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# Paper Urges Judges to Reduce Securities Class Action Litigation Incentives

On the subject of private securities fraud class action litigation, California Representative Anna Eshoo once remarked, "Businesses in my region place themselves in one of two categories: those who have been sued for securities fraud and those that will be." Driven by such concerns, Congress enacted two legislative reforms in three years during the 1990s, aimed at returning control of securities suits to investors. In spite of the reforms, plaintiffs' lawyers, driven by financial and other incentives, continue to shake down public companies for lucrative settlements paid by the defendants' own shareholders. A new Washington Legal Foundation (WLF) paper directly addresses those litigation incentives, how they continue to inspire often meritless lawsuits, and what can be done to restore reason and balance to securities class actions.

The publication, **SETTLEMENTS IN SECURITIES FRAUD CLASS ACTIONS: IMPROVING INVESTOR PROTECTION**, is the latest installment of WLF's educational WORKING PAPER series. The paper's authors are **Neil M. Gorsuch**, a partner with the Washington, D.C. law firm Kellogg, Huber, Hansen, Todd, Evans & Figel, P.L.L.C., and **Paul B. Matey**, an associate with the firm.

The authors first review the structural flaws inherent in securities class action litigation and how these flaws create incentives for lawyers to pursue, and companies to readily settle, questionable claims. Gorsuch and Matey argue that the immense financial risks at stake for public companies in fighting multi-million or billion dollar lawsuits often make settlement the only option, which in turn leads to more litigation. Another potent incentive, inherent in the class action mechanism and uncontrolled by congressional reform legislation, is the availability of attorneys' fees which are outrageously out of proportion with the damage amounts each plaintiff receives.

The paper next provides a brief overview of the reforms Congress enacted in 1995 and 1998 to purportedly rein in securities fraud suits. The authors also explain why these reforms have been insufficient to the task of preventing unmeritorious securities fraud cases.

The authors then examine seven reforms targeted directly at the underlying financial incentives to litigate, all of which can be implemented by judges, rather than through legislation. Those reform ideas are:

- Enforce the PSLRA's Loss Causation Requirement
- Mandate Separate Fee Funds
- Revive the Lodestar Method for Calculating Fees
- Employ Competitive Bidding to Select Class Counsel
- Encourage Meaningful Oversight
- Don't Duplicate Governmental Efforts
- Encourage Meaningful Oversight by Litigants

As the authors conclude, "While no single reform can guarantee that securities fraud class action settlements will always be fair and reasonable, these proposals are just a few possible steps in the direction of helping to secure the full promise of the securities class action mechanism as the vehicle for consumer protection [originally] envisioned nearly six decades ago."

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Copies of this educational paper, WLF WORKING PAPER, Number 128 (April 2005), can be obtained by forwarding a request to: Publications Department, Washington Legal Foundation, 2009 Massachusetts Avenue, NW, Washington, D.C. 20036, or calling (202) 588-0302.