

**DOES THE PLAINTIFF MATTER? AN EMPIRICAL  
ANALYSIS OF LEAD PLAINTIFFS IN SECURITIES CLASS  
ACTIONS**

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*With the enactment of the Private Securities Litigation Reform Act of 1995 (“PSLRA”), the U.S. Congress introduced sweeping substantive and procedural reforms for securities class actions. A central provision of the Act is the lead plaintiff provision, which creates a rebuttable presumption that the investor with the largest financial interest in a securities fraud class action should be appointed the lead plaintiff for the suit. The lead plaintiff provision was adopted to encourage a class member with a large financial stake to become the class representative. Congress expected that such a plaintiff would actively monitor the conduct of a securities fraud class action so as to reduce the litigation agency costs that may arise when class counsel’s interests diverge from those of the shareholder class.*

*Now, more than ten years after the enactment of the lead plaintiff provision, the claim that the lead plaintiff, and particularly the lead plaintiff that is an institutional investor, is a more effective monitor of class counsel in securities fraud class actions continues to be intuitively appealing, but remains unproven. In this study, Professors Cox and Thomas inquire anecdotally and empirically whether the lead plaintiff provision has performed as projected. The anecdotal evidence they uncover is mixed, in some instances demonstrating the virtues of the lead plaintiff provision, while in*

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*others showing that the provision has encountered difficulties, including hesitance among institutional lead plaintiffs to take on the burden of serving as lead plaintiff (though recently more institutional investors are taking on the role of lead plaintiff) and allegations of “pay-to-play” schemes between plaintiffs’ law firms and potential lead plaintiffs.*

*Professors Cox and Thomas then conduct a series of statistical analyses of the lead plaintiff provision’s costs and benefits. Surprisingly, their results indicate that the ratio of settlement amounts to estimated provable losses in securities class actions---the most important indicator of whether investors have been compensated for their damages---has been lower since the passage of PSLRA and that settlement size has not increased since the passage of PSLRA. However, they also find that the presence of an institutional investor increases the dollar amount of settlements in those cases in which they appear, suggesting that the current trend for institutional investors to be lead plaintiffs in securities class actions will positively affect average settlement size in such actions in the future. Their analysis also sheds new light on the relative impacts other types of lead plaintiffs, such as individuals versus an aggregation of individuals, have on the outcome of settlements. They conclude with a discussion of the policy implications of their findings.*

#### INTRODUCTION

With the enactment of the Private Securities Litigation Reform Act of 1995 (“PSLRA” or “the Act”),<sup>1</sup> the U.S. Congress introduced sweeping substantive and procedural reforms for securities class actions. A central provision of the Act is the lead plaintiff provision,<sup>2</sup> which creates a rebuttable presumption that the investor with the largest financial interest in a securities fraud class action should be appointed the lead plaintiff for the suit.<sup>3</sup> The lead plaintiff provision was adopted to encourage a class member with a large

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1. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.) (amending Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77z-1 (2000)) and Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78u-4)).

2. See *id.* sec. 101(a), § 27(a) (amending 15 U.S.C. § 77z-1(a)(3)); *id.* sec. 101(b), § 27D(a) (amending 15 U.S.C. § 78u-4(a)(3)).

3. The idea behind the lead plaintiff provision was first proposed in an influential law review article by Professors Weiss and Beckerman. See Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 *Yale L.J.* 2053, 2057–58 (1995) (arguing that institutional investor would more likely serve as “litigation monitor” if made lead plaintiff, but claiming that judicial practices discouraged such assignment).

financial stake to become the class representative. Congress expected that such a plaintiff would actively monitor the conduct of a securities fraud class action<sup>4</sup> so as to reduce the litigation agency costs<sup>5</sup> that may arise when class counsel's interests diverge from those of the shareholder class.<sup>6</sup> The Congress clearly envisioned that various financial institutions—pension funds, insurance companies, and mutual funds—were the most likely types of investors who could combine a large financial stake in the suit's outcome with the sophistication to guide the suit to an appropriate result. Proponents of the provision claimed that there would be substantial benefits from having institutional investors serve as lead plaintiffs, including more favorable settlement terms, lower attorneys' fees for class counsel, fewer strike suits, more adjudications of class actions,<sup>7</sup> greater deterrence of securities fraud, and the reduction of some potential costs.<sup>8</sup> To be sure, the net benefits that would

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4. See S. Rep. No. 104-98, at 11 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 690 (“[I]ncreasing the role of institutional investors in class actions will ultimately benefit the class and assist the courts.”).

5. A very different agency cost problem is whether institutional investors that are the victims of fraudulent reporting systematically fail to present proof of their losses in *settled* securities class actions so that their lapse harms their beneficiaries. See 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, 875–77 tbls.2 & 3 (2002) [hereinafter Cox & Thomas, *Leaving Money on the Table*] (finding that more than two-thirds of those required to record their holdings of public companies with SEC failed to submit proof of claims in fifty-three securities class action settlements); 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, 421–24 tbl.1 (2005) [hereinafter Cox & Thomas, *Letting Billions Slip*] (finding that, in 108 settled securities class actions, 72% of large investors fail to present proof of claims).

6. See Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA*, Law & Contemp. Probs., Spring/Summer 2001, at 53, 53 [hereinafter Fisch, *Aggregation*] (arguing that lead plaintiff can “reduce agency costs and improve litigation decisions”). For a more general discussion of litigation agency costs in class actions, see Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 Vand. L. Rev. 133, 148–56 (2004).

7. See Weiss & Beckerman, *supra* note 3, at 2121–23.

8. See, e.g., Keith L. Johnson, *Deterrence of Corporate Fraud Through Securities Litigation: The Role of Institutional Investors*, Law & Contemp. Probs., Autumn 1997, at 155, 156–57 [hereinafter Johnson, *Deterrence*] (suggesting that institutions develop more graduated fee structures to discourage class counsel from bringing “unnecessary” suits; seek damages directly from officers and directors who had engaged in wrongdoing; and ask for governance changes at companies where firm's culture or internal governance structure had contributed to problem).

Private suits are not the only means of assuring deterrence, as violators can also be prosecuted by the Securities and Exchange Commission (SEC) and even the Department of Justice. For a study of the profile of the type of suit that attracts both private and SEC actions as contrasted with those that only attract the attention of private litigants, see James D. Cox & Randall S. Thomas, *Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?*, 80 Notre Dame L. Rev. 893, 901–02 (2005) (finding that SEC involvement is more likely to occur, post-2001, in settlements involving larger market capitalization issuers); James D. Cox & Randall S. Thomas with Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 Duke L.J. 737, 764–66 (2004) [hereinafter Cox & Thomas,

flow from the lead plaintiff provision were impossible to estimate when it was adopted in 1995; nonetheless, the premise that institutions would make more effective monitors than individual investors seemed reasonable and was not seriously contested.

Now, more than ten years after the enactment of the lead plaintiff provision, the claim that the lead plaintiff, and particularly the lead plaintiff that is an institutional investor, is a more effective monitor of class counsel in securities fraud class actions continues to be intuitively appealing, but remains unproven.<sup>9</sup> In this study, we inquire empirically whether the lead plaintiff provision has performed as projected. More importantly, this study provides insights into how the type of plaintiff impacts settlements of securities class actions. We begin on an anecdotal level in Part I, raising examples scattered throughout the literature and popular press of instances where institutional lead plaintiffs have achieved large settlements in high profile cases, negotiated advantageous attorneys' fee agreements, and apparently acted as good monitors in reducing litigation agency costs.

However, the evidence bearing on the virtues of the institutional lead plaintiff is not all positive. Disturbingly, many institutions have been reluctant to assume the role of lead plaintiff, especially in smaller cases.<sup>10</sup> The available evidence suggests that, as late as 2001, institutions had appeared in only 5 to 10% of all securities fraud class actions, although there are indications that they are getting involved more frequently in recent years.<sup>11</sup> Indeed, in our study of 388 settlements, pension funds and other financial institutions represented a very small percentage of the post-PSLRA plaintiffs. As our data

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SEC Heuristics] (finding that, for settlements prior to 2002, parallel SEC enforcement action more likely involved smaller market capitalization issuers experiencing financial distress than settlements arising from violations that did not involve parallel SEC enforcement action).

9. Compare, e.g., Max W. Berger et al., *Institutional Investors as Lead Plaintiffs: Is There a New and Changing Landscape?*, 75 *St. John's L. Rev.* 31, 31–32 (2001) (concluding that larger settlements are due to expanding role of institutions as lead plaintiffs), with John C. Coffee, Jr., *Litigation Governance: A Gentle Critique of the Third Circuit Task Force Report*, 74 *Temp. L. Rev.* 805, 807 (2001) [hereinafter Coffee, *Litigation Governance*] (arguing that it is “reasonable” but unproven that institutional lead counsel can perform effectively).

10. See, e.g., *Martin v. Atchison Casting Corp.*, 200 F.R.D. 453, 456–57 (D. Kan. 2001) (bemoaning that court had only two extremely small investors who had petitioned to be lead plaintiffs and that it had no power to conscript larger institution in class to become lead plaintiff).

11. See PricewaterhouseCoopers LLP, *2003 Securities Litigation Study 6* (2003), available at [www.10b5.com/2003\\_study.pdf](http://www.10b5.com/2003_study.pdf) (on file with the *Columbia Law Review*) (“In 2002 institutional investors and public investment or pension funds comprised 51 percent of the lead plaintiffs for all cases filed. In 2003 these major investors represented 42 percent of the lead plaintiffs in cases filed.”); Laura E. Simmons & Ellen M. Ryan, *Cornerstone Research, Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003*, at 9 (2004) (“Approximately 30% of all post-Reform Act settlements have involved institutions serving as lead plaintiffs.”). If we focus only on public pension fund lead plaintiffs, then these numbers drop significantly. For example, the PricewaterhouseCoopers study cited above finds that in 2003, based on cases filed through September 30, public pension funds filed only 28% of the cases in their sample. See PricewaterhouseCoopers LLP, *supra*, at 6.

reveals, by any metric—for example, the number of settled cases, the dollar amount of settlements, or the provable losses suffered by the class—a securities class action suit’s representative is far more likely to be an aggregation of nonfinancial institutional investors or even a single individual. Thus we examine here not only whether having a financial institution as a lead plaintiff impacts the quality of the settlement, but also whether differences exist between suits having as their representative an aggregation of nonfinancial institutions and individuals versus a single individual investor as the class representative.

Moreover, there have been press reports that institutions are aggressively lobbied by plaintiffs’ law firms to appear as lead plaintiffs. One prominent business publication went so far as to imply the presence of “pay-to-play” schemes. This practice, if present, means political contributions are made in exchange for institutional investors’ agreement to become a lead plaintiff and to select a preferred law firm as class counsel.<sup>12</sup> While such claims are difficult to verify empirically, we reviewed state-posted electronic information about lobbyists and found some evidence that plaintiffs’ law firms have hired lobbyists in several states. We have also learned from pension fund officials that these lobbyists have attempted to persuade them to act as lead plaintiffs. And we have personally observed the efforts of several plaintiffs’ firms to host conferences and other gatherings designed to attract institutions.

After this anecdotal cost-benefit comparison, we turn to our empirical analysis in Part II. Our data shows that courts consistently favor financial institutions over other types of investors when there is a contest among them to be appointed lead plaintiff. As will be seen in Part II.A, in the overwhelming majority of the Westlaw and Lexis cases in which a court issued an opinion selecting one lead plaintiff candidate over another, we found that courts invariably select institutional investors as lead plaintiffs in lieu of other types of petitioners. We therefore explore whether this preference is borne out by the evidence, namely whether financial institutions are the most effective monitors of the class counsel.

In order to do so, in Part II.B we examine the size of actual lead plaintiffs’ claims. For a group of thirty-five class action settlements, we have complete data on the lead plaintiff’s actual claims which we obtained from proprietary databases of claims administrators. We break the lead plaintiffs into four categories: public pension funds; other institutional investors; single individual lead plaintiffs; and aggregate groups of lead plaintiffs. We find that the lead plaintiff public pension funds in our sample have much larger dollar claims than any of the other types of lead plaintiff.<sup>13</sup> The lead plaintiff public pension funds on average represent a much larger percentage (4%) of the

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12. See Neil Weinberg & Daniel Fisher, *The Class Action Industrial Complex*, *Forbes*, Sept. 20, 2004, at 150, 152–53.

13. Furthermore, on average, the public pension fund claims are bigger than 99.7% of all the other claims filed in those cases.

claims filed in the case, too. By contrast, single individual investors that are lead plaintiffs have the smallest average total dollar claims and represent on average the smallest percentage (0.11%) of the claims filed in cases. Overall, our data suggests that only institutional investor lead plaintiffs have large enough stakes in these cases to justify their active monitoring of the class counsel.

In Part II.C, we turn to an analysis of a sample of securities fraud class action settlements to further investigate the effect of the lead plaintiff provision. We begin with descriptive statistics for the key variables in our sample. We find that, first, with the exception of the small set of cases where institutional investors have acted as lead plaintiffs, there are no significant differences between the pre-PSLRA and post-PSLRA cases in our sample with respect to almost every relevant characteristic: settlement amounts, length of class period, size of defendant firms, and estimated provable losses. In other words, only institutional investor lead plaintiffs appear to be associated with any difference in these metrics.

We were, however, shocked to find that the ratio of settlement amounts to estimated provable losses—which is the most important indicator of whether investors are being compensated for their damages—was statistically *lower* in the post-PSLRA period. After the passage of PSLRA, investors in our sample appear to be worse off because they are recovering a lower percentage of their losses. One possible interpretation of this finding is that Congress should repeal PSLRA in its entirety if it wishes to help defrauded investors.

We next use multivariate regressions to test three different hypotheses. First, we hypothesize that PSLRA's lead plaintiff provision has increased the dollar amount of settlements in securities fraud class actions. Our results show that after controlling for estimated losses, market capitalization of defendant firms, the length of class period, and the presence of parallel SEC actions, the dollar amount of post-PSLRA settlements is not statistically different from that of the pre-PSLRA cases in our sample. This finding suggests that PSLRA has not raised overall settlement size.

Second, we analyze the determinants of institutional investors' decisions to become lead plaintiffs in the cases in our sample. We hypothesize that institutions are more likely to become lead plaintiffs in cases involving larger provable losses, with longer class periods, with larger defendant firms, and when there is a parallel SEC enforcement action. Our results are consistent with this hypothesis. In other words, institutional investors are selecting the biggest cases in which to appear as lead plaintiffs.

Finally, we theorize that institutional lead plaintiffs will be the most effective in raising settlement size. In our regression, we find that the presence of an institutional lead plaintiff improves the settlement size, even holding constant estimated provable losses, firm market capitalization, the length of class period, and the presence of an SEC enforcement action. This result suggests that the trend toward using institutional investors as lead plaintiffs

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will have a positive effect on settlement size in securities fraud cases.

Our focus is not isolated to the effects of institutional lead plaintiffs. We also examine whether settlements are significantly different among various types of noninstitutional lead plaintiffs: a single individual, an aggregation of individuals, and a group comprised of individuals and a noninstitutional entity. We conclude that individual lead plaintiffs perform best in the smallest cases and worst in the large cases.

In our concluding section, we discuss the policy implications of our results and the current status of the lead plaintiff provision.

## I. THE PROMISE OF THE LEAD PLAINTIFF PROVISION

### A. *The Value of Lead Plaintiff Monitoring in Reducing Litigation Agency Costs*

At the heart of the lead plaintiff provision is Congress's belief that the securities class action needed an "owner" of the suit's outcome. This belief is founded on Congress's appreciation of the weak incentives that abound to act in the class interest in securities class actions.<sup>14</sup>

Well before 1995, the problem of incentives for class action suits was understood. Because class action suits typically were maintained on a contingency fee basis, the class attorney had a nontrivial investment in the suit that assumed increasing importance to the attorney as it proceeded. Maintaining a portfolio of such suits spread the risk of failing to recoup costs among several possible actions. But the risk remained, and the attorney could be expected to be a rational economic actor. As such, a settlement offer that provided recovery of the attorney's tangible and opportunity costs could loom larger than the prospect of aggressively pursuing the action to a more lucrative prospective judgment or settlement.<sup>15</sup>

The class action lawyer's weak incentives to pursue aggressively a meritorious action were not overcome by the self-interest of the members of the class. Class members suffered profound collective action problems that prevented close monitoring of the class action attorney. Though class action procedures required that there be a representative of the class, the requirements to be such a representative were not very demanding. The class representative

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14. See, e.g., S. Rep. No. 104-98, at 6 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 685 (observing that investors in class suits have "great difficulty exercising any meaningful direction over the case").

15. See, e.g., John C. Coffee, Jr., Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working, 42 Md. L. Rev. 215, 230 (1983) (arguing that attorneys generally had more at stake in class actions than their clients); Jill E. Fisch, Class Action Reform: Lessons from Securities Litigation, 39 Ariz. L. Rev. 533, 535 (1997) [hereinafter Fisch, Reform] (discussing goal of PSLRA to limit suits where settlements did not benefit individual plaintiffs but were of enormous financial benefit to their attorneys).

was frequently recruited by plaintiffs' lawyers in the securities bar, who maintained "a list of potential plaintiffs and their stockholdings."<sup>16</sup> These plaintiffs were viewed as often "poorly informed about the theories of their cases, . . . totally ignorant of the facts, or . . . illiterate concerning financial matters."<sup>17</sup> In many instances, they had "close relationship[s] to the plaintiff's lawyer or her firm."<sup>18</sup> Uninformed, and sometimes conflicted, class representatives were hardly ideal monitors.<sup>19</sup>

Furthermore, the presiding judge, overwhelmed by a crowded docket and poorly armed against the possible self-interest of the attorneys who promoted the suit's settlement,<sup>20</sup> was not capable of effectively protecting the interests of the class. And there was the ever present danger that suits were without merit and brought solely to extort a settlement at a level that was just a tad below the costs to defend the suit.<sup>21</sup>

These perceived agency costs prompted Congress to enact the Private Securities Litigation Reform Act in 1995.<sup>22</sup> The legislation, reflecting the

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16. Weiss & Beckerman, *supra* note 3, at 2060–61 (noting that prior to enactment of PSLRA, "usual pattern" for finding lead plaintiff was for plaintiffs' lawyer to "take the initiative" in launching securities fraud action after observing significant move in defendant company's stock price).

17. *Id.* at 2060.

