

Testimony of
James D. Cox
Before
Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government
Sponsored Enterprises
U.S. House of Representatives
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on
H.R. 5491

My name is James D. Cox. I am Brainerd Currie Professor of Law, School of Law, Duke University where my research and teaching focuses on securities and corporate law. Prior to coming to Duke in 1979, I taught at Boston University, University of San Francisco, University of California, Hastings College of the Law, and Stanford University School of Law. I have in the recent past been a member of the New York Stock Exchange Legal Advisory Committee and the National Association of Securities Dealers Legal Advisory Board. Among my publications are Securities Regulations: Cases and Materials (5th ed. Aspen 2006)(with Langevoort and

Hillman) which has been adopted in approximately two-thirds of American law schools.

I submit this statement and appear before the Subcommittee on behalf of no organization and the costs incurred in connection with my appearing before this committee are being borne entirely by myself. I appreciate the research assistance in preparing this statement of Mr. Michael S. Roach, a second-year student, at the Duke University School of Law.

I. Questioning the Underlying Supposition of H.R. 5491

H.R. 5491, “Investor Protection: A Review of Plaintiffs’ Attorney Abuses in Securities Investor Protection,” embraces three distinct provisions: a modification of the present procedures and substantive standard for imposing costs on the plaintiff or his/her attorney, disclosure of conflicts of interest(s) the plaintiff may have with respect to the suit, and authorization for auctions and other mechanisms for the selection of counsel to be considered by the presiding judge. In considering these reforms, or any others that might arise during the legislative process, several points should be kept in mind.

First, the total number of securities class action filings in 2005 declined 17 percent from the number in 2004. This decline is not an aberration but no doubt reflects the confluence of several on-going forces that are likely to stabilize or cause further reduction in the number of new filings. The large number of suits filed in 2003 and 2004 reflected the after effects of the wide-spread financial and accounting frauds that came to light beginning in late 2001 and throughout 2002. Also, the serious market correction that occurred through this same period gave rise, as typically occurs during such periods, to reporting abuses that ultimately produced a

significant number of class action suits. At the same time, the strengthening of board independence, particularly for the audit committee, by the listing requirements of the New York Stock Exchange (NYSE) and Nasdaq, the tightening of various disclosure requirements in SEC guidelines and forms, and the many contributions of the Sarbanes-Oxley Act of 2002 have each had their positive impact on reporting practices by public companies. Congress did its homework in 2002, culminating in the most significant reform of the American securities laws since the Great Depression. Now, financial markets are strong and stock prices on the NYSE have recently flirted with their pre-Enron high.

Second, we should also appreciate the numerous judicial decisions that reduce the likelihood of securities class action complaints surviving the defendants' motion to dismiss. The relevance of such developments is they are well-recognized hurdles that class counsel must assess in representing the class. Among the developments are the disappearance of aiding and abetting liability with the decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). A related development is the bright-line test for determining who is a primary participant. Pursuant to this test, a person is not responsible under the antifraud provision, even though he or she actively participated in drafting, editing, or reviewing a document known by him or her to be materially misleading, if the investor from reading the document that contains the misrepresentation cannot "attribute" the misrepresentation directly to that defendant is not in the document attributed to that actor. *See e.g., Wright v. Ernst & Young LLP.*, 152 F.3d 169 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999). When the entity on whose behalf the misrepresentation is committed is bankrupt or in serious financial distress, these holdings eliminate a financially responsible party as a defendant from the suit and, hence,

reduces the viability and attractiveness of pursuing the claim. Moreover, there are multiple screening devices that courts customarily apply to forward-looking statements, such as the statutory safe harbor for forward looking statements *see* Section 27A of the Securities Act, 15 U.S.C. § 77z-2, and Section 21E, 15 U.S.C. § 78u-5, of the Securities Exchange Act, the “bespeaks caution” doctrine that exists in all the circuits *see e.g., Kaufman v. Trump’s Castle Funding*, 7 F.3d 357 (3d Cir. 1993), the “truth on the market” defense *see e.g., Phillips v. L.C.I. Internat’l, Inc.*, 190 F.3d 609 (4th Cir. 1999), and the expanding concept of what constitutes harmless “puffery” *see e.g., Eisenstadt v. Centel Corp.*, 113 F.3d 738 (7th Cir. 1997). Causation has been greatly complicated for class action plaintiffs by the Supreme Court’s decision in *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336 (2005), which requires the pleadings to closely connect the alleged material misrepresentation with an *actual* decline in the value of the stock following a corrective disclosure. Each of these holdings not only draws the court into the case’s facts at the pleading stage, but also poses significant obstacles in the path of the class action where the allegation involves forward looking statements. And, this term, the Supreme Court held that the Securities Litigation Uniform Standards Act bars class actions in state courts brought by investors duped into “holding” their shares by deceitful statements by analysts and others. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503 (2006). As a consequence, the suit must be removed to the federal court, where, under federal antifraud jurisprudence, non purchasers or non sellers lack standing to sue.

