W.R. Huff Asset Mgmt. Co.*, 409 F.3d 555, 557–60 (2d Cir. 2005).

72. The twelve independent directors of WorldCom paid some \$25 million based on a requirement that they contribute 20% of their net worth, as defined to exclude certain retirement-related assets. E-mail from Sean Coffey, Partner, Bernstein, Litowitz, Berger & Grossman LLP, to author (Aug. 15, 2006) (on file with the *Columbia Law Review*). Bernstein, Litowitz served as counsel to the plaintiff class in the WorldCom class action.

73. Sometimes, particularly when the corporation is insolvent, the insurer will seek to rescind its policy based on its claim that fraudulent misrepresentations were made to it. See *infra* notes 164–165 and accompanying text.

74. The nature of the market for D&O liability insurance has long been debated. Over a decade ago, Kent Syverud argued that the demand for liability insurance was inelastic, and thus insurers can expect to be able to pass along fully the liability costs that they bear to their corporate clients in the form of increased insurance premiums. Kent D. Syverud, *On the Demand for Liability Insurance*, 72 *Tex. L. Rev.* 1629, 1644–49 (1994). This thesis is controversial, but even if demand is not inelastic and even if insurers do evaluate the corporation's risk level *ex ante*, the market may still be one in which corporate managers prefer to pay high premiums, rather than limit their autonomy, either in the choice or monitoring of defense counsel, or commit to loss prevention measures. Why? The simple answer is that the potential cost savings on D&O insurance are not important to them, whereas control over the litigation's management is. This appears to be the conclusion of Baker and Griffith. Baker & Griffith, *Missing Monitor*, *supra* note 38 (manuscript at 4–5, 12–25). They conclude, as does this Essay, that “D&O insurance seems likely to *increase* the amount of shareholder losses due to securities law violations.” *Id.* (manuscript at 4).

75. For a general overview of this issue, see Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 *Harv. L. Rev.* 563, 571–81 (1988). Professor Sykes argues that placing vicarious liability on the employer (or principal) for the employee's (or agent's) misconduct tends to be inefficient if (a) the enterprise did not cause the wrong, and (b)

Before reaching any bottom line assessment, however, fairness requires the observation that nonfinancial consequences of a securities class action might conceivably also deter. For example, some research has found that securities class actions tend to result in CEO turnovers in their wake.<sup>76</sup> In one study, the filing of a securities class action was found to more than double the likelihood of a CEO turnover, increasing it from 9.8% before the filing to 23.4% afterwards.<sup>77</sup> Realistically, however, even if the risk of ouster for the insider were to exceed 25%, this risk, by itself, would seldom constitute a deterrent threat capable of offsetting the potentially enormous financial gains to insiders from inflating the firm's stock price.<sup>78</sup> The problem is that the corporate officer who faces the greatest exposure to ouster also probably has the greatest incentive to inflate the firm's financial results; this is a classic "final-period problem" for which market and private sanctions rarely work.<sup>79</sup>

The policy prescription that flows from this analysis may seem obvious: The law should attempt to impose a greater share of the securities class action's costs on the more culpable insiders. But a counterargument also deserves attention: The scale of the change that would be necessary is so great and the financial resources of insiders so limited that meaningful change may be infeasible. Even at first glance, it is evident that securities class actions often result in enormous settlements to which

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the enterprise cannot effectively reduce the probability of the wrong through contracting with its employee or agent. *Id.* at 575. For a discussion on this topic, see *infra* notes 101–103 and accompanying text.

76. See Philip E. Strahan, *Securities Class Actions, Corporate Governance and Managerial Agency Problems* 18–25 (June 1998) (unpublished manuscript, on file with the *Columbia Law Review*), available at <http://papers.ssrn.com/abstract=104356>.

77. *Id.* at 22.

78. Again, the example of Gary Winnick, the CEO of Global Crossing, illustrates the problem. He did resign under pressure and contributed \$55 million to the settlement of class actions, but he sold \$734 million in Global Crossing stock shortly before his firm's bankruptcy. See *supra* notes 67–70 and accompanying text. Similarly, in the case of Enron, the top three executives "earned more than \$100 million each in 2000," and Enron's total compensation to its top 200 executives soared from \$193 million in 1998 to \$1.4 billion in 2000, a sevenfold increase. Alan Murray, *Twelve Angry CEOs—the Ideal Enron Jury*, *Wall St. J.*, Feb. 15, 2006, at A2.

79. "Final-period" problems classically arise as the corporation approaches bankruptcy or as the manager faces the prospect of job loss. The more that the manager expects ouster, the more that the manager's incentives are no longer aligned with those of the shareholders, and the manager cannot be as easily deterred by future private sanctions or reputational loss. For descriptions of this problem, see Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 *UCLA L. Rev.* 675, 694–95 (1999) (describing impact of "final-period problem" on managerial decisionmaking); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 *Duke L.J.* 1397, 1426 n.132 (2002) (describing conflicts of interest between managers and shareholders during final period). Here, the manager who realizes that current earnings cannot be sustained and that the corporation's stock price will eventually fall has a powerful incentive to delay the market's recognition of this decline until after the manager's options have vested and the manager has sold his stock.

insiders could conceivably contribute no more than a modest percentage. For example, the *Stanford Law School Securities Class Action Clearinghouse* lists the ten largest securities class action settlements since the passage of the PSLRA, and, as of early 2006, the cases on this list settled for amounts ranging from \$7.1 billion down to \$574 million:<sup>80</sup>

TABLE 5: LARGEST SECURITIES CLASS ACTION SETTLEMENTS

Rank	Issuer	Maximum Asserted Valuation
1	Enron	\$7,160.5 Million
2	WorldCom	\$6,156.3 Million
3	Cendant	\$3,528.0 Million
4	AOL Time Warner	\$2,500.0 Million
5	Nortel Networks	\$2,473.6 Million
6	Royal Ahold	\$1,091.0 Million
7	IPO Allocation Litigation	\$1,000.0 Million
8	McKesson HBOC	\$960.0 Million
9	Lucent Technologies	\$673.4 Million
10	Bristol-Myers Squibb	\$574.0 Million

Obviously, officers and other insiders lack the assets to contribute more than a modest fraction to such “mega-settlements.” But this is less of an obstacle to deterrence than it may initially appear for three reasons. First, the mean and median settlements in securities class actions are much smaller.<sup>81</sup> Second, a full transfer of the costs to the more culpable insiders is not necessary to achieve deterrence. All that is needed is that the expected penalty, which would include both the financial and nonfinancial costs of a securities class action settlement, exceed the expected gain. Third, D&O insurance provides far less protection to insiders than it does to outside directors. Insurance companies can seek to rescind the policies applicable to insiders for fraud in the application (and are currently seeking to do so) or can assert the traditional exclusions to cover-

80. Stanford Law Sch. Sec. Class Action Clearinghouse, Post-Reform Act Securities Case Settlements: Securities Fraud “Top Ten Mega-Settlements” List (2006), at [http://securities.stanford.edu/top\\_ten\\_list.html](http://securities.stanford.edu/top_ten_list.html) (on file with the *Columbia Law Review*).

81. NERA Economic Consulting and Cornerstone Research both report mean and median data on securities class action settlements. In 2004, NERA reports that the mean settlement rose by 33% to \$27.1 million, while the median settlement fell to \$5.3 million from \$5.5 million in 2003. See Elaine Buckberg et al., NERA Econ. Consulting, Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements 4 (2005), available at [http://www.nera.com/image/Recent\\_Trends\\_Final\\_2.28.05.pdf](http://www.nera.com/image/Recent_Trends_Final_2.28.05.pdf) (on file with the *Columbia Law Review*). Cornerstone Research found the median settlement in 2004 to be \$6.0 million (down from \$6.2 million over the period from 1995 to 2003) and the average settlement to be \$24.6 million (up from \$19.2 million over the 1995 to 2003 period). See Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, Post-Reform Act Securities Settlements: Updated Through December 2004, at 2 (2005), available at [http://www.cornerstone.com/fram\\_res.html](http://www.cornerstone.com/fram_res.html) (on file with the *Columbia Law Review*). In common, these data show that most securities class actions settle for amounts that are well within the personal assets of insiders, but there is a long tail to the right on the dispersion curve of settlements, with an increasing number of very large mega-settlements.

age in such cases.<sup>82</sup> In addition, as the foregoing list shows, many settlements are now exceeding the ceiling on insurance coverage. No corporation can afford to insure its board for \$1 billion; nor are insurers willing to offer coverage in such amounts<sup>83</sup> (indeed, insurance at such a level might even invite litigation). As a result, at least the insider defendant can no longer confidently rely on liability insurance in all cases.

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

At the outset, a basic distinction must be drawn between two types of securities class actions: (1) those that challenge actual sales of securities by an issuer, and (2) those in which the plaintiff purchases instead from another shareholder, but asserts that the issuer's materially misleading statements or omissions caused the plaintiffs to purchase the company's stock at an inflated price in the secondary market.<sup>84</sup> In the former "primary market" case, there is at least some privity between the plaintiffs and the corporate issuer, and the plaintiff class is effectively asserting that the other shareholders profited at its expense because of the inflated price of the issuer's stock. But in the latter "secondary market" case, neither the defendant corporation nor its continuing shareholders ordinarily benefit from the plaintiffs' purchases. Typically, the shareholders who will bear the recovery are innocent of any wrongdoing. Moreover, the plaintiffs and defendants tend to overlap heavily because many shareholders are in both classes, having bought stock at different times.<sup>85</sup> The key distinction here is that, in the first case, the existing shareholders benefit when their corporation sells stock at an inflated price to the plaintiffs, but, in the

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82. With respect to attempts to rescind insurance policies for fraud in the application, see *infra* notes 164–165 and accompanying text. Also, the typical D&O policy contains exclusions on coverage that are more likely to apply to insiders than to outside directors. The D&O policy usually excludes claims based on "fraudulent, dishonest or criminal" misconduct or based on transactions in which the insured received "any personal profit or *advantage* to which [he] is not *legally entitled*." 2 William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors* §§ 25.03, 25.13 (7th ed. 2005) (internal quotation marks omitted).

83. Currently, D&O insurers appear to be placing a ceiling of \$300 million on the insurance that they will offer. See Baker & Griffith, *Missing Monitor*, *supra* note 38 (manuscript at 10) (citing interviews with industry officials).

