

SECURITIES LAW—THE EROSION OF SECURITIES CLASS ACTIONS

I. INTRODUCTION

“Start with arrogance. Add greed, deceit, and financial chicanery. What do you get? A company that wasn’t what it was cracked up to be.”¹ Enron, AOL, Charles Ponzi, and Bernard Madoff have become household names because they, along with many others, belong to some of the most egregious United States securities law violators.² Since the 1920s, securities violations have resulted in the loss of many billions of American dollars.³ A security represents a right in something else, such as stock with an accompanying right in a corporation or an investment contract with an accompanying right in a profit-seeking undertaking.⁴ Money lost from securities investments includes loss from market forces and loss from mismanagement of corporate funds,⁵ but a significant portion of money lost is attributable to fraudulent activities involving securities.⁶ Fraudulent activities include misstatements

1. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, No. H-01-3624 (consolidated complaint for violation of the securities laws), 1 (S.D. Tex. April 8, 2002) (quoting Fortune Magazine).

2. Other well-known violators of the U.S. securities laws include WorldCom, Inc., Bank of America, Philip Morris, and the KPMG accounting firm. See Sherrie Raiken Savett, *Securities Class Actions Since the 1995 Reform Act: A Plaintiff’s Perspective*, ALI-ABA 510, 535–37 (May 4–5, 2006), http://files.aliaba.org/thumbs/datastorage/skoobesruoc/pdf/CL085_chapter_11_thumb.pdf; *Top Ten Settlements Post-Reform Act Securities Class Action Settlements*, STANFORD SECURITIES CLASS ACTION CLEARINGHOUSE, http://securities.stanford.edu/top_ten_list.html (last visited Mar. 28, 2012).

3. See ELLEN M. RYAN & LAURA E. SIMMONS, *SECURITIES CLASS ACTION SETTLEMENTS: 2009 REVIEW AND ANALYSIS* 4–5 (2010), available at http://securities.stanford.edu/Settlements/REVIEW_1995-2009/Settlements_Through_12_2009.pdf (an empirical study of “plaintiff-style” damages in securities actions based on settlement figures). See also *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity and Facilitates Capital Formation*, SECURITIES AND EXCHANGE COMMISSION, <http://sec.gov/about/whatwedo.shtml> (last modified Oct. 24, 2012) [hereinafter *The Investor’s Advocate*] (briefly discussing “the SEC’s history, responsibilities, activities, organization, and operation” as well as briefly describing a few securities laws).

4. THOMAS LEE HAZEN, *SECURITIES REGULATION IN A NUTSHELL* 27–39 (10th ed. 2009); MARC I. STEINBERG, *SECURITIES REGULATION* 39–46 (1986).

5. William A. Niskanen, *A Crises of Trust*, in *AFTER ENRON: LESSONS FOR PUBLIC POLICY* 2–9 (William A. Niskanen ed., 2005).

6. 1 HAROLD S. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* 23–29 (2009–2010).

in a company's prospectus, questionable or false financial reporting, and abnormal accounting practices.⁷

Beginning in 1911, with the goal of providing protection to securities investors, states enacted blue sky laws.⁸ Blue sky laws are conduct-regulating statutes that seek to protect investors from potential security fraud.⁹ In an attempt to achieve uniform regulation in the field of securities, Congress enacted various pieces of legislation between 1933 and 2002.¹⁰ As distinguished from blue sky laws, the federal securities laws are notice statutes designed to assist investors in making informed decisions related to the purchase and sale of securities.¹¹ The federal securities laws include multiple fraud provisions and a private right of action, which serve as a remedy to defrauded investors.¹² Private securities actions serve as a necessary supplement to the United States Securities and Exchange Commission's¹³ (SEC) enforcement activities and deter securities law violations.¹⁴ Without this private right of action, millions of stockholders and employees with pension and 401k plans would be vulnerable to securities law violators, and they would be at risk of permanently losing their investments without any mechanism for redress.

While the private right of action is "the primary vehicle for compensating defrauded investors,"¹⁵ it is usually cost prohibitive for a single investor.¹⁶ As a result, one of the most effective ways to address securities fraud is through a securities class action.¹⁷ Securities class actions are recognized

7. Savett, *supra* note 2, at 504.

8. STEINBERG, *supra* note 4, at 5. *See also* 1–2 BLOOMENTHAL, *supra* note 6, at 28, 681–84. Many state securities laws, known as "blue sky" laws, contain anti-fraud provisions, which include private rights of action. *See id.* at 694. These laws parallel the various legislative provisions enacted by Congress. *See also* 50 STATE STATUTORY SURVEYS: BLUE SKY LAWS: SECURITIES VIOLATIONS 12 (2011).

9. STEINBERG, *supra* note 4, at 5.

10. *In re Enron Corp. Sec.*, 535 F.3d 325, 337 (5th Cir. 2008).

11. STEINBERG, *supra* note 4, at 6–7.

12. *See* John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 337 (1996).

13. The SEC is the agency charged with the principal responsibility of enforcing and administering federal securities laws. *The Investor's Advocate*, *supra* note 3.

14. Avery, *supra* note 12, at 335.

15. *Id.*

16. The costs of an individual lawsuit include attorney fees, discovery, and the requirements under "security for expense statutes" to post monies to be paid to defense counsel if the court finds the plaintiff's lawsuit to be frivolous. James Cotton, *Another Nail in the Coffin of the Small Investor: The Private Securities Litigation Reform Act of 1995*, 17 Touro L. REV. 733, 734, 748–51 (2001).

17. Avery, *supra* note 12, at 371 ("Class action lawsuits generally further judicial efficiency and make it feasible for a broad group of investors who have relatively small individual claims to maintain an action for damages."); Theodore Eisenberg & Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*,

by Congress as an “indispensable tool” to provide investors with financial recovery for their losses.¹⁸ In the past fifteen years, Congress has enacted three pieces of legislation that have a significant impact on securities class actions: Federal Rule of Civil Procedure (FRCP) 23;¹⁹ the Private Securities Litigation Reform Act of 1995 (PSLRA);²⁰ and the Securities Litigation Uniform Standards Act of 1998 (SLUSA)²¹ (collectively, the “securities legislation”). These three pieces of legislation were designed to improve federal class action litigation,²² in part, to provide more effective representation for investors, decrease frivolous lawsuits, and provide increased recovery for plaintiffs.²³

This note examines interrelated provisions of the securities legislation and the resulting impact on the effectiveness of class actions as a remedy for settling disputes. Part II of the note will discuss securities class actions as well as the background, history, and intended goal of each relevant legislative provision. Part III will discuss the securities legislation’s impact on the availability of securities class actions, the parties to those class actions, and the discord between the goal of the legislation and the practical application as related to settlement opt-out claims. Part IV will discuss existing mechanisms that may serve as viable solutions to this emerging problem and will propose a new solution to the problem. Finally, Part V briefly concludes by summarizing the information and findings of this note.

57 VAND. L. REV. 1529, 1530 (2004) (“Class actions are a useful means for achieving economies of scale in litigation, facilitating the prosecution of claims that would be uneconomic to litigate individually, and strengthening enforcement of the laws.”).

18. Lisa L. Casey, *Class Action Criminality*, 34 J. CORP. L. 153, 162–63 (2008).

19. FED. R. CIV. P. 23.

20. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77k, 77l, 77t, 77z-1, 77z-2, 78a, 78j-1, 78t, 78o, 78u, 78u-4, 78u-5 and 18 U.S.C. § 1964 (2006)).

21. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. §§ 77, 77aa, 77aaa, 77b, 77ccc, 77ddd, 77k, 77m, 77mmm, 77p, 77r, 77sss, 77v, 77z-1, 77z-2, 77z-3, 78, 78bb, 78c, 78d, 78ee, 78g, 78kk, 78ll, 78n, 78o, 78o-4, 78o-5, 78q, 78s, 78t, 78u-4, 78z, 80a, 80a-1, 80a-18, 80a-2, 80a-29, 80a-3, 80a-30, 80b, 80b-18a and 80b-3 (2006)).

22. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 74, 82–83, 88 (2006).

23. Avery, *supra* note 12, at 336, 348; Adam C. Pritchard, *Should Congress Repeal Securities Class Action Reform?*, in *AFTER ENRON: LESSONS FOR PUBLIC POLICY* 130–31 (William A. Niskanen ed., 2005).

