DETERRENCE OF CORPORATE FRAUD THROUGH SECURITIES LITIGATION: THE ROLE OF INSTITUTIONAL INVESTORS

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If an institutional investor, which represents the long-term interests of many small investors, decides that a certain form of relief is appropriate, it is more likely superior for the majority of investors than the relief which would be sought by a "professional plaintiff's" lawyer.[1]

I

INTRODUCTION

Securities class action lawsuits just might be the schizophrenic stepchildren of our civil litigation system. They are expected to serve two masters at the same time. The first is the goal of obtaining compensation for wronged investors who have suffered losses at the hands of corporate wrongdoers. The second is filling the role of private attorneys general to sanction violators and deter future misconduct.[2] There is often a tension between these two masters. Approaches that provide the most effective deterrence of future fraud may not necessarily provide the largest loss recovery.[3]

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The views in this comment are solely those of the author and do not represent the position of the State of Wisconsin Investment Board. The author gratefully acknowledges the assistance of Kerry Jung in preparing this Comment.

1. Gluck v. CellStar Corp., 976 F. Supp. 542, 548 (N.D. Tex. 1997).

2. The court in *Gluck* cited legislative history of the Private Securities Litigation Reform Act as emphasizing this role:

> Congress acknowledged the value of private securities litigation to the integrity of American capital markets. Meritorious suits, it found, maintained public and private confidence in the markets and served as strong deterrents to illegal action and nondisclosure by corporate fiduciaries. Private actions complemented SEC enforcement mechanisms and remained a necessary component of the federal regulatory structure.

Gluck, 976 F. Supp. at 544 (citations omitted).

3. For example, a settlement that requires payment of $5 million directly from the culpable officers and directors of a company may have a greater deterrent effect than a $10 million recovery from the company's insurer. Similarly, a settlement that installs a majority of independent directors on the board of a defendant company that was controlled by insiders who perpetrated the fraud might be more effective in preventing future fraud than a monetary recovery.

This comment explores the role of institutional investors in simultaneously pursuing these compensation and deterrence goals. It suggests that institutions are uniquely positioned to enhance the deterrence function of securities litigation without undermining the compensation goal. Consequently, class members and investors could generally benefit from judicial efforts to facilitate the participation of institutions in securities litigation. Furthermore, institutions need not be limited to serving as lead plaintiffs under the Private Securities Litigation Reform Act of 1995 ("PSLRA")[4] in order to enhance the deterrence of fraud in securities litigation.

The Comment concludes that bringing fewer cases but prosecuting them more vigorously would most effectively deter securities fraud. Class members and courts could encourage this strengthened deterrence by: developing a more graduated fee award structure for class counsel than is currently in place that focuses class lawyers on serious violations and removes any fee incentive to bring unnecessary actions; seeking payment of damages directly from culpable corporate officers and directors when they have personally profited from the fraud or their conduct was egregious; and pursuing governance changes at defendant companies where corporate culture or structure contributed to the fraud.

II

RENEWING THE ROLE OF PLAINTIFFS IN PRIVATE SECURITIES LITIGATION

A. The Unique Institutional Interest in Deterrence

The three papers on the role of clients that were presented at the Duke University School of Law/Institute of Law and Economic Policy Conference on Deterring Corporate Misconduct[5] contain a common theme: Clients have been notoriously absent in class action litigation. These lawsuits have tended to be attorney driven, with little input from class members. 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.[6]

This dynamic has also resulted in a system in which deterrence usually takes a back seat to the compensation goal. As long as class counsel is paid on a contingency basis out of money recovered, the lawyers have little incentive to pursue corporate governance changes that would address underlying causes of a

4. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C. (Supp. I 1995-96)).

