CLOSING THE LOOPHOLE IN THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

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INTRODUCTION

In response to the perceived rise in "abusive" and "meritless" securities fraud lawsuits, Congress overrode President Clinton's veto and enacted the Private Securities Litigation Reform Act of 1995[1]

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As this Note went to press, the Senate was holding hearings on S. 1260, the Securities Litigation Uniform Standards Act of 1997, which would adopt a uniform federal standard for the prosecution of certain securities fraud class actions by eliminating parallel state causes of action. See S. 1260, 105th Cong., 1st Sess. (1997). Specifically, S. 1260 would preempt class actions that are based on the statutory or common law of any state and that allege an untrue statement or omission of material fact, or other fraudulent conduct, in connection with the purchase or sale of specified securities trading over national exchanges. See id.

Such preemption of state securities fraud class actions poses several problems. First, federal securities laws were designed as supplements to, not substitutes for, state blue sky laws. See Securities Act of 1933, § 16, 15 U.S.C. § 77p (1994) (preserving rights and remedies existing at law or in equity); Securities Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb (1994) (same). Preemption of state claims thus raises significant federalism concerns. Many state courts, particularly those in California, Delaware, and New York, have developed expertise and a coherent body of case law which provides guidance to companies and lends predictability to corporate transactions. See infra text accompanying note 106. Second, the bill, if enacted, would deprive investors of important protections, such as aiding and abetting liability and longer statutes of limitations, that are available only under state law. Third, the bill may discourage institutional investors from seeking lead plaintiff status in securities fraud class actions, because it would prevent them from bringing related state claims unless they opted out of the plaintiff class. Finally, the bill would not preempt typical state claims of a breach of a fiduciary duty by an officer or director of a public company, perhaps with the exception of claims alleging a breach of the fiduciary duty of disclosure that is based on a misrepresentation or omission in connection with the purchase or sale of a security. See generally Securities Litigation Uniform Standards Act of 1997: Hearings on S. 1260 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 105th Cong. (1997), available in 1997 WL 14152726 (statement of Arthur Levitt, Jr., Chairman, Securities Exchange Commission). Because a number of states allow claims that cannot be brought under federal law, and because it is not always cost effective for plaintiffs to proceed individually, the bill would preclude relief as a practical matter for some small investors who may have been defrauded. Calls for a uniform federal standard may be premature in light of the fact that courts have not yet tested the full breadth of the Private Securities Litigation Reform Act.

1 Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C.A. §§ 77, 78 (West 1997)) [hereinafter PSLRA].

(Reform Act or PSLRA). The Reform Act, amending both the Securities Act of 1933[2] (1933 Act) and the Securities Exchange Act of 1934[3] (1934 Act), imposed unique requirements and limitations on private class actions alleging securities fraud in federal courts.[4] By doing so, it sought to reduce the number of frivolous securities class actions that were filed simply to extort settlements from defendant corporations.[5]

Such nonmeritorious securities fraud claims are often labeled "strike suits." Strike suits occur when a plaintiff's attorney initiates an action without reasonable grounds to believe it has merit or, having initiated an action reasonably believing it was meritorious, maintains the action even after discovery makes clear the action lacks merit.[6] Despite the focus on strike suits in the debate leading up to passage of the Reform Act,[7] few in Congress suggested eliminating altogether a private right of action for securities fraud claims. Private class actions and derivative suits[8] are seen as necessary supplements to the efforts

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2 Pub. L. No. 73-38, 48 Stat. 74 (codified as amended at 15 U.S.C.A. §§ 77a-77z-3, 77aa (West 1997)).

3 Pub. L. No. 73-404, 48 Stat. 881 (codified as amended at 15 U.S.C.A. §§ 78a-78ll (West 1997)).

4 See PSLRA § 101(a), 109 Stat. at 737-38 (1995) (codified at 15 U.S.C.A. § 77z-1(a)(2) (West 1997)) (establishing pleading requirements for private actions under 1933 Act); id. § 101(b), 109 Stat. at 743 (codified at 15 U.S.C.A. § 78u-4(a)(2) (West 1997)) (same for actions brought under 1934 Act); id. § 102(a), 109 Stat. at 749-52 (codified at 15 U.S.C.A. § 77z-2 (West 1997)) (establishing "safe harbor" for certain forward-looking statements made by companies pursuant to 1933 Act); id. § 102(b), 109 Stat. at 753-56 (codified at 15 U.S.C.A. § 78u-5 (West 1997)) (same for actions brought under 1934 Act).

5 See S. Rep. No. 104-98, at 6 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 685 (acknowledging that many securities class actions "are brought on the basis of their settlement value").

6 See Elliot 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, 2085-86 (1995) (defining strike suits to exclude dismissed lawsuits that have been both initiated and maintained in good faith).

7 Legislative hearings focused principally on the 200 to 300 securities fraud class actions that are filed each year. See, e.g., Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 103d Cong. 121 (1993) [hereinafter Senate Hearings] (testimony of William R. McLucas, Director, Division of Enforcement, Securities Exchange Commission (SEC)) (citing data from Administrative Office of United States Courts).

8 The procedural form of a shareholder suit depends on whether managers are said to have harmed the corporation or its shareholders directly. In the typical case, where the corporation is the injured party, a shareholder must sue "derivatively" on behalf of the corporation. See Robert Charles Clark, Corporate Law 639 (1986) (discussing derivative suits). If a derivative suit succeeds, any recoveries go to the corporation, while the plaintiffs' attorney receives legal fees from the company that typically exceed the out-of-pocket costs of prosecuting the suit. See id. at 659-62 (discussing fee awards). Sometimes, however, a manager's breach of duty injures shareholders directly, in which case a public shareholder can sue as the named plaintiff on behalf of the shareholder class, and any recoveries

of the Securities and Exchange Commission (SEC) to deter securities fraud, and provide the only effective mechanism for compensating investors injured by securities fraud.[9]

Instead, to counteract the problem of entrepreneurial attorneys, the Reform Act adopted a procedure that was designed to give greater control of the conduct of class actions to persons or entities holding the largest stakes in the defendant companies. Under the procedure created in the Act, federal courts may appoint as lead plaintiff—the "most adequate plaintiff"—the individual or entity whom the court determines to be most capable of representing the interests of the class.[10]

The legislative history reveals that Congress intended for institutional investors[11] to play a larger role (as lead plaintiffs) in securities fraud litigation on the assumption that such entities would minimize

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go to the plaintiff class rather than to the corporation. See id. at 640 (discussing shareholder class actions).

9 See, e.g., William S. Lerach, Securities Class Actions and Derivative Litigation Involving Public Companies: A Plaintiff's Perspective, in 1 Securities Litigation 7, 13-18 (Bruce G. Vanyo & Edward J. Yodowitz eds., 1985) (suggesting that private securities litigation is necessary to curb corporate excesses that would otherwise escape notice by overburdened regulatory agencies); David Rosenberg, Class Actions for Mass Torts: Doing Individual Justice by Collective Means, 62 Ind. L.J. 561, 562 (1987) (arguing that through consolidation of claims of similarly situated parties in one proceeding, class actions and derivative suits can result in reduced litigation expenditures and help avoid inconsistent verdicts).

10 The Reform Act provides:

> [T]he court shall adopt a presumption that the most adequate plaintiff in any private action arising under this title is the person or group of persons that—
> (aa) has either filed the complaint or made a motion in response to a notice under subparagraph (A)(i);
> (bb) in the determination of the court, has the largest financial interest in the relief sought by the class; and
> (cc) otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure.

PSLRA, Pub. L. No. 104-67, § 101(a), 109 Stat. 737, 739 (1995) (codified at 15 U.S.C.A. § 77z-1(a)(3)(B)(iii) (West 1997)); id. § 101(b), 109 Stat. at 744 (codified at 15 U.S.C.A. § 78u-4(a)(3)(B)(iii) (West 1997)). Identical PSLRA provisions amend both the 1933 Act and the 1934 Act.

11 Institutional investors include public pension funds, corporate pension funds, union pension funds, retail mutual funds, banks and thrifts, insurance and annuity companies, and private foundations. See The Brancato Report on Institutional Investment Patterns of Institutional Investment and Control in the USA 9-23 (Carolyn K. Brancato ed., 1996) (identifying trends of stock ownership among institutional investors). Pension funds and mutual funds hold about one-third of the value of public and private equity. See Institutions Hold Dominant Stake in Equities Market, Tax Mgmt. Fin. Plan. J., Aug. 17, 1993, at 290. The most activist institutional investors include the California Public Employees' Retirement System (CalPERS), the New York State Common Retirement Fund, the State of Wisconsin Investment Board (SWIB), and the Florida Board of Administration. See The Loneliness of the Shareholder Activist, Institutional Investor, Mar. 1997, at 46.

the agency costs[12] of shareholder litigation. Institutional investors may be better equipped to estimate ex ante whether litigation would yield an expected benefit. In making this determination, they must consider that expected recovery from managers may not be a true gain for the corporation, because any recovery is offset, at least in part, by increases in liability insurance premia, indemnification payments made by the corporation on the managers' behalf, and managerial compensation.[13] And, unlike diffuse shareholders, institutional investors can capture the deterrent benefit of suits by credibly committing themselves beforehand to sue when, but only when, misconduct occurs.

The Reform Act, however, affects only class actions brought in federal courts.[14] Significantly, the old rules still apply to class actions brought in state court and to all derivative suits, whether brought in federal or state court. Nor does the Reform Act expressly preempt any provisions of state securities laws. Instead, it permits the various states to craft their own securities laws tailored to their individual circumstances. Consequently, state courts have become an attractive alternative forum for litigating securities fraud.[15] Forty percent of the securities class actions filed in the first ten months of 1996 were filed in state courts, compared to approximately twenty percent during 1995.[16] Yet another startling statistic reported in *Business Week* revealed that the number of securities fraud lawsuits brought in Califor-

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12 In the context of securities fraud litigation, the term "agency costs" refers to the costs that arise from the conflict of interest between principal (the plaintiff class) and agent (the plaintiffs' attorney). The agent may engage in inappropriate behavior when she does not provide her best effort in performing her duties ("shirking") or when her discretionary behavior is guided by her own self-interest rather than the best interests of the principal. See John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Colum. L. Rev. 669, 679-81 (1986).

13 See Reinier Kraakman et al., When Are Shareholder Suits in Shareholder Interests?, 82 Geo. L.J. 1733, 1736 (1994) (finding that shareholder incentives to sue may be either excessive or insufficient relative to criterion of maximizing corporate value).

14 The Reform Act repeatedly states that it applies only to those actions brought pursuant to Rule 23 of the Federal Rules of Civil Procedure. See, e.g., PSLRA § 101(a), 109 Stat. at 737 (codified at 15 U.S.C.A. § 77z-1(a)(1) (West 1997)) ("The provisions of this subsection shall apply to each private action arising under this title that is brought as a plaintiff class action pursuant to the Federal Rules of Civil Procedure.").

15 See Richard H. Walker et al., The New Securities Class Action: Federal Obstacles, State Detours, 39 Ariz. L. Rev. 641, 677 (1997) (concluding that state courts have become more attractive due to absence of discovery stay found in federal court, which would allow plaintiffs to obtain otherwise unobtainable discovery that is usable in federal action).

16 See Walter Hamilton, Lawyers' End Run Around Legal Reform, Investor's Bus. Daily, Oct. 21, 1996, at A1.

nia state courts increased five-fold during the first six months after the Act's passage.[17]

This Note argues that state courts should adopt the Reform Act's most adequate plaintiff requirement for both securities fraud class actions and derivative suits. Part I reviews the agency costs of strike suits generally with the aid of a paradigmatic case. Part II examines in detail how the Reform Act attempted to reduce these agency costs through various procedural requirements and, in particular, through the most adequate plaintiff requirement. Although the most adequate plaintiff requirement facilitates institutional investor involvement as lead plaintiffs, and such involvement will likely minimize the agency costs associated with bringing a shareholder class action,[18] the fact that this requirement is limited to federal courts has created a new problem, namely, forum shopping. The plaintiffs' bar may circumvent the Act simply by opting to bring more strike suits in state rather than federal courts. Part III therefore argues that individual states should incorporate similar changes into their procedural laws both to close this loophole and to reduce agency costs.

I
The Agency Costs of Securities Fraud Lawsuits

A. *Paradigmatic Case*[19]

A secretary owns a single share in each of an enormous portfolio of Fortune 500 companies. A well known attorney, specializing in plaintiffs' securities litigation, monitors the performance of those

[17] See Mike France, Bye, Fraud Suits. Hello, Fraud Suits, Bus. Wk., June 24, 1996, at 127, 127.

[18] In an influential article by Professors Elliott J. Weiss and John S. Beckerman, the authors advocated for new securities laws to allow institutional investors more opportunity "to monitor the conduct of plaintiffs' attorneys as proxies for all members of plaintiff classes." Weiss & Beckerman, supra note 6, at 2056 (describing empirical analysis of large investors' stakes in securities litigation and arguing for legal rules to permit such investors to take more central roles).

[19] This hypothetical is based on the court documents of In re Warner Communications Sec. Litig., 618 F. Supp. 735 (S.D.N.Y. 1985), aff'd, 798 F.2d 35 (2d Cir. 1986), and echoes the fact pattern of many securities fraud lawsuits. For example, in Kamen v. Kemper Fin. Servs., 908 F.2d 1338 (7th Cir. 1990), rev'd on other grounds, 500 U.S. 90 (1991), the court noted:

> When defendants' counsel took [plaintiff's] deposition and learned that [plaintiff] knew little about either the Fund or the case and had given counsel free reign, they learned only that this case fits the norm.... Counsel to whom [plaintiff] entrusted the litigation—perhaps more accurately, who found [plaintiff] to wage the litigation—is a specialist in the field ....

Id. at 1349; see also L. Stuart Ditzen, Richard Greenfield Is Barred by U.S. Court for One Year, Phila. Inquirer, Dec. 23, 1993, at C1 (reporting that Richard D. Greenfield, well known plaintiffs' attorney, was suspended from practice for one year for attempting to holdings. On Monday morning, one of the portfolio firms, ABC Corporation, announces that its earnings will be significantly below projections that it had previously issued. On Tuesday, the price of ABC's stock drops by twenty-five percent. The attorney alerts the secretary of the bad news and subsequently files a securities class action in federal district court on his behalf.

