This Article seeks what may be the holy grail of securities law scholarship—
the role of the “merits” in securities class actions—by investigating the relationship between settlements and directors’ and officers’ (D&O) liability insurance. Drawing upon in-depth interviews with plaintiffs’ and defense lawyers, D&O insurance claims managers, monitoring counsel, brokers, mediators, and testifying experts, we elucidate the key factors influencing settlement and examine the relationship between these factors and notions of merit in civil litigation. We find that, although securities settlements are influenced by some factors that are arguably merit related, such as the “sex appeal” of a claim’s liability elements, they are also influenced by many that are not, including, most obviously, the amount and structure of D&O insurance. The virtual absence of adjudication results in payment to the plaintiffs’ class for every claim surviving the motions stage and, as importantly, a lack of authoritative guidance about merit at settlement. Without such adjudication, the weight of various factual patterns is untested, and the validity of competing damages models remains
unknown. Parties structure their settlement by reference to other settlements, but these are opaque and subject to the same set of distortions. In this murky environment, plaintiffs and defendants collude to pressure the D&O insurer to settle on terms that may not reflect the ultimate merits of the claim. More adjudication, we argue, would be the best solution to the problem, but barring that, disclosure of D&O insurance and settlement terms would offer some improvement.

INTRODUCTION

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 detect-
ing, 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 the amounts paid at settlement, or are they essentially irrelevant? Alexander’s answer was that the merits do not matter.⁴ Her argument played an important role in changing the law, providing rhetorical support and academic credibility to interest groups lobbying to make securities class actions more difficult for plaintiffs to bring—an endeavor that succeeded in 1995 with the enactment of the Private Securities Litigation Reform Act (PSLRA).⁵ Indeed, Alexander’s article is still widely cited even though its empirical foundation has been undermined,⁶ perhaps because her basic claim—that the merits do not matter in securities litigation—is so widely believed.⁷

¹ Nathan Koppel, Milberg Figure Lerach Retires Amid Plea Talks, WALL ST. J., Aug. 29, 2007, at B2.
² Id. Others have suggested as much, often with less restraint. See, e.g., Karen Donovan, Bloodsucking Scumbag, WIRED, Nov. 1996, at 134, 136-37 (describing Lerach’s role in securities class actions against high-technology companies).
⁴ See id. at 500 (noting that “a strong case . . . appears to have been worth no more than a weak one”); id. at 597 (concluding that “[s]ettlements that do not reflect the merits therefore may be typical of securities class actions generally”).
⁷ Alexander’s Do the Merits Matter?, supra note 3, was published in February 1991. Based on our February 27, 2008, Westlaw search, Alexander’s article was cited in 11 court cases, 143 law review articles, and 23 appellate filings or briefs—or 177 times in
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. Their results, not surprisingly, are ambiguous. Studies since the PSLRA have found that securities lawsuits are now more often dismissed, but the additional dismissals may include meritorious and nonmeritorious suits alike, therefore leaving researchers unable to conclude that only the meritorious survive. Securities claims now take longer to settle, perhaps suggesting that plaintiffs’ lawyers are bringing better claims and pushing them harder, and claims featuring easily identifiable indicia of wrongdoing or fraud—such as earnings restatements, insider selling, and concomitant regulatory investigations—settle higher than claims without such features. Insofar as such indicia correlate with the merits of a securities claim, these studies may support the total—from June 1992 to June 1997. Although the frequency of cites has declined over time, her article was still cited in 3 cases, 76 law reviews, and in 26 appellate filings or briefs—105 times in total—between 2003 and 2008.

We are a case in point. In a prior article, Griffith assumes that the merits matter to some degree in arguing for mandatory disclosure of D&O insurance information. 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, 1161 (2006) (“[T]he total cost of shareholder litigation depends, at least in part, on corporate wrongdoing . . . .”). Similarly, after finding that D&O insurers do weigh merits-related factors in their underwriting decisions, we concluded that that “the merits somewhat matter.” Tom Baker & Sean J. Griffith, Predicting Corporate Governance Risk: Evidence from the Directors’ & Officers’ Liability Insurance Market, 74 U. CHI. L. REV. 487, 538 (2007).

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.”); Jonathan C. Dickey & Marcia Kramer Mayer, Effect on Rule 10b-5 Damages of the 1995 Private Securities Litigation Reform Act: A Forward-Looking Assessment, 51 BUS. LAW. 1203, 1219 (1996) (concluding that reduced damages after the PSLRA may deter the filing of suits “that would have been brought under the prior law”).

See Denise N. Martin et al., Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions, 5 STAN. J.L. BUS. & FIN. 121, 123 (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”).

See Marilyn F. Johnson et al., Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act, 23 J.L. ECON. & ORG. 627, 630 (2007) (finding “a significantly greater correlation between litigation and both earnings restatements and abnormal insider selling after the PSLRA”).

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. See id. at 649 (“[L]awyers may be unable to prove some meritorious claims under the rigorous constraints imposed by the PSLRA.”).
proposition that at least some meritorious claims settle higher than nonmeritorious claims.\textsuperscript{13} 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.

In this Article, we confront the issue of merits in securities class actions.\textsuperscript{14} But we do not ask whether the merits matter. Our question, instead, is how the merits matter. How do the participants in securities class actions understand the merits, and how do they talk about them? How do they use the idea of merit in settlement negotiations? And what do they view the role of merit to be in shaping outcomes at settlement?

Because our research question is qualitative—asking how the settlement process works—our research methods are also qualitative, not quantitative.\textsuperscript{15} Our basic tool is the semistructured interview, in which

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  \item \textsuperscript{13} For a discussion on how the merits affect settlement amounts, see infra Part III.A.
  \item \textsuperscript{14} Throughout this Article, we are dealing with the “fat middle” of securities class actions—i.e., those that are not too big and not too small. Researchers have shown that extremely small claims—those settling in the $2 million to $3 million range—are more likely to be nuisance claims. See James D. Cox et al., There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements, 61 VAND. L. REV. 355, 383 (finding that small settlements exhibit qualities associated with strike suits). Similarly, the largest cases—those resulting in “megasettlements” of $300 million or more—differ systematically from those that are settled within or close to D&O insurance limits. As one defense counsel put it,
    
    \begin{quote}
    In a case that is going to go for $5 million, . . . usually the parties get together and say, “Look, we should wrap this case up. It’s not that big a case. I know you think it is.” And you know that kind of thing happens, but in the bigger cases, it is just more complicated.
    
    Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Defense Counsel #5, at 12 (May 23, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Defense Counsel #5]; see also id., Interview with Claims Head #9, at 15-17 (July 10, 2007) [hereinafter D&O Interviews, Claims Head #9] (noting that large settlements “bring in a lot of profits to yourself and the firm, a lot of name recognition and high profile, and as a result there’s a lot attached, and the defense counsel who can stand above that and settle early is overcoming a lot of pressures,” and that “[t]here’s both psychological and career motivational factors to do otherwise”). For our purposes, the paradigmatic securities class action is one that settles for more than $2 million but either less than or not much more than total D&O insurance limits.
  \item \textsuperscript{15} Qualitative research employs field interviews and other sociological techniques to develop thick descriptions of a problem area. See, e.g., Lisa Bernstein, Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions, 99 MICH. L. REV. 1724, 1725 (2001) (relying “on a detailed case study of contractual relations in the cotton industry to examine the ways that the rules, norms, and institutions that constitute the industry’s [private legal system] create value for transactors”). We are not critics of quantitative research, but the use of regressions to show
\end{itemize}
we ask questions, but also allow our participants simply to talk, to de-
scribe the settlement process in their own words, and to illustrate their
explanations with stories and anecdotes.\textsuperscript{16} During 2006 and 2007, we
interviewed over fifty people involved in the process of settling securi-
ties claims, including plaintiffs’ and defense lawyers, claims managers
at directors’ and officers’ (D&O) liability insurance companies, insurers’ monitoring counsel, claims-side brokers, mediators, and testifying
experts.\textsuperscript{17} In addition, we read their trade literature and participated
in industry conferences. In short, we entered the field in an effort to
understand it from the perspectives of those working within it.\textsuperscript{18}

A principal focus of our research was the role of D&O liability in-
surance. D&O insurance covers losses that corporations and their di-
rectors and officers incur in connection with corporate and securities
litigation.\textsuperscript{19} Virtually all U.S. public corporations buy D&O insur-

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\textsuperscript{16} Pursuant to 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
redacted transcripts have been provided to the editors of the \textit{University of Pennsylvania
Law Review} for verification.

\textsuperscript{17} These interviews build upon an initial round of forty-eight interviews of direc-
tors’ and officers’ liability insurance professionals conducted in connection with our
prior research. Baker & Griffith, supra note 8, at 493. We describe the interviews and
their selection at the beginning of Part III of this Article.

\textsuperscript{18} Legal scholarship of this kind dates back to the Legal Realists, most notably
NEIGHBORS SETTLE DISPUTES} (1991) (finding, primarily through field interviews,
that neighbors in Shasta County, California, resolve most conflicts through the use of
informal norms, rather than formal legal rules). Intensive qualitative research has
long been the hallmark of anthropologists and much of sociology, and even of some
scholars working within a law-and-economics framework, particularly in recent years.
\textit{See}, \textit{e.g.}, RICHARD V. ERICSON ET AL., \textit{INSURANCE AS GOVERNANCE} (2003) (offering a
sociological investigation of the insurance industry); SALLY ENGLE MERRY, \textit{COLONIZING
HAWAI’I: THE CULTURAL POWER OF LAW} (2000) (presenting an anthropological inves-
tigation of the role of law in colonization); H. LAURENCE ROSS, \textit{SETTLED OUT OF
COURT: THE SOCIAL PROCESS OF INSURANCE CLAIMS ADJUSTMENTS} (1970) (providing a
sociological investigation of automobile law in action); Lisa Bernstein, \textit{Opting Out of the
Legal System: Extralegal Contractual Relations in the Diamond Industry}, 21 \textit{J. LEGAL STUD.}
115 (1992) (describing the private legal system at work in the diamond industry);
Bernstein, \textit{supra} note 15 (examining, through a detailed case study of the cotton in-
dustry, how private legal systems can reduce costs).

\textsuperscript{19} Policies cover not only losses incurred by individual directors and officers, but
also losses incurred by the corporation itself in defending and settling securities
claims. A typical policy excludes adjudication of “actual fraud,” but pays for judgments
and the vast majority of securities claims settle within or just above the limits of the defendant corporation’s D&O coverage. As a result, it is not a stretch to assert that the principal party at interest in most securities class actions is the D&O insurer. Our research focused largely on uncovering the interests of this party, in discovering how it understands “merit,” and how these interests and understandings influence the settlement of securities litigation.

In emphasizing the centrality of liability insurance in determining substantive legal outcomes, this Article continues a theme from our prior work, and indeed it may be viewed as the conclusion of a trilogy where the defendants meet the lower standard of reasonableness. Policies typically cover amounts paid in settlement as well as defense costs. Because virtually all securities class actions settle without adjudication, the exclusion of “actual fraud” typically does not affect payment obligations, and it is not an overstatement to assert that D&O policies cover all losses typically incurred by corporations in connection with securities litigation. See Baker & Griffith, supra note 8, at 499-501 (describing important facets of the coverage offered by D&O policies).


21 According to the Towers Perrin data, the size of the average D&O policy ranges from approximately $20 million in limits for small-cap companies to over $195 million in limits for large-cap companies. Id. at 17 exhibit 13. At the same time, average D&O settlements range from less than $10 million for the majority of settlements to more than $100 million for the most expensive 11% of cases. See Stephanie Plancich et al., NERA Econ. Consulting, Recent Trends in Shareholder Class Action Litigation 9-11 (2007), available at http://www.nera.com/image/BRO_Recent_Trends_Dec07_0708_final.pdf (reporting that average settlements—including those over $1 billion—increased from $22.7 million in 2006 to $33.2 million in 2007, and noting that including settlements over $1 billion would raise the 2007 average to $40.2 million); PricewaterhouseCoopers, 2006 Securities Litigation Study 33, 36-37 (2007), available at http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2006_Final.pdf (reporting that for cases that settled between $1 million and $50 million, the average settlement amount was $9.6 million, but that the average for all cases settled in 2006 was $62.3 million, and that 11% settled for over $100 million); Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, Securities Class Action Settlements: 2006 Review and Analysis 3 & fig.3 (2007), available at http://www.cornerstone.com/pdf/practice_securities/2006Settlements.pdf (reporting that over 60% of all securities class action settlements in 2006 were for less than $10 million, consistent with past years). The average settlement is well within average limits. See Cox, supra note 6, at 512 (“[A]pproximately 96% of securities class action settlements are within the typical insurance coverage, with the insurance proceeds often being the sole source of settlement funds.”).
on the interaction between law and insurance in the corporate and securities law context.\textsuperscript{22} In the first article, we described how insurers evaluate risk in underwriting D&O policies and analyzed the implications of the policies’ role in furthering the deterrence objectives of corporate and securities litigation.\textsuperscript{23} In the second article, we investigated the relationship between insurer and insured during the life of the policy; we found 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, raising the attendant moral-hazard concerns.\textsuperscript{24} In this third and final Article, we inquire into the role of the D&O insurer at settlement, asking whether the deterrence function of securities law is reintroduced through an insistence on merits at settlement or whether other dynamics at settlement subvert deterrence.

A common theme underlying our work in this area is the extent to which liability insurance preserves or subverts the deterrence objectives of corporate and securities law. Scholars customarily treat deterrence as the principal objective of civil damages in corporate and securities litigation.\textsuperscript{25} Because D&O insurance funds the settlement of corporate and securities litigation, any deterrent effect of settlement can only be achieved by the insurance intermediary.\textsuperscript{26} In order for

\textsuperscript{22} We are not the first to address the role of insurance in settlement. See, e.g., Bernard Black et al., Outside Director Liability, 58 STAN. L. REV. 1055, 1067 (2006) (focusing on the importance of D&O insurance in explaining why outside directors almost never pay their own money in corporate and securities litigation settlements). However we are the first to address it directly with extensive participant interviews, relating our empirical observations from those interviews to the question of merit in securities litigation.

\textsuperscript{23} See Baker & Griffith, supra note 8, at 516-17 (finding 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”).

\textsuperscript{24} See Tom Baker & Sean J. Griffith, The Missing Monitor in Corporate Governance: The Directors’ & Officers’ Liability Insurer, 95 GEO. L.J. 1795, 1822-23 (2007) (arguing, furthermore, that the entity-protection aspects of D&O coverage are likely to be pure waste from a diversified shareholder’s point of view).

\textsuperscript{25} See id. at 1817-18; see also John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation, 106 COLUM. L. REV. 1534, 1536 (2006) (emphasizing the deterrence function of securities class actions over the compensation function).

\textsuperscript{26} This fact, of course, does not mean that bad acts are wholly undeterred. Civil litigation is but one of the misfortunes that can befall one engaged in securities fraud, to which job loss, regulatory fines, and jail time must be added. See, e.g., Jonathan M. Karpoff et al., The Legal Penalties for Financial Misrepresentation 3 (May 1, 2007) (unpublished manuscript), available at http://ssrn.com/abstract=933333 (comparing regulatory and private penalties for misrepresentation claims). Our focus is solely on
civil litigation’s potential damages awards to deter, D&O insurers must in some way preserve the deterrent effects of the liability regime. Do they? Our prior research was not optimistic on this point.\textsuperscript{27} And we are no more optimistic here, finding that D&O insurance clouds the role of the merits in the settlement process. Moreover, putting this insight together with those gleaned in our prior research, we ultimately conclude that, absent disclosure, D&O insurance significantly undermines the deterrence function of shareholder class actions.

