Can Congress Legislate Litigation?

by Bruce Angiolillo

Let's roll back the clock to 1995. We are in the middle of what turns out to be the longest economic boom in national history. What follows is a heady time of technological innovation, frothy IPOs, and Main Street's rush into the stock market. We become infatuated with that boom, which is driven largely by America's technology and telecommunications industries. Countless dot-com success stories are just around the corner. We think we are entering a new paradigm—the Goldilocks Economy.

In those sunny days, at first some and then many people saw the prospect of shareholder securities class action litigation as a serious threat to corporate expansion in key, high-growth business sectors. Like storm clouds on the horizon, such litigation cast a shadow over the public companies and the investment banks, accounting firms, and other professionals that served them. Many of the hottest stocks were in start-ups that were long on promises, short on profits. Indeed, a good number of them were being valued almost entirely on untested ideas because they lacked much, if anything, in the way of operating histories.

Those companies feared—and rightly so—that almost any statements about their future earnings and growth would become engraved invitations to sue. They knew that whenever their future performances deviated from their management's public expectations, they would be accused of having fraudulently misled investors.

By the mid-1990s, more than half of the top 150 corporations in Silicon Valley—including each of its ten largest companies—had been sued for securities fraud. *See* D. Abrahms, "Veto override makes high-tech firms happy," *Wash. Times*, Dec. 23, 1995, at A13. Critics proclaimed that the securities laws designed during the Great Depression to protect investors were being misused now by lawyers to threaten the very essence of America's economic engine: corporate risk-taking innovation. Business and some government leaders spoke of the need to reform the securities laws as a matter of life and death for companies in the high-technology sectors. *See* S. Walsh, "House Overrides Veto of Securities Bill; Senate May Vote Today on Frivolous Shareholders Lawsuits," *Wash. Post*, Dec. 21, 1995, at A20.

In the fall of 1995, the political stars aligned. A consensus emerged in Congress reflecting American public opinion that there should be some reining in on securities class actions. Not since the initial passage of the federal securities statutes in 1933 and 1934 had Congress focused as intensely on securities litigation issues. As a result, Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA). If, in the words of Chief Justice Rehnquist, private securities litigation is "a judicial oak which has grown from little more than a legislative acorn," then the PSLRA represented a decision by Congress to prune that tree. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). Not even President Clinton's veto could keep Congress from picking up the saw.

Ten years ago, my clients tended to be firms on the receiving end of securities lawsuits. Naturally, I supported the spirit of reform embodied by the PSLRA. But, upon its enactment, an old adage came to mind: Be careful what you wish for, you may get it. If Congress were intent on putting an end to private securities litigation as we then knew it, what, I asked myself selfishly, did that mean for me? Had Congress, heaven forbid, just put me out of business?

A decade of experience with the PSLRA has shown that private securities litigation has not disappeared. Without question, the Act has altered how securities cases are litigated. But not all the changes were intended by Congress, and some were quite unexpected. The PSLRA specifically targeted plaintiffs' lawyers and their conduct. But nothing gets a litigator's attention like a challenge, and it is illuminating to see how the plaintiffs' bar responded.

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When Congress passed the PSLRA, the two most important of the perceived ills were that securities class actions were too lawyer-driven, with investors having little control over the process, and that notice pleading standards did not adequately allow judges to weed out frivolous cases at the motion-to-dismiss stage. *See* 141 *Cong. Rec.* S9320-01 (daily ed. June 28, 1995) (statement of Sen. Dodd). The first concern, lawyers run amok, was widely known and well understood. Legend has it that a prominent plaintiffs' securities lawyer once boasted, "I have the greatest practice of law in the world. I have no clients." N. Weinberg & D. Fisher, "The Class Action Industrial Complex," *Forbes*, Sept. 20, 2004, at 150. Without clients to whom they were accountable, plaintiffs' lawyers could serve their own interests first and foremost, and many believed that they did. In a client-free (or even a client-lite) atmosphere, do lawyers grow less careful about the quality of the cases they bring? Do they file more cases than they can manage? Do they permit valid claims to be settled too easily, leaving injured shareholders undercompensated?