The complaint alleges that ABC knowingly or recklessly issued false and misleading reports and projections and that various ABC officers and directors sold more than $30 million in ABC stock. The attorney also files companion derivative actions in federal district court and Delaware Chancery Court, alleging that ABC's directors violated their fiduciary duties by participating in, permitting, or not preventing these unlawful and potentially costly actions.

Both the federal and state court judges to whom the cases are assigned use status conferences to organize pretrial proceedings. Assuming several plaintiffs' lawyers are contending for the position of lead counsel for the class, each court appoints lead counsel on a "first come, first served" basis.[20] Since the secretary's attorney was the first to file the complaint, the secretary likely will be named lead plaintiff to represent the class of ABC shareholders, and his attorney will win the contest for lead counsel. As lead counsel, she effectively will control the conduct of the class action, including assignment of work among all lawyers who represent other members of the class. She will also likely be able to claim the lion's share of any attorneys' fees awarded.[21]

Following certification of the plaintiff class and discovery, ABC will make motions to dismiss and for summary judgment. Although the secretary's claims may appear marginal and ABC may produce documents that appear to establish that the plaintiffs' claims lack merit, the malleable, fact-based standards that courts use to determine whether information is "material"[22] and whether defendants have ac-

deceive court concerning his personal interest in plaintiff corporation on whose behalf he initiated class action).

20 See, e.g., Hearing on Securities Litigation Reform Proposals: Subcomm. on Securities, Senate Comm. on Banking, Housing, and Urban Affairs, 104th Cong. 10 (1995) (prepared statement of David J. Guin, National Association of Securities and Commercial Law Attorneys) (arguing that strengthened securities laws are necessary to maintain investor confidence).

21 See Garr v. U.S. Healthcare, Inc., 22 F.3d 1274, 1277 (3d Cir. 1994) ("The lead attorney position is coveted as it is likely to bring its occupant the largest share of the fees generated by the litigation.").

22 See TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (finding that fact is "material if there is a substantial likelihood that a reasonable shareholder would consider it important" in making investment decision).

ted with "scienter"[23] make it difficult for ABC Corporation, like most defendants, to persuade the court to dismiss the complaint for failure to state a claim or to grant its summary judgment motion. The secretary, like many plaintiffs, enjoys an initial cost advantage by exploiting "the plasticity of legal rules that lie at the heart of modern discovery"[24] to pursue additional discovery, including seeking to depose numerous officials of the defendant corporation.[25] Courts have had little success in policing such exploitation of the rules governing discovery.[26]

Eventually, ABC and the plaintiffs' attorneys agree to settle the class action and derivative suit after they survive motions to dismiss and motions for summary judgment. Counsel for the parties then ask the court to approve the settlement provisionally. In general, when courts review proposed class action settlements, they focus almost exclusively on whether the plaintiff class received adequate compensation for the value of its claims. If those claims have little apparent merit or little evidentiary support, and plaintiffs' attorneys have succeeded in securing a relatively substantial recovery for the class, courts tend to reward those attorneys generously.[27] The prospect of such a reward provides plaintiffs' attorneys, like the secretary's attorney in this case, with the incentive to initiate and pursue weak claims of securities fraud until they extract a settlement offer from defendants.[28] Accordingly, this paradigmatic case illustrates the opportu-

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23 To satisfy the scienter requirement, the plaintiff must prove that the defendant had "intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976); 2 Thomas Lee Hazen, Treatise on the Law of Securities Regulation § 13.4, at 82-85 (2d ed. 1990) (surveying holdings of federal courts with regard to definition and level of scienter required in various factual circumstances).

24 Frank H. Easterbrook, Discovery As Abuse, 69 B.U. L. Rev. 635, 640 (1989).

25 See John C. Coffee, Jr., Rethinking the Class Action: A Policy Primer on Reform, 62 Ind. L.J. 625, 637 (1987) ("[I]t is far simpler to demand that the defendant identify and furnish all documents, memoranda, letters and conversations conceivably pertaining to a particular subject matter over a multi-year period than it is to comply with such a demand.").

26 See Easterbrook, supra note 24, at 639-40 (lamenting courts' inability to prevent discovery abuse).

27 See In re Cenco Inc. Sec. Litig., 519 F. Supp. 322, 326-27 (N.D. Ill. 1981) (awarding higher attorneys' fee where contingency factor was "very high"); Galdi Sec. Corp. v. Propp, 87 F.R.D. 6, 14 (S.D.N.Y. 1979) ("The lower the probability of success, the higher the bonus should be.").

28 See Lucian Arye Bebchuk, Suing Solely To Extract A Settlement Offer, 17 J. Legal Stud. 437, 437-41 (1988) (arguing that strike suits may yield positive returns to plaintiffs where defendants are uncertain whether they face meritorious suit); cf. In re Agent Orange Prod. Liab. Litig., 611 F. Supp. 1296, 1311 (E.D.N.Y. 1985) ("Rewarding the filing and prosecution of large, complex lawsuits with poor prospects for success arguably risks fueling the growth of 'nuisance' or 'strike' litigation, in which settlement becomes the main

nity for abuse that is present within the typical securities fraud class action.

B. Analysis of the Agency Costs of Securities Fraud Lawsuits

Such a system—still in place in most states—does not serve to further shareholders' interests. Two net benefits may result from securities fraud litigation: positive net recovery and/or deterrence of misconduct.[29] However, shareholder suits also impose two types of costs on corporations that are ultimately borne by its shareholders. First, a corporation and its shareholders together must pay for both prosecuting and defending shareholder suits.[30] Despite the fact that most shareholder suits settle, litigation costs remain high.[31] Second, the risk of shareholder suits can raise the expenses that corporations must incur in order to attract managers.[32]

As an agent for the principal (the plaintiff class), the plaintiffs' attorney must sometimes choose between maximizing attorneys' fees and maximizing recovery; consequently, the attorney may not always act in the principal's best interests.[33] While the same conflict of inter-

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object and attorney fee awards an overpowering motivating force."), rev'd in part on other grounds and aff'd in part, 818 F.2d 226 (2d Cir. 1987).

29 See Kraakman et al., supra note 13, at 1736 (finding that shareholders tend to bring class actions on basis of only expected recoveries net of litigation costs but not deterrence benefits).

30 See John C. Coffee, Jr., The Unfaithful Champion: The Plaintiff As Monitor In Shareholder Litigation, 48 Law & Contemp. Probs. 5, 17-18 (1985) (describing asymmetrical litigation costs of shareholder suits). Plaintiffs' attorneys can research and prepare, at relatively modest cost, boilerplate complaints alleging that corporations and their managers have engaged in securities fraud. Plaintiffs' attorneys can also generate, at similarly modest cost, extensive requests for documents and interrogatories. Defendants will almost always incur much higher costs to respond. See Fed. R. Civ. P. 11 (requiring defendant to answer, respond to discovery, and generally incur legal expenses before it is entitled to motion to dismiss or for summary judgment).

31 See Roberta Romano, The Shareholder Suit: Litigation Without Foundation?, 7 J.L. Econ. & Org. 55, 60-70 (1991) (finding that 66% of derivative suits and 79% of class actions were settled out of sample of 128 shareholder suits). Because attorneys' fees were awarded in 60% of the cases, shareholders effectively paid for both plaintiff and defendant costs in most suits through the higher premia charged by the corporation's insurer. See id. at 65. Corporate directors and officers are rarely required to shoulder their own attorneys' fees beyond the corporation's insurance coverage. See Kraakman et al., supra note 13, at 1738 n.15. But see Waltuch v. Conticommodity Servs., Inc., 88 F.3d 87, 95 (2d Cir. 1996) (holding that Delaware statute authorizing indemnification nevertheless imposed "good faith" requirement mandating that director or officer, in order to be indemnified by corporation, must not be aware that her conduct constituted knowing violation of securities laws).

32 If managers face a risk of suit, a corporation must either purchase adequate liability insurance or raise managers' salaries by a proportionate amount to induce them to stay on the job. See Kraakman et al., supra note 13, at 1738.

33 For studies analyzing the incentives of litigants in securities class action cases, see, e.g., Janet C. Alexander, Do the Merits Matter? A Study of Settlements in Securities Class

est may occur in a traditional single plaintiff/single attorney relationship, class actions and derivative suits present significantly greater opportunities for attorneys to engage in opportunistic behavior, because the representative plaintiff's typically small stake in the action creates insufficient incentives for the representative plaintiff or other class members to monitor counsel's conduct.[34]

Plaintiffs' attorneys' potential opportunistic behavior may include not only taking the initiative in filing class actions but also deciding on the manner in which to conduct and settle the litigation. Plaintiffs' attorneys typically do not rely on named plaintiffs for vital testimony, do not bargain with named plaintiffs over the fees they will be paid, and do not require named plaintiffs' approval of the terms on which they propose to settle shareholder suits.[35]

The only constraints on plaintiffs' attorneys are the rules of professional responsibility,[36] attorneys' personal sense of duty, and Rule 23's requirement that a court approve any settlements and reasonable fees for attorneys' efforts.[37] None of these constraints has proven an adequate deterrent of such opportunistic behavior.

First, the rules governing attorneys' professional conduct bar an attorney from allowing her own interests, financial or otherwise, to

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Actions, 43 Stan. L. Rev. 497, 534-48 (1991) (identifying non-merit related outcomes in securities litigation settlements); John C. Coffee, Jr., The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action, 54 U. Chi. L. Rev. 877, 887-88 (1987) (examining potentially detrimental effects of entrepreneurial litigation upon those represented by class counsel); Coffee, supra note 12, at 685-86 (developing economic model of plaintiffs' attorneys' incentives to litigate); Jonathan R. Macey & Geoffrey P. Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. Chi. L. Rev. 1, 12-27 (1991) (proposing auction in which attorneys bid for right to litigate class claim, thereby restoring proper balance between client and attorney interests).

34 See, e.g., John C. Coffee, Jr., Rescuing The Private Attorney General: Why The Model Of The Lawyer As Bounty Hunter Is Not Working, 42 Md. L. Rev. 215, 229-34 (1983) (arguing that agency problems, asymmetric stakes, and cost differentials prevent efficient matching of counsel and class); Macey & Miller, supra note 33, at 19-27 (describing consequences of divergence of interest between class action attorneys and their clients).

35 See generally Geoffrey P. Miller, Some Agency Problems In Settlement, 16 J. Legal Stud. 189 (1987) (suggesting that attorney-client conflicts of interest in contingent fee structures affect litigation and settlement decisions).

36 See Model Rules of Professional Conduct Rule 1.2(a) (1995) (directing that lawyer is to abide by client's decisions concerning objectives of representation, including whether to accept settlement offer); id. Rule 1.7(b) (barring lawyer from representation of clients with conflicts of interest); id. Rule 2.1 (discussing duty to advise client of alternatives to litigation); Model Code of Professional Responsibility DR 5-101(A) (West 1995) (forbidding lawyer from representing client when her own interests would affect her exercise of independent professional judgment on behalf of client).

37 See Fed. R. Civ. P. 23(e).

influence how she serves her client's interests.[38] These rules do not, however, effectively constrain plaintiffs' attorneys in class actions and derivative suits.[39] The conflicts of interest inherent in such actions lead some plaintiffs' attorneys—critics would say most[40]—to give considerable weight to their interest in maximizing their fee income when deciding on what terms to settle class actions.[41] Second, the attorney's personal sense of duty provides wide ranging degrees of constraint depending, of course, on the convictions of the individual. Third, the requirement that a court approve any settlement of a class action provides only modestly more protection to class members than do the rules of professional responsibility, largely because settlement hearings typically are not adversarial in character.[42] Objectors to settlements are rare and are often "straw objectors" represented by disgruntled attorneys who have been frozen out of participation in a case.[43] Moreover, trial judges approve almost all class action settle-

38 See Cal. Rules of Professional Conduct Rule 3-300 (West 1995) ("Avoiding Interests Adverse to a Client"); Del. Lawyer's Rules of Professional Conduct Rule 1.7 (1974) ("Conflict of Interest: General Rule"); N.Y. Code of Professional Responsibility Disciplinary Rule 5-103 (West 1995) ("Avoiding Acquisition of Interest in Litigation"). In addition to California's prescriptions in its Rules of Professional Conduct, its attorneys may be disbarred for "moral turpitude." See Cal. Bus. & Prof. Code § 6106 (West 1995); Silver v. State Bar, 528 P.2d 1157, 1164 (Cal. 1974) (finding that commingling of client funds with attorney's personal funds constituted moral turpitude).

39 See Charles W. Wolfram, Modern Legal Ethics § 8.14 (1986) (finding that collective action and free-rider problems discourage class members from actively monitoring their attorney's conduct of class action and serve to discourage efforts to prove that attorney violated governing ethical rules).

40 See Mary Kay Kane, Of Carrots and Sticks: Evaluating the Role of the Class Action Lawyer, 66 Tex. L. Rev. 385, 395-96 (1987) (identifying several potential conflicts of interest for plaintiffs' attorney in settlement negotiations); Charles W. Wolfram, The Second Set Of Players: Lawyers, Fee Shifting, and the Limits of Professional Discipline, 47 Law & Contemp. Probs. 293, 295 (1984) (analyzing effect of divergent lawyer-client interests and effective lawyer control on fee shifting mechanisms).

41 One study of 104 shareholder class actions found that plaintiffs' attorneys earned a statistically significant settlement premium in cases that were settled compared to the fees earned by attorneys in actions litigated to judgment. See Andrew Rosenfield, An Empirical Test Of Class-Action Settlement, 5 J. Legal Stud. 113, 116-17 (1976).

42 See Coffee, supra note 30, at 26-28 (criticizing collusive class action settlements); Macey & Miller, supra note 33, at 45 ("[J]udicial approval appears to be highly imperfect as a protection for the plaintiffs' interests, for several reasons.").