18. *Id.*

19. See *id.* at 2064–65 ("No one disputes that a named plaintiff who has only a nominal financial interest in a class action, especially a plaintiff that an attorney has 'recruited,' is unlikely to monitor effectively her attorney's prosecution of the action or the terms [of the settlement]."); Fisch, *Aggregation*, *supra* note 6, at 56 ("The stakes of class members are generally too small to warrant active monitoring. Instead, class actions are effectively run by class counsel. Plaintiffs' lawyers bear most of the risk of the lawsuit and exercise virtually complete control over litigation decisions."); Johnson, *Deterrence*, *supra* note 8, at 156 ("Clients have been notoriously absent in class action litigation.").

20. See, e.g., *Alleghany Corp. v. Kirby*, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, J., dissenting) ("Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend [their] joint handiwork . . ."). A more cynical view of the judge's role in reviewing settlements appears in *In re Warner Communications Securities Litigation*, 618 F. Supp. 735, 740 (S.D.N.Y. 1985) ("[T]he court starts from the familiar axiom that a bad settlement is almost always better than a good trial."). See generally James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 *Ariz. L. Rev.* 497, 523–24 (1997) (arguing that PSLRA may have focused on wrong issues because courts have always had power to select more meritorious plaintiff as class representative and to impose sanctions for baseless suits).

21. A related problem is that class counsel would agree to a lowball settlement of a meritorious claim in exchange for a large fee. See Fisch, *Aggregation*, *supra* note 6, at 57 (noting this problem to be "[t]he most commonly cited example of the potential conflict between lawyer and client interests"); Johnson, *Deterrence*, *supra* note 8, at 156 ("Lack of effective client oversight has led to concern that class counsel might prosecute class actions in a way that produces the greatest legal fees rather than the result that would be most beneficial to class members.").

22. See Lisa L. Casey, *Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 *BYU L. Rev.* 1239, 1286 ("Both the statutory language and the legislative history of the PSLRA make manifest Congress's concern that securities class counsel, if left unmonitored, will behave in ways that harm both absent class members and the

interests of the narrow group of high-tech executives and accounting firms who were its strongest backers, focused only on the conduct of private securities litigation.<sup>23</sup> The PSLRA establishes a process to select a class representative. Under the supervision of the court, notice is published to class members seeking one or more to become the representative. Any shareholder that is a member of the class can respond by filing a motion to be appointed lead plaintiff. The court, within ninety days of the notice's publication, is required to select a lead plaintiff.<sup>24</sup>

In making this decision, the court is guided by the PSLRA's provision that there is a rebuttable presumption that the member of the class with the largest financial stake in the relief sought is the "most adequate plaintiff."<sup>25</sup>

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private enforcement system generally."); Thompson & Thomas, *supra* note 6, at 136–37 (noting that such "litigation agency costs" prompted Congress to pass PSLRA).

23. Antitrust, product liability, and other types of suits that are commonly maintained as class actions, and for which the same weak incentives abound, were unaffected by this legislation. The PSLRA altered many features of class action securities litigation. Foremost of these in the minds of class action lawyers is the heightened pleading requirement. Abandoning seven decades of notice pleading, the Act requires that securities fraud claims must be made with such particularity as to raise a "strong inference" of a violation. See 15 U.S.C. § 78u-4(b)(2) (2000). This stronger pleading requirement is coupled with the Act's bar of any discovery until the disposition of motions to dismiss, including a motion to dismiss for failure to plead with the requisite particularity. See *id.* § 78u-4(b)(3)(B). The class action attorney is therefore caught in the procedural jaws of a strong vice that first demands that the complaint set forth facts establishing a strong inference that the defendants knowingly or recklessly misrepresented a material fact, while simultaneously depriving the attorney of discovery procedures whereby facts could be gathered to support the allegation. Although estimates vary, one source claims that, after passage of the PSLRA, approximately one-quarter of the motions to dismiss in securities class actions are granted. See Lisa Klein Wager & Adrienne M. Ward, *Securities Class Actions: A Company's Bad News Gets Worse*, *Bus. L. Today*, July–Aug. 2002, at 15, 18. A more recent study found that 40.3% of securities class actions filed between 1998 and 2003 were dismissed. See Ronald I. Miller et al., *NERA Econ. Consulting, Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, Is Stabilization Ahead?* 4 (2006). Before the PSLRA, 20.3% of the suits filed in 1991–1995 were dismissed within five years of their filing. See Elaine Buckberg et al., *NERA Econ. Consulting, Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?* 3 (2005) [hereinafter Buckberg et al., *WorldCom and Enron*].

24. See 15 U.S.C. § 78u-4(a)(3).

25. *Id.* § 78u-4(a)(3)(B)(iii). For the rare instance when the largest loss does not qualify one to be a class's lead plaintiff, see *Tice v. Novastar Fin., Inc.*, No. 04-0330, 2004 U.S. Dist. LEXIS 16800, at \*24 (W.D. Mo. Aug. 23, 2004) (believing market maker would be subject to unique defenses even though having largest loss among those petitioning to be lead plaintiff and therefore selecting plaintiff with second largest loss along with two individual investors); *In re Terayon Commc'ns Sys., Inc., Sec. Litig.*, No. C 00-01967, 2004 U.S. Dist. LEXIS 3131, at \*21–\*22 (N.D. Cal. Feb. 23, 2004) (removing as lead plaintiff entities with large losses incurred in connection with defendant corporation's apparent scheme to depress its common shares using massive short sales).

Because the lead plaintiff provision makes rebuttable the presumption that the petitioner with the largest loss is the most adequate plaintiff, Congress obviously recognized that other considerations may more aptly qualify one to be a lead plaintiff despite that petitioner's smaller loss. To be sure, it may be easiest to see the presumption being overcome by extreme facts, such

The Act does not prescribe all the roles that the lead plaintiff can fulfill, but it does include selection of class counsel among the lead plaintiff's roles.<sup>26</sup> In doing so, Congress sought to reverse the pre-PSLRA practice of counsel choosing the plaintiff rather than the plaintiff choosing counsel.<sup>27</sup>

The theory behind this structure was that institutions with the largest losses would have the most to gain from becoming better monitors of the conduct of the litigation. Institutional investors would reject quick settlements of meritorious cases because these settlements would not compensate them for their losses.<sup>28</sup> Proponents optimistically projected that activist institutions

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as that the petitioner was a market maker. See, e.g., *Tice*, 2004 U.S. Dist. LEXIS 16800, at \*24 (suggesting that market maker is subject to unique defenses and is therefore not most adequate plaintiff in spite of having largest losses among those petitioning). However, the PSLRA places explicit limits on a competing petitioner's ability to discover the existence of unique defenses that would impair the petitioner with the largest loss from being an effective representative of the class. See 15 U.S.C. §§ 78u-4(a)(3)(B)(iii)(II)–(B)(iv); *Steiner v. Aurora Foods, Inc.*, No. 00-602, 2000 U.S. Dist. LEXIS 20341, at \*15 (N.D. Cal. June 5, 2000) (holding that individual plaintiff who merely alleged possibility that lead plaintiff would have unique defenses failed to overcome presumption). For a case permitting discovery once the court was satisfied of the possibility of unique defenses, see *Crawford v. Onyx Software Corp.*, [2001–2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,682 (W.D. Wa. Jan. 10, 2002) (permitting discovery against petitioner because its assertion of claims under both 1933 and 1934 Acts may be subject to unique defenses that render their representation of 1934 Act claims inadequate). Moreover, the court may well prefer a single institution to a loose aggregation of individuals who collectively have a much larger loss. For example, in *Switzenbaum v. Orbital Sciences Corp.*, 187 F.R.D. 246, 251 (E.D. Va. 1999), a group of retirement funds was preferred by the court over several individuals who collectively had a larger loss, in part because the group of funds, unlike the individuals, had an established procedure for acting collectively.

There is reason to question whether the lead plaintiff provision has even broader consequences. Some courts believe that the lead plaintiff provision raises the bar that one must clear to be deemed an adequate representative. Thus, the Fifth Circuit recently recognized in *Berger v. Compaq Computer Corp.*, 257 F.3d 475, 480–81 (5th Cir. 2001), that the presiding court has an obligation to satisfy itself that the lead plaintiff is capable of directing the litigation. The Fifth Circuit held that the court must assure itself that the lead plaintiff “possess[es] a sufficient level of knowledge and understanding to be capable of ‘controlling’ or ‘prosecuting’ the litigation.” *Id.* at 482–83. The court, therefore, understood the PSLRA's lead plaintiff provision to raise the standard above the adequacy threshold that applies to class actions in other contexts. See *id.* at 483. To this end, the court held it would consider the fee agreement the petitioner had negotiated with the proposed lead counsel. It would thereby determine whether the plaintiff was not just the petitioner with the largest loss, but the most adequate among those petitioning to be named lead plaintiff. *Berger* appears to represent a distinctly minority position, as other courts do not seek to confirm a petitioner's larger loss qualifying it to be a lead plaintiff by examining the negotiations the petitioner has had with proposed counsel. See, e.g., *In re Cavanaugh*, 306 F.3d 726, 734, 739 (9th Cir. 2002) (reversing district court's selection of petitioner whose loss of \$59,000 was much smaller than that of other petitioners but who had negotiated fee one-half the rate of counsel to represent five petitioning businessmen whose total losses were \$3.3 million).

26. See 15 U.S.C. § 77z-1(a)(3)(B)(v); *id.* § 78u-4(a)(3)(B)(v).

27. See H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 730 (stating impetus for legislation was “manipulation by class action lawyers of the clients whom they purportedly represent”).

28. See *Fisch, Reform*, *supra* note 15, at 538–39 (“[L]arge investor[s] ha[ve] a financial

would garner “disproportionately large benefits” from their involvement as lead plaintiffs because they would increase the return on their funds’ larger investments.<sup>29</sup> These gains would bolster the funds’ comparative performance vis-à-vis other institutions and result in further benefits for the activists. Furthermore, since institutional investors who manage other people’s money have fiduciary obligations to take “reasonable steps to realize on claims that will advance the interests of beneficiaries,”<sup>30</sup> proponents of the PSLRA structure were optimistic that institutional investors would become involved in these cases.

While the lead plaintiff provision was principally designed to improve shareholder monitoring of class counsel, its proponents also hoped that it would introduce market forces into class action litigation and change the ways in which plaintiffs’ securities law firms did business. For example, plaintiffs’ lawyers would “no longer find it necessary to race to the courthouse” but could instead more carefully investigate the merits of potential claims before deciding whether to file complaints.<sup>31</sup> Furthermore, institutional investors might be solicited by plaintiffs’ law firms to become lead plaintiffs, but, as more experienced and sophisticated clients, such institutions would be better able to select competent class counsel.

In the next two subsections, we examine the benefits and costs of the lead plaintiff provision. Our analysis is based on interviews with institutional investors, survey data, reported cases, and earlier research by other scholars. Our survey data is taken from a confidential survey of institutional investors that had served, or had considered serving, as lead plaintiffs in securities fraud class actions.<sup>32</sup>

#### B. *Beneficial Effects of the Lead Plaintiff Provision*

There are many levels at which the lead plaintiff can enhance the welfare

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incentive to prevent plaintiffs’ counsel from selling out legitimate claims too easily . . .”).

29. Weiss & Beckerman, *supra* note 3, at 2111.

30. Johnson, *Deterrence*, *supra* note 8, at 157. But see Cox & Thomas, *Leaving Money on the Table*, *supra* note 5, at 877 (finding that between two-thirds and three-quarters of institutional investors failed to file claims in securities fraud class action settlements to recover their share of settlement fund).

31. Weiss & Beckerman, *supra* note 3, at 2106; see also Elliott J. Weiss, Comment, *The Impact to Date of the Lead Plaintiff Provisions of the Private Securities Litigation Reform Act*, 39 *Ariz. L. Rev.* 561, 561–62 (1997) (“[Prior to PSLRA,] a relatively small number of plaintiffs’ attorneys regularly were filing class actions only hours or days after the disclosure of information that precipitated a major move in the price of a corporation’s stock.”).

32. We distributed the survey to a large number of institutional investors in conjunction with another survey of claims filing practices. We received seven completed surveys back. Given the complexity of the survey and the sensitivity of the information being requested, it is not surprising that our response rate was so low. Because of the low response rate, we offer the results of the survey as anecdotal evidence only and make no attempt to use it to draw statistical inferences. We thank those institutions that were willing to share this information with us.

of all members of the class. Areas that have attracted attention by the courts and commentators include the selection of the lead class attorney as well as the shaping of the attorneys' fee structure.<sup>33</sup> Before 1995, courts usually selected the attorneys that were first to file a securities fraud complaint as the lead counsel for the class.<sup>34</sup> This judicial practice led to a "race to the courthouse," as the lead counsel position can be quite lucrative for the firm that is chosen.<sup>35</sup>

After the passage of PSLRA, things changed in cases where institutional investors became involved as lead plaintiffs. In some instances, efforts of lead plaintiffs have visibly yielded results to the class's benefit. For example, in *Moore v. Halliburton*, the court refused to approve a settlement when one of the class's lead plaintiffs protested that the settlement accomplished too little.<sup>36</sup> *Moore* involved a class counsel that did not consult with the protesting lead plaintiff and proceeded to reach a settlement that was smaller than the sanction the SEC had imposed on the defendant for the same misbehavior alleged in the class action.<sup>37</sup>

The strongest embrace the lead plaintiff provision has received from the courts is *In re Cendant Corp. Litigation*.<sup>38</sup> The Third Circuit held that, with rare exceptions, the court should defer to the lead plaintiff's decision about who should be the class attorney as well as what the fee arrangement should be for the class counsel.<sup>39</sup> The *Cendant* court also reversed the decision of the

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33. See, e.g., Fisch, Aggregation, *supra* note 6, at 92–93 (describing how institutional investors are negotiators of "sophisticated compensation agreements that reduce legal fees and minimize agency costs").

34. See Weiss & Beckerman, *supra* note 3, at 2062. In jurisdictions where the courts preferred to allow the filing attorneys to determine which among them would be appointed as lead counsel, early filing was still important. In this situation, the first filing attorneys would frequently "share copies of their complaints with other plaintiffs' lawyers who [would] support their election as lead counsel." *Id.* at 2063.

35. See *id.* at 2062 ("The lead counsel effectively controls the conduct of a class action, including assignment of work among all lawyers who represent putative class action plaintiffs. If the lead counsel chooses to do much of the work herself, she will be able to claim the lion's share of any fees awarded."); see also Fisch, Aggregation, *supra* note 6, at 56–57 (noting that pre-PSLRA practice of selecting counsel based on first to file rule encouraged, among other abuses, counsel to "seek out prospective plaintiffs").

36. No. 3:02-CV-1152-M, 2004 U.S. Dist. LEXIS 18187, at \*15–\*21 (N.D. Tex. Sept. 9, 2004). This is not to say that the opposition of a lead plaintiff dooms the settlement. See *Kloster v. McColl (In re BankAmerica Corp. Sec. Litig.)*, 350 F.3d 747, 752 (8th Cir. 2003) (approving settlement over objections of three members of one lead plaintiff group in class action involving four plaintiff classes).

37. See *Moore*, 2004 U.S. Dist. LEXIS 18187, at \*13–\*20 (discussing SEC's imposition of \$7.5 million penalty when proposed class action settlement was \$6 million).

38. 264 F.3d 201 (3d Cir. 2001). Subsequently, the Third Circuit also held that there is a rebuttable presumption of the correctness of the lead plaintiff's decision not to compensate three law firms that represented some class members and that provided various professional services they argued benefited the class. See *In re Cendant Corp. Sec. Litig.*, 404 F.3d 173, 197–98 (3d Cir. 2005) (viewing primary responsibility for deciding attorneys' compensation as shifting from court to lead plaintiff after appointment of lead plaintiff).

39. See *In re Cendant Corp. Litig.*, 264 F.3d at 276 (holding that courts should defer to lead

trial court that substituted an auction among competing law firms to select the class's attorney for the agreed-upon fee.<sup>40</sup> *Cendant* is a dramatic illustration of how institutional investor involvement can impact positively the selection and compensation of the class's lead counsel. The fee structure negotiated by the lead plaintiff was approximately \$76 million less than the lowest bid submitted via the auction carried out by the trial court.<sup>41</sup> The result in *Cendant* reflects the broader experience of institutional investors: They are often able to lower counsel fees to one-half to one-third of the historical average of 32% of the recovery.<sup>42</sup>

To the extent a lead plaintiff can substitute bargaining between the lead plaintiff and the class counsel for the auction process, this may more accurately account for additional, societally relevant factors. If fees are but one of many factors in evaluating the value of class counsel, the auction process as conducted by courts probably poorly internalizes the other factors into the process. For example, the auction process is ill suited for sharp judgments on less quantifiable factors such as the quality of the representation, the likely timeliness of the suit's disposition, and the responsiveness of the lead plaintiff to the interests of the class members.<sup>43</sup> We suspect that lead plaintiff-class

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plaintiff's choice of counsel and fee agreement when choice is "reasonable on [its] own terms"); see also *In re Razorfish, Inc. Sec. Litig.*, 143 F. Supp. 2d 304, 310 (S.D.N.Y. 2001) (reasoning that auction approach is inconsistent with PSLRA's emphasis on close client supervision of counsel). For an illustration of how the court's displeasure with the lead plaintiff's inability to retain counsel on terms favorable to the class can lead to intervention by the supervising court, see *In re Quintus Sec. Litig.*, 201 F.R.D. 475, 482, 487-89 (N.D. Cal. 2001).

40. See *In re Cendant Corp. Litig.*, 264 F.3d at 279 (reversing use of auction for abuse of discretion).

41. *Id.* at 272 n.50.

42. See Keith L. Johnson, *Selecting Lead Counsel in the Midst of Judicial Chaos*, Institutional Investor Advoc. (Bernstein Litowitz Berge & Grossman, New York, N.Y.), Third Quarter 2001, at 1, 2, available at <http://www.blbglaw.com/advocate/adv2001Q3.pdf> (on file with the *Columbia Law Review*) [hereinafter Johnson, *Selecting Lead Counsel*] (estimating that State of Wisconsin Investment Board (SWIB) alone might have saved \$6 million in legal fees over previous five years if other lead plaintiffs had employed "competitive fee setting practices"); see also Richard B. Schmitt, *Pension Fund Plays Crucial Role in Suit*, *Wall St. J.*, Dec. 17, 1998, at B19 (reporting that SWIB acting as lead plaintiff had negotiated lead counsel fees of 18% of total settlement compared with national average of 32%); Michael A. Perino, *Markets and Monitors: The Impact of Competition and Experience on Attorneys' Fees in Securities Class Actions 2* (St. John's Univ. Sch. of Law Legal Studies Research, Working Paper No. 06-0034, 2006), available at <http://ssrn.com/abstract=870577> (on file with the *Columbia Law Review*) (finding "significant negative correlation between public pension fund participation as a lead plaintiff and both fee requests and fee awards").