5. *See* Jill E. Fisch, *Class Action Reform,* Qui Tam, *and the Role of the Plaintiff*, 60 LAW & CONTEMP. PROBS. 167 (Autumn 1997); Geoffrey Miller & Lori Singer, *Nonpecuniary Class Action Settlements*, 60 LAW & CONTEMP. PROBS. 97 (Autumn 1997);

6. In *Gluck,* the court cites Congress's conclusion that "[s]pecialized securities litigation firms had researched potential targets for these suits, enlisted plaintiffs, controlled the course of litigation, and often negotiated settlements that resulted in huge profits for the law firms with only marginal recovery for the shareholders." 976 F. Supp. at 544.

violation. Neither is there any fee incentive to continue aggressive prosecution of a case in order to seek what might be relatively small (but highly deterrent) personal payments from wrongdoers. In fact, the financial interests of class counsel are adverse to enhancing deterrence because greater deterrence could reduce the number of future cases that can be brought, leading to reduced incomes and layoffs in the plaintiffs' bar. Furthermore, class counsel has little incentive voluntarily to restructure its fees in a manner that would reduce them.

On the other hand, large claimants with broad market portfolios are uniquely qualified to provide oversight of class counsel and pursue both compensation and deterrence goals because they have both the sophistication and financial incentives to do so. Institutional investors that manage monies held in trust also have a fiduciary duty to take reasonable steps to realize on claims that will advance the interests of beneficiaries.[7] Although enhanced deterrence would accrue to the benefit of all investors, other class claimants are unlikely to have the same abilities and level of financial and fiduciary motivation to direct the course of litigation in ways that promote the interests of the class in deterrence as well as the interests of class counsel in obtaining financial recoveries that will maximize their fees.

B. Institutions as Balanced Stakeholders in Securities Litigation

A 1995 study of securities class actions found that institutions regularly hold large stakes in the outcome of securities class actions.[8] The two largest class claimants were found to be institutions ninety percent of the time. The single largest claimant on average accounted for thirteen percent of total allowed class claims, which was more than the estimated eleven percent average aggregate total of claims held by all small individual investors. The average loss of the largest fifty claimants in all of the cases studied was about $600,000 and, in one out of five lawsuits, the fifty largest claimants' average loss exceeded $1 million. Among the fifty largest claimants, institutions alone accounted for almost half of total class losses. Individual institutional investor recoveries of as much as $2.1 million in a single case were found, with the largest claimant taking as much as thirty-four percent of the class distribution.

In addition, a recent report by National Economic Research Associates ("NERA") concluded that the ratio of class action settlements compared to plaintiffs' claimed damages, on average, has not been more than fourteen percent.[9] While plaintiffs' claimed damages might not be the most reliable basis for measuring what is a good result, this finding does provide an indication that class members have substantial damages that go uncompensated.

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7. *See* RESTATEMENT (SECOND) OF TRUSTS § 177 (1959).

8. *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, 2056 (1995).

9. DENISE N. MARTIN ET AL., NATIONAL ECONOMICS RESEARCH ASSOCIATES, RECENT TRENDS IV: WHAT EXPLAINS FILINGS AND SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? 10 (1996) [hereinafter NERA REPORT].

The same NERA report also found that average attorney fee awards in class actions have been about thirty-two percent of the total class recovery and that size of the recovery has no significant impact on the percentage deducted as attorneys' fees.[10] Total legal fees paid to class counsel out of recoveries between January 1991 and June 1996 were more than $1 billion, an average of almost $200 million per year.[11]

Not only do institutions have large stakes in class action recoveries, they are also significant owners of the companies being sued. When debating the PSLRA, Congress observed that "[i]nstitutional investors are America's largest shareholders, with about $9.5 trillion in assets, accounting for fifty-one percent of the equity market."[12] Although all shareholders are harmed by securities fraud, institutions tend to bear a higher proportion of the losses because of their extensive portfolio holdings. Their repeat player status also causes institutions to bear a higher proportion of costs associated with inefficiencies in the securities litigation system, such as losses to legal fees that are not based on competitive market rates and costs associated with prosecuting and defending unnecessary cases.