43 Judge Henry Friendly pointed out many years ago: "Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend the joint handiwork . . . ." Allegheny Corp. v. Kirby, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, J., dissenting), aff'd per curiam, 340 F.2d 311 (2d Cir. 1965). Professors Macey and Miller describe settlement hearings as "pep rallies jointly orchestrated by plaintiffs' counsel and defense counsel." Macey & Miller, supra note 33, at 46.

ments, because they lack the time and information to evaluate attorneys' efforts.[44]

In addition to the potential for opportunistic behavior during the conduct of the litigation, plaintiffs' attorneys also may exploit the settlement process. If attorneys settle the case or prevail on the merits, the court generally awards the plaintiffs' attorneys a fee in the range of twenty to thirty percent of the settlement fund.[45]

The prevailing method for calculating attorneys' fees is the lodestar method, under which the court attempts to compensate the plaintiffs' attorney for the reasonable value of the time she spent prosecuting the action, with adjustments in certain cases based on the quality of the work, the riskiness of the litigation, or other similar factors.[46] In this situation, attorneys may have incentives to engage in make-work or otherwise to multiply their charges, at least to the extent they expect the court will still approve those fee requests.[47] Excessive charges of this nature are obviously contrary to the interests of the class, because any fee award is deducted from the common fund.[48] The incentives created by the lodestar method may also cause plaintiffs' attorneys to settle for a lower amount on the eve of trial, even if they reasonably expect that they could obtain a greater recovery for the class at trial.[49] This is so because just before trial, the class's attorneys have completed most of the work upon which their fee will be based, and they typically expect insufficient additional fees by going to

[44] This is not to say that the requirement for judicial review of settlements is meaningless. It undoubtedly imposes at least a weak constraint on plaintiffs' attorneys. See Kane, supra note 40, at 403 ("[T]he rule protects the parties only against the most egregious and blatant abuses.").

[45] See Court Awarded Attorney Fees, Report of the Third Circuit Task Force, 108 F.R.D. 237, 247 n.32 (Oct. 8, 1995) (reporting that fees in class actions often amounted to 20% to 30% of gross amount recovered from defendants).

[46] See Lindy Bros. Builders v. American Radiator & Standard Sanitary Corp., 487 F.2d 161, 166-69 (3d Cir. 1973) (adjusting lodestar based on considerations of riskiness of lawsuit and quality of attorney's work), aff'd in part and vacated in part, 540 F.2d 102 (3d Cir. 1976); Macey & Miller, supra note 33, at 22-27 & 22 n.63 (noting that plaintiffs' attorneys compensated under lodestar method will have incentive "to settle for a relatively low sum on the eve of trial, knowing that in so doing they obtain most of the benefits they can expect from the litigation while eliminating their downside risk").

[47] For an excellent critical discussion of the lodestar method, see In re Oracle Sec. Litig., 131 F.R.D. 688, 689 (N.D. Cal. 1990) (noting that lodestar approach "is now thoroughly discredited by experience").

[48] See Central R.R. & Banking Co. v. Pettus, 113 U.S. 116, 128 (1885) (recognizing principle that attorneys have legitimate claim to fees payable from common fund that their efforts created).

[49] See Coffee, supra note 33, at 888 (describing problems of distribution and conflicting interests within class).

trial to compensate them for the risk of losing and recovering nothing.[50]

The alternative method for awarding fees, the percentage of recovery method, is gaining broader acceptance but can also create perverse incentives, including incentives for plaintiff's counsel to agree to "premature" settlements.[51] Under the percentage of recovery method, plaintiffs' attorneys receive a fixed share of the total amount recovered by the class.[52] Both methods create the potential for collusive agreements where the plaintiffs' attorney barters a low settlement, or a settlement paid predominantly by the corporation rather than by culpable individuals, for a high negotiated attorneys' fee or for an agreement that the defendants will not oppose plaintiffs' attorneys' fee request.[53] These costs are ultimately absorbed by sharehold-

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[50] See Coffee, supra note 12, at 717 (arguing that even if victory at trial yielded common fund five times greater than proposed settlement, attorney "would have had to accept a significant risk that his substantial investment of time would go uncompensated [if plaintiffs' suit was unsuccessful]"). Thus, lodestar acts as a disincentive to vigorous prosecution even where the plaintiffs' case is strong. But cf. David J. Bershad et al., A Dissenting Introduction, in Securities Class Actions: Abuses and Remedies 5, 21-23 (Edward J. Yodowitz et al. eds., 1994) (arguing that plaintiffs' lawyers in securities litigation face "a very real risk" of being undercompensated and therefore are forced to consider carefully merits of case).

[51] In *Chesny v. Marek*, Judge Posner offered the following example to illustrate this problem:

> Suppose a defendant offers $100,000, the contingent fee is 30 percent regardless of when the litigation ends, and the lawyer is sure he can get a judgment for $120,000 if the case is tried but knows that it will cost him, in time and other expenses, $8,000 to try it. His client will be better off if the case is tried, for after paying the lawyer's fee he will put $84,000 in his pocket rather than $70,000 if it is settled. But the lawyer will be worse off, since his additional fee, $6,000 ($36,000-$30,000) will be less than the trial costs of $8,000 that he must incur.

720 F.2d 474, 477 (7th Cir. 1983), rev'd on other grounds, 473 U.S. 1 (1985); see also Coffee, supra note 33, at 887 (pointing out that contingency fee attorneys have incentive to encourage class members with high stake claims to opt out of class when doing so would benefit attorney but not client).

[52] See Weiss v. Mercedes-Benz of N. Am., 899 F. Supp. 1297, 1304 (D.N.J. 1995) (applying percentage of recovery method). Some courts have modified the straight percentage of recovery method and awarded fees based on a sliding scale. In In re First Fidelity Bancorp., 750 F. Supp. 160 (D.N.J. 1990), the district court awarded plaintiffs' counsel 30% of the first $10 million recovered, 20% of the next $10 million, and 10% of all recovery above $20 million. See id. at 163. Regardless of the approach used, courts frequently consider equitable factors in determining "reasonable" attorneys' fees. The most important factor in this regard is generally the value of the overall result obtained for the class. See, e.g., Levin v. Mississippi River Corp., 377 F. Supp. 926, 930, 932 (S.D.N.Y. 1974) (awarding $850,000 to counsel for one class of shareholders who had expended 14,312.50 hours and $1,750,000 to counsel for another class of shareholders who had expended 11,083.25 hours in case lasting 10 years and yielding $42 million settlement fund).

[53] See John C. Coffee, Jr., Class Wars: The Dilemma of the Mass Tort Class Action, 95 Colum. L. Rev. 1343, 1378-82 (1995) (outlining problems of collusion when defendant is

ers through at least two distinct mechanisms. First, to the extent that litigation involving real fraud is settled "on the cheap," the insufficient settlements will underdeter harmful behavior by managers. Second, because incentive structures in class action litigation make it rational to sue defendants who are in fact innocent of any wrongdoing, shareholder costs are imposed in the form of excessive resources devoted to unnecessary litigation.[54] At the end of the day, we may have too many weak cases filed and too many good cases settled out too cheaply. The next Part will explore the Reform Act's attempts to address these problems.

II
Private Securities Litigation Reform Act of 1995

The Reform Act attempts to realign agent and principal interests by altering the adequacy of representation requirement, discovery, and the settlement process. Through these procedural changes, Congress hoped to encourage the most capable representatives of the plaintiff class to participate in class action litigation and to exercise supervision and control over the lawyers for the class.[55] The main procedural changes are detailed below.

A. Implementation of Federal Changes

Under the Act, the first plaintiff to file a complaint must, within twenty days of filing, provide notice to members of the purported class in a widely circulated business publication.[56] This notice must identify the claims alleged in the lawsuit and the purported class pe-

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permitted to negotiate settlement terms with plaintiffs' attorneys prior to certification of class action); Coffee, supra note 30, at 24 (discussing problems of collusion in settlement of derivative suits); Weiss & Beckerman, supra note 6, at 2067-71 (describing circumstances surrounding settlement of class actions and derivative suits against Warner Communications and some of its officers and directors). An example of such a settlement is the one General Motors entered into in 1995 to settle class action litigation that alleged that older model General Motors trucks were defective because they posed an excessive fire hazard in certain collisions. That settlement, which was rejected on appeal to the Third Circuit, merely would have given owners of allegedly defective trucks coupons toward the purchase of a new General Motors truck. See generally In re General Motors Corp. Pick-up Truck Fuel Tank Prods. Liab. Litig., 55 F.3d 768 (3d Cir. 1995).

[54] See Joseph A. Grundfest, Why Disimply?, 108 Harv. L. Rev. 727, 742-43 (1995) (suggesting that settlement values often may be less than avoided litigation costs).

[55] See S. Rep. No. 104-98, at 10 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 689 ("The Committee believes that the lead plaintiff—not lawyers—should drive the litigation."); H.R. Rep. No. 104-369, at 34 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 733 ("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.").

[56] The relevant provision of the Reform Act provides as follows:

riod, and inform potential class members that, within sixty days, they may move to serve as the lead plaintiff.[57] Within ninety days of the published notice, the court must consider motions to appoint the lead plaintiff.[58] If a motion has been filed to consolidate multiple class actions brought on behalf of the same class, however, the court will not appoint a lead plaintiff until after consideration of that motion.[59]

In order to designate the lead plaintiff, the Reform Act introduces the concept of the "most adequate plaintiff." The Act creates a rebuttable presumption that the person or entity appointed as lead plaintiff should be the one "most capable of adequately representing the interests of class members."[60] The most adequate plaintiff would be one that has responded to the earlier described notice, has the largest financial interest in the relief sought by the class, and otherwise satisfies Rule 23 requirements.[61] This presumption in favor of the most adequate plaintiff, which tends to favor institutional and

> *In General.*—Not later than 20 days after the date on which the complaint is filed, the plaintiff or plaintiffs shall cause to be published, in a widely circulated national business-oriented publication or wire service, a notice advising members of the purported plaintiff class—
>
> (I) of the pendency of the action, the claims asserted therein, and the purported class period; and
>
> (II) that, not later than 60 days after the date on which the notice is published, any member of the purported class may move the court to serve as lead plaintiff of the purported class.

PSLRA, Pub. L. No. 104-67, § 101(a), 109 Stat. 737, 738 (codified at 15 U.S.C.A. § 77z-1(a)(3)(A)(i) (West 1997)); id. § 101(b), 109 Stat. at 743 (codified at 15 U.S.C.A. § 78u-4(a)(3)(A)(i) (West 1997)).

If multiple actions are filed on behalf of the class asserting substantially the same claim or claims arising under either the 1933 Act or the 1934 Act, only the plaintiff or plaintiffs who filed first shall be required to cause notice to be published. See id. § 101(a), 109 Stat. at 738 (codified at 15 U.S.C.A. § 77z-1(a)(3)(A)(ii) (West 1997)); id. § 101(b), 109 Stat. at 744 (codified at 15 U.S.C.A. § 78u-4(a)(3)(A)(ii) (West 1997)).

57 See id. § 101(a), 109 Stat. at 738 (codified at 15 U.S.C.A. § 77z-1(a)(3)(A)(i) (West 1997)); id. § 101(b), 109 Stat. at 743 (codified at 15 U.S.C.A. § 78u-4(a)(3)(A)(i) (West 1997)).

58 See id. § 101(a), 109 Stat. at 739 (codified at 15 U.S.C.A. § 77z-1(a)(3)(B)(i) (West 1997)); id. § 101(b), 109 Stat. at 744 (codified at 15 U.S.C.A. § 78u-4(a)(3)(B)(i) (West 1997)).

59 See id. § 101(a), 109 Stat. at 739 (codified at 15 U.S.C.A. § 77z-1(a)(3)(B)(ii) (West 1997)); id. § 101(b), 109 Stat. at 744 (codified at 15 U.S.C.A. § 78u-4(a)(3)(B)(ii) (West 1997)).

60 Id. § 101(a), 109 Stat. at 739 (codified at 15 U.S.C.A. § 77z-1(a)(3)(B)(i) (West 1997)); id. § 101(b), 109 Stat. at 744 (codified at 15 U.S.C.A. § 78u-4(a)(3)(B)(i) (West 1997)).

61 Although the Reform Act does not specify how to determine who has the largest financial interest, one court has specified four factors. See Lax v. First Merchants Acceptance Corp., Civ. No. 97-C-2715, 1997 WL 461036, at *5 (N.D. Ill. Aug. 11, 1997) (suggesting that following factors are relevant in determination: (1) number of shares purchased, (2) number of net shares purchased, (3) total net funds expended by plaintiffs during class period, and (4) approximate losses suffered by plaintiffs).

other large investors, is based on Congress's belief that those investors will represent the interests of the plaintiff class more effectively and will be less likely to bring strike suits because they hold a large financial stake in defendant corporations.[62] The presumption may be rebutted by evidence that the plaintiff would not fairly and adequately represent the interests of the class or is subject to unique defenses.[63]

Although the Reform Act provides no more guidance regarding the lead plaintiff's role, the legislative history clearly indicates that Congress intended the lead plaintiff to "take a more active role" in the conduct of the lawsuit.[64] The lead plaintiff has the right to select lead counsel for the class, subject to court approval.[65] Generally, then, the plaintiff will choose counsel rather than, as in the paradigmatic strike suit, counsel choosing the plaintiff.

The Reform Act's conflict provision is another limitation on the selection of lead counsel.[66] If a plaintiff class is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court must make a determination of whether the ownership or other interest con-

[62] See H.R. Rep. No. 104-369, at 32 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 731 (describing Reform Act as "protect[ing] investors who join class actions against lawyer-driven lawsuits by giving control of the litigation to lead plaintiffs with substantial holdings of the securities of the issuer").

