



From Nuisance to Menace:

The Rising Tide of Securities
Class Action Litigation

441

Number of federal securities class actions filed in 2018

<25

Number of the 5,200 securities class actions filed since 1996 that have gone to trial

\$0.0

The amount shareholders received in 85% of settled merger objection claims in the past five years

3x

Multiple of securities class actions filed in 2018 versus the average filed from 1996 to 2016

85%

Percentage of M&A deals >\$100 million challenged with a merger-objection lawsuit in 2018

73%

Percentage of surveyed retail investors who believe lawyers are the main beneficiary of lawsuits against companies

\$13M

The median cost of a securities class-action settlement in 2018

1 in 10

Likelihood that a S&P 500 company was hit with a securities class actions in 2018

\$3.8M

Average total cost of settling a merger-objection claim from 2012-2017

Message from John Keogh

*Executive Vice Chairman and
Chief Operating Officer
Chubb*

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Securities class action lawsuits have a legitimate and important purpose: protecting the interests of shareholders when harm is done.

In the current legal environment, however, the class benefitting most from such litigation is not shareholders. Rather, the real winner is a growing cohort of lawyers who are filing meritless lawsuits in federal and state courts across the United States

every time a merger or acquisition is announced or a corporate misfortune impacts a company's share price.

In 2017 and 2018, the number of securities class action lawsuits (SCAs) filed in federal court broke new records each year, and the volume of suits is now twice the rate of 2014. A fair-minded person might ask: is the rising tide of SCAs an indicator of corporate malfeasance on a grand and growing scale?

The evidence points to a very different, but no less troubling, explanation: the financial rewards are accruing not to harmed investors but to lawyers who are bringing cases of dubious merit in order to reap a windfall in legal fees and a disproportionate share of settlement dollars. In the last five years, half of the nearly \$23 billion in securities claims costs have gone to lawyers – both plaintiff and defense. In the case of merger-objection lawsuits, two thirds of the costs have been paid to lawyers. Remarkably, in 85% of settled merger-objection claims, shareholders received not even a dime.

If a cohort of lawyers and law firms are the winners, who is losing? The answer is American business and, ultimately, small investors. Legal fees and settlement costs have become an increasingly unavoidable tax on American business. Last year, for example, about one in 10 S&P 500 companies was the target of an SCA. There are indirect costs as well, including to our national competitiveness. Rampant securities litigation is also one of the reasons why the number of public companies in the U.S. is half of what it was two decades ago. Fewer public companies mean fewer investment opportunities for the average small investor – and therefore less opportunity to participate in American growth and prosperity.

As a global leader in financial lines insurance, which includes directors and officers (D&O) and errors and omissions (E&O) coverage, Chubb has an informed perspective on this trend and on the full costs of SCAs and merger-objection litigation. We are committed to sharing our data, insights and resources to raise awareness about this problem and to work on behalf of American business to effect meaningful reform.

At Chubb, we are not willing to accept this broken system. Instead, we are driving for meaningful reform. Business as usual is simply not acceptable. This means taking a more active role in public policy reform. In this paper, we outline the origin and scope of the problem, and present several pragmatic – and needed – solutions.

We hope you will join us in advocating for reform.

Rising Tide of Securities Class Actions: Déjà Vu All Over Again

A generation ago, companies in the United States became the target of a flood of frivolous and unwarranted securities lawsuits. At the time, the claims were triggered simply by a decline in the price of a company's stock. Plaintiffs' lawyers then used the discovery process as a fishing expedition to identify potential fraud. Eventually, the abuses became too much, and Congress took action by passing the Private Securities Litigation Reform Act of 1995 (PSLRA). The bill became law when a bipartisan supermajority in the Senate voted to override a Presidential veto. The legislation achieved its purpose: shareholders could continue to access the courts and hold companies accountable when there was real harm. But the tide of frivolous cases receded.

Fast forward to today. The kinds of abuses that led Congress to act in the 1990s have returned, as a new and rapidly growing segment of the plaintiffs' bar has found fresh ways to bring lawsuits against businesses, collect fees and reap a disproportionate share of the benefits.

The facts are startling. In 2018, nearly one in 10 S&P 500 companies was the target of a securities class action (SCA) lawsuit.ⁱ The number of SCAs filed has increased each year since 2014, breaking new records each time. By 2018, the cases filed were more than twice the number recorded in 2014.ⁱⁱ

The plaintiff's bar has focused its litigiousness on two types of lawsuits. The first category of lawsuits is known as event-driven litigation. An event refers to a disaster or other adverse situation involving a company, such as a defective product that harms customers, a plant explosion or a data breach. Such events have long resulted in civil lawsuits brought on behalf of those who were impacted. To be clear, event-driven securities litigation does not refer to such lawsuits. Rather, event-driven securities litigation is a yet another lawsuit – a securities class action – usually brought against the officers and directors of a company. Frequently, the basis for this kind of lawsuit is that the directors and officers did not provide adequate disclosures that such an unexpected disaster or accident could occur, or did

not put sufficient controls in place to prevent it. In 2018, an average of one in 12 public companies was the target of an SCA. That's three times the average – 2.9% – that prevailed from 1996, after the enactment of the PSLRA, until 2016.ⁱⁱⁱ

The second category is merger-objection lawsuits, which are brought when two companies enter into a merger or acquisition. The basis of the claim is usually that the acquiring company paid too much, or that the target company sold for too little. Frequently, one law firm will file a claim based on the former, while another firm will file a suit arguing the latter. Last year, 85% of mergers were challenged with a merger-objection lawsuit.^{iv} If the plaintiffs are right, that would mean that nearly nine out of 10 mergers and acquisitions were flawed and failed to maximize shareholder value.

