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A Defense Counsel's Perspective AFTER SIX YEARS THE JURY IS STILL OUT ON THE PSLRA

By Jonathan J. Lerner

I must confess to having had at least a modicum of trepidation before accepting the honor of venturing a few personal observations on the success of the Private Securities Litigation Reform Act (the "PSLRA") to a group comprised primarily of active institutions to whom the PSLRA handed the responsibility to bring securities class actions against my clients. But like Daniel and the proverbial lion's den, I could not resist the opportunity. After all, a dialogue is really a monologue if the views expressed lack diversity and civil discourse on almost any subject can be constructive. And, given the Enron debacle, the time for reflecting on the PSLRA seems especially propitious.

One area of common ground that we can all agree on is that after an initial lull in filings, the PSLRA has certainly failed to reduce the number of securities class actions. But, the stated purpose of the PSLRA was to reduce the unmeritorious cases—not to throw the baby out with the bath water. And, although it took awhile, institutional shareholders have certainly arrived on the scene—some with such great gusto that they have attempted to exceed the statutory limitation on serving as lead plaintiff in more than five cases in a three-year period.

Is The PSLRA Responsible For Any Increase In Settlement Values?

Some would argue that institutional involvement in securities class actions—a direct result of the PSLRA—has led to great success, pointing to the historic size of the *Cendant* settlement and other large settlements as proof. To be sure, the class counsel in *Cendant* lawyered the case superbly, obtained more than $3 billion cash and achieved this result in a relatively short time. On the other hand, it strains credulity to suggest that these same lawyers would have done anything different or less if the PSLRA did not exist. Of course, it is possible that under the pre-PSLRA regime, the lead plaintiff would not have been a large institution with the good sense to select strong counsel. Before the PSLRA, it is possible that the lead plaintiff could have been the typical 100-share holder accompanied by far less qualified and formidable law firms. Given the

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A DEFENSE COUNSEL'S PERSPECTIVE ON THE PSLRA

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size of the *Cendant* case, the large number of lawsuits (more than 80) and the visibility of the situation, however, it is unrealistic to believe that the case could have been hijacked by a small fringe player and that an unreasonable outcome would not have drawn a torrent of objections.

In this same vein, it is not entirely clear that any statistical increase in the value of settlements since the PSLRA became effective is attributable to institutional involvement or the PSLRA. As we know, since 1995 the number of financial restatements—especially large ones—also has risen dramatically. At the same time, the bull market pushed stock prices to all time highs. As a result, larger price drops and larger potential damage claims along with more financial restatements may have more to do with higher settlement values than the PSLRA.

The PSLRA Selection Process Has Produced Incongruous Battles Between Institutions

One area where the PSLRA plainly has made a difference is in the selection of the lead plaintiff. In general, it has imposed a degree of order and orderliness on the process where the chaos associated with a race to the courthouse once reigned. From the defendants' vantage point, the current selection process, which includes the automatic discovery stay, is a quantum leap forward. It provides a hiatus for defense counsel to get a handle on the case while plaintiffs organize themselves and has generally eliminated much of the vexatious motion practice directed at defendants by a few grandstanding would-be lead plaintiffs who would attempt to substitute misplaced zeal for other attributes in their quest to garner a lead position. To be sure, we still encounter the occasional filing of random cases in odd venues by fringe plaintiffs hoping to exert leverage at some point in the process. But, these "outrider" cases appear to have achieved few, if any, benefits and the number has declined significantly. Although some added delay has been built into the process by the introduction of an initial sixty-day notification period, which has the effect of extending the automatic discovery stay, the additional delay is relatively modest.

Some delay is inevitable, especially if the court does not decide the lead plaintiff motion with dispatch, but the longer delays are caused by the briefing of the dismissal motions and the time it takes for the court of dispose of them.

At the same time, however, the PSLRA process for selecting a lead plaintiff has frequently precipitated incongruous, and often nasty, battles between institutions vying to become lead plaintiff. From the defendant's perspective, it is hard to understand the reasons for these contests. After all, the Congressional objective of the PSLRA was to eliminate lawyer-driven litigation and to replace "phantom" placeholder plaintiffs with adult supervision by real institutional "clients". This goal is achieved whenever a large institutional shareholder with substantial losses seeks to be appointed as lead plaintiff. Once that occurs, one would think that other institutions would be only too happy to avoid the time, effort, expense and distraction associated with overseeing a complex securities class action by deferring. But that has hardly been the case. On the contrary, titanic battles have raged over which institution will control the case—often leading one institutional plaintiff to denigrate the substantive claims of the other and vice versa—while we sit back and take notes.

Two-Tier System

Not all cases attract institutional activism, especially smaller cap stocks, and the PSLRA has led to unevenness in the manner in which the selection of lead plaintiff is conducted. In reality, a "two-tier" system of cases has developed. There exists a whole category of less visible cases — comprised largely of the non-restatement cases traditionally (if not pejoratively) known as "fraud by hindsight" cases. In this genre, bad news is announced, the stock drops and suits are filed claiming the bad news should have been disclosed earlier. In most of these cases, especially where the issuer's capitalization—and thus the potential damages—are relatively small, the PSLRA regime appears to have left the "old rules" undisturbed. In these cases, the competing lead plaintiffs organize themselves into a "committee" to share the responsibility and usually submit a stipulation carving up the case which judges routinely sign without opposition — or question.

The "Rigorous" Pleading Requirements

The "rigorous" new uniform pleading requirements were a central feature of the PSLRA. At a minimum, these "fraud by hindsight" complaints are the cases that the more "rigorous" pleading

requirements of the PSLRA combined with the mandatory sanctions provisions were designed to deter or eliminate. The heightened pleading requirements generated a good deal of Congressional debate. Indeed, President Clinton's short-lived veto was predicated largely on his stated view that the pleading requirements being imposed would be too stringent. Unfortunately, the disparate interpretation of the specificity requirements among the various circuits—and even within circuits—has led to a welter of inconsistent and confusing interpretations. As a result, even the most "generic" allegations of "scienter" have managed to survive in some cases. In this important area, the PSLRA has not performed as it was intended—even before Enron. Not surprisingly, the drumbeat—fueled no doubt by special interest groups—has already begun to roll back the pleading requirements in the name of preventing future Enrons.

Attorneys' Fees

With the increased supervision of class counsel by the lead plaintiff called for under the PSLRA, the courts were supposed to have enlisted an ally in determining the amount of attorneys fees to be paid to class counsel. The Court of Appeals for the Third Circuit has now firmly placed the responsibility, at least in the first instance, on the shoulders of lead plaintiff. The increased importance of an ex ante fee agreement was explicitly reinforced in the Third Circuit's approval of the Cendant settlement in which the Court of Appeals also rejected the right of a district court to select counsel through an auction (except in rare circumstances).

Are Class Actions Really Efficient for Institutional Plaintiffs Where The Losses Are Larger?

The ultimate question is whether institutions could more efficiently recover their own damages by foregoing the "class" aspects of a securities litigation and simply hire a lawyer and go it alone without the extra complexity, judicial oversight and other difficulties associated with a class action. Indeed, those institutional plaintiffs which proceed in a class wide basis may find themselves faced with other institutions "opting out", an increasing phenomena. Indeed, the purpose of the class action device is to allow the aggregation of claims by shareholders with claims too small to allow them to proceed individually. Where an institution finds itself with large damages and a strong claim, it may conclude that it is far better off to proceed on its own outside the class framework.

Conclusion

In the final analysis, it is still too early to measure the impact of the PSLRA—the jury is still out.

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