With this broad presence in the equity markets, their overwhelming interests in individual cases, and their fiduciary duty to act in the best interest of investors, institutions have incentives to pursue both of the competing interests involved in securities litigation.[13] As the largest claimants, they have a strong interest in maximizing recoveries in class action lawsuits. However, they also have a direct incentive both to increase portfolio returns by taking actions to reduce losses to securities fraud through enhanced deterrence and to improve efficiency of the system.[14] This incentive structure is something that no other players in securities litigation share.

10. *Id.* at 13.

11. *See id.*

12. *See* H.R. REP. NO. 104-369, at 34 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 733 (joint explanatory Statement of the Committee of Conference, Statement of Managers—The Private Securities Litigation Reform Act of 1995).

13. "Because they bear the costs associated with both the presence of fraud and of inefficiencies in class action litigation, institutions have natural incentives to seek a balanced resolution of the problems presented by securities class litigation. Those incentives closely reflect society's aggregate interests." Joseph A. Grundfest & Michael A. Perino, *The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation*, 38 ARIZ. L. REV. 559, 578 (1996).

14. For example, if the experience of the State of Wisconsin Investment Board ("SWIB") in selecting lead counsel through a competitive process in *Gluck* is an indication of what competitive market fees would be, it appears that compensation paid to class counsel out of recoveries could be reduced by one-quarter to one-third of current levels. *See generally* Gluck v. CellStar Corp., 976 F. Supp. 542 (N.D. Tex. 1997), *supra* note 2. Based on average legal fee payments to class counsel of about $200 million each year, *see* NERA REPORT, *supra* note 9, at 13, one might suspect that regular competitive selection of lead counsel could save class members roughly $50 to $70 million annually. This does not take into consideration other positive results of institutional involvement in securities litigation, such as potential additional returns to shareholders from reduced defense fees and insurance premiums, as well as eliminating company management time spent on unnecessary or inefficient litigation.

C. Evaluating the Invitation from Congress to Become Lead Plaintiffs

Despite these inherent incentives and the PSLRA provisions that encourage institutional investors to become lead plaintiffs in securities class actions in order to provide effective client oversight of class counsel,[15] few institutions have yet come forward. During the first year after enactment of the PSLRA, the Securities and Exchange Commission ("SEC") reported that institutional investors became lead plaintiff in only eight of 105 cases filed.[16] While several additional institutions have come forward to serve as lead plaintiffs since the SEC issued the report, the numbers are still small in comparison to total cases filed.[17]

The SEC noted that institutions have identified costs and perceived liability exposure as disincentives to becoming lead plaintiff.[18] Their concerns include costs associated with exposure to discovery, time needed to manage the litigation, possible public disclosure of proprietary investment information, and fear that other plaintiffs who disagree with how the case was handled might sue them.[19]

Most of these concerns are risks that the courts could minimize by interpreting the PSLRA in ways to protect institutions that become lead plaintiffs and act in good faith. However, institutions also have other methods besides the lead plaintiff role for pursuing their interests in securities class actions.

D. Alternatives to Becoming the Lead Plaintiff

Alternatives are available to institutional investors that choose not to become lead plaintiffs. For example, in 1997 the State of Wisconsin Investment Board ("SWIB") and Colorado Public Employees' Retirement Association ("ColPERA") successfully objected to the level of legal fees being sought by class counsel in the Horizon/CMS securities litigation.[20] After the institutions intervened and objected, the court reduced fees to twenty percent of the set-

15. The Congressional Conference Committee Report on the PSLRA states: "The Conference Committee believes that increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." *See* H.R. REP. NO. 104-369, at 34, *reprinted in* 1995 U.S.C.C.A.N. at 733.

16. *See* OFFICE OF THE GENERAL COUNSEL, SECURITIES AND EXCHANGE COMMISSION, REPORT TO THE PRESIDENT AND CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 at 51 (1997) [hereinafter SEC REPORT].