The second concern, that notice pleading requirements served no gatekeeping function against meritless claims, meant that the existing procedural rules gave plaintiffs nearly immediate access to discovery upon filing their case. As a result, a threadbare complaint, standing alone, could suffice to permit trolling through a corporation's internal files in search of a fraud.

In 1995, Congress decided it was time for a change. In enacting the PSLRA, Congress sought to reduce the role of plaintiffs' lawyers in securities litigation by increasing the role of the injured investors, and to restructure standard pleading and discovery procedures for the benefit of corporate defendants. As Congress intended, the Act revamped the process by which lead plaintiffs are selected. Previously, the race to the courthouse generally determined who would become lead plaintiff. The presumption favored the first party to file suit, and the speed with which a lawyer could get a complaint on file controlled. Lawyers developed proprietary networks, private alliances, and other mechanisms to achieve ready access to investors who were willing to lend their names to complaints.

The PSLRA ended the practice of rewarding with lead plaintiff status the lawyers who drew the lowest docket numbers at the clerk's office. What Congress did instead was to make the plaintiff with the largest economic stake in the litigation the presumptive lead plaintiff. *See* 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb). Implicit in this approach was Congress's desire to break the grip that a dominant group of plaintiffs' securities lawyers had on these cases. If the courts could select those investors that they perceived were willing and able to monitor lead counsel, the roles of the dominant plaintiffs' lawyers would diminish. The goal was to align the interests of lead plaintiff's counsel with the interests of the lead plaintiff and of the class itself.

What has a decade's experience shown? Judicial selection of lead plaintiffs under the PSLRA indeed has increased the role of institutional investors in securities litigation. L. Simmons & E. Ryan, *Post-Reform Act Securities Settlements, Updated Through December 2004*, Cornerstone Research, at 9. Institutional investors have the greater economic stake in the outcome of the securities cases that they bring, and they command greater resources. This, in turn, should make them active clients who are better able to monitor their counsel than a pre-Act plaintiff in name only.

The influence that institutional investors are able to exert should diminish the role of self-interest by plaintiffs' counsel in securities litigation. Institutional investors, Congress believed, better serve the interests of the class than smaller shareholders with a lesser ability to monitor the action. And it was thought that institutional investors' counsel would far better serve those interests than plaintiffs' lawyers whose self-interest Congress blamed for the prevalence of so-called nuisance suits. But the question remains: Has the PSLRA really altered the balance between the interests of the lawyers and the interests of the shareholder litigants?

Consistent with the intent of the Act, institutional investors now commonly serve as lead plaintiffs in securities litigation. For example, they are at the forefront in *Enron* (Regents of the University of California), *WorldCom* (New York City Employees' Retirement System), and *Global Crossing* (Public Employees Retirement System of Ohio and State Teachers Retirement System of Ohio). The economists who have mined the historical data suggest that cases with an institutional investor plaintiff settle for approximately one-third higher value than those with an individual plaintiff. *See* E. Buckberg et al., *Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements*, NERA Economic Consulting, Feb. 2005, at 7.

But contrary to Congress's expectations, institutional investors are not turning to different counsel—which may suggest these institutional investors are more than clients in name only, actually supervising their counsel and, with greater insight, demanding better results. This activism may be a reason for relatively higher settlement values for their cases. The securities cases also may be settling for relatively greater amounts because institutional investor plaintiffs are more discriminating and seek to "invest" in the cases in which either the claims are strong or the losses are large—or, better yet, both. And not surprisingly, the cases that do not attract the interest of an institutional plaintiff tend to be viewed—and valued—differently.

Congress wanted to increase the role of larger investors in securities litigation, and it appears to have accomplished that. But they still do not control the majority of the litigation. Institutions are lead plaintiffs in only about 35 percent of all securities cases. *See Post-Reform Act Securities Settlements*, *supra*, at 9. And if Congress also wanted to disenfranchise what was perceived or portrayed as an entrenched plaintiffs' securities bar, that certainly has not happened either. The pre-Act dominant law firms have been the overwhelming counsel of choice for institutional investors, too. *See id.*, at 14.