43. See Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 *Colum. L. Rev.* 650, 710-16 (2002) (arguing that institutional investor empowerment more effectively incorporates market forces into selection of counsel than auctions do); Third Circuit Task Force Report on Selection of Class Counsel, 74 *Temp. L. Rev.* 689, 704-05 (2001) (concluding that auctions are inconsistent with goals of PSLRA and that traditional methods of selecting class counsel are preferable); Kendra S. Langlois, Note, *Putting the Plaintiff Class' Needs in the Lead: Reforming Class Action Litigation by Extending the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 44 *Wm. & Mary L. Rev.* 855, 904

counsel negotiations therefore make possible a more nuanced perspective toward establishing the incentive structure for the class counsel.<sup>44</sup>

Certainly the PSLRA empowers the lead plaintiff to “select and retain” counsel with the approval of the court,<sup>45</sup> which envisions the possibility that the lead plaintiff may substitute counsel so as to bring an early conclusion to the case.<sup>46</sup> This could occur when the lead plaintiff believes that the expected class recovery is dwarfed by the burdens imposed on the corporation and other defendants.<sup>47</sup> Some institutional investors have expressed their frustration with settlements wrested largely from the defendant company in whom the institutions have a continuing ownership stake large enough that the settlement in part is borne by the institution itself:

We [financial institutions] own these companies. . . . We are the market, or at least a recognizable fraction of it. So I’m not sure it makes much sense to sue ourselves, give the plaintiff’s bar a cut of our money and then

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(2002) (explaining that lowest bidder may be too risk averse because of low fee caps to pursue aggressively large settlement). But see James L. Tuxbury, Note, A Case for Competitive Bidding for Lead Counsel in Securities Class Actions, 2003 Colum. Bus. L. Rev. 285, 290 (stating that class recovers higher percentage of settlement when attorneys’ fees are established by competitive bidding).

44. It would be interesting to compare the performance of counsel selected by auctions with that of counsel selected under the lead plaintiff provision to see which produces a better recovery for shareholders. Assuming that the data could be collected, the ratio of settlement amounts to estimated provable losses might be an appropriate yardstick.

45. See 15 U.S.C. § 78u-4(a)(3)(B)(v) (2000).

46. The heightened pleading standards also partially address the problem of cost-ineffective suits. Heightened pleading standards probably work best to bar suits that are not well grounded in the facts, such as the infamous “strike suits” that were the focus of so much of the testimony in the hearings leading up to the PSLRA’s enactment. See, e.g., S. Rep. No. 104-98, at 4, 9–11 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 685 (recounting how settlements depend less on suits’ merits than on defense costs and that plaintiff with true economic stake in suit would improve this calculus). However, even the presence of a “strong inference” of scienter on the part of the company officers does not assure that the amount recoverable for the misrepresentation so committed will be economically significant. Those responsible, including the corporate defendant, may have too few assets or insufficient insurance to provide any expectation of a material recovery. Also, even the purposeful lie may not have impacted the security’s price to such a degree as to yield provable damages, or at least at the level to justify the suit’s continuance. After all, any corporate burdens arising from the suit’s continuance and settlement may well be transmitted to class members who continue to hold shares in the corporate defendant. See *Gluck v. Cellstar Corp.*, 976 F. Supp. 542, 548 (N.D. Tex. 1997) (rejecting challenge to proposed lead plaintiff on grounds that Congress was aware of possibility that such plaintiff would continue to hold substantial interest in defendant and could be sensitive to defendant company’s welfare). Such considerations existed prior to the PSLRA, and it was believed they would become even more frequent after the PSLRA institutionalized the formal appointment of a lead plaintiff who was likely to have a continuing significant ownership interest in the defendant. See Joseph A. Grundfest & Michael A. Perino, *The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation*, 38 Ariz. L. Rev. 559, 595–96 (1996) (reviewing role of institutions in pursuing relatively quick dismissal of suit against large technology company).

47. See Weiss & Beckerman, *supra* note 3, at 2122–23 (suggesting that institutions might be able to discourage their counsel from pursuing suits with modest recoveries and high costs).

pocket (to be reinvested) the rest. To the extent that there are third parties to cover the losses, we probably own them as well—including the insurance companies, the underwriters and the auditors. Citigroup is a good example. They settled their underwriter liability in WorldCom on [May 10] and their stock took a 2% hit as a result, which cost my funds about \$6 [million]. It's probably a temporary impact, but it illustrates the point.<sup>48</sup>

On the other hand, the lead plaintiff—certainly one whose substantial trading loss has qualified it to be the lead plaintiff—can easily be seen as an important restraint on the class attorney settling the suit for too small an amount. After all, the very purpose of the lead plaintiff provision is to harness effectively its self-interest to the class action by providing a mechanism for the class representative to be one who stands to recover a large amount through the aggressive prosecution of the suit. Such a heavy hitter is more likely to overcome the personal interests of class counsel who may prefer the certainty of settling the suit quickly for a smaller amount to investing more of the law firm's resources in pursuing a larger settlement that does not yield a proportional increase in counsel fees.<sup>49</sup>

As institutional investors have become accustomed to the lead plaintiff provisions, some broader benefits have been realized. Several of our survey respondents identified possible changes in corporate governance as an important potential benefit of becoming involved. These institutions wanted to “change the system” and therefore were willing to expend the extra time and effort to become involved. Institutional investor involvement may also be positively affecting the outcome of settlement negotiations,<sup>50</sup> a topic to which we will return below.

All of these benefits add up. One leading institutional investor told us that acting as lead plaintiff at a minimum doubles, and often triples or quadruples, the amount that the institution would have expected to receive if it had not become involved.<sup>51</sup> It also expects to reduce legal fees by one-half to

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48. E-mail from confidential institutional investor to authors (May 18, 2004) (on file with the *Columbia Law Review*).

49. The classic illustration of institutional investors inserting themselves to cause the rejection of a weak settlement otherwise championed by the class counsel is *In re California Micro Devices Securities Litigation*, 168 F.R.D. 257, 275–76 (N.D. Cal. 1996), class certified and settlement approved, 965 F. Supp. 1327 (N.D. Cal. 1997), where intervening lead plaintiffs secured a settlement with more cash to class members and a contribution from culpable corporate directors.

50. See Fisch, *Aggregation*, supra note 6, at 62 (discussing increasing sophistication of institutional investors in shareholder actions).

51. See e-mail from Keith Johnson, Chief Legal Counsel, State of Wis. Inv. Bd., to authors (Mar. 10, 2003) (on file with the *Columbia Law Review*) [hereinafter Johnson Correspondence] (stating that pension funds vastly increase their recovery by taking active lead plaintiff role); see also Schmitt, supra note 42 (noting that SWIB recovered more than 40% of its estimated damages in CellStar litigation where it acted as lead plaintiff as compared to average recovery in securities class actions of 14% of total damages).

one-third of those normally paid in federal securities class actions.<sup>52</sup> Finally, we note that being repeat players seems to sharpen the skills of institutional lead plaintiffs, as they have developed litigation guidelines to apply in determining when to participate as lead plaintiffs, they have prequalified certain law firms as potential class counsel, and they have become more sophisticated in negotiating fee agreements.<sup>53</sup>

Thus, multiple a priori beliefs that prompted Congress to enact the lead plaintiff provision find anecdotal support in the post-PSLRA case law. Having an independent, engaged plaintiff is socially useful. Despite these benefits, few financial institutions seek to so involve themselves, presumably because they do not see that the rewards of doing so are sufficient to offset the cost of becoming involved. The next section examines the expected cost of being a lead plaintiff.

### C. *The Burdens of Being a Lead Plaintiff*

Despite this impressive list of benefits, institutional investors have been slow to answer the call to become lead plaintiffs. This reluctance may be explained by the costs of doing so. The SEC's study of the first year's experience under the PSLRA found that institutional investors identified a number of concerns about the costs and potential liability that they would face if they became lead plaintiffs.<sup>54</sup> In particular, they identified the threat of discovery into the institutional investor's business, the amount of time that they would need to spend to manage the case,<sup>55</sup> the potential for disclosure of proprietary nonpublic information, and the threat of suit by other disgruntled plaintiffs.<sup>56</sup> Others have noted that activist institutions also need to worry

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52. See Johnson Correspondence, *supra* note 51; see also Johnson, *Selecting Lead Counsel*, *supra* note 42, at 2 (discussing role of plaintiff institutional investors in minimizing legal fees); Schmitt, *supra* note 42 (noting ability of SWIB to decrease legal fees in securities class action to 18% of settlement instead of national average of 32% of settlement).

53. Most of the survey respondents reported having adopted securities litigation policies that they applied in making their decision about whether to seek lead plaintiff status. Several also reported that they had prequalified a number of potential law firms to act as lead counsel before deciding to apply for a lead plaintiff position. See Fisch, *Aggregation*, *supra* note 6, at 62 ("Institutions are developing guidelines to determine when their participation in shareholder litigation is desirable. Institutions are developing ongoing relationships with plaintiffs' firms and increasing sophistication in evaluating and negotiating fee arrangements." (footnotes omitted)).

54. Office of the Gen. Counsel, U.S. Sec. & Exch. Comm'n, Report to the President and Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995, at 48-49 (1997), available at <http://www.sec.gov/news/studies/lreform.txt> (on file with the *Columbia Law Review*) [hereinafter Office of the Gen. Counsel, Report to the President and Congress].

55. Institutions will need to bear the costs of investigating whether such claims are meritorious, reading the complaint, selecting the lead counsel, and actively overseeing the litigation and settlement of any cases. See Fisch, *Reform*, *supra* note 15, at 542.

56. See Office of the Gen. Counsel, Report to the President and Congress, *supra* note 54, at 48-49.

about the effects of potential access to inside information on their trading activity or their loss of preferential access to information from defendant companies, as well as possible political pressure.<sup>57</sup> Our conversations with attorneys active in securities litigation suggest that the potential hardships of being a lead plaintiff are an important factor that institutional investors are still considering before acting as lead plaintiffs,<sup>58</sup> although the benefits of doing so may have become increasingly apparent to them.<sup>59</sup> We discuss some of these costs below.<sup>60</sup>

1. *Discovery Into the Lead Plaintiff's Business Practices.* — The possibility that defendants—and other plaintiffs' law firms competing to obtain the lead plaintiff position—might seek to engage in disruptive discovery about institutional investors' internal business practices and trading activities was well understood prior to the passage of PSLRA.<sup>61</sup> It was foreseen that defendants would try to use discovery, or at least the threat of discovery, to discourage institutions from volunteering to become lead plaintiffs.<sup>62</sup> Among the discovery issues that were projected as potential obstacles were the cost of producing information about the institution's trading over the years, its investment philosophy, and other proprietary information.<sup>63</sup> However, the early advocates of the lead plaintiff provision argued that such costs could be offset by judicial approval for reasonable expenses, perhaps augmented by

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57. See *id.*

58. Other factors that we were told are considered include the relative merits of the case, the size of the loss, and the willingness of other institutional investors to take the lead plaintiff position. Because settlements are distributed in proportion to each class member's loss, and lead plaintiffs are not guaranteed they will be reimbursed for the expenses incurred in connection with being a lead plaintiff, these are significant reasons to not become a lead plaintiff. See Johnson Correspondence, *supra* note 51. Thus, the lead plaintiff provision poses significant free rider issues, a point examined below. See *infra* notes 77–82 and accompanying text.

59. Our survey respondents were very sensitive to the balance of costs and benefits of acting as lead plaintiffs. For example, many of them required a multimillion dollar potential loss before they would even consider the possibility of becoming a lead plaintiff.

60. In a related vein, institutions may take passive roles about becoming lead plaintiffs, much as they do with filing claims in settled class actions, because their recoveries, while positive, are not seen as significant enough in comparison to the overall amounts of money that they are managing. See Cox & Thomas, *Leaving Money on the Table*, *supra* note 5, at 879–80 (hypothesizing that small recoveries, even with large losses, would deter institutions from filing suit).

61. See Weiss & Beckerman, *supra* note 3, at 2101–03 (examining how institutions may fear “boxcar discovery” motions after filing suit).

62. See *In re Cendant Corp. Litig.*, 264 F.3d 201, 270 n.49 (3d Cir. 2001) (observing that courts must be cautious in granting discovery against lead plaintiff so as to avoid harassment of lead plaintiff through discovery process); Fisch, *Reform*, *supra* note 15, at 545–46 (noting that defendants will seek discovery to challenge typicality of institutional investor as class representative or to investigate institution's trading behavior which might bear on “the manner in which the class is defined and the institution's reliance”).

63. See Weiss & Beckerman, *supra* note 3, at 2103 (recognizing that lead plaintiffs could face “[t]he cost of producing all documents concerning an institution's investment philosophy and trading over several years [and other] disclosure of proprietary information”).

incentive awards to the lead plaintiff.<sup>64</sup>

More directly, the Act conditions the ability of other potential class representatives to conduct discovery to challenge whether a petitioner should be appointed lead plaintiff to first demonstrating “a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class.”<sup>65</sup> Although the PSLRA does not expressly limit the defendants’ ability to engage in discovery about the typicality or adequacy of an institution to act as a lead plaintiff, courts have found in the quoted provision congressional intent that defendants cannot engage in discovery for purposes of challenging the adequacy of the plaintiff to represent the class.<sup>66</sup> Instead, defendants can engage in discovery that is focused on substantive issues relevant to the case.<sup>67</sup>

Our discussions with attorneys in this area lead us to believe that discovery issues, while initially of some concern to institutions, have not proved to be too onerous.<sup>68</sup> Defendants’ counsel have quickly learned that the investment advisors who advise institutional investors regarding securities transactions are extremely knowledgeable about the company’s securities filings and its financial statements. In this sense, the lead plaintiff may well have more of the characteristics of a reasonable investor than do many of the class members. As defendants contemplate their lack of success in demonstrating that the plaintiffs were not acting in reliance on the company’s statements or did not understand the meaning of its disclosures, their interest in pursuing discovery about the institutional investors’ actions has declined.

2. *Greater Recoveries for Institutions That Pursue Their Own Actions.* — Institutional investors with large potential claims have sometimes found it more advantageous to act for themselves rather than on behalf of all other investors.<sup>69</sup> Institutional investors with such claims may believe that their claims are better pursued as individual claims than as part of a class action.<sup>70</sup>

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64. See *id.* at 2124 (“[C]ourts grant expenses and incentive awards to plaintiffs in some class actions [and there should be] no reason why they would not do the same for institutional plaintiffs.”).

65. 15 U.S.C. § 78u-4(a)(3)(B)(iv) (2000).

66. See, e.g., *Fields v. Biomatrix, Inc.*, 198 F.R.D. 451, 455 (D.N.J. 2000) (denying discovery focused on adequacy of petitioner to represent class).

67. See, e.g., *In re Grand Casinos, Inc.*, 181 F.R.D. 615, 620–21 (D. Minn. 1998) (permitting discovery against lead plaintiff for purpose of inquiring in fraud on market case whether plaintiff in fact relied upon integrity of market when trading).

68. Only one of our survey respondents identified the costs of discovery as a problem. In that instance, the respondent reported that it had spent over forty hours of attorney time complying with discovery requests from the defendant in the case where it was acting as a lead plaintiff. Confidential communications with authors (Mar. 2003) (on file with the *Columbia Law Review*). We have also had discussions with attorneys that are active in the field about this issue and were told that their clients do not believe the discovery issues to be major ones.

69. Four of our survey respondents reported at least one instance where they had opted out of a securities class action to pursue their own individual recovery.

70. See Langlois, *supra* note 43, at 876 (“[Institutional] investors feel that they can present a

They may believe that, in a class action, their stronger claims will be combined with weaker claims to dilute their ultimate share of the settlement value.<sup>71</sup> Some evidence that has been gathered supports this point.<sup>72</sup> Moreover, institutions, with their cadres of analysts, may be in a better position than other investors to sue under section 18 of the Securities Exchange Act of 1934,<sup>73</sup> where they can likely meet its double reliance standard and thereby escape the necessity of pleading scienter.<sup>74</sup>

On the other hand, institutions that opt out of a class action to pursue their own individual action do face risks. Mainly, such institutions are no longer able to control the class action litigation. But this should not be a major deterrent. To be sure, an inadequate record and a poor settlement in a parallel class is likely to affect adversely the institution's individual action. However, many of the public pension funds that have been most active in this area want to try to fix the system. They desire not only to improve the effectiveness of class action litigation, but also to strengthen the financial reporting process through corporate governance changes and to encourage recoveries from individual corporate officers and directors so that institutional plaintiffs do not bear indirectly some of the cost of the suit's successful prosecution.<sup>75</sup> These institutions may be limited in the number of cases in which they can get involved and would prefer to deploy their resources in class actions where they can have a broader impact.<sup>76</sup>

3. *Disincentives to Becoming a Lead Plaintiff.* — Institutional lead plaintiffs incur costs when monitoring the actions of lead counsel. These costs include investigating the claims made, selecting lead counsel, reading any complaint or pleadings filed by counsel, and expending time and resources to

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stronger individual claim than class members can establish as a class action.”)

71. See Grundfest & Perino, *supra* note 46, at 571–72 (describing strategic benefits of class actions for weaker claimants and disadvantages for stronger claimants).

72. See Langlois, *supra* note 43, at 876 (citing Implementation of the Private Securities Litigation Reform Act of 1995: Hearing Before the House Comm. on Commerce, 105th Cong. 21 (1997) (statement of Arthur Levitt, Chairman, Securities & Exchange Commission)).

73. See 15 U.S.C. § 78r (2000). Section 18 causes of action lie only for material misrepresentations appearing in documents required to be filed with the SEC and are not available for misrepresentations appearing only in other media, such as press releases.

74. See generally James D. Cox et al., *Securities Regulation: Cases and Materials* 553–54 (5th ed. 2006) (reviewing elements of section 18).

75. On the desirability of encouraging recovery from individual wrongdoers so as to avoid the circularity problem that arises when a corporation contributes significantly to a settlement that is awarded in part to its existing owners, see generally John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 *Colum. L. Rev.* \_\_\_ (2006).