II. BACKGROUND

A. Securities Class Actions

The life of a class action begins at certification and usually ends at dismissal or settlement.²⁴ Securities actions are the largest category of class actions, and they usually take the form of a class action because this device makes the pursuit of small individual recoveries economical.²⁵ The most common securities class action is based on fraud.²⁶ There are at least nine fraud-related provisions²⁷ in the securities law statutory scheme, and several of these provisions provide an express or implied right of action, which is necessary to initiate litigation.²⁸ Furthermore, in securities fraud class actions, the plaintiff sues the corporation and its officers for misrepresentations regarding the company's financial performance.²⁹

The steps toward trial and resolution in a securities class action are similar to the procedures in any other lawsuit (motions, pre-trial hearings, discovery, etc.), but they are conducted and regulated differently in a securities class action, and the securities legislation now substantially impacts these procedures. The securities legislation created several procedural hurdles that a plaintiff must overcome to defeat summary judgment and move past the initial stage of filing a complaint.³⁰ If a plaintiff can successfully overcome these procedural hurdles, the securities class action proceeds much like any other lawsuit, with the majority of claims being resolved through settlement.³¹ Settlement, however, is another area significantly complicated by the securities legislation.³²

24. Michael J. Kaufman & John M. Wunderlich, *The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions*, 43 U. MICH. J.L. REFORM 323, 324 (2010); Melissa Colón-Bosolet, *The Elusive Nine: Securities Class-Action Trials Since 1995*, A.B.A. COM. & BUS. LITIG., Summer 2010, at 1, 14–17 (only nine securities class actions have been resolved by trial in the past fifteen years).

25. Kaufman & Wunderlich, *supra* note 24, at 324.

26. See Savett, *supra* note 2, at 508. See generally BLOOMENTHAL, *supra* note 6, at 26–33 (discussing general fraud provisions and introducing actions for fraud in the sale of securities).

27. Frequently cited fraud-related provisions of the Securities Act include: Section 10b and Rule 10b-5, Section 11, Section 12(a), Section 17, Section 18, and Section 20(a). BLOOMENTHAL, *supra* note 6, at 25–31.

28. BLOOMENTHAL, *supra* note 6, at 25–31.

29. Pritchard, *supra* note 23 at 126–30.

30. See 15 U.S.C. §§ 77k, 77l, 77p, 77v, 77z-1, 77z-2, 78a, 78j-1, 78t, 78u, 78u-4, 78u-5, 78bb (2006); 18 U.S.C. § 196 (2006); FED. R. CIV. P. 23; Kaufman & Wunderlich, *supra* note 24, at 324–29.

31. See Savett, *supra* note 2, at 509; CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 2009: A YEAR IN REVIEW, 21–22 (2010), available at

B. Legislation

While the securities legislation was designed to permit the fair resolution of legitimate claims, it does not operate fairly for all parties.³³ In fact, the legislative intent and the actual effect of the securities legislation are vastly different. Although aspects of the securities legislation offer many positive results to class action plaintiffs, such as increased settlement amounts³⁴ and decreased attorney fees,³⁵ upon closer examination one can see that the securities legislation produces a significant negative impact overall. Some of the problems caused by the securities legislation include procedural hurdles that operate in favor of defendants, increased participation in and influence upon class actions by institutional investors, and increased dismissal rates for class actions.³⁶

Each piece of the securities legislation has a different purpose and goal. FRCP 23 applies to all class actions brought in federal court.³⁷ PLSRA is applicable to all private actions involving securities that must be registered under the Securities Act of 1933 and securities that are traded under the Securities Exchange Act of 1934.³⁸ SLUSA is applicable to class actions with more than fifty plaintiffs whose lawsuit involves securities covered under the Securities Act of 1933 and the Securities Exchange Act of 1934.³⁹ Taken together, the securities legislation applies to a group of fifty or more plaintiffs bringing litigation in federal court to exercise a private right of action regarding a registered or traded security under the Securities Act of 1933 or the Securities Exchange Act of 1934.

http://securities.stanford.edu/clearinghouse_research/2009_YIR/Cornerstone_Research_Filings_2009_YIR.pdf.

32. See 15 U.S.C. §§ 77k, 77l, 77p, 77v, 77z-1, 77z-2, 78a, 78j-1, 78t, 78u, 78u-4, 78u-5, 78bb; 18 U.S.C. § 196; FED. R. CIV. P. 23; Kaufman & Wunderlich, *supra* note 24, at 344–49.

33. Kaufman & Wunderlich, *supra* note 24, at 330. See also Avery, *supra* note 12, at 335 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)); Cotton, *supra* note 16, at 733–39 (discussing the hurdles small investors face “in obtaining information relating to potential fraud and misrepresentation by corporate management”).

34. Savett, *supra* note 2, at 508–09. See also RYAN & SIMMONS, *supra* note 3, at 1–5.

35. Pritchard, *supra* note 23, at 131–32.

36. Savett, *supra* note 2, at 503–14.

37. FED. R. CIV. P. 23.

38. 15 U.S.C. §§ 77z-1, 77u-4. The Securities Act of 1933 was enacted after the stock market crash of 1929. STEINBERG, *supra* note 4, at 6. The Act requires that any offer or sale of securities using the means and instrumentalities of interstate commerce be registered pursuant to the 1933 Act unless an exemption from registration exists under the law. *Id.* at 16–18. The Securities Exchange Act of 1934 governs the trading of securities after their initial public offering and regulates the U.S. financial markets and those who trade on them. *Id.* at 18–21. This Act also established the Securities and Exchange Commission. *Id.* at 6.

39. 15 U.S.C. §§ 77p, 78bb.

1. *Federal Rule of Civil Procedure 23 (FRCP 23)*

The preliminary stage of every class action is class certification.⁴⁰ This means the securities class action plaintiff must plead and demonstrate satisfaction of the requirements of FRCP 23(a) and (b) in the initial complaint before the lawsuit can proceed.⁴¹ FRCP 23(a) requires plaintiffs to demonstrate the prerequisites of numerosity, commonality, typicality, and adequacy of representation.⁴² FRCP 23(b) requires plaintiffs to demonstrate that their action fits into one of three categories that will afford them relief:

[FRCP] 23(b)(1) class actions are maintainable if either (1) the defendant is at risk of inconsistent adjudication or (2) the class members are fighting over a limited fund. [FRCP] 23(b)(2) class actions are maintainable if the class seeks solely injunctive relief. Last, [FRCP] 23(b)(3) class actions are maintainable if questions of law and fact common to the members of the class predominate over any questions affecting only individual members.⁴³

Since the majority of securities class actions result in settlement, the grant of class certification is a vital step toward monetary recovery.⁴⁴ Because most securities class actions seek monetary damages, rather than injunctive relief or payment from a limited fund, plaintiffs most often seek certification under FRCP 23(b)(3), and they must overcome the demanding requirement of predominance.⁴⁵ Predominance “requires [the] court to consider ‘how a trial on the merits would be conducted if a class were certified,’” so that the class does not degenerate into a series of individual trials.⁴⁶

The court’s role in the certification process is the first of many procedural hurdles erected by the securities legislation. The court’s consideration of class certification requires “identifying the substantive issues that will control the outcome, assessing which issues will predominate, and then de-

40. FED. R. CIV. P. 23. See also Kaufman & Wunderlich, *supra* note 24, at 323–24.

41. FED. R. CIV. P. 23.

42. FED. R. CIV. P. 23(a). For a detailed discussion of these prerequisites, see generally John C. Coffee, Jr. & Stefan Paulovic, *Class Certification: Developments Over the Last Five Years 2002-2007 The Future of Class Actions*, 8 CLASS ACTION LITIG. REP. (BNA) S-787 (2007).

43. Kaufman & Wunderlich, *supra* note 24, at 325. See also *In re Global Crossing Sec. & ERISA Litig.*, 225 F.R.D. 436, 453–55 (S.D.N.Y. 2004).

44. Kaufman & Wunderlich, *supra* note 24, at 323. See also Colón-Bosolet, *supra* note 24, at 1, 14–17 (noting that most securities actions end in settlement and discussing the nine class-action trials since 1995).