A third development retarding the initiation of class action suits are legislative reforms introduced by the Private Securities Litigation Reform Act of 1995. As the committee is well aware, the PSLRA not only bars discovery until all pretrial motions by defendants have been

resolved, but also tests any allegation involving fraud by the requirement that the allegations be pled with particularity and also must establish a “strong inference” of fraud. One consequence of these developments, according to the work of Professor Stephen Choi of New York University, is to reduce the number of meritorious class actions that could be maintained but for the heightened pleading requirement and discovery bar introduced by the PSLRA. *See* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 *Vand. L. Rev.* 1465, 1472 (2005).

The heightened governance and financial reporting requirements, as well as judicial and statutory developments, summarized above, in combination, explain the dramatic change in dismissal rates following defendants’ motions for summary judgment and motions to dismiss. A 2006 study by the National Economic Research Associates reports that the probability of dismissal pursuant to a pre-trial motion rate in the period 1993-1995 was 19.4 percent and climbed to 40.3 percent in the 2003-2005 period. *See* Ronald I. Miller, Todd Foster, & Elain Buckberg, *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, is Stabilization Ahead?* 3 (NERA, April 2006). The high and apparently rising dismissal rate is not consistent with the thesis that baseless suits mature into extortionate settlements. Instead, the declining rates of filings support the view that doctrinal and legislative developments reviewed above are having a most sobering impact on decisions to prosecute securities class action settlements.

Understanding the above-described forces’ contributions toward a decline in the number of securities class action filings should cause us pause in considering additional reforms at this time. Simply stated, we don’t know what the right number of suits in any year is or should be. Rather than focus too much on that number, it is far wiser to focus, as the Congress did in the

Sarbanes-Oxley Act of 2002, on how best to strengthen the financial reporting process.

My co-author, Randall Thomas, John S. Beasley II Professor of Law and Business, Vanderbilt University Law School, and I have carried out a series of empirical studies of securities class action settlements. *See e.g.*, Cox & Thomas, SEC Enforcement Heuristics: An Empirical Inquiry, 53 Duke. L. J. 737 (2004); Cox & Thomas, Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?, 80 Notre Dame L. Rev. 893 (2005); Does the Plaintiff Matter? Cox & Thomas, An Empirical Analysis of Lead Plaintiffs In Securities Class Actions, working paper (May 2006) Our data set now includes several hundred settlements dating from 1990 through spring of this year. At the committee's request, we would be delighted to provide copies of our published articles. Let it be sufficient to say that our work documents that most settlements involve significant sums of money, with the median settlement in the post-PSLRA era approaching \$6 million (median settlements attracting institutions as lead plaintiffs yield settlements more than five times as large as settlements not involving institutional lead plaintiffs) and suits consistently reflect large provable losses per the economic model we use in our analysis. Our data clearly reflects that significant sums are recovered in securities class actions.

The chief disquiet arising from our work is the evidence we have gathered that financial institutions for a variety of reasons fail to submit claims in settled securities class actions. Our study of settlements prior to 2002 reveal that approximately 70 percent of the financial institutions with claims in settled securities class actions do not submit them. *See* Cox & Thomas, Letting Billions Slip Through Your Fingers: Empirical Evidence And Legal Implications Of The Failure Of Financial Institutions To Participate In Securities Class Action

Settlements, 58 Stan. L. Rev. 411 (2005); Cox & Thomas, Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?, 80 Wash. U. L. Q. 883 (2002). Our articles suggest means to easily remedy this problem. We believe our suggestions are worthy of this committee's and the SEC's attention since it would assure that those harmed by securities fraud equally participate in the settlements.

If investor protection and sparing American business needless expenses are the focus of this committee's efforts, it is doubtful that H.R. 5491 will achieve much toward that goal. The following identifies reasons for my less than wholehearted embrace of H.R. 5491. Indeed, it is quite likely that H.R. 5491 will have totally unintended consequences of actually increasing the defendants' cost of litigation.