The voices of prominent legal experts are rising to challenge the growth of these meritless SCAs. Judge Richard Posner, writing for the majority in a 2016 merger-objection case heard by the 7th U.S. Circuit Court of Appeals, said, “In this case the benefit for the class was not meager; it was nonexistent. . . . The type of class action illustrated by this case – the class action that yields fees for class counsel and nothing for the class – is no better than a racket. It must end. No class action settlement that yields zero benefits for the class should be approved, and a class action that seeks only worthless benefits for the class should be dismissed out of hand.”^v

Andrew Pincus, a partner at Mayer Brown who has argued more than 29 cases before the U.S. Supreme Court, has written, “The securities class action

In the decade after the enactment of the PSLRA, the average annual litigation rate was 2.9%, meaning that less than 3% of companies would be sued in a given year. By 2017, the rate was 8.4%, and it rose again in 2018, to 8.8%.

system is spinning out of control. Abusive lawsuits are imposing huge costs on investors without providing any benefit. The only winners are the lawyers, who take home millions of dollars in fees.”^{vi}

“Once, securities class actions were largely about financial disclosures. In this world, the biggest disaster was an accounting restatement. Now, the biggest disaster may be a literal disaster,” John Coffee, law professor at Columbia University, has written. “The inherent problem in all event-driven securities litigation is that just because something bad happened does not mean that the company or its directors and officers committed fraud.”^{vii}

Fewer Public Companies, More Lawsuits

While the total number of companies named in SCAs has risen, the rate at which public companies are being targeted is even higher. The litigation rate is simply the number of SCA filings relative to the total number of publicly traded companies. Since the 1990s, the number of publicly traded companies has been reduced by half.^{viii}

In the decade after the enactment of the PSLRA, the average annual litigation rate was 2.9%, meaning that less than 3% of companies would be sued in a given year. By 2017, the rate was 8.4%, and it rose again in 2018, to 8.8%. For S&P 500 companies, the likelihood of being the target of a SCA was even higher: 9.4%.^{ix}

“Companies have become reluctant to IPO in the United States because of the tax on public companies attributable to securities litigation,” said Gerard G. Pecht, Partner, Global Head of Litigation and Disputes, Norton Rose Fulbright US LLP. “The reduction in IPOs due to the securities litigation tax also prevents our nation’s best companies from sharing their gains with the general public at large.”

While there has been a recent uptick in the number of IPOs, the underlying trends are unchanged.

Follow the Money

Advocates for SCAs point to two principal benefits. SCAs, they say, offer a way for shareholders to be compensated for losses. Second, the prospect of paying out big settlements or damages is a powerful check on corporate wrongdoing. By this logic, however, the social value of SCAs would be undercut if the benefits do not accrue to shareholders.

That is precisely what is happening. In SCAs, most of the money – and in some cases all of it – is flowing to lawyers, both plaintiff and defense. When cases are settled, the amount of the settlement is recorded and publicly available. Data about what plaintiffs’ lawyers are paid is also generally publicly available. A major cost of SCAs, however, is not publicly disclosed: the legal fees paid to defense attorneys. Chubb, a global leader in financial lines insurance including D&O, with its vast data set, has a unique window on costs paid out to defense lawyers, which provides a more complete perspective on the overall economic costs of SCAs.

Where the Money Goes

Chubb’s analysis of settled merger-objection claims from 2012 to 2017 reveals that attorneys are collecting more money than the shareholders they represent. Over the six-year period, the average total direct cost to defend and settle each suit was \$3.8 million.

Total Direct Costs of Settled Merger Claims from 2012-2017



According to Chubb data, half of the nearly \$23 billion in securities claims costs in the last five years has gone to plaintiff and defense lawyers. In the case of merger objections, nearly two-thirds – 65% – have gone to the lawyers. When there is a settlement in a merger-objection case, fully 85% of the claims provide no monetary value to shareholders.^x

Settlement Costs are Rising

As the number of SCAs grows, so too does the cost. For merger-objection claims, Chubb has analyzed the full direct costs of about half of the settled cases from 2012-2017, which includes the amount paid to shareholders, plaintiffs' attorney fees and expenses, and defense costs. During this six-year period, the average total direct cost was \$3.8 million per claim. The largest share of the total – 61% – went to attorney fees and expenses, including 38% flowing to plaintiffs' attorneys. Only 39% – less than two fifths – of the total went to shareholders.^{xi}

Chubb conducted a similar review of merger-objection claims that were dismissed. From 2012 to 2017, the average cost to obtain a dismissal was \$844,000, with 100% of the costs paid to defense attorneys. These types of cases, represent a significant direct cost to the companies sued and, indirectly, to their shareholders.^{xii}

NERA Economic Consulting has also tracked the value of SCA settlements over time. In 2018, the median cost of settled SCAs, excluding merger objections, was \$13 million, a near record and more than twice the \$6 million median in the prior year.^{xiii} According to NERA, the higher settlement costs were driven by relatively high settlements of moderately sized cases.

