

**HOW THE MERITS MATTER:
D&O INSURANCE AND SETTLEMENTS IN SECURITIES
CLASS ACTIONS**

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To: UCLA Law Faculty
From: Tom Baker
Date: October 25, 2007
Re: My Faculty Talk

The attached article is an early draft reporting the results of field research I conducted with my former colleague Sean Griffith (who is now at Fordham). The further you get toward the end, the less finished the piece is. The good news is that there is plenty of opportunity for you to help us figure out what our field research means.

This is the third installment in a series of articles that investigate the relationship between directors' and officers' liability insurance, corporate governance, and securities litigation. If anyone is interested in taking a look at the first two, the easiest way to do that is to go to my author's page at www.ssrn.com.

In my talk next week I plan to spend some of my time defending the proposition that qualitative research of this sort is worth doing. I'm hoping that you will press me hard on that topic and also on any weaknesses you see in the analysis so far.

How the Merits Matter: D&O Insurance and Settlements in Securities Class Actions

Tom Baker and Sean Griffith

In an article announcing the retirement of Bill Lerach, the famous and widely reviled plaintiffs' lawyer, the *Wall Street Journal* concisely summarized the debate surrounding securities class actions. On one side, the reporter wrote, are those who claim securities class actions force defendant corporations to settle “regardless of the underlying merits of the claim,” and on the other are those who argue that such lawsuits “help keep corporate America accountable” by detecting, punishing, and deterring fraud.¹ Lerach, the newspaper suggested, was that controversy personified.² But the controversy is much bigger than one man, and it has hardly been put to rest.

The question, as it was powerfully framed by Janet Cooper Alexander, is *do the merits matter in the settlement of securities class actions?*³ In other words, do the merits of claims determine amounts paid at settlement? Are they a significant factor affecting settlement outcomes? Or are they essentially irrelevant? Rising to the challenge of her article's title, Alexander answered no.⁴ The merits do not matter.⁵ Although it was forcefully critiqued soon after it appeared,⁶ the article played an important role in changing the law, providing rhetorical support and academic credibility to interest groups then lobbying to make securities class actions more difficult for plaintiffs to bring,⁷ an endeavor that succeeded in 1995, with the enactment of the Private Securities Litigation Reform Act.⁸ Indeed, Alexander's article is still widely cited

¹ Nathan Koppel, Milberg Figure Lerach Retires Amid Plea Talks, *Wall St. J.* (Aug. 29, 2007) at B2.

² Others have suggested as much, often with less moderation. See, e.g., Karen Donovan, Bloodsucking Scumbag, *Wired* (Nov. 1996) (describing Lerach's role in securities class actions against high technology companies).

³ Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements of Securities Class Actions*, 43 *STAN. L. REV.* 497 (1991).

⁴ *Id.*, at 500 [jca pin cite and quote.]

⁵ cite/ quote.

⁶ See, e.g., Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 *SAN DIEGO L. REV.* 959, 964 (1996).

⁷ Private Securities Litigation Reform Act of 1995, 15 U.S.C.A 77k-78 (West Supp. 1996) [hereinafter “PSLRA”]. On the influence of Professor Alexander's article in the enactment of the PSLRA, see generally William S. Lerach, *Securities Class Action Litigation Under The Private Securities Litigation Reform Act's Brave New World*, 76 *WASH. U. L. Q.* 597 (1998) (stating that Congress “relied heavily upon Professor Janet Cooper Alexander's article” in enacting the PSLRA).

⁸ Private Securities Litigation Reform Act of 1995, 15 U.S.C.A 77k-78 (West Supp. 1996) [hereinafter “PSLRA”]

even though its empirical foundation has been largely discredited,⁹ perhaps because Alexander’s basic claim—that the merits do not matter in securities litigation—is so widely believed.¹⁰

Because the merits question is now so loaded—taking a firm position on it is like declaring a political allegiance or picking a fight—researchers approach it with considerably more caution.¹¹ And their results, not surprisingly, are ambiguous. Studies since the PSLRA have found that securities lawsuits are now more often dismissed, but heightened scrutiny on the pleadings may lead to dismissal of meritorious and non-meritorious suits alike, and researchers are unable to conclude that only the meritorious survive.¹² Claims now take longer to settle, suggesting perhaps that plaintiffs lawyers are bringing better claims and pushing them harder,¹³ and claims featuring easily-identifiable indicia of wrong-doing or fraud—such as earnings restatements, insider selling, and concomitant regulatory investigations—settle higher than claims without such features.¹⁴ Insofar as such indicia correlate with the merits of a securities claim,¹⁵ these studies may support the proposition that at least some meritorious claims settle higher than non-meritorious claims.¹⁶ But, as the researchers acknowledge, the correlation is far from perfect—some fraudulent conduct will not leave behind such a tangible trace—preventing us from drawing a strong conclusion about the merits of securities claims. Indeed, putting these studies together, perhaps the most we can say is that while there is evidence that the merits matter at least somewhat, just how much remains unclear.¹⁷

In this article, we confront the question of merits. But we do not ask *whether* the merits matter. That, in our view, is the wrong question since, with currently available methods and data, it is impossible to prove either that merits do not matter at all or that they matter enough to justify

⁹ See James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 503-504 (1997) (arguing that the damages estimates supporting Alexander’s core thesis had been calculated incorrectly); 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, 2084 (1995) (recalculating potential damages for the lawsuits in Alexander’s sample and finding much more variation, thereby destroying the support of the article’s core assertion). See also Simon & Dato, *supra* note XX, at 991-93.

¹⁰ Do a citation count from an arbitrary date and scale or compare to other securities citations.

¹¹ We are a case in point. [Griffith reluctantly assumes that merits matter to some degree in his article advocating mandatory disclosure of D&O insurance information depends on the assumption that “the total cost of shareholder litigation does depend, at least in part, on corporate wrongdoing.” (Penn) The Chicago article concludes that “the merits matter somewhat” since underwriting on the basis of merits-like stuff takes place on the margin (after the quant stuff).]

¹² Choi. Marsha Meyer.

¹³ Denise N. Martin, *et al.*, *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 STAN. J.L. BUS. & FIN. 121 (1999) (acknowledging that “the timing of settlements may indeed be reflective of a case’s merits” and that “only a portion of low-valued settlements are likely to be nuisance suit settlements”).

¹⁴ See Marilyn F. Johnson, Karen K. Nelson and A.C. Pritchard, *Do the Merits Matter More After Securities Litigation Reform? Evidence from Restatements, Earnings Forecasts and Insider Trading*, available online at <http://ssrn.com/abstract=589221> (July 2004) (finding “a significantly greater correlation between litigation and both earnings restatements and insider trading after the PSLRA”).

¹⁵ As the studies’ authors acknowledge, the correlation will not be perfect. Some meritorious claims will lack hard evidence. And some hard evidence may not point to actual fraud. PIN CITE.

¹⁶ X-REF *supra* to the section where we discuss this question in detail.

¹⁷ See Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1498 (2004) (“[T]he existing literature on filings and settlements in the post-PSLRA time period provide[s] evidence that frivolous suits existed prior to the PSLRA and that a shift occurred in the post-PSLRA period toward more meritorious claims.”).

continued existence of the securities class action.¹⁸ Our question, instead, is *how* the merits matter. How do the merits enter into the settlement process? How do the participants in securities class actions understand the merits and how do they talk about them? How do they use the merits in settlement negotiations and what do they understand about the role of the merits in shaping settlement outcomes?

Because our research question is qualitative—*how* does the settlement process work?—our research methods too are qualitative, not quantitative.¹⁹ We did not plug data points into regressions.²⁰ Our basic tool is the semi-structured interview, in which we ask questions but allow our participants simply to talk, to describe the settlement process in their own words and to illustrate their explanations with stories and anecdotes.²¹ During 2006 and 2007, we interviewed over fifty people involved in the process of settling securities claims, including plaintiffs’ and defense lawyers, claims managers at insurance carriers, insurers’ monitoring counsel, claims-side brokers, mediators, and testifying experts. In addition, we read their trade literature and participated in industry conferences. In short, we enter the field that we are researching in an effort to understand it from the perspectives of those working within it.²²

Our investigation into how, not whether, the merits matter, leads us to draw an analogy between the process of arriving at a settlement amount and the process of arriving at the price for a D&O insurance policy, which we described in earlier work. In both cases, a simple financial algorithm sets the price range. In selling insurance, the financial factors are the market cap, volatility and industry sector. In settling a case, the financial factors are the number of the shares or other securities outstanding and the difference between the prices for those securities during and after the alleged fraud. But at both ends of the D&O insurance relationship, the financial factors only set the range; they do not determine the point on the range where the policy is priced or the case settled. Other factors play an important role. At the settlement table those other factors include the strength of the evidence on the liability elements of the case – misrepresentation, scienter, and loss causation – along with damages and some non-merits factors.

Among the “merits” factors, the influence of the evidence on misrepresentation and scienter may begin to wane once the plaintiffs survive the motion to dismiss. At that point, plaintiffs and defense counsel typically agree that the case should settle. The only question is when and for how much, and other factors move to the forefront of their negotiations: the strength of the evidence on loss causation, the size and structure of the defendant’s D&O insurance, whether the D&O insurers have good coverage defenses, and the business realities facing the defendant. Fraud remains part of the settlement equation – in the form of the “sex

¹⁸ NERA 2007 at --.

¹⁹ fn to explain this use of “qualitative” to law review editors and economists.

²⁰ We are not critics of quantitative research. But the use of regressions to show whether a particular variable is relevant requires an a priori theory of how something works, which then determines what kinds of data ought to be tested. We are asking the *how* question, not the *whether* question.

²¹ Pursuant to a research protocols approved by the Institutional Review Boards of the University of Connecticut and Fordham University, we interviewed the participants under a promise of confidentiality. The interviews were recorded and transcribed and participant-identifying information was removed from the transcripts. Copies of the transcripts have been provided to the editors of the [LAW REVIEW] for verification but returned to us.

²² Legal scholarship this kind dates back to the Legal Realists, most notably Roscoe Pound and Karl Llewellyn. Intensive qualitative research has long been the hallmark of anthropologists and much of sociology, and even some branches of economics, particularly in recent years. Big cites to anthro, sociology, and recent qualitative turn in economics.

appeal” of the case²³ – but the negotiations focus on the numbers, and the main obstacle becomes the D&O insurers. This means that in order to understand settlement outcomes, we must understand the design of the D&O insurance product and the incentives of D&O insurance carriers.²⁴

In emphasizing the centrality of liability insurance in determining substantive legal outcomes, this article continues a theme from our prior work on D&O insurance. In an Article describing how insurers evaluate risk in underwriting D&O policies, we found that in addition to employing a variety of financial risk factors similar to those used by investors, underwriters evaluate risk through a consideration of a corporation’s “deep governance” structure, which includes an assessment of the firm’s “culture” and management’s “character.”²⁵ In a second Article we reported that D&O insurers do almost nothing to monitor the risky activities of their corporate insureds and that, as a result, D&O insurance is a pure risk-spreading form of insurance, the entity protection aspects of which are likely to be pure waste from a diversified shareholder’s point of view.²⁶

The common theme was the extent to which liability insurance preserved or subverted the deterrence objectives of corporate and securities law.²⁷ On that question, the first two articles were in tension. The fact that D&O insurers price on the basis of risk means that the prices may send a deterrence signal. But the fact that D&O insurance provides only risk distribution, and not loss prevention, means that the insurance itself undercuts the deterrence objectives of securities law. We pursue the same theme here, inquiring into the role played by the D&O insurer at settlement, asking whether the deterrence signal is reintroduced through an insistence on merits at settlement or whether other dynamics at settlement further subvert the deterrence function of securities law. Once again, our results are mixed. The settlement focus on sex appeal, loss causation, and damages is consistent with the deterrence objectives of securities liability. But the salience of insurance and other non-merits factors points in the other direction.

²³ See, e.g. Claims Manager 1 at 20-21 (“Well, they will always start off with a ridiculous number, but generally the way they ultimately play out is they settle for a small percent which has been clearly, you know, if there is culpability on the part of the directors and officers, that jacks it up. You know, the sexier the case, the more interest there is.”)

²⁴ We are not the first to address the role of insurance in settlement. See, e.g., Black, Cheffins, & Klausner, Stanford (focusing on the importance of D&O insurance in explaining why outside directors “almost never” pay their own money in settlement of corporate and securities litigation). But we are the first to address it directly with extensive participant interviews, relating our empirical observations from those interviews to the question of merits in securities litigation.

²⁵ Tom Baker & Sean J. Griffith, Predicting Corporate Governance Risk: Evidence from the Directors’ and Officers’ Liability Insurance Market, ___ Chicago L. Rev. ___ (2007).

²⁶ Tom Baker & Sean J. Griffith, The Missing Monitor in Corporate Governance: The Directors’ and Officers’ Liability Insurer, ___ Georgetown L. J. ___ (2007).

²⁷ Our conclusion, in brief, was that D&O insurance, as currently structured, subverts the deterrence signal. First, although D&O insurers may seek to price corporate governance factors, marginal difference in the price of insurance may not be enough to induce bad actors to be good. [PIN CITE CHICAGO.] Moreover, because D&O premiums are not disclosed, as one of us has argued they ought to be, the capital markets impose deterrence by adjusting the valuations on the basis of information signaled by a corporation’s D&O insurance package. See Sean J. Griffith, Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors’ and Officers’ Liability Insurance Policies, 154 U Pa L Rev 1147 (2006). Finally, the D&O insurer’s failure to control moral hazard or otherwise monitor the riskiness of its corporate insureds similarly impedes the deterrence function of corporate and securities law. [pin cite missing monitor].

The Article proceeds as follows. Part I provides a brief background, both on shareholder litigation and D&O insurance. Part II discusses competing definitions of the merits in securities class actions. Part III reports our findings on the role played by merits in securities settlements, how that process works, and how ideas about merit ultimately translate (or fail to translate) into a settlement amount. Part IV applies our findings to the debate over merits and situates our findings within corporate and securities law scholarship. We close, finally, with a brief summary and conclusion.

I. Shareholder Class Action Law and Procedure

Although the potential bases for shareholder actions are many,²⁸ federal securities law claims are the most significant, in terms of both settlement values and absolute numbers. According to ISS data, securities class actions account for xx% of the shareholder fund cases filed in the 2003 to 2006 period, and settlement funds in securities class actions represent xx% of the total settlement funds in cases filed in 2000 to 2006. Consistent with these data, our participants reported that securities class actions are “head and shoulders above” any other liability exposure.²⁹ This section briefly describes the law and procedure of the securities class action.

A. Substantive Law

Class action securities litigation arises most often under Section 11 of the Securities Act of 1933³⁰ and under Section 10(b) of the Securities Exchange Act of 1934.³¹ Section 11 claims address misrepresentations and omissions in registration statements and may be brought not only against the issuer’s directors and officers but also the bankers, accountants, and lawyers involved in the offering.³² Although it is applicable to a wide variety of defendants, Section 11 claims arise in a single factual context: registered offerings—that is, transactions in which a company sells securities to the public by means of a registration statement filed with the SEC.³³ Much activity in the securities market occurs outside of this context and, thus, is free from Section 11 liability.

Rule 10b-5, promulgated by the SEC under the authority of Section 10(b) of the Exchange Act, has a much broader reach than Section 11 of the Securities Act.³⁴ Rule 10b-5 is “the catch-all antifraud provision,”³⁵ proscribing fraudulent conduct in connection with the purchase or sale of any security. Although 10b-5 claims may arise in a wide variety of contexts, 10b-5 class actions are most often brought against companies for misstatements made in their

²⁸ See generally WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS, § 17.02 (7th ed. 2002) (listing 170 possible grounds for liability in shareholder litigation).

²⁹ Interview with Counsel #1, at 11 (Aug. 4, 2005) (transcript on file with author) (“The big exposure to D&O, as I am sure you know, that is number one, head and shoulders above everything else is securities class actions”); see also Interview with Counsel #3, at 5 (Oct. 12, 2004) (transcript on file with author) (“[S]ecurities litigation outweighs derivative litigation by far.”). Source. See if this can be pulled out of ISS data. In the last two years there has been an unusually large number of derivative actions, many of which arise out of the recent revelations regarding options backdating. It is too soon to tell whether this is a trend or a unique event.

³⁰ See 15 U.S.C.A. §§ 77a-77aa (West 1997 & Supp. 2006) (hereinafter the “Securities Act”).

³¹ See 15 U.S.C.A. §§ 78a-78mm (West 1997 & Supp. 2006) (hereinafter the “Exchange Act”).