76. For some institutions, such as public pension funds, the size of their staff may be limited by political considerations so that adding extra workers may not be possible even if it makes financial sense. At other institutions, staff time may be limited because they are reluctant to increase staffing if they cannot increase their management fees to cover the additional expenses. Given that existing staff have other duties to perform, this caps the amount of staff time that can be devoted to litigation.

monitor the prosecution and possible settlement of the action.<sup>77</sup> Related to such costs are potential “free rider problems, because institutions, particularly those concerned about minimizing administrative costs generally, are rationally apt to prefer that another investor take the initiative to become involved.”<sup>78</sup> In fact, one attorney who represents institutional investors in securities fraud class actions told us that the first question his clients ask before considering undertaking a lead plaintiff position is whether any other institution is willing to do it.<sup>79</sup>

Free rider problems have been a barrier to institutional investor activism in almost every area of corporate governance.<sup>80</sup> The fact remains that, in the United States, even the largest institutional investors rarely own more than 5% of a company’s stock, making it imperative that they act as part of a group of investors if they wish to have a significant impact. In all these situations, the costs of initiating and sponsoring action are borne by the activists, while any benefits fall proportionately among all members of the group. Lead plaintiff proponents claim that free rider problems should not pose the same problems for institutions choosing to pursue that position because an institution does not need any other institution’s support to do so.<sup>81</sup> In fact, the passivity of other institutions enhances the chances of the selection of activist funds as lead plaintiff, assuming such an institution chooses to act.

However, institutional investors’ initial unwillingness to participate as lead counsel could well have been attributable to free rider problems. Acting as an effective lead plaintiff can be a very time-consuming task in complex, aggressively litigated cases, where multiple suits against different sets of defendants at different points in time may be necessary in order to maximize the class recovery. Of course, some cases are much more straightforward and require less oversight, and some institutions will devote less time than is needed to achieve the most appropriate client-driven litigation goals. But, in general, an institutional investor lead plaintiff will probably need to devote significant amounts of out-of-pocket expenses, legal staff time, and investment staff time. While out-of-pocket expenses are reimbursed in successful actions, the courts have only sometimes agreed to compensate institutions for the time spent by their in-house professional staff at market rates.<sup>82</sup>

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77. Fisch, Reform, *supra* note 15, at 542.

78. *Id.*

79. Telephone interview with confidential source (Mar. 2003).

80. See, e.g., Robert Charles Clark, Corporate Law §§ 9.5.1–9.5.2 (1986) (explaining infrequency of proxy contests focused on corporate mismanagement in part being due to free rider problems associated with rationally apathetic stockholders).

81. See Weiss & Beckerman, *supra* note 3, at 2110–11.

82. The PSLRA’s provisions provide that “[n]othing in this paragraph shall be construed to limit the award of reasonable costs and expenses (including lost wages) directly relating to the representation of the class . . . .” 15 U.S.C. § 78u-4(a)(4) (2000); see also *State of Wis. Inv. Bd. v. Bartlett*, No. 17727, 2002 Del. Ch. LEXIS 42, at \*22–\*23 (Del. Ch. 2002) (denying recovery and stating that SWIB had enough at stake to merit its involvement without award for costs); cf.

A number of our survey respondents identified monitoring costs as an important issue in their decisionmaking process, although their estimates of the time involved ranged widely from 40 to 100 hours to as much as 250 to 1000 hours for their total involvement through settlement.<sup>83</sup> As discussed in the preceding footnote, we obtained very complete estimates from the general counsel of a leading institutional investor. Using these estimates and valuing the institution's average personnel cost at \$100 per hour, which seems quite

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*Cook v. Niedert*, 142 F.3d 1004, 1016 (7th Cir. 1998) (stating that factors to be considered in providing incentive reward to class representative include whether representative's actions conferred substantial benefit on class, time and effort expended, and steps representative has taken to protect class); *Brotherton v. Cleveland*, 141 F. Supp. 2d 907, 913–14 (S.D. Ohio 2001) (permitting incentive award of \$50,000 to individual class representative for her extensive participation in what was ultimately successful prosecution of action); *Enter. Energy Corp. v. Columbia Gas Transmission Corp.*, 137 F.R.D. 240, 250–51 (S.D. Ohio 1991) (permitting similar awards).

83. We asked the general counsel of one leading institutional investor that has acted as lead plaintiff in a number of cases how much time a lead plaintiff needs to spend on an "average" case. See Johnson Correspondence, *supra* note 51. He answered that in securities class actions there are several stages to the case that can take significant amounts of in-house personnel's time. In stage one, the institutional investor must make its initial decision about whether to file a motion to be named lead plaintiff and then to select lead counsel. He estimated that this part of case management would take twenty to one hundred hours of its legal staff's time and two to ten hours of its investment staff's time. If the institution is selected as lead plaintiff—an outcome that is highly likely—it would thereafter assist class counsel in preparing and filing an amended complaint. To be sure, class counsel would probably do most of this work, but in-house counsel would still spend five to ten hours, and the investment staff would devote an additional two to five hours at this point.

Institutions must also spend significant amounts of time helping class counsel brief important motions. This work is performed almost entirely by the legal staff of the institution, taking anywhere from five to fifty hours of time. The investment staff's involvement in this stage would be minimal, totaling less than two hours. Discovery in all its various aspects can also absorb in-house legal staff's time as well as that of the investment staff. This general counsel thought that legal staff would spend ten to fifty hours on discovery, and the investment staff would be required to do about an equal amount of work.

If the case proceeds to the point of negotiating a settlement, then both in-house legal staff and investment staff are typically involved. These negotiations can be quite short or very protracted, making estimate ranges here fairly broad. Here, our source estimated that legal staff might put in ten to two hundred hours of time, while investment staff would be needed less (only one to ten hours). If the case actually goes toward trial, the institutional investor's staff will be heavily involved. Legal staff could be employed full time for several weeks with trial preparation. Investment staff, while less needed, could still spend several days helping with these preparations. All of this preparation time would be required even though the trial itself is very unlikely to be held since almost no federal securities class actions go to trial. See Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Outside Director Liability 7* (Am. Law & Econ. Ass'n, Working Paper No. 11, Apr. 2004), available at <http://law.bepress.com/alea/14th/art11> (on file with the *Columbia Law Review*) (showing 1,557 federal securities cases settling out of 2,930 cases filed from 1991 to June 2003).

Finally, according to our source, the lead plaintiff's legal staff will need to engage in general oversight and communication activities throughout the case. This can add up to an additional one to three hours a month of legal counsel's time. Over the course of an entire case, this might amount to a total of twenty to eighty hours of in-house legal staff time per lawsuit.

low to us, then the cost of a reasonable case management effort by an institutional investor lead plaintiff in an “average” case would total between \$25,000 and \$100,000. Even though some institutional investors believe that they can double or even quadruple their recovery by serving as active lead plaintiffs, these are substantial upfront costs to bear relative to the incremental benefits institutions expect their involvement to yield. Moreover, several of our survey respondents stated that they had very limited manpower to staff cases and therefore chose not to become involved as lead plaintiff in many cases.

An individual investor, or even an aggregation of individuals, is not likely to engage in the extensive involvement described in the preceding paragraphs at each of many stages of litigation by an institution. Our data base reflects that the individual investor is not a repeat player in the process as is the case with some public pension funds. Moreover, the individual investor is not likely to have an internal staff to involve it in the monitoring assessments that occur at multiple stages of the suit’s life. Hence, these monitoring costs are not sunk costs, as they are in large part with institutions, but rather require the individuals to devote new resources to the enterprise. In light of these facts, individuals are likely to underinvest in monitoring. We therefore do not believe it is likely that lead plaintiffs who are not such a financial institution are likely to produce gains that approach those associated with a lead plaintiff who is a financial institution. We empirically test this hypothesis later in this study.<sup>84</sup>

Finally, we would be remiss if we did not mention two other important obstacles to institutional investors becoming lead plaintiffs. First, a number of our survey respondents noted the lack of information about the case at the very early stage of the litigation—when they are forced to decide whether to become lead plaintiffs—as a barrier to serving as class counsel. In essence, PSLRA gives institutions a maximum of sixty days to make this choice, which essentially limits the information on which they base their decision to the complaint, the publicly available information about the company, and the size of their estimated loss.<sup>85</sup> Sixty days appears to be a relatively brief time for institutional investors to inform themselves fully enough to decide whether to become a lead plaintiff, especially where the loss estimates generated at this stage can vary wildly.

Second, many institutions have commercial relationships that may be jeopardized if they become lead plaintiffs. Even though financial institutions are not monolithic in their missions or operations, many institutions’ managers

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84. See *infra* Part II.C.

85. See 15 U.S.C. § 77z-1(a)(3)(A)(i)(II) (requiring class members to move to serve as lead plaintiff within sixty days of notice of complaint); *id.* § 78u-4(a)(3)(A)(i)(II) (same). Given the type of damage models that they use, the plaintiffs’ lawyers that are trying to persuade institutions to become involved are likely to overestimate the amount of these losses, which further complicates the institutions’ situation.

face conflicts of interest when considering whether to become a lead plaintiff.<sup>86</sup> Banks, mutual funds, and insurance companies—three of the five largest classes of financial institutions—are each vendors of financial services and products. Their customers include the corporations and accounting firms who are the grist of securities class actions. And, to the extent that public pension funds and endowments appear not to have the same conflicts as other types of institutions, those conflicts appear when the public pension fund or endowment depends on outside money managers who have such conflicts.<sup>87</sup> These relationships are jeopardized if the institution becomes the lead plaintiff in a class action focused on its customers or benefactors.

As we have observed elsewhere,<sup>88</sup> financial service providers are not eager to become, or to align themselves with, antagonists of their clientele.<sup>89</sup> This observation likely explains why our data contains no settlement where a bank, mutual fund, or insurance company has served as a lead plaintiff in a securities class action. Our intuition is that such institutions are generally unwilling to lead the assault on executives who have issued misleading reports if such visibility could pose problems in selling financial services to other executives who likely share the view that most securities class action suits are strike suits.<sup>90</sup> Consorting with “class action lawyers” does not win one friends in the executive suites of America or at the club.<sup>91</sup> Furthermore, there is only the thinnest social divide between executives of banks, insurance companies, and mutual funds and executives of industrial firms. These are groups of individuals who understand one another and who are aware of the price to be

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86. See Cox & Thomas, *Letting Billions Slip*, supra note 5, at 425–28 (explaining social and commercial forces that prevent banks, mutual funds, and insurance companies from stepping forward to become lead plaintiffs).

87. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 596–97 (1990) [hereinafter Black, *Shareholder Passivity*] (observing that some institutional investors suffer inherent conflicts of interest derivatively through their external advisors who face such conflicts).

88. See Cox & Thomas, *Letting Billions Slip*, supra note 5, at 427–28.

89. Thus, we find that many types of financial institutions are not themselves the proponents of a bylaw or other proposal that will alter the governance of their portfolio companies, although they will at times vote in favor of such a proposal that is advanced by another, less conflicted institution. See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811, 883 (1992) (“A bank trust department may not make a shareholder proposal itself, but the trust department may be able to vote for a proposal by another institution, especially if corporate managers can’t easily discover how the trust department voted.”). More pointedly, “for a conflicted institution, crossing the street in a crowd is safer than crossing alone.” Black, *Shareholder Passivity*, supra note 87, at 606.

90. We recognize that an institution may be averse to participating in individual class action recoveries if it believes that a particular case is just extorting money from a company.

91. The same social and commercial forces that prevent banks, mutual funds, and insurance companies from stepping forward to be a lead plaintiff may also weaken the commitment of their managers to assure that the firm reaps the full advantage of securities class action litigation. See Cox & Thomas, *Letting Billions Slip*, supra note 5, at 424 (finding in study of 118 securities class action settlements that 72% of potential claimants in settled class actions fail to submit their claims).

incurred by failing to honor that understanding.<sup>92</sup> By default, therefore, it is the public or union pension fund that is most likely to serve as a lead plaintiff because it is the type of institution not likely to have such a commercial interest that would be jeopardized by aligning itself with the plaintiffs' bar.<sup>93</sup> As we will see, these are the overwhelming majority of institutional investors that are appearing as lead plaintiffs in our sample. Thus, there are distinct imputed costs to becoming a lead plaintiff when the institution is also a vendor of commercial products to those who may become the targets of future securities class actions.

*D. Forces that Corrupt: Strategies that Circumvent the Objective of the Lead Plaintiff Provision*

The broad objective of the PSLRA's mechanism for selecting a lead plaintiff is to place a class member in the lead harness and thus make securities class actions less lawyer driven. Because of practices described in this section, this objective, regrettably, may largely remain just a hope and not a reality.

Plaintiff law firms competing to represent the class each have a significant financial stake in who the court selects as the suit's lead plaintiff: This selection customarily means the counsel representing the new lead plaintiff is appointed to be class counsel. To be sure, the PSLRA does not require this result because the lead plaintiff provision expressly conditions selection of the class counsel on approval by the court. Nevertheless, the courts regularly avoid any "shotgun marriage" between the lead plaintiff and a counsel not selected by the lead plaintiff.<sup>94</sup> We can therefore understand that the winning strategy for the plaintiffs' lawyer is to find and befriend an investor or group of investors who are likely to have substantial financial losses due to the defendant's fraudulent acts.

1. *"Pay-to-Play" Allegations.* — The most obvious place to find such a high-loss investor is among the ranks of institutional investors. As seen above, most institutions face commercial restraints on serving as lead plaintiff. Two

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92. See William M. O'Barr & John M. Conley with Carolyn Kay Brancato, *Fortune and Folly: The Wealth and Power of Institutional Investing* 230–31 (1992) (examining cultural identities that managers of institutions share with managers of their portfolio companies); cf. James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, *Law & Contemp. Probs.*, Summer 1985, at 83, 85–108 (examining social and psychological forces, among which includes being of same social strata, that can impede director's decision to sue another).

93. Labor union shareholder activists often wear two hats, protecting their interests as shareholders but also furthering their interests as workers. For further discussion of the potential conflicts of interest that may arise in these situations, and of labor union shareholder activism in general, see Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 *Mich. L. Rev.* 1018, 1074–84 (1998).

94. See *In re Cavanaugh*, 306 F.3d 726, 733–35 (9th Cir. 2002) (deciding that selecting counsel through competitive bidding is inconsistent with PSLRA); *In re Cendant Corp. Litig.*, 264 F.3d 201, 273–74 (3d Cir. 2001) (same).

important exceptions to these commercial restraints are public and labor pension funds. In theory, a priori considerations that should guide institutions in selecting a law firm to serve as class counsel include the firm's reputation and the formula for determining fees to be awarded counsel for any success in the suit.

Dimming this idealistic vision of selecting lead counsel are numerous reports of "pay-to-play" practices pursued by some large plaintiffs' law firms.<sup>95</sup> A case in point is the *Cendant* litigation. The lead plaintiffs in *Cendant*, the California Public Employees' Retirement System, the New York City Pension Funds, and the New York State Common Retirement Fund (NYSCRF), selected Barrack, Rodos and Bacine (BRB) and Bernstein Litowitz Berger & Grossman LLP (BLBG) as lead counsel. An elected official, New York State Comptroller H. Carl McCall, had sole responsibility with respect to all matters related to NYSCRF, and it was his office that urged the selection of BRB and BLBG as lead counsel. But Comptroller McCall had received approximately \$100,000 in campaign contributions from three plaintiffs' law firms between 1999 and 2001—the relevant period for having selected and retained counsel in the matter. Two of those contributing law firms were the two firms selected to be counsel in the *Cendant* litigation.<sup>96</sup> Ultimately counsel was awarded attorneys' fees of \$55 million in connection with the \$3.2 billion settlement of the suit.<sup>97</sup> Not surprisingly, in 2002 it was estimated that BRB and BLBG, their partners, and their families made nearly \$200,000 in campaign donations to McCall.<sup>98</sup>

Recall that in *Cendant*, in response to an objection by a lawyer for another shareholder who was not selected as the lead plaintiff, the district court held an auction to choose counsel.<sup>99</sup> The objector argued that both BRB and BLBG should be disqualified because they had made political contributions to McCall.<sup>100</sup> The district court permitted both firms to represent the class,

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95. Cf. John R. Wilke, Nathan Koppel & Peter Sanders, *Milberg Indicted on Charges Firm Paid Kickbacks*, Wall St. J., May 19, 2006, at A1 (reporting federal indictment of nation's largest securities class action firm for alleged "kick backs" to *individuals* who served as plaintiffs in securities class actions over twenty-year period).

96. See Kevin McCoy, *Campaign Contributions or Conflicts of Interest?*, USA Today, Sept. 11, 2001, at 1B. The third law firm, Milberg Weiss Bershad Hynes & Lerach, was selected by McCall as lead counsel in the Global Crossings securities class action. See Shaila K. Dewan, *Donors to McCall Profit in Cases State Pursues Against Corporate Wrongoers*, N.Y. Times, Aug. 14, 2002, at B4. And McCall selected BRB and BLBG to represent the fund as lead plaintiff in another large class action, *McKesson HBOC, Inc.* Id. Since BRB is based in Philadelphia, its support of a public official of another state, who aspired only to office in that state, supports our unease that the purpose of BRB's campaign contribution was driven by commercial and not civic objectives.

97. See *In re Cendant Corp. Litig.*, 243 F. Supp. 2d 166, 174 (D.N.J. 2003), *aff'd*, 404 F.3d 173 (3d Cir. 2005) (holding that \$55 million in attorneys' fees requested by lead counsel is "not clearly excessive").

98. See Dewan, *supra* note 96.

99. See *In re Cendant Corp. Litig.*, 264 F.3d at 270–72.

100. See *id.* at 269.

provided they would agree to match the low bid.<sup>101</sup> Not surprisingly, they agreed because the low bid they were asked to match was \$75 million greater than the fee they had negotiated with the three lead plaintiffs.<sup>102</sup>

Interestingly, McCall chose not to appeal the higher fee award; the appeal instead was brought by the New York City Pension Funds, for whom there were no reports of campaign contributions. The Third Circuit reversed the award, remanded the case to the district court with suggestions that a lower figure was in order, and dealt obliquely with the possible corrupting influences of campaign contributions to McCall.<sup>103</sup> The court suggested that “in cases where the court determines that a publicly-managed fund is the presumptively most adequate plaintiff, the court *could* properly require that the fund disclose any campaign contributions by the fund’s choice of counsel to any elected officials possessing direct oversight and authority over the fund.”<sup>104</sup>

The odor of corruption surrounds more than Mr. McCall’s choice of counsel in *Cendant* and other instances when NYSCRF has been appointed lead plaintiff.<sup>105</sup> Milberg Weiss, the leading securities class action plaintiffs’ firm, has repeatedly been mired in controversy over whether it secures the support of public institutions through political or other contributions to decisionmakers.<sup>106</sup> And in a news account based on examination of campaign finance records in five states and two cities, reporters found not only a substantial increase in campaign contributions in Louisiana, Pennsylvania, and New York following the enactment of the PSLRA and its lead plaintiff provision, but a correlation between the contributing law firms and the funds’ selection of these firms to represent the fund as counsel in suits where the fund served as lead plaintiff.<sup>107</sup>

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101. See *id.* at 219–20 (discussing district court’s counsel selection process).