The Article proceeds as follows: Part I provides a brief background on shareholder litigation and its procedural stages. 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 the settlement 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 merit and offers our policy proposals, recommending increased disclosure of corporations’ D&O coverage and a reduction in entity-level coverage. We close, finally, with a brief summary and conclusion.

I. SHAREHOLDER CLASS ACTION LAW AND PROCEDURE

Although there are many potential bases for shareholder actions,\textsuperscript{28} federal securities law claims are the most significant in terms of both absolute numbers and settlement values.\textsuperscript{29} Our participants reported that securities class actions are “head and shoulders above” any other

\textsuperscript{27} In our first article, we concluded that risk-based pricing by D&O insurers is likely to have very little impact on the behavior of corporate executives—both because of the difficulty of predicting securities litigation risk and because D&O insurance prices and other contract terms are not disclosed to investors. Baker & Griffith, supra note 8, at 536, 538-40. We concluded in our second article that D&O insurers do not engage in any significant monitoring and that, as a result, D&O insurance poses a significant moral hazard. Baker & Griffith, supra note 24, at 1817.

\textsuperscript{28} See generally 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 17.02 (7th ed. 2003) (listing 170 possible grounds for liability in shareholder litigation).

\textsuperscript{29} One study found that 77% of shareholder class actions from 1993 to 2002 were securities class actions, although the authors admit that this is likely overstated. Theodore Eisenberg & Geoffrey P. Miller, Attorney Fees in Class Action Settlements: An Empirical Study, 1 J. Empirical Legal Stud. 27, 46 (2004); see also TOWERS PERRIN, supra note 20, at 60 exhibit 83 (reporting that more than 80% of claims made against public companies dealt with securities issues).
liability exposure.\textsuperscript{30} For this reason, our qualitative research focused exclusively on securities class actions. This section briefly describes the law and procedure of the securities class action.

\textbf{A. Substantive Law}

Class action securities litigation arises most often under section 11 of the Securities Act of 1933 (Securities Act)\textsuperscript{31} and under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act).\textsuperscript{32} 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 against the bankers, accountants, and lawyers involved in the offering.\textsuperscript{33} Although the section 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.\textsuperscript{34} Much activity in the securities market occurs outside of this context and, thus, is free from section 11 liability.

Rule 10b-5,\textsuperscript{35} promulgated by the Securities and Exchange Commission (SEC) under the authority of section 10(b) of the Exchange Act, has a much broader reach than section 11 of the Securities Act.
Rule 10b-5 is “the ‘catch-all’ antifraud provision,” 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 public disclosures, especially financial reports. 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 2007, 80% of securities class actions alleged violations of Rule 10b-5; only 19% alleged a section 11 violation.

Plaintiffs bringing a 10b-5 claim must show that the defendants, acting with scienter, made a material misstatement on which the plaintiffs relied and that caused a financial loss. Recklessness generally satisfies the scienter requirement. But scienter nevertheless

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37 See, e.g., Coffee, Jr., supra note 25, 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.”).
38 See Cornerstone Research, Securities Class Action Case Filings, 2007: A Year in Review 1 (2007) (reporting 2218 class actions, excluding IPO-allocation, analyst, and mutual-fund actions, filed between 1996 and 2007). In 2007, only 10% of securities class actions alleged a claim under section 12(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. Id. at 21 exhibit 19; cf. 15 U.S.C. § 77l(a)(2); Gustafson v. Allord Co., 513 U.S. 561, 573 (1995) (limiting the applicability of section 12(2) to issuer communications in public offerings). We note that these are cumulative remedies and that the percentages need not add to one hundred.
39 The proper standard for scienter has not been elucidated fully by the Supreme Court. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 & n.12 (1976) (rejecting a negligence standard and holding that private plaintiffs must show scienter, but reserving the question of whether recklessness satisfies the standard). As a result, courts of appeals have fashioned their own standards, with most accepting that the standard has been met when a defendant, unaware of the true state of affairs, can foresee the likelihood that a statement will mislead. See, e.g., AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 234 (2d Cir. 2000) (“In securities law, however, the critical issue is what a reasonable investor would have considered significant, and foreseeability is generally from the plaintiff’s point of view . . . .”); SEC v. Falstaff Brewing Corp., 629 F.2d 62, 76 (D.C. Cir. 1980) (holding that information is material if “there is a substantial likelihood that a reasonable shareholder would consider [it] important in deciding how to vote” (internal quotation marks omitted) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976))).
poses a significant hurdle for plaintiffs due to a combination of two of the PSLRA’s features: (1) the stay of discovery until the motion to dismiss has been decided, and (2) the requirement that plaintiffs plead facts giving rise to a “strong inference” that the defendants had the requisite state of mind. The standard for scienter was most recently discussed by the Supreme Court in Tellabs, Inc. v. Makor Issues & Rights, Ltd., in which the Court resolved a split among the circuits in interpreting the “strong inference” standard. There, the Court held that “[t]o qualify as ‘strong’ within the intendment of [the PSLRA], we hold, an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” Plaintiffs, in other words, must equal or surpass the plausibility of any innocent inference that defendants may claim could arise from the same set of facts. We are told that without access to discovery, this is no small feat. As a result, proving scienter is typically seen as a significant obstacle to plaintiffs.

Materiality, in 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. 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

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43 Id. at 2504-05 (emphasis added).
44 Plaintiffs’ lawyers commented that “sometimes . . . cases that don’t look very good turn out to be great, and sometimes cases that look really good at the beginning turn out not to be so good, because you really don’t know [prior to discovery].” Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Plaintiffs’ Counsel #3, at 8 (May 25, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Plaintiffs’ Counsel #3]. Similarly, a defense lawyer noted that neither side can get a firm sense of scienter until discovery: “[Y]ou want to get a sense of . . . what your documents look like. In the days of electronic discovery and e-mail, there is usually something, enough smoke in there that can be a concern to both sides. There is a lot more detail than there used to be.” Id., Interview with Defense Counsel #1, at 14-15 (Mar. 24, 2007) [hereinafter D&O Interviews, Defense Counsel #1]; see also id., Interview with Claims Head #6, at 26 (May 16, 2007) [hereinafter D&O Interviews, Claims Head #6] (“Sometimes you get into discovery, and the discovery shows that[ ] what these plaintiffs thought was a real meritorious case really is nothing.”).
45 See TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (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”).
statements are incorporated into share price and reliance is presumed for any investor trading at the market price.46 Indeed, apart from scienter, the only significant substantive legal obstacle to recovery for a corporate misrepresentation may be the requirement, recently affirmed by the Supreme Court in Dura Pharmaceuticals, Inc. v. Broudo, that the plaintiffs show a causal link between the misrepresentation and the plaintiffs’ loss.47

Loss causation, as the requirement is commonly known, is not new.48 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 that the plaintiff has in mind.”49 What exactly plaintiffs must plead to establish loss causation after Dura, however, remains unclear.50 For claims resembling what we have been treating as the paradigmatic securities claim—plaintiffs purchasing under the cloud of a misrepresentation and holding until a corrective disclosure has a significant impact on the security’s price—Dura does not present additional diffi-
However, the situation is less clear when 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. “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. 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 a leaked truth that had the effect of lowering the price and therefore causing their loss. By 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 also acknowledged that it remains to be seen what effect Dura and its progeny will ultimately have on securities settlements.

As we describe in the sections that follow, the substantive law is almost always expressed in motions practice. Trials are exceedingly rare in securities class actions, and adjudicated outcomes after the motion to dismiss are almost unheard of. This means that issues arising from Tellabs and Dura and all other substantive legal standards are

51 See id. at 849 (noting that there is “little doubt that [such a] plaintiff satisfies the Court’s requirements under Dura concerning causation”).
53 See id. at 1444 (“An essential underpinning of our test is determining whether specific disclosures that reveal the effect of the fraud . . . actually impacted the share price of the stock at issue.”); Fox, supra note 50, at 850-51 (“The fact that there was no negative price reaction after the unambiguous announcement . . . does not rule out the possibility that the misstatement inflated the purchase price[,] . . . because . . . the market may have realized the true situation prior to the public announcement of the truth.”).
54 See Eisenhofer et al., supra note 52, at 1442-43 (“The questions are: (i) was the stock price inflated by fraud; and (ii) has the stock price declined because the fraud is no longer propping up the price?”); Fox, supra note 50, at 854-55 (“[T]o prove that the misstatement caused a loss, the plaintiff must both show that the misstatement inflated the purchase price and that his sale occurred after at least partial market realization of the true situation.”).
evaluated, for the first and essentially last time, at the pleadings stage. The implications of this fact are explored in greater detail below. 56

B. Procedural Stages

Procedurally, the securities class action resembles much other large-scale, aggregate litigation. As alluded to above, however, the PSLRA changes the environment by increasing the plaintiffs’ burden to survive the motion to dismiss and staying discovery until the motion is decided. Most claims proceed through predictable stages, including investigating and filing, class certification and lead plaintiff selection, the motion(s) to dismiss, discovery, trial preparation, and finally, 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 does: liability; damages; and defendants with the ability to pay. 57 Absent information to the contrary, ability to pay is typically assumed at this stage in the litigation, 58 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 nega-

56 See infra Part I.B.3.

57 See D&O Interviews, Plaintiffs’ Counsel #3, supra note 44, at 8-10 (explaining that a potential case must show sufficient grounds for liability in order to survive a motion to dismiss at the outset); Tom Baker & Scan J. Griffith, D&O Interviews, Roundtable Discussion, The Role of Directors’ and Officers’ Liability Insurance in the Settlement of Securities Class Actions, at the Fordham Corp. Law Ctr., in N.Y., N.Y., 59 (Nov. 16, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Roundtable] ("[I]et me just say I don’t see a lot of this as very much different than negligence cases in the Bronx Supreme Court in lots of ways."); see also Tom Baker, Transforming Punishment into Compensation: In the Shadow of Punitive Damages, 1998 WIS. L. REV. 211, 222 (quoting a plaintiffs’ personal injury lawyer who said, “I was taught on my first day of practice there are three things: liability, damages, collectibility”).

58 As a plaintiffs’ counsel put it,

[s]o what we do is we have to figure out what we consider to be a wide range of damages very early on. Then we have to take a look at the solvency of the corporate defendant. You know, we will take a look at the company and just form some kind of rough judgment in our own minds, is this a company that is likely to have insurance and if so, a lot of insurance, a little bit of insurance? We don’t even really worry about the insurance if the company is solvent.

Tom Baker & Scan J. Griffith, D&O Interviews, Interview with Plaintiffs’ Counsel #5, at 7-8 (May 24, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Plaintiffs’ Counsel #5].
tive 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 increasing their chances of being selected as lead plaintiff.59 Smaller law firms become aware of prospective claims on a more ad hoc basis, through contacts with former employees, disgruntled investors, or referring attorneys who represent the prospective plaintiff for other purposes, such as real estate transactions or estate planning.

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.60 Initially, these investigations will help the plaintiffs’ firm determine whether to file a claim. 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

59 See id., Interview with Plaintiffs’ Counsel #6, at 2-3 (June 5, 2007) [hereinafter D&O Interviews, Plaintiffs’ Counsel #6] (noting that his firm monitors market developments for institutional developments and that “one way or another we will either hear from the client, or we will be reporting to the client on what we are seeing”); id., Interview with Plaintiffs’ Counsel #7, at 2 [hereinafter D&O Interviews, Plaintiffs’ Counsel #7] (“[W]e monitor the research analyst [who] has this general Bloomberg and Dow Jones terminal[,] and access to all the financial news and keeps CNN and CNBC going on a 24/7 basis, etc., etc. . . .”).

60 See Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Plaintiffs’ Counsel #1, at 10-11 (Jan. 31, 2007) (unpublished interviews, on file with authors) (describing how his firm obtains clients through referrals from the brokers that his firm represents in other capacities and through other lawyers); D&O Interviews, Plaintiffs’ Counsel #3, supra note 44, at 4-6 (describing how his firm relies on referrals from lawyers whose specific business is developing clients to pass on to litigation firms).

61 See Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Plaintiffs’ Counsel #4, at 6 (May 31, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Plaintiffs’ Counsel #4] (describing how his firm employs lawyers whose “sole job is to look at significant market movements,” accompanied by some kind of disclosure, and then to “look at what the disclosures were sixty or ninety days before and if there is a gap, then they will do further investigation . . . to see whether [the gap is] associated with facts that suggest there was a nondisclosure”); see also D&O Interviews, Plaintiffs’ Counsel #6, supra note 59, at 2 (“We have private investigators and use them.”); D&O Interviews, Plaintiffs’ Counsel #7, supra note 59, at 1-2 (“We employ a team of people that includes three lawyers, a former Wall Street research analyst . . . , three or four private investigators that are led by a former FBI agent . . . , and we employ forensic accounting consultants . . . .”)}
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 increasing the 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 that ultimately are dismissed), they will, on the whole, require greater settlements in order to recoup their costs, thereby increasing settlement amounts.62

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 over the plaintiffs’ class not to the first to file but to the “most adequate plaintiff.”63 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,64 the filing of a class action starts a sixty-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.65 The big-

62 This may result from a selection effect in which lawyers decide not to take the less profitable cases, from the lawyers working the selected cases more intensively, or some combination of the two.
64 See Weiss & Beckerman, supra note 6, at 2062-63 (noting that the lawyer filing the first complaint is often appointed lead counsel by the court, and even where a court has a different procedure for appointing lead counsel, it generally also “rewards lawyers who file early”).
65 Judges retain some discretion in selecting class counsel. The identity of the lead plaintiff can be affected by the definition of the class period (different institutional
gest investors tend to be deemed the “most adequate.” As a result, the trick is for the plaintiffs’ firm to represent large institutional investors or, in some cases, groups of investors.

Although the PSLRA seems to have been effective in ending the freewheeling days when plaintiffs’ lawyers had, at best, nominal clients with no real influence over their claims, plaintiffs’ actual involvement in the litigation remains secondary in most cases. Institutional shareholders were lead plaintiffs in only 18% of the securities class actions during the post-PSLRA period. As a result, the plaintiffs’ lawyer is still largely in control of the prosecution and, ultimately, settlement of the claim.

Recent research suggests that cases with 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 et al., supra note 14 (listing cases in which the largest plaintiff was not selected as lead plaintiff).


See Stephen J. Choi, Motions for Lead Plaintiff in Securities Class Actions 13-20 (Law & Econ. Research Paper Series, Working Paper No. 08-53, 2008), available at http://ssrn.com/abstract=1293926 (reporting that even after the PSLRA, plaintiffs’ lawyers remain influential in the selection of the lead plaintiff—often by aggregating groups of plaintiffs and cutting side deals); see also Cox & Thomas, supra note 63, at 1588-90 (noting that the PSLRA’s rebuttable presumption that the investor with the largest financial stake has the most interest produces strong incentives for plaintiffs’ firms to seek out that investor); D&O Interviews, Plaintiffs’ Counsel #4, supra note 61, at 7 (describing how 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 that 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.