³²

³³ pin to section and 12(2).

³⁴ 15 U.S.C. § 77(1)(2) (2000); 17 C.F.R. § 240.10b-5 (2006). [add cites to Section and 12]

³⁵ STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 252 (2005).

public disclosures, especially financial reports.³⁶ In a typical 10b-5 claim, plaintiffs allege that a company's release of false financial information had the effect of inflating (or deflating) the company's share price, causing investors to buy (or sell) and thereby to suffer monetary loss when the truth is revealed and the share price adjusts. The ability of 10b-5 claims to reach beyond the relatively limited context of registered offerings has caused it to dominate other potential bases for securities law liability. In 2005, 93% percent of securities class actions alleged violations of Rule 10b-5. Only 9% alleged a Section 11 violation.³⁷

Plaintiffs bringing a 10b-5 claim must show that defendants, acting with scienter, made a material misstatement on which the plaintiffs relied and which caused a financial loss. Recklessness generally satisfies the scienter requirement.³⁸ But scienter nevertheless poses a significant hurdle for plaintiffs due to a combination of two features of the PSLRA: (1) the stay of discovery until the motion to dismiss has been decided,³⁹ and (2) the requirement that plaintiffs plead facts giving rise to a "strong inference" that the defendants had the requisite state of mind.⁴⁰ Without access to discovery, finding facts to support a claim concerning an opposing party's mental state is, we are told, no small feat.⁴¹ As a result, scienter may be seen as a significant obstacle to plaintiffs. Materiality, by contrast, is not a significant barrier to claims. In 10b-5 claims, as in other securities law contexts, materiality depends upon a "reasonable investor" standard, which is not difficult to show given significant investor losses.⁴² Similarly, reliance is unlikely to constitute a serious barrier to plaintiffs since, on the basis of the "fraud on the market" theory, when shares trade in an efficient market, public statements are incorporated into share price and reliance is presumed for any investor trading at the market price.⁴³ Indeed, apart from scienter and misrepresentation, the only significant substantive legal obstacle to recovery may be the requirement, recently affirmed by the Supreme Court in *Dura Pharmaceuticals, Inc., v.*

³⁶ See, e.g., Coffee, *supra* note, at 1545 ("[A]lthough it would be an overstatement to say that the securities class action exclusively polices fraud in financial reporting, this seems to be its primary role.").

³⁷ See CORNERSTONE, *supra* note, at 16-17. Even fewer, 5%, alleged a claim under 12(a)(2) of the securities act, which provides a remedy for securities sold by the issuer to the public pursuant to a false or misleading prospectus or oral communication. CITE S.A. 12(A)(2); *Gustafson v. Alloyd Co*, 513 U.S. 561 (1995) (limiting the applicability of 12(a)(2) to issuer communications in public offerings). **UPDATE TO 2006**

³⁸ The proper standard for scienter has not been fully elucidated by the Supreme Court. See *Ernst & Ernst*, 425 U.S. 185, n. 12 (1976) (holding that private plaintiffs must show scienter and rejecting a negligence standard, but reserving the question of whether recklessness satisfies the standard). As a result, circuit courts have fashioned their own standard, most accepting that the standard has been met when a defendant, unaware of the true state of affairs, can foresee the likelihood of a statement to mislead. See, e.g., *AUSA Life Insurance Co. v. Ernst & Young*, 206 F.3d 202 (2d Cir. 2000); *SEC v. Falstaff Brewing Co.*, 629 F.2d 62, 76 (D.C. Cir. 1980).

³⁹ See PSLRA, codified in Exchange Act §21D(b)(3)(B) (staying discovery until the motion to dismiss has been decided).

⁴⁰ PSLRA, codified in Exchange Act §21D(b)(2). Cite to recent Tellabs decision.

⁴¹ CITE AN INTERVIEW.

⁴² *TSC Industries v. Northway*, 426 U.S. 438 (1976) (deeming information to be material if there is "a substantial likelihood that the disclosure... would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available").

⁴³ See *Basic v. Levinson*, 485 U.S. 224 (1988). Of course, if defendants can show that the relevant market does not efficiently impound information into share price, the "fraud on the market" presumption of reliance will not apply. See, e.g., *Polymedica*. That the plaintiffs traded is another necessary element of the claim. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749-55 (1975) (holding that plaintiffs must be those who purchased or sold securities, not those who merely held them, between the time of the misstatement and the corrective disclosure).

Broudo, that the plaintiffs show a causal link between the misrepresentation and the plaintiffs' loss.⁴⁴

Loss causation, as the requirement is known, is not new.⁴⁵ What the Supreme Court said in *Dura*, most basically, is that merely pointing to an inflated security price after a misrepresentation is not sufficient to establish loss causation. Instead, the pleadings must include "some indication of the loss and the causal connection the plaintiff has in mind."⁴⁶ What exactly plaintiffs must plead to establish loss causation after *Dura*, however, remains unclear.⁴⁷ For claims resembling what we have been treating as the paradigmatic securities claim—plaintiffs purchasing under the cloud of a misrepresentation and holding through to a corrective disclosure that has a significant impact on the security's price—*Dura* does not present additional difficulties.⁴⁸ However, the situation is less clear where the market price does not react significantly to the corrective disclosure or where plaintiffs sell prior to the corrective disclosure. Commentators have suggested that it may still be possible to plead loss causation in these situations, perhaps by offering a theory of how the truth leaked into the market (and therefore into the security's price) prior to the corrective disclosure.⁴⁹ Leaky truth theories may support claims where there is no price reaction to the corrective disclosure as long as a price reaction can be shown when the leak occurred.⁵⁰ Such theories may also support the claims of plaintiffs who sold prior to the corrective disclosure if they can argue that the price at which they sold reflected the leaky truth which had the effect of lowering the price and therefore causing their loss.⁵¹ In leaving these and other details to be worked out by lower courts, however, the Supreme Court has not settled the controversy surrounding the pleading of loss causation so much as it has flagged it as an area for future developments. Our participants regularly noted the importance of *Dura*, but it remains to be seen what effect *Dura* and its progeny will ultimately have on securities settlements. *Dura* left enough open questions that the parties have great room to disagree about, not only the loss causation facts, but also the loss causation rules.

B. Procedural Stages

Procedurally, the securities class action resembles much large scale, aggregate litigation. As alluded to above, however, the PSLRA changes the environment somewhat and, by increasing the plaintiffs burden to survive the motion to dismiss and staying discovery until the motion is decided, alters the stakes at each procedural stage. Most claims proceed through predictable

⁴⁴ *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005).

⁴⁵ Courts have long treated loss causation as an element of 10b-5, and in 1995, the PSLRA codified loss causation. See 15 U.S.C. §78u-4(b)(4) ("the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to have violated this chapter caused the loss for which the plaintiff seeks to recover damages").

⁴⁶ 125 S.Ct. at 1634.

⁴⁷ See Merritt B. Fox, *After Dura: Causation in Fraud-on-the-Market Actions*, 31 J. Corp. L. 829 (2006) (identifying issues remaining open to include situations where the plaintiff sells the security at a price higher than the purchase price, situations where the price does not drop immediately after the corrective disclosure, and situations where the plaintiffs sell shares prior to the corrective disclosure).

⁴⁸ See *id.*, at 849 (noting that there is "little doubt that this plaintiff satisfies the Court's requirements under *Dura* concerning causation").

⁴⁹ See, e.g., Jay W. Eisenhofer, Geoffrey C. Jarvis, and James R. Banko, *Securities fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate-Finance Based Theory of Loss Causation*, 59 Bus. Law. 1419, 1443-44 (2004).

⁵⁰ cite cases/ commentary

⁵¹ cite cases/ commentary

stages, including investigating and filing, class certification and lead plaintiff selection, the motion(s) to dismiss, and finally, discovery, trial preparation, and settlement.

1. Investigation and Filing

Plaintiffs' lawyers monitor the securities markets in search of potential claims. They are looking for the same three things that any contingent fee lawyer looks for: liability, damages, and defendants with the ability to pay.⁵² Absent information to the contrary, ability to pay is typically assumed at this stage in the litigation,⁵³ and plaintiffs' lawyers focus on liability and damages. If they can tie a significant stock drop (which will go to damages) to a financial misstatement or negative news story (which may go to liability, either for misrepresentation or failure to disclose), they will have the basic elements of a claim. Large plaintiffs law firms continuously monitor the portfolios of institutional investors, seeking to keep them apprised of potential claims and thereby to increase their chances of being selected as lead plaintiff.⁵⁴ Smaller law firms become aware of prospective claims on a more ad hoc basis, though contacts with former employees, disgruntled investors, or referring attorneys who represent the prospective plaintiff for other purposes, such as real estate transactions or trusts and estates.⁵⁵

Once a plaintiffs' firm is aware of a potential claim, it will begin to investigate the claim. The firm will engage in a detailed review of the company's public documents and SEC filings and, frequently, retain a private investigator to interview former employees or others with inside knowledge about the corporate defendant.⁵⁶ Initially, these investigations will help the plaintiffs' firm determine whether to file a claim.⁵⁷ Once the claim is filed, however, this informal investigation is likely to continue, perhaps even to intensify, in an effort to unearth facts to support the complaint. Recall that the PSLRA both raises the bar to survive the motion to dismiss and stays discovery until the motion has been decided. As a result, the plaintiffs' firm will often continue the informal investigation of the claim until formal discovery begins, seeking to amend the complaint with any new and damning information found along the way.

This dynamic has two important implications, both with the effect of increasing amounts paid at settlement. First, because plaintiffs invest more effort in investigating their claims, surviving claims on the whole may be more likely to include facts that are damaging to defendants, thereby increasing settlement amounts. Second, because plaintiffs expend resources of time and money in their investigative efforts (including resources spent on investigations of claims which ultimately *are* dismissed), they will, on the whole, require greater settlements in order to recoup these costs, thereby increasing settlement amounts.

2. Class Certification and Lead Plaintiff Selection

As in other class actions, securities class actions proceed under the nominal direction of representative plaintiffs but under the actual direction of the lawyers chosen to represent the class. With the enactment of the PSLRA, Congress sought to alter this dynamic by awarding control

⁵² Transcript cites. See also Kritzer, Baker.

⁵³ Even if a defendant corporation is insolvent, the vast majority of U.S. public companies have D&O insurance to fund securities settlements. Cite Tillinghast stat. Cite interview saying they assume solvency now but look into it later (Plaintiffs7.).

⁵⁴ See INFRA.

⁵⁵ Plaintiffs1, Plaintiffs3.

⁵⁶ Plaintiffs4, Plaintiffs6.

⁵⁷ Plaintiffs7.

over the plaintiffs’ class not to the first to file but to the “most adequate plaintiff.”⁵⁸ Now, in place of the old system, under which the plaintiffs’ firm that filed the first complaint had an advantage in the court-directed process through which the class counsel was selected,⁵⁹ the filing of a class action filing starts a 60-day competitive process among plaintiffs’ firms to identify and recruit those plaintiffs who are most likely to be deemed the “most adequate plaintiff” and thereby endowed with the authority to name class counsel.⁶⁰ The biggest investors tend to be deemed the “most adequate.”⁶¹ As a result, the trick is for the plaintiffs’ firm to represent large institutional investors or, in some cases, groups of investors.⁶²

Although the PSLRA seems to have been effective in ending the free-wheeling days when plaintiffs’ lawyers had, at best, nominal clients with had no real influence over their claims,⁶³ plaintiffs’ actual involvement in the litigation remains secondary.⁶⁴ Institutional shareholders were lead plaintiffs of X% of the U.S. shareholder fund cases filed in 2003; the settlement funds in those institutional plaintiff cases represent xx% of the total settlement funds recovered to date in cases filed in 2003.⁶⁵ As a result, the plaintiffs’ lawyer is still largely in control of the prosecution and, ultimately, settlement of the claim.⁶⁶ Recent research suggests that cases with institutional settlements settle for a higher percentage of investor loss than other cases, but the researchers have been able to draw a conclusion about cause and effect.⁶⁷ This

⁵⁸ PSLRA cite. See also Cox & Thomas (2006) (describing the “rebuttable presumption that the member of the class with the largest financial stake in the relief sought is the ‘most adequate plaintiff.’”)

⁵⁹ See Elliott Weiss and John Beckerman, Let the Money to the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions, 104 Yale L. J. 2053 (1995).

⁶⁰ Judges retain some discretion in selecting class council. The identity of the lead plaintiff can be affected by the definition of the class period (because different institutional investors will have held different amounts of the affected securities during different periods), by the degree to which law firms are permitted to assemble groups of plaintiffs, and by the judge’s assessment of the representativeness of the proposed plaintiff or plaintiffs’ group. See Cox & Thompson, at n. 15 (listing cases in which the largest plaintiff was not selected as lead plaintiff).

⁶¹ CITATION.

⁶² COX/ THOMAS RESEARCH HERE. In a potentially significant class action, leading plaintiffs’ law firms often wait until the very last day to file, so as not to tip off their competitors about the size of the potential losses they have accumulated for their lead plaintiff application. The leading lawyers know each other, know who the key institutions are, and know which institutions tend to go with which lawyers, and our participants described a level of gamesmanship in trying to assess the extent of potential losses accumulated on competitors’ lead plaintiff applications. Plaintiffs 4.

⁶³ As described by a prominent mediator:

In a typical pre-PSLRA mediation, the mediator would ask the plaintiff’s lawyer to go out in the hall and speak to the client about a proposed offer. Perplexed, the plaintiff’s lawyer would respond, ‘I don’t have a client here.’ ‘Well then,’ the mediator would respond, ‘why don’t you go to the restroom, look in a mirror, talk to yourself, and come back here and tell me whether you want to accept the settlement or not.’

Hon. Nicholas Politan, Mediating Securities Class Actions: A View From the Captain’s Quarters, Institutional Investor Advocate, 4th Quarter, 2005.

⁶⁴[report from transcripts: plaintiffs lawyers suggest institutional investors are not necessarily well suited to make litigation decisions (lack financial sophistication and have political incentives).]

⁶⁵ See if they have a report on this; if not we can calculate from their data.

⁶⁶ See also Choi and Thompson, *supra* (reporting that institutional investors “tended to develop repeat relationships with select top tier law firms”)

⁶⁷ See James D. Cox, Randall S. Thomas, An Empirical Analysis of Institutional Investors’ Impact as Lead Plaintiffs in Securities Fraud Actions (2006) SSRN 898640. Cf. Michal A. Perino, Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions (2006) SSRN 938 722 (reporting that “cases with public pension fund plaintiffs have larger

correlation may be the result of institutional investors choosing to play a lead role in the more valuable cases.⁶⁸

After the court selects the lead plaintiff and class counsel, defendants have the option of challenging the class certification, but due largely to the presumption of reliance derived from the fraud on the market theory, class certification has not traditionally been a significant hurdle to plaintiffs' lawyers.⁶⁹ Recently, however, class certification has become a more frequently contested stage of the securities class action. Arguments over "loss causation" and other requirements are increasingly heard at the class certification stage.⁷⁰ And indeed, although there is some controversy over the degree to which inquiry into the merits of a claim is permitted at the class certification stage – Supreme Court precedent seems to point in both directions⁷¹ – most circuits permit some discretionary weighing of the merits at the class certification stage.⁷²

3. The Motion to Dismiss, Discovery, and Settlement

Following the stiffening of the pleading requirements in the PSLRA, the motion to dismiss has become a very important screen in securities class actions; courts routinely dismiss about 25% of securities class actions filed in a given year.⁷³ Our participants reported that defendants filed a motion to dismiss in every case with which they were familiar; settlement

settlements, recover a greater percentage of the stakes at issue in the case, have greater attorney effort, and have lower fee requests and awards than cases with other types of lead plaintiffs")

⁶⁸ NERA 2007.

⁶⁹ See Defense Counsel 0307. On the fraud on the market theory, see *supra* note X-REF. But for the fraud on the market theory, each individual plaintiff would need to show reliance on the misrepresentation, a showing which would cause individual issues to dominate common class issues, thereby preventing class certification. Cite the class certification rule about commonalities/ individual issues. Some defendants have been successful at challenging the efficiency of the relevant market, thus requiring defendants to make individual showings of reliance and thereby successfully challenging class certification. See, e.g., *Polymedica*. See also Defense Counsel 4 at 13-14 (explaining how he challenges class certification and citing *Polymedica* as an example of what can work.).

⁷⁰ Discuss recent 5th circuit case in this note.