Do institutional plaintiffs necessarily bring the same motivations as individual investors? Congress assumed so. But a decade of post-Act history suggests that institutional investors, be they private or public entities, have interests, needs, and separate agendas that individual investors do not inherently share. Things like portfolio management and diversification guidelines, complex trading strategies, institutional hierarchies, political pressures and ambitions, and the like all come into play with institutional plaintiffs. How these factors affect the role of a lead plaintiff is hard to plumb. But

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not all institutional plaintiffs are necessarily typical investor representatives. Some of the largest institutional investors are state- or municipal-based pension funds. They are part of the political infrastructures of the states and communities where they reside. They often are led by patronage appointees with allegiances to elected officials: the governor, mayor, treasurer, or attorney general. Unintentionally, therefore, the PSLRA has empowered state and local office holders. Individuals in charge of quasi-political institutional investors may have agendas to advance that are not shared generally by the shareholder class. Without generalizing about how parochial interests or local politics can affect these government-based institutional plaintiffs, it's clear that Congress never intended to put control over federal securities litigation under the purview of local politicians.

Before the Act, securities litigation was criticized for its inefficiency. In the words of Chief Justice Rehnquist:

> a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.

Blue Chip Stamps, 421 U.S. at 740. Companies faced the unappealing choice of paying money to settle cases making relatively weak claims, or suffering the exorbitantly high costs of discovery.

But defendants do not want securities actions settled—they want them dismissed. Under the old system, the imbalance between litigation costs and the merits of the lawsuits created perverse incentives. A weak complaint could have an economic value bearing no real relationship to its claims. Critics argued that plaintiffs' lawyers were being paid to bring cases they otherwise never would have brought, and that companies were being forced to settle early or pay through the nose to vindicate themselves. *See* 141 *Cong. Rec.* S9320-01, *supra.*

Congress did two things to end the practice of filing generalized securities complaints and using the discovery process to dig for evidence to find an alleged fraud. First, it heightened the standard for securities fraud cases. Instead of notice pleading, plaintiffs must, under the Act, plead with particularity both a defendant's alleged misrepresentations and scienter. *See* 15 U.S.C. § 78u-4(b)(1)-(2). Second, Congress stayed all discovery, with limited exceptions, against a defendant until determination of the motion to dismiss. *See* 15 U.S.C. § 78u-4(b)(3)(B). Through these PSLRA changes, Congress attempted to increase dismissals of "meritless" cases and to shut down the costly discovery process until a complaint passed muster under the new heightened pleading standards.

What, if anything, Congress spared the court system in volume may be offset by the duration of litigation under the new regime. Although it is hard to estimate the number of weak cases that the Act has precluded filing, the filed cases that survive dismissal seem to take longer to resolve. The heightened pleading provisions in the PSLRA, which Congress designed to handicap the ability to bring securities claims in the first place, has become a plaintiff's strategic weapon where the motion to dismiss is denied; any suit that survives a dismissal motion significantly increases in value. Congress probably did not have this consequence fully in mind back in 1995.

Indeed, raising the pleading bar to eliminate the worst features of pre-Act private securities cases may effectively have validated the complaints that do satisfy the PSLRA. There could be some truth to the notion that, in trying to weed out frivolous securities complaints that ultimately had relatively small settlement value, the PSLRA actually increased the settlement value of those complaints that meet Congress's new requirements. It could be that the PSLRA actually presaged the current boom in private securities litigation because this unintended de facto congressional validation of complaints turned out to be more significant than the Act's explicit limitations on them.

After the court rules on the motion to dismiss, the PSLRA's stay of discovery dissolves. Regardless of what the economists who study such things say, after a client's PSLRA motion to dismiss is denied, plaintiffs' counsel are not shy about upping the value from that assessed on the case the previous day. Now, surviving a dismissal motion is viewed much differently—and priced more expensively—than in the pre-reform days.

Raising the pleading standards and instituting a discovery stay during the pendency of the motion to dismiss has reduced early settlements of securities litigations. *See Recent Trends in Shareholder Class Action Litig.,* at 4. Largely gone are the quick settlements disconnected from the merits of any given case. Now that the Act has postponed the start of discovery, the early pressure on defendants to settle is reduced. In the post-PSLRA era, settlements before the court's denial of a defendant's motion to dismiss are becoming an endangered species. Overall, an open question is whether the PSLRA actually has reduced either the amount or costs of securities litigation.