45. See Coffee & Paulovic, *supra* note 42, at 196, 216.

46. *Gene & Gene, LLC v. BioPay, LLC*, 541 F.3d 318, 326 (5th Cir. 2008) (quoting *Bell Atl. Corp. v. AT&T Corp.*, 339 F.3d 294, 302 (5th Cir. 2003)).

termining whether the issues are common to the class.”⁴⁷ Unfortunately, federal courts have turned the class certification process into a mini trial, requiring plaintiffs to prove or proffer elements of their securities fraud case, thereby jeopardizing valid fraud claims and plaintiff recovery.⁴⁸ FRCP 23 makes the court the sole arbiter in determining whether the proposed class is “sufficiently cohesive to warrant adjudication by representation.”⁴⁹ In the statutory scheme of securities class actions, once a plaintiff overcomes the hurdles of FRCP 23, the class must also address PSLRA, which among other things requires a heightened pleading standard that must be taken into account when seeking class certification.⁵⁰

2. *Private Securities Litigation Reform Act of 1995 (PSLRA)*

PSLRA is a comprehensive “revision of both substantive and procedural law governing private [class] actions under the federal securities laws.”⁵¹ PSLRA was designed to reduce the number of frivolous securities class actions filed in federal court and to stop coercive settlement practices.⁵² PSLRA, however, significantly alters the treatment of meritorious claims.⁵³ Provisions that alter the treatment of meritorious claims and erect several hurdles a plaintiff must overcome include a heightened pleading standard, lead plaintiff requirements, an automatic stay of discovery pending the resolution of dismissal motions, a safe harbor for forward-looking statements,⁵⁴ a system of proportionate liability for certain defendants,⁵⁵ and mandatory sanctions for violations of FRCP 11(b).⁵⁶

One of the most daunting provisions of PSLRA is the heightened pleading requirement applicable to securities fraud actions brought under the Securities Exchange Act of 1934.⁵⁷ This heightened standard requires the plaintiff to plead facts as to each alleged fraudulent statement or omission

47. *Id.*

48. Kaufman & Wunderlich, *supra* note 24, at 323. *See generally* Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 233–34 (5th Cir. 2009).

49. *Gene & Gene*, 541 F.3d at 326 (citing *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 623–24 (1997)).

50. 15 U.S.C. §§ 78a, 77z-1, 78u-4 (2006); Avery, *supra* note 12, at 357.

51. Avery, *supra* note 12, at 335.

52. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77k, 77l, 77z-1, 77z-2, 78a, 78j-1, 78t, 78u, 78u-4, 78u-5 and 18 U.S.C. § 1964); Avery, *supra* note 12, at 353–54.

53. *See* Avery, *supra* note 12, at 354.

54. A forward-looking statement is one that is issued by the corporation and makes a projection about the company’s financial future. *Id.* at 344.

55. Defendants that have not knowingly committed a violation of the securities law are given preferential treatment and are exempt from joint and several liability. *Id.* at 361–63.

56. *Id.* at 336–37.

57. 15 U.S.C. § 78u-4(b).

and to plead with particularity facts that demonstrate the defendant had the requisite wrongful state of mind with regard to the fraudulent statement or omission.⁵⁸ “[A]n inference of scienter [or wrongful state of mind] must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.”⁵⁹ One can imagine that heightened pleading is challenging during the early stages of litigation and even more challenging at the class certification stage.⁶⁰ Before a securities fraud class is certified or any discovery has taken place, the court “must engage in a comparative evaluation . . . [and] consider, not only inferences urged by the plaintiffs . . . but also competing inferences rationally drawn from the facts alleged.”⁶¹ The heightened pleading requirement ties plaintiffs’ hands in private actions, requiring them to produce evidence they do not have and cannot obtain without the benefit of discovery.⁶²

Equally significant changes, and another procedural hurdle created by PSLRA, are the requirements for identifying the lead plaintiff and the mandate that the court choose the lead plaintiff that will represent the class.⁶³ Under PSLRA, the plaintiff named in the initial complaint is no longer the lead plaintiff; rather, the court must select from the class members the person(s) or entity that the court determines is most capable of adequately representing the interests of the class members.⁶⁴ This statutory mandate comes with a presumption, rebuttable in only two instances,⁶⁵ that the lead plaintiff should have the largest financial interest in the case.⁶⁶ PSLRA also proscribes the steps required to identify the lead plaintiff. The initial plaintiff is required to publish notice and advise class members of their opportunity to serve as lead plaintiff.⁶⁷ Any class member may come forward and request

58. 15 U.S.C. §§ 78u-4(b)(1)–(2).

59. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007).

60. *See Lapin v. Goldman Sachs & Co.*, 254 F.R.D. 168, 180–181 (S.D.N.Y. 2008).

61. *Tellabs, Inc.*, 551 U.S. at 314. *See also Elam v. Neidorff*, 544 F.3d 921, 926–27 (8th Cir. 2008).

62. *See generally Elam*, 544 F.3d at 926–30 (holding that the plaintiffs’ allegations of inflated stock prices where the defendants had access to information that conflicted with company statements did not give rise to a strong inference of scienter).

63. 15 U.S.C. §§ 77z-1(a)(2)–(3), 78u-4(a)(2)–(3); *Avery*, *supra* note 12, at 373–75.

64. *Savett*, *supra* note 2, at 513.

65. 15 U.S.C. §§ 77z-1(a)(3)(iii)(II), 78u-4(a)(3)(B)(iii)(II) (“The presumption . . . may be rebutted only upon proof by a member of the purported plaintiff class that the presumptively most adequate plaintiff [] (aa) will not fairly and adequately protect the interests of the class; or (bb) is subject to unique defenses that render such plaintiff incapable of adequately representing the class.”).

66. 15 U.S.C. §§ 77z-1(a)(3)(B)(iii)(I)(bb), 78u-4(a)(3)(B)(iii)(I)(bb). *See also Avery*, *supra* note 12, at 336–37.

67. 15 U.S.C. §§ 77z-1(a)(3)(A)(i)(II), 78u-4(a)(3)(A)(i)(II). *See also Savett*, *supra* note 2, at 513.

to be considered as lead plaintiff.⁶⁸ Serving as lead plaintiff is significant because, as the class representative, the lead plaintiff makes binding decisions regarding how the action goes forward, including decisions such as the selection of class counsel.⁶⁹

Plaintiffs' attorneys fuel and control class actions.⁷⁰ During the last decade, as many as half of all settled securities class actions were litigated by the law firms of Milberg, Weis, Bershad, Hynes & Lerach and Coughlin, Stoia, Geller, Rudman & Robbins.⁷¹ Class action plaintiffs' attorneys do not wait for clients to come to them, but, instead, they often seek out potential class members.⁷² These attorneys investigate the potentially fraudulent violations of securities law and devote significant resources to building a case, all in pursuit of attorney fees.⁷³ With the enactment of PSLRA, recovery of historically high attorneys' fees declined.⁷⁴ The decline in revenue for attorneys, coupled with the increased regulation of federal court class actions as compared to state court actions,⁷⁵ led many securities class action attorneys to control their litigation by filing actions in more plaintiff-friendly and less regulated state courts.⁷⁶ Plaintiffs' attorneys began using blue sky laws,⁷⁷ which exist in almost every state, to circumvent FRCP 23 and PSLRA. In response to such attempts to circumvent the federal legislation, Congress enacted SLUSA.⁷⁸

68. Savett, *supra* note 2, at 514.

69. 15 U.S.C. §§ 77z-1(a)(3)(B)(v), 78u-4(a)(3)(B)(v).

70. See Pritchard, *supra* note 23, at 131.

71. RYAN & SIMMONS, *supra* note 3, at 14; Mukesh Bajaj, Sumon C. Mazumdar & Atulya Sarin, *Securities Class Action Settlements: An Empirical Analysis*, 43 SANTA CLARA L. REV. 1001, 1030–31 (2003); CORNERSTONE RESEARCH, *supra* note 31, at 28. Milberg Weis and Coughlin Stoia are plaintiffs' law firms based in New York, New York.

72. Casey, *supra* note 18, at 156–58 (2008).

73. *Id.* at 157–58.

74. Pritchard, *supra* note 23, at 131–32 (discussing attorneys' fees pre-PSLRA and the practical effect of the PSLRA regulations). See also 15 U.S.C. §§ 77z-1(a)(6)–(a)(7)(C) (restricting attorneys' fees).