102. See *id.* at 272 n.50.

103. See *id.* at 220–21.

104. *Id.* at 270 n.49 (emphasis added).

105. See *id.* at 230–31. In this regard, New York State Comptroller Alan Hevesi chose BRB and BLBG to represent the municipal pension system as lead plaintiff in the securities class action arising out of the accounting scandal of WorldCom. In combination the two firms contributed \$42,900 to Hevesi’s campaign. See Editorial, *Citigroup Wake-Up Call*, N.Y. Sun, May 11, 2004, at 10.

106. See, e.g., Josh Gerstein, *Huge Class-Action Law Firm Splits After Dispute*, N.Y. Sun, May 4, 2004, at 1 (reporting grand jury investigation of Milberg Weiss’s efforts to obtain business from Philadelphia city controller); N.Y.’s Milberg Weiss Faces 2nd Investigation, N.Y. Law., Feb. 27, 2002, at <http://www.nylawyer.com/news/02/02/022702f.html> (on file with the *Columbia Law Review*) (reporting grand jury investigation into whether Milberg Weiss representatives had made contributions to Philadelphia City Controller to secure appointments as lead counsel in securities class actions).

107. See McCoy, *supra* note 96. For example, Louisiana State Treasurer Ken Duncan, who oversaw the state retirement funds, received no contributions from securities class action law firms in his campaign in 1995, but four years later several such law firms were his biggest contributors. *Id.* He lost that election to John Kennedy, who, unlike Caesar’s wife, reported receiving a campaign contribution from a Boston law firm that Kennedy later selected to represent a Louisiana teachers’ pension fund in the lucrative settlement of a suit against Summitt

Plaintiffs' side securities law firms are also said to have recently begun employing lobbyists to assist them in their efforts to obtain the lead counsel position. Of course, many businesses in the United States hire lobbyists, and they are widely employed to engage in a broad variety of activities, such as fighting adverse legislation and promoting good public relations. However, we were informed by several public pension fund officials that at least some of these lobbyists are engaged in efforts to persuade funds to assume the lead plaintiff position in securities fraud class actions and retain the law firm to act as lead counsel. To determine the veracity of this claim, we decided to see how widespread this activity was amongst the leading plaintiffs' law firms. We visited the lobbyist disclosure web sites for all fifty states to see if any of the best-known plaintiffs' law firms had disclosed hiring lobbyists and, if so, how much they paid them.<sup>108</sup> Our search turned up six states where the best-known plaintiffs' securities class action law firms<sup>109</sup> had made such disclosures.<sup>110</sup> Three law firms have disclosed hiring lobbyists: Milberg Weiss,<sup>111</sup> Abbey Gardy and Squitieri,<sup>112</sup> and Bernstein Liebhard and

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Technology. *Id.* Similarly, Kennedy selected as counsel in the Gateway and Lucent cases a New York-based firm that had made a substantial contribution to his campaign. *Id.*

108. Where possible, we tracked down how much these firms paid their lobbyist in a given state using the information provided on that state's website. If the state's website did not provide that information, we called the state agency to inquire whether that information was available from another source. Each state agency that we called indicated that it does not track how much lobbyists are paid by their employer. The poor accessibility and quality of the data that is available through some of these sites make it possible that we missed some firms. We did not examine any of the U.S. territories, Puerto Rico, or Washington, D.C.

109. We searched for sixteen law firms that are actively engaged in shareholder litigation. These firms were identified in an earlier study by one of the authors. See Thompson & Thomas, *supra* note 6, at 186-87 tbl.12. While these firms are not the only plaintiffs' law firms bringing securities fraud class actions, they file a large percentage of these cases. See *id.* at 186 & n.199.

110. We began at the website for the Center for Public Integrity (CFPI). See Ctr. for Pub. Integrity, <http://www.publicintegrity.org/default.aspx> (last visited Sept. 6, 2006). The CFPI site contains links to the state agencies in every state that monitor lobbying efforts at <http://www.publicintegrity.org/hiredguns/information.aspx> (last visited Sept. 6, 2006) (on file with the *Columbia Law Review*). This page also indicates whether a particular state tracks executive lobbyists, legislative lobbyists, or all lobbyists. Using the links provided, we searched every state's website for information on lobbyists and their employers. Where possible, we downloaded any reports that provided information on lobbyists and their employers. Then we searched those reports for the sixteen plaintiffs' firms identified in our discussion. Some states do not allow reports to be downloaded. Instead, those states have search engines that allow searching of the lobbyist registration data. In those states, we searched using their search engines. We also searched for lobbyist information in every state using the popular search engine Google, at <http://www.google.com> (last visited Sept. 18, 2006).

111. See Alaska Pub. Offices Comm'n, 2002 Employer Year-End Summary 15 (2002), available at <http://www.state.ak.us/apoc/pdf/02empsum.pdf> (on file with the *Columbia Law Review*) (disclosing \$84,000 in 2002); Alaska Pub. Offices Comm'n, 2003 Employer Year-End Summary 16 (2003), available at <http://www.state.ak.us/apoc/pdf/03empYESum.pdf> (on file with the *Columbia Law Review*) (disclosing \$84,000 in 2003); Alaska Pub. Offices Comm'n, 2004 Employer Year End Summary 15 (2004), available at <http://www.state.ak.us/apoc/pdf/04empyesum.pdf> (on file with the *Columbia Law Review*) (disclosing \$21,000 in 2004); Cal. Sec'y of State, Lobbying Activity: Milberg Weiss Bershad

Lifshitz.<sup>113</sup>

To the extent that plaintiffs' class action firms engage in this behavior, it appears to be just part of a larger tapestry of pay-to-play practices by law firms generally.<sup>114</sup> This practice is not well regulated, even though the American Bar Association's position is that "[a] lawyer or law firm shall not accept a government legal engagement or an appointment by a judge if the lawyer or law firm makes a political contribution or solicits political contributions *for the purpose* of obtaining or being considered for that type of legal engagement or appointment."<sup>115</sup> In addition to the obvious difficulty of proving in any disciplinary proceeding that a contribution was made for the avowed purpose of securing future appointment as lead counsel, the ABA's position is further weakened because no state has made this statement a part of its rules of professional conduct. What would surely be more effective would be a total bar to the appointment of a law firm that has made a political contribution to a governmental official who could influence the choice of counsel to represent a governmental fund in a securities suit. Such an approach has analogues in other areas, with a virtually identical rule adopted by the Municipal Securities Rulemaking Board to govern relationships between broker-dealers who underwrite municipal securities and the elected officials who select the underwriters.<sup>116</sup> An equally well-informed response is that followed in a few states that have placed the counsel-selecting decision in the hands of nonpartisan boards, and not in the hands of elected officials.<sup>117</sup> A third,

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Hynes & Lerach, at <http://cal-access.ss.ca.gov/Lobbying/Employers/Detail.aspx?id=1143713&session=2003&view=activity> (last visited Oct. 5, 2006) (on file with the *Columbia Law Review*) (disclosing \$181,000 in 2003–2004).

112. See N.Y. State Temp. Comm'n on Lobbying, Client Semi-Annual Report: Abbey Gardy, at [https://www.nytscol.org/Data\\_CSRQuery.asp?ID=1801&CSRID=1199](https://www.nytscol.org/Data_CSRQuery.asp?ID=1801&CSRID=1199) (last visited Sept. 6, 2006) (on file with the *Columbia Law Review*) (disclosing \$30,000 in 2003).

113. See Ctr. for Pub. Integrity, *supra* note 110 (providing links to Arkansas, Illinois, and Ohio websites).

114. See Michael Higgins, Pondering "Pay-to-Play": ABA Scrutinizes Link Between Campaign Contributions and Legal Work, *A.B.A. J.*, Nov. 1997, at 96, 96 (offering as one of several examples that thirty-three lawyers, whose firms together held approximately 70% of state's bond work, each pledged \$25,000 to reelect Pennsylvania Governor Tom Ridge). Similar connections appear to hold in New York and New Jersey. See *id.*

115. Model Rules of Prof'l Conduct R. 7.6 (2006) (emphasis added).

116. See Mun. Sec. Rulemaking Bd. Rule G-37(b)(i) (2005), available at <http://www.msrb.org/msrb1/rules/ruleg37.htm> (on file with the *Columbia Law Review*) (prohibiting broker-dealers from engaging in municipal securities business for issuer if broker-dealer, its associates, or committee controlled by broker-dealer has made political contributions to official of issuer within two years). See generally Jon B. Jordan, The Regulation of "Pay-to-Play" and the Influence of Political Contributions in the Municipal Securities Industry, 1999 *Colum. Bus. L. Rev.* 489 (discussing rise and fall of "pay-to-play" and how dealers who make political contributions can influence elected officials to select them for municipal bond business).

117. See Diana B. Henriques, Conflict over Conflicts: Class-Action Lawyers Defend Their Political Contributions, *N.Y. Times*, July 30, 1998, at D1 (detailing, for example, that State of Wisconsin Investment Board created four-member nonpartisan panel consisting of its assistant

perhaps more easily implemented, response tracks the lines suggested by the Third Circuit in the *Cendant* litigation.<sup>118</sup> Federal courts could routinely require the disclosure of all campaign contributions made by the plaintiffs' counsel to any official associated with an institutional investor applying for a lead plaintiff position. The court could then decide if these contributions should influence its decision about the appointment of lead counsel.

2. *Who Wins the Beauty Contest?* — When the contest to be designated the lead plaintiff is between a financial institution, an individual, a group of individuals, or a nonfinancial institution, the courts with great consistency prefer the financial institution over others.<sup>119</sup> This demonstrative preference is driven largely by the institution being the *single* claimant with the largest loss. Despite this recognized strong preference on the part of the courts and the potential benefits of financial institutions becoming a lead plaintiff, financial institutions have not swollen the ranks of those petitioning to be a lead plaintiff.<sup>120</sup> Two early studies illustrate this point. The first, an SEC study of

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legal counsel, in-house investment manager, representative of Attorney General, and local lawyer noted for litigation experience).

118. See *In re Cendant Corp. Litig.*, 264 F.3d 201, 270 n.49 (3d Cir. 2001) (stating that court should inquire of publicly managed fund seeking to be designated as lead plaintiff whether contributions have been made and, if so, how fund selected contributing counsel as suit's counsel).

119. *Gluck v. Cellstar Corp.*, 976 F. Supp. 542 (N.D. Tex. 1997), addresses potential conflicts posed by selecting as lead plaintiff an institution that has the largest claim and also continues to own shares in the defendant corporation. *Gluck* concludes that, even though a conflict may cause the institution to prefer a more moderate settlement than would be preferred if the petitioner did not continue as stockholder, this conflict is not disabling because Congress envisioned that longer term corporate interests would be taken into consideration by the lead plaintiff in guiding terms of the settlement. *Id.* at 547–49.

120. See PricewaterhouseCoopers LLP, *supra* note 11, at 7 (documenting that institutional investors represent only 14% of lead plaintiffs in recent securities litigation); Coffee, *Litigation Governance*, *supra* note 9, at 806 n.7 (explaining that few institutional investors are willing to serve as lead plaintiffs and concluding that costs of such role likely exceed benefits for institutional investors); John P. Coffey & John C. Browne, *The Results Are in . . . Class Action Settlements Are Significantly Higher When Institutional Investors Act as Lead Plaintiffs, Institutional Investor Advoc.* (Bernstein Litowitz Berge & Grossman, New York, N.Y.), Second Quarter 2004, at 3, 3, available at <http://www.blbglaw.com/advocate/adv2004Q2.pdf> (on file with the *Columbia Law Review*) (“Less than a decade ago, most institutional investors would have scoffed at a suggestion that they seek to be appointed as lead plaintiff in a securities class action lawsuit.”). Despite the probable positive effects institutions can have on settlements, there is no definitive legal compulsion that they so involve themselves. See, e.g., Craig C. Martin & Mathew H. Metcalf, *The Fiduciary Duties of Institutional Investors in Securities Litigation*, 56 *Bus. Law.* 1381, 1404–08 (2001) (reviewing fiduciary duties of pension fund managers without identifying obligation to become lead plaintiff, but emphasizing obligations of managers once becoming lead plaintiff).

There is some evidence that recently institutional investors have become increasingly interested in becoming lead plaintiffs. See, e.g., Fisch, *Aggregation*, *supra* note 6, at 61–62 (explaining that, due to adoption of lead plaintiff provision, “[a]n increasing number of institutional investors are seeking appointments as lead plaintiff”); Adam C. Pritchard, *Should Congress Repeal Securities Class Action Reform 8* (Cato Inst., Policy Analysis No. 471, 2003), available at <http://www.cato.org/pubs/pas/pa471.pdf> (on file with the *Columbia Law Review*).

the first year's experiences under PSLRA, found that in the 105 securities fraud class actions the Commission's staff examined, institutional investors moved to become lead plaintiffs in only eight cases.<sup>121</sup> Later findings indicate that, in 1997, institutional investors appeared as lead plaintiffs in securities fraud class actions in only nine out of 175 cases examined.<sup>122</sup> If we add the results of these two studies together, we find that over the two year interval 1996–1997, institutions sought lead counsel status in only seventeen out of 280 cases—only about 6% of the cases studied.

With the realm of prospective financial institutions to serve as lead plaintiffs being largely limited to public or labor pension funds, a far more prevalent strategy attorneys pursue to become class counsel is to assemble a group of investors who, hopefully, have the largest aggregate financial loss among those petitioning to be selected as lead plaintiff. The PSLRA explicitly refers to the lead plaintiff as a “person or *group* of persons,”<sup>123</sup> even though the legislative history of the PSLRA is fairly compelling that Congress's vision of the lead plaintiff was a nonaggregated large holder—namely a financial institution.<sup>124</sup> This may well cause us to wonder if “persons,” as used in the act, poorly expresses Congress's vision because the plural usage was never intended to include natural persons but institutions.

Considering that the weakness the PSLRA's lead plaintiff provision sought to address was the class representative's poor incentives to monitor the suit's prosecution because of a small economic incentive, this interpretation becomes more compelling. It is difficult for us to understand how this concern is overcome by aggregation of claimants, especially when each member of the group has a relatively small claim. Indeed, aggregation likely makes the problem worse, not better. The aggregation of several small claimants carries forward the problems present when a single small claimant is the suit's

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(“[Due to the PSLRA,] institutional investors are now starting to step forward in greater numbers to take charge of securities fraud class actions.”). Prior to 2002, the support for this claim was largely anecdotal and based on citations to particular instances in which institutions have petitioned to be named lead counsel. During this time period, out of all of the potential institutions that could act as lead plaintiffs, “only public pension funds, and a limited number of union-related institutions, [had] been willing to serve as lead plaintiffs.” Coffee, *Litigation Governance*, supra note 9, at 806 n.7. Private pension funds and mutual funds are conspicuously absent from the lead plaintiff positions. See *id.*

121. Office of the Gen. Counsel, Report to the President and Congress, supra note 54.

122. See Coffee, *Litigation Governance*, supra note 9, at 807 n.7 (citing Elayne Demby, *Ducking Lead Plaintiff Status*, Plan Sponsor, May 1999, at <http://www.plansponsor.com> (on file with the *Columbia Law Review*)).

123. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I) (2000) (emphasis added).

124. See, e.g., H.R. Rep. No. 104-369, at 34 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 733 (lamenting that pre-PSLRA system “works to prevent institutional investors from selecting counsel or serving as lead plaintiff[s]” and expressing hope that “increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts”); S. Rep. No. 104-98, at 6 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 685 (stating hope that legislation will increase role of institutional investors in securities class actions).

representative and also adds a new problem: When several individuals are the suit's representatives, they face a collective action problem in coordinating their monitoring of the class counsel.<sup>125</sup> Moreover, we cannot envision that a member of a group will have a stronger incentive to monitor the conduct of the suit than she would have as a single class representative, so there is every reason to expect a good deal of free riding behavior within such a group. Thus, the aggregation approach, even though quite well received among the courts, strikes us as being inconsistent with the rationale of the lead plaintiff provision. For the reasons stated above, aggregation likely yields a lead plaintiff that has no greater incentive than that of an individual investor whose loss equals that of the group's largest member.

Reflecting on over ten years' experience with the PSLRA's lead plaintiff provision raises fascinating questions about whether its impact has been positive. There is no doubt that political officers benefit from law firms' quest for a public pension fund that will dispense its favor by first stepping forward to be a lead plaintiff and, if selected, next nominating as the class counsel a law firm that is a patron of its political officers. But is this beneficial to either the process or society more generally? Most certainly the PSLRA was not enacted to create further angst over how political fundraising might compromise the judgment and trust of elected officials. Similarly, just as it is problematic to believe that an individual investor with a small financial stake in a class action's outcome will be a vigilant monitor of the suit's prosecution and ultimate settlement, it is equally doubtful that a group of individuals will be more diligent than the single individual class representative. Admittedly, our misgivings about each of these outcomes are based solely on reason alone. But following Holmes's admonition,<sup>126</sup> we believe the real answer to this question lies in experience, not logic. Accordingly, we now turn to the empirical evidence we have gathered that bears not just on the contribution, if any, made by lead plaintiffs but also on whether the type of lead plaintiff matters.

## II. EMPIRICAL EVIDENCE OF THE EFFECTS OF THE LEAD PLAINTIFF PROVISION

The empirical evidence concerning the lead plaintiff provision that has

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125. See, e.g., *In re Critical Path, Inc. Sec. Litig.*, 156 F. Supp. 2d 1102, 1109, 1111 (N.D. Cal. 2001) (requiring preexisting relationship for institutions and individuals collectively to serve as lead plaintiff, even though group's alleged losses exceeded \$14 million); *In re Landry's Seafood Rest., Inc. Sec. Litig.*, No. H-99-1948, 2000 U.S. Dist. LEXIS 7005, at \*15-\*16 (S.D. Tex. Mar. 30, 2000) (denying aggregation by reasoning, in part, that too loose affiliation among class representatives will result in manipulation by attorneys); *In re Telxon Corp. Sec. Litig.*, 67 F. Supp. 2d 803, 815-16 (N.D. Ohio 1999) (denying aggregation because coordination costs of members with no prior relationship would render effective monitoring of counsel unlikely).