17. For instance, since issuance of the SEC REPORT, *supra* note 16, the Minnesota State Board of Investment was appointed lead plaintiff in *Minnesota State Bd. of Inv. v. Mercury Fin. Co.*, No. 97-C-1949 (N.D. Ill. filed Mar. 21, 1997); the City of Philadelphia was appointed as one of the lead plaintiffs in *Blaich v. Employee Solutions, Inc.*, No. CIV97-545-PHX-RGS (D. Ariz. filed Mar. 17, 1997); the Colorado Public Employees' Retirement Association has moved to be appointed lead plaintiff in *Metro Servs., Inc. v. Oxford Health Plans, Inc.*, No. 97 CIV 8023 (CLB) (S.D.N.Y. filed Oct. 29, 1997); and the State of Wisconsin Investment Board has moved to be appointed lead plaintiff in *Spiegel v. Physician Computer Network*, No. 98-CV-981 (MJB) (D.N.J. filed Mar. 5, 1998).

18. *See* SEC REPORT, *supra* note 16, at 52.

19. *See id.*

20. *See* Donnarumma v. Ortenzio, No. 96-0442-BB (D.N.M. filed Apr. 2 1996).

tlement from the twenty-five percent finally sought by lead counsel.[21] SWIB and ColPERA argued that the fee request was excessive, given that the settlement was for less than ten percent of plaintiffs' estimated damages, it was reached before formal discovery was taken or motions to dismiss had been decided, and the company was motivated to settle more by a pending merger than by events in the lawsuit. They also argued that a twenty-five percent fee for an early settlement was substantially higher than fee schedules agreed to in other cases where lead counsel had been chosen through a competitive selection process initiated by either lead plaintiff or the court.[22]

A similar fee reduction from one-third to twenty-five percent of the recovery was voluntarily agreed to in 1997 by lead counsel in the Chiron securities litigation, after ColPERA filed an objection.[23] In that case, ColPERA argued that reasonableness of the fee could not be determined because the settlement was a variable amount that could range from $20 million to $35 million.[24]

In 1996, the California Public Employees' Retirement System ("CalPERS") intervened in a state court derivative action involving W.R. Grace in order to challenge a proposed settlement that it believed to be inadequate.[25] CalPERS objected because the settlement lacked any monetary recovery for shareholders and provided for adoption of a corporate sexual harassment policy that already seemed to be required by law.[26] The court made CalPERS a party to the action and appointed its counsel as co-lead in order to permit the institution to play an active role in settlement discussions on behalf of shareholders.[27]

CalPERS and the Florida State Board of Administration also challenged the settlement of a derivative case in 1997 against Archer Daniels Midland ("ADM") as large shareholders of the company.[28] They complained that the monetary component of the settlement would go to pay lawyers' fees and that the corporate governance component consisted primarily of unsatisfactory

21. The original notice of settlement that was sent to class members indicated that class counsel would seek up to one-third of the recovery as fees. After being contacted by SWIB about the level of fees being requested, lead counsel indicated a willingness to seek less than one-third and ultimately asked the court to approve an award of 25%. Based on the one-third number set forth in the class notice, the fee reduction to 20% was almost $3 million.

22. SWIB and ColPERA argued that a 17.5% fee would be more consistent with fee levels agreed to by lead counsel where a competitive selection process had been used. For example, the fee schedule agreed to by lead counsel in *Gluck* where a competitive selection process was used, started at 12.5% of first dollar recoveries and topped out at 25% of amounts in excess of $15 million. *See* Gluck v. CellStar Corp., 976. F. Supp. 542 (N.D. Tex 1997); Keith Johnson, *Institutional Investors and Securities Class Action Reform: A Report from the Trenches*, CORP. GOVERNANCE ADVISOR, Jan./Feb. 1997, at 4.

23. *See* Perera v. Chiron Corp., No. C-95-20725-SW (N.D. Cal. filed Jan. 1995).