[63] The "lead plaintiff" provision anticipates attempts to rebut the presumption. See PSLRA § 101(a), 109 Stat. at 739 (codified at 15 U.S.C.A. § 77z-1(a)(3)(B)(iv) (West 1997)); id. § 101(b), 109 Stat. at 745 (codified at 15 U.S.C.A. § 78u-4(a)(3)(B)(iv) (West 1997)). The duplicate provisions in the 1933 Act and 1934 Act limit discovery by requiring the objecting plaintiff to first demonstrate a reasonable basis for a finding "that the presumptively most adequate plaintiff is incapable of adequately representing the class." Id. The broad language of the presumption, however, presents the potential for litigation. For instance, litigation has already arisen over whether the lead plaintiff bought or sold securities based on the same information available to the public and whether the claims are otherwise typical of those of the class. See Gluck v. Cellstar Corp., 976 F. Supp. 542 (N.D. Tex. 1997). In *Cellstar*, the State of Wisconsin Investment Board (SWIB), the tenth largest pension fund in the United States, petitioned the court for, and was granted, lead plaintiff status. See id. at 543. Although Milberg Weiss, a leading plaintiffs' firm, filed a detailed complaint on behalf of individuals with substantial investments in Cellstar, SWIB chose the less experienced Blank, Rome, Comisky & McCauley to represent it as lead counsel. See id. at 549 n.8. Blank Rome agreed to a fee that was substantially less than that sought by Milberg Weiss. See Keith L. Johnson, Institutional Investor Participation in Class Actions After the Private Securities Litigation Reform Act of 1995, at 379, 389 (ALI-ABA Course of Study No. SB40, 1996) (recounting SWIB's experience in *Cellstar*).

[64] See H.R. Rep. No. 104-369, at 34 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 733 ("[T]he Conference Committee . . . intends that the lead plaintiff provision will encourage institutional investors to take a more active role in securities class action lawsuits.").

[65] See PSLRA, Pub. L. No. 104-67, § 101(a), 109 Stat. 737, 740 (1995) (codified at 15 U.S.C.A. § 77z-1(a)(3)(B)(v) (West 1997)); id. § 101(b), 109 Stat. at 745 (codified at 15 U.S.C.A. § 78u-4(a)(3)(B)(v) (West 1997)).

[66] See id. § 101(a), 109 Stat. at 741 (codified at 15 U.S.C.A. § 77z-1(a)(8) (West 1997)); id. § 101(b), 109 Stat. at 746 (codified at 15 U.S.C.A. § 78u-4(a)(9) (West 1997)).

stitutes a conflict of interest sufficient to disqualify the attorney from representing the plaintiff class.[67]

In addition to these selection criteria, the Reform Act limits the allocation of class settlement funds for attorneys' fees and lead plaintiff's recovery. It limits attorneys' fees to "a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class,"[68] although the Act is notably silent on what factors the court is supposed to consider in making that determination. The Reform Act also limits the lead plaintiff's recovery to its pro rata share of the settlement or final judgment.[69] The lead plaintiff still may be reimbursed for reasonable costs and expenses associated with service as a lead plaintiff,[70] including lost wages, but there is no longer a disproportionate financial incentive to be a lead plaintiff per se. What is deemed "reasonable," of course, remains open to interpretation by the federal courts.

B. Why Institutional Investors Are Often the Most Adequate Plaintiffs

1. Encouraging Institutional Participation

Most critiques of class actions assume that substantial agency costs are unavoidable because no class member has a stake in the litigation large enough to justify monitoring the attorneys who represent the class.[71] This assumption no longer holds true in an increasing number of public companies whose shares are held in blocks by institutional investors. In 1993, institutions were estimated to own 54.2% of the nearly $5 trillion value of public and private equity.[72] They also

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67 See id. § 101(a), 109 Stat. at 741 (codified at 15 U.S.C.A. § 77z-1(a)(8) (West 1997)); id. § 101(b), 109 Stat. at 746 (codified at 15 U.S.C.A. § 78u-4(a)(9) (West 1997)).

68 Id. § 101(a), 109 Stat. at 740 (codified at 15 U.S.C.A. § 77z-1(a)(6) (West 1997)); id. § 101(b), 109 Stat. at 745 (codified at 15 U.S.C.A. § 78u-4(a)(6) (West 1997)).

69 See id. § 101(a), 109 Stat. at 740 (codified at 15 U.S.C.A. § 77z-1(a)(4) (West 1997)); id. § 101(b), 109 Stat. at 745 (codified at 15 U.S.C.A. § 78u-4(a)(4) (West 1997)).

70 See id. § 101(a), 109 Stat. at 741 (codified at 15 U.S.C.A. § 77z-1(a)(7)(C) (West 1997)); id. § 101(b), 109 Stat. at 746 (codified at 15 U.S.C.A. § 78u-4(a)(7)(C) (West 1997)).

71 See Bell Atl. Corp. v. Bolger, 2 F.3d 1304, 1309 n.9 (3d Cir. 1993) (observing that "[g]enerally, the costs of monitoring will exceed the *pro rata* benefit to any single shareholder even though they may be lower than the benefits to all"); Macey & Miller, supra note 33, at 20 ("[T]he small size of the individual claims creates enormous free-rider effects: no rational plaintiff would take on the role of litigation monitor because she would incur all the costs of doing so but would realize only her pro rata share of the benefits.").

72 See Institutions Hold Dominant Stake in Equities Market, supra note 11, at 290. The percentage of equities owned by institutions first surpassed that owned by individuals in 1991. See id.; see also Supplementary Information to Securities Transactions Settlement, 58 Fed. Reg. 52,891, 52,896 (1993) (estimating that institutions accounted for at least two-thirds of daily share volume on New York Stock Exchange in 1992); James A. White, Nas-

accounted for roughly 70% of trading volume[73] and collected the lion's share of recoveries in federal class action securities fraud proceedings.[74]

Despite such large stakes, institutional shareholders traditionally have sat on the sidelines during the prosecution of securities fraud class actions and simply collected their shares of the class fund distributions from settlements.[75] There are several cogent explanations for this passivity with respect to class action securities fraud litigation. Professor Mark Roe has argued that passivity was historically imposed on institutional investors by legislation, as corporate managers manipulated the regulatory system to protect their positions and constrain financial intermediaries.[76] Another explanation has been offered by Professor John Coffee, who doubts that legal restraints are primarily responsible for shareholder passivity.[77] Instead, he posits a liquidity/control tradeoff, where the cost of high liquidity is weak voice.[78] Given that institutions tend to manage extremely diverse portfolios with thin resources to monitor investments effectively, they prefer liquidity over control.[79]

Yet another explanation is proffered by Professors Weiss and Beckerman, who attribute institutional passivity largely to obstacles that arise as a consequence of the procedures courts employ in class

daq Posts a Blistering 56.8% Surge for 1991 as More Big Investors Pile On, Wall St. J., Jan. 2, 1992, at 15 (discussing institutions' increasing purchases of stock in small companies that trade over the counter).

73 See Weiss & Beckerman, supra note 6, at 2056 n.10 (citing Supplementary Information to Securities Transactions Settlement, 58 Fed. Reg. 52,891, 52,896 (1993)).

74 See id. at 2088-94 (finding that 10 largest settlement claimants in securities class action settlements accounted for approximately 40% of dollar value of all claims filed).

75 See id.

76 See Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance 51-146 (1994) (arguing that history of legal restrictions on banks, insurers, mutual funds, and pension funds inhibits them from institutional activism); see also Ronald J. Gilson & Mark J. Roe, Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization, 102 Yale L.J. 871, 873 (1993) ("In particular, in the United States, populism, federalism, and interest group conflicts combined to restrict the growth of large financial intermediaries, especially banks, and constrained other efforts to oversee management, through a regulatory web of banking, insurance, tax, and securities laws."); Joseph A. Grundfest, Subordination of American Capital, 27 J. Fin. Econ. 89, 101-02 (1990) (arguing that agency problems in United States corporate governance are perhaps exacerbated by attempts to address them through legislative process).

77 See John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277, 1287-89 (1991) (arguing that substantial losses that institutional investor may suffer upon sale of securities create disincentive to sell).

78 See id. at 1279-80.

79 See id. at 1336-66 (arguing that institutional investors make poor corporate monitors and rationally prefer "exit" over "voice").

action litigation.[80] Under the old federal procedures, and most current state procedures, institutions seldom received details about the claims filed or the progress of settlement discussions until a deal already had been struck. If they wanted to object, they had to retain separate counsel, opt out of the settlement, and battle both the company and class counsel in opposing the settlement. Given the relatively short time period in which decisions had to be made, institutional shareholders were rarely in a position to challenge a settlement.[81]

None of the above explanations is necessarily inconsistent with the others, and all three may partially account for passivity among institutional shareholders. The Reform Act, however, relied primarily on Professors Weiss and Beckerman's theory and thus focused on fixing the perceived procedural deficiencies of securities fraud class actions.[82] Through its notice provisions, adequacy of representation requirement, discovery rules, and changes in the settlement process, the Act was designed to increase institutional activism by removing the procedural barriers believed to have caused their passivity.

2. *Benefits Resulting from Institutional Participation*

For various reasons, it is also in the interest of most institutional investors to take an active role in these class action suits. Given that there are substantial differences, often amounting to millions of dollars, between the allowable losses claimed by institutions in class actions and the amounts actually recovered, institutions could realize substantial benefits by serving as litigation monitors.[83] If an institu-

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[80] See Weiss & Beckerman, supra note 6, at 2097-98 (detailing obstacles in procedural steps that confront class action plaintiffs).

[81] See Harvey L. Pitt et al., A Plaintiff Wail: The New Role of Institutional Investors Under the Securities Litigation Reform Act, in 1 Twenty-Eighth Annual Institute on Securities Regulation 253, 257 n.8 (PLI Corp. Law & Practice Course Handbook Series No. B-962) (citing Keith Johnson, Assistant General Counsel, SWIB, Securities Class Action Reform: A Real Client's Perspective, 1995 ABA Annual Meeting Section of Business Law).

[82] See H.R. Rep. No. 104-369, at 34 n.3 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 747 (citing Weiss & Beckerman, supra note 6).

[83] See Bernard S. Black & John C. Coffee, Jr., Hail Britannia?: Institutional Investor Behavior Under Limited Regulation, 92 Mich. L. Rev. 1997, 2063-64 (1994) (discussing how institutional investors are inclined to become active on governance issues affecting corporations in which they have larger than average investments and to be passive on governance issues affecting corporations in which they have smaller than average investments). But see Note, Investor Empowerment Strategies in the Congressional Reform of Securities Class Actions, 109 Harv. L. Rev. 2056, 2071 (1996) (arguing that large shareholders will not necessarily reduce socially wasteful, nonmeritorious litigation because they will rationally choose to participate in strike suits that will produce net gains even though participation will decrease corporate value).

tion has the largest financial stake of a plaintiff class, its losses due to the defendants' alleged fraud generally will exceed those of other institutions; the institution will then stand to gain comparatively more from a settlement than will other institutions. The prospect of such an improvement in comparative performance might well cause some institutional investors to participate as lead plaintiffs in those class actions in which they have the largest stake.[84]

There is more than just the mere size of the potential recoveries involved to prompt institutional shareholder action. Institutional investors also should be in a position to recognize broader systemic sources of gain from activism. Like all shareholders, institutional investors are harmed by fraud and have incentives to reduce the incidence of fraudulent activities in the securities markets.[85]

At the same time, institutional investors' large presence in the market over time means that they will tend to bear a greater portion of the costs imposed by inefficiencies in class action litigation.[86] For example, plaintiffs' class action attorneys are often able to obtain a settlement in a case that has little substantive merit simply because they have the ability to impose substantial litigation costs on defendants.[87] Institutional investors bear a large share of the inefficiency costs generated by such litigation through their shareholdings. Inefficiencies of this sort essentially impose a tax on capital formation that is reflected in higher capital costs or insufficient capital formation, as too many resources are spent on litigation costs and litigation avoidance.[88] If the institutions that bear a large share of these costs can

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84 According to initial estimates, institutional participation has been low. See Dominic Bencivenga, Litigation Re-Formed: Lawyers Report on "Year 1" Under Securities Act, N.Y. L.J., Jan. 16, 1997, at 5 (observing that "large investors and institutional investors have not been stepping forward in significant numbers to become the most adequate plaintiff"). If the institution seeks alternative methods of participation, it may participate secondarily, by intervening in the action or objecting to a settlement once it is reached. Under this scenario, however, the institution would have less influence over plaintiffs' attorneys and would probably have to pay both its own attorneys' fees and its share of any fees awarded to the attorneys who represent the class. See County of Suffolk v. Long Island Lighting Co., 907 F.2d 1295, 1326-28 (2d Cir. 1990) (awarding reasonable hourly rate to counsel for plaintiffs, defendants, and intervenors despite some parties' opposition to settlement). Intervenors' claims, even if large, rarely are large enough to justify payment of attorneys' fees at reasonable hourly rates.

85 See Grundfest, supra note 54, at 732 (observing that securities fraud adversely affects all participants in securities markets and thus all participants have much to gain from elimination of fraud).

86 See id. at 733 ("The costs of suboptimal securities litigation are borne—to varying degrees—by all corporate issuers.").

87 See supra notes 27-28 and accompanying text.

88 See S. Rep. No. 104-98, at 9 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 688 (noting that strike suits have "added significantly to the cost of raising capital and represent a 'litigation tax' on business") (citing testimony of Marc E. Lackritz, Securities Industry As-

undertake initiatives in individual class litigation to make class actions generally more efficient, they may be able to enhance their portfolio values sufficiently to justify the expense of participation. Indeed, this is the same type of analysis that has led some institutional investors to become active in corporate governance issues.[89]

Because they bear the costs associated with both fraud and 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.[90] Institutional investors may therefore represent the best, although clearly an imperfect, proxy for the public interest in shareholder litigation. At the same time, it is important to recognize that the larger institutions are in many cases aggregations of small investors. Collective action problems and the difficulty of focusing on larger systemic concerns mean that the individual investor has little incentive to focus on the big picture.[91] A major mutual or pension fund, which in reality comprises the holdings of many smaller investors, can take that broader view. Thus, politically and socially, the

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sociation, and J. Carter Beese, former SEC Commissioner). Of course, the presence of fraud will have similar effects, because the corporation's shareholders will bear these costs through employment agreements or through the costs of directors' and officers' insurance policies. See Thomas M. Jones, An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits, 60 B.U. L. Rev. 542, 545, 567-68 (1980) (finding that high rate (70.7%) of settlement of shareholder suits provided slight benefit to shareholders).