126. See Oliver Wendell Holmes, Jr., *The Common Law* 5 (Mark DeWolfe Howe ed., Harvard Univ. Press 1963) (1881) ("The life of the law has not been logic: it has been experience.").

been marshaled to date in the academic literature has been very limited.<sup>127</sup> In the remainder of this study, we contribute to this body of knowledge by analyzing publicly available electronic databases of court decisions, proprietary databases from securities claims administrators,<sup>128</sup> and information that we collected about securities fraud class actions.

#### A. Courts' Preference for Institutional Investors in Disputed Situations

Courts have been asked to decide numerous controversies over which investors should be selected as lead plaintiff. In order to determine systematically how institutional investors have fared in the battle to be named lead plaintiff, we conducted a survey of all court decisions about the selection of a lead plaintiff. We searched the Westlaw and Lexis electronic libraries for all opinions relating to the court's appointment of a lead plaintiff for the time period from January 1, 1996, to December 31, 2004. We found 129 decisions in which a court was asked to appoint a lead plaintiff. We then read them and classified the decisions in Table 1 below. Included within the data in Table 1 are a number of cases where there is only one petitioner for the position of lead plaintiff. Thus, among the fifty cases in the category "Cases Without an Institutional Investor Petitioner," there are seventeen cases where there was only one petitioner. Furthermore, in the category "Single/Multiple Institutions Selected Over Individuals/Groups, or No Competing Petitioner," there are seven cases where only a single institution applied for the lead plaintiff position.

Table 1: Outcomes of Judicial Decisions Appointing Lead Plaintiff

Type of Investors	Number of Cases
Cases Without an Institutional Investor Petitioner	50
Cases with Multiple Institutional Investors Petitioning: Single Institution Selected	38
Single/Multiple Institutions Selected over Individuals/Groups, or No Competing Petitioner	24
Institution and Individual Selected over Competing	8

127. In addition to our work, two recent working papers by other legal academics will help to fill this gap. See Stephen J. Choi, Jill E. Fisch & A.C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act 1* (N.Y.U. Law & Econ. Research Paper Series, Working Paper No. 04-08, 2005), available at [http://www.luc.edu/law/faculty/facworkshops/fisch\\_do\\_institutions\\_matter.pdf](http://www.luc.edu/law/faculty/facworkshops/fisch_do_institutions_matter.pdf) (on file with the *Columbia Law Review*) (finding that public pension fund lead plaintiffs are correlated with higher class recoveries than other types of lead plaintiffs, including private institutional lead plaintiffs); Perino, *supra* note 42, at 34 (finding that public pension funds negotiate lower attorneys' fees than other types of lead plaintiffs in securities fraud class actions).

128. For a more detailed discussion of the data we obtained from claims administrators, see Cox & Thomas, *Leaving Money on the Table*, *supra* note 5, at 871-74.

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Individuals/Groups/Institutions	
Cases with Institutional Investor(s) and Competing Individual/Group of Individuals Petitioning: Individual or Group Selected	9
Total Number of Cases	129

This data reflects the courts' preference for institutional investors as lead plaintiffs. Courts found in their favor in the vast majority of cases in which an institutional investor was competing for the position of lead counsel. However, there are two important caveats to this statement. First, courts were willing to select groups of individuals over institutions in situations where the institutions did not have large shareholdings in the company that was the subject of the litigation, especially where the court exhibited concerns about the typicality of the institutional investor as a class representative. Second, in several cases courts accepted groups of institutions and individuals over their competitors where they found such groups to have the largest stake in the defendant company. Both of these situations appear to reflect continued judicial acceptance of groups as effective monitors of plaintiffs' counsel in securities fraud class actions, a preference which we have earlier noted seems questionable to us.

*B. Size of Claim and Type of Lead Plaintiffs*

In a pair of earlier studies of claims filing behavior in securities fraud class actions, we obtained confidential data concerning the size of stockholdings for a large group of securities fraud class action settlements covering the time period 1996–1998.<sup>129</sup> Using this data, we identified the lead plaintiffs, the size of their claims in the settlements, and the percentage of all claims that these institutions held in thirty-five post-PSLRA cases. Table 2 below presents this information for four different types of lead plaintiffs: public pension funds, other institutional lead plaintiffs, single individuals, and groups of individuals. The sample size is small, and the cases included are selected solely on the basis of having complete data, so the observations made below must be viewed as descriptive.

Table 2: Lead Plaintiff Claims in Securities Fraud Class Actions

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129. See *id.*; Cox & Thomas, *Letting Billions Slip*, *supra* note 5, at 421–24 tbl.1 (reporting purchase activity and settlement data during class period).

Type of Lead Plaintiff	Number of Cases	Average Dollar Amount of Lead Plaintiff's Claim <sup>130</sup>	Average Total Dollar Amount of Settlement Claims <sup>131</sup>	Average Percentage of Lead Plaintiff's Claim Out of Total Settlement Claims <sup>132</sup>	Average Total Settlement Amount (Including Valuation of Securities) <sup>133</sup>
Public Pension Fund Lead Plaintiff	3	9,217,290	228,956,932	4.025%	17,183,333
Other Type of Institutional Lead Plaintiff	2	505,154	269,574,988	0.18%	28,150,000
Individual Lead Plaintiff	21	52,461	45,238,397	0.11%	6,863,028
Groups of Individuals	9	349,808	32,785,285	1.066%	8,068,841

130. The values in this column are calculated by aggregating the claims of each lead plaintiff and then calculating the average value. For example, for public pension fund lead plaintiffs, the claims of the three funds were \$7,040,077; \$16,709,600; and \$3,902,195, for the three cases in this category. The average of these three cases is \$9,217,290. However, for the groups of individuals category, we treated each group as a single observation and made calculations on a per group basis.

131. The values in this column are calculated by aggregating the total settlement claims for each separate case and then calculating an average value for the category. For example, in the public pension fund lead plaintiff category, the total amount of claims in the three cases was \$25,633,658; \$62,681,470; and \$598,555,670, respectively. The average of these three values is \$228,956,932. With the groups of individuals category, we treated each group as a single observation and calculated values on a per group basis.

132. The values in this column are calculated by dividing the value in the "Average Dollar Amount of Lead Plaintiff's Claim" column by the value in the "Average Total Dollar Amount of Settlement Claims" column.

133. For this column, we added together the actual dollar settlement amount for each case in the category, then divided by the number of observations in the category. For instance, for the public pension fund lead plaintiff category the dollar settlement amounts were \$14,500,000; \$21,150,000; and \$15,900,000, respectively. The average for these three cases is \$17,183,333.

Beginning with the public pension fund cases, in two of these actions the lead plaintiff was the largest stakeholder in the case, holding over 25% of the claims made in the case. These cases are indicative of the type of lead plaintiff that Congress envisioned when it enacted this provision. The third case also featured a lead plaintiff with a large dollar stake in the litigation (\$3.9 million), but, given the extremely large settlement size, this plaintiff held a relatively small percentage (0.65%) of the total claims made in the case.

Each of these lead plaintiffs had at least several million dollars at stake in the litigation. Such large claimants may be able to justify incurring substantial monitoring costs if they will receive potentially larger benefits in any settlement. For example, if a lead plaintiff incurs between \$25,000 and \$100,000 in monitoring costs<sup>134</sup> as a result of taking on that responsibility, this would only represent about 0.25% to 1% of the three institutions' average total losses (\$9,217,290) in these cases. For an institution engaging *ex ante* in a cost-benefit analysis of the value of the lead plaintiff position, this suggests that even a slightly optimistic assessment of the increased settlement value could result in a positive decision.

The economics of actively monitoring class counsel are more problematic for the two other institutional investors that have acted as lead plaintiffs. The first case involved a single institutional investor (an insurance company) where the lead plaintiff's total stake in the litigation was so small (\$40,000) that it could rationally only support the absolute minimum amount of monitoring possible. In the second case, where the lead plaintiffs were an institutional investor (a labor fund) joined by an individual investor, the potential for monitoring was a bit more promising, although the size of their individual stakes were correspondingly smaller than in the other cases previously discussed.<sup>135</sup>

Next, we consider the minimum size of claim that it would make sense to pursue. First, we estimate conservatively that there was an approximately 10% average recovery rate for losses in securities fraud settlements during this time period.<sup>136</sup> Thus, if an institution had a \$1 million claim, it would expect to

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134. These costs will vary substantially depending on the case and the level of monitoring by the institution. One well-known institutional investor estimated that, in an "average" case, an institution incurs between \$25,000 and \$100,000 of unreimbursed staff time actively monitoring the cases in which it is lead plaintiff. See Johnson Correspondence, *supra* note 51; see also *supra* note 83 and accompanying text (describing basis for this estimate).

135. As we discussed more fully above, we believe that there are serious collective action problems with allowing aggregation of lead plaintiffs. See *supra* Part I.D.2.

136. For our sample in this study, we found that the average is 12.7% for the complete sample, 13.5% in the pre-PSLRA sample, and 12.3% in the post-PSLRA sample. However, for purposes of illustration, we use the more conservative 10% value. Compare this approach with Alison Beard, *Shareholders Demand Their Day in Court*, *Fin. Times*, July 11, 2002, at 28 (summarizing Cornerstone Research study finding that plaintiffs are recovering 5.1% of total damages post-PSLRA), and Wager & Ward, *supra* note 23, at 18 ("Median settlement is less than 6 percent of investors' alleged losses."). The enormous divergence among damage estimates in securities fraud class actions may arise because of differences in their underlying assumptions.

recover about \$100,000 from this claim. If we assume that an institution can double this recovery rate by taking an active lead plaintiff role, then this would generate an additional \$100,000 in value on a \$1 million claim. However, even this may not be a sufficient incentive to overcome the uncertainty of the expected benefits of being an active lead plaintiff. In any event, this analysis suggests that a minimum claim size of \$1 million is necessary for an institution to give serious consideration to becoming a lead plaintiff. Risk-averse institutions might choose a higher multiple to be sure of recouping their costs<sup>137</sup> or to allocate scarce administrative resources more efficiently.<sup>138</sup>

For the single individual lead plaintiffs, we see that these class representatives have small dollar and percentage stakes in their respective cases. However, we suspect that competition, or potential competition, for this role today has resulted in the appointment of individual lead plaintiffs with larger stakes than was seen earlier. It seems apparent that these claimants cannot be realistically expected to engage in costly monitoring of class counsel.

Finally, for the groups of individuals acting as lead plaintiffs, we observe that the average dollar size of the group of claims is larger than with the individual lead plaintiffs. However, the size of the average *individual* claim for all group members is only \$89,950.<sup>139</sup> While this is larger than the amount reported for individual lead plaintiffs, it is well below the level where we would expect significant monitoring of class counsel. Also, these groups must overcome greater coordination problems in negotiating with and monitoring class counsel.

We conclude that the evidence we have presented, which is admittedly for a very small sample of cases, provides some support for the idea that public pension fund lead plaintiffs have the most potential to improve client monitoring of class counsel.

### C. Impact of the Lead Plaintiff Provision

To supplement the above analysis, we empirically test several hypotheses about the possible impact of the lead plaintiff provision. Our data set of 388 class actions was assembled from a variety of sources, including various claims administrators, a private consulting firm that provides litigation support

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For a discussion of our methodology and its underlying assumptions, see Cox & Thomas, SEC Heuristics, *supra* note 8, at 768 n.100.

137. A risk-averse institution will want to recover more than the amount of its actual expenses to compensate itself for bearing the added uncertainty and costs of being an active lead plaintiff.

138. One institutional investor has told us that because of staffing limits, it can only take on one or two cases at a time. To focus on the biggest impact cases, its threshold claim for considering a lead plaintiff position is \$7 million. See Johnson Correspondence, *supra* note 51.

139. We calculated the average claim for each of the individual groups and then averaged the averages.

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for securities fraud suits, and information about settlements obtained from Institutional Shareholder Services (ISS).<sup>140</sup>

1. *Descriptive Statistics.* — Table 3 provides descriptive statistics for our sample. Panel A separates the 388 cases in our sample<sup>141</sup> into pre-PSLRA and post-PSLRA cases, with the post-PSLRA cases broken into five categories of lead plaintiff. Panel B, sorting cases by year of filing, shows that the vast bulk of cases were filed between 1993 and 2002.<sup>142</sup>

Table 3: Descriptive Statistics

Panel A	Description	Count	Percent <sup>143</sup>
Type of Lead Plaintiff	Pre-PSLRA Cases	128	33.0
1	Single Institution	34	8.8
2	Group of Individuals	106	27.3
3	Institution-Individuals	12	3.1
4	Single Individual	50	12.9
5	Entity	58	15.0
Total	All Types of Lead Plaintiffs	388	100
Panel B	Year Complaint Filed	Count	Percent
	1989–1992	14	3.6
	1993–1995	109	28.3
	1996–1999	180	46.8
	2000–2002	82	21.3
	Total	385	100

Roughly one-third of the sample is comprised of pre-PSLRA settlements,

140. We would like to thank ISS, the National Economic Research Associates (NERA), and several claims administrators (who requested anonymity) for their willingness to share this data.

141. We excluded cases where the only defendant was an accounting firm and it was not possible to identify the firm that was the auditor's client. One potential impact of this is to reduce the settlement amount recovered in cases involving their audit clients because the accounting firms' contribution to the settlement would be excluded. However, there were only four of these settlements.

142. While we are missing the exact date of three settlements, we can nevertheless classify them as pre- or post-PSLRA because we have other information about the case, such as the dates of the class period.

143. We rounded these values off to the nearest tenth of a percent. As a result, the total does not add up to exactly 100%.

while the remaining two-thirds are from the post-PSLRA period. For the post-PSLRA cases, Category 1 (single institutional lead plaintiff)<sup>144</sup> and Category 3 (institution and one or more individuals) are frequently combined for analytical purposes under the general rubric of “Institutional Lead Plaintiff.” Together, these two groups make up slightly less than 18% of our post-PSLRA sample (forty-six cases), or nearly 12% of the entire sample. Groups of individuals constitute the largest single type of lead plaintiff in the sample, comprising nearly 41% of the post-PSLRA settlements (27.3% overall) or 106 cases. Individuals and entities<sup>145</sup> make up the rest of the cases with 12.9% (fifty cases) and 22% (fifty-eight cases), respectively, of the post-PSLRA data set.

For the cases in the sample, Table 4 describes settlement amounts in thousands of dollars, cutting the sample into pre- and post-PSLRA cases (Panel A), post-PSLRA cases by type of lead plaintiff (Panel B), and institutional lead plaintiffs versus other groups (Panel C). Panel A shows that pre-PSLRA cases have an average settlement value of about \$10 million and a median settlement value of \$5.5 million. In comparison, post-PSLRA cases in our sample have a much larger mean value for settlements, although they have about the same median value. Differences in these means and medians are not statistically significant at traditional levels.<sup>146</sup>

**[INSERT TABLE 4]**

In Panel B, we see that Categories 1 and 3 exhibit mean settlements of more than \$37 million (median \$20.75 million) and \$90 million (median \$20.075 million), respectively. By comparison, the total settlement values displayed for groups of individuals, single individuals, and entities do not appear very different from that observed prior to the passage of the PSLRA.

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144. “Institutional lead plaintiff” as used in our analysis of the sample refers to a lead plaintiff that could clearly be identified as a financial institution in the classic sense of an insurance company, bank, pension fund, mutual fund, endowment, or foundation. As we reviewed documents to identify the suit’s plaintiff, we removed from such classification natural persons or entities that from their title did not identify the entity as fitting within one of these categories.

145. “Entities” are defined as cases where there is no identifiable financial institution or pension fund, but we see a lead plaintiff that is not a natural person. Some examples would be partnerships and individual trusts. Some of the cases in this category also have named individuals as co-lead plaintiffs. We have, therefore, confined financial institutions to the classic description (i.e., banks, pension and mutual funds, insurers, foundations, and endowments) out of necessity since there is not publicly available information by which we could determine if any entity was likely of a size equal to what Congress envisioned when it contemplated the lead plaintiff provision would best be used by “institutional” investors.

146. To preserve the readability of these summary statistics, we do not provide p-values in all tables that present summary statistics of the data. Instead we discuss the most important equality hypotheses in the text and support them with the appropriate p-values.

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Panel C illustrates starkly that institutional investor cases exhibit much larger settlements. When we test for statistical significance, comparing panels A and C, we find that settlements involving an institutional investor lead plaintiff are statistically larger than those for the pre-PSLRA cases and for other groups post-PSLRA. However, the mean and median of the pre-PSLRA cases are not statistically different from those in all noninstitutional investor post-PSLRA cases. This suggests the PSLRA's impact on settlements may be limited to cases involving institutional lead plaintiffs.

One possible explanation for this result might be that institutional investors appear in bigger, higher quality cases. To investigate this hypothesis, we look first at whether institutional investors appear as lead plaintiffs in cases where more investors are harmed. As a proxy for the number of investors harmed, we use the length of the class period because it should be correlated with the number of investors trading in the security during the alleged fraud. Table 5 presents data on the length of the class period for the different types of lead plaintiffs, with the bottom row providing information on all institutional lead plaintiffs.

**[INSERT TABLE 5]**

Table 5 shows that institutional lead plaintiffs appear in cases with statistically longer class periods. We find that there is no significant difference between the length of class periods for the pre-PSLRA cases and Categories 2, 4, and 5 of the post-PSLRA cases. This again suggests that only the institutional lead plaintiff cases are different.

Looking deeper at the question of why institutional investor lead plaintiffs obtain better settlements, Table 6 provides data about the market capitalization of defendant firms in securities fraud class actions. Larger companies have more resources to pay settlements and a larger trading volume that can lead to greater damage claims. The data shows the same pattern as in the previous two tables: Institutional lead plaintiffs sue significantly larger companies than all other groups of lead plaintiffs, and the sizes of defendants sued in pre-PSLRA and post-PSLRA cases are not statistically different.