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

85. If an investor—individual or institutional—wishes to remain diversified, it will be necessary for it to make continuing purchases as its portfolio increases. Thus, even a passive and indexed mutual or pension fund will be buying the same stocks on a continuing basis. Because the typical class period is under one year, see *infra* note 94, it is likely that such an investor will have purchased some of its holdings in the defendant corporation before the class period commenced, and thus it will straddle the class period's boundary line.

second case, the continuing shareholders seldom receive any benefit—direct or indirect—from the sales by former shareholders at inflated prices to the plaintiff class members. As a result, the moral entitlement of the plaintiff class to seek its recovery from the equally nonculpable continuing shareholders seems debatable at least.

That much may seem obvious. But the circularity problem is subtler still, as the real costs do not fall on all shareholders evenly, but are borne unequally by different classes of shareholders. This section will examine the differential impact of securities class action litigation on diversified and undiversified shareholders and then examine whether the deterrent benefits can justify these costs.

#### A. *Case One: The Simple Wealth Transfer*

Because of the long-established separation of ownership and control in the United States, the vast majority of stock in “public” companies is owned by dispersed shareholders, all holding relatively small percentage stakes.<sup>86</sup> When a “secondary market” securities class action is brought against a public corporation that has not sold or purchased its own securities, the action is essentially brought on behalf of shareholders (and former shareholders) who purchased the stock during the “class period” (i.e., the time period during which the market was allegedly affected by material misinformation).<sup>87</sup> Typically, this class period will end on the date that corrective disclosure is made (and the market price of the stock declines in response).<sup>88</sup> Any judgment or settlement in this action will be borne by the corporation (and thus indirectly by all its current shareholders).<sup>89</sup> As a result, securities litigation in this context inherently results in a wealth transfer between two classes of public shareholders—those in the class period and those outside it—and typically neither class is culpable. Worse still, the most likely beneficiaries of the fraud will be the insid-

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86. The dispersed character of U.S. stock ownership was first recognized by Berle and Means over seventy years ago. See Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* 47–68 (1932) (describing growth in number of shareholders per corporation and dilution of large ownership stakes across companies and industries). The distribution of stock between individual and retail ownership has continually changed, with institutions now owning roughly 50%, but the separation of ownership and control has been constant. See Coffee & Seligman, *supra* note 84, at 43–46 (showing breakdown of share ownership by ownership categories in public corporations).

87. That is, the class will typically be defined as all persons who bought the stock of the issuer beginning on date X and ending on date Y, excluding any of the defendants.

88. Once corrective disclosure is made, the alleged fraud is at an end. Even if individual shareholders might remain deceived when they later purchase the stock, the premise of the securities class action is that the market will immediately incorporate into the stock price both the original fraudulent disclosure and the corrective disclosure. See *Basic Inc. v. Levinson*, 485 U.S. 224, 248–49 (1988). Thus, they are not injured by a postcorrective disclosure purchase.

89. See *supra* notes 61–66 and accompanying text (indicating that insurers and corporation bear entire cost of securities class action settlements). Costs borne by the corporation are by definition indirectly borne by its shareholders.

ers who sold at inflated prices. Because they bailed out prior to any judgment or settlement, they will escape without bearing any cost when liability is later imposed exclusively on their former corporation.

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

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

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

Worse yet, on each such wealth transfer, the continuing shareholders will be taxed the transaction costs of the litigation, which includes the legal fees paid to both plaintiffs' and defendants' counsel, the increased insurance premiums in the wake of the litigation, and the possible costs of business disruption and adverse publicity to the subject company.<sup>90</sup> In addition, hidden costs are also borne by the corporation, including the

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

cost of diverted managerial time, possible stigma, and damage to reputation. When all those costs are aggregated, the sum may often exceed the net recovery to the class. Absent high deterrent benefits, the result seems to be a dead weight loss to investors as a class.

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

Of course, not all investors are diversified. Clearly, most retail investors do diversify because they invest through mutual funds and pension funds, which are required by law to diversify.<sup>91</sup> Large, sophisticated investors also understand the wisdom of diversification. Nonetheless, let's make the assumption that many investors are undiversified. Undiversified investors can benefit from the securities class action (if they are lucky enough to be in the plaintiff class and not in the class of existing shareholders). But in reality, small undiversified investors are seldom likely to receive a monetary benefit from the securities class action. Indeed, their position is even more exposed than the diversified investor's. This is because the typical small, undiversified investor is likely to be a “buy and hold” investor who does not trade frequently.<sup>92</sup> Such investors trade less

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91. As of 2005, nearly three-fourths of Americans' liquid financial resources were invested in securities-related products, with mutual funds being the fastest growing category. In contrast, in 1975, slightly more than half of American financial assets were in bank deposits (55%). Sec. Indus. Ass'n, *Key Trends in the Securities Industry*, at [http://www.sia.com/research/html/key\\_industry\\_trends.html](http://www.sia.com/research/html/key_industry_trends.html) (last updated Jan. 13, 2005) (on file with the *Columbia Law Review*). Savings then have moved from banks to mutual funds. Mutual funds are clearly the fastest growing sector of the financial marketplace, now holding 23% of all equities. See Alan R. Palmiter, *U.S. Mutual Funds: The Awakening Behemoth?* 1 (May 31, 2006) (unpublished manuscript, on file with the *Columbia Law Review*). Mutual funds are basically required to diversify their investments if they wish to classify themselves as a “diversified” fund (as most do). See Investment Company Act § 5(b)(1), 15 U.S.C. § 80a-5(b)(1) (2000). For an overview of these diversification requirements, see generally Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission Is Appropriate?*, 80 *Notre Dame L. Rev.* 909, 917–18 (2005). Hence, if individual investors are moving their retirement savings to mutual funds, they are at the same time likely becoming diversified.

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

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

Inv. Co. Inst. & Sec. Indus. Ass'n, *Equity Ownership in America, 2005*, at 24 (2005), available at <http://www.sia.com/research/pdf/EquityOwnership05.pdf> (on file with the *Columbia Law Review*). In short, slightly more than 60% of individual shareholders do not trade in any given year and thus could not be members of a class that reached back less than one year from the date of corrective disclosure. As noted below, the typical class period is less than one year. See *infra* note 94.

actively because: (1) They pay higher brokerage commission rates than do larger investors; (2) they receive less current information than do larger investors with closer ties to securities analysts; and (3) they are not professionals who can watch their investments constantly.<sup>93</sup> As a result, because of their typically longer holding period, individual “buy and hold” investors are more likely to have purchased their stock before the class period commenced.<sup>94</sup>

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

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93. There is vast empirical literature on trading intensity which finds that different classes of investors have vastly different proclivities to trade. For a brief overview, see, e.g., John Finnerty & George Pushner, *An Improved Two-Trader Model for Measuring Damages in Securities Fraud Class Actions*, 8 *Stan. J.L. Bus. & Fin.* 213, 230–32 (2003); Michael Barclay & Frank C. Torchio, *A Comparison of Trading Models Used for Calculating Aggregate Damages in Securities Litigation*, *Law & Contemp. Probs.*, Spring/Summer 2001, at 105, 117–18. As a result, most contemporary empirical models of damages in securities litigation use a “two-trader model” which distinguishes between “traders” and “investors.” I do not assert that all retail investors follow a “buy and hold” philosophy (indeed, some were “day traders” in the late 1990s) or that all institutional investors are active traders (many are in fact indexed). But on average, the small investor has a lower trading intensity than the institutional investor, in part because the former faces much higher trading costs on a per share basis. A common heuristic used by the modelers of securities damages is that 20% of the shareholders are active “traders” and 80% are passive “investors.” If securities litigation does largely cause wealth transfers, those transfers should systematically flow from investors to traders.

94. One empirical study has found that the mean length of the class period in securities litigation was 358 days, with a median length of 257 days. See Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 *Ariz. L. Rev.* 491, 497 (1996). Thus, unless retail investors bought the majority of their stock interest in the company during this period of less than a year, they will on average bear the proportionate cost of the recovery and the litigation, but not share in any portion of the recovery. In general, it seems a fair assumption that the typical small investor has not purchased his or her shares within the 257 or 358 days preceding the date of corrective disclosure. This may not be true in some special cases, such as IPO litigation, where the small investor buys in the initial public offering. But these cases are examples of “primary market” offerings where this Essay argues that securities litigation can work. See *supra* note 84–85 and accompanying text.

PSLRA to large diversified investors, who often have highly contrary interests.<sup>95</sup>

#### D. *The Policy Debate*

The essential circularity of the securities class action in the secondary market context has not escaped the attention of legal academics.<sup>96</sup> But their responses have diverged radically. One school—best typified by Professor James Cox—argues that holding the nontrading corporation liable for secondary market purchases is justifiable because it is consistent with the standard rule of enterprise liability that prevails across tort law generally.<sup>97</sup> In sharp contrast, another school maintains that once the inevitable circularity of the wealth transfers in securities class actions is recognized, the logical policy response is to convert the securities class action into a form of civil penalty.<sup>98</sup> Thus, Professor Donald Langevoort has suggested capping the damages at a low level, pointing to the American Law Institute's (ALI) Federal Securities Code as a relevant model.<sup>99</sup> Professor Janet Cooper Alexander has similarly proposed a civil

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95. Although the lead plaintiff provision in the PSLRA may be an important and successful reform, its hidden consequence is to ensure that undiversified small shareholders will have their interests slighted in the organization of the class action. The PSLRA assigns control of the class action to a class member who is likely to be highly diversified. See Securities Exchange Act of 1934 § 21D(a)(3), 15 U.S.C. § 78u-4(a)(3) (creating presumption that volunteering class member with “largest financial interest in the relief sought by the class” should be lead plaintiff). Experience with this provision has shown that the lead plaintiff will typically be a large public pension fund (which must by law diversify) or at least another financial institution that is likely to be a diversified investor. Hence, even if one is sympathetic to the position of the undiversified investor, the securities class action is no longer designed to be a remedy for protecting the interests of such persons.

96. See, e.g., Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. Ill. L. Rev. 691, 698–700 (describing how enterprise liability imposes costs of fraud upon shareholders, even though they were not responsible for, and did not benefit from, fraud); Langevoort, *supra* note 2, at 642 (“[W]hatever compensation comes via class actions in open market cases is funded directly or indirectly by other innocent investors, creating a system of pocket-shifting that takes little money out of the hands of those natural persons who contrived the fraud.”); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 Va. L. Rev. 623, 635 (1992) (“A 10b-5 judgment, which simply transfers wealth among shareholders . . . clearly will not deter managers. Even if liability could be imposed directly on managers, the contractual nature of the firm suggests that the liability will end up back with the shareholders.”).

97. See Cox, *supra* note 4, at 509–12. Professor Cox argues broadly that “[t]he financial burdens of a securities fraud settlement borne by the innocent stockholders of the corporate violator is indistinguishable from the burden borne by the shareholders of the corporation that produces a defective product or violates the environmental laws.” *Id.* at 511.