“Cases of moderate size not only made up the bulk of settlements in 2018 but also had a median ratio of settlement to investor losses more than 50% higher than in past years. Moreover, unlike 2017, there were generally few very small settlements,” NERA concluded.^{xiv}

Securities Class Action Whack-a-Mole

For years, the venue of choice for plaintiffs bringing merger-objection lawsuits was Delaware state court. A pair of decisions in 2015 and 2016 by the Delaware Supreme Court and the Delaware Chancery Court, however, made the state a much less hospitable venue for cases that provided no benefits to shareholders and large fees for the lawyers. Almost immediately, merger-objection cases began to appear in federal courts. A 2018 white paper issued by the U.S. Chamber of Commerce Institute for Legal Reform reported the dramatic shift. In 2009, only 15% of M&A deals triggered federal court lawsuits. In 2017, after the court decision in Delaware, there was a five-fold increase: three out of four M&A transactions with a deal value in excess of \$100 million triggered a federal lawsuit.^{xv}

“So far, the federal courts have done little to discourage these lawsuits,” observed Bruce G. Vanyo, Chair – Securities Litigation Group, Katten Muchin Rosenman LLP. “These lawsuits are an abomination. They really are. It is embarrassing that our legal system tolerates it.”

Spotlight on Event-Driven Litigation

The new generation of plaintiffs' firms is increasingly pursuing cases against companies whose share prices have declined following an event in the company's operations, such as a cyber breach or product liability lawsuit. These cases are typically filed without much investigation by plaintiffs' firms – sometimes less than 24 hours after the event. The volume and speed at which these claims are filed reflect the low cost of entry for the lawyers filing them, and the lack of constraints they face in using abusive tactics when litigating them.

“Today, every time a company reports disappointing results that is accompanied by a loss of share price, investigations and then filings follow. Operational difficulties alone should not be equated to securities fraud,” said Seth Aronson, Partner, O'Melveny & Myers LLP.

In 2018, SCA filings were highest in three sectors: healthcare, technology and financial services.^{xvi} Securities lawyers have observed how emerging risks, such as cyber breaches, #MeToo movement cases, and the widespread use and abuse of opioids, are beginning to increase potential exposures for directors and officers.

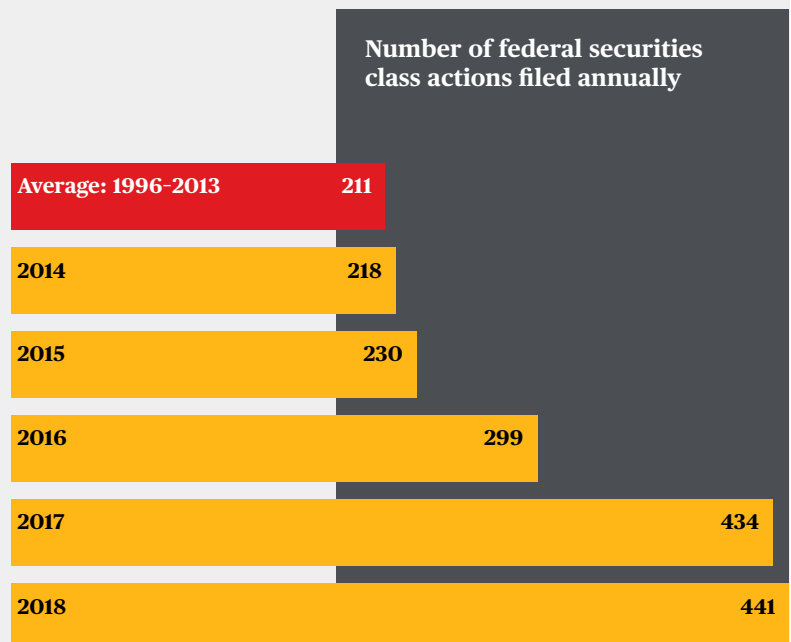
“Event driven claims are not new in concept or structure. But there are now a lot more events percolating through the business world that can cause stock prices to decline which is the event that leads to the filing of class action securities cases,” said Barry M. Kaplan, Partner, Wilson Sonsini Goodrich and Rosati. “This relatively new phenomenon will continue to generate more securities class action suits.”

“You can expect to see a securities class action filed whenever there is an event followed by a drop in the stock price,” said Scott Meyer, Division President, North America Financial Lines at Chubb. “But now, even events that didn’t move the stock price are triggering securities class actions against the board. For example, many companies these days are settling #MeToo-related claims with employees. And we’re now seeing more derivative lawsuits filed against directors following those settlements. It’s happening with cyber breaches as well, when companies must pay big sums to manage the cost of the attack. SCAs are being filed which claim the cost to the company would have been less if better controls were in place. These suits are coming even though such attacks can occur no matter how strong a company’s cyber security practices.”