As described by a prominent mediator,

In a typical pre-PSLRA mediation, the mediator would ask the plaintiffs’ lawyer to go out in the hall and speak to the client about a proposed offer. Perplexed, the plaintiffs’ 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.”

Nicholas Politan, Mediating Securities Class Actions: A View From the Captain’s Quarters, INSTITUTIONAL INVESTOR ADVOC., Fourth Quarter, 2005, at 1, 9.

Cox & Thomas, supra note 63, at 1623 & tbl.3; see also James D. Cox & Randall S. Thomas, Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?, 80 Wash. U. L.Q. 855, 877 tbl.3 (2002) (reporting similar findings).

See Stephen J. Choi & Robert B. Thompson, Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA, 106 COLUM. L. REV. 1489, 1529 (2006) (reporting that institutional investors “tend to develop repeat relationships with only a
institutional shareholders settle for a higher percentage of investor loss than other cases, but the researchers have not been able to draw a conclusion about cause and effect. This correlation may be the result of institutional investors choosing to play a lead role in the more valuable cases rather than the result of institutional investors changing the dynamics of settlement negotiation.

After the court selects the lead plaintiff and class counsel, defendants have the option of challenging the class certification. However, largely due to the presumption of reliance derived from the fraud-on-the-market theory, class certification has not traditionally been a significant hurdle for plaintiffs’ lawyers. Recently, however, class certi-
fication has become a more frequently contested stage of the securities class action. Arguments over “loss causation” and other requirements are increasingly heard at that early stage. 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 directions—most circuits permit some discretionary weighing of the merits at the class certification stage.

#4 (explaining ways to challenge class certification and citing Polymedica as an example of what can work).

74 See D&O Interviews, Defense Counsel #5, supra note 14, at 18 (“[C]lass certification . . . is becoming a much more rigorous process than it had [been].”).

75 See, e.g., Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 271 (5th Cir. 2007) (vacating a class-certification order in a securities action because plaintiffs had not shown loss causation). However, most district court decisions in other circuits are at odds with this holding. See Lapin v. Goldman Sachs & Co., No. 04-2236, 2008 WL 4222850, at *15 (S.D.N.Y. Sept. 15, 2008) (providing an overview of district court decisions that “have rejected the notion that a showing of loss causation is a requirement at the class certification stage”); see also Richard A. Nagareda, Class Certification in the Age of Aggregate Proof, 84 N.Y.U. L. REV. (forthcoming 2009) (manuscript at 3), available at http://ssrn.com/abstract=1247720 (critiquing the analysis performed by courts at class certification and emphasizing the role of courts in clearly articulating the governing law).

76 Compare Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177 (1974) (“[N]othing in either the language or 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 Gen. Tel. Co. v. Falcon, 457 U.S. 147, 161 (1982) (holding that courts must conduct a “rigorous analysis” of the 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” (quoting Charles A. Wright et al., Federal Practice and Procedure § 3911, at 489 n.45 (1976))).

77 See, e.g., Szabo v. Bridgeport Machs., Inc., 249 F.3d 672 (7th Cir. 2001) (permitting courts to “look[ ] beneath the surface of a complaint to conduct the inquiries identified in [Rule 23],” and holding that if those Rule 23 inquiries “overlap [with] the merits . . . then the judge must make a preliminary inquiry into the merits”). A similar rule is followed in the First, Second, Third, Fourth, Fifth, Sixth, and Eleventh Circuits. See, e.g., Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc., 546 F.3d 196, 202 (2d Cir. 2008) (holding that in the Second Circuit, “the preponderance of the evidence standard applies to evidence proffered to establish Rule 23’s requirements”); In re IPO Sec. Litig., 471 F.3d 24, 41 (2d Cir. 2006) (holding that district courts must determine that each of the Rule 23 requirements has been met prior to certifying a class, even where Rule 23 requirements involve factual disputes and overlap with the merits); Waste Mgmt. Holdings, Inc. v. Mowbray, 208 F.3d 288, 298 (1st Cir. 2000) (noting that “a district court must formulate some prediction as to how specific issues will play out in order to determine whether common or individual issues predominate in a given case”).
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, with courts routinely dismissing about 30% of securities class actions filed in a given year. Our participants reported that defendants filed a motion to dismiss in every case with which they were familiar, that settlement discussions almost never take place until after the motion is filed, and that settlement discussions typically do not take place until after the class action has survived the motion to dismiss.

Most substantive legal arguments are heard at the time of the motion to dismiss. In deciding a motion to dismiss, courts generally accept as true all well-pleaded allegations as well as all plausible inferences arising from them. They also view the complaint in the light most favorable to the nonmoving party. In securities class actions, however, the PSLRA complicates this standard. Well-pleaded allegations are still regarded as true, but following the Tellabs decision, any inference of scienter must be more than merely reasonable or plausible; it must be at least as strong as any competing inference of non-fraudulent intent. In this way, at least with regard to scienter, the motion to dismiss presents plaintiffs in securities class actions with a stricter standard than in other federal claims. Moreover, as noted above, Dura may pose additional difficulties to some plaintiffs in

79 See Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Claims Head #2, at 21 (Jan. 30, 2006) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Claims Head #2] (“The events surrounding a motion to dismiss are the first genuine settlement opportunity.”); D&O Interviews, Plaintiffs’ Counsel #7, supra note 59, at 18-19 (“[T]here are natural breaking points for settlement discussions. The first is generally after the motion to dismiss is decided . . . .”); D&O Interviews, Plaintiffs’ Counsel #8, supra note 70, at 27-28 (“Well, the biggest issue is surviving the motion to dismiss. I mean if you survive a motion to dismiss you’re going to be okay until you get to summary judgment, and usually those cases settle.”).
80 See Fed. R. Civ. P. 8(a) (establishing the pleading standard in federal courts).
81 See Bell Atlantic Corp. v. Twombly, 127 S. Ct. 1955, 1974 (2007) (holding that to survive a motion to dismiss, a complaint must allege sufficient facts to support a “plausible”—and not merely “conceivable”—claim for relief).
82 See Cool v. Int’l Shoe Co., 142 F.2d 318, 320 (8th Cir. 1944) (“[O]n a motion to dismiss for insufficiency of statement, the complaint should be construed in the light most favorable to the plaintiff and with all doubts resolved in his favor.”).
83 See supra notes 42-44 and accompanying text.
pleading a theory of loss causation. These facts thus enable the motion to dismiss to function as a screening for merit. Nevertheless, a hearing on the pleadings where the allegations are treated as facts and plaintiffs benefit from a favorable presumption with regard to factual inferences is not the same as a proceeding that finds facts and forces plaintiffs to prove their claims. The motion to dismiss does not render judgment on the truth of the allegations, nor does it provide any guide to the amount of damages that the defendants ought to pay were the allegations to be proven.

Surviving the motion to dismiss essentially clears the case for settlement, since summary judgment is rare. Our participants reported that class actions typically do not last to the stage when they are ripe for summary judgment, and few of those that go all the way through discovery are in fact resolved through summary judgment.

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, Black, Cheffins, and Klausner found only thirty-seven se-

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84 See supra notes 47, 49 and accompanying text.
85 See D&O Interviews, Plaintiffs’ Counsel #4, supra note 61, at 4 (describing how plaintiffs must invest more in a case to prove its strength in order to survive the motion to dismiss after the PSLRA); see also Stephen J. Choi, Do the Merits Matter Less After the Private Securities Litigation Reform Act?, 23 J. L. ECON. & Org. 598, 620-21 (2006) (providing evidence that claims lacking hard evidence of fraud are more likely to be dismissed in the post-PSLRA period); Johnson et al., supra note 11, at 643-45 (finding that plaintiffs after the PSLRA tailor their accusations to a real likelihood of fraud in order to survive a motion to dismiss).
86 See, e.g., Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Monitoring Counsel #8, at 11 (June 13, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Monitoring Counsel #8] (“[T]here 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.”). 87 As one monitoring counsel noted,
[T]here is often a big pressure to settle. Often you want a relatively quick space after the motion to dismiss litigation phase. . . . Some people are kind of thinking through that a little bit more because it makes sense to push some of these cases towards summary judgment or not [depending on] how likely [it is] that you can likely get summary judgment in a 10b-5 case where the motion to dismiss is denied. . . . I am not aware of any 10b-5 cases that have been dismissed at the summary judgment stage.

Id. at 10. An exception to this rule is the WorldCom case, which generated a summary judgment opinion. In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004).
88 NERA reports that between 1991 (when they started collecting this data) and 2007, around 3900 federal securities cases were filed against public companies. See
securities law cases seeking damages that were tried to judgment. RiskMetrics’ Securities Litigation Watch reports that only six cases have gone to trial since 1996. The JDS Uniphase trial in late 2007 would appear to be the exception that proves the rule. As a result, once a claim survives the motion to dismiss, all involved know that the odds strongly favor an eventual settlement.

Our participants emphasized, nevertheless, that they do prepare for trial, if only to have a credible threat. 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 multimillion dollar proposition. The cost of discovery creates an obvious and well-known incentive for defendants to settle. While plaintiffs’ costs are not usually as high as defendants’, it is worth noting that the defendant’s higher costs do not necessarily give the plaintiff an advantage, as defense costs reduce available insurance limits. Assuming that the claim will settle within insurance limits, this means that increasing defense costs also decreases the total pot available to

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89 Black et al., supra note 22, at 1064. The statistic includes only securities law cases seeking damages from “public companies, their officers and directors, or both.” Id.
91 See Fighting Class Actions, supra note 55.
92 See D&O Interviews, Defense Counsel #4, supra note 73, at 29 (“What you do know is that when it goes to trial, defendants tend to win. You do know when it goes to trial, our experts will outperform their experts . . . .”); D&O Interviews, Plaintiffs’ Counsel #5, supra note 58, at 11 (“[H]aving a firm trial date where a jury is going to decide for you or against you is often a driver for settlement.”). Of course, if every case settles well before reaching the courthouse steps, the threat rings empty.
93 See Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Monitoring Counsel #2, at 51 (May 3, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Monitoring Counsel #2] (reporting that electronic data discovery alone costs $1 million to $3 million in a public-company securities case).
94 See STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 401-03 (2004) (providing a formal model and offering examples of how trial costs encourage parties to settle rather than continue litigation).
95 See Black et al., supra note 22, at 1098 (“In securities and corporate litigation, defendants’ costs are usually higher than plaintiffs’ costs . . . .”).
96 See Baker & Griffith, supra note 8, at 495 n.29 (estimating that defense costs represent at least 25% of a typical class action settlement).
plaintiffs in settlement. Thus, plaintiffs may also have a strong incentive to avoid high discovery costs.

Settlement, of course, is the way out of discovery. Consistent with this expectation, our participants reported that although settlement can happen at any point in the process, it most often occurs after the motion to dismiss, when the machinations of discovery have begun. 97

By focusing in this paper on the role of merits at settlement, we do not mean to discount the role that merits may play at other points in the process. As noted above, the substantive merits of a claim are increasingly involved in the class-certification decision and are the guiding consideration in the motion to dismiss. Some consideration of merit clearly is involved in the litigation process. Indeed, if one assumes that cases surviving the motion to dismiss are more meritorious than cases failing to survive the motion—a reasonable assumption in our view—then the fact that virtually no cases settle prior to a decision on the motion to dismiss suggests that merits do affect outcomes in shareholder suits. Moreover, the fact that 30% of motions to dismiss are granted suggests that a significant screening of claims is taking place at the motions stage. These facts belie the conclusion that merits do not matter.

97 Our participants reported that the immediate impetus to settle is likely to be a corporate event—a change of CEO, merger, or acquisition transaction, or other corporate event that causes the defendant to wish to eliminate contingent liabilities, including the pending securities claim. See, e.g., D&O Interviews, Defense Counsel #5, supra note 14, at 14-15 (“[I]t could be that they want to sell the company and they want to get everything behind them[,] . . . [or] that they are going to get rid of the CEO . . . and they want to have everything happen on the watch of the old CEO.”); Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Defense Counsel #6, at 1 (May 15, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Defense Counsel #6] (explaining that litigation usually results from corporate-governance problems or the hiring or firing of a CEO); id., Interview with Monitoring Counsel #6, at 22-23 (May 8, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Monitoring Counsel #6] (describing situations such as a change in general counsel, a new CEO, or a proxy fight threatening exposure preceding litigation). Such events can, of course, occur at any time during the life of a claim.

98 See Choi et al., supra note 78, at 5 (noting that the PSLRA prevents discovery while there is a pending motion to dismiss); see also D&O Interviews, Defense Counsel #1, supra note 44, at 14 (“[T]he real opportunity [to settle] is right after the motion [to dismiss] is denied . . . .”); D&O Interviews, Monitoring Counsel #8, supra note 86, at 10 (noting that a promising opportunity for settlement comes “after the motion to dismiss litigation phase”); D&O Interviews, Plaintiffs’ Counsel #7, supra note 59, at 19 (“I don’t know what the percentages are, but there are a group of cases that will be settled in between the date the judge comes down with the decision [on the motion to dismiss] and the date you start to get heavily involved in discovery.”).
Nevertheless, if one assumes that some nonmeritorious suits survive the motions stage—another reasonable assumption in our view—then the question becomes what mechanisms exist to make outcomes at settlement reflect the merits of the claim. 99 Indeed, even if the motions stage provided a perfect screen for nonmeritorious claims—if, in other words, no meritorious claims were dismissed and only meritorious claims survived the motion—then the question of how settlement practices take into account a claim’s underlying merits would still be an important one in determining whether the dollar amount at settlement reflects the severity of the defendant’s fraud. In a world where merits matter, both serious and minor frauds should survive the motion to dismiss, but serious frauds ought to cost defendants more than minor ones. We think that it is important to investigate the role of merits at settlement for both reasons—because the question of how the merits affect settlement amounts is a critical question, and because we suspect that at least some nonmeritorious claims survive the motion to dismiss. The question of merits at settlement is thus our principal focus in this Article.

II. WHAT WE TALK ABOUT WHEN WE TALK ABOUT MERITS

The term “merits” regularly appears in both academic and popular discussions of litigation, often in opposition to the term “frivolous.” 100 In this common usage, a lawsuit is understood to be meritorious if the facts that 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 that the plaintiff alleges are false or if the plaintiff’s legal theory is unsound. By extension, the merits do not matter if the probability

99 We note that it is also reasonable to suppose that some claims that would ultimately prove meritorious are disposed of at the motion to dismiss because, without discovery, not enough facts could be found to support the “strong inference” standard for scienter. The motion to dismiss, in other words, is probably both over- and underinclusive as a filter for merit.

100 See, e.g., Robert G. Bone & David S. Evans, Class Certification and the Substantive Merits, 51 DUKE L.J. 1251, 1251, 1254 (2002) (critiquing the class-certification rules for “avoid[ing] inquiring into the merits of substantive issues” and thus “inviting frivolous class action suits”); Choi, supra note 85, at 599 (noting that “the PSLRA requires courts to review a class action on the merits . . . and impose sanctions . . . on frivolous litigation”).
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 securities litigation does not have a simple, objective quality that can be used to measure merit. Indeed, our participants offered various understandings of merit and differed on whether the merits matter. 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: to demonstrate on the basis of external, objective evidence that the right people are being held liable for doing what the law forbids.

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 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 with the commonsense view of, for example, doctors who might tend to view a malpractice claim as meritorious only if a physician’s conduct falls below the relevant stan-

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101 See generally Choi, supra note 9, at 1472-73 (noting the problematic character of “merit”); Johnson et al., supra note 11, at 649 (cautioning that the proxies used in their article may not fully capture “merit”).