98. See Langevoort, *supra* note 2, at 660 (favoring “use [of] the civil penalty model in defining the maximum amount of recovery”).

99. *Id.* at 657–58. The ALI's Federal Securities Code would limit damages for the issuer corporation in the case of an open market fraud where the corporation was not contemporaneously selling its securities to the greater of \$100,000, 1% of the issuer's gross

penalty that can be enforced both by the SEC and/or plaintiffs' attorneys.<sup>100</sup>

But there are problems with both lines of argument. Those who point to tort law's general preference for enterprise liability as a justification for the status quo miss what is most distinctive about the securities class action. When a corporation is fined or incurs liability in a class action because of a defective product or environmental pollution, society is imposing a cost on the corporation (and indirectly its shareholders) to induce it to monitor the behavior of its managers more diligently. Shareholders are not themselves the primary victims of the offense. Instead, a negative externality is being internalized (at least partially) by shifting costs from the victims of the tort to the corporation and its shareholders. But in the case of at least the "secondary market" securities class action, the victims and the shareholders are largely the same (at least if we assume the shareholders to be diversified). Thus, enterprise liability in this context is a strategy akin to punishing the victims of burglary for their failure to take greater precautions. Although this strategy might produce some enhanced monitoring, it offends social norms, including the public's basic sense of fairness, to punish the victim for conduct that it did not cause. Thus, the more this strategy becomes transparent, the more it will predictably encounter both political and judicial resistance. Nor is punishing the victim terribly effective, as victims are generally not the best-suited persons to detect and prevent the offense (which is ultimately why they became victims).

Defenders of the current system of enterprise liability tend to assume that the corporation's agents and employees are engaging in legal violations to maximize profits for the corporation. But again securities litigation is distinctive. Although this assumption is generally valid when the corporation sells a defective product or pollutes the environment, the corporate manager usually has more self-interested reasons for inflating the firm's earnings. Except in the case where the corporation is itself issuing shares, securities fraud appears to be primarily motivated by the manager's own personal interests. Typically, managers hide bad news because they fear loss of their jobs (either from a dismissal or a hostile takeover), and they overstate favorable developments or inflate earnings in order to maximize the value of their stock options and other equity com-

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income (to a maximum of \$1,000,000), or any profits received, unless the fraud was made with knowledge by the defendants. Fed. Sec. Code § 1708(c)(2) (1980).

100. See Alexander, *Rethinking Damages*, *supra* note 63, at 1489. As she points out, such civil penalties are sometimes enforced by private litigation under which the successful plaintiff's attorney receives attorney's fees. *Id.* at 1509 (citing Clean Water Act, Clean Air Act, Resource Conservation and Recovery Act, and other environmental statutes). Under her proposal, the SEC would receive the first option to sue and, if it did not, then private plaintiffs could sue. *Id.* at 1523. Obviously, this approach significantly erodes the incentive to search for legal violations, as the private plaintiff (or plaintiff's attorney) who incurs costs to identify a violation would not profit unless and until the SEC declined to sue.

pensation. After analyzing a large sample of class actions,<sup>101</sup> Professors Arlen and Carney report that managerial self-interest seems to be the dominant motivation underlying securities fraud, with managers frequently engaging in behavior that closely resembles insider trading.<sup>102</sup> If so, enterprise liability may work less well than a strategy that focuses directly on the managers themselves.<sup>103</sup>

On the other hand, use of a civil penalty system (as Professors Langevoort and Alexander have each independently proposed) could well underdeter. The \$1 million ceiling proposed by the ALI's Federal Securities Code now seems dwarfed by the potential gains in recent securities frauds.<sup>104</sup> Worse yet, even if a civil penalty system were to be enforced by private litigation, the incentive for plaintiffs' attorneys to bring such actions would be modest in comparison to their current incentive to prosecute securities class actions. Assume for the sake of simplicity that the plaintiff's attorney will receive on average a fee award of around 25% of a class action settlement.<sup>105</sup> Mega-settlements of over \$100 million in

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101. See Arlen & Carney, *supra* note 96, at 721–24.

102. *Id.* at 702–03, 720–40.

103. Professors Arlen and Carney argue that “enterprise liability for Fraud on the Market is not better able to deter Fraud on the Market than is agent liability” and that “agent liability probably achieves superior deterrence.” *Id.* at 694. This Essay agrees with much of their analysis, but doubts that private enforcers will be motivated to pursue cases under an agent liability system involving inherently smaller damages (and thus smaller attorneys' fees). Thus, a combined or hybrid system of agent and enterprise liability (with the agent's liability being increased and the enterprise's liability being decreased) seems likely to better deter securities fraud. Also, some of their critique of enterprise liability now seems dated. For example, they argue that monitoring by the corporation of its managers will not work well because of the board's limited capacity and incentives to monitor its structural bias, and the ability of managers to conceal their self-interested actions. See *id.* at 710–12, 715–16. But their analysis, written over a decade ago, may underestimate the monitoring capacity of the modern board and its gatekeepers. Particularly in light of the Sarbanes-Oxley Act, independent audit committees are in a position to monitor for abuses, such as premature revenue recognition, and thus enterprise liability cannot be as easily dismissed as a futile strategy today in the manner that Arlen and Carney did in their article fifteen years ago. In addition, they give little attention to the possibility that enterprise liability coupled with incentive contracting between the enterprise and its agent can produce superior deterrence to a simple rule of agent liability. See Sykes, *supra* note 75, at 577–78. Professor Sykes concludes that enterprise liability is generally superior whenever the use of incentive devices can reduce the probability of the wrong. *Id.* In an era when stock options are the basic currency of senior executive compensation, such incentive contracting is certainly possible. Thus, enterprise liability probably works to a considerable degree, but at high cost to shareholders. A hybrid system that combines agent liability with enterprise liability should reduce those costs.

104. As noted earlier, the CEO of Global Crossing sold over \$734 million in his company's stock, and Enron executives were in a position to profit similarly by hiding Enron's problems. See *supra* note 78.

105. Research shows that the actual fee award in securities class actions during the 1990s was approximately 32% of the recovery. See Martin et al., *supra* note 37, at 141. More recent research finds somewhat lower percentages today (possibly because of the impact of the lead plaintiff) and that the fee award is a declining percentage of the recovery. See Theodore Eisenberg & Geoffrey P. Miller, *Attorney Fees in Class Action*

securities class actions are now common, and thus the plaintiff's attorney is motivated to bring and pursue securities class actions by the prospect of receiving a sizable percentage of such a recovery. But if we reduce the damages significantly, we correspondingly reduce the plaintiff's attorney's expected recovery and thus the incentive to seek out and prosecute securities fraud. For example, a \$10 million civil penalty would probably not justify the costs, expenses, and risks that the plaintiff's attorney today incurs to prosecute a securities class action<sup>106</sup>—even if the civil penalty went exclusively to the plaintiffs' attorneys who brought the action (which seems politically unacceptable in any event).<sup>107</sup> Moreover, low penalty levels would encourage defendants to stretch out the litigation interminably and wage a war of attrition in order to erode the expected value of the payoff to the plaintiff's attorney.

In short, although a system of managerial liability seems likely to yield greater deterrence than enterprise liability, one cannot safely eliminate corporate liability in securities class actions without radically reducing the likelihood of private enforcement. As noted earlier, the federal securities laws rely on private enforcement (even if its effectiveness may often seem questionable).<sup>108</sup> Thus, the most sensible policy approach is an incremental and substitutionary one: to seek to shift the incidence of the liability so that it falls more substantially on managers and other insiders, but not to abolish corporate liability, which would continue to play a residual role. Shaky as the case for corporate liability may be, economic theory suggests that vicarious liability is efficient so long as the principal and agent can enter into contracts that reduce the probability of the wrong that is to be deterred.<sup>109</sup> Even given the "final period" problem, there are conceivable means by which the corporation could write such contracts with its managers, for example, by restricting stock options and

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Settlements: An Empirical Study, 1 *J. Empirical Legal Stud.* 27, 50–54 (2004). Thus, as the recovery surpasses the \$100 million level, the 32% figure for the average fee award may be an overstatement. Hence, this Essay uses the more conservative estimate of 25% in its illustration.

106. Over a decade ago, Professor Alexander suggested that market losses of over \$20 million appeared to be necessary to elicit a securities class action. Alexander, *Merits*, supra note 24, at 511–13. While this estimate was challenged at the time because of her small sample of cases, the combined impact of both the PSLRA and inflation over the subsequent interval has probably made this estimate overly conservative today.

107. Although the public may accept the payment of attorneys' fees to the private enforcer in the field of environmental regulation, the idea of paying the entire penalty to the plaintiffs' attorneys is far more radical. Payment of a \$25 to \$50 million penalty to a law firm in a securities case would likely shock the public (even though such a payment no more than matches the attorneys' fees paid in many securities class actions today). Even more importantly, political and judicial distaste for awarding such a penalty to a bounty-hunting law firm might cripple enforcement.

108. See supra notes 19–21 and accompanying text.

109. See Sykes, supra note 75, at 577–78.

other incentive compensation.<sup>110</sup> That they have done so only to a modest degree to date probably evidences the inherent problems in inducing the principal to monitor its agents in this context.

A deeper question also lurks here that this Essay will not attempt to resolve: How much deterrence is needed? The simplest answer is that modest penalties will produce little, if any, deterrence because private enforcement will be nonexistent unless the expected recovery to the private enforcer will exceed its expected costs and yield a return commensurate with the risk assumed.<sup>111</sup> But this is only the first step. To achieve deterrence, the expected penalty must also cancel out the expected gain to the wrongdoer, who may often face a low probability of detection. But even this further step may still be insufficient because the private enforcer may not be motivated to search diligently enough to detect hidden violations. Thus, some economists argue that to truly deter, the expected penalty should equal the expected social harm.<sup>112</sup> Yet, this in turn raises even more perplexing questions: What is the overall social harm in securities fraud? How should it be measured?

Here, one school of thought tends to view the harm as simply the loss to the victimized investors, whose loss is more or less counterbalanced by the gains received by the usually equally innocent investors on the other side of these transactions.<sup>113</sup> But this is overly narrow and myopic accounting. The deeper problem in securities fraud is the impact of fraud on investor confidence and thus the cost of equity capital. Here, it is impossible to quantify the impact of any individual scandal, but clearly the cumulative impact of Enron, WorldCom, and a host of other scandals in the 2000 to 2002 era made stockholders wary, chilled the initial public offering market, and caused investors to demand a higher return based on the perceived higher risks—in short, the cost of capital rose. When the cost of capital rises, the economy as a whole suffers, as Gross National Product declines or stagnates, and unemployment may increase. As a result, not only investors, but also citizens throughout society experience a loss. In addition, fundamental misallocations of resources may result because of what might best be termed a “contagion effect.” That is, companies in the same industry may feel compelled to

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110. For example, if the driving force behind managerial financial misconduct is stock options, as many believe, the corporation could substitute restricted stock contracts under which the manager would not be able to sell for an extended period—thus preventing a simple bailout. There has been some modest movement in this direction since Enron, and the securities class action could have been one of the forces driving the corporation marginally in this direction.