II. Selection of Counsel

In re Cendant Corp. Securities Litigation, 264 F.3d 201 (3d Cir. 2001), held that selecting lead counsel via an auction was inconsistent with the lead plaintiff provision of the Private Securities Litigation Reform Act of 1995. In *Cendant*, the suit's lead plaintiff, a consortium of three of the country's largest pension funds, had originally negotiated a retainer agreement with lead counsel. The district court decided to disregard the choice made by the lead plaintiff and in turn the retainer agreement. The district court proceeded to conduct an auction among competing law firms whereby it ultimately decided that the best bid was that submitted by the same counsel as initially chosen by the lead plaintiff. After aggressively pursuing the case and negotiating a then record-breaking settlement, the district court awarded counsel fees

pursuant to the formula set forth in the winning bid submitted by the chosen law firm. The fees per that bid were \$76 million greater than that provided in the initial agreement the lead plaintiff had negotiated per the retainer agreement. On appeal, the Third Circuit reversed the district court's use of an auction with the effect of restoring the fee award to that negotiated by the lead plaintiffs with class counsel. The Third Circuit's decision in *Cendant* represents the socially desirable focus, namely, the focus should first be on the adequacy of the plaintiff as a representative of the class. One measure of this is the fee arrangement the petitioning lead plaintiff has negotiated with counsel. *See e.g., Berger v. Compaq Computer Corp.*, 257 F.3d 475 (5th Cir. 2001)(PSLRA raises the standard of adequacy so that consideration of fee agreement negotiated with proposed lead counsel is relevant to determining if petitioner is the "most adequate" plaintiff). To this end, I would think insufficient consideration was given to this factor in *Herrott v. Cavanaugh*, 306 F.3d 726 (9th Cir. 2002), which rejected as lead plaintiff one whose fee agreement with counsel was one-half that negotiated by another petitioner whose losses were six times those of the hard-nosed petitioner.

Section 4 of H.R. 5491 would not only hamper lead plaintiffs negotiating retainer agreements such as occurred in *Cendant* but likely will retard the rising trend of financial institutions to petition to become lead plaintiffs. The empirical research I have conducted with Professor Randall Thomas documents the significant contributions to the settlement process when the lead plaintiff is a financial institution. Our data reflects that for every percentage change in provable losses suffered by the class, the presence of a financial institution as a lead plaintiff increases the settlement by 4 basis points. This number is statistically significant at traditional levels and when applied in the large market capitalization firms that attract financial

institutions yields a dollar settlement difference that is significant. Moreover, our own calculations do not take account, as does the work of Professor Michael Perino of St. Johns University Law School, of the contribution an institutional lead plaintiff makes by negotiating a fee retainer agreement with class counsel. Professor Perino's work, now being joined by our own, reflects that fees are significantly lower on average when the product of negotiation between the lead plaintiff and lead counsel. The district court decision in *Cendant* reflects what happens if courts were encouraged, as would be H.R. 5491's effect, to conduct auctions to select counsel.

Moreover, our research has informed us that institutions have clear preferences regarding who their counsel is so that their on-going participation, indeed monitoring, of the conduct of the suit, at all phases, is much more likely to occur if the institution perceives the class' counsel as one it has selected. A shotgun marriage to the lowest bidder is hardly likely to introduce the same dynamics into the relationship between the lead plaintiff and lead counsel. Multiple reasons for rejecting in most instances auctions is set forth in the "Third Circuit Task Force on the Selection of Class Counsel" (Final Report Jan. 2002). Academics, typically champions of market solutions, find that this market-based solution works poorly in the context of monitoring the conduct of securities class actions. *See* Jill Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 Colum. L. Rev. 650 (2002).

Finally, there is no need for this legislation. Most circuits have not decided whether auctions are a permitted mechanism for selecting class counsel. Even the Third Circuit's decision in *Cendant* and its Task Force Report leave open the possibility of auctions in instances the judge believes appropriate. Thus, Section 4 of H.R. 5491 is unlikely to alter existing practices

since it merely reflects the present jurisprudence regarding the appropriateness of auctions as a means to select class counsel in a post-PSLRA lead plaintiff world. We find few instances of auctions being employed in this environment because there is little reason to expect, generally, that the mail order marriage between lead plaintiff and lead counsel contrived by the auction can rival that based upon thoughtful screening of potential law firms as is the practice followed by institutions. And, when an institution is not involved, the decisions are replete with opinions where the presiding court, as part of its identification of lead plaintiff, gives ample attention to the experience of counsel representing the non-institutional lead plaintiff.

There is one area where the research I have conducted with Randall Thomas does point to a question about counsel for the class action. The problem area are suits where the plaintiff is a single individual - as contrasted with a financial institution, an aggregation of individuals or an individual and an entity, such as a trust or partnership. When the designated plaintiff is an individual, our study of class action settlements indicate that the percentage of losses recovered by the class via the settlement declines as the losses suffered by the class increase. This appears to have no relationship to the attorney's fee structure; it appears to reflect the risk aversion of the attorney and the derivative suit plaintiff to pushing for a better settlement. This is a problem of incentives which is likely to be exacerbated by competitive bidding among attorneys. The answer to this problem is focusing more on the approval of the settlement which is not the focus of H.R. 5491.