“Both cybersecurity breaches and sexual misconduct by a CEO or other high-ranking officer will contribute to this new trend in event driven litigation claims,” said John Reed, Partner, Head of Delaware Litigation at DLA Piper LLP (U.S.). “These are very fact-specific cases and the magnitude of financial harm to a company, the pervasiveness of the problem, and the extent of red flags that should have put diligent directors on notice will ultimately determine the outcomes.”

Surfeit of Suits: The New Normal?

In the years following the enactment of the Private Securities Litigation Reform of Act of 1995, the number of annual SCA filings was stable. That changed in 2014, as the number of annual SCA filings exploded – doubling by 2018. That dramatic increase has occurred even as the number of publicly traded companies fell by 50% over the past 20 years.



Source: NERA Economic Consulting Report
January 29, 2019

The Impact of *Cyan v. County Employees Retirement Fund*

Securities class action and merger-objection litigation is proliferating at a time when there are no macro or systemic events to explain the rise beyond a well-financed, creative plaintiffs' bar. Notably, the number of SCAs prompted by a drop in a company's stock price has occurred during the longest-ever bull market for stocks.

In 2018, a major decision by the U.S. Supreme Court made the situation demonstrably worse. The case involved the initial public offering of a telecommunications company, Cyan. Following the IPO, the value of the company's stock fell and investors, led by the Beaver County Employees Retirement Fund, filed suit against the company in California state court, claiming that Cyan's offering documents contained misstatements and, therefore, violated the Securities Act of 1933.

Cyan filed a motion to dismiss. The company argued the state court lacked jurisdiction, pointing to a 1998 law that removed state court jurisdiction over most class-action securities lawsuits, including those related to the purchase or sale of securities. The 1998 law, known as the Securities Litigation Uniform Standards Act (SLUSA), amended the landmark Securities Act of 1933.

In its decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*, the U.S. Supreme Court sided with investors. The court ruled that the 1998 law did not strip state courts of jurisdiction of class actions brought under the 1933 securities act. Further, the law did not permit defendants to remove such securities class actions from state to federal court.

With its decision, the Supreme Court opened wide the door for plaintiffs to file SCAs in both state and federal courts. And it provided a clear pathway for plaintiffs to forum shop for friendly jurisdictions. The spike in IPO-related lawsuits being brought in both state and federal court is a direct result of the Cyan decision.

"The Cyan decision is increasing costs for companies that have done IPOs," said Hille R. Sheppard, Partner and Co-Chair of Securities and Shareholder Litigation Global Practice at Sidley Austin LLP. "Cyan allows these cases to be brought in multiple jurisdictions, including in multiple different state courts where it may be impossible to consolidate the actions, and where there is no lead plaintiff process and no automatic stay of discovery. Litigating in multiple fora against multiple plaintiffs makes cases more complicated to litigate and resolve, and is much more expensive."

The New SCA Lottery: "Hey, You Never Know"

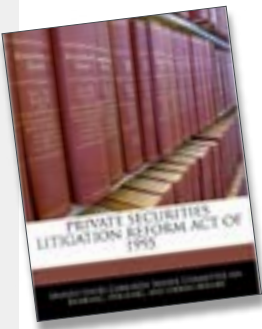
The plaintiffs' bar continues to file as many cases as possible, upping the odds that one will get past a motion to dismiss. Because the costs associated with surviving a motion to dismiss are not high, these firms are incentivized to continue filing these suits with the hope of higher payouts if they can survive an early-stage dismissal. Some observers have compared these current practices to buying lottery tickets – but even that depiction doesn't fully hold up. For most litigation cases the question is not whether there will be a payout, but rather how much the payout will be. Companies usually opt to pay the "tax" in order to avoid the substantial expense and risk of further litigation.

Prior to 1995, many firms were using "professional plaintiffs" to file suits against companies following stock drops with the goal of settling cases quickly. These settlements greatly benefitted the lawyers, but were of little value to shareholders. The PSLRA attempted to stop these practices through various measures, including raising pleading standards, directing that petitioners with the greatest loss be appointed lead plaintiff and select lead counsel, and imposing a discovery stay until the motion to dismiss was decided.

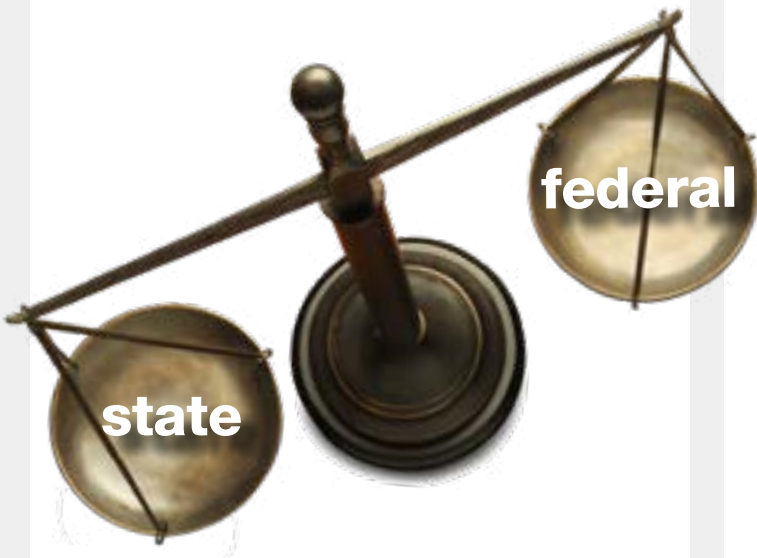
"The securities class action law reforms enacted during the 1990s endeavored to address various aspects of the pleading, procedural and proof requirements for securities fraud class actions to reduce the filing of frivolous claims and strike suits," said Theodore J. Sawicki, Alston & Bird LLP. "Nevertheless, over the last several years, it appears that the plaintiffs' securities class action bar has used its ingenuity and aggressiveness to find and exploit loopholes in those reforms to continue to file huge numbers of securities class actions and reap unfair financial benefits at the expense of public companies and their insurers."