75. See Edward F. Sherman, *Class Action Fairness Act and the Federalization of Class Actions*, 238 F.R.D. 504, 505–06 (2007). See generally *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (discussing the private right of action under federal law as compared to state law).

76. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 82 (2006).

77. See *supra* note 8 and accompanying text.

78. Securities Litigation Reform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. §§ 77p, 77v, 77z-1, 78u-4, 78bb (2006)); John G. Despriet & Shayne R. Clinton, *Evolution of the Securities Litigation Uniform Standards Act*, 33 SEC. REG. L.J. 268, 268–69 (2005).

3. *Securities Litigation Uniform Standards Act of 1998 (SLUSA)*

SLUSA was enacted after PSLRA to ensure that PSLRA fully achieved its objectives.⁷⁹ SLUSA is targeted directly at securities fraud class actions, and it prevents a private party from bringing a class action alleging “an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security or [alleging] that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.”⁸⁰

Congress wanted to curb litigation that circumvented PSLRA’s federal court requirement and distorted the efficient operation of the national securities market.⁸¹ The basic thrust of SLUSA is to require that all “covered class actions”⁸² based on state laws be removed to federal district court.⁸³ A “covered class action” is a lawsuit in which

(I) damages are sought on behalf of more than [fifty] persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—

(I) damages are sought on behalf of more than [fifty] persons; and

79. Securities Litigation Reform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. §§ 77p, 77v, 77z-1, 78u-4, 78bb).

80. 15 U.S.C. §§ 77p(b)-(c) (emphasis added). “The term ‘covered security’ means a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 18(b) of the Securities Act of 1933 [15 U.S.C. § 77r(b)], at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred . . .” 15 U.S.C. § 78bb(f)(5)(E). “Section 18(b) of the 1933 Act in turn defines covered security to include securities listed on a national exchange.” 15 U.S.C. § 77r(b). *See also Merrill Lynch*, 547 U.S. at 84 (“covered security” includes one that is “traded nationally and listed on a regulated national exchange”).

81. Despriet & Clinton, *supra* note 78, at 268. *See also In re Enron Corp. Sec.*, 535 F.3d 325, 337–38 (5th Cir. 2008).

82. 15 U.S.C. § 78bb(f)(5)(B).

83. Securities Litigation Reform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. §§ 77p, 77v, 77z-1, 78u-4, 78bb).

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.⁸⁴

SLUSA was designed to close a loophole in PSLRA that allowed plaintiffs to litigate securities fraud class actions under state law and bypass the PSLRA requirements.⁸⁵

SLUSA preempts a securities class action if four conditions are satisfied: (1) the action is a “covered class action;” (2) the claims are based on state law; (3) the action involves one or more “covered securities;” and (4) the claims allege a misrepresentation or omission of material fact “in connection with the purchase or sale” of the security.⁸⁶

SLUSA functions as both a preemption and removal statute.⁸⁷ Once the defendant removes the action from state to federal court, the court must determine if SLUSA preempts state law claims, and if it does, the court must dismiss the claims.⁸⁸ Courts interpret SLUSA broadly to ensure the effectiveness of its stated purpose,⁸⁹ but one detrimental effect of SLUSA is that certain claims are barred from litigation in both federal and state court, leaving many individual plaintiffs without a remedy.⁹⁰

C. Settlement

Once a class is certified and a lead plaintiff is chosen, the issue of money can be addressed. In a class action, monetary recovery can be accomplished by final judgment or settlement, with settlement occurring most often.⁹¹ Another lead-plaintiff decision involves settlement.⁹² Legislators and courts view settlements favorably, and this is especially true in class actions because settlement encourages compromise and the conservation of judicial resources.⁹³

Without settlement agreements, some plaintiffs would be completely without recovery, yet the securities legislation erects hurdles in this stage of

84. 15 U.S.C. § 78bb(f)(5)(B). *See also Merrill Lynch*, 547 U.S. at 84 n.8.

85. *In re Enron Corp. Sec.*, 535 F.3d at 338.

86. *Id.* at 338–39.

87. *Id.* at 341.

88. *Despriet & Clinton*, *supra* note 78, at 273.

89. *See Merrill Lynch*, 547 U.S. at 86.

90. Securities Litigation Reform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. §§ 77p, 77v, 77z-1, 78u-4, 78bb); *Merrill Lynch*, 547 U.S. at 74 (SLUSA preempts state law class actions that have no remedy under federal law).

91. *Colón-Bosolet*, *supra* note 24, at 1.

92. *See generally* *Newby v. Enron Corp.*, 394 F.3d 296, 300 (5th Cir. 2004) (where representative plaintiffs agreed to a partial settlement and several groups intervened to object to the partial settlement).

93. *See In re Global Crossing & ERISA Litig.*, 225 F.R.D. 436, 455 (S.D.N.Y. 2004).

the litigation as well.⁹⁴ PSLRA requires a detailed disclosure of proposed, partial, or final settlements to all class members,⁹⁵ while at the same time FRCP 23 requires a showing of procedural fairness and desirable results.⁹⁶ An approvable settlement must be “fair, adequate, and reasonable and not the product of collusion between the parties.”⁹⁷ Because of the importance of settlements to plaintiffs’ recovery,⁹⁸ recent court decisions have even approved partial settlements.⁹⁹ Once a class action settlement is approved, it can only be set aside for an abuse of discretion.¹⁰⁰

D. Objectors and Opt-Outs

Plaintiffs who are unhappy with settlement terms have two options—formally object or opt out of the settlement.¹⁰¹ The ability to object or self-exclude, provided by FRCP 23(c) and allowed in FRCP 23(b)(3) cases,¹⁰² has become a fundamental aspect of class action litigation.¹⁰³ Opt-out rights are considered a favorable means of protecting plaintiffs, particularly absent ones, from abuses in litigation.¹⁰⁴ Unfortunately, the possibility of mass numbers of plaintiffs exercising opt-out rights can threaten a negotiated class settlement.¹⁰⁵ When too many plaintiffs opt out, the judge has to determine how to proceed with the litigation. Options include using judicial discretion to either approve or deny the settlement agreement as to all remaining plaintiffs in the class or to decertify the class.¹⁰⁶ In cases where the settlement is denied or the class is decertified, litigation is affected, causing additional delays in recovery for class plaintiffs who must choose between dismissing the class action, litigating to the conclusion of the class action, or, if the class is decertified, litigating multiple individual or small group lawsuits in state court.¹⁰⁷

Taken together, the securities legislation funnels securities class action lawsuits into federal district courts and requires that litigation proceed based

94. *Newby*, 394 F.3d at 301–02.

95. 15 U.S.C. §§ 77z-1(a)(7), 78u-4(a)(7).

96. FED. R. CIV. P. 23(e); *In re Global Crossing*, 225 F.R.D. at 455.

97. *Newby*, 394 F.3d at 301.

98. *Id.* at 302; *In re Global Crossing*, 225 F.R.D. at 455–56.

99. *Newby*, 394 F.3d at 298–99; Avery, *supra* note 12, at 365.

100. *Newby*, 394 F.3d at 300.

101. *See, e.g., id.* at 296; Eisenberg & Miller, *supra* note 17, at 1531.

102. FED. R. CIV. P. 23(c)(2)(a).

103. Eisenberg & Miller, *supra* note 17, at 1531.

104. *Id.* at 1534–35.

105. *Id.* at 1537.

106. FED. R. CIV. P. 23.

107. *In re Global Crossing Sec. & ERISA Litig.*, 225 F.R.D. 436, 455–457 (S.D.N.Y. 2004) (discussing judicial approval of class action settlements).

upon federal securities laws. The securities legislation also regulates the content of the pleadings and creates substantial hurdles for class action certification and ensuing litigation. The requirements and regulations contained in the securities legislation essentially curtail the plaintiffs' legal remedies by significantly regulating and limiting the litigation of meritorious claims.