⁷¹ Compare *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 177 (1974) ("Nothing in either the language or the history of Rule 23... 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.") with *General Telephone Co. v. Falcon*, 457 U.S. 147, 160-61 (1982) (holding that courts must "conduct a rigorous analysis" of Rule 23 requirements) and *Coopers & Lybrand v. Livesay*, 437 U.S. 463, 469 n.12 (1978) (stating that the analysis of Rule 23 requirements will be "intimately involved with the merits of the claims").

⁷² See, e.g., *Szabo v. Bridgeport Machines, Inc.*, 249 F.2d 672 (7th Cir. 2001) (permitting courts to "look[] beneath the surface of the complaint to conduct the inquiries identified in [Rule 23] and exercise the discretion it confers," which inquiries, if they "overlap the merits," force the judge to "make a preliminary inquiry into the merits"). A similar rule is followed in the First, Third, Fourth, Fifth, Sixth, and Eleventh Circuits. See, e.g., *Waste Management Holdings v. Mowbray*, 208 F.3d 288, 298 (1st Cir. 2000) (fashioning a similar rule for the first circuit). The Second Circuit has recently moved closer to this rule as well. See *Heerwagen v. Clear Channel Communications*, 2006 U.S. App. LEXIS 524 at *32-33 (2d Cir. 2006) ("Some overlap with the ultimate review on the merits is an acceptable collateral consequence of the 'rigorous analysis' that courts must perform when determining whether Rule 23's requirements have been met.").

⁷³ See Stephen J. Choi, Karen K. Nelson, A.C. Pritchard, *The Screening Effect of the Private Securities Litigation Reform Act (2007)* SSRN 975301.

discussions almost never take place until after the motion is filed; and settlement discussions typically do not take place until after the class action has survived the motion to dismiss.⁷⁴

Strengthening the pleading requirements has had a number of consequences. As already noted, plaintiffs' counsel must invest heavily in investigation earlier in the case in order to survive the strengthened motion to dismiss, and those cases that do survive must settle for a large enough amount to compensate the plaintiffs' firm not only for increased investigation costs in that claim but also increased investigation costs in dismissed claims.⁷⁵ Moreover, the cases that survive a motion to dismiss are, on average, stronger cases for the plaintiffs.⁷⁶

Surviving the motion to dismiss essentially clears the case for settlement. Summary judgment is rare. Our participants reported that class actions typically do not last through to the stage when they are ripe for summary judgment,⁷⁷ and few of those that go all the way through discovery are in fact resolved through summary judgment.⁷⁸ Trial, moreover, is virtually unheard of. In an empirical study going back to 1980, a period in which thousands of securities fraud cases were filed,⁷⁹ Black, Cheffins, and Klausner found only thirty-seven securities law cases seeking damages that were tried to judgment.⁸⁰ The Risk Alert service of the Institutional Shareholder Services reports that only five cases have gone to trial since 1995.⁸¹ And the reporting around the JDS Uniphase trial that began in Oakland on October 22, 2007, emphasized that no case nearly as large has ever gone to trial and that few people believe that this case will ever see the inside of a jury room.⁸² As a result, once a claim has survived the motion to dismiss, everyone involved knows that the odds now very strongly favor an eventual settlement in the case.

Our participants emphasized, nevertheless, that they do prepare for trial, if only to have a credible threat.⁸³ This means embarking on discovery, which as every lawyer knows, is both laborious and expensive. Our participants reported that the cost of simply creating the document discovery database in a significant class action is itself a multi-million dollar proposition. The cost of discovery creates an obvious and well-known incentive for defendants to settle.⁸⁴ Costs

⁷⁴ TS CITATIONS.

⁷⁵ See *supra* X-REF.

⁷⁶ Expert 1 at. See also Choi, Nelson & Pritchard, *supra*.

⁷⁷ See, e.g., Monitoring Counsel 8 at 10 (“there is a lot of talk in the industry about how some of these cases need to be pushed to summary judgment and not to settle until a decision is made at the summary judgment level, but to date I am literally not aware of a single one”).

⁷⁸

⁷⁹ NERA reports that between 1991, when they started collecting this data, and 2004, 3239 federal securities cases were filed against public companies. See Elaine Buckberg et al., NERA Economic Consulting, *Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements* (2005). See also PriceWaterhouseCoopers LLP, *2004 Securities Litigation Study* (2005) (reporting similar numbers); Cornerstone Research, *Securities Class Action Filings, 2005: A Year in Review* 3 (2005) (same).

⁸⁰ See Black, Cheffins, & Klausner, at 1064 (the statistic includes only securities law cases seeking damages from public companies, their officers and directors, or both).

⁸¹ See www.wsj.com at:

⁸² AP, Reuters. Blogosphere.

⁸³ WLRK/LABATON? (Both plaintiffs and defense.) Of course, if every case settles well before reaching the courthouse steps, the threat rings empty.

⁸⁴ STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 401-03 (2004).

are high on plaintiffs’ lawyers too, if not as high.⁸⁵ But it is worth noting that the defendant’s higher costs do not necessarily give the plaintiff an advantage. Defense costs reduce available insurance limits.⁸⁶ Assuming that the claim will settle within insurance limits, this means that the imposition of defense costs on the other side also decreases the total pot available to fund the settlement. Thus plaintiffs may also have a strong incentive to avoid high discovery costs.

Settlement, of course, is the way out of discovery. And, consistent with this expectation, our participants reported that although settlement can happen at any point in the process,⁸⁷ it most often occurs after the motion to dismiss, when the machinations of discovery have begun.⁸⁸

II. What We Talk About When We Talk About Merits

The term “the merits” regularly appears in both academic and popular discussions of litigation, often in opposition to the term “frivolous.”⁸⁹ In this common usage, a lawsuit is understood to be “meritorious” if the facts the plaintiff alleges are true and if the plaintiff’s legal theory is sound. By extension, the merits matter if the resolution of the case strongly depends on the probability that the facts are true and the legal theory is sound. By contrast, a lawsuit is frivolous if the facts the plaintiff alleges are false or if the plaintiff’s legal theory is unsound. By extension, the merits do not matter if the probability that the facts are false or the legal theory is unsound does not strongly affect the resolution of the case.

If the merits in securities litigation could be objectively shown, it would be possible to resolve the question of whether and how much they affect the resolution of claims. Yet the voluminous literature on securities class actions demonstrates, if nothing else, that securities litigation does not have a simple, objective quality that can be used to measure merit. The problem, of course, is not unique to securities litigation. The “do the merits matter” question poses a challenge to nearly all forms of liability: a challenge to demonstrate on the basis of external, objective evidence that the right people are being held liable for doing what the law prohibits.

If, at the simplest level, we understand the merits exclusively in terms of the liability elements of a claim, litigation outcomes are judged according to how well settlement amounts accord with the evidence of liability. Did the defendant in fact engage in those activities that the law defines as the basis of liability? Are damages paid predominantly in cases where there is strong evidence of wrongdoing? Are damages greater in those cases with relatively more evidence of wrongdoing? This approach accords to the commonsense view of, for example, doctors who might tend to view a malpractice claim as meritorious only if a physician’s conduct

⁸⁵ Black, Cheffins & Klausner, at 1098 (“In securities and corporate litigation, defendants’ costs are usually higher than plaintiffs’ costs....”).

⁸⁶ X-REF.

⁸⁷ Our participants reported that the immediate impetus to settlement is likely to be a corporate event—a change of CEO, merger or acquisition transaction, or other corporate event which causes the defendant to wish to eliminate contingent liabilities, including the pending securities claim. INTERVIEW CITES. Such events can, of course, occur at any time during the life of a claim.

⁸⁸ x-ref. (interview cites) can ISS help us say when they settle? Maybe Pria Huskins can tell us.

⁸⁹ citations.

in fact falls below the relevant standard of care and who are therefore appalled by the strong role that the size of potential damages plays in the decision to sue or settle.⁹⁰

The trouble with this liability-centered understanding of merits is that it is difficult if not impossible to find an objective standard of truth to judge the liability elements of a claim. The problem is not unique to securities litigation. Indeed, in other litigation contexts, researchers have gone quite far in seeking to construct such a standard. In the context of medical malpractice litigation, for example, medical experts have conducted large scale, closed-claim file reviews, making independent judgments about the merits of claims.⁹¹ There are, unfortunately, no comparable closed claim studies of securities class action settlements, and there are good reasons to doubt there ever will be. What kind of expert, sitting after the fact, could ever judge whether a given defendant actually possessed the requisite mental state for 10b-5 liability? It is easier to inquire into the key elements of liability for a medical malpractice claim – “Did the doctor depart from the professional standard of care?” and “Did that departure cause the plaintiff’s injury?” – than it is for a securities claim – “Did the board of directors act with scienter?” and “How did the misrepresentation affect the price of the security?”

If, moving beyond simple liability, we seek to understand merits in terms of all the legally defined elements of a claim, including damages,⁹² we build back into the model the incentive created by law for the parties to take into account not only whether a given activity is permitted, but also what the costs of engaging in it are likely to be.⁹³ Because it is rational to spend a great deal of money to avoid very large, reasonably foreseeable harms, but not to avoid small or unforeseeable harms, the size of the potential damages is relevant to the consideration of the merits of a claim. Understood in this way, the merits matter as long as settlements bear a reasonable relationship to the probability that the defendants committed fraud multiplied by the potential damages in each case.⁹⁴ Put another way, the merits matter as long as the fault and loss causation variables would be positive and significant in a well-constructed regression model of securities class action settlements in which the settlement amount is the dependent variable.

Some securities class action researchers have approached the merits question by comparing easily-identifiable indicia of wrong-doing to settlement amounts. They identify proxies for scienter – such as concomitant SEC investigations, earnings restatements, and insider trading – and test to see whether cases with such proxies are more likely to survive a motion to dismiss and then settle at a higher value than claims without such evidence.⁹⁵ Their answer is yes, in both cases, which may be seen to support the view that merits matter. Yet the researchers candidly admit that all they are measuring is a proxy for damages and that the provisions in the

⁹⁰ This may explain why some of the closed claim research treats payment as an on/off variable rather than a continuous variable. See, e.g. [pull specific studies from MMM]. For a criticism of that approach see, Tom Baker, Reconsidering the Harvard Medical Practice Study Conclusions about the Validity of Medical Malpractice Claims, 33 *Journal of Law, Medicine & Ethics* 501, 508 (2005).

⁹¹ See Tom Baker, The Medical Malpractice Myth at --- (2005) (collecting and analyzing the closed claim file literature published through March 2004); David Studdert et al (2006 NEJM article) (reporting the results of the most recent and most definitive medical malpractice closed claim file review). See also Philip G. Peters, What We Know about Medical Malpractice Settlements, 92 *Iowa L. Rev.* 1783 (2007) (the latest effort to collect the research).

⁹² Cf., Defense Counsel 4 at 50 (“I count damages as part of the merits”).

⁹³ we should do more here to explain

⁹⁴ See, e.g. Steven Shavell, Suit, Settlement and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs, 11 *J. Legal Stud.* 55 (1982).

⁹⁵ JNP.

PSLRA that privilege these indicia of fraud may well have made it harder for plaintiffs to bring meritorious claims without such clear indicia of fraud.⁹⁶

We propose to use a very different proxy: qualitative, admittedly subjective reports from participants in the securities class action settlement process about the role of the merits in that process. These reports are proxies because the participants do not have direct access to an objective truth. They have better access to the evidence than anyone else, but they are hardly objective. They serve interests; they do not seek the truth.

For that reason we do not claim to be answering the question “Do the merits matter?” Indeed, the question whether the *objectively true* merits matter is, for us, very nearly a meaningless research question, not because it is unimportant, but because it cannot be answered. There is not now nor is there ever going to be a judge or jury in possession of knowledge of all relevant facts of a claim. Indeed, precious few judges or juries ever sit in final adjudication of securities litigation. In our view, therefore, a better way to approach the merits of securities class action claims is by focusing on the understanding of reality that can be reached through existing institutions. The better questions are: “What are ‘the merits’ in the settlement process?” and “How do they matter?”

III. Field Research on Settling Shareholder Class Actions

With the problem of merits firmly in mind, we began our interviews. Building on an initial round of 48 interviews conducted in connection with an earlier related project,⁹⁷ we conducted an additional round of [50] interviews, focusing on those most involved in the settlement of securities class actions.⁹⁸ Our participants included ten claims managers from eight D&O

⁹⁶ In the author’s words:

Our study provides some evidence that the merits do matter more, at least in the filing of complaints and the allegations included in those complaints.

To be sure, this conclusion comes with some caveats. Our model cannot explain all the variation in the incidence of litigation. The unexplained variation undoubtedly has both merit and nonmerit aspects. If the nonmerit aspects predominate (an unlikely scenario in our view), our conclusion that there has been a shift in the determinants of litigation may not hold. The inconclusive results from our settlement regression should also be a cautionary note. We find little evidence that the PSLRA has enhanced the sorting process of litigation. One plausible explanation is that the PSLRA has a greater impact in discouraging meritless litigation than it does in enhancing the accuracy of litigation once initiated. The discovery stay, after all, limits the evidence available to the court to assess whether fraud has been committed.²⁰ Another important question not addressed by our research is whether the PSLRA has deterred lawsuit filings, a principal concern of the law’s critics. Plaintiffs’ lawyers may be unable to prove some meritorious claims under the rigorous constraints imposed by the PSLRA (see Choi [2007] for an analysis of this issue). In particular, the forward-looking safe harbor has changed the definition of merit for some claims, which may well have the effect of excluding some claims that would have been deemed meritorious under the pre-PSLRA regime.

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⁹⁷ In the first phase of our research we interviewed forty-one people involved in selling and buying D&O insurance: brokers, underwriters, risk managers, reinsurers, and attorney advisors. See *supra* *Predicting Risk and Missing Monitor*

⁹⁸ Pursuant to a research protocols approved by the Institutional Review Boards of the University of Connecticut and Fordham University, we interviewed the participants under a promise of confidentiality. The interviews were recorded and transcribed and participant-identifying information was removed from

insurance companies; twelve lawyers who specialize in bringing shareholder litigation on behalf of shareholders; nine lawyers who specialize on the defense side of shareholder litigation; nine lawyers who specialize in representing D&O insurance companies in the monitoring and settlement of shareholder litigation; two policyholder coverage counsel; three mediators who are actively involved in the settlement of shareholder litigation; one expert who assists parties in assessing the damages in shareholder litigation; and two claims advisors from two brokerage houses.

Before describing our findings, we should acknowledge that our sample is neither large nor random. We began our interviews with people we learned about in our prior research, then worked outward to references from these interviewees. In spite of the self-selecting and self-referential nature of this sample, however, we can accurately describe the settlement process, because each of securities class action field is remarkably small and densely connected. On the plaintiffs' side, the universe of players has remained small and relatively stable,⁹⁹ with the top eight plaintiffs' firms accounting for 75% of total settlement collections.¹⁰⁰ The defense bar is less concentrated than the plaintiffs' class action bar, but the panel counsel lists maintained by the top D&O insurance carriers are a good guide to that bar, and perhaps not surprisingly, the top New York and national firms are well represented.¹⁰¹ D&O insurance, moreover, is a highly concentrated market, clustering around two dominant primary insurers—AIG and Chubb—which together account for more than half of the market for primary insurance.¹⁰² The excess D&O market is broader,¹⁰³ but in both cases (primary and excess), the market is intermediated through the personal connections of a few brokerage firms.¹⁰⁴ Moreover, a small number of outside law firms handle the settlement responsibilities of most of the D&O insurers and, thus, serve to bring to claims managers the same breadth of information about the settlement market that the brokers bring to underwriters about the D&O insurance market.

the transcripts. Copies of the transcripts have been provided to the editors of the [LAW REVIEW] for verification but returned to us.

⁹⁹ See Steven J. Choi and Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA* (2006) SSRN 912531 (arguing that, if anything, the PSLRA has only succeeded in making this universe even smaller). Even as firms have split, the major players have remained the same, and even the recent round of criminal indictments and forced retirements, notably against Mel Weiss and Bill Lerach, amounts to more of a changing of the guard than a revolution in the industry.

¹⁰⁰ [For each of the past four years, Institutional Shareholder Services has ranked the top 50 plaintiffs' law firms by the total value of the settlements in that year in cases in which the law firms served as lead or co-lead counsel. Four firms were in the top 11 for all four years, and in each of those years, 8(?) firms were responsible for 75% of the total settlement fund dollars collected by the top 50 firms.] These figures were computed using the list of the SCAS 50 firms the ISS website. Of note, we treat Milberg, Weiss and Lerach Coughlin as two separate firms even in 2003 and we treat firms that have retained the same key name partner(s) over the years as the same firm. See also Choi & Thompson (reporting that 4 firms handled cases that represent 50% of the total settlement value since 1995).