89 See generally Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing With Barbarians Inside the Gates, 45 Stan. L. Rev. 857 (1993) (discussing institutional action in corporate governance context). There is nothing in the Reform Act to prevent institutions from forgoing Congress's invitation to become lead plaintiffs and to continue to experiment with corporate governance initiatives. In many instances, institutions may conclude that litigating would be less beneficial than resorting to the array of flexible, informal, and relatively inexpensive mechanisms by which they can make their views known to the defendant corporation. The only potential problem with the Act is thus not any prohibition, but the possibility that it could chill other strategies that may be better suited to a particular case. To the extent that flexibility is lessened as a result of courts' focusing on Congress's preferred mechanism, the window in which institutions may effectively overcome collective action problems may narrow. See Joseph A. Grundfest & Michael A. Perino, The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation, 38 Ariz. L. Rev. 559, 562 (1996) (suggesting that carefully researched letter to counsel sent by large institutions with stake in outcome of litigation can help persuade plaintiff counsel to dismiss meritless claim); Dennis J. Block & Jonathan M. Hoff, Corporate Governance and Institutional Activism, N.Y. L.J., Jan. 18, 1996, at 5 (finding that institutional investors relied predominantly on meetings with board of directors and management, in conjunction with use of media, to voice their displeasure).

90 See S. Rep. No. 104-98, at 11 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 690 (noting that institutional investors have same interests as small investors generally) (citing 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 (1995)).

91 See supra notes 33-34 and accompanying text.

institutional investor represents much the same constituency as the individual investor.[92] Focusing on the needs of institutional investors, however, causes that constituency to consider its entire portfolio and the full consequences of its actions.

Two recent cases demonstrate the feasibility of institutional investor participation in litigation. In the spring of 1995, before the Reform Act was passed, the Council of Institutional Investors (Council) retained legal counsel to assist its members in reviewing class actions.[93] As a result of the Council's monitoring efforts, the Colorado Public Employees Retirement Association filed a motion to intervene in a lawsuit against California Micro Devices.[94] In a separate action, the California Public Employees' Retirement System (CalPERS) moved to intervene in a state court derivative proceeding, thereby intruding into an area that had been viewed as the traditional domain of smaller individual investors.[95] Both these examples occurred *before* passage of the Reform Act, suggesting that the most adequate plaintiff requirement will encourage increased participation.[96]

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92 The Reform Act's legislative history recognizes that institutional investors are really just conglomerations of smaller investors. See S. Rep. No. 104-98, at 11 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 690.

93 See Karen Donovan, Pension Managers Speaking Up: Institutional Investors Ready for Role in Class Action Securities Suits, Nat'l L.J., Mar. 13, 1995, at A6 (reporting that Council of Institutional Investors asked law firms to submit proposals describing how they could play more active role in class actions).

94 See In re California Micro Devices Sec. Litig., 168 F.R.D. 257, 260 (N.D. Cal. 1996) (refusing to approve settlement of class action because putative class representatives failed to monitor class counsel adequately).

95 See Weiser v. Grace, No. 95-106285, slip op. at 3 (N.Y. Sup. Ct., Sept. 3, 1996) (permitting CalPERS to intervene and appointing CalPERS's counsel to serve as co-lead counsel for plaintiffs, thereby allowing CalPERS full participation in settlement negotiations).

96 Few cases have been litigated fully under the provisions of the Reform Act, because they apply only to those actions filed after December 22, 1995, the effective date of the Act. However, several motions for lead plaintiff have been made under the Reform Act. See Gluck v. Cellstar Corp., 976 F. Supp. 542, 547-49 (N.D. Tex. 1997) (appointing institutional investor as lead plaintiff and refusing to appoint co-lead plaintiff for purpose of minimizing challenges to adequacy of class representation at later stage); Raftery v. Mercury Fin. Co., Civ. No. 97-C-624, 1997 WL 529553, at *2 (N.D. Ill. Aug. 15, 1997) (appointing Minnesota State Board of Investment (MSBI) as presumptively most adequate plaintiff but expressing concern that MSBI may not protect interests of class if counsel fee agreement contemplated more than reasonable fee); Lax v. First Merchants Acceptance Corp., Civ. No. 97-C-2715, 1997 WL 461036, at *3 (N.D. Ill. Aug. 11, 1997) (consolidating three motions for appointment of lead plaintiff and appointing two groups as co-lead plaintiffs because they timely moved for appointment, had largest financial interest in relief sought, and otherwise appeared to meet Rule 23's adequacy and typicality requirements); Ravens v. Iftikar, Civ. No. C-96-1224-VRW, 1997 WL 405110, at *19 (N.D. Cal. July 16, 1997) (refusing to designate petitioner group as lead plaintiff because notice of motion was inadequate); D'Hondt v. Digi Int'l Inc., Civ. No. 97-5-JRT-RLE, 1997 WL 405668, at *3 (D. Minn. Apr. 3, 1997) (appointing 21 co-lead plaintiffs over defendant's objection that large number of lead plaintiffs predisposed class to control of lead counsel); In re

C. *The Reform Act's Loophole*

Despite the Reform Act's goal of reducing the agency costs associated with securities fraud lawsuits, the fact that the statute is limited to federal courts may result in a wash. If plaintiffs can obtain the same or better recovery in state court, and if their bargaining position in settlement negotiations is unaffected by their choice of forum, plaintiffs may choose to file their claims in state court to avoid the Reform Act's procedural obstacles. At worst, the new procedural disparities now existing in federal and state courts may actually cause a net increase in the number of strike suits by funneling securities fraud lawsuits into state courts.

In particular, the plaintiffs' bar may find it more advantageous to file securities fraud suits in state courts to avoid being replaced by the "most adequate plaintiff." Currently, lawsuits that include claims for violations of the provisions of the 1934 Act, such as 10b-5 violations,[97] must be brought in U.S. district courts, which have exclusive jurisdiction over such claims.[98] Lawsuits for violations of the 1933 Act, on the other hand, may be brought in either federal or state courts, which have concurrent jurisdiction.[99] Claims under state law may be filed in state court or appended to federal claims in federal court under supplemental jurisdiction.[100]

Thus, there are many ways to end-run the Reform Act as the system is currently structured. A shareholder-plaintiff has the option of bringing 1933 Act claims in state courts such as Delaware, New York,

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Donnkenny Inc. Sec. Litig., 171 F.R.D. 156, 158 (S.D.N.Y. 1997) (denying motions of four groups of plaintiffs to consolidate actions and gain appointment as co-lead plaintiffs, where limited partnership had largest financial interest among named plaintiffs, filed complaint, and moved to be lead plaintiff); Zuckerman v. Foxmeyer Health Corp., Civ. No. 3:96-CV-2258-T, 1997 WL 314422, at *2 (N.D. Tex. Mar. 28, 1997) (appointing 11 co-lead plaintiffs and two lead counsels); Fischler v. AmSouth Bancorp., Civ. No. 96-1567-Civ-T-17A, 1997 WL 118429, at *3-*4 (M.D. Fla. Feb. 6, 1997) (deferring motion for appointment as lead plaintiff pending discovery as to whether movant will adequately and fairly represent interests of class); Greebel v. FTP Software, Inc., 939 F. Supp. 57, 64 (D. Mass. 1996) (appointing three individuals as co-lead plaintiffs and Milberg Weiss firm as lead counsel).

[97] Rule 10b-5 prohibits insider trading and fraud and misrepresentation in connection with the purchase or sale of any security, such as stock manipulation schemes and false or misleading press releases issued by corporations. See 17 C.F.R. § 240.10b-5 (1995).

[98] See 15 U.S.C. § 78aa (1994) (providing that federal courts have "exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder").

[99] See id. § 77v.

[100] Supplemental jurisdiction allows a federal court to adjudicate a state law claim if it arises from the same "common nucleus of operative fact" as the federal claim. See 28 U.S.C. § 1367(a)-(c) (1994) (authorizing courts to exercise jurisdiction over supplemental state claims); United Mine Workers of America v. Gibbs, 383 U.S. 715, 725 (1966) (upholding exercise of supplemental jurisdiction).

or California, which have been amenable to certifying nationwide classes. If the shareholder-plaintiff perceives a diminished likelihood of prevailing under Rule 10b-5, or if the plaintiff cannot convince a federal court to accept supplemental jurisdiction over her state law claims,[101] then filing suit in state court becomes more attractive as a forum choice. This trend is already becoming evident in a few states, notably California.[102] Furthermore, some state legislatures may enact investor-friendly laws (either intentionally or inadvertently), which may subsequently increase the number of securities claims filed in state courts on behalf of national classes.[103] The plaintiff may then assert multiple causes of action under state law to avoid the Reform Act's restrictions.

While Congress could choose to preempt state securities laws altogether based on its Commerce Clause powers,[104] such a measure would close the loophole only partially, since Congress does not have the constitutional authority to preempt state laws regulating shareholder suits based on state common law.[105] Alternative state rights and remedies for defrauded shareholders include blue sky laws, antitakeover statutes, corporate regulatory statutes, and traditional common law remedies. This section will examine state remedies and procedures in California, Delaware, and New York, the three most

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101 A federal court may decline jurisdiction over state law claims based on the same case or controversy if (1) state law claims predominate over federal claims or raise novel or complex issues; (2) federal claims are dismissed; or (3) there are "exceptional circumstances" creating "compelling reasons" for denying jurisdiction. See 28 U.S.C. § 1367(c).

102 See Robert Ablon, New Front in Shareholder Suits, The Recorder, Apr. 2, 1996, at 1, available in LEXIS, News Library, Rcrdr File (reporting that investors are filing securities fraud class actions in California state courts); France, supra note 17, at 127 (reporting five-fold increase in number of securities fraud suits filed in California state courts).

103 The National Association of Securities Administrators opposed the Reform Act and may be instrumental in pushing for counterreform state legislation. See Nicholas E. Chimicles, The Future of Securities Litigation Under the Private Securities Litigation Reform Act of 1995, in Practice Under the 1995 Securities Litigation Reform Act and Recent SEC Initiatives 33, 66 (ALI-ABA Course Study No. Q253, 1996).

104 See U.S. Const. art. I, § 8, cl. 3. The doctrine of preemption, which derives from the Supremacy Clause, id. art. VI, cl. 2, requires any state law "which interferes with or is contrary to federal law" to yield to federal law. Felder v. Casey, 487 U.S. 131, 138 (1988) (quoting Free v. Bland, 369 U.S. 663, 666 (1962)). As of November 1997, three bills are pending in Congress that would, to varying degrees, require certain securities class actions to be brought in federal court, thus preempting such state actions. See S. 1260, 105th Cong. (1997); H.R. 1653, 105th Cong. (1997); H.R. 1689, 105th Cong. (1997).

105 The power of the federal government to regulate securities transactions is rooted in its constitutional power to regulate interstate commerce. Therefore, certain shareholder suits are not subject to federal regulation—for example, shareholder suits based on securities transactions of a purely intrastate nature, or shareholder suits alleging breach of fiduciary duty or corporate waste.

popular fora for securities fraud lawsuits,[106] in order to illustrate the various loopholes that exist under the current system.

1. Causes of Action Under State Law

First, state blue sky laws[107] require certain disclosures and prohibit certain frauds in connection with the sale of securities.[108] There are significant advantages to bringing shareholder claims based on blue sky laws.[109] Unlike the stringent scienter standard laid down for SEC actions,[110] blue sky laws require only a negligence standard of liability.[111] To avoid liability, the defendant must demonstrate not only that it did not know of the material misrepresentation or omission, but also that it could not have known of the misrepresentation or omission by exercise of reasonable care. Furthermore, there is an explicit provision for attorneys' fees; an opportunity for plaintiffs to receive punitive damages;[112] and a longer statute of limitations.[113]

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106 See Stuart J. Baskin, Recent Developments in State Securities, Derivative and Corporate Law, in Securities Regulation 449, 451-52 (PLI Corporate Law & Practice Course Handbook Series No. B-958, 1996) (discussing importance of state courts in Delaware, California, and New York in addressing securities and corporate issues).

107 Prior to the enactment of federal securities laws in 1933, almost all of the states had adopted statutes designed to protect the public from "speculative schemes which have no more basis than so many feet of 'blue sky.'" Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917); see Manning Gilbert Warren III, Symposium: Striking the Right Balance: Federal and State Regulation of Financial Institutions: Securities Litigation: Legitimacy in the Securities Industry: The Role of Merit Regulation, 53 Brook. L. Rev. 129, 132 (1987) (noting that every state but Nevada had enacted blue sky laws by 1933).

108 See, e.g., Cal. Corp. Code §§ 25000-25706 (West 1996) (California blue sky laws); Del. Code Ann. tit. 6, §§ 7301-7330 (1993) (Delaware blue sky laws); N.Y. Gen. Bus. Law §§ 339, 352 to 359-h (McKinney 1996) (New York blue sky laws).

109 New York's blue sky law does not provide for civil liability. Thus the plaintiffs' bar has been filing lawsuits asserting causes of action for common law fraud and negligent misrepresentation. See Bruce G. Vanyo et al., Securities Class Action Litigation in State Courts 215-16 (PLI Corp. Law & Practice Course Handbook Series No. B-958, 1996). In both California and Delaware, where civil liability for securities fraud exists, plaintiffs have filed lawsuits asserting violations of blue sky laws in addition to common law claims. See id.

110 See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (denying recovery to plaintiffs who were victims of fraudulent securities scheme perpetrated by brokerage firm's president, because plaintiffs failed to allege any "intent to deceive, manipulate, or defraud").

111 See Vanyo et al., supra note 109, at 300 (stating that claims under Uniform Securities Act do not require proof that person making false or misleading statements acted with scienter).

112 See, e.g., Komanoff v. Mabon, Nugent & Co., 884 F. Supp. 848, 861 (S.D.N.Y. 1995) (dismissing punitive damages demand as to Rule 10b-5 claim but not as to state fraud claim); Hofmayer v. Dean Witter & Co., 459 F. Supp. 733, 741 (N.D. Cal. 1978) (finding that punitive damages may be awarded for violations of California's blue sky laws if defendant's conduct was "willful and malicious and in reckless disregard of the rights of plaintiff").