Congress designed the PSLRA to make the federal courts an inhospitable place for securities fraud claims. Because the days were past when one could plead fraud generally and then take discovery to find it, plaintiffs' lawyers started to figure out ways to avoid the federal system entirely and go where the grass was greener and the pleading standard was lower: state court. There, they would be beyond the reach of PSLRA. This prompted a revival of state common and statutory law claims.

Thus, only three years after enacting the PSLRA, Congress responded by passing the Securities Litigation Uniform Standards Act (SLUSA) to try to shut down these end runs. SLUSA generally mandates that, whether an action is styled as a common law fraud case or an action based on another tort theory, if there are more than 50 plaintiffs and the facts of the case involve misrepresentations or omissions regarding the purchase or sale of securities, the case can be removed to federal court, where it will be dismissed on preemption grounds. 15 U.S.C. § 77p(b). As Congress intended, SLUSA pushed many but not all securities-based actions back to federal court. It did not, however, end all efforts to avoid an uninviting federal forum. Testing the boundaries of what Congress had done, plaintiffs' lawyers began pleading new and different claims—claims that could not be removed to federal court yet still looked and smelled like securities fraud claims.

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Securities fraud claims were dressed up—or disguised—as state law derivative suits. Traditionally, derivative suits challenge improper conduct that caused injury to the corporation itself rather than to its shareholders. Because of the traditional role of derivative suits and their well-established province of the state courts, Congress had carved them out of SLUSA, and these cases could not be removed to federal court. *See* 15 U.S.C. § 77p(f)(2)(B).

This federal respect for the traditional role of the state courts became a hook to circumvent SLUSA's federal preemption, as plaintiffs attempted, with some success, to plead securities fraud claims as derivative claims. And because derivative suits are not subject to the PSLRA's automatic stay of discovery, such suits reopened the door to discovery fishing expeditions that Congress explicitly had tried to close.

Another type of claim, virtually unheard of before the Act, began to emerge: the state law "holding" claim. In these suits, plaintiffs allege not that fraud induced investors to buy or sell a security but rather that fraud induced them *to hold* a security they otherwise would have sold. Because these claims do not plead a purchase or sale of securities, they do not fall under Rule 10b-5.

Since these holding claims are not actionable under Rule 10b-5, federal courts have had to grapple with whether they are exempt from SLUSA's reach. Circuits are already split on this issue. *Compare Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005) (holding claims preempted by SLUSA), *with Dabit v. Merrill Lynch et al.*, 395 F.3d 25 (2d Cir. 2005), *cert. granted*, 73 U.S.L.W. 36 32 (U.S. Sept. 27, 2005) (No. 04-1371) (holding claims not preempted by SLUSA). The holding claims can be based on the same underlying facts as a typical 10b-5 case. But the argument goes that because they involve holders of securities, instead of purchasers or sellers, they can proceed in state court, while cases involving classes of purchasers and sellers based on the same facts can be removed to federal court. Classes are now being carefully defined to include only holders of securities and to exclude purchasers and sellers, with the goal of keeping the cases in state court.

Institutional plaintiffs also have begun going it alone in the wake of the PSLRA and SLUSA. An unintended consequence of PSLRA was that institutional investors realized not only that it was good to be lead plaintiffs in federal class actions, but also that it sometimes was even better to be opt-outs and pursue their separate claims in state court. In addition, and in the wake of SLUSA, institutional plaintiffs also realized that if they do not act on behalf of a putative class, they can file actions in state court and avoid both SLUSA-mandated removal and the PSLRA's heightened pleading standard. These renegade state court actions can create real headaches for defendants. There are no discovery stays or pretrial coordination with the federal class action, yet there is the real threat of res judicata or collateral estoppel if the state court case gets fast-tracked to an early trial setting.

Not only have actions based on state law become more widespread in the wake of the PSLRA and SLUSA, but ERISA has become an alternative way to sue for securities-based losses. Because ERISA is a federal statute, these cases are subject to federal jurisdiction but avoid the PSLRA's heightened pleading standard and automatic discovery stay. ERISA cases also avoid the necessity for plaintiffs' lawyers to deal with the oversight of a lead institutional plaintiff.