¹⁰¹ [The panel counsel lists maintained by the two leading D&O insurance companies – AIG and Chubb – provide one indication of the size and of the bar. One list contains 105 firms; the other contains about 300. Prominent New York and national firms appear on both. [SUPPLY EXAMPLES FROM LISTS... SUPPLY LISTS?]

¹⁰² AIG and Chubb account for more than half of the market by premium volume. By [OTHER MEASURE] they rank [WHERE]. See Tillinghast, *2005 Survey* at 85, table 70 (cited in note) (reporting on primary market share).

¹⁰³ still, from our participants: only about 30 firms active in the public d&o insurance market at any time pull this from latest tillinghast survey. Note re: limits on tillinghast.

¹⁰⁴ CITE.

Clearly, everybody does not know what everybody else is doing in every detail, but everybody in a position of authority in each of the subfields – plaintiffs counsel, defense counsel, monitoring counsel, and claims managers – does have a good sense of the market in which they are operating. The primary actors are repeat players in long-term relationships outside of and across individual cases. As one of our participants said to us, “It’s a really small sandbox. You don’t want to pee in it.”¹⁰⁵ As a result, we are confident that we can accurately describe the securities class action litigation field based on a number of interviews that may seem small to researchers used to working with large quantitative data sets.

In the sections that follow, we report the findings from our interviews, mindful of the fact that the distinction that our participants drew between merits and non-merits factors is a product of norms developed through a litigation and settlement process. At best, this process produces weakly shared understandings about the strength of the evidence of fraud and loss causation in any particular case, along with a range of potential damages. Their assessments cannot be tested against an absolute truth and, in the context of securities class actions, cannot even be tested against the truth as determined by a judge or jury.

We approached the question of what matters in settlement both directly and indirectly in our interviews. We began indirectly by asking participants to describe the settlement process and explain what drove the parties to settlement and what factors affected timing of settlements. We then approached the question of value directly, asking them to describe which factors, in their experience, are most important in determining the ultimate settlement amount. In the sections that follow, we describe what we learned.

A. Liability and Damages in Securities Settlements

In our interviews, we devoted substantial effort to learning how the parties arrived at a settlement amount. From a process perspective, the participants uniformly described negotiations that involved slow movement from extreme positions, almost always through mediation.¹⁰⁶ Consistent with the standard economic model of settlement,¹⁰⁷ our participants uniformly explained this process in terms of both liability and damages. Yet, the fact that securities class actions almost never go to trial complicates the story. With no trials to use as comparisons, expected trial value calculations are, in an important sense, fictions.

¹⁰⁵ Monitoring Counsel 3 at 73. See also Monitoring Counsel 8 at 25:

Because the bar is so small, your personal reputation counts. Integrity counts. Saying you are going to do a deal means something. You know double crossing someone, maybe you can pull it off once, but you are going to be caught. So there is that, that you trust people within this circle, and of course you do have all the due diligence and documentation and settlement agreements that are million pages long, but there is some level of trust, some level of candor.

¹⁰⁶ See, e.g., Monitoring Counsel 7 at 35:

Q. There must be a recognizable sort of script or flow to the settlement discussions or dance, whatever you want. How would you describe it?
A. It’s starting off on opposite extremes and working to the midpoint.
Q. And what is the - and what are the tools that you use to get to the midpoint?
A. Basically, arguing to the plaintiffs that their case doesn’t have a sex appeal, doesn’t have the players, doesn’t have the damages, doesn’t have any of the factors that make a case expensive, and sometimes you win, sometimes you lose.

¹⁰⁷ See, e.g., George L. Priest and Benjamin Klein, The Selection of Disputes for Litigation, 13 J. Legal Stud. 1 (1984).

In terms of the economic model of settlement, a \$200 million settlement of a securities fraud action with a five percent chance of success represents the ordinary and unremarkable operation of the civil justice system, as long as the likely damages that would be awarded in the event the plaintiffs proved fraud are \$10 billion or more. Yet, without trials, there is no experience-based way to estimate the probability of judgment, unless the parties agree that the defendant committed fraud (in which case there is no doubt about the merits), and, even then, the parties almost certainly will not agree about the damages. A statement that, for example, \$30M is an acceptable settlement because there is a 10% chance of being held liable for \$300M cannot be justified on the basis of experience.¹⁰⁸ There are not remotely enough trials to be able to estimate either that probability or damages.¹⁰⁸ Yet, lawyers do talk that way, and these assessments may be “objective” in the sense that the assessments are shared by others in the field. But, at best, a statement like this actually means “This case is like other cases that we have settled in the belief that there is a low but worrisome probability of a plaintiffs’ verdict and in the belief that the damages could be in a similar range.” Liability and damages, like the other factors we will explore, can only be assessed in relation to other settlements, not in relation to trial results.

a. Liability

Consistent with the research of Pritchard, et al., the factors our participants named as important in explaining settlement outcomes included a host of factors that might be understood as “hard evidence” of securities fraud.¹⁰⁹ For example, our participants frequently mentioned earnings restatements, insider selling, and SEC investigations as highly significant in determining settlement outcomes.¹¹⁰ They also mentioned facts that might support a story of earnings management, such as questionable revenue recognition practices, especially where the managerial compensation was associated with stock performance.¹¹¹ These kinds of facts provide evidence of a motive for fraud, supporting the plaintiff’s assertions of scienter.¹¹²

Upon further examination, however, it became clear that our participants are not just interested in fitting the facts of the case into an established legal category. Rather they are looking for “factors in the litigation that give it what is normally referred to as sex appeal.”¹¹³ Cases with sex appeal are cases that have exciting facts or are part of a scandal.¹¹⁴ As one mediator put it, a “boring” case that “took place in the dimly lit corner of the accounting world” does not have the “sizzle” of “the SEC investigation,” or “the executives being led out of the office with handcuffs.”¹¹⁵ A plaintiff’s lawyer explained, “You need sex appeal, you know. We used to think that just a restatement case was great because it was an admission, but you need

¹⁰⁸ Cf., Marc Galanter, *The Civil Jury as a Regulator of the Litigation Process*, 1990 U. Chi. Legal F. 201 (questioning ability of trial lawyers to predict jury verdicts).

¹⁰⁹ X-REF TO PRITCHARD ET AL.

¹¹⁰ Plaintiffs 6 at 18-20. MC 7, 8-9. M2, 8.

¹¹¹ Plaintiffs 6 at 18-20.

¹¹² X-Ref supra, discussing scienter.

¹¹³ See Monitoring counsel 7 at 7-8. See also Claims Manager 1 at 20 (“the sexier the case, the more interest there is”).

¹¹⁴ Describing how he gets an initial impression of the value of a claim, one claims manager distinguished between cases with sex appeal and those without: “You take a look at what is alleged. Is this part of a scandal? Is this one where there is just outright cooking of the books? Or is it just old fashioned misrepresentations of what they call projection cases?” CH 2/12/07.

¹¹⁵ M2 at 8.

more than just a restatement. You need a restatement, and you need [to show] that somebody benefited by the wrong.”¹¹⁶

Juicy, exciting facts may increase the settlement value of a claim because they may embarrass or shame defendants for reasons that do not directly relate to the merits. One defense lawyer emphasized that executives are often unwilling to take the stand to explain a bad business outcome.¹¹⁷ Another lawyer described a situation in which at least part of the sizzle was sharp business practices that called into question the business ethics of the defendants.¹¹⁸ But sizzle does more than shame defendants; it makes the plaintiffs’ story more appealing and pulls the imaginary jury in the lawyers’ minds closer to the plaintiffs’ view of the case, increasing the plaintiffs’ lawyer’s bargaining power at settlement.¹¹⁹

Sex appeal is not the same as the technical merits of a claim, but it relates to merits, as illustrated in the following story told by a plaintiffs’ lawyer:

[I had] a one quarter restatement case. At the end of the quarter, the company booked a sale where the customer had the right to return the goods. So, instead of it being a bona fide final sale where the risk of loss transferred to the customer, instead it was a conditional sale where the customer could take the goods and if he could sell them or wanted to return them he could. And so that doesn't qualify for revenue recognition, because basically the transfer of risk never left the seller to go to the buyer. ... And then the company within a quarter or two after that disclosed the fact that they improperly – they didn't use the word “improper” — but that they booked revenue they shouldn't have and ... restated.

But the case lacks sex appeal. Why did it lack sex appeal? At the end of the quarter what I would have liked to have seen was some insider selling, so that the guy who improperly booked the thing and basically inflated the price in the marketplace benefited by selling some of their stocks and say, *ah-ha*, the reason they did this is because they wanted to sell stock.... So the motive for keeping the revenue and earnings up and everything else would be the keep the price of stock up. [But] nobody sold their stock. And so the argument then that's being

¹¹⁶ P 8, 31

¹¹⁷ Defense Counsel 6 at 9-10, 14-15. This defense counsel stressed that there is a genuine cost to the organization of doing so—lost executive time, bad publicity, legal costs in preparing to testify. Plus the relevant people may no longer be with the organization, so the organization cannot rely on their appearance or, if they do appear once they have moved on, on what they will say on the stand. Under these circumstances as a business matter, it is often better for the defendant to settle (provided its own outlays in settlement are less than these costs, as they often are, given the presence of the D&O insurer).

¹¹⁸ MC 6 at 31:

There is a case where somebody convinced the Japanese to buy like 2 warehouses full of syrup or something, whatever it was, but it was total channel stuffing [i.e., selling so much to one customer that they will not need to buy more for a long time, a practice that leads to excellent short term sales figures without improving long term sales]. Nobody wants that s--- to come out, and that’s a bad case. You know you can say to a judge, like, “Oh, that doesn’t have anything to do with 10b-5” and ... “We didn’t have any obligation to disclose that.” You know selling 6 warehouses full of syrup sounds pretty bad, and you go to a jury with that and you have a person who knows how to advocate before a fact finder, and you are f----- dead. ... I mean it’s about telling you the story and having somebody gasp as you are saying it and say, you know, I can’t believe it.

¹¹⁹ TS CITE.

made by the defendants is, “Oh, this was a, you know, this was negligence, it wasn’t fraud, what’s the dah, dah, dah, dah, dah.” ... And I don’t have an answer because I don’t have any juice, I don’t have any sex appeal.¹²⁰

Insider trading is not an element of the cause of action, but it provides evidence of motive. Motive helps prove scienter, which is one of the elements of the cause of action.¹²¹

Factors giving a case sex appeal or sizzle include SEC investigations, criminal charges, suspicious stock repurchase programs, defendants pointing fingers at each other, the resignation of board members, whistle blowers, termination of the top officers, bad documents, and a variety of case specific facts that cast the defendants motives or honesty in a bad light – the sorts of things that we are likely to remember about the securities fraud cases reported in the newspaper.¹²²

Consistent with the emphasis on sex appeal, many of our participants asserted that the merits do matter in determining the amount paid to settle a case. As one monitoring counsel, put it, “most of the time, if you pay attention to what really happens at the friction points in either mediations or other settlement discussions, it is ultimately the fear of bad facts being proven, and I think that is merits.”¹²³

b. Damages

Many participants viewed the amount of potential damages as the most important factor driving settlement.¹²⁴ Damages exert a coercive influence, defense and monitoring counsel argued, because the initial damages estimate—so-called “plaintiff’s style damages,” based on the shift in the defendant’s market capitalization following corrective disclosures—can easily be astronomical, presenting an unacceptable risk to corporate defendants.¹²⁵ The larger the

¹²⁰ P8, 29-30. As one defense lawyer put it, “insider trading makes a dramatic difference in terms of the value of a case. Now you say well that’s not really the merits. That’s the cosmetics. OK they merge a little bit.” Defense 4 at 50-51

¹²¹ X-REF.

¹²² See, e.g., Plaintiffs’ 5 at 7-8 (board member resignations); Plaintiffs’ 6 at 19-20 (“suspicious stock repurchase programs”); Defense 3 at 19 (“if people have been convicted of crimes and stuff like that, then the plaintiffs are going to hang tougher for a bigger number to get a better case”); Claims Head 021207 at 35-36 (distinguishing between weaker “old fashioned misrepresentation of projection cases” and “accounting manipulations” that involve “outright cooking of the books”); Monitoring Counsel 8 at 31-32, 41-44 (importance of “hot docs,” termination of CEO or CFO, whistleblower). ClaimsHead031407 at 59-64 (bad documents, whistleblower); Claims Head 7 at 34-35 (conflicts among parties on the defense side, e.g. outsiders vs insiders). On case specific facts, see, e.g., Monitoring Counsel 8 at 44-45:

Yeah, we’ve had situations where literally there were allegations of trucks just going in a circle and then you know coming back, you know like an airplane that never lands, but they log it in as a flight. You know the flight to nowhere. I remember once with a prominent firm you danced around it, but essentially didn’t deny that trucks were kind of parked somewhere, and it was like a question of you didn’t have enough space we think in these storage facilities. They had to move space somewhere else and there were some lame things, and those kind of cases are obviously very troubling.

¹²³ MC 6 at 29.

¹²⁴ See, e.g., Defense Counsel 0307.

¹²⁵ Claims Manager, 5/16/07 (“More often than not we hear [from our insured that] there is really is nothing there, but there’s these documents and these e-mail messages that if taken out of context could be embarrassing and maybe would put things together so that we would have something to explain to a jury....

plaintiff's style damages, the argument goes, the less the liability elements, the factors that many would consider the true "merit" factors, actually matter. Indeed, our participants agreed, the single most significant settlement factor, the "driving factor," is "investor loss."¹²⁶ As one defense counsel reported, "If your exposure is \$5 million, you will handle the case one way; if it is \$500 million, you are going to handle it another way."¹²⁷ Similarly, a monitoring counsel explained:

Suppose they have a defense that in a \$500,000 case every single lawyer worth his salt says "Go to a jury because you can prove this, and you will prove this. You can't go wrong with this." Take the 500 and make it 3 billion. Everybody changes their mind."¹²⁸

As any securities law student can report, investor loss is typically much higher than the legally compensable damages, but investor loss provides a useful, easy means of computing the outer limit of what is at stake.¹²⁹ The head of one D&O claims department described how he used the investor loss to set his initial reserve on a case:

When I get a securities claim in, one of the very first things I do is pull up just some core statistics and do a true back of the envelope plaintiff's style damages calculation. ... So I will go to Yahoo. We get a lawsuit in, you know, any public company, and the stock took a hit and this lawsuit comes in - it's a 10B5, you know after market type loss.... [Y]our standard 10B5 class action comes in, and I will quickly just pull up the chart as I am looking at it and take a look at the alleged stock drop ... and the key is to go to the key statistics page and take a look at the float. How many shares were outstanding and what the float is. ... That is, I'm giving the full benefit to the plaintiffs. So take the full float, times dollar amount of the drop. So say a hundred million shares times \$7 a share is \$700 million of potential damages. From that I apply what is generally understood, not written anywhere, but generally understood in the industry for whatever reason, and it is just averages I guess, that the garden variety 10B5 claim will settle for somewhere around 5% give or take of plaintiff's style

There's no way we can possibly present them to a jury. They don't want to do that. You better settle it _____."

¹²⁶ Defense Counsel, 3/24/07. See also, e.g., Mediator 2 at 4-6 ("potential damages is the No. 1 thing"); Policyholder 2 at 6; Plaintiffs 8 at 22 ("the most important factor is the amount of the damage"); Defense Counsel 4 at 11 ("By the time you get to mediation, damages is very much in the forefront of the discussion."); Defense Lawyer0307 at 29 ("the driving force ... is investor loss"); Monitoring Counsel 7 at 8-9 ("I think the largest and most determining factor is potential damages").

¹²⁷ Defense Counsel 5 at 15.

¹²⁸ Monitoring Counsel 6 at 25. Monitoring Counsel 8 at 13("You said you wanted to talk to me about why they don't get tried, and it's real simple. The stakes are just too high. There are very few cases where if the plaintiffs prevail there is not potentially a, you know, high 8, 9 figure number and you know at the end of the day it is difficult for insurers to really want to run that risk."). See also, e.g., Monitoring Counsel 7 at 18 ("Because the potential exposure is overwhelming"); ; Monitoring Counsel 4-5 at 3 ("look, there's a very simple reason that there is too great of a risk for the insured."); Defense Counsel 3 at 46 ("I mean you could tick off all the reasons you want to settle. ... The numbers are too big "); Plaintiff's 8 at 16 ("trying one of these big huge cases, it's hugely time consuming, hugely costly, and hugely risky"); Plaintiffs' 5 at 12 ("you are driving your case to trial and very few people want to shoot the moon"); Mediator 1 at 3 ("The stakes are huge, and oftentimes it requires massive document and discovery investigation, and lots of unsettled questions as to actually how to finish the case").