Because the reporting requirements are frequently more onerous than comparable federal provisions, and because blue sky laws regulate more than intrastate commerce,[114] they can be effective weapons in a plaintiff's arsenal.[115]

A second source of state created rights and remedies for shareholder litigants is the state anti-takeover statute. New York and Delaware have legislation regulating all takeovers, while California regulates takeovers only for the state's insurance companies.[116] Such provisions typically extend management's fiduciary duties of care and loyalty in connection with a takeover attempt not only to shareholders but also to employees, customers, suppliers, and the surrounding community.[117]

Third, corporate regulatory statutes create additional rights for shareholders and require administrative or other approvals for corporate action. California, Delaware, and New York each has its peculiar provisions that impinge on the corporation. Those of California are general regulatory statutes which require controlling shareholders or directors to run a certain course before enacting fundamental corporate changes.[118] Delaware laws set standards of corporate behavior, violation of which may constitute negligence or a breach of fiduciary

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113 State common law fraud claims are subject to varying limitations periods, but they generally toll the limitations period until the plaintiff discovers the fraud or could have discovered the fraud through reasonable diligence. In contrast, the federal limitations period is not tolled upon discovery, but rather a shorter, one-year period applies once the plaintiff discovers the fraud. See Vanyo et al., supra note 109, at 254.

114 The relevant statutes of California, Delaware, and New York require only that the alleged misconduct occurred within the state. See, e.g., Del. Code Ann. tit. 6, § 7301 note (1995) (stating that transactions are governed under "traditional tests" of jurisdiction); Singer v. Magnavox Co., 380 A.2d 969, 981 (Del. 1977) (refusing to apply Delaware Securities Act to transaction where plaintiffs were residents of Pennsylvania and were not solicited in Delaware), overruled on other grounds by Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

115 In actions filed in California since the passage of the Reform Act, claims for market manipulation have been made most frequently. See Cal. Corp. Code §§ 25400, 25500 (West 1996) (forbidding individuals from making fraudulent statements with purpose of manipulating market for a security); Vanyo et al., supra note 109, at 318 (noting relative frequency of market manipulation claims due to lack of privity requirement). Compared to other claims available under most blue sky laws, this claim is very attractive to plaintiffs because it is not limited to persons who actually bought or sold securities from the defendants. Defendants are liable to anyone trading in the marketplace who is able to meet the jurisdiction prerequisite. See 1 Harold Marsh, Jr., & Robert H. Volk, Practice Under the California Securities Laws § 14.05[3][a] (1993).

116 See Cal. Ins. Code § 1215.2 (West 1993 and Supp. 1997) (requiring disclosure in connection with tender offers); N.Y. Bus. Corp. Law §§ 1600-1613 (McKinney 1986) (same).

117 See Clark, supra note 8, at 570-71 (discussing state takeover regulations).

118 See, e.g., Cal. Corp. Code § 1203 (West 1990 & Supp. 1997) (defining directors' duties toward shareholders in consideration of tender offers).

duty.[119] New York statutes provide remedies specifically intended to deter shareholder oppression, such as involuntary dissolution and appraisal.[120] Still others, like a growing number of state prohibitions of consumer fraud, technically may be applicable to shareholder litigation, despite a primary purpose to regulate "bait and switch" tactics,[121] false advertising, and other state concerns.[122]

Finally, common law remedies are flexible enough to fill the loopholes of federal and state securities statutes. These include breach of fiduciary duty, common law fraud, and negligent misrepresentation, all of which may be brought by the shareholders on behalf of the corporation as a direct or derivative suit.[123]

California, Delaware, and New York have adopted a recklessness standard for common law fraud, permitting liability if the speaker recklessly makes a false statement; however, the plaintiff faces the extreme difficulty of pleading and proving actual reliance on the allegedly misleading statements.[124] If the claims survive the pleading stage, plaintiffs have remedies that are not available to them under the fed-

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119 See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (identifying triad of directors' fiduciary duties—good faith, loyalty, and due care).

120 See, e.g., N.Y. Bus. Corp. Law § 623 (McKinney 1986) (providing right to receive payment for shares of dissenting shareholders); id. § 1104 (allowing judicial dissolution of corporation under cases of deadlock among shareholders); see also Wilson v. Great Am. Indus. Inc., 979 F.2d 924, 930-31 (2d Cir. 1992) (allowing suit by minority shareholders who claimed that misrepresentations in proxy solicitation materials had induced them to refrain from asserting their state law appraisal rights).

121 Bait and switch tactics typically involve advertising a product at a sale price to bring a customer into the showroom, followed by a sales pitch to convince the customer to switch to a more expensive product. See generally Wade R. Habeeb, Validity, Construction, and Effect of State Legislation: Regulating or Controlling "Bait-and-Switch" or "Disparagement" Advertising or Sales Practices, 50 A.L.R.3d 1008 (1974) (surveying state bait and switch laws).

122 Claims that were once brought under section 11 of the 1933 Act or Rule 10b-5 of the 1934 Act might now be brought under a state's consumer fraud or unfair trade practices statute. For example, Pennsylvania's consumer fraud law has been held to apply to securities transactions. See Denison v. Kelly, 759 F. Supp. 199, 202 (M.D. Pa. 1991) (holding that Pennsylvania Unfair Trade Practices and Consumer Protection Law, 73 Pa. Cons. Stat. Ann. § 201-3 (West 1996), covered defendant's alleged churning and purchase of inappropriate investments).

123 For examples of shareholder derivative suits based on common law causes of action, see infra notes 126-35 and accompanying text.

124 See, e.g., Gonsalves v. Hodgson, 237 P.2d 656, 662 (Cal. 1951) ("In an action for damages for deceit, the fraudulent representation relied upon must be as to a material fact which is false and known to be false by the maker, or is recklessly made or made without reasonable grounds for believing its truth."); Jo Ann Homes at Bellmore, Inc. v. Dworetz, 250 N.E.2d 214, 217 (N.Y. 1969) (noting that for fraud to be actionable under New York law, "[t]here must be a representation of fact, which is either untrue and known to be untrue or recklessly made, and which is offered to deceive the other party and to induce them to act upon it, causing injury").

eral securities laws, such as punitive damages for common law fraud.[125]

2. *State Court Procedures*

In the aggregate, the above alternative avenues undermine the effectiveness of the Reform Act in deterring strike suits. No state court has yet adopted a similar requirement for plaintiff representation, although derivative suits and class actions in almost all state courts trigger special procedural safeguards not present in ordinary litigation. The following sections examine these procedural safeguards in California, Delaware, and New York.

a. Derivative Suits. Derivative actions are available to shareholders when management wrongfully refuses to vindicate a corporate claim based on management's breach of its fiduciary duties or carelessness in managing the affairs of the corporation.[126] Refusal to proceed with the lawsuit leaves the corporation qua entity powerless to enforce its claim. Since the shareholder is indirectly affected by the failure to press the action, in that she may suffer a reduction in the value of her stock, the law gives her the right to sue derivatively—on behalf of the corporation—to redress the wrong. If a derivative suit succeeds, recovery goes to the corporation and the plaintiff-shareholder (and attorney) receives legal fees from the company.

In derivative suits, since the direct cause of injury is management, the shareholder must first "demand" the assistance of corporate management in correcting the wrong.[127] The derivative plaintiff must also

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125 For example, in California, punitive damages are available by statute in all actions other than breach of contract where the defendant is "guilty of oppression, fraud, or malice." Cal. Civ. Code § 3294(a) (West 1997). Under this definition, "fraud" includes "intentional misrepresentation, deceit, or concealment of a material fact." Id. § 3294(c)(3). This definition has been used to cover securities fraud. See Koehler v. Pulvers, 614 F. Supp. 829, 849 (S.D. Cal. 1985) (awarding punitive damages where developers omitted material facts in selling limited partnership interests in violation of federal securities laws as well as common law fraud and deceit).

126 Such suits often allege that an officer or director breached her duty of loyalty by self-dealing, accepting kickbacks, appropriating a corporate opportunity, wasting corporate assets, or entrenching her position to avoid removal. See William L. Cary & Melvin Aron Eisenberg, Cases and Materials on Corporations 1013-15 (7th ed. 1995) (discussing types of derivative and class actions).

127 The laws governing the prelitigation demand requirement in a shareholder derivative suit are substantially similar. See Cal. Corp. Code § 800(b)(2) (West 1996) (requiring that derivative plaintiff "alleges in the complaint with particularity plaintiff's efforts to secure from the board such action as plaintiff desires, or the reasons for not making such effort"); Del. Ch. R. 23.1 (similar); N.Y. Bus. Corp. Law § 626(c) (McKinney 1986) (similar); Shields v. Singleton, 19 Cal. Rptr. 2d 459, 466 n.5 (Ct. App. 1993) (implying that requirements of California law for providing demand futility are identical to Delaware law); Marx v. Akers, 666 N.E.2d 1034, 1039 (N.Y. 1996) (stating that Delaware case law on demand

meet two other procedural requirements: (1) she must prove contemporaneous ownership of the corporation's stock,[128] and (2) she must post security for litigation expenses.[129] None of these requirements exists for class actions.[130]

State courts accord significant discretion to boards of directors by allowing them to determine whether institution and prosecution of a derivative action is well advised from the corporation's standpoint.[131] Not surprisingly, the boards rarely allow derivative suits to proceed to trial. However, the institution of a derivative suit still has settlement value ex ante, because the corporation must incur substantial legal and related fees in investigating the claims.

If the derivative action is settled, the court must approve the settlement.[132] The corporation may be obliged to pay plaintiffs' attorneys' fees if the action is found to have benefited the corporation or its shareholders.[133] This "substantial benefits" rule applies even

futility resembles New York law "in some respects," but noting that Delaware approach incorporates frequently criticized "reasonable doubt" standard).

128 See Cal. Corp. Code § 800 (West 1996) (requiring derivative plaintiff to allege that she was stockholder of corporation at time of challenged transaction or that her shares devolved upon her by operation of law, but allowing shareholder not meeting these requirements to maintain action, in court's discretion, upon proper showing of various circumstances); Del. Code Ann. tit. 8, § 327 (1991) (requiring derivative plaintiff to prove contemporaneous ownership of stock); N.Y. Bus. Corp. Law § 626(b) (McKinney 1986) (same).

129 See Cal. Corp. Code § 800(e) (West 1990) (requiring derivative plaintiff to post $50,000 security bond); N.Y. Bus. Corp. Law § 627 (McKinney 1986) (requiring derivative plaintiff to post "reasonable expenses" including its attorneys' fees). However, Delaware does not have a security-for-expense requirement. The security requirement has been of limited effect, because courts have allowed shareholder plaintiffs to meet the threshold by aggregating holdings. See Note, Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience, 4 Colum. J.L. & Soc. Probs. 50, 62-63 (1968) (discussing statutes that discourage nonmeritorious derivative claims).

130 See Eisenberg v. Flying Tiger Line, Inc., 451 F.2d 267, 270-72 (2d Cir. 1971) (designating shareholder action to undo merger of corporation as personal and not derivative, thus plaintiff could not be required to post security for costs).

131 The leading case is Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981) (stating that committee of directors may terminate shareholder derivative suit if court finds that they acted in good faith, with independence, and after reasonable investigation); see also Findley v. Garrett, 240 P.2d 421, 425 (Cal. Ct. App. 1952) (holding that directors could bar derivative action if, upon good faith exercise of their business judgment, they decided not to bring it); Auerbach v. Bennett, 393 N.E.2d 994, 1001-02 (N.Y. 1979) (adopting less stringent judicial scrutiny to disinterested director's decision to dismiss derivative litigation).

132 See Del. Ch. R. 23.1 (specifying that, except in cases where dismissal is without prejudice or without prejudice to nonplaintiffs, plaintiffs may dismiss or compromise derivative actions only with approval of court and after notice to shareholders as court directs); N.Y. Bus. Corp. Law § 626(d) (McKinney 1986) (same); see also Kane, supra note 40, at 397 ("Rule 23(e) protects class members from some potential attorney conflicts of interest in settlements by mandating judicial approval and notice of any proposed settlement.").

133 See, e.g., Cal. Civ. Proc. Code § 1021.5 (West 1980 & Supp. 1998) (permitting recovery of costs and expenses by successful derivative plaintiff if significant benefit has been

where the benefit obtained was not monetary, so long as the benefit is specific and substantial.[134] The avoidance of litigation costs usually qualifies as a "substantial benefit" warranting the award of attorneys' fees.[135]

b. Class Actions. A shareholder may maintain a direct action against the corporation if she has sustained an independent and distinct injury, which may take the form of either a wrong inflicted upon the shareholder alone or a wrong affecting a particular right that the shareholder is asserting. Thus, when shareholders assert fraud in connection with the sale or purchase of securities, those shareholders likely may institute both a derivative action and a class action, because the corporation qua entity has lost value through the fraud and because the individual shareholders have suffered injury from the intentional misrepresentation or omission.[136]

States model their provisions for class actions largely on the Federal Rules of Civil Procedure.[137] For example, like federal district courts, state courts must approve all settlements of class actions, and a practice has evolved of holding fairness hearings on such settlements.[138] In these hearings, courts make an independent evaluation

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conferred on plaintiff class). This is a well established exception to the general rule that the prevailing party cannot recover attorneys' fees. See Mills v. Electric Auto-Lite Co., 396 U.S. 375, 391-95 (1970) (awarding attorneys' fees to shareholder plaintiffs where plaintiffs established violation of securities laws).

[134] See Elite of N.Y. Cars, Ltd. v. Zarbhanelian, 626 N.Y.S.2d 258, 258 (App. Div. 1995) (awarding attorneys' fees of disbursements where corporation received "substantial benefit" from settlement of shareholder derivative litigation that resulted in forgiveness of $250,000 debt).

[135] See, e.g., Lewis v. Anderson, 81 F.R.D. 436, 439 (S.D.N.Y. 1978) (finding that "avoidance of further expense" benefited defendant corporation).

[136] See In re Pacific Enters. Sec. Litig., 47 F.3d 373, 378 (9th Cir. 1995) (approving global settlement of (1) shareholders' derivative suit against Pacific Enterprises' directors and officers for breach of fiduciary duties, (2) shareholders' derivative suit against company's auditors who had certified allegedly misleading financial statements, and (3) shareholders' class action suit against company for violation of federal securities laws); Stepak v. Ross, Civ. No. 7047, 1985 WL 21137, at *2 (Del. Ch. Sept. 5, 1985) (noting that 18 class actions and four derivative suits were filed after price of Warner Communications stock plunged).