102 See supra notes 74-77; see also D&O Interviews, Claims Head #6, supra note 44, at 62 (“Well, it’s impossible for me to guess what other people mean when they say ‘merits,’ and I, well I like the concept of settling the cases based on the merits. I haven’t quite given up on that hope, but it just doesn’t happen. The most I can hope to achieve is to get a reasonable settlement value based on what other cases, similar cases are being resolved for.”); Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Defense Counsel #2, at 3 (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Defense Counsel #2] (“[I]t’s like the difference between gross motor skills and fine motor skills. Merits matter, but they matter at the level of the gross motor skills.”); D&O Interviews, Defense Counsel #6, supra note 97, at 10 (“[M]y experience is that the level of settlement has nothing to do with the merits of the claim.”); D&O Interviews, Monitoring Counsel #6, supra note 97, at 29 (“I have almost religiously said merits do matter, because most of the time if you pay attention to what really happens meaningful[ly] 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.”).
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.\textsuperscript{103}

One problem with this liability-centered understanding of merit is that it is difficult, if not impossible, to find an objective standard of truth by which to judge the liability elements of a claim. Researchers have sought to construct such standards in other areas of the law, and their efforts are instructive. 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.\textsuperscript{104} There are, unfortunately, no comparable closed-claim studies of securities class action settlements. Indeed, there is some reason to doubt that there ever will be, given that the answer to the key liability question in a securities class action—whether the defendants acted with reckless disregard for the truth—lies hidden in a way that the question of whether a doctor followed medical custom is not.

If we seek to understand the merits in terms of all of the legally defined elements of a claim, including damages,\textsuperscript{105} we build back into our implicit model the incentive created by the 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. Understood in this way, the merits matter as long as settlements bear a reasonable re-

\textsuperscript{103} 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., Frederick W. Cheney et al., Standard of Care and Anesthesia Liability, 261 J. AM. MED. ASS’N 1599, 1601-02 (1989) (using payment as both an on/off and continuous variable); Frank A. Sloan & Chee Ruey Hsieh, Variability in Medical Malpractice Payments: Is the Compensation Fair?, 24 LAW & SOC’Y REV. 997, 1006 (1990); Stephen J. Spurr & Sandra Howze, The Effect of Care Quality on Medical Practice Litigation, 41 Q. REV. ECON. & FIN. 491, 502-04 (2001); see also Mark I. Taragin et al., The Influence of Standard of Care and Severity of Injury on the Resolution of Medical Malpractice Claims, 117 ANNALS INTERNAL MED. 780, 781-82 (1992) (treating settlement or jury award as simply “payment” while also subdividing jury award by amount). For a criticism of that approach, see Tom Baker, Reconsidering the Harvard Medical Practice Study Conclusions About the Validity of Medical Malpractice Claims, 33 J.L. MED. & ETHICS 501, 508 (2005).

\textsuperscript{104} See Tom Baker, The Medical Malpractice Myth 68-87 (2005) (collecting and analyzing the closed-claim-file literature published through March 2004); David M. Studert et al., Claims, Errors, and Compensation Payments in Medical Malpractice Litigation, 354 NEW ENG. J. MED. 2024, 2024 (2006) (reporting the results of the most recent and most definitive medical malpractice closed-claim-file review); see also Philip G. Peters, Jr., What We Know About Medical Malpractice Settlements, 92 IOWA L. REV. 1783, 1787-1802 (2007) (explaining the latest effort to collect malpractice-settlement research).

\textsuperscript{105} Cf. D&O Interviews, Defense Counsel #4, supra note 73, at 50 (“I count damages as part of merits.”).
relationship to the probability that the defendants committed fraud, multiplied by the potential damages in each case.\textsuperscript{106} 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 in just this way, collecting data on readily identifiable indicia of wrongdoing and settlement amounts. They identify proxies for fraud—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.\textsuperscript{107} Their answer is yes, in both cases, which supports the view that merit matters.\textsuperscript{108} But these researchers are only using proxies, as they acknowledge, and their regression models only explain part of the variation in settlements that they observe.

We propose to use a very different methodology to consider the relationship of the merits to settlement outcomes: qualitative reports from participants in the securities class action settlement process about the role of the merits in that process. As with any other empirical research method, ours has limitations. For example, our 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 a meaningless research question for us, not because it is unimportant, but because it cannot be answered. There is not now, nor is there ever likely 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


\textsuperscript{107} See Johnson et al., \textit{supra} note 11, at 632 (opting to investigate multiple attributes instead of a single attribute as was done in prior research).

\textsuperscript{108} See \textit{id.} at 649 (concluding that the “study provides some evidence that the merits do matter more, at least in the filing of complaints and the allegations included in those complaints”).
claims is by focusing on the understanding 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 forty-eight interviews conducted in connection with our earlier research on D&O insurance pricing and loss prevention, we conducted an additional round of over fifty interviews, focusing on those most involved in the settlement of securities class actions. Our participants included twelve claims managers from ten D&O insurance companies, eleven lawyers who specialize in bringing shareholder litigation on behalf of shareholders, twelve lawyers who specialize on the defense side of shareholder litigation, ten 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, two experts who assist parties in assessing the damages in shareholder litigation, and two claims advisors from two brokerage houses. In addition, we presented an early draft of our findings at a confidential, off-the-record roundtable of practitioners and industry experts, who read and commented on our work.

We acknowledge that our sample is neither large nor random. We began our interviews with people about whom we learned in our prior research, then worked outward to references from those interviewees. Despite the self-selecting and self-referential nature of this sample, we can describe the settlement process with some confidence because the securities class action field is remarkably small and

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109 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 Baker & Griffith, supra note 24, at 1798 (describing interviews with over forty people regarding “the relationship between D&O insurers and their public company insureds”); Baker & Griffith, supra note 8, at 493 (describing the breakdown by job type of the forty-one people interviewed).

110 See generally D&O Roundtable, supra note 57, at 4 (describing the goals and conditions of the discussion).

111 It is worth noting that no one whom we approached refused to be interviewed. We did not interview everyone we approached because of the limits of time. In order to avoid a potential bias attributable to the time constraints of the most busy attorneys, we made a special effort to interview attorneys with a reputation for being in great demand during the period of our interviews.
densely connected. On the plaintiffs’ side, the universe of players has remained small and relatively stable, with the top eight plaintiffs’ firms accounting for 75% of total settlement collections. 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 provide a good guide to that bar, and perhaps not surprisingly, the top New York and national firms are well represented. D&O insurance, moreover, is a highly concentrated market, clustering around two dominant primary insurers—AIG and Chubb—which together ac-

112 As one of our participants said, quoting a co-coverage counsel, “it’s a really small sandbox. You don’t want to pee in it.” Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Monitoring Counsel #3, at 73 (May 25, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Monitoring Counsel #3]. As another monitoring counsel noted,

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 [a] million pages long, but there is some level of trust, some level of candor.

D&O Interviews, Monitoring Counsel #8, supra note 86, at 25.

113 See Choi & Thompson, supra note 70, at 1518 (arguing that the PSLRA initially succeeded in making this universe smaller, but that in recent years the universe has expanded to pre-PSLRA levels). Even as firms have split, the major players have remained the same, as the pay-to-play controversy surrounding Mel Weiss and Bill Lerach has shown. See, e.g., Barry Meier, Another Notch for U.S. Prosecutors: Lawyer Pleads Guilty in Kickback Case Involving His Firm, N.Y. TIMES, Sept. 19, 2007, at C3 (describing Lerach’s indictment on behavior stretching back to the 1970s); Barry Meier, Top Class-Action Lawyer Faces Federal Charges: Accused of Payoffs to Enhance Legal Fees, N.Y. TIMES, Sept. 21, 2007, at C3 (reporting on the indictment of Melvyn Weiss for obtaining $250 million in legal fees on class action cases for which his firm paid kickbacks to plaintiffs); David Weidner, No Class, But a Lot of Action: Bill Lerach, MARKET WATCH, Aug. 30, 2007, http://www.marketwatch.com (enter “Bill Lerach” in Search Box in upper righthand corner; then follow second hyperlink to “David Weidner’s Writing on the Wall”) (reporting that despite Lerach’s departure, his firm had filed twelve class actions in August 2007).

114 See Adam Savett, RISKMETRICS GROUP, SCAS 50 POWER RANKINGS 1 (2007) (providing data on settlement amounts from 2003 to 2006 for the top fifty securities class action firms). 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 named partner(s) over the years as the same firm. See also Choi & Thompson, supra note 70, at 1515 tbl.3 (reporting that four plaintiffs’ firms have handled cases that represent 50% of the total settlement value since 1995).

115 See Baker & Griffith, supra note 24, at 1816-17 (noting that though the panel counsels from two of the leading D&O insurance companies did not include all leading securities defense firms, those firms on the list were primarily large national firms or specialized litigation firms with distinguished reputations).
count for more than half of the market for primary insurance. The excess D&O insurance market is broader, but both primary and excess markets are intermediated through the personal connections of a few brokerage firms. 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. 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 accustomed to working with large quantitative data sets.

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 to explain what drove the parties to settlement. We then approached the question of value directly, asking them to describe what 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 described negotiations that involved slow movement from extreme positions, almost always through mediation.

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116 AIG and Chubb account for approximately 60% of the market by premium volume. Towers Perrin, supra note 20, at 39 exhibit 54. By policy count they rank third and first, respectively, while ACE ranks second. Id. 
117 Only about twenty-six firms are active in the public D&O insurance market at any time. Id. 
118 Consider the following description of the settlement process, as related by a monitoring counsel:

A. It's starting off on opposite extremes and working to the midpoint.
Q. And what is . . . one of 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.

Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Monitoring Counsel #7, at 35-36 (June 13, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Monitoring Counsel #7].
Consistent with the standard economic model of settlement, our participants explained this process in terms of predictions about how liability and damages would be assessed at trial. 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.

In terms of the economic model of settlement, a $200 million settlement of a securities fraud action with a 5% 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 that 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, $30 million is an acceptable settlement because there is a 10% chance of being held liable for $300 million cannot be justified on the basis of experience. The number of trials is simply too small to support any such conclusion. 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 that we will explore, can only be assessed in securities class actions in relation to other settlements, not in relation to trial results.

1. Liability

Consistent with prior research, the factors that our participants named as important in explaining settlement outcomes included a host of factors that might be understood as “hard evidence” of securi-

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119 See, e.g., George L. Priest & Benjamin Klein, The Selection of Disputes for Litigation, 13 J. LEGAL STUD. 1, 6-30 (1984) (presenting a model that predicts litigation outcomes based on economic conditions).

120 See, e.g., D&O Roundtable, supra note 57, at 57 (“[I]t’s not just a question of ‘Is it liability or damages?’ It’s really, ‘What are the probabilities for success?’ You can call it any label you want.”).

ties fraud. For example, our participants frequently mentioned earnings restatements, insider selling, and SEC investigations as highly significant in determining settlement outcomes. They also mentioned facts that might support a story of earnings mismanagement, such as questionable revenue recognition practices, especially where the managerial compensation was associated with stock performance. These kinds of facts provide evidence of a motive for fraud, supporting the plaintiffs’ assertions of scienter.

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.’”

Cases with sex appeal are cases that have exciting facts or are part of

122 See Johnson et al., supra note 11, at 634-36 (examining factors such as false or misleading forward-looking statements, stock sales by executives and directors, and weak corporate governance (which often leads to SEC investigations), and the ability of these factors to predict settlement outcomes in cases of alleged securities fraud).

123 A plaintiffs’ counsel listed the factors that increase settlement value as including “[r]estatement, insider selling[,] . . . suspicious stock repurchase programs[,] . . . accounting violations . . . [, and] rebates which often go[ ] on in the . . . resale wholesale industry.” D&O Interviews, Plaintiffs’ Counsel #6, supra note 59, at 18. In addition, a mediator told us that

[the mediator will say] “Look, there is no sizzle in this case. You don’t have any of the upgrades,” he said, “that make this a nice case. You don’t have the accounting restatement. You don’t have the SEC investigation. You don’t have the executives being led out of the office in handcuffs, all of which are sort of sizzle facts,” he said, “that might lead to a nice settlement for the plaintiffs. You don’t have any of that stuff. This is kind of a boring case.”

Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Mediator #2, at 8 (June 4, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Mediator #2]; see also D&O Interviews, Monitoring Counsel #7, supra note 118, at 8 (“[T]here are some factors in the litigation that give it what is normally referred to as sex appeal. And you know insider trading . . . where the defendants have profited greatly from their sale of the company stock, that gives a case sex appeal. And the backdated options cases are a perfect example of that, and there is not really much in the way of hard injury to the company from these backdated options . . . .”).

124 See D&O Interviews, Plaintiffs’ Counsel #6, supra note 59, at 18 (“What else [might affect settlement outcomes]? Obviously bonuses associated with stock performance.”).

125 See supra note 39 and accompanying text (discussing the standards that the courts of appeals have created for establishing scienter).

126 D&O Interviews, Monitoring Counsel #7, supra note 118, at 8; see also Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Claims Head #1, at 22 (Dec. 2005) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Claims Head #1]. The same Claims Head also noted that “the sexier the case, the more interest there is.” Id.
scandal.\textsuperscript{127} As one mediator put it, a “boring” case that “[took] place in a 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 in handcuffs.”\textsuperscript{128} A plaintiffs’ 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 more than just a restatement. You need a restatement and you need some benefit[, you need to show] that somebody benefited by the wrong.”\textsuperscript{129}

We suspect that when our participants spoke to us about sex appeal, they were describing factors that cognitive psychologists might consider under the vividness or “availability” heuristics.\textsuperscript{130} Nevertheless, vivid and exciting facts may increase the settlement value of a claim without indicating greater merit because such facts may embarrass or shame defendants into settlement.\textsuperscript{131} One defense lawyer emphasized that executives are often unwilling to take the stand to explain a bad business outcome.\textsuperscript{132} 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. But sex ap-

\textsuperscript{127} Describing how he gets an initial impression of the value of a claim, one claims head distinguished between cases with sex appeal and those without: “[Y]ou take a look at what is alleged. You know, is this part of a scandal? Is this one of these where it is outright cooking of the books? Or is it . . . just old-fashioned misrepresentations of what they call projection cases?” Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Claims Head #3, at 35 (Feb. 12, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Claims Head #3].

\textsuperscript{128} D&O Interviews, Mediator #2, \textit{supra} note 123, at 8.

\textsuperscript{129} D&O Interviews, Plaintiffs’ Counsel #8, \textit{supra} note 70, at 30.

\textsuperscript{130} See Norbert Schwarz & Leigh Ann Vaughn, \textit{The Availability Heuristic Revisited: Ease of Recall and Content of Recall as Distinct Sources of Information}, in \textit{HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT} 103, 105 (Thomas Gilovich et al. eds., 2002) (describing the “availability” heuristic as the means by which individuals estimate the likelihood that an event will occur, and examining studies that attempt to explain the underlying mental processes involved in the availability heuristic).

\textsuperscript{131} As one observer explained,

More often than not . . . we hear there is really 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, and by the way, our president and CFO and CEO, there’s no way we can possibly present them to a jury.

D&O Interviews, Claims Head #6, \textit{supra} note 44, at 26-27.