Table 6: Market Capitalization of Defendant Companies (millions of dollars)

Plaintiff Type	Mean	Median	# of observations
Pre-PSLRA	930	185	121
Post-PSLRA	3,345	223	230
(1) Institution	4,482	1,782	28
(2) Group of Individuals	1,487	189	94

(3) Institution-Individuals	36,262	10,753	11
(4) Single Individual	413	184	46
(5) Entity	1,693	207	51
Total	2,513	215	351
Institutional Lead Plaintiffs: Categories 1 & 3	13,446	1,875	39

A third possible explanation for institutional investors' greater settlements is that they bring cases with greater damages. Damage calculations in securities fraud cases involve complex estimations of the amount of the shareholders' provable losses. Using a model we developed earlier for estimating provable losses,<sup>147</sup> we calculated these values for each case in our sample.

Table 7: Estimated Provable Losses (millions of dollars)

Table 7: Panel A	Mean	Median	# of observations
Pre-PSLRA	380.4	57.1	128
Post-PSLRA	982.2	131.4	260
(1) Institution	3123.9	417.1	34
(2) Group of Individuals	380.8	91.8	106
(3) Institution-Individuals	6,352.8	1,817.8	12
(4) Single Individual	197.8	76.1	50
(5) Entity	391.0	148.5	58
Total	783.7	91.1	388
Table 7: Panel B	Mean	Median	# of observations
Pre-PSLRA	380.2	57.1	128
Institutional Lead Plaintiff: Groups 1 & 3	3,966.2	492.2	46
All Other Lead Plaintiffs Post-PSLRA	340.9	91.8	214

In Table 7, Panel A shows estimated provable losses for different categories of lead plaintiffs, while Panel B compares these losses for institutions with pre-PSLRA cases and all other post-PSLRA cases. Panel A demonstrates that institutional lead plaintiffs appear in the cases with the largest estimated provable losses: Both the means and medians for the two institutional groups are statistically greater than for the other groups at all

147. See Cox & Thomas, SEC Heuristics, *supra* note 8, at 768 n.100.

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conventional levels.

Casual scrutiny of the remaining categories shows that cases brought by entity lead plaintiffs seem to be the largest, while single individuals bring the smallest cases on average. Pre-PSLRA cases have the lowest median provable loss. Panel B reinforces this message.

These descriptive statistics demonstrate that institutional lead plaintiffs bring the largest cases in the sample in terms of provable losses of the class. Moreover, our data shows that there are no significant differences between average provable losses in cases filed pre-PSLRA and those filed by the remaining categories of lead plaintiffs. The medians, however, are statistically different at the 5% level.

Our final set of descriptive statistics is in Table 8, which compares the ratio of settlement amounts to provable losses. In essence, this table reports the percentage of the estimated losses suffered by the class members that was recouped through the settlement.

Table 8: Ratio of Settlement Amount to Provable Losses (%)

Plaintiff Type	Mean	Median	# of observations
Pre-PSLRA	13.5%	9.6%	128
Post-PSLRA	12.3%	5.1%	260
(1) Institution	5.8%	4.1%	34
(2) Group of Individuals	14.2%	5.7%	106
(3) Institution-Individuals	6.1%	3.3%	12
(4) Single Individual	17.0%	5.6%	50
(5) Entity	9.8%	4.7%	58
Total	12.7%	6.1%	388
Institutional Lead Plaintiffs: Categories 1 & 3	5.8%	4.1%	46
All Other Lead Plaintiffs Post-PSLRA	13.7%	5.3%	214

Surprisingly, pre-PSLRA cases show the highest median settlement percentage of provable loss ratio, although the post-PSLRA single individual lead plaintiff category exhibits the highest average percentage recovery. By contrast, institutional lead plaintiffs have the lowest average and median recovery percentages of any group. This would seem to indicate that institutional investors are doing a worse job of recovering the losses of class members. The regression analysis in Part II.C.2.d below provides a more

positive explanation of the institution's contribution.

To briefly summarize the descriptive statistics, the most important finding is that institutional investors file the biggest cases, while the pre- and post-PSLRA data seems very similar for the lead plaintiffs falling within Categories 2, 4, and 5. Given the relatively small number of institutional investor cases that are filed, it does not appear that the passage of PSLRA has resulted in much change in securities fraud class action awards. In the next section, we dig deeper into the data to test these univariate findings.

2. *Hypothesis Testing.* — In this section, we use multivariate regression analysis to better understand the interrelationships between the variables. We focus on four questions: (1) Has PSLRA increased settlement amounts; (2) what factors do institutional lead plaintiffs consider most important in deciding to become lead plaintiffs; (3) does the presence of an institutional lead plaintiff increase settlement sizes; and (4) which type of lead plaintiff among the three noninstitutional lead plaintiff categories performs best? We note that in all of the following regressions we use a logarithmic transformation of all the variables measured in dollars. This technique mitigates the effect of some large outliers in the data.

a. *Impact of Lead Plaintiff Provision on Settlement Amounts.* — One important policy question is whether settlements in the post-PSLRA period are larger than those in the pre-PSLRA era. Supporters of the PSLRA claimed that its multiple provisions would reduce the incidence of strike suits and that more meritorious suits would be successfully prosecuted in the less lawyer-driven environment. That is, cases filed after the passage of PSLRA can proceed only by satisfying a demanding pleading requirement and an opportunity for the suit to be superintended by a class member with a substantial financial stake in the suit's outcome.<sup>148</sup> Hence, the supporters reasoned that there would be fewer cheap settlements of strong claims and fewer frivolous suits filed.<sup>149</sup> If true, this should increase settlement values post-PSLRA.

Table 9 presents the results for our regression analysis of the determinants of settlements. The dependent variable is settlement amounts with independent variables for estimated provable losses, market capitalization, length of class period, and two dummy variables. "Dummy-SEC" is a dummy variable that takes on a value of 1 if there is a parallel SEC action and a value of 0 if there is not. It can be thought of as a proxy for quality of a case, as the SEC is more likely to file an enforcement action against companies experiencing fraud. "Dummy-PSLRA" has a value equal to 1 for post-PSLRA cases and a value of 0 for pre-PSLRA cases.

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148. See *supra* notes 22–27 and accompanying text.

149. Of course, there may be other reasons for fewer frivolous cases being filed after the Act's passage, including the possibility of court-ordered sanctions for frivolous cases and the increased use of motions to dismiss.

Table 9: Determinants of Log (Settlement Amounts)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Log (Provable Losses)	0.33	0.043	7.66	0.000
Log (Market Capitalization)	0.13	0.033	3.89	0.000
Class Period	0.02	0.007	2.45	0.015
Dummy-SEC	0.40	0.125	3.16	0.002
Dummy-PSLRA	-0.13	0.106	-1.25	0.213
Intercept	4.11	0.376	10.94	0.000
R-squared	0.50			
Adjusted R-squared	0.49			

Table 9 reports one of the most significant findings of our study. Once we control for estimated losses, market capitalization of the defendant firms, the length of the class period, and the presence of a parallel SEC action, post-PSLRA settlements are not statistically different from those in the pre-PSLRA period. These results suggest that the enactment of PSLRA had no significant impact on settlement size.<sup>150</sup> This finding raises the question whether PSLRA and all of its procedural and substantive bells and whistles have been worth the candle.

b. *Determinants of Institutional Lead Plaintiff's Decision to Come Forward.* — We next try to explain the determinants of institutional investors' decisions to become lead plaintiffs. As we discussed earlier,<sup>151</sup> relatively few institutional investors have chosen to become lead plaintiffs, and they have been very selective in their interventions. Our conversations with these institutions and their attorneys lead us to believe that the decision criteria focus primarily on the likelihood that the institution will be able to increase substantially its recovery over what it would otherwise expect. Thus, we would anticipate that institutional investors likely “cherry pick” cases, selecting those where there are substantial potential damages and a high probability of corporate malfeasance. Table 10 presents our regression results. The dependent dummy variable measures the presence of an institutional lead plaintiff, taking a value of 1 when an institution is lead plaintiff and 0

150. To test the robustness of this finding, we broke our sample into several subsamples with low, middle, and high settlement amounts and ran the regression for each of them separately. In each case, the coefficient on the PSLRA dummy remains insignificant.

151. See supra Part I.C.

otherwise.<sup>152</sup>

Table 10: Determinants of Institutional Investors' Decisions to Be Lead Plaintiff (Logit Regression Analysis, post-PSLRA cases)<sup>153</sup>

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Log (Provable Losses)	0.32	0.155	2.10	0.036
Log (Total Assets)	0.40	0.141	2.85	0.004
Class Period	0.03	0.019	1.45	0.148
Dummy-SEC	1.23	0.404	3.05	0.002
Intercept	-8.44	1.662	-5.08	0.000
McFadden R-squared	0.26			

The regression shows that provable losses, total assets, and SEC actions are statistically significant variables. In other words, an institutional investor is more likely to become a lead plaintiff for cases against large capitalization

152. Logit regression allows us to handle binary dependant variables and to evaluate the effect of a change in predictive variables on an event probability. In our case, such an event is the decision of an institutional investor to become a lead plaintiff. Since logit is a nonlinear regression, its coefficients do not have a simple interpretation. Specifically, consider the population logit model with multiple regressors:

$$\Pr(Y=1 \mid X_1, X_2 \dots X_n) = F(b_0 + b_1 \cdot X_1 + \dots b_n \cdot X_n)$$

The effect of a change in, for example, the first regressor can be understood by calculating the difference in predicted probabilities:

$$\Pr(Y=1 \mid X_1^* + dX_1, X_2^* \dots X_n^*) - \Pr(Y=1 \mid X_1^*, X_2^* \dots X_n^*),$$

which, given the previous equation, equals to:

$$F(b_0 + b_1 \cdot [X_1^* + dX_1] + \dots b_n \cdot X_n^*) - F(b_0 + b_1 \cdot X_1^* + \dots b_n \cdot X_n^*)$$

Notice that one must decide on the initial value of the regressor whose effect is of interest, as well as all other regressors. One solution is to fix the regressors at their sample means or other appropriate levels (here, fixed values are denoted with a ""). The quantitative effect, of course, will critically depend on the prespecified levels of regressors. The qualitative effect, on the other hand, is easy to assess since F is the cumulative distribution function. For example, a positive sign on the estimated coefficient of the provable loss variable suggests that, all else equal, cases with high aggregate damages are more attractive to institutional investors. Thus, higher levels of provable losses increase the probability that institutions come forward as lead plaintiffs.

153. We use total assets instead of market capitalization because there is a high degree of multicollinearity between the estimated aggregate damages and the size of the defendant company (the correlation between provable losses and market capitalization is about 80%). Total assets is another credible measure of the size of the defendant company, and it has the advantage of avoiding the multicollinearity problem because it has a smaller correlation (about 65%) with provable losses.

firms, with bigger estimated losses, and when the SEC has filed a parallel action. The decision to become a lead plaintiff seems not to be affected by the amount of estimated provable losses.

c. *Impact of Institutional Lead Plaintiff on Settlements.* — We next analyze whether the presence of an institutional lead plaintiff leads to a greater recovery. A popular thesis is that institutional investors are better monitors than individuals, or groups of individuals, because they have larger financial interests in the settlement and do not suffer from the collective action problems experienced by groups of individuals trying to act as monitors.<sup>154</sup>

We have already seen in Table 4 that institutional investor lead plaintiffs are associated with larger settlements, but is their presence the reason for the larger recovery? In order to sort out whether it is the institutional lead plaintiff or some other factor that results in bigger settlements, we include independent variables for the market capitalization of the defendant company, the strength of the claim, the size of the estimated damages, and the presence of a parallel SEC action. The variable “Provable Losses \* Dummy-Institution” equals the amount of estimated provable losses in the settlement if the lead plaintiff is an institutional lead plaintiff and 0 otherwise.<sup>155</sup> We use this term to test whether the elasticity of the amount of settlement with respect to provable losses goes up (i.e., the percentage rate at which a typical settlement increases relative to a 1% increase in provable losses) when there is an institutional lead plaintiff.<sup>156</sup> In other words, a positive value on this coefficient indicates that the relative recovery is higher if there is an institutional lead plaintiff.<sup>157</sup> Table 11 gives the results of our regressions.

Table 11: Determinants of Log (Settlement Amount), post-PSLRA cases

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154. See *supra* Part I.D.2.

155. This variable is the cross-product of the amount of provable losses and a dummy variable that is equal to 1 if an institution is among a lead plaintiff group and 0 otherwise. The interpretation of the results is the following: If we consider two cases that differ in the type of lead plaintiff but have the same market capitalization, class period, and the presence of an SEC action, then the elasticity of the dollar amount recovered in the class action with respect to the amount of provable losses increases by 0.04 in the case of an institutional lead plaintiff. That is, for the case without an institutional lead plaintiff, the elasticity of the settlement is equal to 0.26, while for the case with an institutional lead plaintiff it goes up to 0.3 (0.26 + 0.04), with the increase being economically and statistically significant.

We note that this variable does not exhibit a high degree of multicollinearity with the provable loss variable, with the correlation coefficient equal to 0.42.

156. One possible objection to this equation is that there might be an endogeneity problem because of uncertainty whether the presence of an institutional lead plaintiff caused a higher settlement or whether the presence of a higher potential settlement attracted an institutional lead plaintiff. We considered this problem, but determined it was not an issue. By the time the settlement agreement is reached, the identity of the lead plaintiff is already determined, which eliminates any potential endogeneity.

157. We had no prior hypothesis about what the correct specification for this variable should be and therefore tried several specifications, including a linear specification. The reported form of equation gave the best fit to the data.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Log (Provable Losses)	0.26	0.055	4.85	0.000
Log (Market Capitalization)	0.13	0.039	3.25	0.001
Class Period	0.02	0.008	1.96	0.052
Dummy-SEC	0.33	0.161	2.02	0.045
Log (Provable Losses) * Dummy-Institution	0.04	0.017	2.07	0.040
Intercept	4.70	0.526	8.95	0.000
R-squared	0.47			
Adjusted R-squared	0.45			

The increased recoveries observed when an institution serves as the lead plaintiffs are economically and statistically significant. For each 1% increase in provable losses, the settlement amount increases 0.26%. If there is an institution as lead plaintiff, the settlement amount increases an *additional* 0.04%.<sup>158</sup> Institutional lead plaintiffs, therefore, increase settlement size, all other things being held constant.<sup>159</sup> Most of the independent variables in this equation are statistically significant at the 5% level, with only class period slightly less significant, at the 5.2% level.

d. *Impact of Other Types of Lead Plaintiffs.* — Having found that institutional lead plaintiffs positively increase settlements, we next ask the same question about a single individual (“individuals”), an aggregation of individuals (“aggregations”), and a group that includes a noninstitutional entity (“entities”).<sup>160</sup> Is any one of these three superior to the other two?

158. In other words, holding all other regressors fixed, a 1% increase in provable losses yields a 0.26% increase in the amount of settlement plus an additional 0.04% increase if the lead plaintiff is an institution. The dollar amount of this effect obviously depends on starting (or benchmark) levels of variables. For example, let us, for expositional simplicity, assume that the sample median of settlement amount (\$5.7 million) corresponds to the median amount of provable losses (\$91 million). Then, if the amount of estimated aggregate losses increases by \$9.1 million, the amount of settlement is expected to increase by \$148,000 and \$171,000 in the case of noninstitutional and institutional lead plaintiffs, respectively.

We note that these results appear inconsistent with the findings of Professor Alexander that settlement size is invariant to the merits of a case in securities class action litigation. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 *Stan. L. Rev.* 497, 499–500 (1991).

159. Of course, we cannot control for all other factors, only the ones on which we have data. There may be other indicators of quality that we are not capturing. If so, it could still be true that higher recoveries remain a function of these other better qualities of the cases selected by institutions.

160. For a subsample of 162 cases for which we had data, we calculated the percentage of

We saw earlier that the three groups, post-PSLRA, are not statistically different across mean and median length of the class period, market capitalization of defendant companies, time to reach settlement, and the ratio of settlement amount to provable losses. However, the median settlement amounts are statistically different at the 1% level. The median settlement amount for the entities, at \$6.5 million, is nearly double that for individuals (\$3.3 million) and one-third larger than that for aggregations (\$4.4 million). The relative settlement amounts across these three types of lead plaintiffs mirror in some respect their differences in provable losses: The median provable loss for entities (\$148.5 million) is nearly double the median provable loss for settlements with individuals (\$76 million) and 38% greater than when the lead plaintiff is an aggregation (\$91.8 million).<sup>161</sup> Thus, as among the three types of noninstitutional lead plaintiffs, it appears that entities bring cases against larger companies that have larger market capitalization, significantly greater provable losses, and larger settlement amounts.

To examine more fully our data regarding the three types of noninstitutional lead plaintiffs, we divide the post-PSLRA settlements for each type of lead plaintiff into three groups based on the market capitalization of the defendant (i.e., highest third, middle third, and lowest third of market capitalization). After doing so, we observe that for the individuals, the size in dollars of the settlements reached against the lowest-tier market capitalization defendants are bigger than those reached against the top-tier market capitalization defendants. The other two types of lead plaintiffs exhibit the opposite pattern, with settlement amounts increasing with the defendant firms' market capitalization.<sup>162</sup> On the other hand, the provable loss ratio declines significantly across all three types of lead plaintiffs as market capitalization and provable losses increase. However, individuals perform better than the other two types of lead plaintiffs in the bottom-tier cases. The converse is true in the top-tier cases. In short, it appears that individuals perform best in the small cases and perform worst in the big cases.

To further examine the relative strengths of these three types of lead plaintiffs, we performed a regression analysis similar to the one in Table 9. Specifically, we regressed the logarithm of the settlement amount on the logarithms of provable losses and market capitalization as well as on the length

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settlements reached by the largest plaintiffs' law firm by type of lead plaintiff. We found that the largest firm filed 87% of the cases brought by individual lead plaintiffs, 32% of the institutional lead plaintiff cases, and roughly 65% of the remaining cases. These differences were not statistically significant, although we did find that the presence of this particular law firm did result in faster settlements without a significant loss in settlement value.

161. Although these medians' differences are statistically significant at the 20% level, this is outside generally accepted standards of significance.

162. We performed the same analysis with provable losses. We found modest increases in settlement amount for individuals between the bottom and top market capitalization tiers based on relative provable losses, but dramatically larger increases for the other two types of plaintiffs: Increases were nearly triple for entities and quadruple for aggregations.

of class period and a dummy variable that controls for a parallel SEC action. In addition, we included two cross-product terms that would allow us to test how individuals' performance in terms of relative recovery differs from the performance of other lead plaintiff types. The results are shown in Table 12.<sup>163</sup> The residual category in this specification includes the pre-PSLRA cases, and therefore all coefficients measure the effect of the variable in comparison to the pre-PSLRA levels.