¹²⁹ Cite to securities law hornbook

damages, generally speaking. ...So here is 100, 700 million in damages. 5% of that is \$35 million. I'm 10X80.¹³⁰ Right there I look at it and say I'm probably not going to be involved in this case just through that back of the envelope¹³¹

In his view, the larger this rough and ready number, the less likely any of the parties to the litigation are willing to take the case to trial:

Pfizer has - I'm talking off the top of my head - 3 billion shares outstanding, and the stock went down 10 bucks. That's 30 billion of damages. Five percent of that is 1.5 billion. Settlement. And you go to a judge and say, "The damages are 30 billion. We are proposing a settlement that is 5 percent. How can you say that is unreasonable?" And we say, "It's unreasonable because it doesn't reflect the liability." And they say, "Sure it does. It's 5% of the total, but it could happen. So it is 5 to 95 chance to win. Yes, it's a perfect discount." But we say, the carriers, "Wait a minute. Wait a minute. They have a \$250 million D&O policy. Are you telling me it is torched on a claim where they did nothing wrong?" And so sometimes the numbers will in and of themselves take over, and I have that on a number of the pharmaceutical companies or large large jumbo cap companies. I have it with General Motors, General Electric. The stock ticks down \$2, which isn't enormous. It's not a free fall. [It's] based on some news that might be innocuous, and it's enough because that creates a damage pool that is into the billions, which immediately gets the plaintiff's lawyers out because there is damages, and the case has value irrespective of the merits.¹³²

Of course, smaller investor loss cases also almost always settle, so we are skeptical about the claim that the size of the investor loss, alone, explains the aversion to trial. We do think that it explains something, however, particularly in combination with the size and structure of the D&O insurance program, so we will return to this topic when we discuss the role of insurance below.

As reflected in the claims manager's five percent rule of thumb, the lawyers handling securities class actions closely monitor the settlements in other class actions. This rule of thumb works well for setting reserves. And an only slightly more complex rule of thumb may help define a range of settlement values. These rules of thumb do not explain the results in individual cases, as a monitoring counsel described:

The majority of securities class action cases, then you can take a look at - there has been enough of them - you can slice that information in different ways to try to come up with a grouping that is most similar to the case you particularly have and to look at what those cases have settled for and then predict that is what should be. You can also look at the settlement value by trying to say, alright here's the - even though this is not admissible in a court of law and it is a good value, a judgment of what the "damages" are, but the plaintiffs' style damages. This is what the stock price was and this is how much it dropped. These numbers usually result in a settlement of this percentage of that. So if you take this percentage of that total amount of money, this is about what those kinds of cases

¹³⁰ 10X80 means that his company sold a \$10 million layer of insurance that does not come into play until \$80 million has been paid by some combination of the insured and the underlying layers of insurance.

¹³¹ ClaimsHead 021207 at 34-36.

¹³² ClaimsHead021207 at 95-97. The participant, however, conceded in the next breath that "a better fraud case would settle faster." Id.

should settle for. Those are the two most common ways of doing a back of the envelope settlement calculation. More back of the envelope because I don't want to belittle the effort that can go into trying to figure out what a case is really worth.¹³³

But I think the largest and most determining factor is potential damages, and all these, the studies that like Cornerstone's that we refer to are extrapolations from what we refer to as plaintiff's style damages. And they say if the plaintiff's style damages expert say that damages are X, then the settlement value is a percentage within a fairly narrow band of X. And that's pretty much where you wind up.¹³⁴

"Pretty much where you wind up" is very different than exactly where you wind up. Investor loss, alone, does not explain the settlement amount in any particular case:

You know, the plaintiff's firm is bringing in their economists, and come up with some inflated crazy stuff. And obviously the defense tries to counter it, and actually I think it has worked out pretty well. If you look at the numbers, the settlement compared to the damages - you are talking anywhere from 2 to 6% of plaintiffs style damages [i.e., investor loss] if indeed truly you think there was something done wrong, I think it is actually pretty reasonable. So I can't really dispute. You know, there may have been a few individual cases where, probably rightfully so, that the case settled higher because they had more leverage.¹³⁵

Investor loss sets the range,¹³⁶ but other factors determine where a case settles in that range. Combining past experience with the investor loss in the case at hand allows the lawyers to set a reasonably accurate upper bound on the likely settlement amount, using the high end of the percentage of investor loss paid in prior settlements. Where exactly the case will settle depends on case-specific factors that include the participants' assessment of the strength of the evidence of misrepresentation and scienter, as well as other factors we will discuss.

Thus, settlement valuation is analogous to the D&O insurance pricing process we described in our earlier work.¹³⁷ Just as D&O insurance underwriters make an initial assessment of the premium based on a simple financial algorithm, so, too, do D&O claims managers make an initial assessment of the settlement valuation. And, just as D&O insurance underwriters arrive at a final price through a credit and debit process that takes into account "deep governance" and the state of the insurance market, so, too, do D&O claims managers arrive at a settlement price that they are willing to pay through a negotiation process that takes into account other variables, at least some of which relate to the strength of the evidence of fraud and the strength of the evidence linking the fraud to the harm.

Before leaving the topic of damages, it is important to note that, in securities class actions, damages can be a "merits" issue even in the narrow, "liability elements" definition of that term. A defense lawyer explained why:

¹³³ ClaimsHead051607 at 36

¹³⁴ Monitoring Counsel 7At 8-9:

¹³⁵ ClaimsHead031407 at 59-64.

¹³⁶ NERA 2007 report. Others?

¹³⁷ Baker & Griffith, Predicting Risk

In a securities case, if a statement is made in a large cap stock and there's a big drop you know in the stock when that statement is shown to be arguably inaccurate, OK, the issues of immateriality, the issues of loss causation, that's what the case is about. I mean big stock drops don't occur for only one reason so that this aggregation of those causative factors particularly after the Supreme Court's decision in *Dura*, that's frequently the only thing that the case is about. I mean there's no dispute about what was said originally, because it's in a filing. And there's no dispute about what numbers they reported. The numbers they reported are the numbers they reported, but the question of, you know, whether or not people knew that they were reporting something or saying something that was misleading is a critical issue, but so are the issues that relate to loss causation.¹³⁸

In the securities class action context, discussion of damages often includes considerations that would be classed under the heading of causation in tort law. The legal rules regarding the legally compensable damages require the plaintiff to prove that the misrepresentation caused the price of the security to be inflated,¹³⁹ a rule that a half generation of high-powered lawyering has made very difficult for plaintiffs.¹⁴⁰ Causation is an element of liability and, thus, a merits issue even under the narrow definition of that term.¹⁴¹

Indeed, once the motions are decided, much of the tactical skirmishing between plaintiffs and defendants revolves around the application of the loss causation rules to the investor loss in order to arrive at a damages number:

- A. By the time you get to mediation, damages is very much in the forefront of the discussion.
- Q Not liability so much?
- A Well, liability is there too, but you want to know something, it's much harder to back people off on liability. It is much more complicated. It's a lot easier just to say, "OK, just suppose for argument's sake you are right. There was a terrible fraud here. How much are you using by way of an inflation assumption? What is your trading model? What is your theory of causation?" Now -
- Q And, "What about these 3 other things that happened [in the securities market] at the same time?"
- A Exactly. In other words, "You tell me this drug was trading based on its cancer cure, and the whole thing of the cancer cure was wobbly BS. I'm telling you this company offered a metabolite for Prozac, and until the Prozac folks walked away from metabolite, that was chasing the stock price up!" OK, so you do focus on analysts' reports, stock price movements, OK. Marketplace news, baskets of comparables, and then very divergent forms of assumptions about who was trading and what and so forth and so on.¹⁴²

¹³⁸ Defense Counsel 5 at 16

¹³⁹ X-ref to *Dura* discussion.

¹⁴⁰ See, e.g. Plaintiffs' 8 at --.

¹⁴¹ Cite to med mal research treating causation as part of the merits.

¹⁴² Defense Counsel 4 at 11.

Defense counsel claim that they have the better loss causation and damages experts and that law is moving their way, but the monitoring counsel and mediators stressed the uncertainty in the law and, especially, in the application of the law to facts.¹⁴³ Indeed, one of the defense counsel who scorned the plaintiffs’ damages experts later admitted that defendants had better experts because they needed better experts, and that he doesn’t have a good answer to the following argument:

You can have, you know, plaintiffs just saying, “Listen, I’ll go up in front of a jury and I’m going to show \$2 billion in investment loss that you are going to have to explain why it is really only \$200 million. In any event, you only have \$100 million [of D&O insurance] in the tower, and I will settle for 124.”¹⁴⁴

As long as the plaintiff is willing to settle the case within a range that that is reasonable based on past settlements, the available insurance, and, in some cases, the ability of the issuer to pay the excess amount that is demanded, the case will settle for an amount that is greater than the damage figure produced by an aggressive defense expert’s model. The merits are part of that equation, but other variables clearly matter as well, as we now discuss.

B. The Role of D&O Insurance in the Settlement Process

If we include damages as part of the merits of a claim, then the most important non-merits factor in the securities class action context is the ability and willingness of the defendants

¹⁴³ Notes from Monitoring Counsel 4-5 at 2-3:

[W]hat really drives these things is the availability of the damages model is some expert who will get on the stand and offer affidavits that damages can be proven to such and such a number as a result of such and such decline over whatever period of time. These damages models ... were very often BS, but an important factor here... is that the damages models are never tested. You never go to trial. So there is never a case or very rarely a case like *Dura* where a court says this model of damages is BS. So because of this, things never go to trial and damages models never really get thrown out. It may be too easy for plaintiff’s lawyers to be able to articulate some kind of damages on the basis of some kind of initial economist’s damages model and then get into court on the basis of that.

See also Monitoring Counsel 7 At 11-12:

Q The complaint we have heard about is called kitchen claims, kitchen sink disclosure. Is that something -

A Yeah, that’s another problem that *Dura* has not solved, because if you read *Dura*, you know it seems to be pretty categorical in its description of how these cases work and when people first read *Dura*, they said this is great because unless there is one curative disclosure creating a drop of a fixed amount and then you just back in the number of shareholders, then you’ve got your case. If there is no specific drop at a specific announcement, then there is no securities fraud.

Q That can’t be right, right.

A Exactly right. It hasn’t turned out to be right. You know there is a great windfall that the defense lawyer thought was coming their way just hasn’t materialized because the plaintiff’s have said, no you can’t have periodic disclosures which have a cumulative effect of bringing the price down, so you look at the drop at the occasion of each what they call partial disclosure, and that’s what creates the damages.

¹⁴⁴ Defense Counsel 4 at 44.

to pay. Securities settlements are largely funded by insurance proceeds,¹⁴⁵ so in most cases the willingness to pay that really matters is that of the D&O insurers.

It is important to understand that, despite the label “Directors’ and Officers’ Liability Insurance,” D&O insurance largely protects corporate rather than individual assets, especially in shareholder class actions. Directors and officers already are protected by corporate indemnification.¹⁴⁶ The D&O insurance indemnifies the corporation, both for the corporation’s obligation to the directors and officers and also for the corporation’s own liability in the shareholder class action.¹⁴⁷ Thus, to a very substantial extent, D&O insurance is corporate asset protection insurance, not individual asset protection insurance, as we explored in detail in prior work.¹⁴⁸

The presence of D&O insurance means that securities settlements are funded by other people’s money from the perspective of plaintiffs and defendants alike. Other people’s money often is viewed as easy money.¹⁴⁹ As described by a monitoring counsel:

[T]he meeting of the board of directors to decide how to resolve these securities class actions goes something like this: Defense counsel comes in, makes a presentation that’s very erudite about the nature of the case and the defenses that are available. At the end of the presentation he says that “We believe it would be recommendable and it is appropriate and highly recommended that the board approve resolution that allows us to pay \$60 million to resolve this case.”

“Gasp, gasp, that’s \$60 million.” ... “How are we going to pay for \$60 million? We just had a presentation with the finance committee, and they said we need this, this and this. How are we going to pay for \$60 million?”

The general counsel says, “OK, fine. We have \$70 million in D&O insurance and every dollar is coming out of D&O.”

The next question is “What time is lunch?”¹⁵⁰

¹⁴⁵ [statistics: extent to which average settlements are funded by insurance proceeds.]

¹⁴⁶ citation

¹⁴⁷ A typical policy under “Side A” coverage protects each individual officer or director; “Side B” coverage protects the corporation itself from losses resulting from its indemnification obligations to individual directors and officers; and “Side C” coverage protects the company if it is itself a defendant in a shareholder claim. X-Ref to extended discussion in *Predicting Risk*.

¹⁴⁸ *Missing Monitor*.

¹⁴⁹ See Defense Counsel 3 at 34 (“You know, the company doesn’t care about the insurance company’s money”); Monitoring Counsel 6 at 25 (“[I]t is much easier to [talk settlement] when you can play with somebody else’s money”). Claims Manager 1 at 39-40 (“I think it is easier to get money out of an insurance carrier than it is out of an insured. Why? Because it is a third party’s money. We are in the business of paying claims. That is what we do for a living.”).

¹⁵⁰ MC 6 at 26. The same participant described defense counsel as interested only in keeping the settlement within insurance limits, further supporting the idea that, for defense lawyers and their clients, someone else’s money is less painful to lose. MC 2, at 48 (“As defense counsel, our obligation is to get the number inside the insurance limits.”)

To insurers, of course, the insurance proceeds are their money, and they will seek to save it.¹⁵¹ The easy availability of insurance proceeds, thus, is checked to some degree by the ability of the insurer to influence the settlement. Because the D&O insurer must approve of any settlement funded by insurance proceeds, insurers, as a class, can be understood to exert an influence over settlement outcomes in line with the extent to which the total settlement funded by insurance.¹⁵² As in the standard rational-actor model of insurance, the insurer steps into the shoes of the insureds to push back on plaintiffs' excessive demands.¹⁵³ The insurer will have two principal interests: first, and most obviously, to reduce settlement payouts, and second, to maximize investment returns by delaying the payout of invested capital.¹⁵⁴

D&O insurers achieve these interests through their power to veto settlement offers. D&O insurance policies provide that the policyholder must obtain the insurers' consent before entering into a settlement. As a result, the D&O insurance policy covers only settlements to which the D&O insurer has consented.¹⁵⁵ As some D&O insurance policies explicitly provide, and as contract law would imply in any event, the insurer's consent cannot be reasonably withheld.¹⁵⁶ But it is only in very unusual situations that a corporation would even consider settling without the insurers' consent. The few examples that we learned about involved settlement amounts substantially in excess of the D&O insurance program.¹⁵⁷

The insurers' veto, however, is not all-powerful. Indeed, the ability of the insurer to refuse settlement is subject to an insurance law constraint that is potentially much more significant than the contract law rule that consent cannot be unreasonably withheld. Refusal to settle entails the risk that the insurer could be liable for the entire judgment that results, not just the limits of the D&O insurance policy. As described by our participants:

[I]f there is a demand to settle within the limits, then the insurer takes on a very great risk in refusing that demand to settle within limits and saying that they are going to seek to go to judgment.... [T]hey risk bad faith action or some other kind of action that will make them responsible for the whole amount and not just the limits. So the defendant wants to settle and the insurer needs to settle in order to avoid the bad consequences of refusing to settle.¹⁵⁸

Under longstanding principles of insurance law, a liability insurer that refuses to accept a reasonable offer of settlement within the limits of the policy has, in effect, waived the limits of the insurance policy and, thus, will be liable for the full amount of any resulting judgment, no matter how much that judgment exceeds the limits of the policy.¹⁵⁹ Given the potentially very

¹⁵¹ In the words of one of our participants: "Insurers more often than not are not really interested in how good or bad your case is. ... [W]hat they really want to do is save money." cite (I have lost track of who said this, but I will figure it out.)

¹⁵² This is intuitively obvious, but we should provide a citation.

¹⁵³ Cite Shavell or something similar here?

¹⁵⁴ The precise percentage of D&O insurer profits from investment on reserves cannot be calculated because the aggregate financial statistics used for studying insurance solvency and other topics do not separately report the results of D&O insurance. Nevertheless, it is possible to report that in the general category that includes D&O insurance ("other liability claims made") investment income represented X% of insurer revenue in 2005. See Best's Aggregates and Averages: Property/Casualty Edition at -- (2005).