\textsuperscript{132} D&O Interviews, Defense Counsel #6, \textit{supra} note 97, at 9-10, 14-15 (emphasizing the cost to the organization of executive testimony in terms of lost executive time, bad publicity, and legal costs in preparing for deposition and testimony, and also noting the possibility that the relevant people may no longer be with the organization and would therefore make unreliable witnesses).
peal or sizzle does more than inconvenience or shame defendants; it makes the plaintiffs’ story more appealing and pulls the imaginary jury in the lawyer’s mind closer to the plaintiffs’ view of the case, thereby increasing the plaintiffs’ lawyer’s bargaining power at settlement.\footnote{See D&O Interviews, Monitoring Counsel #6, supra note 97, at 31 (“[I]t’s about telling you the story and having somebody gasp as you are saying it and say, you know, ‘I can’t believe it.’”).}

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.

... [A]nd 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... re-stated. [B]ut 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 to keep the price of stock up.

[But] nobody sold their stock. And so the argument then that’s being 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...”... [A]nd I don’t have an answer because I don’t have any juice, I don’t have any sex appeal.\footnote{D&O Interviews, Plaintiffs’ Counsel #8, supra note 70, at 28-29. As one defense lawyer put it, “[I]nsider 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, [but] they merge a little bit.” D&O Interviews, Defense Counsel #4, supra note 73, at 50.}
Insider trading is not an element of the cause of action, but it provides evidence of motive. Motive can establish scienter, which is one of the elements of the cause of action.\textsuperscript{135}

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, whistleblowers, termination of senior 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 newspapers.\textsuperscript{136}

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 meaningfully at the friction points in either mediations or other settlement discussions, it

\begin{quote}
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.
\end{quote}

\textsuperscript{135} See supra note 39 and accompanying text (discussing the standards that the circuit courts have created for establishing scienter).

\textsuperscript{136} See, e.g., D\&O Interviews, Claims Head #3, supra note 127, at 35 (distinguishing between weaker “old-fashioned misrepresentation of projection cases” and “accounting manipulations” that involve “outright cooking of the books”); Tom Baker & Sean J. Griffith, D\&O Interviews, Interview with Claims Head #5, at 59-64 (Mar. 14, 2007) [hereinafter D\&O Interviews, Claims Head #5]; id., Interview with Claims Head #7, at 34-35 [hereinafter D\&O Interviews, Claims Head #7] (describing conflicts among parties on the defense side, such as the mistrust between outsiders and insiders when outsiders believe that they are not receiving adequate information); id., Interview with Defense Counsel #3, at 20 (May 23, 2007) [hereinafter D\&O Interviews, Defense Counsel #3] (“[I]f 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.”); D\&O Interviews, Monitoring Counsel #8, supra note 86, at 34-35, 42 (describing the importance of “hot docs,” the termination of a CEO or CFO, and whistleblowers as factors that the defense counsel considers in discerning damage amounts); D\&O Interviews, Plaintiffs’ Counsel #5, supra note 58, at 7-8 (describing board-member resignation occurring immediately before a decrease in the value of a stock); D\&O Interviews, Plaintiffs’ Counsel #6, supra note 59, at 19 (citing “suspicious stock repurchase programs” as a sign of internal problems within a company). For a more concrete illustration, consider the following:

\textsuperscript{135} See supra note 39 and accompanying text (discussing the standards that the circuit courts have created for establishing scienter).

\textsuperscript{136} See, e.g., D\&O Interviews, Claims Head #3, supra note 127, at 35 (distinguishing between weaker “old-fashioned misrepresentation of projection cases” and “accounting manipulations” that involve “outright cooking of the books”); Tom Baker & Sean J. Griffith, D\&O Interviews, Interview with Claims Head #5, at 59-64 (Mar. 14, 2007) [hereinafter D\&O Interviews, Claims Head #5]; id., Interview with Claims Head #7, at 34-35 [hereinafter D\&O Interviews, Claims Head #7] (describing conflicts among parties on the defense side, such as the mistrust between outsiders and insiders when outsiders believe that they are not receiving adequate information); id., Interview with Defense Counsel #3, at 20 (May 23, 2007) [hereinafter D\&O Interviews, Defense Counsel #3] (“[I]f 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.”); D\&O Interviews, Monitoring Counsel #8, supra note 86, at 34-35, 42 (describing the importance of “hot docs,” the termination of a CEO or CFO, and whistleblowers as factors that the defense counsel considers in discerning damage amounts); D\&O Interviews, Plaintiffs’ Counsel #5, supra note 58, at 7-8 (describing board-member resignation occurring immediately before a decrease in the value of a stock); D\&O Interviews, Plaintiffs’ Counsel #6, supra note 59, at 19 (citing “suspicious stock repurchase programs” as a sign of internal problems within a company). For a more concrete illustration, consider the following:
is ultimately the fear of bad facts being proven, and I think that is merits.\textsuperscript{137}

2. Damages

Many participants viewed the amount of potential damages as the most important factor driving settlement.\textsuperscript{138} Damages exert a coercive influence, defense and monitoring counsel argued, because the initial damages estimate—so-called “plaintiffs’-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.\textsuperscript{139} The larger the plaintiffs’-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 is “investor loss.”\textsuperscript{140} As one defense counsel reported, “[I]f 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.”\textsuperscript{141} 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

\textsuperscript{137} D&O Interviews, Monitoring Counsel #6, supra note 97, at 29.
\textsuperscript{138} See, e.g., D&O Interviews, Defense Counsel #1, supra note 44, at 29 (asserting that while the merits are a factor in settlement negotiations, the driving force is the amount of investor loss, which is reflected in the amount of damages).
\textsuperscript{139} See PLANCICH ET AL., supra note 21, at 14 (finding that investor losses are the most powerful determinant of settlement values and account for upwards of 50% of settlement values’ variation); D&O Interviews, Defense Counsel #5, supra note 14, at 16-17 (arguing that plaintiffs often drive settlement values because insurers pattern their responses to claims based on the potential damages to the corporation’s stock value caused by harmful disclosures).
\textsuperscript{140} D&O Interviews, Defense Counsel #1, supra note 44, at 29; see also D&O Interviews, Defense Counsel #4, supra note 73, at 11 (“By the time you get to mediation, damages is very much in the forefront of the discussion.”); D&O Interviews, Mediator #2, supra note 123, at 4 (“Potential damages is the number one thing . . . .”); D&O Interviews, Monitoring Counsel #7, supra note 118, at 8-9 (“I think the largest and most determining factor is potential damages . . . .”); D&O Interviews, Plaintiffs’ Counsel #8, supra note 70, at 22 (“[T]he most important factor is the amount of the damage . . . .”); Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Policyholder #2, at 6 (May 31, 2007) (unpublished interviews, on file with authors) (“He said that he thinks they do argue about liability but the damages more.”).
\textsuperscript{141} D&O Interviews, Defense Counsel #5, supra note 14, at 16.
wrong with this.’ Take the $500 [thousand] and make it $3 billion. . . . Everybody changes their mind.”\(^{142}\)

While investor loss is typically much higher than the legally compensable damages, it still provides a useful, easy means of computing the outer limit of what is at stake.\(^ {143}\) The head of one D&O insurance 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, plaintiffs'-style damages calculation.

So I will go to Yahoo. . . .

. . . 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. . . .

. . . I’m giving the full benefit to the plaintiffs.

So take the full float, times [the] 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 10b-5 claim will settle for somewhere around 5%, give or take, of plaintiffs'-style damages, generally speaking.

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\(^{142}\) D&O Interviews, Monitoring Counsel #6, supra note 97, at 25; accord D&O Interviews, Monitoring Counsel #8, supra note 86, at 13 (“[Y]ou 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. . . . [I]t is difficult for insurers to really want to run that risk.”); see also D&O Interviews, Defense Counsel #3, supra note 136, at 46 (“I mean you could tick off all the reasons you want to settle. . . . The numbers are too big . . . .”); D&O Interviews, Plaintiffs’ Counsel #5, supra note 58, at 11 (“[Y]ou are driving your case to trial, and very few people want to shoot the moon.”); D&O Interviews, Plaintiffs’ Counsel #8, supra note 70, at 16 (“[T]rying one of these big huge cases, it’s hugely time consuming, hugely costly, and hugely risky.”); Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Mediator #1, at 3 (May 25, 2007) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Mediator #1] (“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.”); id., Interview with Monitoring Counsel #4 & #5, at 3 (May 16, 2007) [hereinafter D&O Interviews, Monitoring Counsel #4 & #5] (“[T]here is too great of a risk for the insured.”); D&O Interviews, Monitoring Counsel #7, supra note 118, at 18 (explaining that “the potential exposure is overwhelming”).

\(^{143}\) 2 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION §§ 12.12[1], at 553, 12.15[1][J] (4th ed. 2002) (describing damages as a “confused area,” but noting that under the 1995 Reform Act, damages are limited to the losses actually caused by material misstatements or omissions or what can be legally proven).
... So here is... $700 million in damages. 5% of that is $35 million. I'm 10x80.\textsuperscript{144} 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 envelope.

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. 5% 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%. 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 to 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 plaintiffs’ lawyers out because there [are] damages, and the case has value irrespective of the merits.\textsuperscript{145}

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, however, think that the size of investor loss explains something, 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.

The lawyers handling securities class actions closely monitor the settlements in other class actions, and they develop rough settlement approximations that are similar to the claims manager’s rule of thumb.\textsuperscript{146} The main difference is that the lawyers generate a range of

\textsuperscript{144} “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.

\textsuperscript{145} D&O Interviews, Claims Head #3, supra note 127, at 34-36.

\textsuperscript{146} Id. at 95-96. The participant, however, conceded in the next breath that “a better fraud case... would settle faster.” Id. at 96.

\textsuperscript{147} See D&O Interviews, Monitoring Counsel #7, supra note 118, at 8-9 (“I think the largest and most determining factor is potential damages[,]...[S]udies... that we
settlement values, while the claims managers need point values, because claims managers have to set reserves.

Investor loss alone, however, does not explain the settlement amount in any particular case:

[T]he plaintiffs’ firm is bringing in their economics, 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] \(^{148}\) 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, . . . the case settled higher because they had more leverage. \(^{149}\)

Investor loss sets the range, \(^{150}\) 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. The exact settlement amount 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 that we will discuss.

Thus, settlement valuation is analogous to the D&O insurance pricing process that we described in our earlier work. \(^{151}\) Just as D&O insurance underwriters make an initial assessment of the premium based on a simple financial algorithm, \(^{152}\) so too do D&O insurance claims managers make an initial assessment of the settlement valuation. And, just as D&O insurance underwriters arrive at a final price refer to are extrapolations from . . . plaintiffs’-style damages. And they say if the plaintiffs’-style damages expert say[s] that damages are \(X\), then the settlement value is a percentage within a fairly narrow band of \(X\).”)

\(^{148}\) Our participants used the term “plaintiffs’-style damages” imprecisely. As a result, it took us some time to realize that they were using the term differently in different contexts. Sometimes, as in this quotation, the term means the investor-loss amount. Other times it was simply a term of opprobrium for an inflated damages number produced using methods that, in the defense lawyers’ view, failed to take loss causation adequately into account.

\(^{149}\) D&O Interviews, Claims Head #5, \(supra\) note 136, at 62.

\(^{150}\) See FOSTER ET AL., \(supra\) note 72, at 9 (finding that investor losses are the greatest predictor of settlement values).

\(^{151}\) See Baker & Griffith, \(supra\) note 8, at 527-32 (exploring the three components—“the algorithm, the system of credits and debits, and the market constraint”—that D&O underwriters use to derive an insurance price).

\(^{152}\) Id. at 528-29.
through a credit and debit process that takes into account “deep governance”\footnote{Id. at 490.} and the state of the insurance market,\footnote{Id. at 529-32.} so too do D&O claims managers arrive at a settlement price that they are willing to pay through a negotiation process. This negotiation process 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—in other words, loss causation.

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, because securities lawyers often discuss causation as a damages issue. One defense lawyer explained the importance of causation as follows:

In a securities case, if a statement is made in a large-cap stock and there’s a big drop . . . in the stock when that statement is shown to be arguably inaccurate, OK, the issue\footnote{D&O Interviews, Defense Counsel #5, supra note 14, at 17-18.} 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 Pharmaceuticals, Inc. v. Broudo], 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 recorded, but the question of . . . 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.\footnote{Id. at 490.}

Causation is an element of liability and, thus, a merits issue even under the narrow definition of that term. Indeed, once the initial round of motions is decided, causation may be the most important merits issue, as this defense counsel suggests:

By the time you get to mediation, damages is very much in the forefront of the discussion. . . . [L]iability is there too, but . . . 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 our given 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?”
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 bullshit. 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.

Defense counsel claimed that they have the better loss-causation and damages experts and that the law is moving their way, but the monitoring counsel and mediators stressed the uncertainty in the law, especially in its application to facts. 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 did not have a good answer to the following argument:

[You can have . . . 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 [million].”]

As long as the plaintiff is willing to settle the case within a range 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 loss causation and estimation of the amount of the damages as part of the merits of a claim, then the most important nonmerits factor in the securities class action context is the ability and

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156 D&O Interviews, Defense Counsel #4, supra note 73, at 11-12.

157 See, e.g., D&O Interviews, Monitoring Counsel #4 & #5, supra note 142, at 2-3 (“These damages models . . . were very often BS, but an important factor here . . . is that the damages models are never tested.”); D&O Interviews, Monitoring Counsel #7, supra note 118, at 12 (noting that Dunia offered “a great windfall that the defense lawyers thought was coming their way [but that] just hasn’t materialized because the plaintiffs 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”).

158 D&O Interviews, Claims Head #9, supra note 14, at 20.
willingness of the defendants to pay. As already noted, virtually all U.S. public corporations purchase D&O insurance, and securities settlements are largely funded by insurance proceeds. More often than not, then, the D&O insurer’s willingness to pay, rather than the willingness of the corporation to pay, is what ultimately matters.

It is important to understand that, despite its label, D&O insurance largely protects corporate rather than individual assets, especially in shareholder class actions. Individual directors and officers are adequately protected by indemnification agreements with their corporation. The corporation, in turn, is protected by the D&O insurer, which reimburses it not only for its indemnification obligations to individual directors and officers, but also for losses it incurs directly as a result of securities claims. Thus, as we have said previously, D&O insurance is, to a very substantial extent, corporate-asset-protection insurance, not individual-asset-protection insurance.

What all of this ultimately means is that, from the perspective of plaintiffs and defendants alike, securities settlements are funded by other people’s money. Recognition of this fact is often accompanied by the view that other people’s money is easy money. As described by a monitoring counsel:

159 See Baker & Griffith, supra note 24, at 1797 (“U.S. publicly traded corporations—virtually all of them—protect themselves against the costs associated with corporate and securities law liability by purchasing D&O insurance.”).

160 See Baker & Griffith, supra note 8, at 499-501 (“[A]ll D&O policies have the effect of shifting the risk of shareholder litigation from individual directors and officers and the corporation they manage to a third party insurer.”); supra text accompanying note 19.

161 The D&O insurer compensates individual directors and officers only when the corporation itself cannot indemnify them, as, for example, when the corporation is insolvent or when the payment is to settle a derivative claim. Baker & Griffith, supra note 24, at 1802-03.

162 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 when it is itself a defendant in a shareholder claim. Baker & Griffith, supra note 8, at 499.