Table 12: Effect of Individual Lead Plaintiff on Log (Settlement Amount)<sup>164</sup>

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Log (Provable Losses)	0.25	0.059	4.14	0.000
Log (Provable Losses) * Single Lead Plaintiff	-0.09	0.118	-0.78	0.438
Log (Market Capitalization)	0.21	0.039	5.40	0.000
Log (Market Capitalization) * Single Lead Plaintiff	-0.08	0.033	-2.34	0.020
Class Period	0.02	0.007	2.82	0.006
Dummy-SEC	0.18	0.167	1.10	0.274
Intercept	7.44	0.211	35.29	0.000
R-squared	0.33			
Adjusted R-squared	0.31			

These results are consistent with the discussion above. In particular, the variable "Log (Market Capitalization) \* Single Lead Plaintiff" is negative and significant, showing that the elasticity of the amount of settlement with respect to market capitalization deteriorates significantly if a single individual acts as a

163. This regression is calculated for the subsample of cases involving individuals, groups of individuals, and other entities only. We do not include cases involving institutional investors.

164. As mentioned earlier, see *supra* note 153, the amount of provable losses is highly correlated with the size of the defendant company. Given that market capitalization and provable losses are highly correlated, including both in the regression will lead to estimates that may not correctly reflect an individual effect of each variable. To circumvent this problem, we first regress provable losses onto market capitalization; the residual from this regression, consequently, is orthogonal to the size of the defendant company. We then use this residual in the regression specification presented in Table 12—this technique allows us to track the effect of provable losses on the amount of settlement beyond that contained in the market capitalization variable and to separate and analyze the effect of provable losses. While this procedure affects point estimates of regression coefficients, it does not affect the overall fit of the regression.

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lead plaintiff as opposed to a group of individuals or an entity.<sup>165</sup> Thus for each 1% increase in market capitalization, the settlement amount increases by 0.21%. If the lead plaintiff is an individual, the increase is only 0.13%. The same result appears in the relative recovery per additional percent of provable losses. This decline, however, is not statistically significant. In short, individual lead plaintiffs do best in increasing settlements in small cases, while the two groups do better for the larger ones.<sup>166</sup>

e. *Explaining the Decline in Provable Loss Ratios.* — As we noted in our discussion of Table 8, our univariate analysis shows that provable loss ratios (that is, the ratio of settlement amounts to estimated provable losses) apparently declined in the post-PSLRA period. To unpack this result, we use a multivariate regression of the determinants of these ratios and present the results in Table 13.

Table 13: Determinants of Provable Loss Ratio

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Log (Market Capitalization)	-1.20	0.315	-3.80	0.000
Class Period	-0.20	0.087	-2.30	0.022
Dummy-SEC <sup>167</sup>	-0.11	1.640	-0.07	0.945
Dummy-Institution	-5.69	1.994	-2.85	0.005
Dummy-Group of Individuals	-2.76	2.087	-1.32	0.187
Dummy-Institution and Individuals	-5.67	2.497	-2.27	0.024
Dummy-Single Individual	-6.11	2.256	-2.71	0.007
Dummy-Entity	-2.23	2.734	-0.81	0.416
Intercept	21.87	2.607	8.39	0.000

165. The intuition behind this result is identical to that explained at supra note 155.

166. The regression reported in Table 12 is specified in logs. As such, it allows us to analyze the impact of the lead plaintiff type on the *relative* recovery in settlements, not the absolute dollar amount.

167. This variable refers to the presence of an SEC enforcement action involving the same misrepresentation that is the subject of the class action settlement. In a separate study, we examined the effects on settlements when there is a parallel SEC enforcement action vis-à-vis when there is not. See Cox & Thomas, SEC Heuristics, supra note 8, at 767–74 (concluding that private suits with parallel SEC enforcement actions settle sooner and finding some evidence that such suits also recover higher percentages of provable losses, particularly in very low percentage recovery cases).

R-squared	8.1%
Adjusted R-squared	5.5%

Table 13 shows that provable loss ratios have significantly declined in the post-PSLRA period from their pre-PSLRA level for both categories of institutional investors and the individuals.<sup>168</sup> These results are robust to different specifications of the regression equation, although the explanatory power of the equation is quite low.<sup>169</sup>

Institutional investors bring cases in which the estimated provable losses are very high, and the amount of settlement dollars, although greater on average than in the pre-PSLRA period,<sup>170</sup> nonetheless did not increase as rapidly as did provable losses.<sup>171</sup> One possible reason for the relatively slower rate of growth of settlement amounts relative to provable losses might be that the amount of the defendants' insurance policies have not kept pace with the firm's exposure as captured by the provable losses in individual cases.<sup>172</sup> One practitioner commenting on these results suggested that \$100 million is the top end of the insurance coverage for these cases.<sup>173</sup> If PSLRA has increased

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168. We were also concerned that the relatively short period of time between the end of our sample and our analysis might bias our results in favor of finding that post-PSLRA cases had lower provable loss ratios. In results not shown, we tested to see if the length of time to settlement had an effect on the results shown in Table 11, panel B. We found this term to be insignificant when included in the regression analysis. We also found that the length of the settlement period is only weakly correlated with the settlement amount and estimated provable losses. We conclude that the shorter time to settlement is not a significant determinant of the differences between our pre-PSLRA and post-PSLRA provable loss ratios.

169. In addition to the results shown, we used specifications that included replacing market capitalization with other proxies for firm size such as the amount of total assets, combining dummy variables into coarser groups, and excluding variables that did not seem to affect significantly the dependent variable.

170. See *supra* Table 4.

171. Our results are consistent with those found by Buckberg et al. in their recent survey of trends in the shareholder class action area. See Buckberg et al., *WorldCom and Enron*, *supra* note 23, at 6 (showing decline in median ratio of settlement to investor losses from 6.1% in 1995 to 2.5% in 2005).

172. We strongly suspect that an important variable in the settlement process is the amount of insurance available. We did not examine this variable for several reasons. First, it would be quite burdensome (and in many cases fruitless) to try to obtain this information. The amount of insurance coverage is not disclosed in SEC filings; hence, this information would have to be obtained from the documents obtained by plaintiff's counsel through discovery. Second, and more importantly, the standard insurance policy is akin to a wasting asset in the sense that litigation expenses (most importantly attorneys' fees for the company as well as covered officers and directors) are paid periodically throughout the life of the suit. Thus, what is relevant is not the initial amount of available insurance but the coverage that has not been depleted when the hour of settlement approaches. Discovering this figure in each of our cases would be truly a Herculean if not imponderable undertaking.

173. These comments were made by Geoffrey C. Jarvis, a director of Grant & Eisenhofer, P.A., during a conference held at Fordham Law School. Both authors attended this conference,

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defense costs on average by prolonging these cases, then that may also drain the funds in the typical insurance policy.<sup>174</sup>

In cases involving individual lead plaintiffs, the interpretation is more difficult. We know that on average these cases are the smallest ones in the post-PSLRA period in terms of settlement amounts, market capitalization of the defendant firms, and estimated provable losses. We speculate that since these cases typically involve issuers with relatively small market capitalizations, they attract fewer large institutional investors, who generally eschew small issuers because of liquidity concerns. Thus, smaller investors are more likely to become lead plaintiffs.

If these investors are the worst monitors of plaintiffs' counsel, and therefore the least likely to reduce litigation agency costs, settlements in these cases may recover lower levels of provable losses compared to the pre-PSLRA cases when we adjust for the effect of market capitalization and the length of the class period. This could explain the apparent disparity between the univariate results shown in Table 8 and the multiple regression results appearing in Table 13.

**CONCLUSIONS AND POLICY RECOMMENDATIONS**

We find that institutional lead plaintiffs add value for shareholders, although perhaps not as much as was expected by the architects of PSLRA's lead plaintiff provision. Our data shows that institutions increase settlements by 0.04% for every 1% increase in provable losses. Although this is small, it is statistically significant among the variables we examined. Institutional lead plaintiffs appear in cases involving larger provable losses and generate better recoveries in those cases, but they appear in very few cases, at least during the period of our data set. Moreover, given the difficulty of controlling for all aspects of quality, it is also possible that the higher settlements in these cases may reflect that institutions take the better cases.

Our real concern about institutions is that they do not seem to be able to increase dollar recoveries at the same pace as provable losses. This is disappointing and facially inconsistent with institutional lead plaintiffs' beliefs that they can double or triple recoveries overall.<sup>175</sup> We also need to assess

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which was held on November 4, 2005.

174. PSLRA has led to longer times before cases reach settlement than under the old system. See Elaine Buckberg et al., NERA Econ. Consulting, *Recent Trends in Securities Class Action Litigation: Will Enron and Sarbanes-Oxley Change the Tides?* 5 (2003) ("Prior to PSLRA, 61% of cases were disposed in three years and 77% in five years; since, only 44% have been disposed in three years and 62% in five years."). If this increases litigation costs for the parties, then less money is left in the policy for paying class members because most directors' and officers' insurance policies deduct defense costs out of the amount of the policy's coverage. Plaintiffs' counsel will also incur greater costs from any increased litigation, and these may increase the amount of any attorneys' fees award that they obtain in a settlement.

175. See supra note 51 and accompanying text.

how institutional shareholders will impact settlements if they appear in a broader set of cases. Our data reflects that institutions do increase settlements relative to other types of lead plaintiffs, although the increase, while statistically significant, is small. We therefore question whether institutions' sole goal is to maximize settlement amounts. Instead, we believe they might see their role as balancing settlements against the long-term interests of the defendant company whose shares the institution may continue to own. In that scenario, institutions can be expected to trade off higher recoveries against the company's treasury for small recoveries against the insurer and officers responsible for the fund as well as prospective reforms of the company's corporate governance structure.

More generally, we were surprised to find that provable loss ratios have declined in the post-PSLRA period. While we must be cautious not to overinterpret this result, its potential significance is enormous: Investors appear to be recovering a smaller percentage of their losses today than they did before the passage of the Act.<sup>176</sup> We speculate about some explanations for this phenomenon, such as a relatively slow rate of growth of insurance policies, but this remains an important area for more research.

On a policy level, we continue to support the overall value of financial institutions serving as lead plaintiffs. Our major recommendations focus on nurturing greater participation in securities class actions by institutional lead plaintiffs. Steps in this direction would not only be consistent with our data but also with the legislative history of the PSLRA, which is richly laden with expectations that class action suits would be greatly improved by attracting institutions to become the suits' plaintiffs.<sup>177</sup>

In particular, we believe courts should be more willing, indeed activist, in awarding costs to institutional lead plaintiffs for *all* expenses related to an institution's participation as a lead plaintiff. Such awards should compensate the institution not only for direct costs of participation, such as travel or deposition time related to the suit's prosecution, but should also include reasonable reimbursement for indirect costs such as those recounted earlier.<sup>178</sup> Indeed, we believe any award of costs should be some multiple of the actual amount attributed to the damages.<sup>179</sup>

The appropriate analogy is to the "lodestar" method for determining fee awards in class action suits.<sup>180</sup> Just as the class counsel is rewarded for such

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176. As noted earlier, this result is confirmed in Buckberg et al., *WorldCom and Enron*, supra note 23, at 6 (showing decline in median ratio of settlement to investor losses from 6.1% in 1995 to 2.5% in 2005).

177. See supra note 27–31 and accompanying text.

178. See supra Part I.C.3.

179. The professional plaintiffs limitation in PSLRA, discussed further at infra note 181, could be used to police any aberrant behavior, such as taking lots of cases to make money on the reimbursement multiple.

180. The lodestar method of calculating attorney fee awards in class actions takes the

factors as the uncertainty of the suit, the skill and experience devoted to the suit's prosecution, and the ultimate outcome, we believe similar considerations should justify awarding to the institutional lead plaintiff an award greater than the costs directly attributable to the suit. We hope this would encourage more institutions to adopt socially desirable internal and external procedures to evaluate their decision to become a lead plaintiff.

Furthermore, we believe courts generally should follow the lead of the few judges that have been willing, in the right circumstances, to excuse the "professional plaintiff" restrictions of the PSLRA.<sup>181</sup> Simply stated, a demonstrated record as a diligent monitor of the present suit, when coupled with a good track record of being such a monitor in other cases, should be more than enough to persuade the court that the petitioning institution has only the positive characteristics associated with being a professional plaintiff. We

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number of hours worked by class counsel and multiplies them by a reasonable hourly rate with some adjustments for factors like the uncertainty of the suit and the skill and experience of counsel. This method has been criticized by some scholars as creating financial incentives for class counsel to prolong the litigation and for giving these attorneys little incentive to try to maximize the class recovery. See John Bronsteen, *Class Action Settlements: An Opt-In Proposal*, 2005 U. Ill. L. Rev. 903, 911 n.54 (arguing that lodestar method "results in collusion [with defendants] even more than does the contingent fee"); Charles Silver, *Due Process and the Lodestar Method: You Can't Get There from Here*, 74 Tul. L. Rev. 1809, 1817-20 (2000) (noting several ways in which contingency fee arrangements are superior).

181. The PSLRA added § 21D(a)(3)(B)(vi) to the Securities Exchange Act of 1934, see Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, sec. 101(b), § 21D(a)(3)(B)(vi), 109 Stat. 737, 745 (codified at 15 U.S.C. § 78u-4(a)(3)(B)(vi) (2000)), which bars one from serving as a lead plaintiff if during the preceding three-year period the person has been a lead plaintiff in more than five securities class actions, unless the court otherwise approves that such a plaintiff being a representative is "consistent with the purposes of" the lead plaintiff provision. *Id.* Most courts recognize that the professional plaintiff bar is less applicable or even inapplicable to institutional investors. See *Smith v. Suprema Specialties, Inc.*, 206 F. Supp. 2d 627, 640-41 (D.N.J. 2002) (collecting cases). Our approach is less sweeping and generally follows the results reached in a series of cases initiated by the Florida State Board of Administration (FSBA), which is a frequent lead plaintiff in securities suits. Courts have invoked the bar against FSBA when another party whose losses are greater is petitioning to become the lead plaintiff, see *In re Telxon Corp. Sec. Litig.*, 67 F. Supp. 2d 803, 818-24 (N.D. Ohio 1999) (choosing as plaintiff group two plaintiffs whose losses were twice those of FSBA during relevant class period), or when an institution whose losses are less than that of FSBA is petitioning to be the lead plaintiff. See *In re Enron Corp. Sec. Litig.*, 206 F.R.D. 427, 456-57 (S.D. Tex. 2002) (justifying in part selection of another institution whose losses were 40% those of FSBA because FSBA was actively involved in four ongoing suits); *Aronson v. McKesson HBOC, Inc.*, 79 F. Supp. 2d 1146, 1156-57 (N.D. Cal. 1999) (justifying in part disqualification of FSBA because of presence of other institutional investors seeking to serve as lead plaintiff). FSBA has been excused from the professional plaintiff bar when it is the only institution petitioning to be a lead plaintiff. See *In re DaimlerChrysler AG Sec. Litig.*, 216 F.R.D. 291, 299 (D. Del. 2003) (explaining selection of FSBA as lead plaintiff based on its attention to suit despite its status as lead plaintiff in eight other suits); *Naiditch v. Applied Micro Circuits Corp.*, No. 01-CV-0649, 2001 U.S. Dist. LEXIS 21374, at \*2-\*3 (S.D. Cal. Nov. 5, 2001) (selecting FSBA with losses of \$5.3 million over two individuals with losses of \$980,000); *In re Critical Path, Inc. Sec. Litig.*, 156 F. Supp. 2d 1102, 1112 (N.D. Cal. 2001) (preferring FSBA to other flawed institutional investors despite FSBA's status as lead plaintiff in six ongoing suits).

believe this exception is more easily made when the institution has internal safeguards, such as those required by a few states, which insulate the decision to become a lead plaintiff from “pay-to-play” influences.<sup>182</sup> More generally, all institutions considering becoming a lead plaintiff should adopt procedures to insulate their internal processes from the harmful effects of political contributions by class action law firms.

If we consider the remaining types of lead plaintiffs, our data supports the view that groups perform better than individuals as lead plaintiffs in larger cases, while groups that include an entity yield larger settlements and greater provable loss ratios than those that occur with mere aggregation of individuals. These are among the most surprising findings of our study because most commentators (ourselves included) have cast a skeptical eye toward aggregation as a means of finding the most adequate plaintiff. However, our earlier supposition that a group would perform worse than an individual is not borne out by our settlement size and provable loss data.

We suspect that any group’s strength as a monitor is correlated positively to the biggest group member’s financial stake in the suit. We have not tested this hypothesis because we lack data on which to conduct such a test, but our small sample of cases in Table 2, showing stock ownership of lead plaintiffs, is suggestive in this regard. Nevertheless, we believe that, when a court is considering two competing groups of individuals, the relative inquiry should not be which group has the largest financial loss but rather the relative size of the financial loss suffered by the biggest owner in each group. In other words, courts should look most critically at the size of the largest group member’s stake in deciding between otherwise similar groups.

Single individual plaintiffs perform best in the smallest cases. This is encouraging because no institutions apply to be appointed lead plaintiff in these cases. Smaller capitalization firms with their concomitant smaller provable losses mean that the costs of being a lead plaintiff in such a suit dwarf the likely benefits from doing so. Moreover, most financial institutions do not hold shares in very small market capitalization defendants because of their illiquid nature. Hence, suits against such defendant companies are likely to remain the domain of individual investors or groups of individual investors.

Conversely, in bigger cases with larger provable losses, single individual lead plaintiffs do worse than institutional plaintiffs. We suspect this is due to inattention by the lead plaintiff and the eagerness of the suit’s class counsel to reap the proffered settlement rather than to push for a larger settlement. It is in this domain that the securities class action remains lawyer driven and that the ill effects that the lead plaintiff provision was designed to address continue to abound. Groups seem to be preferable in these situations.

Finally, we wish to reiterate our concerns about the possible “pay-to-play”

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182. See *supra* Part I.D.1.

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practices that are alleged to be emerging in this area.<sup>183</sup> We think that this type of allegation, if widely substantiated, could undermine the legitimacy and utility of the lead plaintiff provision. The simplest, and perhaps most effective, solution would be for courts to require plaintiffs' law firms that are candidates for the lead counsel position to disclose any campaign contributions or other payments they have made to prospective class representatives, their managers, directors, or other control persons, before the court appoints a lead plaintiff for the class. Hopefully, this disclosure would put to rest ugly rumors and also serve as a good disinfectant.

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183. See *supra* Part I.D.1.