24. *See generally* Notice of Objection to Settlement Filed by ColPERA on February 3, 1997, Perera v. Chiron Corp., No. C-95-20725-SW (N.D. Cal. filed Jan. 1995).

25. *See* Motion to Intervene at 9, Weiser v. Grace, No. 106285/95 (N.Y. Sup. Ct. filed Sept. 1996).

26. *See id.* at 5.

27. *See id.* at 9.

28. *See generally* Objections of California Public Employees' Retirement System and Florida State Board of Administration to Proposed Settlement of Derivative Actions, Felzen v. Andreas, No. 95-2279 (C.D. Ill. filed July 1995).

changes ADM had already agreed to make.[29] While the court confirmed the settlement over these objections, the matter is currently on appeal.[30]

Institutions have also begun to monitor proactively securities litigation. SWIB and CalPERS filed notices of appearance during early 1998 in the Advanced Micro Devices securities litigation[31] in an effort to jointly evaluate settlement discussions. The institutions cooperatively retained counsel separate from the class to monitor the case.[32]

In a class action involving S3, Inc., SWIB asked the court in early 1998 to use its discretion under Rule 23(d) to order that SWIB be served with all papers in the litigation, be heard on selection and compensation of lead counsel and be allowed to participate in any settlement negotiations, even though it did not seek to intervene or become lead plaintiff.[33] SWIB noted that it was a member of the class and one of the company's largest shareholders. Class counsel subsequently announced their intent to dismiss the case and move to state court. SWIB then negotiated an agreement with lead counsel in the state case that provides SWIB with rights to obtain access to discovery materials, participate in settlement discussions and receive privileged status reports from counsel in the litigation as an absent class member.[34]

Institutional activity has not been confined to pursuit of claims. In a pre-PSLRA situation involving class action and shareholder derivative action cases filed against Intel, four institutional shareholders of the company collectively wrote to the lawyers who brought the lawsuits, stating that they questioned the merits of the complaints.[35] The institutions were CalPERS, Stanford Management Company, College Retirement Equities Fund, and Wells Fargo Institutional Trust Company. The shareholders noted in the letter that non-meritorious lawsuits impose substantial costs on companies and do not promote the interests of investors. The derivative action was subsequently dismissed

29. *See id*. at 5-6.

30. Counsel for CalPERS and Florida has advised the author that a petition for certiorari will be filed with the United States Supreme Court to seek review of a Seventh Circuit decision that dismissed the funds' appeal of the district court's settlement approval for want of jurisdiction, due to failure of the funds to intervene before the district court as a party to the action. *See* Felzen v. Andreas, 134 F.3d 873 (7th Cir. 1998) (dismissing funds' appeal).

31. *See generally* Notices of Appearance of Class Member Filed by SWIB and CalPERS, McDaid v. Sanders, No. C-95-20750-JW (N.D. Cal. filed in 1995).

32. SWIB and CalPERS retained the law firm Hogan & Hartson to monitor the litigation on their behalf and, with the involvement of the author, have actively evaluated discussions which lead to an $11.5 million settlement.

33. *See generally* Letter Dated Jan. 2, 1998 to the Honorable Vaughn R. Walker from John A. Busch on behalf of SWIB, Rudolph v. S3, Inc., No. C-97-4066-VRW (N.D. Cal. filed Nov. 3, 1997). The court has discretion to issue appropriate orders to allow class members to "signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action." FED. R. CIV. P. 23(d).

34. *See* Response of Class Member State of Wisconsin Investment Board to Named Plaintiffs' Motion for Voluntary Dismissal of Class Actions Without Prejudice, *Rudolph* (No. C-97-4066).

35. *See* Gunther v. Moore, No. CV-94-20878 (N.D. Cal. filed Dec. 21, 1994); Whittaker v. Moore, No. CV-94-20855 (N.D. Cal. filed Dec. 12, 1994).

voluntarily by counsel. The class action was also voluntarily dismissed by stipulation of counsel after the letter was written but before it was received.