"The PSLRA limited the number of times that a particular plaintiff could actually serve as a lead plaintiff," said Mr. Kaplan. "But the PSLRA did not limit the number of times that a plaintiff could file a class action lawsuit and seek to be lead plaintiff. As a result, we see the same filers over and over again filing initial complaints and seeking but not winning lead plaintiff status," he said. "Perhaps the PSLRA needs to not only limit actually serving as lead plaintiff, but limiting filing class actions in the first place."

Key Milestones for Securities Class Actions

	1933	1934	1988
	Securities Act of 1933 – the landmark “truth in securities law”– enacted by the U.S. Congress during the Great Depression that followed the stock market crash of 1929. 	Securities Act of 1934 creates the Securities and Exchange Commission with broad regulatory authority over the securities industry. 	Volume of frivolous securities class actions begins to rise. 
1995	1996	1998	2000
Private Securities Litigation Reform Act (PSLRA) passed by Congress to reduce flood of frivolous and unwarranted securities lawsuits. 	Tide of frivolous federal SCAs recedes; period of stability in number of annual filings begins. 	In response to growing number of securities fraud lawsuits brought in state court, Congress enacts the Securities Litigation Uniform Standards Act (SLUSA) of 1998. This effectively makes federal court the exclusive venue for securities fraud class action lawsuits. 	Dot.com crash is followed by a spike in securities class actions, including hundreds of “IPO laddering” lawsuits, in which investment banks were accused of fraudulently offering clients large allocations in initial public offerings if they agreed to buy additional shares once trading commenced.

2009	2013	2014	2016
Securities class actions spike again following the onset of the financial crisis.	Period of stability in the number of federal SCAs filed annually comes to an end.	Volume of both event-driven and merger-objection securities class actions rises.	Delaware Chancery Court announced it would no longer approve “disclosure only” settlements in merger-objection lawsuits, citing volume of cases with no benefits to shareholders but large fees for plaintiffs’ lawyers. Judge Richard Posner of the 7th U.S. Circuit Court of Appeals states “class actions that yield fees for class counsel and nothing for the class is no better than a racket.”
<i>Cyan Inc. v. Beaver County Employees Retirement Fund</i> – U.S. Supreme Court holds the Securities Litigation Standards Act of 1998 did not strip state	courts of jurisdiction for securities class actions. Ruling opens the door for companies to be sued in both federal and state court.	411 federal class actions filed, a new record; chance that a S&P 500 company will be the target of an SCA approaches 1 in 10.	Elevated volume of SCA filings continues unabated; Congress and the SEC have yet to take action to stem the tide of meritless SCAs.



Proposed Reforms

There is a real need for legal reform at both the state and federal levels. It is imperative that American business advocate for reform, including pressuring those states with a history of abuses to change.

Advocates for reform have proposed a range of actions that would curb abuses and minimize the incentives for plaintiff firms to file meritless lawsuits. Some of these reforms will require the U.S. Congress to act. But there is also a role for the U.S. Securities and Exchange Commission to study the issue and use its considerable influence by issuing policy papers and filing amicus briefs in federal court cases that highlight the magnitude and consequences of the problem. Educating judges to make better decisions in these cases is an important role.

Here are a number of reforms that would make a meaningful difference in stemming the tide of meritless SCAs and abusive tactics used by some plaintiff law firms.

Reform 1: Overturn Cyan

Cyan opened the door for offering-related SCAs to be filed in both state and federal courts. Congress should close this door. Companies should not have to incur the risk and costs of defending themselves in two or more different courts simultaneously. The principle at stake is simple and defensible: federal courts should be the jurisdiction for litigating federal securities class actions. In Cyan, the U.S. Supreme Court had a peculiar reading of SLUSA. The consequences were both predictable and unfortunate. Congress can fix this problem.

“The Cyan case has interpreted federal law to permit the filing of 1933 Act claims in both federal and state courts,” Mr. Reed noted. “Congress should take action to eliminate state court jurisdiction and require that all federal securities claims be filed in federal courts and they should expressly authorize corporations to adopt exclusive forum provisions, including arbitration provisions, for all securities claims.”