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

112. See, e.g., Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 *J. Pol. Econ.* 169, 170, 180 (1968).

113. For essentially such a position, see Thakor, *Economic Reality*, *supra* note 2, at 15–16.

copy the accounting tricks of an industry leader, lest their stock price fall far behind and they become a takeover target. Other firms may simply abandon a market or industry in the belief that they cannot effectively compete with the seemingly dominant competitor (who is in fact using crooked accounting). Considerable evidence suggests that Enron and WorldCom had this impact on other firms within their respective industries.<sup>114</sup>

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

### III. WHY DON'T INSIDERS PAY MORE?

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

#### A. Agency Costs

When corporate executives are sued alongside the corporation as co-defendants in securities litigation (as they almost always are<sup>115</sup>), a clear conflict of interest arises: The executives will naturally want to settle their own liability with funds advanced by the corporation. In principle, the board should recognize the conflict of interest inherent here, but boards of directors have little capacity (and perhaps even less incentive) to moni-

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114. For example, AT&T appears to have responded to the accounting manipulations practiced by WorldCom, including its artificially low ratio of line costs to revenues, by deciding to abandon the field on the false premise that it could not compete effectively with WorldCom. Initially, it laid off "tens of thousands [of workers] in the late 1990s as it tried frantically to match WorldCom's infuriatingly low costs." Geoffrey Colvin, *The Other Victims of Bernie Ebbers's Fraud*, *Fortune*, Aug. 8, 2005, at 32, 32; see also John J. Keller, *AT&T's Armstrong Is Expected to Cut as Much as 15% of Staff*, *Wall St. J.*, Jan. 22, 1998, at A3 (noting that 19,000 appeared likely to be laid off in order to match "lean trend setters such as WorldCom, Inc."). Unlike AT&T, Qwest and Global Crossing appear to have emulated WorldCom's accounting fraud, and the latter went into bankruptcy. Colvin, *supra*, at 32. Ultimately, in 2000, AT&T split itself into four separate businesses based partly on its mistaken belief that it could not compete with WorldCom in the long distance business. See Adam Cohen, *Ma Bell Calls It Splits*, *Time*, Nov. 6, 2000, at 96, 96–97. Similarly, Dynegy appears to have copied many of Enron's accounting tricks and as a result entered into a major settlement with the SEC and class action plaintiffs. For a description of Dynegy's structured finance transactions, see Nathan Koppel, *Wearing Blinders*, *Am. Law.*, July 1, 2004, at 75, 78–79; see also *United States v. Olis*, 429 F.3d 540, 549 (5th Cir. 2005) (affirming securities fraud conviction of Dynegy executive with respect to these transactions).

115. See *supra* notes 52–53 and accompanying text.

tor the complex details and complicated procedures of securities litigation. Even more importantly, the directors may themselves also be sued. Or, they may have been sued in the past, giving them a closer identification with the interests of the officer-defendants than with those of the shareholders. “Structural bias” is always a possible explanation for lax monitoring, but seldom is it more legitimately applicable than in the context of litigation against corporate officials, which seems to trigger a “circle-the-wagons” defensive response from directors eager to protect their colleagues in management.

Also, if the settlement is fully covered by the corporation’s own liability insurance (as it usually is<sup>116</sup>), the board has little reason to resist a settlement that involves no contribution by the individual defendants. Even if the settlement were to require individual defendants to pay some amount out of their own funds, corporate counsel might still advise the board that the corporation was legally required to indemnify its officers and employees under its bylaws.<sup>117</sup> If so, it can be plausibly argued that requiring the individual defendants to contribute would only produce a pointless circularity. If this advice is accepted (as it normally appears to be), the net result is both that the corporation bears virtually the entire cost of the settlement and that actual indemnification is seldom paid because few payments by individual defendants are ever made.

### B. *Indemnification and the Settlement Approval Process*

Although state corporate law broadly authorizes indemnification of corporate officials, the SEC partially withdraws that protection by precluding indemnification of liabilities arising under the federal securities laws.<sup>118</sup> But the practical impact of the SEC’s position has been modest.

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116. See *supra* notes 61–63 and accompanying text.

117. As discussed below, this conclusion is not necessarily correct, even if all the other defendants settle. See *infra* notes 155–157 and accompanying text. Also, it would be clearly incorrect if the manager-defendants went to trial and were held liable. See *infra* notes 118–119 and accompanying text. Counsel can still argue, however, that, if the corporation wants a settlement and an end to the controversy, it may be necessary to pay the settlement costs of officers and defendants because the plaintiff may want a global settlement, and the corporation will likely want an end to the adverse publicity and disruption.

118. The leading decision is *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1288–89 (2d Cir. 1969), which found that actual knowledge by a corporate official of material misstatements barred recovery because indemnification would be contrary to public policy, given the deterrent purposes of the federal securities laws. Later cases have said that even liability based on recklessness may not be indemnified. See, e.g., *Heizer Corp. v. Ross*, 601 F.2d 330, 334 (7th Cir. 1979). Indeed, “mere negligence” on the part of an underwriter, which is actionable under sections 11 and 12(a)(2) of the Securities Act of 1933, has been held to bar indemnification under this deterrent rationale. See *Eichenholtz v. Brennan*, 52 F.3d 478, 484–85 (3d Cir. 1995); *First Golden Bancorporation v. Weismann*, 942 F.2d 726, 729 (10th Cir. 1991) (holding indemnification barred even under strict liability provisions of Section 16(b)); *Stewart v. Am. Oil & Gas*, 845 F.2d 196, 200 (9th Cir. 1988). The SEC enforces this position by requiring companies seeking to

Although courts have largely accepted the SEC's position that indemnification of securities law liabilities is inconsistent with the policies underlying the federal securities laws, neither courts nor the SEC have extended this policy to apply to settlement payments or defense costs where the defendants do not admit liability.<sup>119</sup> The result is to create powerful pressures to settle in order that the individual defendants can escape any risk of personal liability.

Equally important, federal courts have repeatedly held that they have no responsibility for supervising how the multiple defendants in a securities class action apportion liability among themselves, so long as the aggregate settlement is fair to the class.<sup>120</sup> An illustrative case is *In re Cendant Corp. Litigation*, which, at the time it settled, was the largest class action settlement on record<sup>121</sup>—but also one in which the entire \$2.85 billion settlement came from the defendant corporation. No contributions were made by Cendant's defendant officers and directors, even though numerous officers and directors received releases from all claims under the settlement. Understandably, a shareholder objected to this settlement, pointing out that thirteen out of the fourteen Cendant directors had been sued in the action and yet none had made any contribution to the settlement.<sup>122</sup> On this basis, the objector claimed that the settlement amounted to an illegal indemnification of the individual defendants. The district court dismissed these claims and was upheld by the Third Circuit,<sup>123</sup> which agreed that (1) the district court need only be concerned as to whether the settlement was adequate and reasonable to the class,<sup>124</sup> and (2) the settlement did not amount to indemnification because no reimbursement was made by the corporation to its directors.<sup>125</sup> As a practical matter then, indemnification of securities liabilities is both

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register their securities to give an undertaking that if a director seeks indemnification for damages, the company "will . . . submit to a court of appropriate jurisdiction the question whether such indemnification . . . is against public policy as expressed in the Act." 17 C.F.R. § 229.512(h)(3) (2006). But this language requires court approval only for indemnification of damages, not settlements.

119. See, e.g., *Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170, 1177 (N.D. Cal. 1994); *Pepsico, Inc. v. Cont'l Cas. Co.*, 640 F. Supp. 656, 661 (S.D.N.Y. 1986). The SEC's position is most clearly set forth in Regulation S-K in Item 510, and there it is stated to apply only to damages. 17 C.F.R. § 229.510.

120. See, e.g., *In re Warner Commc'ns Sec. Litig.*, 798 F.2d 35, 37 (2d Cir. 1986).

121. 264 F.3d 286, 288, 291 (3d Cir. 2001) (stating that Cendant paid \$2,851,500,000, and Ernst & Young, its auditor, paid \$335,000,000, for a grand total of just over \$3.186 billion).

122. *Id.* at 291–92.

123. *In re Cendant Corp. Sec. Litig.*, 109 F. Supp. 2d 273, 285 (D.N.J. 2000), *aff'd*, 264 F.3d 286 (rejecting objection filed by Martin Deutch).

124. *Cendant*, 264 F.3d at 293–96 (holding claims that contributions made by individual defendants were inadequate should be resolved in derivative action filed in Delaware).

125. *Id.* at 301.

possible and common, so long as it is done with the appropriate cosmetic subterfuge.

### C. *D&O Insurance*

The latest relevant development involves a change in the coverage of D&O insurance. Traditionally, public companies insured their directors, paying the premiums on their D&O policies.<sup>126</sup> This closed a hole that indemnification left open, because indemnification is not available in bankruptcy and certain other contexts.<sup>127</sup> Over time, corporations also came to insure their own obligation to pay indemnification, but they did not insure their own direct liability as defendants. Typically, the two policies were written in tandem by the insurance company because the insurer knew it would not have to pay twice and could thus sell the joint policies at a cheaper rate.<sup>128</sup>

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

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126. For concise histories of the law on corporate indemnification of officers and directors, see *United States v. Stein*, 435 F. Supp. 2d 330, 353–55 (S.D.N.Y. 2006); Joseph Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 *Bus. Law.* 1993, 1994–96 (1978).

127. In bankruptcy, any executory obligation, such as the contractual obligation to pay indemnification, can be rejected. As a practical matter, directors rely on their individual insurance policies only when the corporation becomes insolvent. See Baker & Griffith, *Missing Monitor*, supra note 38 (manuscript at 11). Otherwise, all payments are made by the insurer under its other policies. See infra notes 128–129. Another problem with traditional indemnification was that the obligation to pay indemnification arose only “after the defense to [the] legal proceedings ha[d] been ‘successful on the merits or otherwise.’” *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 211 (Del. 2005). This left open the question of advances of legal expenses.

128. Most D&O policies came to include two basic types of insurance coverage: “Side A” coverage, which protected the individual officers and directors against covered losses, and “Side B” coverage, which insured the corporation itself from losses resulting from its indemnification obligations. See Baker & Griffith, *Missing Monitor*, supra note 38 (manuscript at 10–11).