These are all examples of a new activism on the part of institutional investors in securities litigation, which does not involve assuming control of a case as lead plaintiff. Such alternatives have been used by institutions to protect shareholder interests where becoming lead plaintiff is not believed to be cost-effective.[36] Given that the first few institutional lead plaintiff cases have not yet reached resolution and the costs and benefits of being lead plaintiff are still somewhat uncertain, it is likely that this trend toward parallel track activism will continue.[37] Both tracks provide opportunities to increase the deterrent effect of private securities litigation.

E. Enhancing Deterrence by Pursuing Fewer Cases More Vigorously

The willingness of people to transgress social rules, conventions, and laws depends primarily on their perception of the likelihood, severity, and promptness of sanctions that might be imposed upon them for a violation.[38] Of these three factors, likelihood of being sanctioned and severity of punishment have the greatest impact on deterrent effect.[39] The more likely it is that the perpetrators of fraud will be severely sanctioned when caught, the less likely it is that corporate officials will commit securities fraud or fail to put safeguards in place that will discourage others at the company from breaking the law. One of the papers presented at the Duke University School of Law/Institute of Law and Economic Policy Conference on Deterring Corporate Misconduct put it succinctly: "As a matter of theory and fact, penalizing individuals is singularly effective."[40]

When it enacted the PSLRA, Congress noted that pursuit of unnecessary cases by the class action bar was undermining the effectiveness of securities litigation.[41] In addition, the NERA found that pre-PSLRA settlements reached

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> [I]nstitutions have available to them a rich array of flexible, informal, and relatively inexpensive mechanisms by which they can make their views known to litigants and courts alike. These alternative, flexible, and informal mechanisms allow institutions to influence the course of litigation without incurring the costs or exposing themselves to the litigation risks inherent in strategies that require formal participation.

Grundfest & Perino, *supra* note 13, at 561.

37. In addition to securities class action lawsuits, institutional investors have also become proactive in shareholder derivative actions. For example, 13 institutional investors have joined as named plaintiffs to bring a derivative action involving allegations of fraud at Columbia/HCA Healthcare Corporation. *See* McCall v. Scott, No. 3-97-0838 (M.D. Tenn. filed Nov. 1997).

38. *See* Edmund S. Howe & Thomas C. Loftus, *Integration of Certainty, Severity, and Celerity Information in Judged Deterrence Value: Further Evidence and Methodological Equivalence*, 26 J. APPLIED SOC. PSYCHOL. 226, 229-30 (1996).

39. *See id.* at 238-39.

40. Stephen Calkins, *Corporate Compliance and the Antitrust Agencies' Bi-Modal Penalties*, 60 LAW & CONTEMP. PROBS. 127, 165 (Summer 1997).

41. "The House and Senate Committees heard evidence that abusive practices committed in private securities litigation include: (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer . . . ." H. REP. NO. 104-369, at 31, *reprinted in* 1995 U.S.C.C.A.N. 679, 730.

within a year of lawsuit filing were twenty-five percent lower than cases that survived longer[42] and that about twenty-five percent of securities class action settlements were for under $2 million.[43] The NERA concluded, "At least twenty-one percent, and possibly forty-two percent of these low-value settlements may well be nuisance suits, and are likely settling for nuisance value."[44]

Despite finding that a significant number of cases appear to be unnecessary, NERA determined that there was no difference in the percentage of recoveries class members paid for legal fees in these cases as compared to meritorious cases.[45] This apparent uniformity of fee awards between meritorious and frivolous cases provides little disincentive for class counsel to avoid filing nuisance lawsuits.[46] Such a fee dynamic is inconsistent with PSLRA provisions intended to heighten pleading standards for securities litigation.[47] To the extent unnecessary cases are brought primarily because they can be financially rewarding to class counsel, all shareholders are harmed.[48] Even the continued appearance that strike suits are being pursued undermines the credibility of legitimate suits, weakening the negative social stigma associated with being sued for securities fraud and reducing the deterrent effect of the system.