¹⁵⁵ Cite to standard policies; also to treatise.

¹⁵⁶ E.g. AIG 75011 (2/00) at 11; also to treatise

¹⁵⁷ Need citation – I know that I asked about this.

¹⁵⁸ Monitoring Counsel 4-5 At 6.

¹⁵⁹ See Kent Syverud, *The Duty to Settle*.

large damages at stake in a securities class action, and the small size of individual D&O policy in relation to those damages, the duty to settle places pressure on D&O insurers.¹⁶⁰ And, indeed, our plaintiff lawyer participants confirmed that they craft their settlement offers to put this precise kind of pressure on insurers.¹⁶¹

In addition to their veto power over settlement offers, the insurer may be able to raise coverage defenses to decrease its share of a settlement, most significantly through a threat to rescind coverage on the basis of misrepresentation in the insurance application.¹⁶² Corporations typically submit a copy of their financial statements with their application for D&O insurance, and D&O insurance underwriters commonly use financial measures derived from the financial statements to price that insurance.¹⁶³ Thus, fraud in the financial statements can become fraud in the application for insurance, provided that the underwriter had insisted that the corporation provide an application that incorporated the financial statements and that the insurer can prove that the underwriter relied on the fraudulent information in the statements.¹⁶⁴ According to our participants, D&O insurers only rarely use a rescission defense to avoid paying at all, but they do use the rescission defense to reduce the amount that they will pay to settle a securities class action.¹⁶⁵ As frankly described by one claims manager: “What happens, 9 times out of 10, [is] the larger the fraud, you are going to get a discount on your limit. You are going to cash in essentially your coverage case.”¹⁶⁶

The rarity of complete rescission can be explained in part by the adverse market impact that attends a carrier with a reputation for rescission.¹⁶⁷ The public company D&O insurance world is small. The buyers are well informed. And they are willing to pay what it takes to get the best coverage, as we explored in detail in prior work.¹⁶⁸ Not only would individual insureds hesitate to work with such a carrier, but so too would insurance brokers, leading to a more drastic

¹⁶⁰ Black et al.

¹⁶¹ References. This is part of the stock in trade of plaintiffs’ lawyers any time that a defendant has liability insurance. Baker, *Transforming Punishment Into Compensation*.

¹⁶² As described by a plaintiff’s lawyer in the following colloquy:

Q Do you feel like [insurers] use [coverage defenses] in settlement negotiations?

A Oh, yes.

Q Because they say, “Hey, we have this good coverage defense.” Is that meaningful to you?

A Absolutely, because I mean it’s a credible threat.

Plaintiffs 3 At 38.

¹⁶³ Baker & Griffith, *Predicting Risk*

¹⁶⁴ See, e.g., Cutter & Buck. In our earlier interviews we learned that insurance companies often do not require applications, particular in the case of a renewal, because the financial information can be found so easily from publicly available sources. Indeed, the main reason for requesting an application is not to get the information but rather to provide a basis for bringing a rescission defense in the future. [cites from earlier interviews]

¹⁶⁵ See, e.g., Notes from UConn Conference, RW speaking.

¹⁶⁶ Claims Head, 2/12/07.

¹⁶⁷ Quote re: Genesis.

¹⁶⁸ Baker & Griffith *Missing Monitor*. Moreover, almost every time insurance company side coverage lawyers develop a new tactic or defense, the D&O underwriters prepare a new insurance policy form that explicitly provides the coverage currently in dispute and thus protects D&O policyholders on a going forward basis. [need to email KL on this]. The most recent examples are “non-rescindable” D&O insurance policies, and a new endorsement that explicitly provides coverage for a category of claims that is hotly contested: Section 11 disgorgement actions.

and immediate loss of underwriting business. Rescinded policies not only hurt brokers' reputations with their client base, but also raise liability issues for the brokerage firm, leading the broker to place policies with carriers that are less likely to rescind.¹⁶⁹ Thus, it is not easy, from a business perspective, for insurers to pursue a misrepresentation defense all the way through to rescission.

A second, potential coverage defense that has received significant attention in the academic literature – the fraud exclusion – may have less impact than previously reported.¹⁷⁰ All D&O policies exclude payments resulting from fraudulent acts on the part of insureds. The exclusion has traditionally been subject to a “final adjudication” condition that obligates the insurer to fund the criminal and civil defense of directors or officers unless and until the fraud is finally adjudicated in the proceeding for which coverage is sought.¹⁷¹ Because shareholder litigation almost always is settled—and, therefore, not adjudicated in the proceeding for which coverage is sought—the “Fraud” exclusion does not narrow the D&O insurance policy to the extent that a simple reading of the D&O insurance policy might suggest.¹⁷²

This dynamic is well understood, and other researchers have used it to help explain why securities class actions almost always settle.¹⁷³ Our difference with their explanation is one of degree. The “final adjudication” provision may contribute to some defendants' incentive to settle; for fear that their insurance would disappear if the case were to go to trial. But monitoring counsel explained to us that they believe that, in most cases, there would be defendants whose behavior would meet the recklessness standard required for liability, but who were not too peripheral to the fraud to come within the scope of the exclusion, with the result that the insurer would still have to pay even if a jury were to find intentional fraud.¹⁷⁴

Moreover, plaintiffs' lawyers report that the fraud exclusion leads them to plead strategically, crafting their pleadings to avoided coming within the exclusion.¹⁷⁵ Pleading

¹⁶⁹ As described by one of our participants: “At some point the brokers would stop bringing business, because they were just too much of a hassle to deal with and that every time you raise a rescission issue, you raise a broker E&O issue, and you know, as long as it is an intermediary driven market, the brokers are going to help steer where the business goes.” MC 2, 11-12.

¹⁷⁰ Black et al, Arlen, Romano [need to check]

¹⁷¹ See JOHN H. MATHIAS, JR. ET AL., DIRECTORS AND OFFICERS LIABILITY: PREVENTION, INSURANCE AND INDEMNIFICATION § 8.04 (4th ed. 2003) (collecting cases holding that “[i]f the exclusion requires a final adjudication, that adjudication must take place in the underlying action for which coverage is sought”); see also Little v. MGIC Indem. Corp., 836 F.2d 789, 794 (3d Cir. 1987) (noting that the final adjudication language requires an insurance company to “pay loss as the insured incurs legal obligation for such loss, subject to the requirement that the insured reimburse any monies received if it is subsequently determined in a judicial proceeding that he engaged in active and deliberate dishonesty.”) Some more recent policies contain broader fraud exclusions, but these exclusions have not yet been tested. *Id.* Our participants confirmed that the adjudication in fact requirement takes most of the teeth out of the fraud exclusion. See, e.g. Claims Manager 1 at 45-46. During the “hard market” years of 2002 to 2005, some D&O insurers began to use a broader exclusion, without the final adjudication language, but many corporations were able to insist on the traditional language even during that period. See Baker & Griffith. (reporting that insurance market conditions would inhibit insurers' ability to insist on the broader term, and brokers confirm that the final adjudication language is almost always available).

¹⁷² MATHIAS ET AL, *supra* note 171 (noting that the application of the final adjudication provision “drastically diminishes the force and effect of the [actual fraud] exclusion”).

¹⁷³ Arlen, Black.

¹⁷⁴ MC1. Others?

¹⁷⁵ Plaintiffs6 at 23 (“Typically why would you want to plead yourself into a coverage denial that is valuable to the case.”). Accord Plaintiffs 5, at 24 (“[We] make sure that we don’t use words like you

intentional fraud would give the D&O insurers a bargaining chip that they could use in the settlement negotiations. Plaintiffs’ lawyers are not anxious to give liability insurers bargaining chips, so they construct their case around allegations of reckless conduct, further reducing the effect of the fraud exclusion on settlement values.

In summary, D&O insurers have significant control over settlement. That control is limited by the insurance law rule regarding the duty to settle. The insurance market limits insurers’ ability to rescind policies. And the final adjudication clause and the fact that the fraud exclusion applies separately to each entity insured under the policy limit the impact of that exclusion. We now turn to the major structural factors that shape the impact of D&O insurance on settlement: limits and layers.

1. Limits

The limits of the D&O insurance policies are an obvious and widely noted structural factor affecting the value of securities class action settlements.¹⁷⁶ Insurance, as we noted above, is seen as relatively easy money.¹⁷⁷ And reaching for damages beyond insurance limits can be difficult, as described by a plaintiffs’ lawyer:

[I]t is just easier to get money out of an insurance company. [Paying claims] is what they do. ... [Y]ou are going to have a bigger fight if you are trying to get the issuer itself to pay up, just as you know you are going to have an even bigger fight if you are trying to squeeze money out of individual managers.¹⁷⁸

Whether insurance money is easy money or not, insurance drives settlements. Indeed, one of our participants candidly admitted that one way to avoid securities litigation was to buy very little D&O insurance.¹⁷⁹ Clearly, this was facetious advice: a highly solvent underinsured company might be as desirable a target as an adequately insured company. But the point of the comment was plain: we sue for the insurance. As a result, insurance limits can serve as an anchor for settlement amounts.

If, as is generally the case, D&O insurance limits are significantly lower than potential investor losses,¹⁸⁰ then average settlements will tend to be pulled down to a range closer to typical policy limits. Average settlement amounts thus reflect trends in D&O insurance policies as much as they do the severity of corporate fraud. Thus, in a period such as the late 1990s and

intentionally cook the books or you did this or you did that. We don’t want to provide any sort of out for the insurance carriers. We are careful to emphasize that recklessness can prove scienter and that is not intentional ...”); Plaintiffs 2, at 34 (describing a case “where the fraud was too good, and the judge voided the insurance policies on grounds of fraud and inducement. So we end up arguing and structuring our arguments more in terms of recklessness. Because recklessness [is sufficient] under 10b5. You can’t insure against an intentional tort, the old principle.”). See Ellen Pryor, *Underlitigation*; Tom Baker, *Transforming Punishment Into Compensation* (reporting similar underpleading in bodily injury torts)

¹⁷⁶ NERA, Janet Alexander, Black et al, Romano

¹⁷⁷ X-REF.

¹⁷⁸ Plaintiffs’ Lawyer 7 at 15. Accord Defense Counsel 3, at 34 (“[M]ost plaintiffs’ lawyers are very mindful of the policy limits, and they realize that if they are reaching beyond the policy, this is a different case. [If] you talk about the company coffers, people are going to resist heavily, [but] the company doesn’t care about the insurance company’s money.”).

¹⁷⁹ Plaintiffs7.

¹⁸⁰ cite recent tillinghast survey.

early 2000s, when public company market capitalizations increased, thereby raising potential investor losses in securities suits,¹⁸¹ and D&O coverage limits did not experience a similar increase, D&O insurance limits may actually have resulted in less damages being paid than legally recognizable loss.¹⁸²

Insurance, of course, is a hard limit only for insolvent defendants. And plaintiffs' lawyers occasionally claimed to be more or less indifferent to insurance if the corporate defendant was financially strong.¹⁸³ Indeed, there are settlements in excess of the limits of the D&O insurance, and defendants sometimes contribute to settlements that are less than the amount of the D&O insurance.¹⁸⁴ These two categories of cases deserve careful attention in any effort to provide a comprehensive analysis of securities law in action. In particular, they suggest two important variables that should be considered when using quantitative methods to develop a model of securities class action settlements: whether the defendant paid part of the settlement, and, if so, whether that amount was in excess of the available insurance.¹⁸⁵

Nevertheless, given that insurance funds a large portion of settlements even for solvent corporations and that all our participants reported that insurance is at least somewhat easier to get than damages from the corporation itself, it would not be surprising to find that plaintiffs, more often than not, are willing to settle within limits. And indeed, this is what we find. In the words of one plaintiff's lawyer "it is great to [make a demand to settle within limits] because then you put the insurers in a bad faith posture potentially. [And that] really does strengthen the hand of the defendants against the insurers."¹⁸⁶ Defense lawyers confirmed this dynamic.¹⁸⁷

Indeed, plaintiffs and defense lawyers alike suggested that they have a common adversary in the insurer and a common objective in persuading the insurance company to pay out their limits.¹⁸⁸ In his words of one plaintiffs' lawyer:

I can think of at least three times in the last two years that I have had a defense counsel say to me, "We could settle this, but the carrier is giving me a hard time you know and this is all an off the record conversation, etc., etc., but if you want

¹⁸¹ x-ref to section where we explain potential losses as a function of stock drop and not that bigger market cap = farther to fall.

¹⁸² See Monitoring Counsel 8, at 45 ("[O]nce you have the top [limits of insurance], you can almost always work something off of it. So here's something that had nothing to do with merits of the case, and we were able to get some reasonable savings off of our limit, because it now became the ceiling and could work down from it.").

¹⁸³ Plaintiffs 7.

¹⁸⁴ Interview cites. Also cite to news story about settlements excess of limits.

¹⁸⁵ Cases with payments in excess of the limits are very large settlements, and, all other things being equal (most importantly, the size of the investor loss at issue), a case with a large settlement seems less likely to be frivolous than a case with a small settlement. See Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 *Vanderbilt L. Rev.* 1465, 1494 n. 142 (citing literature treating every low value settlements as nuisance settlements in which the merits did not matter).

¹⁸⁶ Plaintiffs 6 at 10-11.

¹⁸⁷ Defense Counsel 3, at 35 ("I mean normally you want if you are a defendant, you want a policy limits demand because that is what puts you in a position to say, you can now settle this case without hurting me, and I demand you do it...").

¹⁸⁸ See, e.g., Plaintiffs 2, at 19 ("With the insurers, I mean a lot of times we are teaming with the defendant's lawyers basically because, you know, they will tell you honestly that they have, their clients bought insurance. The reason you buy homeowner's insurance or car insurance. You are not looking for an accident, but if it occurs, you expect to be compensated for it.")

to write a letter like this or you want to do that,” or “Listen, when we go to the mediation session, I am going to have these two guys from the carrier there. I suggest you say in your presentation X, Y and Z.” I mean they script it for me.¹⁸⁹

Although collusion between plaintiffs and defense attorneys may seem jarring, from the defense counsel’s point of view, settling within insurance limits, even up to the maximum insurance limits, may be the best way of serving the interests of his or her client—the corporate defendant.¹⁹⁰ And the defense lawyers that we talked to confirmed that much of their role involves persuading the insurer to pay, often by warning them of the potentially severe consequences of failing to settle.¹⁹¹

In this regard, a sophisticated plaintiff’s style damages analysis that includes careful consideration of loss causation may be a tool used by defense attorneys against their insurers. As candidly described by one defense counsel:

[H]ere’s what we do. Suppose it was going to mediation. I call Cornerstone and say, “Get plaintiff’s style damages.” Cornerstone will immediately produce for me a breathtaking number and how it’s calculated. OK. Now *sometimes you want to use that to scare the insurance company pony up more jack...*¹⁹²

Insurance carriers confirmed that defense lawyers do use such tactics on them.¹⁹³

The phenomenon of defense lawyers and plaintiffs’ lawyers ganging up on liability insurers is hardly unique to securities class actions. Indeed, it is a well-recognized feature of personal injury litigation.¹⁹⁴ But in personal injury litigation the insurance company chooses the defense lawyer, so the lawyer’s long-term interest in getting business from the insurer moderates this phenomenon to at least some extent.¹⁹⁵ By contrast, D&O insurers do not choose the defense

¹⁸⁹ P7, 22.

¹⁹⁰ Consider the following anecdote, described by an insurer’s monitoring counsel:

I can remember a mediation I was once at, and the mediator was going around the room and asking everybody to introduce themselves with the plaintiff’s counsel. There was a company principal senior officer, and he said my name is such and such, and I’m, I can’t remember, the CFO or the treasurer or whatever, and my purpose of being here today is to get the case settled for any amount up to and including the full amount of the limit.

This is what was said.

Monitoring counsel 8, at 29-30.

¹⁹¹ cites

¹⁹² Defense Counsel 4, at 19 (emphasis added).

¹⁹³ Consider the following story by a claims manager:

It is almost routine now to see a plaintiff’s style damage analysis filed by Cornerstone and others and given to defense counsel, but many carriers become rather cynical about that because most of them are sophisticated enough to know that those kinds of plaintiff’s style damage analyses really are not a good reflection of what the case is truly worth. ...

They are often given to defense counsel who tend to use those, not necessarily with the plaintiff’s counsel but with the carriers saying, oh my god, we hired this big expensive group of economists, and they are smart people and they did all this number crunching, and look, there is a catrillion dollars in potential damages here.

Claims Head051607 at 37-38.

¹⁹⁴ Baker, Transforming, Blood Money, Pryor, Underlitigation.