III. THE EROSION OF THE SECURITIES CLASS ACTION DEVICE

A. Impact of Securities Legislation

Class action reform “was a victory for accountants, securities firms, and the high-technology industry,” but it was a blow to the plaintiffs’ bar.¹⁰⁸ The reform is considered a victory because of the numerous protections afforded to business and financial industries, but the numerous hurdles erected complicate the initiation and pursuit of a securities class action for plaintiffs. Protections for defendants, such as the rule for proportionate liability and forward-looking statements, and hurdles, such as automatic stays of discovery and heightened pleading standards, operate against plaintiffs. Now, “[t]o be successful, a securities class-action plaintiff must thread the eye of a needle made smaller and smaller over the years by judicial decree and congressional action. [These] ever higher hurdles are not, however, intended to prevent viable securities actions from being brought.”¹⁰⁹ However intended, the years of judicial decree and congressional action have created conditions that facilitated scandals like Enron and Worldcom and fraud by CEOs such as Bernie Madoff.

The securities legislation’s procedural formalities and substantive provisions, with which the plaintiff must comply, coupled with protections afforded to the defendant, create a shield for the defendant, allowing for varying levels of deception, lying, and unaccountability. The plaintiffs’ bar argues that the restrictions on class actions gives “corporations carte blanche to engage in fraud.”¹¹⁰ For example, a defendant that issues a prospectus with exceptional statements regarding financial projections is protected from litigation so long as the statements are denoted as forward-looking. Meanwhile, because of their reduced ability to bring successful litigation, the individual investor has become the victim of unintended consequences,¹¹¹ and

108. Pritchard, *supra* note 23, at 125–26.

109. Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 235 (5th Cir. 2009).

110. Pritchard, *supra* note 23, at 126.

111. Cotton, *supra* note 16, at 739.

institutional investors are emerging as goliaths of the plaintiff securities class action.¹¹²

Increased participation from institutional investors in securities class actions can cause a problem or provide a solution. Institutional investors are likely to be chosen as the lead plaintiff because they are viewed by the courts as having the necessary size and financial resources necessary to meet PSLRA's mandate.¹¹³ As a strong lead plaintiff, an institutional investor can successfully guide a class action and effectuate a preferential settlement for all members. However, institutional investors also have "the economic incentive and financial wherewithal to pursue their own actions . . . and are opting out of class actions and proceeding on their own."¹¹⁴ Whether as a lead plaintiff or class member, an institutional investor that opts out of a class action weakens the action by removing multiple plaintiffs and vast resources.¹¹⁵

An emerging and fast-growing problem created by the securities legislation is that of opt-outs.¹¹⁶ Opt-outs occur when members of the certified class choose to opt out of the class action and pursue settlement or continued litigation as an individual plaintiff or small group.¹¹⁷ Plaintiffs consider opting out when settlement is a disadvantage because of the small amount of potential recovery per plaintiff.¹¹⁸ The extensive lag-time between case-filing and case resolution created by the securities legislation¹¹⁹ encourages plaintiffs, especially institutional investors, to opt out of the class action in an attempt to receive increased or quicker monetary relief.¹²⁰ By opting out, an institutional investor also gains complete control over the prosecution of its claims.¹²¹ The institutional investor becomes the only plaintiff, avoiding many of the restrictions that come from class representation. Once out of the class action, the institutional investor has increased authority over and flexibility throughout the litigation.¹²² The institutional investor can now select

112. See Bailey Cavaleeri LLC, *Securities Class Action Opt-Out Claims: A Growing Problem*, BAILEYCAVALEERI.COM, http://www.baileycavaleeri.com/73-Securities_Opt_Out_Claims.pdf (last visited May 10, 2012).

113. See *supra* Part II.B.2.

114. Michael Feldberg & Lanier Saperstein, *Class Certification: Bigger Is Not Necessarily Better*, ALLEN & OVERY (Feb. 6, 2009), http://clientlink.allenoverly.com/images/NYPR-BIN/links/Class_certification_bigger_is_not_necessarily_better.pdf.

115. See Eisenberg & Miller, *supra* note 17, at 1536–40; *supra* Part II.D.

116. See Dan Bailey, *Securities Class Action Opt-Out Claims: A Growing Problem*, 2010 EMERGING ISSUES 4975 (2010).

117. See Eisenberg & Miller, *supra* note 17, at 1544.

118. *Id.* at 1533.

119. CORNERSTONE RESEARCH, *supra* note 31, at 2.

120. See Bailey Cavaleeri LLC, *supra* note 112, at 1.

121. *Id.*

122. *Id.* ("By opting out, the institutional investor has the opportunity to actively control the prosecution of its own claims, file the case in its own state, and, most importantly, negoti-

legal counsel; negotiate attorneys' fees; settle the action at any time for any amount (which increasingly is for a larger dollar amount than offered to original class members); and use its size, stature, and time in the class action as leverage in settlement negotiations or at trial.¹²³

Further, when opting out, an institutional investor, an individual, or a small group under fifty in number has the option to pursue litigation in state court.¹²⁴ In a state court action, an investor may bring claims with a broader scope of liability and allege damages against a larger number and more varied type of corporate wrongdoers (including aiders and abettors),¹²⁵ while avoiding the litigation hurdles, limitations, and delays imposed by federal securities laws, including heightened pleading standards and the discovery stay under PSLRA.¹²⁶

By participating as a class member and employing a wait-and-see approach, an institutional investor can either attempt to negotiate a settlement of its claims with defendants before opting out of the class or, if negotiations are not successful, the institutional investor may opt out before class settlement and proceed with a direct action against the defendants, using all the information gained and legal resources exerted by class counsel during its time as a class member.¹²⁷ The ability to participate as a class member and opt out at a later date seemingly creates an incentive to use all available resources (class participation) to gain the best possible settlement, which may come from an individual action rather than participating as a class member.¹²⁸ Headlines throughout the past ten years have highlighted the difference between recoveries for class members and recoveries for individual actions or opt-outs.¹²⁹ These headlines demonstrate larger recoveries for

ate a larger recovery than it would have received as a passive participant in the class action.”).

123. *Id.* at 2–3; Blair A. Nicholas & Ian D. Berg, *Why Institutional Investors Opt-Out of Securities Fraud Class Actions and Pursue Direct Individual Actions*, PRAC. L. INST. (Oct. 15, 2009), http://www.blbgilaw.com/news/publications/data/00113/res/id=sa_File1/PLIreprint7_22_09#2.pdf.

124. Bailey Cavaleeri LLC, *supra* note 112, at 1; Nicholas & Berg, *supra* note 123.

125. *See, e.g.*, Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994) (disallowing aider and abettor liability for 10b and 10-b5 claims, while some state courts expressly allow for it); Nicholas & Berg, *supra* note 123.

126. PSLRA includes a provision that requires the stay of discovery during pendency of a motion to dismiss or motion for summary judgment. Nicholas & Berg, *supra* note 123.

127. *See id.*

128. *See Fractured Class Actions: Opt-outs Are a Growing Headache for Companies*, BUS. WK. (Feb. 27, 2006), http://www.businessweek.com/magazine/content/06_09/b3973059.htm; Nicholas & Berg, *supra* note 123.

129. Josh Gerstein, *Time Warner Case Finds A Surprise*, N.Y. SUN, Dec. 7, 2006, <http://www.nysun.com/national/time-warner-case-finds-a-surprise/44761>; Bailey Cavaleeri LLC, *supra* note 112, at 1–2; Feldberg & Saperstein, *supra* note 114; Kevin LaCroix, *Class Action Opt-Outs: The Impact of Competition on Securities Lawsuit Resolution*, THE D & O

institutional investors that have opted out of class actions than for those who continue as class members.¹³⁰ The opt-out behavior hinders the effectiveness of the class action device, particularly for individual investors, and exploits the securities legislation. As a result, the prospect of large and ever-increasing opt-outs makes negotiating a class settlement more difficult, increases the cost of litigation for both sides, occupies federal judicial resources, and, over time, will erode the securities class action.

B. Discord Between the Goal and the Application—The Erosion

The securities legislation has created some high hurdles that plaintiffs must clear. Some critics refer to PSLRA as the “Corporate License to Lie Act,”¹³¹ while others have commented that it may be an obstacle to investors who attempt to recover billions of lost investments due to fraud.¹³² Several cases and judicial orders demonstrate the problems with applying the securities legislation to securities class actions and the existence of the opt-out problems. Two cases in particular highlight the discord between legislative intent and application, *Enron*¹³³ and *AOL Time Warner*,¹³⁴ where the courts had to address the issues of settlement, objectors, and opt-outs.