III. Rule 11 Sanction: Redux

Section 2 of H.R. 5491 amends the existing provisions of the Securities Act and the

Securities Exchange Act to authorize defendants to move for Rule 11 sanctions against the plaintiff when the plaintiff has incurred an adverse “final judgment against a plaintiff on the basis of a motion to dismiss, motion for summary judgment, or a trial on the merits.” This provision is not likely to be effective for several reasons.

First, the PSLRA introduced a modification to Rule 11 of the Federal Rules of Civil Procedure. The innovation of the PSLRA was to mandate at the final adjudication of any private securities case the judge is to make a finding regarding compliance by each party with Rule 11. The purpose behind the PSLRA’s change was that there was ample evidence that defendants and their counsel rarely moved for Rule 11 sanctions. There were multiple reasons for this; one reason is that to so move would not bring the litigation to a close, but would instead invite on-going litigation and its related costs. And, the outcome of so moving was doubtful. The change proposed in H.R. 5491 is as problematic as was the pre-PSLRA Rule 11’s operation in securities matters. H.R. 5491 does not repeal either the Securities Act’s or the Securities Exchange Act’s mandate that the court make a finding regarding whether the parties have satisfied Rule 11. Thus, the defendant’s motion would have life in the very instance where the court has found that the plaintiff and plaintiff’s counsel have satisfied Rule 11. Such a finding by the presiding court is not likely to encourage the defendant or defendant’s counsel to move for sanctions notwithstanding the judge’s finding.

Second, any inquiry will necessarily be an adversarial one and expensive at that. Hence, the defendants and defendant’s counsel likely will discount heavily the uncertain benefits of so moving by the certain costs of that proceeding. Herein lies the wisdom of the contemporary PSLRA approach. By the PSLRA’s amendments taking this decision out of the hands of the

defendant and defendant's counsel, it has made it possible that in the life of the PSLRA. Indeed, there have been fee awards pursuant to the mechanism set in motion by the PSLRA. Not to be overlooked here is the salutary effects of the lead plaintiff provision which, at least when an institution or other financial entity are involved, provides the suit with an active plaintiff.

There is an even broader concern with any fee shifting arrangement. An important component of our society is our commitment to provide all our citizens with "access to justice." We should be careful to assess the benefits and the costs of any provision that poses a threat to this important component of American society. The American rule has long set us aside from our European and even Asian neighbors where the loser pay rule dominates to the extent of choking off the vindication of private rights. Even businesses who might support H.R. 5491, when asserting their legal rights through litigation, are the beneficiaries of the American Rule. This is a rule that should know no class boundaries and should not be sacrificed in isolated pockets of the law as pleases those who enjoy access to the seats of power.

IV. Conflicts of Interest Disclosure

Section 3 of H.R. 5491 would expand the disclosures the lead plaintiff must make in connection with the suit. Specifically, the plaintiff is to identify "any direct or indirect payment, between such attorney and such plaintiff and between such attorney and any affiliated person of such attorney." Except for the use of the different verb tense, this language closely parallels that added by the PSLRA in amending both section 27(a)(1)(vi) and section 21D(a)(2)(vi) of the Securities Exchange Act which require a sworn certification that "the plaintiff will not accept any payment for serving as a representative party on behalf of the class beyond the plaintiff's pro

rata share of any recovery, except as ordered or approved by the court. . . .” Although there is considerable overlap between the affirmation now required by the PSLRA of lead plaintiffs and the disclosure proposed by H.R. 5491, the latter is more inclusive. It is my own opinion that Section 3 should be even more specific and focused than it is. For example, in our own empirical studies of securities class actions we have called for heightened scrutiny by the courts of possible pay-to-play behavior whereby plaintiff law firms might seek to secure institutional clients as lead plaintiffs via political contributions to those who oversee the financial institution. *See Cox and Thomas, Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs In Securities Class Actions*, working paper (May 2006). Rather than compel disclosure, our recommendation is that a lead plaintiff should not be selected absent demonstrating procedures and safeguards within its organization that fully insulate the decision to become a lead plaintiff from any political or other financial contributions that may be provided those affiliated with the financial institution.

It is my understanding that most federal judges do inquire what financial relations and understandings, if any, exist between the class action plaintiff and proposed class counsel. To the extent not all judges so inquire, H.R. 5491 provides a potentially valuable contribution. It may be wise that this apply more broadly to all class actions brought in the federal courts; this could as easily be accomplished through the Advisory Committee on Civil Rules who has responsibility for updating and improving the Federal Rules of Civil Procedure.

I express my gratitude for having this opportunity to share my comments on H.R. 5491 with you. You and your staff are most welcome to contact me should you believe I can assist you in your efforts in any way.