[137] See Fed. R. Civ. P. 23.

[138] This requirement of court approval is based on the fiduciary character of derivative litigation; its purpose is to protect against abuses such as private settlements between the derivative plaintiff and the defendant. See Wolf v. Barkes, 348 F.2d 994, 995 (2d Cir. 1965) ("[T]he prime 'mischief and defect' the [court approval] rule was intended to prevent . . . [was] 'private settlements under which the plaintiff stockholder and his attorney got the sum paid in settlement, and the corporation got nothing.'" (quoting Craftsman Fin. & Mortgage Co. v. Brown, 64 F. Supp. 168, 178 (S.D.N.Y. 1945))). Accordingly, settlement of a derivative action requires the court to determine that the proposed settlement is fair and reasonable. See Polk v. Good, 507 A.2d 531, 535-36 (Del. 1986) (describing court's function as deciding whether settlement was reasonable in light of nature of claim, possible

of the fairness of the settlement to class members, including an assessment of the relationship between the recovery obtained by class plaintiffs and the fees for the class attorney.[139] Most state courts also require that the Rule 23(a) prerequisites for litigation of a class action, such as commonality and typicality, be satisfied before a class can be certified.[140] Because inadequate prosecution, attorney inexperience, and collusion are "paramount concerns" in pre-certification settlements,[141] a judicial finding of the adequacy of representation appears to be a due process prerequisite to certification of a settlement class.[142] Finally, class action settlements offer notice to the absentee class members,[143] the right to object to the settlement, and in most actions involving money damages, the right of class members to opt out of the class.[144]

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defenses, and legal and factual circumstances of case (citing Rome v. Archer, 197 A.2d 49, 53 (Del. 1964))).

139 Appellate courts have laid down various factors to be considered in evaluating whether a class action settlement should be approved, but the factors themselves are admittedly vague and unclear. See City of Detroit v. Grinnell Corp., 495 F.2d 448, 463 (2d Cir. 1974) (listing nine factors that trial court considered in approving settlement).

140 See Cal. Civ. Code § 1781 (West 1985) (providing that class action must satisfy numerosity, commonality, typicality, adequacy, and efficiency requirements); Del. Ch. R. 23(a), (b) (same); N.Y. C.P.L.R. 901 (same).

141 In re General Motors Corp. Pick-up Truck Fuel Tank Prods. Liab. Litig., 55 F.3d 768, 795 (3d Cir. 1995).

142 See id. at 784 ("The protection of the absentees' due process rights depends in part on the extent the named plaintiffs are adequately interested to monitor the attorneys . . . and also on the extent that the class representatives have interests that are sufficiently aligned with the absentees . . . ."). Some courts reach the issue of adequacy of representation by finding that the requirements of the class action rule apply prior to class certification, while others may collapse the "adequacy of representation" finding into one which evaluates the fairness of the settlement. See 2 Herbert B. Newberg & Alba Conte, Newberg on Class Actions § 11.27, at 11-52 (3d ed. 1992) (noting that some courts have certified settlement classes "without articulating or consciously applying Rule 23 tests"). However characterized, the adequacy of representation requirement should be aimed at determining whether the named plaintiffs and their counsel are suitable representatives of the absentees' claims.

143 California, Delaware, and New York require that notice of the proposed settlement or dismissal of the derivative suit be given to the other shareholders in a manner directed by the court. See, e.g., N.Y. C.P.L.R. 908 ("Notice of the proposed . . . compromise shall be given to all members of the class in such manner as the court directs."). Notice of settlement "is sufficient if it contains a fair description of the proposed settlement, puts stockholders upon notice as to the general nature of the subject matter, and warns them that their substantial interests are involved." Geller v. Tabas, 462 A.2d 1078, 1080 (Del. 1983) (affirming approval of settlement of class action and derivative suit).

144 See Dunk v. Ford Motor Co., 56 Cal. Rptr. 2d 483, 487 (Ct. App. 1996) (finding that objector did not present sufficient evidence of unfair settlement); Nottingham Partners v. Dana, 564 A.2d 1089, 1100-01 (Del. 1989) (holding that due process was satisfied without providing objectors with means of opting out when class action was settled, provided that objectors were (1) adequately represented by named plaintiffs and counsel; (2) given notice of proposed settlement; (3) given opportunity to object; and (4) assured that court had

State courts still generally appoint as lead counsel either the lawyer who filed the first complaint or a lawyer elected by all the lawyers who have filed complaints.[145] Lawyers representing institutional investors are unlikely to win the race to the courthouse or even to be among the early filers. This is because an institution presumably will want to evaluate carefully whether the potential claim has merit before deciding whether to file suit, regardless of whether the institution became aware of the potential claim on its own or was made aware of that claim by a plaintiff's attorney. Without a most adequate plaintiff requirement, however, an institution that proceeds in such a deliberative fashion will face an uphill battle if it decides that the case is strong enough and its stake large enough to justify an effort to become the lead plaintiff.

State courts rarely consider the possibility that one aspiring lead plaintiff is more likely than another to monitor its lawyer's conduct of the litigation. In fact, courts often state that a lead plaintiff need not be the best available class representative, but merely one who is likely to pursue the case in the interests of the class.[146] Courts require nothing more by way of proof of adequacy than that an aspiring plaintiff have sustained losses akin to those incurred by other class members, be represented by competent counsel, and have no interest substantially antagonistic to the interests of the class.[147] An institutional investor inclined to monitor a class action actively who has not participated in the race to the courthouse is therefore unlikely to secure the lead counsel appointment of the lawyers it believes will most faithfully and diligently represent its interests and those of the plaintiff class. Similarly, plaintiffs' attorneys who become aware of a potential

to find settlement fair and reasonable (citing Kincade v. General Tire & Rubber Co., 635 F.2d 501, 507-08 (5th Cir. 1981))); In re Colt Indus. Shareholder Litig., 553 N.Y.S.2d 138, 141 (App. Div. 1990) (noting that while there are no specific guidelines for approving class action settlements, "'the components which should be considered in reviewing a settlement [are]: the likelihood of success, the extent of support from the parties, the judgment of counsel, the presence of bargaining in good faith, and the nature of the issues of law and fact'" (quoting West Virginia v. Pfizer & Co., 314 F. Supp. 710, 740 (S.D.N.Y. 1970), aff'd, 440 F.2d 1079 (2d Cir. 1971), modified on other grounds, 566 N.E.2d 1160 (N.Y. 1991))).

145 See supra note 20 and accompanying text.

146 See, e.g., Youngman v. Tahmoush, 457 A.2d 376, 381 (Del. Ch. 1983) (finding plaintiff adequate representative even though plaintiff had equity interest in corporation that sought to take over defendant corporation).

147 See Fed. R. Civ. P. 23; see also Richmond v. Dart Indus., Inc., 629 P.2d 23, 28 (Cal. 1981) ("[O]nly a conflict [of interest] that goes to the very subject matter of the litigation will defeat a party's claim of representative status."). The adequacy requirement defeats class certification only in extreme cases. See, e.g., Meachum v. Outdoor World Corp., 654 N.Y.S.2d 240, 254 (Sup. Ct. 1996) (denying class certification in part because class representatives were former or present employees of class counsel and thus would not adequately and fairly protect class interests).

class action claim have no incentive to seek out an institutional investor, rather than a figurehead plaintiff, as a client.[148]

There are more inefficiencies in state class action procedures. Under most state systems, plaintiffs' lawyers have no incentive to inform institutional investors of potential securities law claims with a view to enlisting them as clients. Neither are institutions likely to learn of such suits from corporate defendants.[149] A corporation has no obligation to issue a press release disclosing that it has been sued, unless the suit is likely to have a material effect on the corporation's financial condition.[150] Moreover, corporations are generally adverse to publicizing class actions,[151] perhaps fearing that doing so would stimulate the filing of additional claims.

Due to "best practicable notice" provisions, class members rarely receive timely notice of the pendency of a class action.[152] In many cases, the parties agree, with the court's concurrence, to defer for months or even years the resolution of class certification issues. Plaintiffs (or their counsel) initially bear the costs of notice, but defendants eventually pay them whenever a class action suit is settled.[153] Conse-

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148 Absent incentives, plaintiffs' attorneys may prefer the freedom from monitoring that they enjoy when representing figurehead plaintiffs. See Margaret A. Jacobs, Lawyers and Clients: Irate Investors Keep Sharp Eye on Attorneys in Smith Barney Suit, Wall St. J., Sept. 30, 1994, at B10 (describing how committee of well educated, affluent investors monitored securities class action and noting that plaintiffs' lawyers referred to committee as "the Committee from Hell").

149 See Bell Atl. Corp. v. Bolger, 2 F.3d 1304, 1309 n.9 (3d Cir. 1993) (stating that "most shareholders do not learn about the litigation until receipt of the settlement notice").

150 Rule 10b-5 requires that an issuer of securities disclose all "material" facts relating to its securities. See supra note 97. California, Delaware, and New York all have statutes similarly worded and serving a function similar to Rule 10b-5. See Cal. Corp. Code §§ 25400, 25401 (West 1996) (prohibiting "untrue statement of a material fact" and "om[ission] to state a material fact" in connection with purchase or sale of securities); Del. Code Ann. tit. 6, §§ 7303, 7323 (1993) (same); N.Y. Gen. Bus. Law § 352-c (McKinney 1996) (same). Events that affect the issuer's financial condition clearly would be deemed a material fact requiring disclosure. See Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (holding that materiality requirement should be judged on "'substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available'" (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976))).

151 See Cary & Eisenberg, supra note 126, at 1125 (discussing class action settlement process).

152 This language is taken from the Federal Rules of Civil Procedure. See Fed. R. Civ. P. 23(c)(2) (requiring "best notice practicable"); Kass v. Young, 136 Cal. Rptr. 469, 472 (Ct. App. 1977) (recognizing right of plaintiff class to receive "best practical notice under the circumstances"); Del. Ch. R. 23(c)(2) ("[T]he Court shall direct to the members of the class the best notice practicable under the circumstances . . . ."); cf. N.Y. C.P.L.R. 904(a), (b) (providing that notice be given only for class actions not brought primarily for injunctive or declaratory relief and in manner deemed reasonable by court).

153 In settled cases, defendants typically agree to pay the cost of notice either directly or indirectly through the settlement fund. But see Oppenheimer Fund, Inc. v. Sanders, 437

quently, the parties attempt first to resolve whether the plaintiffs' complaint states with sufficient particularity a claim on which relief can be granted. If the complaint survives a motion to dismiss, the parties often decide to proceed with discovery and attempt to negotiate a settlement. Then they can reduce costs related to litigation by sending a single notice informing class members of the pendency of the class action, the settlement, the fairness hearing on the settlement, and class members' rights to object to or share in the settlement or to opt out of the plaintiff class.[154]

Lack of timely notice makes it difficult for institutional investors to participate in class actions. An institution may be aware that it has sustained a large loss in the value of a particular security and may even be able to link that loss to some public disclosure; but institutional investors may not have either the expertise of plaintiffs' lawyers to perceive whether a claim of securities fraud is likely to lie or the incentive to devote substantial resources to investigating potential claims.[155]

On the flip side, it is also possible that an institutional investor falling within the class definition of a purported class action complaint would oppose the bringing of the class action. In such circumstances, early notice of a pending class action would permit large investors who opposed particular class actions to take action to discourage suit or to assist in their defense.[156] Thus, the procedures used in state class actions make it unlikely that institutional investors will play an active role in the litigation of securities fraud class actions. The inefficiencies inherent in these procedures argue in favor of states adopting the most adequate plaintiff rule.

3. *An Additional Twist: Preclusive Effect of State Court Settlements*

An important consideration that tilts the debate in favor of states adopting the most adequate plaintiff requirement is the preclusive ef-

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U.S. 340, 360 (1978) (requiring plaintiff class to bear cost of identifying class members when expense would be no greater for plaintiffs than for defendants).

[154] See Cary & Eisenberg, supra note 126, at 1125 (discussing class action settlement procedure).

[155] Nor does the financial press adequately inform institutional investors about class actions. Not all filings are reported, and press reports typically do not include details about the particulars of the claims asserted or the alleged class period. See Weiss & Beckerman, supra note 6, at 2100 (noting that corporation has no obligation to disclose that it has been sued unless lawsuit is likely to have material effect on corporation's financial condition).

[156] See, e.g., Donovan, supra note 93 (reporting on efforts by pension funds to participate in securities litigation); Mark Walsh, Big Investors Speaking Out on Securities Suits, The Recorder, Feb. 23, 1995, at 3, available in LEXIS, News Library, Rcrdr File (describing how CalPERS and three other pension funds wrote letter urging dismissal of suits against Intel Corp. following disclosure of flaws in Pentium chip).

fect of class action settlements in state courts. As part of the claims administration process following a settlement or judgment in a securities class action, class members generally sign releases against the defendants.[157] Even class members who do not file claims but who do not opt out will be barred from pursuing claims after a class claim is concluded.

In February 1996, the Supreme Court, in *Matsushita Electrical Industrial Co. v. Epstein*,[158] held that settlements in state court may bar federal litigation arising out of the same set of facts, even when the state court lacks jurisdiction over federal claims purportedly settled.[159] The Court determined that the federal Full Faith and Credit Act[160] requires federal courts to give the same effect to a state court's judgment approving a settlement as would other courts in the state.[161] Thus, as long as class representatives are deemed adequate, *Matsushita* invests plaintiffs filing in state courts with the bargaining power to settle federal securities fraud claims. Although necessary to protect defendants faced with litigation in different fora, the *Matsushita* rule may encourage the filing of additional class action complaints in state courts.

The combination of the *Matsushita* rule and the Reform Act's more stringent requirements gives shareholder-plaintiffs an incentive to bring class actions in state court and then negotiate a global settlement encompassing exclusive federal claims.[162] For example, a shareholder-plaintiff and her lawyer who was not selected to represent the federal class may file blue sky and common law claims in a state court class action or a derivative suit based on the same alleged misrepresentations or omissions. The class representative and counsel who settle with the defendant corporation first become the winners regardless of the forum, because the state court and the federal court each have

157 Such agreements release defendants from liability with respect to a particular claim or with respect to all actual or potential claims that may have arisen before a given date. See 3 Newberg & Conte, supra note 142, § 12.17 (discussing releases).