"Lawyers who bring meritorious suits do not benefit when strike suit artists wreak havoc on the nation's boardrooms and courthouses." S. REP. NO. 104-98, at 5, *reprinted in* 1995 U.S.C.C.A.N. 679, 684.

42. *See* NERA REPORT, *supra* note 9, at 26.

43. *See id*. at 12.

44. *Id*.

45. *See id*. at 13.

46. Indeed, the securities fraud litigation business is booming and does not appear to be having much impact on reducing corporate fraud. The NERA REPORT noted that there has been an average 12% growth rate in the number of securities class actions filed since 1991. *Id.* at ii. Since the PSLRA was enacted, the overall number of companies being sued appears to be remaining at about the same levels as prior to 1996. *See* Michael A. Perino, *What We Know and Don't Know About the Private Securities Litigation Reform Act of 1995, Written Testimony Before the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce, United States House of Representatives on October 21, 1997*, at 4, *available at* Stanford Securities Class Action Clearinghouse (visited Jan. 30, 1998), <http://securities.stanford.edu>.

47. "[T]he Conference Committee intends to strengthen existing pleading requirements . . . ." H. REP. NO. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. 679, 740. Although it might prove easier to get nuisance cases dismissed under the new pleading standards, they will still have significant settlement value because of the substantial legal and business costs associated with being a defendant in a fraud lawsuit through a decision on motions to dismiss. Congress observed,

> The dynamics of private securities litigation create powerful incentives to settle, causing securities class actions to have a much higher settlement rate than other types of class actions. Many such actions are brought on the basis of their settlement value. The settlement value to defendants turns more on the expected costs of defense than the merits of the underlying claim. The Supreme Court has recognized that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."

S. REP. NO. 104-98, at 6, *reprinted in* 1995 U.S.C.C.A.N. 679, 685.

48. Research on claiming shows that most of the people who have legal claims choose not to file actions in pursuit of those claims. One can only speculate as to how many fully informed class members would choose to pursue the claims in particular class actions. Cases that would not be seen by most class members as claimworthy are referenced herein as "unnecessary." The current flat fee structure may present the opportunity for "the tail to wag the dog" by creating a class counsel fee incentive to pursue actions that few class members would view as claimworthy.

Consequently, more vigorous pursuit of strong cases combined with elimination of cases perceived to be unnecessary is likely to produce greater levels of compliance with government regulations.[49] This suggests that shareholders stand to benefit from changes in the securities litigation system that would implement these principles.

One way to encourage this approach would be to realign the fee awards for class counsel in a way that eliminates any financial incentive to bring frivolous or unnecessary cases, while rewarding counsel for good recoveries.[50] Movement toward a more graduated fee schedule would focus private enforcement efforts where they can achieve the biggest recoveries and most efficiently produce greater deterrence.

Deterrence could also be enhanced by emphasizing the certainty and severity of sanctions against culpable individuals through vigorous pursuit of personal contributions to damage payments where appropriate. People commit securities fraud, not companies. Nevertheless, in cases where directors and officers of a company are named as defendants, an average of seventy percent of the settlement amount is paid by insurance companies, 29.7 percent by the defendant company, and only 0.3 percent by the officers and directors personally.[51] With so little at stake personally, it is easy to see how the current system provides only minor disincentives to the commission of securities fraud.

Finally, pursuing corporate governance changes that make it more difficult to engage successfully in fraud could also be effective in enhancing deterrence. Shareholders have devoted substantial efforts to enhancing corporate value through addition of independent directors to boards, creation of independent audit, compensation and nominating committees, and development of compensation policies that align the interests of corporate officers and shareholders. One thing that has received little attention is the impact that such efforts are also likely to have on deterrence of corporate fraud. Management changes and imposition of good corporate governance practices can be effective tools to protect shareholders from corporate wrongdoers.