129. Because they were not insuring the corporation for its own liability, the insurers did not want to pick up the portion of the defense effort attributable to the corporation’s defense. For an example of such a dispute, see *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1431–36 (9th Cir. 1995). Also, if there were another defendant, such as an auditor, investment bank, or law firm, an allocation would again obviously be necessary. Alternatively, some officers or directors might be insured by a different insurance company, again causing the insurance company representing the company to want an allocation of expenses. See Ernest Martin, Jr., *D&O Insurance Coverage: Surviving the Turmoil (Lessons We Are Learning from Enron) 2–3* (2002) (unpublished manuscript, on file with the *Columbia Law Review*), available at [http://www.haynesboone.com/FILES/tbl\\_s12PublicationsHotTopics/PublicationPDF60/835/09042002\\_Martin1.pdf](http://www.haynesboone.com/FILES/tbl_s12PublicationsHotTopics/PublicationPDF60/835/09042002_Martin1.pdf).

To end these uncertainties, insurers began to write “corporate entity coverage,” which directly reimbursed the corporation for its own litigation expenses, its own settlement payments in securities cases, and certain other forms of litigation.<sup>130</sup> This form of insurance appears to have first been offered in 1996, and thus is a relatively new development.<sup>131</sup> Despite its recent appearance, entity insurance caught on quickly, and over 90% of D&O insureds reported having entity coverage as of 2002.<sup>132</sup> In the wake of its appearance, D&O insurance now protects both the individual’s assets and those of the corporation. As a result, allocation seemingly became unnecessary, because one insurer covered the exposure of virtually everyone. If the insurer had an overall policy limit of, say, \$50 million on all three coverages (the individual’s policy, the corporate indemnification policy, and the corporation’s own coverage), it could simply write a single check, and neither it nor the corporation needed to allocate the payment among the three policies.

#### D. Analysis

The combination of these three developments means that the process has been simplified so that all costs typically flow back to a single insurance company—until its policy limit is exceeded. But, as a result, the deterrent value of the securities class action has again been eclipsed. In addition, the sharp disparity between the corporation’s ability to indemnify settlement costs, and its inability to indemnify judgments established at trial in securities class actions, places overwhelming pressure on defendants to settle. This in turn may invite frivolous, or at least, low merit, litigation. Finally, with the advent of entity insurance, the corporation has much less incentive than in the past to resist the plaintiff—if it can settle within the policy’s limits. In the past, it shared liability with the individual defendants, and its own exposure was reduced if the individual defendants (or their insurers) contributed to the settlement fund. Today, it is rationally indifferent to the allocation because its insurance covers everything.<sup>133</sup>

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130. See Martin, *supra* note 129, at 2–3. In the industry parlance, this is known as “Side C” coverage, as it insures the corporation’s own direct liability, not its liability to officers or directors. See Baker & Griffith, *Missing Monitor*, *supra* note 38 (manuscript at 10–11).

131. See Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 *UCLA L. Rev.* 413, 443 (2004).

132. See Michael W. Early, *Another Glimpse into the Current State of Directors and Officers Insurance*, (ABA Section on Litig., Comm. on Corp. Counsel), Summer 2003, at 29 (on file with the *Columbia Law Review*). This was up from just over 50% in 1997. *Id.*

133. This can be viewed as a classic “moral hazard” problem, as the availability of insurance reduces the corporation’s otherwise rational desire to shift some of the liability to others (such as responsible officers). Of course, its future insurance premiums will rise if it incurs recurrent litigation or settles too generously, but these payments appear to be either too small or too invisible to motivate managers. To economists, the real puzzle is not the *ex post* behavior of a corporation that has insurance, but the reasoning that leads

What can be done to restore that deterrent role? The most obvious solution might be to preclude the indemnification of settlement costs in securities class actions. But, absent legislation, the doctrinal obstacles to this position are immense. If the SEC took the position that the federal securities laws barred indemnification of settlement costs, it would likely be stretching its own uncertain authority to preclude indemnification beyond the breaking point. At a time when Supreme Court decisions regularly show a fervent concern for the preservation of federalism and states' powers,<sup>134</sup> any attempt by the SEC to encroach through rulemaking on the traditional powers of the states to regulate corporate governance invites strong judicial resistance.<sup>135</sup> Precisely because a right to indemnification is clearly established under state law and because courts to date have not seen the indemnification of settlement costs to conflict with the policies underlying the federal securities laws, a new SEC initiative seeking to bar indemnification of settlement costs would appear highly vulnerable. This does not mean that the SEC is powerless, but it may have to proceed by requiring greater disclosure about the settlement process, rather than by framing a broader prophylactic rule.

The better hope therefore lies in encouraging greater judicial scrutiny of the settlement allocation in securities class actions. Although, in the relatively few decisions on point, courts have so far been unwilling to supervise the apportionment of liability among the defendants in a securities class action, the case for greater scrutiny is strong. Second Circuit Judge Jon O. Newman wrote a powerful concurring opinion in *In re Warner Communications*, arguing that occasions can arise in which such a review is justified.<sup>136</sup> In that case, he first noted the importance of a fair apportionment of liability to the plaintiffs in a securities class action who remained shareholders:

Every dollar contributed to the settlement by the individual defendants is a dollar of gain to appellant and those in his cir-

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corporations to insure themselves, as opposed to only their agents. See Baker & Griffith, *Missing Monitor*, supra note 38 (manuscript at 30–46).

134. See, e.g., *United States v. Morrison*, 529 U.S. 598, 607–19 (2000) (invalidating federal civil remedy of Violence Against Women Act as exceeding Commerce Clause power); *Kimel v. Fla. Bd. of Regents*, 528 U.S. 62, 79–82 (2000) (invalidating Congress's abrogation of states' sovereign immunity under Age Discrimination in Employment Act as exceeding Section 5 of Fourteenth Amendment); *Printz v. United States*, 521 U.S. 898, 918–22 (1997) (invalidating Brady Handgun Violence Prevention Act provisions requiring local "chief law enforcement officers" to conduct background checks as violating dual sovereignty of federal and state governments); *United States v. Lopez*, 514 U.S. 549, 552–53, 564 (1995) (invalidating Gun-Free School Zones Act as exceeding Congress's Commerce Clause power).

135. Indeed, the SEC has been repeatedly rebuffed in this context. See *Bus. Roundtable v. SEC*, 905 F.2d 406, 413 (D.C. Cir. 1990) (vacating SEC's one-share, one-vote rule as in excess of SEC's authority because subject matter was entrusted to state regulation).

136. *In re Warner Commc'ns Sec. Litig.*, 798 F.2d 35, 38 (2d Cir. 1986) (Newman, J., concurring).

cumstances. Every dollar contributed by the corporate defendants is partially offset by the pro rata decrease in the value of appellant's stock due to the payment.<sup>137</sup>

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

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

In the contemporary environment where individual defendants make no contribution and the corporation bears the entire burden, Judge Newman's concerns about the settlement's fairness seem increasingly well placed.<sup>139</sup> But the question remains: How does one induce courts to consider an issue that they seem to prefer to duck? Part IV will approach this question.

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

Based on the premise that the securities class action can serve an important deterrent role, but only a minor compensatory role, this Essay has favored a policy of greater managerial liability. The persons most responsible for the accounting irregularities at Enron, WorldCom, and a host of other companies were managers who, beginning in the 1990s, began to be primarily compensated with equity compensation and so had a strong incentive to recognize income prematurely in order to inflate reported income.<sup>140</sup> More than any other factor, this sudden shift in executive compensation from cash to equity best explains the hyperbolic

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137. *Id.*

138. *Id.* Judge Newman went on to note that this condition was not present in *In re Warner Communications* because the Delaware Chancery Court had specifically determined that the allocation between the corporate and individual defendants was fair. *Id.*

139. Also, the rare fact present in *In re Warner Communications* and emphasized by Judge Newman, that a state court had approved the liability apportionment as fair, will not normally provide a basis for avoiding this issue.

140. Between 1990 and 2001, the percentage of the total compensation of a chief executive officer of a large public corporation in the United States that was paid in the form of equity (rather than cash) rose from 8% to 66%. Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, 15 *J. Applied Corp. Fin.* 21, 23 fig.1 (2003). For a fuller discussion of the destabilizing impact of this rapid shift from cash to equity compensation, see John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 *Cornell L. Rev.* 269, 275–78 (2004).

increase in accounting restatements that began in the mid 1990s.<sup>141</sup> Thus, corporate managers, facing enhanced incentives to engage in fraudulent reporting, are the key actors who most need to be deterred.

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

#### A. *Applying Proportionate Liability to the Corporate Defendant*

Assume that a jury finds a hypothetical corporate issuer and various individual defendants liable for securities fraud in the amount of \$500 million. What happens next? Under section 21D(f) of the Securities Exchange Act of 1934,<sup>142</sup> which establishes a rule of proportionate liability, the factfinder (judge or jury) must now apportion liability among the “covered persons” (a term that covers all the defendants in a securities class action)<sup>143</sup> and assign each defendant that “portion of the judgment that corresponds to the percentage of responsibility of that covered person.”<sup>144</sup> In other words, the factfinder must allocate the judgment among all defendants (and any nondefendants it also considers responsible) based on their relative culpability, with all the percentages so assigned adding up to 100%. This was the PSLRA’s innovation in order to reduce the coercive effect of the former system of “joint and several” liability upon secondary defendants. It was intended to protect auditors, investment bankers, and law firms—all of whom might have only marginal culpability but could end up being held jointly and severally liable for the entire judgment (which amount would clearly be imposed on them alone if the principal defendants were insolvent). Under the PSLRA, “joint and several” liability can only be imposed on a defendant if it has “knowingly committed a violation of the securities laws,”<sup>145</sup> and this term is defined rigorously so as to preclude a merely “reckless” defendant from being subjected to “joint and several liability.”<sup>146</sup>

Presumably, in the normal case, the jury will hear evidence and then answer “special interrogatories” as to the relative culpability of each defendant.<sup>147</sup> But what “percentage of responsibility” should apply to the

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141. Coffee, *supra* note 140, at 282–83; see also U.S. Gen. Accounting Office, GAO-03-138, *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges* 15 (2002) (showing increase from ninety-two restatements in 1997 to an estimated 250 in 2002).

142. Securities Exchange Act of 1934 § 21D(f), 15 U.S.C. § 78u-4(f) (2000).

143. *Id.* § 21D(f)(10)(C).

144. *Id.* § 21D(f)(2)(B)(i).

145. *Id.* § 21D(f)(2)(A).