163 Baker & Griffith, supra note 24, at 1802-04.

164 See D&O Interviews, Claims Head #1, supra note 126, at 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.”); D&O Interviews, Defense Counsel #3, supra note 136, at 34 (“You know, the company doesn’t care about the insurance company’s money.”); D&O Interviews, Monitoring Counsel #6, supra note 97, at 25 (“[I]t is much easier to [talk settlement] when you can play with somebody else’s money.”).
[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 a resolution that allows us to pay $60 million to resolve this case.” [The board responds] “Gasp, gasp, that’s $60 million. . . . [H]ow 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?”

To insurers, of course, the insurance proceeds are their money, and they will seek to save it. The easy availability of insurance proceeds, thus, is checked to some degree by the ability of the insurer to influence the settlement. D&O insurers, as a class, can be understood to exert an influence over settlement outcomes in line with the extent to which the total settlement is funded by insurance. The insurer will have two principal case-specific interests: first, and most obviously, to reduce settlement payouts; and second, to maximize investment returns by delaying the payout of invested capital.

D&O insurers achieve these interests through their power to veto settlement offers. D&O insurance policies provide that the policyholder must obtain the insurer’s 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.

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165 D&O Interviews, Monitoring Counsel #6, supra note 97, at 26.
166 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.” D&O Interviews, Plaintiffs’ Counsel #5, supra note 58, at 23.
167 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”), investment income has varied between a high of almost 28% of net premiums in 1998 and a low of 11% of net premiums in 2002. See A.M. Best Co., Aggregates & Averages: Property/Casualty 415 (2007) (reporting results for net underwriting experience in the insurance industry through 2006).
168 See Am. Int’l Group (AIG), Executive and Organization Liability Insurance Policy § 8 (2000) (“The Insureds shall not admit or assume any liability, enter into any settlement agreement, stipulate to any judgment, or incur any Defense Costs without the prior written consent of the Insurer.”).
held. But it is only in very unusual situations that a corporation would even consider settling without the insurer’s consent.

The insurer’s 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:

[1] If there is a demand to settle within the limits and 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. . . . They 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.170

Under longstanding principles of insurance law, a liability insurer that refuses to accept a reasonable offer of settlement within the limits of its policy has, in effect, waived the limits of the insurance policy and will thus be liable for the full amount of any resulting judgment, no matter how much that judgment exceeds the limits of the policy.171 Given the potentially very large damages at stake in a securities class action, and the small size of any individual D&O policy in relation to those damages, the duty to settle places pressure on D&O insurers.172 Indeed, our plaintiffs’-lawyer participants confirmed that they craft their settlement offers precisely to put this kind of pressure on insurers.173

169 See id. (“The Insurer’s consent shall not be unreasonably withheld, provided that the Insurer shall be entitled to effectively associate in the defense, the prosecution and the negotiation of any settlement of any Claim that involves or appears reasonably likely to involve the Insurer.”).
170 D&O Interviews, Monitoring Counsel #4 & #5, supra note 142, at 6.
171 See Kent D. Syverud, The Duty to Settle, 76 VA. L. REV. 1113, 1116-17 (1990) (noting that an insurer’s failure to accept a reasonable settlement demand within the policy limits is evidence of bad faith).
172 See Black et al., supra note 22, at 1100-01 (arguing that several countervailing pressures motivate insurers with low risk exposure to settle rather than take a chance at trial).
173 As one plaintiffs’ lawyer has stated, insurance is very much a factor in settlement amounts, . . . [since] companies are [much] more willing to pay with insurance-company money than with their own money. . . . [T]hey are very much mindful of setting up the bad-faith case in their settlement strategy, that they always try to offer within limits with exceptions, . . . and when they craft settlement offers that are less than
In addition to its veto power over settlement offers, the insurer may be able to raise coverage defenses to decrease its share of a settlement, most significantly by threatening to rescind coverage on the basis of misrepresentation in the insurance application. 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. 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.

According to our participants, D&O the total tower, they will craft those offers mindful of the structure of the tower so as to put pressure, say, on Level 5 carrier. . . . Any time that you offer to settle within limits of Level 3, then what you have got as your ally Levels 4, 5, and 6 who are pushing Level 3 to settle, and if Level 1 and 2 have already decided that it is into the third carrier level, that brings a lot of pressure on that third carrier.

D&O Interviews, Plaintiffs’ Counsel #4, supra note 61, at 13-14; see also D&O Interviews, Plaintiffs’ Counsel #5, supra note 58, at 23 (“[R]eally good mediators are particularly sensitive to insurance carriers and particularly sensitive and aware of putting carriers in a bad-faith posture. . . . [T]hat’s the only thing that can really create the leverage. Because otherwise, the worst that could happen to them is they pay out insurance money that . . . someone is paying a premium for.”). This is part of the stock in trade of plaintiffs’ lawyers any time that a defendant has liability insurance. See Baker, supra note 57, at 223-25 (explaining how plaintiffs’ lawyers craft settlement offers to place pressure on insurers).

One plaintiffs’ lawyer described it as follows:

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.

D&O Interviews, Plaintiffs’ Counsel #3, supra note 44, at 38-39.

See Baker & Griffith, supra note 8, at 514-16 (detailing the financial features, such as “the prospective insured’s industry and maturity, its market capitalization, volatility, and various accounting ratios,” which “enable underwriters to form an initial estimate of a prospective insured’s exposure to shareholder litigation risk” (footnotes omitted)).

See, e.g., Cutter & Buck, Inc. v. Genesis Ins. Co., 144 F. App’x 600, 601-02 (9th Cir. 2005) (holding that Genesis had a right to rescind because misrepresentations in the insurance application by its signor could be imputed to other directors and officers).
How the Merits Matter

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 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.\textsuperscript{177} As described frankly by one claims manager, “[W]hat happens is nine times out of ten . . . the larger the fraud, [the more] you are going to get a discount on your limit. You are going to cash in essentially your coverage case.”\textsuperscript{178}

The rarity of complete rescission can be explained, in part, by the adverse market impact that attends a carrier with a reputation for rescission.\textsuperscript{179} The public-company D&O insurance world is small; the buyers are well-informed and willing to pay what it takes to get the best coverage, as we explored in detail in prior work.\textsuperscript{180} Not only would individual insureds hesitate to work with such a carrier, but so too would insurance brokers, leading to a more drastic 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.\textsuperscript{181} Thus, it is not easy, from a business perspective, for insurers to pursue a misrepresentation defense all the way through to rescission.

\textsuperscript{177} See, e.g., D&O Interviews, Claims Head \#3, supra note 127, at 42-43.

\textsuperscript{178} Id.

\textsuperscript{179} See D&O Interviews, Claims Head \#5, supra note 136, at 69 ("Genesis successfully rescinded Cutter & Buck. That was a huge nail in their coffin. Brokers talked about that endlessly. They pulled accounts from them and wouldn’t put new business with them.").

\textsuperscript{180} See Baker & Griffith, supra note 24, at 1828 (explaining that “[t]he cost of the premium [of D&O insurance] will be worth incurring when it is less costly to the firm than other forms of contingent financing” in the event of shareholder litigation). Moreover, almost every time insurance-company 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 prospective basis. The most recent examples are “nonrescindable” 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. Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Broker \#2, at 2 (Nov. 6, 2008) (unpublished interviews, on file with authors).

\textsuperscript{181} 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 . . . every time you raise a rescission issue, you raise a broker [liability] issue, and you know, as long as it is an intermediary-driven market, the brokers are going to help steer where the business goes.

D&O Interviews, Monitoring Counsel \#2, supra note 93, at 11.
A second potential coverage defense that has received significant attention in the academic literature—the fraud exclusion—may have less impact than has been previously reported. 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. 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.

This dynamic is well understood, and other researchers have used it to help explain why securities class actions almost always settle.

182 See John H. Mathias, et al., Directors and Officers Liability: Prevention, Insurance and Indemnification § 8.04, at 8-13 to 8-14 (release 7 2004) (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. See Mathias, et al., supra, at 8-16 (suggesting that policyholders contest such exclusions on the basis that they render the coverage illusory). Our participants confirmed that the adjudication-in-fact requirement takes most of the teeth out of the fraud exclusion. See, e.g., D&O Interviews, Claims Head #1, supra note 126, at 45-46 (noting that the fraud exclusion is “[r]aised all the time,” but “[r]arely . . . ever actually triggered” because of the adjudication-in-fact requirement). 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, supra note 24, at 1805 (reporting that insurance-market conditions would inhibit insurers’ ability to insist on the broader term, and that brokers confirm that the final-adjudication language is almost always available).

183 See Mathias et al., supra note 182, at 8-15 (noting that the application of the final-adjudication provision “drastically diminishes the force and effect of the [actual fraud] exclusion”).

184 See Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376, 398 (D. Del. 2002) (holding that a deliberate fraud exclusion should not apply to securities claims since such an exclusion would essentially eliminate coverage); Black et al., supra note 22, at 1100 (“D&O policies typically stipulate that the insurer cannot unreasonably withhold consent to a settlement that the policyholder favors.”); Mary E. McCutcheon, Directors and Officers Liability Insurance: Tensions Between Corporate and Individual Insureds, 3 INT’L J. DISCLOSURE & GOVERNANCE 148, 152 (2006) (observing that the requirement of a “final adjudication” before an exclusion can be enforced makes it difficult for insurers
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 too peripheral to the fraud to come within the scope of the exclusion. As a result, the insurer would still have to pay even if a jury were to find intentional fraud.

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

to refuse to indemnify defendants); Roberta Romano, The Shareholder Suit: Litigation Without Foundation?, 7 J.L. ECON. & ORG. 55, 57 (1991) (reporting that as long as a claim is settled, insurers cannot seek an adjudication of guilt and thereby avoid paying the claim).

185 See Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Monitoring Counsel #1, at 13 (Jan. 24, 2006) (unpublished interviews, on file with authors) [hereinafter D&O Interviews, Monitoring Counsel #1] (“There is also severability of exclusions, which means that there is always an individual for whom the exclusion won’t apply, which means that the carrier’s on the hook . . . .”).

186 Id., Interview with Plaintiffs’ Counsel #2, at 34 (May 3, 2007) [hereinafter D&O Interviews, Plaintiffs’ Counsel #2] (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 10b-5. You can’t insure against an intentional tort—the old principle’’); D&O Interviews, Plaintiffs’ Counsel #5, supra note 58, at 23 (“[W]e make sure that we don’t use words like ‘you 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 . . . .’’); D&O Interviews, Plaintiffs’ Counsel #6, supra note 59, at 22 (“Typically, why would you want to plead yourself into a coverage denial that is valuable to the case?”); see also Ellen S. Pryor, The Stories We Tell: Intentional Harm and the Quest for Insurance Funding, 75 TEX. L. REV. 1721, 1722-23 (1997) (chronicling instances of “underlitigation,” where the plaintiff chooses “to plead and prove negligence rather than or in addition to intentional tort theories when, absent insurance considerations, the plaintiff would either frame the case solely as an intentional tort claim or emphasize the intentional tort claim,” because most insurance policies exclude harm caused intentionally by the insured); cf. Baker, supra note 57, at 223-25 (reporting similar underpleading in bodily injury torts).
In summary, D&O insurers have significant control over settlement, but that control is limited by the insurance law rule regarding the duty to settle. In addition, the insurance market limits insurers’ ability to rescind policies. Finally, 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. Insurance, as we noted above, is seen as relatively easy money. In addition, 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.

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187 See, e.g., SIMMONS & RYAN, supra note 21, at 20 n.12 (noting that both the relative merits of the case and the limits of available insurance influence settlement outcomes); Alexander, supra note 3, at 502 (explaining that the fear of paying damages that far exceed policy limits leads insurers to prefer to settle rather than risk going to trial and being subject to a bad-faith claim); Black et al., supra note 22, at 1104-05 (enumerating the factors that motivate plaintiffs’ attorneys to settle within policy limits even if they believe the value of the suit to be higher than the policy limit); Romano, supra note 184, at 57 (“The plaintiff’s attorney’s calculus [points to settlement]. With a settlement, attorneys’ fees will be recovered, as defendants routinely agree not to oppose petitions for fees, and, in any event, the benefit the plaintiff has conferred on the firm will be recognized in the settlement. If a claim is litigated, however, there is some probability that the plaintiff will lose.”); D&O Interviews, Claims Head #9, supra note 14, at 20 (describing how plaintiffs are influenced by policy limits when calculating settlement demands).

188 See supra note 164 (quoting a defense counsel, monitoring counsel, and claims head to the effect that it is easier to obtain money from insurance companies than from the insured).

189 D&O Interviews, Plaintiffs’ Counsel #7, supra note 59, at 15; accord D&O Interviews, Defense Counsel #3, supra note 136, 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. . . . [I]f you talk about the company coffers, people are going to resist heavily, . . . [but] the company doesn’t care about the insurance company’s money.”).
Whether insurance money is easy money or not, it drives settlements. Indeed, one of our plaintiffs’-lawyer participants suggested that one way to avoid securities litigation was to buy very little D&O insurance.\footnote{See D&O Interviews, Plaintiffs’ Counsel #7, supra note 59, at 44-45 (“In my mind the amount of D&O coverage . . . does impact a group of cases depending upon various economic aspects of what is going on. There are a class of cases where as a practical matter, it’s going to be nearly impossible to get more than the amount of insurance coverage . . . .”).} 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,\footnote{See supra text accompanying note 22 (describing average D&O insurance limits for mid- and large-cap companies). Settlement amounts increase much more slowly than investor losses increase. A $100 million loss would result in an expected settlement of 5.1% of the loss value compared to only 1.1% for a $1 billion loss. In 2007, the median investor loss for settled cases was $310 million, compared to $407 million in 2006. With the settlement of several megacases, the average investor loss in 2007 was $1.75 billion. PLANCICH ET AL., supra note 21, at 14.} 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 early 2000s—when public-company market capitalizations increased, thereby raising potential investor losses in securities suits, 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 losses.\footnote{See Baker & Griffith, supra note 8, at 535 (postulating that the growth in market capitalization as D&O insurance remained stable has resulted in settlements that reflect the growth rate of insurance limits, rather than the real cost of liability); D&O Interviews, Monitoring Counsel #8, supra note 86, 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 the 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 . . . .”).}

Insurance, of course, is a hard limit only for insolvent defendants. Plaintiffs’ lawyers occasionally claimed to be more or less indifferent to insurance if the corporate defendant was financially strong.\footnote{See D&O Interviews, Plaintiffs’ Counsel #7, supra note 59, at 15 (“If it is a large-cap company, I don’t care what the policy is . . . .”).} Indeed, there are settlements in excess of the limits of the D&O insur-
ance, and defendants sometimes contribute to settlements that are less than the amount of the D&O insurance. 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: (1) whether the defendant paid part of the settlement; and (2) if so, whether that amount was in excess of the amount of available insurance.

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 plaintiffs’ lawyer, “it is great to [make a demand to settle within limits] because then you . . . put the insurers in a bad-faith posture potentially . . . . [T]hat really does strengthen the hand of the defendants [against the] insurers.” Defense lawyers confirmed this dynamic.