1. *Lessons from Enron*

Enron Corporation was an energy company based in Houston, Texas.¹³⁵ Enron employed nearly 22,000 people across the United States and last reported revenues of \$101 billion.¹³⁶ In 2001, Enron investors and the business world discovered that Enron’s financial success was a result of an institutionalized and systematic procedure of accounting fraud.¹³⁷ The fraud gave rise to one of the biggest corporate scandals of the twenty-first century.¹³⁸ At the height of the company’s success, Enron stock was worth ninety dollars

DIARY (April 20, 2008), <http://www.dandodiary.com/2008/04/articles/optouts/class-action-optouts-the-impact-of-competition-on-securities-lawsuit-resolution>; *Fractured Class Actions*, *supra* note 128.

130. *See supra* note 126 and accompanying text.

131. Pritchard, *supra* note 23, at 126.

132. *Id.*

133. *Newby v. Enron Corp.*, 188 F. Supp. 2d 684 (S.D. Tex. 2002).

134. *In re AOL Time Warner S’holder Derivative Litig.*, No. 02 Civ. 6302 (CM), 2009 U.S. Dist. LEXIS 124372 (S.D.N.Y. Feb. 1, 2010).

135. *In re Enron Corp.*, 17 FCC Rcd. 624, 625 (2002).

136. *Id.*

137. *Newby*, 188 F. Supp. 2d at 691–92.

138. *In re Enron Corp. Sec. Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 613 (S.D. Tex. 2002).

per share.¹³⁹ By the time the scandal was fully disclosed the company's stock was worth pennies.¹⁴⁰

Enron's practice was to create limited liability subsidiaries, in the United States and in several foreign countries, and to place debts and financial losses on the books of these companies in order to avoid reporting the losses to investors and the SEC.¹⁴¹ Enron executives were also able to inflate company stock prices by using a projection-based system of accounting, mark-to-market, which allows future anticipated profits to be counted on current company financial books.¹⁴² Enron executives had to increasingly distort company finances to create the appearance of large profits.¹⁴³ Some of the most egregious behavior occurred during the last year of the company's existence when founder and CEO, Kenneth Lay, encouraged the public and investors to have faith in him and the company.¹⁴⁴ Lay and other company executives asked investors to buy and hold their Enron stock, while they used their knowledge of company fraud and losses to sell their personal stock for over \$100 million in profit for themselves, their family members, and their friends.¹⁴⁵ These scandalous practices left investors and employees with an alleged forty-four billion dollars in losses.¹⁴⁶

In 2001, nearly sixty-seven billion dollars in debt, Enron filed bankruptcy.¹⁴⁷ In litigation surrounding the Enron collapse, employees and investors in Enron stock filed lawsuits under both federal and state securities laws against the company; individual officers and directors; the company's accounting firm, Arthur Anderson; and the company's former law firm, Vinson & Elkins.¹⁴⁸ Enron settled all of its lawsuits for a total of \$7.2 billion.¹⁴⁹ Institutional investor and lead plaintiff, the University of California, along with more than one million individuals received \$7.2 billion for their settlement of stock investment losses.¹⁵⁰ This settlement is short of the alleged \$44 billion lost by investors and will be less per investor than the \$688

139. ENRON: THE SMARTEST GUYS IN THE ROOM (Magnolia Pictures 2005). *See also In re Enron Corp.*, 235 F. Supp. 2d at 613–19, 622–29 (describing the fraudulent scheme).

140. ENRON, *supra* note 139.

141. *Newby*, 188 F. Supp. 2d at 692–93.

142. *See* ENRON, *supra* note 139.

143. *In re Enron Corp.*, 235 F. Supp. 2d at 613–19.

144. *See* ENRON, *supra* note 139.

145. *Id.*

146. *Newby v. Enron Corp. (In re Enron Corp. Sec.)*, No. H-01-3624, 2008 U.S. Dist. LEXIS 84656, at *55 (S.D. Tex. Sept. 8, 2008).

147. *Newby v. Enron Corp.*, 188 F. Supp. 2d 684, 692 (S.D. Tex. 2002).

148. Constance Parten, *Top 10 Class-Action Lawsuits*, LAWINFO.COM (Apr. 19, 2010), http://www.cnn.com/id/35988343/Top_10_Class_Action_Lawsuits?slide=9. *See also Newby v. Enron Corp.*, 302 F.3d 295, 298–300 (5th Cir. 2002).

149. Parten, *supra* note 148.

150. *In re Enron Corp. Sec.*, 2008 U.S. Dist. LEXIS 84656 at *55–56.

million dollars in legal fees earned by the plaintiffs' law firm, Coughlin Stoia Geller Rudman & Robbins (which, if employing 688 lawyers equally sharing in profit, would give each attorney one million dollars).¹⁵¹

With the goal of recovering as much lost profit as possible and with several thousand litigants and various settlement classes, objections, and opt-outs, the Enron litigation was particularly protracted and complicated, lasting from 2001 until 2006, with settlement payments still being made as late as 2010.¹⁵² Nothing in the securities legislation could have prevented the Enron scandal or the ensuing litigation-related challenges. For example, in 2004, the Fifth Circuit Court of Appeals decided *Newby v. Enron Corp.*,¹⁵³ one of the investor-plaintiff cases. In this case, the Fifth Circuit upheld a \$40 million partial settlement against the objections of class members.¹⁵⁴ The court determined that the \$40 million amount was fair, adequate, and reasonable.¹⁵⁵ In coming to this decision, the court considered the plaintiffs' small estimated potential recovery,¹⁵⁶ the scope of discovery conducted by the plaintiffs,¹⁵⁷ and the fairness test applied by the district court.¹⁵⁸

In a decision handed down within three weeks of the Enron case, the court in *In re Global Crossing Securities & ERISA Litigation*,¹⁵⁹ approved a \$325 million partial settlement over the objections of class members.¹⁶⁰ In coming to this decision, the court made several observations about the efficiencies of class action adjudication and settlement. The court observed that "individual prosecution of securities claims would make little practical sense, especially in light of the proposed settlement."¹⁶¹ The court also observed that "persons or entities wishing to pursue their own actions presumably have excluded themselves from the settlement class," and the remaining class members had "accepted the efficiencies of class-wide litigation."¹⁶² These decisions highlight the realistic options available to a plaintiff seeking recovery under the securities legislation, which are to opt out of the litiga-

151. See Amanda Bronstad, *Coughlin Stoia Bags 'Lion's Share of Enron Fees*, THE NAT'L L.J. (Sept. 9, 2008), <http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202424377705&s1return=1>.

152. *Newby v. Enron Corp. (In re Enron Corp. Sec.)*, No. H-01-3624, 4:01-cv-03624 (S.D. Tex. Nov. 19, 2010) (ordering the rejection of any class claims submitted after October 2010); GILARDI & CO., LLC., <http://www.gilardi.com/enron/securities/#> (last visited July 14, 2012) (stating the third distribution of settlement funds commenced December 31, 2010).

153. 394 F.3d 296 (5th Cir. 2004).

154. *Id.* at 310–11.

155. *Id.* at 301.

156. *Id.* at 302.

157. *Id.* at 305.

158. *Id.* at 300, 308.

159. 225 F.R.D. 436 (S.D.N.Y. 2004).

160. *Id.* at 457.

161. *Id.* at 454.

162. *Id.*

tion and pursue individual claims or settle as part of the class.¹⁶³ The *In re Global Crossing* court seemed comfortable with the idea that unhappy class members will exercise their right to opt out and “pursue their own actions” individually or in small groups.¹⁶⁴ While observing the efficiency of the settlement, the court mentioned the judicial and personal resources that must be expended to pursue one’s own class action.¹⁶⁵ The district court’s decision also highlights that in cases like *Enron* and *In re Global Crossing*, with many plaintiffs, defendants, and consolidated class actions,¹⁶⁶ it is more likely that class plaintiffs accepted that the company owed more money than it owned assets, that a substantial amount of time had passed since the fraudulent behavior was discovered, and that the particular settlement was the most money that could be expected in the quickest timeframe.¹⁶⁷

The Enron and Global Crossing scandals also highlight the significant amount of time it can take a plaintiff to recover any damages from a securities law violator, as well as the devastating effects violations of the securities laws can have on individuals and the business world. The plaintiffs in *In re AOL Time Warner, Inc., Securities & “ERISA” Litigation*,¹⁶⁸ a similar case of fraud and investor loss, also experienced protracted litigation that resulted in settlement and possibly unhappy investor recovery.¹⁶⁹

2. AOL Time Warner, Inc.—*Another Lesson*

In *In re AOL Time Warner, Inc. Securities & “ERISA” Litigation*,¹⁷⁰ investors sued the company for fraud under federal securities law.¹⁷¹ The investors alleged that the company fraudulently accounted for financial transactions between 1998 and 2002.¹⁷² The fraudulent accounting created

163. See generally *Newby*, 394 F.3d 296 (rejecting class members’ objection to the proposed partial settlement).

164. *In re Global Crossing*, 225 F.R.D. at 454.