146. *Id.* § 21D(f)(10)(A)–(B) (requiring that defendant have “actual knowledge that, as a result of the omission, one of the material representations of the covered person is false”).

147. Section 21D(f)(3)(A) requires the jury to be instructed to “answer special interrogatories” as to the “percentage of responsibility” to be assigned to each person

corporate issuer? The PSLRA gives little guidance on this question because its real concern was protecting secondary defendants, such as the accounting firms that lobbied hard for passage of this provision. Arguably, the defendant corporation should not be seen as having “actual knowledge” of the omission (as section 21D(f) requires<sup>148</sup>) because it can only have vicarious knowledge through its officers and agents. In determining the corporation’s “percentage of responsibility” under section 21D(f), it should also be relevant that the corporate officials who perpetrated the fraud may have concealed it from their superiors and the corporation’s audit committee because they were pursuing personal ends (i.e., the maximization of the current value of their stock options and other equity compensation).

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

Alternatively, the factfinder might find that the CEO, CFO, and the corporation each had “actual knowledge” of the material omissions or misstatements and so are jointly and severally liable. Here, where both

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alleged to have “caused or contributed to the loss incurred by the plaintiff.” 15 U.S.C. § 78u-4(f)(3)(A). Section 21D(f)(3)(C) (“Factors for Consideration”) instructs the factfinder as to the criteria to be employed in assessing culpability. *Id.* § 78u-4(f)(3)(C). These factors can only be awkwardly applied to the corporation, because almost by definition, it made the statement that misinformed the market.

148. See § 21D(f)(10)(A).

149. See *supra* notes 118–119 and accompanying text.

150. The issue here will be whether there has been a “final adjudication” that satisfied the “actual fraud” language of the typical exclusion, as Rule 10b-5 liability can be based simply on “recklessness,” which may arguably be a level below “actual fraud.” See *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (defining “reckless conduct” as “highly unreasonable” and involving “an extreme departure from the standards of ordinary care”). Most D&O policies contain an exclusion for “actual fraud” or personal enrichment, but subject this exclusion to a “final adjudication” condition that obligates the insurer to fund the insured’s defense until there is a final adjudication that the officer committed fraud. See *Baker & Griffith, Missing Monitor*, *supra* note 38 (manuscript at 16); see also *Little v. MGIC Indem. Corp.*, 836 F.2d 789, 794 (3d Cir. 1987) (finding that insurer must “pay loss as the insured incurs legal obligation for such loss,” with promise of recompense if court rules that insured “engaged in active and deliberate dishonesty”). Because plaintiffs need to resort to the insurance, they will predictably try to avoid triggering this exclusion and will seek to characterize the defendant as “reckless” but not involved in “actual fraud.” Nonetheless, it is the court that frames this interrogatory (although it too has weak incentives to force a “final adjudication” that would render resort to insurance unavailable).

these individuals and the corporation are held 100% liable, it would again seem to offend and frustrate section 21D(f)'s concept of proportionate liability if the corporation paid the entire liability without any contribution from the other defendants (even though no indemnification would be technically paid).<sup>151</sup> In such a case the court should recognize its responsibility under the PSLRA to assure itself that the apportionment of liability did not offend section 21D(f)'s directions that actual liability be allocated on the basis of relative culpability. To this extent, the old rule of nonreview of apportionment should yield to the PSLRA's explicit policy.

### B. *Extending Proportionate Liability to the Settlement Context*

In a settlement, no such apportionment of liability by the factfinder occurs, and thus it is harder to claim that a corporate payment of the entire settlement offends the PSLRA's proportionate liability provision. But this defines the problem that needs to be addressed. Given the obvious conflict of interest when the corporation and its senior executives or directors are sued in the same action, the SEC could require that independent directors examine any proposed settlement of a securities class action and evaluate its fairness to the corporation, just as they would normally do in the standard self-dealing context. Specifically, these directors should be expected to assess the apportionment of liability among the corporation and its officers and explain in a public statement if and why they consider it to be fair to the corporation. This is a disclosure strategy, rather than a prophylactic rule, and it seems much more clearly within the SEC's jurisdiction than does a ban on indemnification of settlement expenses. This approach of mandating a fairness evaluation and explanation by independent directors has long been used by the SEC in related contexts involving sensitive self-dealing (such as "going-private" transactions).<sup>152</sup> By analogy, the independent directors would be required to state their belief that the apportionment was fair or unfair to the shareholders and to discuss in reasonable detail the "material factors upon

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151. Such a finding might, however, amount to a "final adjudication" that the director or officer engaged in actual fraud and so was not covered under his or her D&O policy, which typically contains an exclusion for actual fraud. See Baker & Griffith, *Missing Monitor*, supra note 38 (manuscript at 8–9).

152. For example, in a "going-private" transaction, a public corporation must comply with Rule 13e-3, 17 C.F.R. § 240.13e-3 (2006), and file a Schedule 13e-3, id. § 240.13e-100. Item 8 of that schedule requires the issuer to evaluate the fairness of the proposed transaction and furnish the information required by Item 1014 of Regulation M-A, id. § 229.1014. In turn, Item 1014 requires a statement as to why the person filing the schedule "believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders." Id. § 229.1014(a). This disclosure must then be followed by a discussion "in reasonable detail" of the "material factors upon which the belief . . . is based." Id. § 229.1014(b).

which the belief . . . is based.”<sup>153</sup> Experience in the related contexts where the SEC has used such a technique suggests that it does have real impact—possibly because independent directors tend to be risk averse.

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

Of course, some replies to such a disclosure obligation are predictable. The directors might, for example, respond that the corporation had no alternative because corporate bylaws required indemnification of settlement costs. But this is an overbroad statement of the law. For example, Delaware law provides that a corporation may indemnify any person who is sued in his or her capacity as “a director, officer, employee or agent of the corporation . . . against . . . amounts paid in settlement . . . in connection with such action . . . *if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation.*”<sup>155</sup> The Delaware statute further provides that any such indemnification shall be made only “upon a determination that indemnification of the present or former director, officer, employee or agent is proper in the circumstances because the person has met the applicable standard of conduct.”<sup>156</sup> In effect, the board must specifically determine that the party to be indemnified “acted in good faith and in a manner the person reasonably believes to be in or not opposed to the best interests of the corporation.”<sup>157</sup>

In light of this requirement that there be a specific determination as to the propriety of the defendant officer’s or director’s conduct, this pro-

153. This disclosure would simply parallel the disclosure now required by Item 1014 of Regulation M-A. See id. § 229.1014(a)-(b). That regulation goes even further and also requires an analysis of “the weight assigned to each factor.” Id. § 229.1014(b).

154. Form 8-K is the SEC-mandated form for current reports under section 13 or 15d of the Securities Exchange Act of 1934. A host of events, including even amendments to the corporation’s bylaws, today require the filing of a Form 8-K. Procedurally, the Form 8-K should be filed before the judicial approval of such a settlement, and thus the articulation of this requirement should require its filing after an agreement in principle is reached, but before the settlement is submitted to the court. Ideally, the SEC might comment on these disclosures to the court in an *amicus curiae* filing.

155. Del. Code Ann. tit. 8, § 145(a) (2001) (emphasis added).

156. See id. § 145(d). Subsection (d) specifically cross references the standard of conduct set forth in section 145(a) and quoted *supra* text accompanying note 155.

157. Id. § 145(a).

posal that the SEC require disclosure by the directors of their evaluation, along with the reason underlying their decision, creates no conflict between federal and state law. Indeed, the two requirements dovetail, as Delaware law seems already to require a determination that the party to be indemnified acted "in good faith," and the required federal disclosure would simply focus in detail on how the board reached that judgment.

As a practical matter, however, such a disclosure requirement might dissuade many independent boards from approving complete assumption by the corporation of settlement costs where officers or directors are also sued. After all, if the settlement were for \$500 million and plaintiffs alleged that the corporation inflated its earnings to maximize its short-term stock price, then independent directors are placed in a ticklish position. They cannot easily claim that they paid \$500 million to settle a frivolous action or simply to avoid disruption of normal business activities. Also, the SEC is experienced at contesting makeweight or boilerplate justifications, and it can demand more detailed explanations. Finally, the directors risk liability themselves if they file an incomplete or misleading Form 8-K with the SEC.<sup>158</sup>

The net result should be that independent directors will be embarrassed into requiring greater fairness in securities class action settlements. Even if federal courts continue to resist assuming responsibility for the apportionment of liability among defendants, they can still use the SEC mandated disclosure as a basis for making further inquiry. Nor should it be assumed that all federal courts will resist consideration of the apportionment of liability. Judge Newman's position in *In re Warner Communications* is convincing.<sup>159</sup> Once a formal corporate evaluation of the apportionment is prepared by the board, objectors to the settlement can bring it to the attention of the court.

A predictable response to this proposal will be that it ignores the role of insurance. Even if indemnification were restrained and the corporation itself did not pick up the entire settlement cost, those costs will still be covered by D&O insurance paid for by the corporation (and thus its shareholders indirectly). This objection has some merit, but it ignores some important contemporary facts.

First, officers and directors today often face liabilities that exceed their insurance coverage. WorldCom is an illustration of this pattern<sup>160</sup> because no corporation can ever afford to insure its officers and directors against the billions in potential liabilities that the WorldCom directors

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158. Although private plaintiffs would be unlikely to sue because the damages would generally be modest, the SEC could itself sue with regard to any false or misleading statement made in a document filed with it. If the Commission sued under section 17(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77g (2000), it would not need to prove scienter. See *Aaron v. SEC*, 446 U.S. 680, 696–97 (1980).

159. See *supra* notes 136–139 and accompanying text.

160. The WorldCom directors paid some \$25 million, or 20% of their net worth each, to settle their liability in that case. See *supra* note 72 and accompanying text.

faced.<sup>161</sup> Today, D&O insurance coverage depends typically on the corporation's market capitalization. Coverage limits in 2004 ranged from \$4.7 million (for corporations with a market capitalization of up to \$100 million) to \$122.9 million (for corporations with a market capitalization of over \$5 billion).<sup>162</sup> Currently, insurers will not offer insurance anywhere near the billion dollar range; reputedly, the highest coverage now being offered is \$300 million.<sup>163</sup> On this basis, officers at a number of companies are subject to potential exposure, particularly if their company files for bankruptcy. Second, insurance coverage has limitations on the conduct covered and can be rescinded if fraudulent statements were made in the original application.<sup>164</sup> Typically, when the corporation applies for D&O insurance, the insurer asks the corporation to attach its financial statements to the application, and if these financial statements are overstated, the insurer has at least a colorable basis for denying cover-

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161. As noted earlier, a significant number of recent settlements have exceeded the issuer's insurance resources. See *supra* notes 80–83 and accompanying text.