¹⁹⁵ Baker, Tetrahedron.

lawyers or control the defense.¹⁹⁶ Instead, D&O insurers pay the defense costs of the securities defense lawyer that the policyholder selects, subject only to the dollar limits of the policy and the requirement that defense costs be reasonable.¹⁹⁷

In sum, limits serve to anchor settlement amount. In some cases the limits may pull settlements up and in other cases they may pull settlements down. When the limits substantially exceed even the upper end of the range of prior settlements in comparable cases, the limits likely have no impact on the settlement amount. When the limits are in the lower end of the range of prior settlements or below that range, the limits likely reduce the settlement amount. And when the limits are in the upper range of comparable settlements, the limits likely increase the settlement. Our hypothesis is, in theory, testable, provided that researchers can gain access to reliable information about the limits of D&O insurance programs.

2. Layers

The question of limits fundamentally is the question of what amount of insurance is available. But, as our participants emphasized, “It’s not just the amount of insurance. It’s amount and structure.”¹⁹⁸ In discussing the structural elements of insurance, our participants drew our attention to the design of the insurance tower. In particular, they focused on where particular insurers are placed within the tower and, more broadly, on the ability of multiple layers in a tower to act as a kind of firebreak on settlements.

D&O insurance is sold in layers. There is a primary insurance policy, and there is a series of layers of “excess of loss” insurance policies, each of which agrees to pay for claims once the underlying layer is exhausted. When we investigated insurance purchasing patterns in 2005, the highest D&O limit that any insurer was willing to write on any single company was \$25 million, and maximum limits of \$15 million, \$10 million, or even \$5 million per insured were common among the insurers active in the D&O market. This means that even relatively small D&O insurance programs almost always involve multiple layers of insurance policies, usually issued by different insurance companies. There easily can be ten or more insurance companies involved in a securities class action filed against a public company with a large D&O program.

Except in a mega case or in a case with extensive parallel proceedings, the primary insurance policy -- the bottom layer -- typically is large enough to cover the defense costs for a securities class action.¹⁹⁹ In a D&O insurance policy, unlike a typical auto or general liability

¹⁹⁶ See *Missing Monitor*. Our interviews for this phase of the research confirmed this finding. The only additional examples of defense cost control that our participants described to us were refusing to approve separate lawyers for different defendants unless there was an active conflict. Our insurer and defense side participants all agreed that D&O insurers otherwise do not have control over defense costs, except in the very rare, truly egregious case bordering on lawyer fraud.

¹⁹⁷ See *id.*. The two leading D&O insurance carriers maintain lists of “panel counsel” that policyholders generally must use in defense of securities claims. The panel counsel list, however, does not appear to be a cost-saving device for carriers, as the most prestigious (read: expensive) national law firms appear on both lists and insurers have not made any arrangement for a discount of their customary fee. This makes D&O panel counsel arrangements different from insurance panel counsel arrangements in more typical torts contexts, in which the lawyers on the panel have agreed to insurance company payments that are lower than their customary fees and to follow the insurance company’s case management and billing guidelines. See insurance cite.

¹⁹⁸ Defense Counsel 99 (SG’s west coast interview)

¹⁹⁹ Need to email MCs to confirm this.

policy, the defense costs count against the limit of the policy. The insurers in the other layers get involved in the case only, and to the extent that, there is a possibility of a settlement within their layer(s) of insurance. Traditionally, the primary insurer was the main point of contact with the defense team, and the only insurer that actively monitored the case on an ongoing basis, but in recent years, insurers much higher in the coverage tower have begun participating in regular conference calls with the defense team.²⁰⁰ In large cases, particularly ones that are accompanied by parallel administrative or criminal proceedings, the defense costs may well consume the primary, and even some excess, layers before the class action is settled.

a. The Arrangement of the Tower

At the beginning of every case, the working layer of insurance is the primary insurer, which generally remains the insurer in charge of coordinating with the defense team at least through the hearing of the motion to dismiss. Many cases, in fact, will never reach the layers of excess insurance. As a result excess layers are unlikely to be interested or involved in the early stages of a typical case.²⁰¹

But some cases, of course, will survive the motion to dismiss. In these cases the limits of the primary insurer and often the initial layers of excess are almost certain to be exhausted. Well before their limits actually are exhausted, these carriers know that they are, in our participants' words, "toast."²⁰² In this case, a conflict of interest may arise among the various layers of insurance within the tower. Layers of excess insurance that may potentially be implicated in the settlement will favor an early settlement at any amount that does not reach their layer, while the primary and any other excess carriers that are toast will prefer to delay settlement so they can maximize their own returns by holding their reserves for as long as they can. According to one of our participants, "if they can drag it out, they can still make money [on those reserves]. So they are not in any hurry to pay out."²⁰³

Of course, this dynamic is subject to the risk of bad faith liability, but bad faith liability requires the ability to actually settle the case within the limits of the recalcitrant insurer. The plaintiffs are unlikely to be willing to make an offer to settle within the limits of policies that everyone agrees are toast. They are looking for more money than that. So the carriers who are toast and the carriers who sit just above them in the tower join in the effort to resist settlement, while the plaintiffs' lawyers, the defense lawyers, and the high level excess carriers push for settlement. One mediator described the push for settlement as follows:

[O]ftentimes [I] can say, "I don't know what the settlement is going to be, but it's going to be at least \$50 million." And then you look at what the insurance tower is, let's say \$100 million, and you look at the fact that they are spending \$1 million a month. Those carriers in the higher end of the tower sort of see the hurricane coming, and they know that absent sort of a hail Mary motion to dismiss or summary judgment ruling, it is going to be at least a \$50 million

²⁰⁰ MC3

²⁰¹ Defense counsel 99 ("Remember who drives the case. The case is driven by the primary carrier. It's very rare that the excess carriers are engaged.").

²⁰² Supra (assuming we cited this earlier.)

²⁰³ Defense counsel 99 The same participant, a defense lawyer, prided himself on his willingness to settle early if early settlement suited the particular claim. In such cases, however, he reported that he often received resistance from insurers who frequently insisted on continuing the procedural fight notwithstanding his advice.

settlement. If you don't settle for 2 years, we are going to get through \$24 million, and so they see it coming and they are urging early settlement because it is in their interests at this time since the hurricane won't get to them, but if and that is why those insurers at the top become much more aggressive advocates for an early settlement whereas the ones down below know that they are toast under any circumstances, whether they get wiped out by the cost of defense or wiped out by the minimum \$50 million settlement.²⁰⁴

In that dynamic, the deeper knowledge of the primary carriers about the details of this case, as well as the details of settlements in other cases, gives them influence over the other insurers. The primary carrier has more information about the case in question because the primary carrier has been working with the defense lawyers from the beginning of the case. If the primary carrier is one of the few insurers with a large market share, that carrier will also have more information about the details of other settlements as well. This information gives the primary carriers an edge in the settlement discussions, limiting the power of the excess carriers to push for early settlement.

The excess insurers themselves could of course, remedy this structural aspect simply by becoming more involved in earlier stages of claims. In general, however, they do not do so.²⁰⁵ The exception to this general rule may arise when two companies within the same corporate group act as both primary insurer and an excess insurer. In such a situation, the primary carrier could protect the limits of its corporate affiliate by settling earlier at a lower total amount. And indeed, our participant confirmed, in such cases primary carriers frequently are amenable to early settlement.²⁰⁶

In sum, the settlement dynamic is shaped by the structure of the tower. Unless the plaintiffs' lawyers have determined that they will accept nothing less than the full amount of the D&O insurance program, the lawyers will craft their settlement strategies mindful of the limits in the individual lawyers. Carriers in the lower layers will be informed that they are "toast" and should get out of the way, while the carrier in the settlement layer is likely to be asked to pay something less than the full amount of the policy so that it now has something to lose by continuing the litigation.²⁰⁷ Carriers higher in the tower, eager to protect their own limits, may

²⁰⁴ Mediator 2, 15-16. .

²⁰⁵ Those carriers who frequently find themselves in the middle level of the tower may find that it is in their particular interest to develop an early and independent assessment of claims. One carrier in our sample confirmed this: "carriers that tend to be in the middle excess layer are required to do more of this kind of merit based detailed analysis to get to what we think is a reasonable result and what is a fair result for our insured." CH 9, at 37.

²⁰⁶ Quote.

²⁰⁷ A settlement too close to a carrier's total limits may induce that carrier to take a chance on continuing the case—to the next motion or next procedural stage. See, e.g., Max Berger 22 (plaintiffs lawyer discussing an example where the defendant has \$18.5 million in limits and the settlement demand is for \$17 million and describing the insurer's reaction as "Why don't I just take a chance?"). As described by a prominent mediator:

I've done mediations where I simply looked at a plaintiff and said, look, if you really want to settle this case now, the reasonable people can disagree as to whether it is a 5, 10, 11 or \$12 million case, but the truth is you are not going to settle this case now unless you give AIG or Chubb some opportunity to save some money off their \$10 million policy, because if they get the choice of tapping themselves out now and paying their \$10 million now or continuing to pay this fireman becoming toast, you get a pretty easy choice, but if you offer them the opportunity to save \$1 million off their policy, they are going to be highly incentivized to perhaps get this done.

pressure the target carrier to accept the discount. And, if that carrier agrees to accept the discount, the pressure is now on the carriers lower in the tower to offer up their policy limits, at the risk of having to pay more later by virtue of the duty to settle.²⁰⁸

b. Firebreaks:

If rising settlement amounts are like wildfires, then the layers within an insurance tower can act like firebreaks.²⁰⁹ Each layer within an insurance tower represents a new level of insurance involvement, a new monitoring counsel, and a new team of claims managers that must approve the settlement. At the very least, this changing of the guard upon breaking through into each layer of excess insurance adds delay. It may also increase defense costs as insurers, understanding that their limits are likely to be consumed, fail to monitor and constrain defense costs.²¹⁰ But perhaps most importantly, the additional layers of process may act as a break on settlement amounts. One mediator described the process of working through layers as follows:

[As] I work my way up these layers, every time I am starting with a new fresh person. And do you have kids who play video games? And you get to go to a higher level? A new monster jumps out. And you slay that one? All you get is a bigger monster? That's what it feels like to me. ... It's exhausting, and they want it to be exhausting.²¹¹

Even plaintiffs' lawyers readily acknowledged coverage layers as an additional burden,²¹² although they, in general, were more likely to downplay their influence in the ultimate outcome.²¹³

Mediator 2, 14.

²⁰⁸ See, e.g., *Twin City Mut. Ins. Co. v. Country Mut. Co.*, 23 F.3d 1175 (7th Cir. 1994, Posner, J.) (holding primary insurer liable to excess insurer in a case in which the excess insurer reasonably settled the case above the primary insurer's policy limits, on the grounds that the primary insurer's earlier failure to settle the case within the limits of the primary insurer's policy breached the duty of good faith).

²⁰⁹ Defense counsel 99 ("In a case that's not Enron or some massive fraud case, every time [the plaintiffs] hit another layer, it acts like a firebreak and makes it easier to negotiate a settlement."). DC 5, 7 ("If there's a \$25 million first layer and there is a case that is going to settle around \$25 million sometimes you will tell the plaintiffs, 'look, I can give you \$25 million assuming the first layer is on board. I can give you \$25 million, but if you want \$28 million, you know, I'm not sure I can get it, and it's going to slow everything down by 6 months.'"). Accord MC2, UConn conference. Accord M2 at 15 (referring to the tiers as a "non-merits savings issue"). But see Mediator 3, at 17 (reacting to the suggestion of firebreaks between layers by exclaiming, "It's a myth!").

²¹⁰ ClaimsHead051607 at 23-25:

The dynamic does change dramatically after a motion to dismiss is denied. Then that is an area or a time period where carriers may have very different ideas about how quickly one should press for a settlement conversation with plaintiff's counsel and that may or may not have to do with where they are attached on the program. At that point depending upon the size of the primary layer, some carriers take the attitude of, "Well, my money is gone. If I'm a primary carrier and I have a little retention below me, and I've only got \$5 million worth of coverage, then I've got big expensive Law Firm X and I've got co-counsel from big expensive Law Firm Y. You know, my \$5 million is gone as soon as I lose the motion to dismiss." ... So you sometimes observe those carriers as kind of going to sleep, not doing anything, just kind of rubber-stamping. "Yeah, do whatever you want."

²¹¹ See Mediator 1, at 32-33 ()

²¹² P 8, at 36 ("[A program with layers] really adds a burden to the situation. I think that truthfully instead of three layers of 5 million for a \$15 million program, you could almost (unintelligible) and probably pay less if you had 15 single million dollar things.")

The impact of multiple layers is not as simple as *more tiers, lower settlements*. But consider a hypothetical involving three companies, A, B, and C, each facing an factually identical securities claim, and each with identical aggregate insurance limits. The only difference is the structure of the tiers. Company A has a tower consisting of four tiers consisting of a \$5 million dollar primary policy, first excess of \$5 million, second excess of \$10 million and third excess of \$20 million. Company B has single \$40 million policy. And Company C has what would probably be most typical, a larger primary layer of \$20 million, and two excess layers of \$10 million. In this example it is easy to see how the multiple layers of coverage of Company A could act as firebreaks contributing to a lower overall settlement than that paid by Company B or C.²¹⁴ Although several of our participants acknowledged this effect of multiple layers in settlement,²¹⁵ and some defense lawyers may recommend adoption of such a structure for strategic reasons,²¹⁶ it is likely that most companies with multiple tiers have them serendipitously, because their underwriters made a decision to limit their exposure to any one risk.²¹⁷ Once again, we note that our hypothesis could be easily tested quantitatively if data on the structure of corporate D&O programs were publicly available.

C. Defense-Side Incentives: Defendant, Insurer, and Defense Counsel

No discussion of the effects on insurance would be complete if we did not describe the basic incentives on the defense side—the corporate defendant, the insurer, and the defense attorney—leading to settlement. As described by our participants, defendants typically favor settlement for reasons related to other business exigencies; insurers typically resist settlement to boost their investment income; and defense attorneys resist settlement, at least to some degree, so that they can maximize billable hours on the case.

The business exigencies of a corporate defendant may lead the defendant to press their insurer for settlement when, on a rational actor model, it may be more advantageous to continue to resist settlement. These exigencies tend to cluster around significant corporate events, such as a major corporate transaction or a change of CEO, or a change in accounting or change of auditor. Each of these events may induce the corporation to settle for reasons external to the litigation itself. The merger partner or new CEO, for example, may want to eliminate contingent liabilities created by the *ancien regime*, and a new auditing firm may want to close the books on old liabilities. Our participants confirmed that a range of such motivations often are the driving force ultimately bringing the corporation to the table.²¹⁸ For example:

²¹³ Cite.

²¹⁴ See Boris Feldman, *The Veil of Tiers: Shareholder Lawsuits and Strategic Insurance Layers*, available online at SITE (offering a similar example and noting that Company A’s structure of layers “would provide strong, natural firebreaks at \$5 million and \$10 million” and concluding “it’s a safe bet that the identical claim against [Company A] would settle for less” than the structure of Company B or C).

²¹⁵ Providing a similar numerical example contrasting companies with different tiered structures. Mediator 2, 15 (“[Even if] the case is a 20 to \$30 million case, that case might settle for \$18 million because the only two insurance companies you can get to tap themselves out are the primary and the first excess.”).

²¹⁶ Feldman, *supra* note [214].

²¹⁷ See Baker & Griffith, *Predicting Governance Risk*, *supra* note XX, describing the tendency of underwriters, after the scandals of Enron and WorldCom, to reduce their individual risk exposure by selling smaller amounts of insurance to more companies.