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. In the 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

194 See, e.g., Thomas O. Gorman et al., Securities Class Actions and Derivative Litigation: Issues that Keep Corporate Counsel Awake at Night, BUS. L. TODAY, Nov.–Dec. 2007, at 37 (reporting that defendants are increasingly paying part of the settlement, with WorldCom directors paying more than 40% of the total settlement); Janet McFarland, The Soaring Cost of a Boardroom Safety Net, GLOBE AND MAIL (Can.), Feb. 23, 2006, at B12 (reporting that directors in the WorldCom and Enron cases paid part of the settlement out of their own pockets).

195 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 Choi, supra note 9, at 1494 n.142 (citing literature treating low-value settlements as nuisance settlements).

196 D&O Interviews, Plaintiffs’ Counsel #6, supra note 59, at 10; see also D&O Interviews, Plaintiffs’ Counsel #2, supra note 186, at 19; D&O Interviews, Plaintiffs’ Counsel #8, supra note 70, at 38-39.

197 See D&O Interviews, Defense Counsel #3, supra note 136, at 35 (“[I]f 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’ . . . .”).
me a hard time you know and this is all an off-the-record conversation, etc., etc., but if you want 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.\footnote{D&O Interviews, Plaintiffs' Counsel #7, supra note 59, at 22.}

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.\footnote{Consider the following anecdote, described by an insurer’s monitoring counsel:}

In this regard, a sophisticated plaintiffs'-style-damages analysis that includes careful consideration of loss causation may be a tool used by defense attorneys against their clients’ insurers. As candidly described by one defense counsel, “[S]ometimes you want to use [plaintiffs'-style damages] to scare the insurance company [to] pony up more jack.”\footnote{One claims head described the scenario in the following exchange:}

\begin{quote}
A. You know, asserting that the failure to consent to the settlement has been made in bad faith is something which is, you know, an occurrence that people are used to in this arena.

Q. It is part of the dance.

A. Well, I wouldn’t call it a dance, because at that point is kind of a—it’s more wrestling than a dance.
\end{quote}

\footnote{D&O Interviews, Claims Head #2, supra note 79, at 33-34; see also D&O Interviews, Defense Counsel #1, supra note 44, at 36 (“I think that [the concern about bad faith] probably has a lot to do with [how they conduct] business . . . . You know, it’s interesting, when I’m talking to coverage counsel, I always use little terms to remind them [about bad faith]. I said, ‘Well your client would like to do this.’ . . . Because they know that if their reputation gets out, the only way they pay for all of these is by underwriting more insurance.”); D&O Interviews, Monitoring Counsel #7, supra note 118, at 31 (“[S]ome [defense counsel] are not afraid to use the term ‘bad faith.’”).}
And, indeed, insurance carriers confirmed that defense lawyers use such tactics on them.\textsuperscript{202}

The phenomenon of defense lawyers and plaintiffs’ lawyers cooperating to place pressure on liability insurers is hardly unique to securities class actions. Indeed, it is a well-recognized feature of personal injury litigation.\textsuperscript{203} 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.\textsuperscript{204} By contrast, D&O insurers do not choose the defense lawyers or control the defense.\textsuperscript{205} Instead, D&O insurers pay the defense costs of the securities defense lawyer that the policy-
holder selects, subject only to the dollar limits of the policy and the requirement that defense costs be reasonable.\footnote{206}

In sum, limits serve to anchor settlement amounts. 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 theoretically testable, provided that researchers can gain access to reliable information about the limits of D&O insurance programs.

2. Layers

The question of limits is fundamentally the question of what amount of insurance is available. But as our participants emphasized, “[i]t’s not just amount of insurance, it’s amount and structure.”\footnote{207} 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 insurance 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.

\footnote{206}{Baker & Griffith, \textit{supra} note 24, at 1814. The two leading D&O insurance carriers maintain lists of “panel counsel” that policyholders generally must use in defending 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 the insurance company’s case-management and billing guidelines. \textit{Id.} at 1817-19.}

\footnote{207}{D&O Interviews, Defense Counsel #2, \textit{supra} note 102, at 1.}
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.

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. Except in a megacase 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. As a result, excess layers are unlikely to be interested or involved in the early stages of a typical case.208

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. In a D&O insurance policy, unlike a typical automobile or general-liability policy, the defense costs count against the limit of the policy. Well before their limits actually are exhausted, these carriers know that they are, in our participants’ words, “toast.”209 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 that 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.”210

208 See id. (“[R]emember who drives the case. The case is driven by the primary carrier. It’s very rare that the excess carriers are engaged.”). But see D&O Interviews, Monitoring Counsel #3, supra note 112, at 70-71 (reporting that in recent years insurers higher in the coverage tower have begun participating in conference calls earlier in the case).
209 D&O Interviews, Defense Counsel #2, supra note 102, at 1.
210 Id. at 2. The same participant, a defense lawyer, prided himself on his willingness to settle early if early settlement suited the particular claim. In such cases, how-
Of course, this dynamic is subject to the risk of bad-faith liability. However, 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.\textsuperscript{211} One mediator described the push for settlement as follows:

\begin{quote}
[O]ften times [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 carrier 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 settlement. If you don’t settle for two 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 . . . and that is why those insurers at the top became 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.\textsuperscript{212}
\end{quote}

In that dynamic, the primary carrier’s deeper knowledge of the details of the 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 it 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 ever, he reported that he often received resistance from insurers who frequently insisted on continuing the procedural fight notwithstanding his advice. \textit{Id.}

\textsuperscript{211} See D\&O Roundtable, \textit{supra} note 57, at 52 (quoting a defense counsel as saying that “often what you find is that defense counsel is aligned with an excess layer to try to put pressure on a lower layer that won’t exhaust or won’t basically open up the coffers”).

\textsuperscript{212} D\&O Interviews, Mediator \#2, \textit{supra} note 123, at 16.
of claims. In general, however, they do not do so. The exception to this general rule may arise when two companies within the same corporate group act as both primary insurer and 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 participants confirmed that in such cases primary carriers frequently are amenable to early settlement.

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 layers. 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. Carriers higher in the tower, eager

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213 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: “[C]arriers [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.” D&O Interviews, Claims Head #9, supra note 14, at 38.

214 As one participant recounted,

> I remember one instance where there was a carrier who does a lot of primary who happened to be excess in a particular case and was being asked to just throw in $100,000. And the notion was basically to pressure the primary to collapse, because if the first layer of excess is throwing in a little bit on top, then the implication is that the primary should be exhausted . . . . The response from the claims lawyer for that usually primary and now sitting first layer excess was, “No, I don’t need authority for just $100,000. I need authority for this case to settle at $5.1 million, and in order to determine that that’s a reasonable settlement.”

Id. at 28.

215 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 the next procedural stage. See, e.g., D&O Interviews, Plaintiffs’ Counsel #5, supra note 58, at 21 (discussing an example where the defendant had $18.5 million in limits and the settlement demand was for $17 million, and the insurer just said, “Why don’t I just basically take a chance?”). As a prominent mediator said,

> I’ve done mediations where I simply looked at a plaintiff and said, “Look, if you really want to settle this case now, . . . 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 protect their own limits, may pressure the target carrier to accept
the discount.\footnote{216} If that carrier agrees to accept the discount, the pres-
sure is then 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.\footnote{217}

b. Firebreaks

If increasing settlement demands are like wildfires, then the layers
within an insurance tower function like firebreaks.\footnote{218} Each layer
within an insurance tower represents a new level of insurance in-
volve, a new monitoring counsel, and a new team of claims man-
gers that must approve the settlement. At the very least, this chang-
ing of the guard that accompanies the breakthrough 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 their costs.\footnote{219} But perhaps most importantly,

\[
\text{D&O Interviews, Mediator \#2, supra note 123, at 14.}
\]

\footnote{216} See, e.g., D&O Roundtable, supra note 57, at 51 (“I think the vision of the insurance carriers working together is sort of funny, because they are rooting against each other.”).

\footnote{217} See, e.g., Twin City Fire Ins. Co. v. Country Mut. Ins. Co., 23 F.3d 1175, 1181 (7th Cir. 1994) (holding the primary insurer liable to an 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).

\footnote{218} As one defense counsel stated,

\[
[\text{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. . . . 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 six months.”}]
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\footnote{219} One of the claims heads interviewed explained why carriers would be willing to incur such large defense costs:
the additional layers of process may act as a break on settlement amounts. One mediator described the process of working through layers as follows:

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. 220

Even plaintiffs’ lawyers readily acknowledged coverage layers as an additional burden, 221 although they were, in general, more likely to downplay their influence in the ultimate outcome. 222

The impact of multiple layers is not as simple as more tiers and lower settlements: Consider a hypothetical involving three compa-

[D]epending 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 rubberstamping: “Yeah, do whatever you want.”

D&O Interviews, Claims Head #6, supra note 44, at 29-24.

220 D&O Interviews, Mediator #1, supra note 142, at 32-33.

221 See, e.g., D&O Interviews, Plaintiffs’ Counsel #8, supra note 70, at 35 (“[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... probably pay less if you had fifteen single million-dollar things.”).

222 See D&O Interviews, Plaintiffs’ Counsel #3, supra note 44, at 48 (“[The structure of the tower matters] because you’ve got sort of a separate negotiation at each level. Sometimes it can work to your advantage.”); D&O Interviews, Plaintiffs’ Counsel #6, supra note 59, at 11 (noting that a layered program “makes it very difficult particularly if you have a recalcitrant level in the middle... [But] I don’t think it really saves them at the end of the day. It just makes the process less pleasant... I don’t know that it changes the outcome very much”); D&O Interviews, Plaintiffs’ Counsel #7, supra note 59, at 16 (acknowledging that the structure of the policy is a factor influencing settlement, but stating that the structure of the policy is a “smaller factor than... the damages and the risks and all that... [When] you have a case that you really think is worth $40 million, you are not going to settle for $12 million because that is the first layer”).
nies—A, B, and C—each facing a factually identical securities claim, and each with identical aggregate insurance limits. The only difference between them is the structure of their tiers. Company A has a four-tier tower consisting of a $5 million dollar primary policy, a first excess of $5 million, a second excess of $10 million, and a third excess of $20 million. Meanwhile, Company B has a 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 Company A’s multiple layers of coverage could act as firebreaks contributing to a lower overall settlement than that paid by Companies B or C. Although several of our participants acknowledged this effect of multiple layers on settlement and some defense lawyers may even recommend adoption of such a structure for strategic reasons, 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. 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.

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223 See Boris Feldman, The Veil of Tiers: Shareholder Lawsuits and Strategic Insurance Layers, RISK MGMT., Apr. 1997, at 77, 86, available at http://www.borisfeldman.com/Veil_of_Tiers.htm (last visited Jan. 15, 2009) (offering a similar example, noting that Company A’s structure of layers “would provide strong, natural firebreaks at $5 million and $10 million,” and concluding that “[i]t’s a safe bet that the identical claim against [Company A] would settle for less with that structure” than it would have if it had the structure of either Company B or Company C).

224 Some participants provided a similar numerical example that contrasted companies with different tiered structures. See, e.g., D&O Interviews, Mediator #2, supra note 123, at 15 (“[E]ven if the case is a $20 million 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.”).

225 See, e.g., Feldman, supra note 223, at 84, 86, 88 (recommending strategic tiering at the outset in order to induce favorable settlements in the event of litigation).

226 See Baker & Griffith, supra note 8, at 504 (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).

227 For a thoughtful treatment of the impact that the structure of excess insurance programs can have in the asbestos mass-settlement context, see Michelle J. White, Why the Asbestos Genie Won’t Stay in the Bankruptcy Bottle, 70 U. CIN. L. REV. 1319, 1334-36 (2002), observing that carriers in low layers have no incentive to take an aggressive approach to weeding out no-injury claims when it is clear that the damages incurred in the serious injury claims will exceed the carriers’ limits.
C. Other Incentives: Defendants and Counsel

No discussion of the effects of insurance would be complete if it left out the basic incentives of the other participants—the corporate defendant, the defense attorney, and the plaintiffs’ lawyer—leading up to settlement. As described by our participants, defendants typically favor settlement for reasons related to other business exigencies. By contrast, insurers typically resist settlement to boost their investment income, while defense attorneys delay settlement, at least to some degree, so that they can maximize billable hours on the case. Plaintiffs’ lawyers have the same incentive as defense attorneys under the lodestar approach to attorneys’-fees calculations, subject to cash-flow pressures attributable to the fact that plaintiffs’ lawyers do not get paid until settlement.

The business exigencies of a corporate defendant may lead the defendant to press its 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, a change of CEO, a change in accounting, or a 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 régime, and a new auditing firm may want to close the books on old liabilities. Our participants confirmed that a range of such motivations are often the driving force ultimately bringing the corporation to the table. For example,

228 D&O Interviews, Plaintiffs’ Counsel #5, supra note 58, at 11-12. Or, as described by a mediator,

[There are many different kinds of pressure points. They can range from . . . the defendant issuer or company want[ing] to make an acquisition or divestiture, . . . [to the fact that] if the litigation is material enough, . . . the litigation itself has to be disclosed and 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 set-
Or again,

it 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 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.”

Such business exigencies, it would seem, tend to lead to higher settlements. As corporate defendants move to settle the litigation sooner rather than later, they also pressure insurers to get it over with. In the event that the insurers resist, defendants agree to fund a larger portion of the settlement themselves in order to get the deal done. 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.

The urge to settle among corporate defendants—which our participants suggested is nearly universal once the plaintiffs’ claim survives the motion to dismiss, even in the absence of business exigencies favoring settlement—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.

Most of our participants confirmed this dynamic. “Insurance carriers’ profitability is driven by two things,” one defense lawyer pointed out: “[T]heir payout ratio and what [they are] 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.” On this point, again, plaintiffs’ and defense lawyers see eye to eye. In the words of a prominent plaintiffs’ lawyer, “Most [insurers] will set very high reserves on these claims internally and then decide when they have to reverse them by really settling the case for less than that reserve . . . so that they can report a higher income.” Some of the insurers we interviewed, perhaps unsurprisingly, denied these suspicions:

[Y]ou 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 . . . .

Regardless of how low the investment returns may be, however, common sense suggests that, other things being equal, the longer a carrier is able to keep its reserves invested, 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 accept an earlier-than-optimal settlement by offering to contribute a larger portion of the overall settlement or by offering to pay an inflated insurance premium at the next renewal. 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.

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233 D&O Interviews, Defense Counsel #2, supra note 102, at 1.
234 D&O Interviews, Plaintiffs’ Counsel #5, supra note 58, at 20.
235 D&O Interviews, Claims Head #9, supra note 14, at 12.
Many of our participants said that the lawyers involved in the case on both sides 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 large fee under a lodestar approach. Defense lawyers are subject to similar accusations in other litigation contexts. Plaintiffs’ lawyers more typically are paid a percentage of the recovery in other contexts, so this incentive to delay may be a special feature of securities class action litigation. This incentive is one reason that commentators have investigated using an auction approach to select class representatives. While not a major focus of our research, the reports about plaintiffs’

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236 See, e.g., D&O Interviews, Monitoring Counsel #7, supra note 118, at 30 (“The defense counsel, however, and I don’t mean to be overly cynical, but you get cynical after you’ve done this stuff for a while. Defense counsel will work a case until they have decided they have earned enough money and then they will tell you it’s time to settle ...”); D&O Interviews, Defense Counsel #7, supra note 231, at 20, 26 (noting that “defense lawyers’ compensation is a function of their billable hours and they have an incentive to take these cases downstream,” and concluding that “as a defendant’s lawyer, we can litigate this all you want and I’m happy to because I can use the billings”).