162. See D&O Coverage, Controller's Rep., Feb. 2005, at 9, 9. For the year 2004, this publication reports, relying on a survey by Tillinghast-Towers Perrin, that the coverage limits for the typical for-profit corporation were as follows:

Average Coverage Limits by Asset Size	
Up to \$100 million:	\$4.7 million
\$100 million - \$400 million:	\$16.3 million
\$400 million - \$1 billion:	\$25.4 million
\$1 billion - \$2 billion:	\$34.3 million
\$2 billion - \$5 billion:	\$58.6 million
Over \$5 billion:	\$122.9 million

Tillinghast-Towers Perrin also reported that the average for-profit U.S. corporation increased its coverage limits in 2005 to \$14.3 million (up from \$13.6 million in 2004). See Dave Lenckus, *Directors Study D&O Cover Limits to Protect Assets*, *Bus. Ins.*, Jan. 30, 2006, at 25.

163. See Baker & Griffith, *Missing Monitor*, *supra* note 38 (manuscript at 10) (citing interviews with corporate risk managers and underwriters).

164. In the wake of recent corporate scandals, many insurers are increasingly attempting to rescind their policies based on a claim that a fraudulent misrepresentation was made to the insurance company in the application. State laws differ widely as to their ability to deny coverage in this fashion. Under New York law, an insurer can rescind based on a misrepresentation in the application without needing to show that the misrepresentation was made with an intent to deceive the insurer. See *Mut. Benefit Life Ins. Co. v. JMR Elecs. Corp.*, 848 F.2d 30, 32 (2d Cir. 1988); *Nationwide Mut. Fire Ins. Co. v. Pascarella*, 993 F. Supp. 134, 136 (N.D.N.Y. 1998). A number of other jurisdictions also permit coverage to be rescinded based on an innocent misrepresentation so long as it was material. See *Nat'l Union Fire Ins. Co. v. Sahlen*, 999 F.2d 1532, 1536 (11th Cir. 1993); *First Nat'l Bank Holding Co. v. Fid. & Deposit Co.*, 885 F. Supp. 1533, 1535 (N.D. Fla. 1995). In contrast, Texas law requires the misrepresentation to be made with an intent to deceive in order for coverage to be denied. See *Cont'l Cas. Co. v. Allen*, 710 F. Supp. 1088, 1092 (N.D. Tex. 1989); *Union Bankers Ins. Co. v. Shelton*, 889 S.W.2d 278, 282 (Tex. 1994).

age to culpable insiders.<sup>165</sup> Hence, removing the corporation as the ultimate backstop who will pay all settlement costs and expenses has real world consequences and tends to ensure that enough liability will fall on corporate officers to have some deterrent value.

A last objection to this proposal is that it will add to the litigation risk associated with being an outside director. If so, then that would be a deficiency. But it should not. Outside directors have virtually no antifraud liability,<sup>166</sup> and negligence on their part is only actionable under the federal securities laws under section 11 of the Securities Act of 1933.<sup>167</sup> Further, under the standard here proposed, little problem arises with indemnification of settlement costs in an action based simply on negligence. Under the above-quoted Delaware statute, a merely negligent director can be found to have acted “in good faith and in a manner [he] reasonably believed to be in or not opposed to the best interests of the corporation.”<sup>168</sup> Thus, under the standard corporate bylaws, indemnification would be mandatory, and the board would have no difficulty explaining its decision in a Form 8-K, as earlier proposed. Only in cases where the insiders appear to have been actively engaged in misconduct, such as by inflating revenues or hiding liabilities in their own interest, do the board’s obligations become more complex under existing law, and it is in these cases that the proposed board explanation would mesh with their obligation to determine if the “good faith” standard was satisfied.

What can be expected of this proposed reform? Clearly in cases where the liability exceeds \$100 million, individual defendants are not likely—even collectively—to fund more than a low percentage of the total settlement. But that is probably enough to deter. Moreover, the contemporary mean and median securities class action settlements are for much

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165. See Martin, *supra* note 129, at 24–25. For examples of rescission on this basis, see *Nat'l Union Fire Ins. Co.*, 999 F.2d at 1536; *Am. Int'l Specialty Lines Ins. Co. v. Towers Fin. Corp.*, No. 94 Civ. 2727 (WK) (AJP), 1997 WL 906427, at \*7–\*8, \*10 (S.D.N.Y. Sept. 12, 1997). Innocent outside directors may remain entitled to their coverage even when the corporation makes a misrepresentation to the insurer in its application for D&O insurance, but the law is divided on this point. For example, in *INA Underwriters Insurance Co. v. D.H. Forde & Co.*, 630 F. Supp. 76, 77 (W.D.N.Y. 1985), the entire policy was declared void, even as to individuals who had not signed the application or committed fraud. Where there is a severability clause, with the result that the D&O policy is to be construed as a separate contract between each insured and the insurer, an innocent insured will not lose coverage because of fraud committed by another. See *Wedtech Corp. v. Fed. Ins. Co.*, 740 F. Supp. 214, 218–19 (S.D.N.Y. 1990). The bottom line here is that culpable insiders may very well lose their insurance coverage in accounting fraud cases, but outside directors are less at risk.

166. See Black et al., *Director Liability*, *supra* note 65, at 1075.

167. This was the basis for liability in the WorldCom case where outside directors paid \$18 million. See *supra* note 72 and accompanying text. Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k(a)–(c) (2000), makes every director liable for any material misstatement or omission in the registration statement, unless the director can establish an affirmative defense of “due diligence.”

168. See *supra* notes 155–156 and accompanying text (quoting Delaware General Corporation Law, Del. Code Ann. tit. 8, § 145(a) (2001)).

smaller amounts (currently around \$27 million and \$5.3 million, respectively).<sup>169</sup> In these cases, insiders could fund a significant proportion of the settlement.

### C. *Activating the Insurer*

The recent advent of entity coverage has created a crisis for many D&O insurers, as securities class actions are now settling at higher levels (at least in part because issuer defendants have less incentive to resist), and the insurers who resist are facing a growing backlog of cases.<sup>170</sup> For nearly every year since 1991, securities class action filings have outpaced settlements, with the result that the D&O insurance industry faces the “specter of the ‘1,000 claims’ inventory”<sup>171</sup>—that is, a thousand or more unresolved securities class actions. Against this backdrop, insurers have more incentive to resist and deny coverage for fraud in the application.

But this does them little good if the corporate client will pay the same amount under its own policy. Although today it is customary (and probably cheaper) for one insurance company to cover both the individual officers and the corporation, the incentives would be quite different if different insurers covered the individual defendants and the corporation. This would create a greater likelihood of a fair allocation of the settlement costs because each corporate insurer would now have a greater reason in its own self-interest to resist an overly generous contribution by its client. Also, the insurer insuring the individual defendants might be more willing to seek to rescind its policies for fraud in the application in the case of the insider defendants.<sup>172</sup> Thus, based on the self-interest of individual insurers, we get to the same end point as we would by insisting that independent directors monitor the settlement: a fair allocation between the corporation and its officers. Again, the SEC probably lacks authority to order this, but could encourage it through disclosure.<sup>173</sup>

If the corporation were required to undertake a study of the responsibility of its officers, conducted by independent counsel, to establish the fairness of the allocation between the corporation and the individual defendants, then the current practice of the corporation requiring the

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169. See *supra* note 81 and accompanying text.

170. See Early, *supra* note 132, at 27. This author is the assistant general counsel of the Chicago Underwriting Group, Inc.

171. *Id.*

172. In the case of the culpable insiders, the insurer has a plausible case for rescinding coverage based on fraud in the application. See *supra* notes 164–165 and accompanying text. Where the insurer insures the corporation and all defendants, it may be reluctant to do so and lose a client. Where, however, it is only insuring the directors, it may be more willing to seek to rescind the policies covering the culpable insiders (who may be fired and thus will have little continuing influence over the insurer).

173. For a fuller discussion of the need and potential for greater disclosure about the terms of D&O liability insurance, see Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors’ and Officers’ Liability Insurance Policies*, 154 U. Pa. L. Rev. 1147, 1147–208 (2006).

plaintiffs to grant releases to the individual defendants in return for no financial contribution to the settlement would become much harder to justify.<sup>174</sup> In addition, such a study might well enhance the ability of the insurer of the corporate officers to rescind its policy for fraud in the application. Even in the case where one insurer writes all the policies, evidence developed by such a study might enable the insurer to rescind the individual officers' policies, and a properly counseled corporation would not pick up the entire liability. Moreover, if the officers' insurance were cancelled for fraud, plaintiffs' attorneys would have no logical reason to accept a payment only from the defendant corporation and not pursue the officers individually. The point is that accurate information, if developed, could change the current dynamics under which a solvent corporation bears virtually the entire cost of the settlement.

#### D. Attorneys' Fees

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

Some modest movement in this direction is already discernable. When public pension funds offered higher fee awards for recoveries from individual defendants, plaintiffs' attorneys responded and obtained recoveries from individual defendants.<sup>175</sup> Courts could similarly revise their rewards. For example, the court awarding attorneys' fees in a securities class action could award substantially higher fees for the portion of the recovery obtained from insiders or third parties than for the portion obtained from the corporation. To illustrate, assume that plaintiffs obtain a \$100 million settlement that is paid 50% by the corporation and 50% by individuals and other third parties (including insiders, controlling shareholders, auditors, investment bankers, law firms, and others,

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174. See *supra* notes 120–125 and accompanying text.

175. See Sue Reisinger, *Investors Offer Bounties to Recover Funds*, N.Y.L.J., Sept. 15, 2005, at 5. Both the California State Teachers' Retirement System, the nation's third largest public pension fund, and the State of Wisconsin Investment Board, the tenth largest such fund, have acknowledged paying "bounties" or, alternatively, a higher percentage fee for recoveries from individual defendants. *Id.* Such a bonus was not paid, however, in the WorldCom case. *Id.*

but not outside directors).<sup>176</sup> Hypothetically, the fee award on the first 50% paid by the corporation might be set at 10%, while the fee award on the other 50% could be 30%, for an aggregate fee award of 20% (a fee award that is not in truth above the current norm). This would reflect both the social utility of recoveries from culpable insiders in generating deterrence and the fact that the 50% paid by the corporation is ultimately a cost that falls on diversified shareholders. If the plaintiff's attorney in securities litigation is a bounty hunter, then it is time to ask courts to set the bounties intelligently.