²¹⁸ As described by a mediator:

There are many different kinds of pressure points. They can range from everything to the defendant issuer or company wants to make an acquisition or divestiture. It could be that if the litigation is material enough so that the litigation itself has to be disclosed and

Well, what drives a settlement? ... Corporate events - a company may be interested in a merger, acquisition. They may be issuing stock. They may be interested in being taken over, going private, whatever. Those things will also cause companies to want to clean up litigation. ...[A] company could be taking a significant write off for unrelated reasons in a particular quarter and throwing litigation reserve on top of that might be a problem because they are already showing a loss. So they might as well clean up in that period.²¹⁹

Or again:

[I]t could be that they want to sell the company and they want to get everything behind them. It could be that they... are going to get rid of the CEO for other reasons or the CEO is going to retire and they want to have everything happen on the watch of the old CEO. There are a lot of situations like that where people want to clean things up. Sometimes they want to, they could have a problem with the government in another area. You know, if you are a drug company and you have a problem with the drug or something like that and then they say, OK, well, let's clean everything up.²²⁰

Such business exigencies, it would seem, tend to lead to higher settlements, as the corporate defendant moves to settle the litigation sooner rather than later, pressing their insurers to get it over with, and in the event that the insurers resist, agreeing to fund a larger portion of the settlement themselves, in order to get the deal done.²²¹ On the other hand, there may be other business exigencies, such as business failure and approaching insolvency, that encourage quick settlement without necessarily increasing settlement amounts.²²²

The urge to settle among corporate defendants—which our participants suggested is nearly universal, even in the absence of business exigencies favoring settlement, once the plaintiffs' claim survives the motion to dismiss²²³—is to some extent tempered by the D&O insurer's reluctance to settle. In addition to the sale of policies, an insurance company's profitability is derived from its investment returns. Other things being equal, the faster an insurance company pays out its reserves, the less investment return it realizes. Every insurance carrier thus has an incentive to delay paying claims in order to maximize investment returns.

discussed in filings that the company is coming up against a quarterly filing where they have to say something about the exposure in this litigation if it is big enough. I can think of one case where the settlement for the company in this case was in the billions of dollars, and that was the pressure point. They were at risk of making another, new false statement, and you know to make the disclosure and not have the case settled would put enormous pressure on them. Or it could be an SEC, something happened in an SEC matter.

Mediator 1 at 56.

²¹⁹ Plaintiffs 5 at 12

²²⁰ Defense Counsel 5 at 15.

²²¹ transcript

²²² As noted by our participants, an insolvent entity cannot contribute to the settlement.

ClaimsHead011207, at 76-77. By contrast, a defendant with a “very substantial cash position ... [will] have the effect of increasing or tending to increase the settlement fight, because they know that there is more to be gotten.” Defense Counsel 7 at 12.

²²³ X-REF. We should describe this earlier somewhere.

Most of our participants confirmed this dynamic. “Insurance carriers’ profitability is driven by two things,” one defense lawyer pointed out, “their payout ratio and what are they earning on their investments. They can have a very high payout ratio and be very profitable [because of their investments]. So they’re never in a hurry to pay out.”²²⁴ On this point, again, plaintiffs and defense lawyers see eye-to-eye. In the words of a prominent plaintiffs’ lawyer: “Most [insurers] in my view will set very high reserves on these claims internally and then decide when they have to reverse them by really settling the case so less than they reserve so that they can report a higher income.”²²⁵ Some of the insurers we interviewed, perhaps unsurprisingly, denied these suspicions: “you wouldn’t have to look too long or hard to recognize that you are not making money by investing with interest rates the way they are. That’s not anyone’s motivation from the insurer’s side. The insurer would be far better making a reasonable settlement at an early time and building good will.”²²⁶ Regardless of how low the investment returns may be, however, common sense suggests that the longer a carrier is able to keep its reserves invested, other things being equal, the better its results will be. As we have explained, the layered nature of D&O insurance may increase this incentive to delay.

Thus, the corporate defendant’s incentive to rush to settle the claim is tempered by the insurer’s incentive to delay. Given a significant business exigency, such as a merger or change of CEO, the corporate defendant may induce the insurer to accepting an earlier-than-optimal settlement by offering to contribute a larger portion of the overall settlement. In any event, the corporate defendant’s incentives tend to increase settlement values and, after the motion to dismiss, promote earlier settlements, while the insurer’s incentive tends to push in the other direction.

Many of our participants said that the lawyers involved in the case also have an incentive to delay settlement: defense lawyers so that they can continue billing the file, and plaintiffs’ lawyers so that they can show sufficient effort to justify a fee under a lodestar approach.²²⁷ Defense lawyers are subject to similar accusations in other litigation contexts.²²⁸ Plaintiffs’ lawyers more typically are paid a percentage of the recovery in other contexts, so this may be a special feature of securities class action litigation. This incentive is one reason that other scholars have called for an auction approach to class representation.²²⁹ While not a major focus of our research, the reports about plaintiffs’ lawyers’ incentive to delay would tend to support the auction idea.

IV. Discussion

We can now put forward a set of propositions, derived from our qualitative research, to illuminate the problem of assessing the role of the merits in securities class actions.

First, as we are hardly the first to observe, there is no adjudication. Securities class actions almost never reach trial, and dispositive summary judgment rulings are nearly as rare.²³⁰ Neither the basic facts of the claim nor the technical details of the damages model are tested by a neutral arbiter. This absence of adjudication deprives future claimants and defendants of

²²⁴ DefenseCounsel 99

²²⁵ Plaintiffs5 at 21.

²²⁶ CH9, 12.

²²⁷ Quotes in this note.

²²⁸ See, e.g., Baker Transforming. Cite to Kritzer article discussion this.

²²⁹ Cites.

²³⁰ X-ref

guidance. The most obvious gaps are rules regarding the application of loss causation rules to facts, but lawyers also have no evidentiary basis for comparing the views of the mock juries that they sometimes convene with those of real juries. In the absence of adjudication, the weight of facts is unclear and a variety of damages models are equally plausible. This leads not only to significant variation in damages models, but also to an inability on the part of a litigator to confidently conclude that the counterparty's assertions can be disproved. Without adjudication, there is no appeal to an objective fact-finder, and as a result, no external judgment of the truth of a claim or the credibility of a damages theory.

Second, essentially all securities class actions that survive a motion to dismiss are settled with a payment to the class.²³¹ This means that the denial of a motion to dismiss is, in an important sense, a dispositive decision. Indeed, in most cases, it is the only “dispositive” decision that a court will make.²³² But a decision to deny a motion to dismiss does not render judgment on the truth of the allegations, nor does it provide any guide to the amount of the damages that the defendants would be required to pay if those allegations were proven. The denial of the motion to dismiss indicates only that the plaintiffs have surmounted an evidentiary hurdle.²³³ As a result, it cannot guide the disputants to the outcome that would be reached through adjudication.

Third, settlements are funded largely, often entirely, by D&O insurance. This means that, in most cases, insurance companies are the real parties in interest. Their primary interest, of course, lies in minimizing payouts and, therefore, throughout most of the claims process, in contesting the plaintiff's claim.²³⁴ As a result, it is customary to treat the insurer as stepping into the shoes of the defendant. Yet, once the motion to dismiss is denied, the defendants will favor settlement as long as the plaintiffs are willing to accept an insurance-funded settlement. Therefore, the insurer, to some extent, steps out of the shoes of the defendant and steps into the shoes of the decider of fact, deciding whether the settlement outcome pushed by the plaintiffs and defendants fairly represents the discounted present value of the claim or, more simply, whether the discounted present value of the claim exceeds the limits of a particular D&O insurer's policy, so that it is time to pass the settlement control baton on to the next layer of insurance. The outcomes of securities class actions are driven, in other words, not by the opinion of a judge or the decision of a jury, but by the consent of the insurers.

Both plaintiffs and defense lawyers cast their arguments with a view towards the insurer. Plaintiffs report that they are careful not to plead facts giving rise to a coverage defense—for example, facts indicating intentional fraud – and they shape their settlement offers to create pressure on the insurance tower. They also described settlement meetings where the defense counsel essentially scripted the plaintiffs' arguments in order to induce the insurers to settle. Likewise, insurers described how defendants change their characterization of a claim—from defensible to more-or-less indefensible and, therefore, worthy of settlement. And the defense lawyers confirmed that they adjust their characterization of the liability and damages facts to keep insurers moving toward settlement. All of these arguments are designed to play on the insurer.

²³¹ deal with exceptions in this footnote, e.g., summary judgment, other outliers.

²³² The only other dispositive ruling the court will make is to approve the final settlement negotiated by the parties and their insurers. The approval of settlement is a pro forma ruling. [Ask the ISS people whether they have data showing how often courts do not approve settlements.]

²³³ Choi says this; JNP also support.

²³⁴ x-ref our discussion about over limits settlements and settlements within limites where the defendant pays a portion.

Fourth, in deciding whether to approve a settlement offer, the insurer obviously cannot be guided entirely by the representations of the parties, both of whom, by that point, strongly favor settlement for their own purposes. The insurer will also look to the only objective information that exists regarding the appropriateness of the settlement offer: other settlements.²³⁵ Insurers have a general sense of the range of settlement values as a percentage of investor loss, and they update that general sense by closely following securities class action settlements. Yet, by looking to other settlements, insurers are bargaining not in the shadow of the law, but in the shadow of prior bargains. If basing settlement decisions on the adjudicated outcomes of similar claims is like being in Plato’s cave, where we form judgments not from the reality outside but by its shadow on the cave wall, then basing settlement decisions on other settlements is like forming judgments from the shadow of shadows, at a further remove from what a judge or a jury would do, which lies at still a further remove from what Plato would understand as the objective truth.

Fifth, the practice of insurers cashing out their misrepresentation and fraud defenses in the settlement of the securities class action has interesting questions for the relationship between deterrence and insurance. Among other things, it suggests that the fact that one or more defendants paid some of their own money, particularly for a within-limits settlement, may be yet another useful, objective proxy for the objective merits. Among these defendant-pay cases, those that are settled *within* the limits of the D&O insurance policy are particularly unlikely to be frivolous. Except when there is a layer of insurance issued by an insolvent insurance company, a within the limits payment by the defendant indicates that the insurance companies had a strong basis for refusing to cover the claim. Typically, that basis would be an alleged misrepresentation in the defendant’s application for D&O insurance, and typically the misrepresentation would be in the defendant’s financial statements. This means that a defendant payment within limits is a good proxy for an admission that the defendant’s financial statements were fraudulent.

Insurance clouds the merits question. As we predicted, we are ultimately unable to say how much or how little merits matter in securities settlements. The focus on “sex appeal” supports the claim that litigants pay some attention to merit-related factors. But sex appeal is, at best, is a loose proxy for merits and, like all proxies, it will be both under and over-inclusive. At worst, sex appeal is a kind of smear campaign, focusing on sensational facts that distort reality and induce defendants to settle to avoid further embarrassment. Moreover, many of our participants reported that, once they get to the settlement table, they focus on loss causation and damages, not fraud. While loss causation and damages might be “merits” factors in an economic model of settlement, when most people ask whether merits matter, we think they are taking the narrow perspective that focuses on the elements of liability. They are asking the basic question of whether there was or was not fraud.

In theory, insurers should know how much insurance matters. They know the limits and structure of the D&O insurance programs. They know the amount of each settlement, whether the policyholder paid any of it, and, if so, how much. Yet, they do not maintain this information in any systematic way. When they want to know what patterns there are to settlements they look in the same places as everyone else: ISS and the Stanford Clearinghouse. Claims-side brokers do maintain settlement databases, they cannot provide reliable information on the impact of insurance limits and the structure of insurance towers on settlement, aspects that our participants insisted are important to the outcome at settlement but which are not publicly reported.²³⁶ Claims-side brokers can and do incorporate this information into their databases when they

²³⁵ “Objective” used here in the sense of information not fed to the insurer by the plaintiffs’ or defense counsel.

²³⁶ note what the broker databases do include.

happen to have access to it, as they would for example, with their own clients.²³⁷ However, such piecemeal data collection is unlikely to contribute to a reliable statistical analysis. And indeed, these brokers openly acknowledge the shortcomings of their databases.²³⁸

B. Implications and Policy Recommendations –**UNDER CONSTRUCTION**

If we must be agnostic on the question of how much the merits matter, can our investigation into how the merits matter lead us to ideas about how to make them matter more?

1. More Adjudication

Insofar as the problematic character of merits in settlement rests upon the absence of adjudication as a source of reference, the situation might be improved by having more adjudication. Clearly not every securities claim should go to trial, and indeed, the parties seem to agree that they would prefer not to go to trial. We may therefore toy with the idea of a mandatory rule forcing a given proportion of securities class actions surviving the motion to dismiss to go all the way through to trial. The proportion would not have to be large, perhaps a 1 in 10 lottery, but the effect might be to create source of reference in settlement.²³⁹

The additional source of reference might be good, in particular, in developing a body of precedent regarding damages models. If some damages models are incorrect as a matter of law or if certain assumptions clearly will not be upheld at trial, parties will be unable to press them in settlement negotiations and untested potential damages models may lose their coercive force. We are aware, of course, that almost every interested party would be against this proposal and that it runs contrary to public policy favoring negotiated settlements to disputes.

[Another way of accomplishing a similar effect to the mandatory lottery would be to require judges to engage in findings of fact and law when they approve of settlement. See Hillary Sale, *Judicial Gatekeepers*.]

A less radical proposal would be to alter the legal rules regarding the duty of the insurance company to settle so that, in an appropriate instance, the insurers in the D&O insurance tower could satisfy their obligation to bargain toward settlement in good faith through a “high-low” settlement offer. A high-low settlement offer is an offer preceding a trial in which the insurance company agrees to pay the plaintiffs a given amount – the “low” – even if the defendant wins at trial and, in return, the plaintiffs agree to accept another amount – the “high” – as the maximum amount of damages in the event that they

²³⁷ broker (pch).

²³⁸ interview cite/ e-mail reference.

²³⁹ we also need to think about the effect of such a rule on incentives? How would plaintiffs respond to the possibility of being selecting in a lottery where they could not settle. Would they drop these claims, thus creating a further premium for other claims that did not draw the short straw? We need to tease out the administrability and incentive effects of this proposal, even if it is only a theoretical conjecture, in the text.

prevail at trial. In the personal injury context the “high” is often the limits of the insurance policy, but it need not be. If such an offer would satisfy the insurers’ settlement obligations, they would not face the risk of having to pay an excess verdict if the plaintiff wins at trial.

2. More Disclosure

Weaknesses of the available data could also be corrected through the disclosure mechanism. As one of us has argued at length elsewhere, there is a great deal to be gained from mandatory disclosure of details concerning D&O insurance.²⁴⁰ Disclosure of premiums and limits, for example, may provide capital market participants with an additional signal concerning corporate governance quality. In this context, additional disclosure at settlement would provide other litigants with additional guidance concerning their own settlements. Important disclosure items include limits, structure, and how the ultimate settlement was funded.

As we have alluded to above, currently the only publicly available information about settlement is the settlement amount. It is thus impossible to disentangle, among other things, the role of insurance in settlement. However, if limits were disclosed, one could determine the percentage of settlement funded by insurance, thus taking the first step in separating insurance-variables from merits-variables. A second step in this direction would be disclosure of the structure of the defendants insurance tower, enabling one to calculate the effect, if any, that multiple tiers or other idiosyncracies of the insurance arrangement may have had on a particular settlement. Finally, the extent to which a settlement was funded by insurance would provide additional valuable information. For example, a settlement amount within limits that is nevertheless partially funded by the company itself may suggest more merits-related elements in the claim—for example, grounds for a potential recession threat, that caused the defendant corporation to contribute its own resources to fund settlement.

This data would be useful to...

3. Advice to D&O Insurers: A Different Insurance Arrangement and a More Complete Settlement Database

A quota-share arrangement could solve the problem of uneven contribution to settlement, in terms of both dollars and effort. Under a quota share arrangement, there are no attachment points, and every insurer is involved, at a stated percentage, at dollar one. As a result, in theory at least, the quota share arrangement would lead insurers to mount a unified approach to claims. However, quota share arrangements occur infrequently in practice. They are unpopular among insurers, our participants claimed, because of a perceived loss of control.²⁴¹ Although any one insurer’s influence in settlements involving a tower of coverage is, of course, limited—an insurers influence is greatest either when it acts as the primary insurer or, if losses exceed the primary layer, it acts as the working layer of coverage, paying defense costs and consulting on

²⁴⁰ Griffith, *Uncovering a Gatekeeper*.

²⁴¹ Claims Mgr 5/16/07 (“You have even less control. You have less say in what positions you are going to take about coverage issues. You have less... ability to influence, if you ever had any influence, the outcome of the resolution of the matter.”)

settlement²⁴²—each insurer retains the ability to stake out its own position regarding the availability of coverage. Each insurer can take its own position on, for example, the Fraud exclusion or the Section 11 issue, described above, and in this way, seek to avoid paying out its full committed limits. This potential source of savings is, by contrast, lost when the insurers agree to a collective quota-share arrangement.

We believe that D&O insurers should similarly consider establishing or supporting an information collection service that would collect all of the public information currently collected by ISS and the Stanford Clearinghouse, plus the information about insurance limits and structure that presently is not public. This would be very easy to do on a going forward basis and, provided that enough insurers cooperated, could even be done retrospectively through closed claim file reviews.

CONCLUSION

[to be continued]

²⁴² The Hartford.