“There is a relatively easy fix here and that is for Congress, through legislation, to make it clear that under SLUSA all federal class actions, even under the '33 Act, must be brought in federal court,” said Mr. Kaplan.

Reform 2: Require that Fees Paid to Lawyers be Proportional

The PSLRA requires that the fees paid to lawyers must be “a reasonable percentage of the amount of damages and prejudgment interest actually paid to the class.” While judges must review and approve legal fees, the prevailing norm is for requests to be rubber stamped by the judges. As three law school professors wrote in a 2019 study commissioned by the U.S. Chamber’s Institute for Legal Reform, this creates an incentive for plaintiffs’ attorneys to seek inflated awards.

“Fees paid to plaintiffs’ counsel should be proportional to their work,” said Mr. Pecht. “They should not be able to piggyback fee requests onto investigations and work government agencies already performed and which the taxpayers paid for. There is no need for such a transfer of wealth from the general public to the small group of professional plaintiffs’ securities class action lawyers.”

“To curb these abuses, judges should scrutinize fee requests far more carefully,” concluded Stephen J. Choi, Jessica Erickson and Adam C. Pritchard in the Institute for Legal Reform research. “Congress can also help curb exorbitant fee requests . . . by setting presumptive limits on fees in the largest cases where exorbitant fees are common.”

Dan Tyukody, Co-Chair of Securities Class Action Practice at Greenberg Traurig, LLP, observes that expecting courts to police plaintiffs’ fee submissions

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may not be realistic. “Ours is an adversary system where each side acts as a check on the other. That aspect fades once a settlement is reached, since defendants have little or no incentive to police plaintiffs’ fee submissions,” he said. “That leaves it to the courts to do the policing. . . . District court judges and magistrate judges are already overworked, and expecting them to expend the time necessary to better police this issue is not realistic.”

One solution, Mr. Tyukody said, is for Congress to require that a special master be appointed for cases that are settled in order to review the fee submissions.

Reform 3: Require Plaintiff Involvement

When Congress enacted the PSLRA, one of the key goals was to ensure that the lead plaintiff in a securities class action was an investor with a large stake. It was understood that the interests of institutional investors would be most aligned with the class. The law was responding to the proliferation of plaintiffs’ lawyers who would rush to the courtroom with a filing, having identified a lead plaintiff who was a small investor with little at stake. Often, those same plaintiffs’ attorneys would file many SCAs with the same individuals as lead plaintiffs.

The PSLRA was effective for years, but the number of cases with individuals as lead plaintiffs began to tick up around 2013, according to Mr. Pincus. By 2017 and 2018, individuals were the sole lead plaintiff in fully 60% of the SCAs filed. “This change is strong additional evidence that claims brought in recent years are less meritorious than in the past,” Mr. Pincus has written. “Plaintiffs’ lawyers therefore are forced to turn to their pet ‘professional plaintiffs,’ which results in the very lawyer-driven litigation that the PSLRA sought to eliminate.”^{xvii}

“Many plaintiffs would not agree to be a plaintiff if they actually had to devote time to the case. At a minimum, they should be required to attend all significant court hearings and to attend any mediation sessions,” noted Mr. Vanyo.

Reform 4: Require the Disclosure of Any Relationship

Sunlight, the saying goes, is the best disinfectant. That principle applies to SCAs as well, where it is important to fully understand the relationships between plaintiffs and their lawyers. The importance of this principle was highlighted in a recent case in Boston that has quickly become notorious. In a lawsuit filed against a major bank, a law firm paid a \$4.1 million referral fee to a lawyer whose only involvement in the

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case was to act as middleman between the law firm and the public pension fund that became the lead plaintiff in the suit against the bank. The existence of the payment was uncovered in an investigation by a special master that was ordered by the judge.

Prof. Coffee, in an article in the *New York Law Journal*, said the case could become a legal “Watergate.” He also compared this case to the New Yorker who sees one cockroach in his apartment: “There is never just one cockroach. Put differently, an active market may today exist in which politically connected attorneys charge extraordinary contingent fees, requiring payments in the millions of dollars, for introducing and connecting prominent plaintiff law firms with public pension funds and other institutions capable of serving as lead plaintiffs’ in major class actions. The attorney who plays this hidden brokerage role does no work on the case, makes no appearance in court, and may not be known to the client, most of the class counsel in the case, the class representatives, or the court!”^{xviii}

Advocates for reform argue that Congress should require the disclosure of all such relationships.

“No referral fees should be permitted for firms that do not perform any of the legal work on a matter,” said Mr. Pecht. “Institutional investors should only be allowed to serve as lead counsel in a securities class action after it has been considered and reviewed by the institutional investor’s board of directors.”

“Contributions to state politicians from plaintiffs’ lawyers should be disclosed (or even prohibited assuming no First Amendment concerns) if the politicians have a say or influence in hiring counsel for the state pension funds that have become notorious plaintiffs,” said Mr. Reed.

Reform 5: Allow Fast-Track Decisions

In the Institute for Legal Reform white paper, Mr. Pincus notes that the defining event of a securities class action is the motion to dismiss. “If the motion is denied, class certification and settlement virtually always follow,” he wrote.^{xix}

Therefore, an expedited process for appealing the denial of a motion to dismiss a SCA is a needed reform. The legal term is interlocutory appeal, which refers to an appeal of a ruling by a trial court that is made before the trial has concluded.