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

All the prior proposals in this section pale in comparison to this final recommendation: The SEC can and should exempt the non-trading corporate issuer from private liability for monetary damages under Rule 10b-5. Effectively, this would require plaintiffs' attorneys to sue the corporate insiders and the corporation's gatekeepers (e.g., its investment bankers, auditors, and attorneys), not the issuer, in order to obtain their recovery. At a stroke, this would eliminate entity insurance (because the corporation now could not be sued), and it would compel the insider defendants to apply to the corporation for indemnification when they settled (thereby activating the board's role in monitoring indemnification requests). Today, the board seldom has to face the issue of indemnification because the corporation contributes the entire settlement and then turns to its insurer for repayment.

But does the SEC have the authority to "disimply" Rule 10b-5—that is, to deny a private cause of action under it? This issue has been elaborately debated in the past.<sup>177</sup> But whether these earlier advocates were right or wrong is no longer the issue. Following an earlier debate over the Commission's authority, Congress in 1996 added section 36 ("General Exemptive Authority") to the Securities Exchange Act of 1934,<sup>178</sup> which authorizes the SEC to "conditionally or unconditionally

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176. Of course, in principle the court would only pay such a bonus on the portion of the individual recovery that was not indemnified or insured. At least on a transitional basis, however, there is a case for paying a higher fee award on even an insured recovery from individual defendants in order to encourage the transition to a fair allocation of the recovery among the defendants.

177. Compare Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 *Harv. L. Rev.* 961, 976–99 (1994) (detailing Commission authority to disimply cause of action), with Joel Seligman, *supra* note 4, at 438 (conceding authority of Commission to disimply, but doubting the wisdom of doing so). For Professor Grundfest's response to Professor Seligman, see Joseph A. Grundfest, *Why Disimply*, 108 *Harv. L. Rev.* 727, 727 (1995).

178. 15 U.S.C. § 78mm (2000). Congress granted the SEC broad exemptive power in section 36 as part of the National Securities Markets Improvement Act of 1996. See Pub. L. No. 104-290, 110 Stat. 3416, 3424 (1996). The SEC first used this authority after the terrorist attacks on September 11, 2001 to broadly authorize corporate share repurchases

exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”<sup>179</sup>

Because Rule 10b-5 is a rule under the Exchange Act, the Commission’s authority to grant an exemption from it seems clear on the face of the statute, so long as the Commission can plausibly make the requisite findings. If this Essay’s analysis is correct, Rule 10b-5 litigation in the secondary market “stock drop” context essentially produces pocket-shifting wealth transfers that injure shareholders and do not protect the public interest. Predictably, some will respond that exempting the corporation will create a haven for fraud. But this is a shallow response.<sup>180</sup> Because no exemption would be given to those officers, employees, or agents who act on the corporation’s behalf or who control it, the real impact of such an exemption would not be to end Rule 10b-5 litigation, but to focus it on the culpable.<sup>181</sup> Exempting the non-trading corporation from Rule 10b-5 litigation effectively moves us at least a significant distance from a system of enterprise liability toward a system of managerial liability.

Of course, such a change would also alter the market for D&O insurance. Now threatened, executives would demand more insurance and would reexamine the corporation’s bylaws to make certain they were guaranteed broad indemnification rights. Such insurance would fund sufficiently large recoveries to continue to motivate plaintiffs’ attorneys to bring suit (even if the overall scale of the recoveries might decline). Because of the SEC’s ban on indemnification of securities law liabilities (when they result in judgments),<sup>182</sup> executives would remain under strong pressure to settle and to seek indemnification. Outside directors

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to stabilize the stock market. See Exemptive Relief Order, Exchange Act Release No. 44,874, [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,547, at 84,867 (Sept. 28, 2001).

179. Securities Exchange Act of 1934 § 36(a)(1), 15 U.S.C. § 78mm(a)(1).

180. As a statutory matter, section 36 recognizes only one area in which the SEC cannot grant exemptions: namely, section 15C of the Exchange Act and the rules and regulations thereunder. See Securities Exchange Act of 1934 § 36(b), 15 U.S.C. § 78mm(b). Section 15C addresses government securities brokers and dealers. The fact that Congress carved out this lone area undercuts any claim that the SEC was implicitly denied authority to curtail its antifraud rules.

181. Managers would remain indemnified and insured, and to an extent they would be shielded by *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 175–78, 191 (1994), which found Rule 10b-5 not to reach aiding and abetting liability. See *supra* note 59 and accompanying text. But corporate officers are liable for statements that they make to the market, and both the chief executive and the chief financial officer today must certify the corporation’s financial results under Sarbanes-Oxley, which will constitute a statement that triggers Rule 10b-5 liability. See Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (Supp. 2002). Also, in Rule 10b-5 litigation, plaintiffs almost automatically name the principal corporate executives as defendants. See *supra* note 52–53 and accompanying text.

182. See *supra* notes 118–119 and accompanying text.

would thus be required to consider carefully and dispassionately whether these defendants acted “in good faith” and in a manner “reasonably believed to be in or not opposed to the best interests of the corporation.”<sup>183</sup> Alternatively, insider defendants might forego indemnification and simply rely on their insurance policies, but now they would face a heightened danger that the insurer would seek to cancel the policy for fraud in the application. Although plaintiffs’ attorneys will predictably collude with defendants to resist any attempt to terminate the insurance policy, these disputes are still likely to be settled on a basis that places some liability on the individual defendant. Minimum deductibles on D&O insurance policies might also come into greater use. At this point, real deterrence would begin to emerge.

Finally, the limited exemption from Rule 10b-5 here contemplated would not apply when the corporation sold its shares during the class period. In such cases, the corporation is benefiting from the fraud and should sensibly be made a cost bearer. This position is consistent with the SEC’s own position on financial penalties.<sup>184</sup>

Some will respond that executives will not bear greater risk without demanding higher compensation. But the contemporary evidence is that executives already receive high rents in the form of executive compensation,<sup>185</sup> and the danger that individuals would be deterred from becoming chief executive seems laughably remote.

Other variations on this proposal are possible, but they carry additional difficulties.<sup>186</sup> The key idea is that by removing the corporate defendant from most Rule 10b-5 cases, we reduce the extent to which it serves as the residual cost bearer and thereby passes the costs of the litigation onto the shareholders.

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183. This is the language of Del. Code Ann. tit. 8, § 145(a) (2001). See *supra* note 155 and accompanying text.

184. The Commission’s new policy on financial penalties focuses on “whether the issuer’s violation has provided an improper benefit to shareholders.” See *supra* notes 8–9 and accompanying text (discussing Statement of the Securities and Exchange Commission Concerning Financial Penalties).

185. For the fullest expression of this view, see generally Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004). Their powerful critique of the excesses in executive compensation was written even before the current stock option backdating scandals.

186. Another variant is that any private action against the corporate issuer would be precluded under section 36 if the SEC brought and settled an action under Rule 10b-5 and deposited the penalties that it collected in an account for the benefit of the plaintiff class members. The problem with this proposal is that it may convert the SEC’s Enforcement Division into a Board of Pardons. Companies might flock to it to settle at an early stage. Historically, the SEC has not settled its cases with a view to achieving an adequate compensatory settlement for the injured plaintiff class members.

## CONCLUSION

To the extent that contemporary securities litigation imposes its costs almost exclusively on the corporation and its insurers, this system benefits three sets of actors—corporate insiders, plaintiffs’ attorneys, and insurance companies—but not shareholders.<sup>187</sup> Viewed in this way, the plaintiff’s attorney is less a champion of shareholders and more a participant in a process by which the parties shift liabilities created by corporate managers onto shareholders through the medium of costly insurance paid for by shareholders.<sup>188</sup> Because the repeat players—managers, attorneys, and insurers—all benefit from this system, it remains stable, and the outcome is usually the same: settlement.

Often, the result is litigation that is, to a degree, feigned. That is, the adversaries may vigorously skirmish and file preliminary motions, but ultimately they agree to settle by imposing the costs of the litigation on the absent party, the shareholders. The best way out of this charade is to eliminate the nontrading corporation as a defendant (and thus remove the fall guy). Doing this would force the true adversaries—plaintiffs’ attorneys and individual corporate defendants—to litigate for real.

Of course, this would increase the risk that plaintiffs’ attorneys assumed in such litigation, and it might scale down the recoveries.<sup>189</sup> Precisely for this reason, attorneys’ fees should be higher with regard to that percentage of the settlement that comes from officers and third parties in order to incentivize the plaintiffs’ bar to pursue personal liability against such persons. Once securities litigation becomes more adversarial than it is today, the next step would be for the SEC to recognize that the settle-

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187. A similar point was made over a decade ago by Kent Syverud, who recognized that the existing system benefited insurers, corporate managers, and plaintiffs’ attorneys. Syverud, *supra* note 74, at 1640–47. Everyone recognizes that a settlement in which the corporation agrees exclusively to nonpecuniary relief but the plaintiff’s attorneys receive a high fee award (paid by the corporation) looks suspiciously like collusion. But a settlement in which the corporation pays a significant financial recovery, while the individual defendants contribute little or nothing, can also be fairly described as collusive in a structural sense, even if the parties litigated intensely, because the real costs are being borne by shareholders who have no effective voice in the settlement process. At bottom, collusion in multiparty litigation involves pushing the costs of the action onto an absent party or at least a party facing high agency costs in the control of its attorney.

188. Although this description will be resented by plaintiffs’ attorneys, a distinctive feature of securities litigation is that the corporation has characteristically insured itself against liabilities imposed on it because of the conduct of its own officers. Corporations do not insure against the risk of antitrust or environmental liabilities or virtually any other class of legal liability (with the possible exception of employment liability). In fairness, when plaintiffs’ attorneys pursue third parties, other than the issuer corporation (as they did in Enron and WorldCom), they are serving as the shareholders’ champion.

189. Actually, the largest securities class action settlements were the Enron and Worldcom settlements. See *supra* note 80 and accompanying text. Neither in Enron nor Worldcom was the issuer corporation sued in the securities class action, because it was already in bankruptcy. These examples demonstrate that large recoveries are possible without the issuer corporation being liable.

ment of a securities class action represents an acute conflict of interest, one requiring independent directors to review it as carefully as they would a management buy out proposal.

For the SEC to take such action and curtail private Rule 10b-5 litigation, it must first acknowledge an inescapable fact: The securities class action is unlikely to afford significant compensation to shareholders. That realization should lead not to the abolition of the class action (as some critics have proposed), but to its reconfiguration into a mechanism for deterrence. Deterrence through private enforcement is possible, but punishing the victim is both unnecessary and unjust. Thus, this Essay has proposed some first steps in a different direction toward a system of greater managerial liability. These steps are only marginal, but they can be taken without legislation or any major reversal of settled precedents.

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