Many retirement plans today, such as the now-familiar 401-k, allow employees to invest their plan assets in securities and, in some cases, in the stock of their employer. These plans are governed by ERISA 29 U.S.C. § 1001 *et seq.* This comprehensive federal statute governs the rights of retirement-plan participants and the duties of employers who sponsor retirement plans. It contains specific provisions governing the fiduciary duties of plan administrators, as well as specific disclosure rules.

ERISA has become an alternative way to sue for securities-based losses.

Pursuant to ERISA, defendants can be held liable under a negligence standard for conduct that, under Rule 10b-5, would require a showing of scienter. Because ERISA places specific duties of prudence and care on plan administrators, a showing of intentional or reckless conduct may not be required.

ERISA securities-based cases generally fall into two categories: so-called prudence claims and misrepresentation claims. Prudence claims generally allege that, due to financial problems of the employer, the employer stock held by the plan became a bad investment and the fiduciaries to the plan were imprudent in allowing the plan to hold and to continue to invest in that stock. Misrepresentation claims allege that plan participants were misled into buying or holding the stock by false statements about the stock's prospects, which concealed significant problems and ultimately led to a stock price decline. *See* 12 No. 5, ERISA Litig. Rptr. (2004).

So far, defendants have had mixed results in obtaining dismissals of ERISA class actions on the ground that they actually are securities fraud actions, governed by the PSLRA, masquerading as ERISA cases. When the PSLRA was enacted, no one predicted that ERISA would become an alternative to bringing securities fraud cases under Rule 10b-5.

The evolution of securities litigation in the wake of the PSLRA has been a window into what can happen when Congress targets a specific area of litigation and then legislates. In some ways, the Act worked as contemplated. It did increase the role of institutional investors in private securities litigation, raise the pleading standard for securities fraud cases filed in federal court, and create an automatic discovery stay in many instances.

In other ways, the law resulted in some things that Congress wasn't aiming at. Because institutional investors have not been the tempering influence on the plaintiffs' bar that Congress may have expected, plaintiffs' lawyers, when forced, are filing new types of cases, sometimes in state courts, to avoid the reaches of the PSLRA and SLUSA.

The realities of lawmaking make doubtful that Congress

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ever can pass bulletproof legislation. Although a statute may end up changing the routes that lawyers use to bring cases, it generally will not stop the cases entirely. And, of course, the statute may well lead to the development of new or somewhat novel theories.

Recently, the political and economic stars again aligned for a sweeping legislative initiative in the litigation arena. Congress passed the Class Action Fairness Act (CAFA), with stated goals for the legislative reform that sounded much like those for the PSLRA. Congress needed to address a perceived explosion of frivolous lawsuits that were taking a dramatic toll on business. According to a *Wall Street Journal* editorial, "Liability today has become what taxes and regulations were 20 or 30 years ago—an enormous drag on our economy and a political tool for redistributing wealth unlinked to any genuine injustice." "Tort Reform Roadmap," *Wall St. J.*, Jan. 27, 2005, at A12.

CAFA is expected to reduce the number of class actions, particularly nationwide class actions and mass tort class actions. CAFA expands diversity jurisdiction, authorizes the removal of certain class actions filed in state court, changes the procedure for settling class actions in federal courts, regulates settlements involving coupons, and bars geographically disparate consideration to class members. *See* 28 U.S.C. §§ 1332(d), 1453, 1711-1715.

Commentators already are predicting that the Act will not function exactly as Congress intended. Ambiguities in the Act's provisions on diversity jurisdiction could cause more

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class actions to be litigated in state court than Congress intended, or, as plaintiffs' attorneys become more accustomed to the federal forum, a huge influx of new class actions could overburden federal courts, particularly in those circuitsthat have a reputation for more freely certifying classes. *See* John C. Coffee Jr., "Corporate Securities," *N.Y. L. J.*, July 21, 2005.

When President Bush signed CAFA, he said it would "ease the needless burden of litigation on every American worker, business and family." V. Morris, "Bush Wins War to Curb Big Lawsuits," *N.Y. Post*, Feb. 19, 2005, at 6. But if past is prologue, it may well be that—like the PSLRA—it is the Act's unintended consequences that we will be talking about.

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