“Congress should provide for interlocutory appeals of denials of motions to dismiss, either as of right or based on a discretionary standard,” wrote Mr. Pincus.

Conclusion – The Unseen Costs

In late 2018, the Institute for Legal Reform conducted a public opinion poll of voters and retail investors to gauge perceptions about the current litigation environment.

Significant majorities of voters – 63% – believe that lawyers are the main beneficiaries of lawsuits against companies. Among investors, that view was even more strongly held – 73% see lawyers as benefitting the most.^{xx}

But those negative views of trial lawyers, who are seen as benefitting at the expense of others, did not necessarily translate to a sympathetic view of corporations.

Perhaps that is because the costs – and consequences – of the tide of SCAs are generally invisible. The vast majority of citizens, including retail investors, do not have a window into the volume and cost of meritless lawsuits.

But those costs are calculable and real. More difficult to calculate – but no less real – is the impact of securities litigation on the number of public companies listed in the U.S. It is half of what it was 20 years ago. While SCAs are not the only reason fewer companies choose to go public, it is an important one.

“This is an unfortunate trend. The number of public companies has been steadily declining. This denies investors, both small and large, the opportunity to participate financially in the success of companies,” said Mr. Vanyo.

“[T]he fear of securities litigation hangs over every newly formed public company, with there being a roughly one-in-five chance of being sued in the first five years following an IPO,” said Mr. Tyukody. “That has led some insurers to question whether they want to be in this market, and has resulted in higher premiums from those who choose to remain. It also limits the pool of potential directors who could contribute to the development of the company because of the threat of potential liability. New companies are the lifeblood of the American economy . . . and their ‘creative destruction’ forces are essential to innovation and capitalism. IPOs also provide a mechanism for spreading wealth to those who have worked hard to achieve success and are the embodiment of the American dream.”

“Small investors are being shut out of potential successful deals,” said Mr. Aronson. “And IPOs have the salutary effect of having the SEC, investment bankers, accountants and lawyers as a check on the IPO process. Once a company goes public, analysts are added to the check and balance mix. Too much wealth hidden in private hands could have disastrous consequences in a downturn.”

The problem – more lawsuits, higher costs, more profits to certain lawyers at the expense of shareholders and, ultimately, citizens – will continue, until the courts, Congress and the SEC take action.

Expert Opinions

The Role of the SEC in SCA Reform

“The SEC can take a closer look at private securities litigation. It can identify repeat filers and attorneys that abuse the system and file cases that are repeatedly dismissed. The SEC can then join the most problematic cases as an amicus in support of dismissal.”

– Gerard G. Pecht, Norton Rose Fulbright US LLP

“Reconstitute the SEC’s mandate, staffing and funding to make it the gatekeeper of federal securities class actions. Empower the SEC to use its investigative powers to identify and investigate potential claims, determine those claims that are meritorious, pursue the enforcement/deterrence remedies and put out for bid to interested law firms the opportunity to pursue civil damages remedies on behalf of injured parties.”

– Theodore J. Sawicki, Alston & Bird LLP

“The SEC could potentially help with curbing other merger-objection cases being filed in federal court. They could refine their rules on what must be disclosed in the proxy statement for a merger transaction which would make it more difficult for plaintiffs to argue that there are material omissions.”

– Bruce G. Vanyo, Katten Muchin Rosenman LLP

The Role of Congress in SCA Reform

“Congress should enact targeted statutory changes that will eliminate the well-documented abuses of securities class actions” including: overturning Cyan, centralizing M&A lawsuits, enacting an Investors’ Bill of Rights, eliminating abusive litigation tactics and adopting a damages cap.^{xxi}

– Andrew Pincus, Mayer Brown

(For a more complete discussion of these proposed reforms, see Containing the Contagion, a February 2019 paper released by the U.S. Chamber Institute for Legal Reform)

“Among the legislative changes suggested would be a prohibition on sharing fees with firms that only act as lead plaintiff finders, and requiring proportionality and transparency in the breakdown of fees paid to class counsel. . . . As part of any reform, Congress should require that for every case that settles (or perhaps every case that settles above a certain level), a special master be appointed (paid out of the settlement proceeds) to review the claimed loadstar amount and opine upon the reasonableness of the total fee award in light thereof. Presumably, special masters would gain expertise and industry knowledge by reviewing different firms’ submissions, thereby gaining a sense of who the good and bad actors are, what rates truly seem to be ‘market,’ and what seems a reasonable amount of time for the work claimed to have been done.”

– Dan Tyukody, Greenberg Traurig, LLP

“Congress should pass legislation requiring that class actions under the 1933 Act be brought exclusively in federal courts. It is very expensive to litigate these cases in multiple venues, and federal courts have the PSLRA’s lead plaintiff appointment processes as well as the automatic stay of discovery, which further reduces costs.”