165. *Id.* at 456.

166. *Id.* at 441. This case involved more than fifty consolidated securities and ERISA class actions.

167. *Id.* at 441–42, 456–57 (noting that GCL filed for bankruptcy protection in 2002, the class period was from February 1999 to December 2003, eighty-one defendants were involved, the significant delay in potential recovery, and that “the proposed settlement would maximize the recovery of insurance money for the class.”). In December 2001, Enron filed for bankruptcy protection. The Enron cases included a class period from October 1998 to November 2001 and involved more than forty individual defendants and businesses. See *Newby v. Enron Corp. (In re Enron Corp. Sec.)*, No. H-01-3624 (consolidated complaint for violation of the securities laws), *supra* note 1, at 2, 43.

168. 381 F. Supp. 2d 192 (S.D.N.Y. 2004).

169. See generally *id.*

170. *Id.*

171. *Id.* at 202–03.

172. *Id.* at 204.

the appearance that the company was generating revenue and inflated the company's value by nearly \$1.7 billion, when in fact the company was simply moving money.¹⁷³ The company spent \$2.4 billion to settle the securities class action to "put these matters behind [the company], [and] avoid the costs and distractions of protracted litigation."¹⁷⁴ Avoiding the cost of litigation was impossible, however, because there were some opt-outs. Janus Capital Group, a thirteen percent owner, and more than 100 other institutional investors all exercised their opt-out rights in an effort to recover more money.¹⁷⁵ Opt-outs are considered a "powerful tactical weapon," and at least one high-profile plaintiffs' attorney, William S. Lerach, encourages clients to pursue high-dollar figures.¹⁷⁶ Lerach sees settlements as "[sitting] passively by and [taking] a couple cents on the dollar."¹⁷⁷ Alone, Lerach persuaded ninety-three state pension funds to opt out of the AOL Time Warner class action.¹⁷⁸

As in the *Enron* cases, there were more claims than money to go around in the AOL Time Warner litigation. Thousands of class plaintiffs filed claims for AOL Time Warner class action settlement funds.¹⁷⁹ According to settlement documents, several billion shares of AOL Time Warner stock were affected by the fraudulent conduct.¹⁸⁰ Even the largest AOL Time Warner stockholder might not be happy with a limited per share settlement amount. The principal reason that the lead plaintiff agreed to the settlement was the "immediacy and certainty of the benefit" as compared to the risk of less or no recovery if the case proceeded to trial.¹⁸¹

If proceeding to trial offers little to no recovery, then how are Lerach and many other plaintiffs' attorneys able to convince so many to opt out and pursue litigation separately? One answer is the desire for more settlement dollars per plaintiff and the growing trend that opt-out plaintiffs are collecting more, while class action plaintiffs are collecting less.¹⁸² Another answer is that the existence of the securities legislation has led to a decrease in class action filings and, therefore, a decrease in the number of class plaintiffs, which increases the amount of available settlement dollars.

173. Parten, *supra* note 148.

174. Fractured Class Actions, *supra* note 128.

175. *Id.*

176. *Id.*

177. *Id.*

178. *See id.*

179. *See In re AOL Time Warner S'holder Derivative Litig.*, No. 02 Civ. 6302 (CM), 2009 U.S. Dist. LEXIS 124372, at *3-5 (S.D.N.Y. Feb. 1, 2010).

180. *Id.* at *47-48.

181. Notice of Proposed \$2.6 Billion Settlement of Securities Class Action, *In re AOL Time Warner, Inc. Sec. & "ERISA" Litig.*, 381 F. Supp. 2d 192 (S.D.N.Y. 2004), available at <http://www.aoltimewarnersettlement.com/pdf/altw1not.pdf>.

182. *See Fractured Class Actions*, *supra* note 128.

C. Erosion by the Numbers

Securities class action filings are declining, while dismissal rates and settlement values are increasing. In 2009, there was a fourteen percent drop in securities class action filings as compared to prior annual filings.¹⁸³ Between 1997 and 2008 an average of 197 class actions were filed as compared to 169 class actions filed in 2009.¹⁸⁴ Each of the twenty-eight class actions¹⁸⁵ not filed in 2009 represents at least fifty plaintiffs—1400 total—that did not pursue litigation. Securities class action filings continue to decrease as the procedural hurdles associated with such filings continue to be refined and litigated.¹⁸⁶

For those plaintiffs that pursued a securities class action, the action was likely settled or dismissed. Between 1996 and 2009, in a sample of 3052 federal securities class action filings, forty-one percent (41%) of class actions were dismissed and fifty-nine percent (59%) settled.¹⁸⁷ The securities legislation continues to fuel the trend of dismissal and settlement.

In a recent 2011 case, a procedural hurdle created by the securities legislation halted a class action.¹⁸⁸ In *Durgin v. Mon*,¹⁸⁹ the Eleventh Circuit Court of Appeals affirmed the district court's dismissal of a putative securities class action.¹⁹⁰ The plaintiffs alleged losses over one million dollars¹⁹¹ based on misstatements by the defendants.¹⁹² The appellate court held that the plaintiffs' "complaint fail[ed] to allege any direct evidence showing [the] defendants acted with the requisite scienter."¹⁹³ Consequently, the action could not proceed for failure to meet the heightened pleading requirement under PSLRA.¹⁹⁴

The most successful class action plaintiffs overcome a motion to dismiss and reach settlement. Between 1996 and 2009, sixty percent (60%) of the securities class actions that settled were settled "after the first ruling on

183. CORNERSTONE RESEARCH, *supra* note 31, at 2.

184. *Id.*

185. This figure was reached by subtracting the number of federal securities fraud class actions filed in 2009 (164) from the annual average of filings between 1997 and 2008 (197) and by applying SLUSA provision 15 U.S.C. §§ 78bb(f)(1)–(2), which defines the term "covered class action" to include one where "damages are sought on behalf of more than 50 persons." *See supra* Part II, B.

186. *See, e.g.*, CORNERSTONE RESEARCH, *supra* note 31, at 22.

187. *Id.* at 1, 21.

188. *Durgin v. Mon*, 415 Fed. App'x 161, 163, 167 (11th Cir. 2011).

189. *Id.*

190. *Id.* at 167.

191. *Durgin v. Tousa, Inc.*, No. 06-61844-CIV-MARRA, 2008 U.S. Dist. LEXIS 76315, at *3–4 (S.D. Fla. July 15, 2008).

192. *Durgin v. Mon*, 659 F. Supp. 2d 1240, 1252–53 (S.D. Fla. 2009).

193. *Durgin*, 415 Fed. App'x at 165. *See also* discussion *supra* Part II.B.2.

194. *Durgin*, 415 Fed. App'x at 163, 165–67. *See also* discussion *supra* Part II.B.2.

the motion to dismiss but before a ruling on summary judgment.”¹⁹⁵ For those plaintiffs that successfully obtained securities class action certification and overcame hurdles erected by the securities legislation, the median time to settlement was thirty-six months, whereas the median time to dismissal was twenty-three months.¹⁹⁶ As the length of time between filing and resolution increases, so does the likelihood of settlement.¹⁹⁷

Courts and participants may view securities actions with extensive lag time as having strong causes of action that are likely to recover damages.¹⁹⁸ The individual plaintiff-participant in a securities class action may benefit the most from this lag time between filing and resolution because he or she is more likely to recover a larger dollar amount.¹⁹⁹ The increased presence of institutional investors, favored by the securities legislation, may explain increased settlement values. In 2009, institutions served as lead plaintiffs in nearly sixty-five percent (65%) of settlements, and these actions were associated with significantly higher settlements.²⁰⁰ Though there has been an increase in settlement values, the increase in the number of settlements is negligible.²⁰¹ In a sample of class action settlements, a majority of cases, almost fifty-eight percent (57.6%), were settled during the pre-reform 1991–1996 period as compared to only twenty-six percent (26%) in the post-reform 1996–2000 period, demonstrating declining settlement rates since the securities legislation was enacted.²⁰² The loss of institutional investors through the exercise of opt-out rights, particularly ones that serve as lead plaintiff, could have a pervasive effect on settlement dollar values as well as the number of securities class action settlements that occur.