Each of these methods of enhancing deterrence can be pursued by shareholders either through service as lead plaintiffs or through alternative methods, where the costs of being lead plaintiff are seen as outweighing the benefits.[52]

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49. Research has shown that selective enforcement strategies that take into consideration the particular circumstances of a violation can be more effective in producing system-wide cooperation and compliance than rule-oriented strategies that seek to coerce compliance through maximal detection and sanctioning of all violations. *See* John T. Scholz, *Cooperation, Deterrence, and the Ecology of Regulatory Enforcement*, 18 L. & SOC'Y REV. 179 (1984).

50. For example, it might be that a contingency fee of 10% for recoveries below a certain amount (such as $1 or $2 million, depending on the case) rather than the current average fee of 32% regardless of outcome, would eliminate financial incentives for lawyers to bring cases that are frivolous or not claimworthy. An ascending scale for contingency fees from that point, as the amount of the recovery or other outcome improves, would align the interests of class counsel with its clients and create an incentive to pursue good cases vigorously.

51. *See* NERA REPORT, *supra* note 9, at 17.

52. For instance, when not serving as lead plaintiff, a class member could object to a settlement that does not contain an appropriate deterrence component or seek an active monitoring role to par-

Corporate governance changes can also be pursued by current shareholders outside of lawsuits through shareholder resolutions or direct negotiations with management.

III

CONCLUSION

Deterrence of corporate fraud is one of the primary goals of private securities litigation. Class members and the courts can enhance this deterrence function by encouraging changes in the structure of fee awards to class counsel so that they have no financial incentive to bring frivolous or unnecessary cases and are motivated to focus on cases where strong sanctions can be obtained. In addition, strategies pursued in lawsuits could enhance deterrence by aggressively seeking recoveries from individuals whose conduct was egregious or who personally benefited from the fraud, and by emphasizing corporate governance changes that would address the causes of violations.

Because of their broad market holdings, institutional investors are the most likely to have the incentives and sophistication to direct the course of litigation in ways that maximize deterrence, while still pursuing compensation for their losses as large claimants and seeking to protect honest officers and directors who act in good faith, in order to attract and retain qualified corporate officials. Institutions can pursue these goals either by serving as lead plaintiffs or through alternative means of bringing their concerns and viewpoints before the courts. Additionally, corporate governance changes can be pursued by shareholders outside the context of litigation.

The extent to which institutions play these roles will depend much upon whether the courts facilitate it. If uncertainties about costs and liabilities associated with serving as lead plaintiff are addressed by the courts in ways that encourage institutions to serve and if the courts permit institutions to be heard as class members outside the role of lead plaintiff, the benefits that could come from their active involvement will be more likely to materialize.[53] By providing comments to the court and by supervising lead counsel in securities litigation, institutions could restore the balance between client, counsel, and judge that

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ticipate in settlement discussions in order to negotiate imposition of deterrent relief. Class members could ask the court to ensure that a competitive process is used to select lead counsel that will result in a fee schedule that aligns the interests of counsel with those of the class. Institutional investors could also benefit the class by using their expertise to evaluate the value of any non-monetary component of a settlement (*e.g.*, warrants for company stock). Similarly, they could also request that class counsel be compensated on the same basis as the class (*e.g.,* be paid in warrants) to maximize continuity of interests. Where necessary to create an incentive to pursue non-monetary relief, other compensation structures could be considered.

53. As Congress put it, "increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." *See* H.R. REP. NO. 104-369, at 34, *reprinted in* 1995 U.S.C.C.A.N. 679, 733. "The Committee believes that an institutional investor acting as lead plaintiff can, consistent with its fiduciary obligations, balance the interests of the class with the long-term interests of the company and its public investors." S. REP. NO. 140-369, at 11, *reprinted in* 1995 U.S.S.C.A.N. 679, 690.

has been a basic principal of our civil justice system. Institutional investors just might be the physicians that can bring a dose of reality to the schizophrenic world of securities class actions.