– Hille R. Sheppard, Sidley Austin LLP

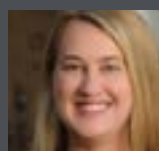
“Before the PSLRA, there was a multitude of plaintiffs firms, many of whom would file securities class actions even if the plaintiff purchased only a small number of shares. There was a race to the courthouse with the hope that the first to file would run the case. The PSLRA, especially the lead plaintiff requirements, ended the race to the courthouse. . . . The race today is not to file first but to be the first to post an internet announcement of the commencement of ‘an investigation’ with the hope of attracting several plaintiffs to form a lead plaintiff group. The current environment is striking in the increased number of securities class action filings and, once again, a large number of plaintiff firms in the chase. . . . Congress can fix the PSLRA by mandating that all securities class actions under the 1933 Act must be filed in federal court.”

– Seth Aronson, O’Melveny



“Congress should consider amending the PSLRA to prohibit lead counsel from sharing its fee with law firms that do not perform actual work. In addition, Congress should also prohibit referral payments in securities fraud class actions. These ‘referrals’ do not uncover cases; they deliver plaintiffs to plaintiffs’ attorneys that allow the lawyers to compete for cases that are generated through other avenues. Additionally, Congress should require lead counsel to disclose how the requested fee award will be distributed among the firms that worked on the case.”^{xxii}

– Stephen J. Choi, New York University School of Law
– Jessica Erickson, University of Richmond School of Law
– Adam C. Pritchard, University of Michigan Law School



“The SEC should take an affirmative stance on whether companies can adopt mandatory arbitration or forum-selection provisions for claims arising out of IPOs. Rather than leaving it up to the SEC, Congress should pass broad reforms, such as (1) eliminating state court jurisdiction for 1933 Act claims and (2) expressly authorizing companies to put in initial offering documents and adopt in their charters or bylaws (a) exclusive forum-selection provisions so class actions can at least proceed in a single designated forum and/or (b) mandatory arbitration provisions, including provisions that bar class claims. Such legislation should also authorize an automatic award of attorneys’ fees against any plaintiff who files an action in violation of such provisions. Federal legislation may be necessary because a recent Delaware Court of Chancery case (Blue Apron) has held that a Delaware corporation cannot put anything in its charter or bylaws that purports to regulate securities claims, including the adoption of an exclusive forum provision.”

– John L. Reed, DLA Piper LLP (US)



“I am generally skeptical of new legislation. I think the key is for more business-oriented judges to be appointed to the federal courts and to keep the publicity going about the abusive nature of these lawsuits at this time.”

– Barry M. Kaplan, Wilson Sonsini Goodrich and Rosati



Endnotes

- i. [Cornerstone Research Securities Class Actions Filings 2018 Year in Review](#)
- ii. [NERA Economic Consulting Report January 29, 2019](#)
- iii. Cornerstone Research, 2018 Year in Review, *op. cit.*
- iv. [Andrew J. Pincus, A Rising Threat: The New Class Action Racket That Harms Investors and the Economy, U.S. Chamber Institute for Legal Reform \(Oct. 24, 2018\)](#)
- v. [ABA Journal: Posner Opinion Blasts Class Actions That Are No Better Than a Racket” \(Aug. 12, 2016\)](#)
- vi. Pincus, A Rising Threat, *op. cit.*
- vii. [Andrew J. Pincus, Containing the Contagion: Proposals to Reform the Broken Securities Class Action System, U.S. Chamber Institute for Legal Reform \(Feb. 25, 2019\)](#)
- viii. [Bloomberg, Where Have all the Public Companies Gone? \(April 9, 2018\)](#)
- ix. Cornerstone Research, 2018 Year in Review, *op. cit.*
- x. Chubb data. Analysis is based on approximately half (49.9%) of all settled merger-objection claims during the period of 2012-2017; sample is a representative of the total universe of claims; data set comprises averages of claims where the total costs are available including: amount to shareholder, plaintiff attorney fees, defense costs and plaintiff attorney expenses.
- xi. Ibid.
- xii. Ibid.
- xiii. NERA Economic Consulting, *op. cit.*
- xiv. Ibid.
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- xvi. NERA Economic Consulting, *op. cit.*
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- xviii. [New York Law Journal, The Market for Lead Plaintiffs \(Sept. 19, 2018\)](#)
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- xxi. Pincus, Containing the Contagion, *op. cit.*
- xxii. [Stephen J. Choi, Jessica Erickson and Adam C. Pritchard, Risk and Reward: The Securities Fraud Class Action Lottery, U.S. Chamber Institute for Legal Reform \(Feb. 2019\)](#)

Infographic Sources

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| <25: | D&O Diary, Rare Securities Class Action Lawsuit Trial Results in Partial Verdict for Plaintiff (February 5, 2019) |
| 3X: | NERA Economic Consulting, <i>op. cit.</i> |
| \$0.0: | Chubb data, <i>op. cit.</i> |
| 85%: | Pincus, A Rising Threat, <i>op. cit.</i> |
| 73%: | U.S. Chamber for Legal Reform, <i>op. cit.</i> |
| \$13M: | NERA Economic Consulting, <i>op. cit.</i> |
| \$3.8M: | Chubb data, <i>op. cit.</i> |
| 1 in 10: | Cornerstone Research, 2018 Year in Review, <i>op. cit.</i> |

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