158 116 S. Ct. 873 (1996).

159 See id. at 879-80 (construing Delaware law to prevent class members from prosecuting their 1934 Act claims in federal court after reaching settlement in state court).

160 28 U.S.C. § 1738 (1994).

161 See *Matsushita*, 116 S. Ct. at 875-76.

162 See Marcel Kahan & Linda Silberman, *Matsushita* and Beyond: The Role of State Courts in Class Actions Involving Exclusive Federal Claims, 1996 Sup. Ct. Rev. 219, 255-56 (suggesting that state courts take account of federal interests in their own settlement techniques and procedures). Professors Kahan and Silberman argue that giving preclusive effect to state court global settlements undermines federal jurisdiction by allowing state law to determine the scope of claims within federal courts' exclusive jurisdiction. See id. at 221.

the authority to approve a settlement precluding future litigation of all other possible claims stemming from the same set of facts.

To date, several consolidated securities class action settlements in federal courts have provided that settlement was contingent on the state court approving the settlement of the derivative actions filed in that court, and vice versa.[163] Such linked settlements, however, may not accommodate the federal interests reflected in the creation of an exclusive federal cause of action and of the most adequate plaintiff requirement in federal securities actions.

III
Closing the Reform Act's Loophole in State Courts

Since the Reform Act's procedural changes apply only to cases brought in federal court, plaintiffs and plaintiffs' attorneys may avoid the more stringent requirements by filing more claims (and more strike suits) in state court. Currently, lawsuits that include claims for violations of the 1934 Act must be brought in U.S. district courts, which have exclusive jurisdiction over such claims.[164] Lawsuits for violations of the 1933 Act may be brought in either federal or state courts, which have concurrent jurisdiction.[165] Claims based on state law causes of action may be filed in either state or federal court. Congress can, of course, directly close this loophole by preempting all state law claims predicated on the interstate sale of securities, but agency costs will remain in derivative litigation based on state common law causes of action.

A. *States Should Adopt the Most Adequate Plaintiff Requirement*

An implicit requirement in derivative suits and an explicit requirement in class actions is that the plaintiff must be an adequate representative.[166] As such, the plaintiff must be qualified to serve in a

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163 See, e.g., Nottingham Partners v. Dana, 564 A.2d 1089, 1105 (Del. 1989) (approving class action settlement that released claims pending in federal court); see also In re Warner Communications Sec. Litig., 798 F.2d 35, 36 (2d Cir. 1986) (affirming district court decision approving class action settlement that also covered shareholder derivative action filed in Delaware Chancery Court, contingent upon concurrent approval by Chancery Court); In re Oracle Sec. Litig., 829 F. Supp. 1176, 1190 (N.D. Cal. 1993) (denying approval of derivative suit settlement and, therefore, of class action settlement where approval of each federal and state settlement was made contingent upon approval of other, because derivative suit settlement lacked disinterested legal advice); Stepak v. Ross, Civ. No. 7047, 1985 WL 21137, at *2 (Del. Ch. Sept. 5, 1985) (approving class action settlement that was contingent on dismissal of several shareholder derivative suits consolidated for purpose of settlement).

164 See 15 U.S.C. § 77v (1994).

165 See id.

166 See Youngman v. Tahmoush, 457 A.2d 376, 379 (Del. Ch. 1983) (insisting that plaintiff in derivative suit must be eligible to serve in fiduciary capacity for entire class of stock-

fiduciary capacity as a representative of a class whose interests are dependent upon the representative's adequate and fair prosecution of claims.[167] The factors courts consider to determine whether the derivative plaintiff is an adequate representative include the following:

> "[E]conomic antagonisms between representative and class; the remedy sought by plaintiff in the derivative action; indications that the named plaintiff was not the driving force behind the litigation; plaintiff's unfamiliarity with the litigation; other litigation pending between the plaintiff and defendant; the relative magnitude of plaintiff's personal interests as compared to his interest in the derivative action itself; plaintiff's vindictiveness toward the defendants; and, finally, the degree of support plaintiff was receiving from the shareholders he purported to represent."[168]

One or any combination of these factors may be sufficient to warrant disqualification of the derivative plaintiff, but the burden is on the defendant to show a substantial likelihood that the derivative action is not being used as a device for the benefit of all the shareholders.[169] Unfortunately, the adequacy requirement is rarely enforced by the state courts,[170] making it an insufficient constraint on nonmeritorious suits.

Instead, state courts should adopt the most adequate plaintiff requirement for two reasons. First, the rebuttable presumption that the largest shareholder will serve as lead plaintiff will in most cases reduce the agency costs of shareholder litigation. Second, a parallel lead plaintiff selection process in federal and state courts will prevent forum shopping.

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holders, but holding that plaintiff who held substantial investment in potential buyer in failed takeover did not have incurable conflict of interest that would preclude his representation of other shareholders in target company).

[167] See id.

[168] Id. at 379-80 (quoting Katz v. Plant Indus., Inc., Civ. No. 6407, 1981 WL 15148, at *2 (Del. Ch. Oct. 27, 1981)).

[169] See id. at 381; Steinberg v. Steinberg, 434 N.Y.S.2d 877, 878 (Sup. Ct. 1980) (adapting adequacy requirement for class actions from N.Y. C.P.L.R. 901(a)(4) to derivative suit and dismissing suit on grounds that plaintiff sought personal profit from litigation and used suit as weapon in pending divorce proceedings); cf. MacAndrews & Forbes Holdings, Inc. v. Revlon, Civ. No. 8126, 1985 WL 21129, at *5 (Del. Ch. Oct. 9, 1985) (holding that plaintiff "will be deemed an inadequate representative only if, as a matter of law, its interests are intrinsically at variance with those of other shareholders").

[170] See McGhee v. Bank of Am. Nat'l Trust & Sav. Ass'n, 131 Cal. Rptr. 482, 487-88 (Ct. App. 1976) (holding that, for purposes of class action, adequacy of representation depended on whether plaintiffs' attorney was qualified to conduct proposed litigation and whether plaintiffs' interests were antagonistic to interests of class). But see City of San Jose v. Superior Court, 525 P.2d 701, 711-13 (Cal. 1974) (concluding that there was insufficient commonality of interest and that representative plaintiffs failed to represent members of putative class adequately).

Currently, in state courts, most class and derivative plaintiffs are unable to exert meaningful control over the conduct of the litigation or the terms of settlements. First, the lead plaintiff's attorney—not the class members whose economic interests are at stake—makes all important decisions: whether to file a claim, how much time and effort to invest in pursuing it, what litigation strategy to employ, and finally whether and on what terms to settle.[171] Second, attorneys' fees are usually awarded based on the amount of litigation costs saved[172]—costs that would have been nonexistent had there been no suit in the first place.

These procedural deficiencies enhance the need for courts to ensure that the class representative and attorney adequately represent the class and that any settlement is fair to all class members. The most adequate plaintiff requirement encourages the most capable representatives of the plaintiff class to participate in class action litigation and to exercise supervision and control over the lawyers for the class.[173]

B. Incorporating the Most Adequate Plaintiff Requirement into State Procedure

State courts can easily incorporate the most adequate plaintiff requirement into current class action and derivative litigation procedures that require a finding of adequacy of representation. To maintain a class action in any state, a named plaintiff must be able to represent the class adequately and must have claims typical of the class.[174] In part, this means that courts will refuse to certify purported classes if named plaintiffs are subject to unique defenses. When plaintiffs' claims are deemed atypical, they render the plaintiffs unsuitable to represent a class.[175] Significantly, the most adequate plaintiff presumption in federal court was not intended to affect current state law with regard to challenges to the adequacy of the class representative or to the typicality of the claims among the class.[176]

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171 See Coffee, supra note 12, at 681-86 (characterizing plaintiffs' attorney as "rational entrepreneur" in deciding which suits to bring, maintain, and settle); Macey & Miller, supra note 33, at 93 (asserting that in large-scale, small-claims shareholder derivative suits, "courts should forthrightly acknowledge that the named plaintiff is a figurehead").

172 See supra notes 45-54 and accompanying text.

173 Reasons why the requirement would encourage institutional investors to participate actively are discussed supra notes 83-92 and accompanying text.

174 See supra note 156.

175 See id.

176 See H.R. Conf. Rep. No. 104-369, at 34 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 733.

The concept of adequacy of representation was first introduced in Rule 23 and has been adopted by almost all the states.[177] It is not a test without bite, despite its vague language. For example, in *Prezant v. DeAngelis*,[178] the Delaware Supreme Court overturned a state class settlement releasing state and federal claims because the Chancery Court failed to make explicit findings on the adequacy of representation by the lead plaintiff.[179]

Adequacy and typicality requirements are designed to safeguard the interests of absentee class members, but courts assume that absentees generally will not challenge the credentials of putative named plaintiffs. Consequently, courts permit defendants, as the best available surrogates, to mount such challenges.[180] Defendants, however, are not interested in ensuring that class members are represented adequately by a named plaintiff with claims typical of the class, but in preventing class members from being represented by any named plaintiff at all.[181] Consequently, defendants use the threat of discovery to deter plaintiffs from coming forward and use discovery itself to develop information that will convince a court to deny plaintiffs' request for class certification.

While a motion for class certification is not an appropriate point at which to litigate the merits of plaintiffs' claim,[182] defendants can question whether an aspiring representative plaintiff is atypical because she is subject to, and is likely to be preoccupied with, defenses unique to her.[183] Although these rulings may be reasonable in cases where defendants have some basis for alleging that a repeat plaintiff

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177 See Jerold S. Solovy et al., Class Action Controversies, in Class and Derivative Litigation in the 1990s, at 16, 22 (Dennis J. Block & William S. Lerach eds., 1992) (reviewing history of class action device).

178 636 A.2d 915 (Del. 1994).

179 See id. at 925 (holding that "*in every class action settlement*, the Court of Chancery is required to make an explicit determination on the record of the propriety of the class action according to the requisites of Rule 23(a) and (b)").

180 See, e.g., Greebel v. FTP Software, Inc., 939 F. Supp. 57, 59-61 (D. Mass. 1996) (recognizing defendant's right to demand compliance with requirements relating to certification of class while holding that defendants lack standing to challenge appointment of lead plaintiff by direct invocation of reform act).

181 See Macey & Miller, supra note 33, at 64 (noting that "defendant cannot be expected to serve the class or corporation's interests when challenging the typicality or adequacy of representation").

182 See Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177 (1974) ("We find nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action.").

183 See City of San Jose v. Superior Court, 525 P.2d 701, 712-13 (Cal. 1974) (refusing to certify class after finding insufficient commonality of interests between representative plaintiff and class members so that plaintiff could not represent class's interests adequately).

purchased stock in a troubled company without regard to price for the purpose of qualifying as a representative plaintiff,[184] they are troublesome to the extent that they open the door to fishing expeditions during discovery. The risk that institutional investors might be required to comply with similar discovery requests deters them from seeking to become lead plaintiffs in class actions. The cost of producing all documents concerning an institution's investment philosophy and trading over several years would be substantial. An institution might also be concerned about disclosure of proprietary information, although use of confidentiality stipulations and protective orders could alleviate most such concerns.[185] Thus, the current adequacy requirement provides a framework within which the most adequate plaintiff requirement could be incorporated. By adopting the most adequate plaintiff rule, states could avoid some of the problems and perverse incentives that pervade their existing schemes.

Conclusion

Securities fraud lawsuits, like most shareholder suits, often decrease corporate value without serving any useful deterrent function.[186] Nonmeritorious claims that have settlement value may discourage firms from voluntarily disclosing information of interest to investors[187] or from engaging in economically beneficial transactions. The Private Securities Litigation Reform Act of 1995 attempted to address these concerns, in part through its adoption of a most adequate plaintiff requirement. Congress apparently felt that institutional investors would most often fill this role of most adequate plaintiff and that institutional investors presumably would not bring nonmeritorious claims ex ante, because they are as likely to be on the

184 See, e.g., Welling v. Alexy, 155 F.R.D. 654, 658 (N.D. Cal. 1994) (holding that shareholder who appeared in 13 other securities class actions and who was unfamiliar with instant litigation failed typicality and adequacy requirement).

185 The parties to class actions usually stipulate that they will treat as confidential all proprietary information produced in discovery and use it only in the litigation. See Fed. R. Civ. P. 26(c) (allowing protective orders for discovery materials to "protect a party or person from annoyance, embarrassment, oppression, or undue burden or expense"). There is no obvious reason why such stipulations should not protect information produced by a named plaintiff.

186 Most settlements are funded largely by directors' and officers' liability insurance, which virtually all public corporations purchase. Thus the costs associated with such litigation are spread among all public corporations in the form of increased insurance premia and, indirectly, among all their shareholders. See Kraakman et al., supra note 13, at 1745 n.33.

187 See Udayan Gupta & Brent Bowers, Small Fast-Growth Firms Feel Chill of Shareholder Suits, Wall St. J., Apr. 5, 1994, at B2 (reporting that rise in shareholder class actions has changed how small high-tech companies deal with investors).

losing as the winning side of any settlement. They also would appreciate that the only real beneficiaries of nonmeritorious lawsuits are lawyers—the plaintiffs' attorneys who initiate such suits and generally reap twenty to thirty percent of any award or settlement, and defendants' attorneys, who most observers believe receive roughly equivalent fees.[188]

Given the Reform Act's limited scope, its provisions may reduce strike suits in federal courts while simultaneously creating a forum shopping problem for state courts. The procedural differences between litigating under the federal securities laws and litigating under state laws provide incentives for investors and their lawyers to file in state courts. Individual states must grapple with how to induce plaintiffs and their attorneys to evaluate cases more carefully before filing. Incorporating the most adequate plaintiff requirement of the Reform Act is one step toward closing the loophole.

188 See In re Warner Communications Sec. Litig., 618 F. Supp. 735, 750 (S.D.N.Y. 1985) (reviewing case law and concluding that standard fee in such cases is 20% to 35%), aff'd, 798 F.2d 35 (2d Cir. 1986).