195. CORNERSTONE RESEARCH, *supra* note 31, at 21.

196. *Id.*

197. *See id.* at 22.

198. *Id.* (stating that time to dismissal is shorter than time to settlement.). *See generally e.g.*, *Newby v. Enron Corp.*, 394 F.3d 296 (2004); *In re Global Crossing Sec. & ERISA Litig.*, 225 F.R.D. 436, 455–56 (S.D.N.Y. 2004) (lag time between filing and settlement was six years and two years, respectively).

199. RYAN & SIMMONS, *supra* note 3, at 1–3. Research demonstrates that there was an increase in settlement values in 2009 and that settlement amounts with higher than historical averages occurred from 1996 to 2008. Also, figure 3 shows an increase in settlement amounts from 1996 to 2009. These increased settlement amounts cover the same period of time and the increase in lag time.

200. *Id.* at 10.

201. *Id.* at 1.

202. Bajaj, Mazumdar & Sarin, *supra* note 71, at 1010.

IV. SOLUTIONS

A. Potential Existing Solutions

Some possible solutions to the opt-out problem have been proposed in other contexts and are applicable here. One possible solution is a “blow provision.”²⁰³ Such a provision would give defendants the ability to terminate a class settlement if a minimum number of class members opt out.²⁰⁴ These provisions are part of current settlements involving defendants with directors’ and officers’ (D & O) liability insurance.²⁰⁵ These provisions seem to be effective, but, when applied, they may not address the problem of increased litigation or opt outs since an unsuccessful settlement would inevitably result in at least some continued litigation.²⁰⁶

A possible solution, not yet instituted, “is to require shareholders to declare their opt-out status before the class settlement is negotiated.”²⁰⁷ This would allow defendants to make informed decisions about the reasonableness and effectiveness of a possible settlement.²⁰⁸ This option would alleviate much of the surprise defendants associated with opt-outs face, would encourage more settlement negotiations, and may decrease some plaintiffs’ practice of participating in a class to gain resources and information only to be used in a separate direct action later. The concern with this approach, however, is that a mandatory early opt-out provision may conflict with the opt-out rights granted by FRCP 23.²⁰⁹

Another possible solution, not yet instituted, is to require plaintiffs to make a showing of good cause before opting out.²¹⁰ This solution would “limit a [plaintiff’s] ability to opt out of a class suit to those instances in which [the plaintiff] could demonstrate that the class will not adequately represent [the plaintiff’s] interests.”²¹¹ To meet this “heightened standard for exclusion,” the opt-out plaintiff would need to show that his claims allege some unique substantive legal issue or material fact.²¹² While this may seem

203. Bailey Cavaleeri LLC, *supra* note 112.

204. *Id.*

205. *Id.*; Richard Bortnick, *Class Action Opt-Outs: The New Frontier*, THE D & O DIARY (Feb. 21, 2007), <http://dandodiary.blogspot.com/2007/02/class-action-opt-outs-new-frontier.html>.

206. Bailey Cavaleeri LLC, *supra* note 112; Bortnick, *supra* note 205.

207. Bailey Cavaleeri LLC, *supra* note 112.

208. *Id.*

209. *Id.*

210. Eisenberg & Miller, *supra* note 17, at 1540.

211. Mark W. Friedman, Note, *Constrained Individualism in Group Litigation: Requiring Class Members to Make a Good Cause Showing Before Opting Out of a Federal Class Action*, 100 YALE L.J. 745, 756–57 (1990).

212. *Id.* at 757.

harsh, this proposed solution would ensure that substantive securities law issues are uniformly resolved. Additionally, this solution would address the goals of the securities legislation by consolidating and litigating cases with common issues of fact and law, reducing vexatious litigation, and efficiently using judicial resources, while ensuring that plaintiffs retain their opt-out right.

B. A Proposed Solution That Combines Several Approaches

The best solution would be to combine the heightened good cause standard for exclusion for opting out with Rule 11 sanctions that currently exist to deter baseless lawsuits,²¹³ thereby ensuring that plaintiffs who opt out do so in good faith and for a valid reason. Rule 11 sanctions are mandatory under PSLRA and are applied to plaintiffs or defendants if the court finds that a party or attorney violated Rule 11(b) of the Federal Rules of Civil Procedure.²¹⁴ Rule 11 attempts to limit frivolous lawsuits, ensuring accuracy and integrity in federal pleadings, by requiring attorneys to certify that a reasonably adequate basis in fact exists to support the claims made in the pleadings.²¹⁵ Rule 11 sanctions require the violating party to pay the opposing side a penalty, usually in the form of fees to the opposing plaintiffs and opposing counsel.²¹⁶

An attorney and a party who opts out of a class action should be subject to a mandatory review for Rule 11 sanctions to ensure that the initial participation in the class action was done with integrity and upon an adequate basis to believe that the case had merit at the time the party joined the original litigation. Applying the current mandatory review in this way, coupled with creating a heightened exclusion requirement for opting out, would work to ensure that when a class action is initiated (1) there is a realistic opportunity for class members to recover damages, (2) class members are committed to a resolution to their claims, and (3) the claims are not so weak that they will result in an undesirable settlement amount. The combined suggestion will also deter institutional investors from exercising opt-out rights as a way to leverage a better individual settlement, which thereby jeopardizes class settlement.

Combining these two proposed solutions would also work to ensure that during the litigation and settlement phases of a class action, the potential resolution of claims are less likely to be jeopardized by the hunt for the

213. See Avery, *supra* note 12, at 358–60.

214. 15 U.S.C. §§ 77z-1(c), 78u-4(c) (2006).

215. See Cotton, *supra* note 16, at 751–52. See also Simon DeBartolo Group, L.P. v. Richard E. Jacobs Group, Inc., 186 F.3d 157, 166–67 (2d Cir. 1999).

216. See Gurary v. Nu-Tech Bio-Med, Inc., 303 F.3d 212, 220 (2d Cir. 2002); *Simon DeBartolo Group, L.P.*, 186 F.3d at 166.

largest recovery. These provisions would require a class member and plaintiffs' attorneys to be reasonably positive about their participation in the class action before joining. Furthermore, these provisions would ensure that once a class member decides to join an action, he will remain a part of that action and be bound by the resulting substantive law and settlement provisions, unless a good cause—not based solely on monetary recovery—dictates that an opt-out should occur. Such a combined approach would make settlement more realistic for the individual class member, reduce the institutional investor's influential effect on the class action, and reenergize the class action device with the power and leverage it was designed to wield.

V. CONCLUSION

Securities fraud never results in a good solution; it only creates victims and violators. The victims want to use any means available to them to recover the money and faith they have lost, and violators want to use any means available to them to keep the money and faith they have gained. The securities fraud class action is a useful means of pursuing claims that would be difficult to litigate individually and a useful means of strengthening the enforcement of securities laws. To assist victims and violators, Congress has enacted, and the judiciary has interpreted, several statutes. Individually, these statutes were drafted with good intentions and were designed to fix the perceived problems in the class action system. The single statutory scheme of securities regulation, however, creates an unintended conflict when separate statutes are enacted at separate times to accomplish one purpose. These conflicts have resulted in multiple hurdles in securities litigation and increased limitations on the rights of small individual investors. Other consequences include increased attempts to circumvent curative legislation, increased attempts to pursue litigation with less restriction, increased opt-outs and litigation from institutional investors, increases in litigation timeframes and judicial review of settlements, and increased settlement recovery for few plaintiffs with corresponding decreased settlement recovery for the majority of plaintiffs. A resolution that combines sanctions with a heightened standard for exclusion would go a long way toward addressing the inherent conflicts in the securities legislation.

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