237 See, e.g., Tom Baker & Sean J. Griffith, D&O Interviews, Interview with Defense Counsel #8, at 4 (July 25, 2007) (unpublished interviews, on file with authors) ("[P]laintiffs’ lawyers would love to settle a case as soon as possible in the litigation, but often they will be aware of the fact that they need to get their settlement approved by a court. ... [T]hey believe that they must do some amount of work and have some sort of a paper record in order to get the settlement approved by a court."); D&O Interviews, Monitoring Counsel #1, supra note 185, at 6 (reporting that “in jurisdictions where there is a lodestar approach to fee awards, there tend not to be early settlements, because [this] rewards the plaintiffs’ lawyers working the file—notwithstanding ... an acknowledgment on all parties that there is decent liability”).

238 See, e.g., Baker, supra note 204, at 110-11 (reporting on lawyers’ incentives and potential conflicts of interest); Herbert M. Kritzer, The Commodification of Insurance Defense Practice, 59 Vand. L. Rev. 2053, 2064 (2006) ("[F]or open-file billing, there is an incentive to keep a file open at least until costs have been covered."); Herbert M. Kritzer, Defending Torts: What Should We Know?, J. Tort L., 2007, at 7, http://www.bepress.com/jtl/vol1/iss3/art3/ (last visited Jan. 15, 2009) (observing that there is a “common perception among plaintiffs lawyers ... that ... settlement is not likely until the defense counsel has had the chance to ‘run the meter’ for a while to build up a fee,” but noting that this has not been carefully studied and that there are countervailing incentives).

239 See, e.g., Lucian Arye Bebchuk, The Questionable Case for Using Auctions to Select Lead Counsel, 80 Wash. U. L.Q 889 (2002) (analyzing drawbacks to using auctions to select class counsel, including minimizing the percentage of recovery paid to plaintiffs’ counsel); Jill E. Fisch, Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction, 102 Colum. L. Rev. 650 (2002) (scrutinizing the claimed benefits of lead-counsel auctions); Andrew K. Niebler, In Search of Bargained-For Fees for Class Action Plaintiffs’ Lawyers: The Promise and Pitfalls of Auctioning the Position of Lead Counsel, 54 Bus. Law. 763 (1999) (suggesting improvements to the auction system designed to modify quality and cost incentives faced by counsel).
lawyers’ incentive to delay support the auction idea. Other “business exigencies” on the plaintiffs’-counsel side include whether the firm has other cases in the pipeline and, if so, cash-flow demands related to those other cases.240

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 very little adjudication beyond the initial motion to dismiss. Securities class actions almost never reach trial, and dispositive summary judgment rulings are nearly as rare.241 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 authoritative guidance.242 In the absence of such 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 such 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.243 This means that the 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.244 But the denial of a motion to dismiss indicates only that

240 See D&O Roundtable, supra note 57, at 45 (“[D]o you need to fund the engine while you are waiting for the huge pot of money?”).
241 See Choi et al., supra note 78 (noting that since the passage of the PSLRA, 100% of securities class actions have been either dismissed or settled).
242 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.
243 See supra Part I.B.3 (discussing the roles of the motion to dismiss and the motion for summary judgment).
244 Depending upon the circuit, class certification may involve some consideration of the claim’s underlying merits and may be seen as a dispositive ruling. See supra notes 73-77 and accompanying text. The only other dispositive ruling that 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.
the plaintiffs have fit their allegations into a recognized legal theory. The decision on the 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.\textsuperscript{245} It is not the same, in other words, as final adjudication on the merits of the claim.

Third, settlements are funded largely, and often entirely, by D&O insurance. This means that, in most cases, insurance companies are the real interested parties. Since their primary interest lies in minimizing payouts throughout most of the claims process, they are involved in contesting the plaintiffs’ claim.\textsuperscript{246} As a result, it is customary to treat insurers as though they are 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. At this point the insurer, to some extent, steps out of the shoes of the defendant and steps into the shoes of the fact finder and decides whether the settlement outcome adopted by the plaintiffs and defendants fairly represents the discounted present value of the claim.\textsuperscript{247} 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’ lawyers report that they are careful not to plead facts giving rise to a coverage defense—for example, facts indicating intentional fraud—and that they shape their settlement offers to create pressure on the insurance tower. They also describe settlement meetings where the defense counsel essentially scripted the plaintiffs’ arguments in order to induce the insurers to settle. Likewise, insurers describe how defendants change their char-

\textsuperscript{245} Cf. Choi, supra note 9, at 1472-73 (arguing that the stay of discovery until after the motion to dismiss may chill the filing of some meritorious claims).

\textsuperscript{246} See supra text accompanying notes 155-156.

\textsuperscript{247} Often, we found, the calculation performed by any one insurer at this point is, more simply, whether the discounted present value of the claim exceeds the limits of that insurer’s policy. If so, that settlement control is passed to the next layer of insurance within the tower, which then becomes the working layer. See, e.g., D&O Interviews, Monitoring Counsel #6, supra note 97, at 12-13 (“The old timers in the industry really can’t believe that this is happening, but it is happening more and more . . . [and] there’s no chance that they are going to say anything because the ad damnum is so big and the defense costs are going to say goodbye . . . [They are just going to] turn to the next up and say ‘I’m done. I’m about to roll. You want to take over? What do you want to do?’ So you politely leave it to the next carrier.”).
acterization of a claim—from defensible to more-or-less indefensible and, therefore, worthy of settlement. Defense lawyers confirm that they adjust their characterization of the facts regarding liability and damages in order to keep insurers moving toward settlement. All of these tactics are designed to move the insurer.

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. Therefore the insurer will look to the only objective information that exists regarding the appropriateness of the settlement offer: other settlements. 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, and are at a further remove from decisions by judges or juries on the merits.

Fifth, the practice among insurers of “cashing out,” or dropping potential coverage defenses, in exchange for greater contributions to settlement from the defendant corporations has interesting implications for the relationship between deterrence and insurance. For one thing, it allows us to infer that the more a corporation contributes to a within-limits settlement, the more likely there is to be actual fraud underlying the plaintiffs claim (of course taking into account alternative reasons for a within-limits payment such as deductibles, coinsurance and the presence or absence of an insolvent insurer in the D&O program). Although above-limits settlements themselves may be suggestive of meritorious claims, the inference to be drawn from defendant contributions may be strongest when the case settles within the total limits of the D&O policy. Within-limits settlement suggests that cashing out the insurers’ coverage defense, and not the sheer size of the investor loss, would explain the defendant’s contribution to the settlement. Because the insurers’ ability to extract a contribution from the corporate defendant turns on the quality of the coverage defense, which itself often turns on bad acts by the defendants, the more the

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248 “Objective” is used here to describe information not fed to the insurer by plaintiffs’ or defense counsel.

249 The presence of business reasons to settle quickly could be an alternative explanation for a within-limits contribution by the defendant. A measure of the time between filing of suit and settlement would be one, admittedly crude, way to control for that variable.
defendant corporation contributes to a within-limits settlement, the more likely it is to have engaged in fraud. Defendant contribution to within-limits settlements thus provides another, potentially measurable, proxy for merit, which could be tested if only the quantitative data on settlement structure and funding were available.

In summary, as expected, we cannot draw a strong conclusion about whether the merits do or do not matter. Our participants reported that they do pay attention to “merits,” variously understood, but they also reported that nonmerit factors contribute significantly to settlement. For example, our participants’ focus on “sex appeal” in settlement discussions supports the claim that litigants pay some attention to merit-related factors. But sex appeal is, at best, a loose proxy for merits and, like all proxies, both over- and underinclusive; at worst, sex appeal is a kind of smear campaign, focusing on sensational facts that distort reality and induce defendants to settle in order to avoid further embarrassment.250

Although we must remain agnostic on the question of just how much the merits ultimately matter, our research does have implications for how to make the merits matter more. The sections that follow outline these implications.

A. More Adjudication

Perhaps the most obvious problem in deciding whether securities class actions are meritorious is the fact that such claims are almost never decided by a judge or jury; cases typically settle. In one sense, of course, this is a success of the civil justice system; judicial resources are spared and compromises are reached that, to some degree, accommodate both sides. As we have seen, however, there is so little adjudication in the securities law context that parties seeking to settle a claim are guided not by adjudicated cases, but rather by other settlements. The settlements being used as points of reference, of course, faced the same lack of adjudicative guidance and were themselves the product of reference to other settlements, so that ultimately, to para-

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250 Moreover, once the defendants reach 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 the merits matter, we understand them to be taking the narrow perspective that focuses on the elements of liability. They are asking the basic question of whether or not there was fraud.
phrase the classic formulation of the problem of infinite regress, “it’s settlements all the way down.”

Decisions on a motion to dismiss do, of course, constitute adjudication, and those decisions determine whether or not a case will settle. For this reason, we cannot—and do not—contend that there is no adjudication. Rather, we simply observe that there is little or no adjudication beyond the motion to dismiss and, as a result, the parties have little guidance concerning the merits of their claims in the settlement process. With more adjudication—particularly through trials—the weight of basic facts in establishing liability would become a matter of precedent and the likelihood of success on the merits with regard to a variety of basic fact patterns would be known. Of equal importance, the details of competing damages models would be tested by neutral arbitrers, leading to a body of precedent in which certain approaches to damages would be rejected. With greater guidance on the weight of basic facts and the credibility of various approaches to measuring damages, it would be possible to create more reliable models of both the probability of success and the likely cost of damages. The world of securities litigation, in other words, could begin to resemble the model of civil litigation propounded by legal academics.

Nevertheless, how one achieves the goal of more adjudication is, to say the least, problematic. An attempt to achieve this goal through a rule barring settlement of securities claims would likely have nega-

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251 “It’s turtles all the way down” is a classic formulation of the problem of infinite regress, the essential problem created by basing settlement upon settlement without a solid foundation of adjudicated fact. Stephen Hawking refers to the problem in aparable about a scientist giving a lecture on the nature and origin of the galaxy:

At the end of the lecture, a little old lady at the back of the room got up and said: “What you have told us is rubbish. The world is really a flat plate supported on the back of a giant tortoise.” The scientist gave a superior smile before replying, “What is the tortoise standing on?” “You’re very clever, young man, very clever,” said the old lady. “But it’s turtles all the way down!”

STEPHEN W. HAWKING, A BRIEF HISTORY OF TIME 1 (1988). Justice Scalia offers another version of the story:

[A]n Eastern guru affirms that the earth is supported on the back of a tiger. When asked what supports the tiger, he says it stands upon an elephant; and when asked what supports the elephant he says it is a giant turtle. When asked, finally, what supports the giant turtle, he is briefly taken aback, but quickly replies “Ah, after that it is turtles all the way down.”


252 See supra text accompanying note 106.
tive consequences. For any pair of litigants, the costs of going to trial will almost certainly be greater than the benefits of additional adjudication (otherwise, there would be no need to require them to adjudicate). Moreover, if the goal of forcing more adjudication is to better guide parties through settlement, prohibiting settlement entirely would have the paradoxical effect of destroying the benefit of more adjudication. What we need, it seems, is a rule that creates some additional adjudication, not one that requires every case to be decided by summary judgment or trial.

What rule could create more adjudication without requiring every case to go to summary judgment and, if necessary, trial? Imagine a lottery system that prohibited five or ten percent of all securities class actions from settling after surviving the motion to dismiss. These

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253 Rosenberg and Shavell have proposed a new rule giving defendants the option to “have courts declare that settlement agreements will not be enforced” as a way of preventing nuisance suits in class actions. See David Rosenberg & Steven Shavell, A Solution to the Problem of Nuisance Suits: The Option to Have the Court Bar Settlement, 26 INT’L REV. L. & ECON. 42, 42 (2006). While innovative and promising, this new rule is not intended to promote additional adjudication, but rather to reduce the number of nuisance claims.

254 This is a collective action problem: all litigants would prefer to negotiate settlement in an environment of more adjudication, but no litigants want to be forced to adjudicate their dispute. The social benefit requires great individual sacrifice by some. All individuals would prefer to free-ride, with the result that the social benefit of more adjudication does not arise. See generally MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION (1971) (describing the free-rider problem).

255 Kozel and Rosenberg have proposed a rule that would bar settlement before summary judgment. See Randy J. Kozel & David Rosenberg, Solving the Nuisance-Value Settlement Problem: Mandatory Summary Judgment, 90 VA. L. REV. 1849, 1860 (2004). This rule would produce more adjudication and, for the reasons that they provide, it would be a superior way to weed out nuisance claims over precertification merits review. Nevertheless, our intuition is that this rule will be rejected as too expensive and too restrictive. See, e.g., John Bronstein, Against Summary Judgment, 75 GEO. WASH. L. REV. 522 (2007) (suggesting that summary judgment is expensive and that our civil justice system would function better without such a requirement).

256 The lottery system responds to the collective action problem by changing the effective ex ante bargain among all prospective litigants. Now, when filing a claim, all litigants should do so understanding that there is a 5% or 10% chance (whatever level is chosen by the lottery system) that their claim will be chosen for adjudication rather than settlement. They should therefore factor the cost of adjudication, discounted by the probability of not being selected in the lottery, into the value of their claim when they file. In this way, viewed from an ex ante perspective, the lottery system distributes the cost of extra adjudication across all claims even though it is ultimately borne by only a few. See, e.g., NEIL DUXBURY, RANDOM JUSTICE: ON LOTTERIES AND LEGAL DECISION-MAKING 145 (1999) (“[T]he use of randomizing techniques in legal contexts may have positive effects on people’s incentives and might also, on occasions, turn out to be cost-efficient and (more controversially) just.”).
cases could only be resolved through adjudication—either summary judgment or trial—or by the voluntary dismissal of a case with no payment from the defendants. We can imagine a wide variety of objections to such a lottery. But perhaps the most damning is that the number of securities class actions is too small for us to be confident that subjecting a small random sample of cases to the no-settlement rule would lead to adjudication that would answer the most pressing open questions. Many claims subjected to the rule would almost certainly be dropped by the plaintiffs’ law firms for the simple reason that having to pursue a claim all the way through to adjudication (as opposed to settlement) may well make the claim a negative-net-present-value investment, and their firms’ resources may be best deployed on other claims that have not been selected for adjudication.

With many of the claims selected for adjudication thus abandoned, the lottery rule may fail to produce much in the way of useful law. More basically, because settlement is, quite sensibly, a favored outcome of civil litigation, it is highly unlikely that policymakers would seriously
consider a rule that forced the parties to litigate through to adjudication, even in a small sample of cases. We are therefore not hopeful that a rule can be designed that will require more adjudication. Nevertheless, we are hopeful that two reforms that we have previously advocated could increase the information value of settlements and, perhaps, increase adjudication.

B. More Disclosure

In the area of securities law especially, disclosure rules are a common alternative to mandatory rules. We have advocated additional disclosure concerning D&O insurance before. Griffith has argued for mandatory disclosure of D&O insurance policies’ details—including a corporate insured’s total limits, structure of coverage, and total policy premium—as a proxy for corporate governance risk. And both of us have argued that without such disclosure, the deterrence value of shareholder litigation may well be lost. Here we advance a similar argument, advocating mandatory disclosure of (1) the amount and structure of a corporation’s insurance coverage, and (2) information on how settlement and defense costs are funded.

Current regulations require virtually no disclosure regarding D&O insurance. Corporations may disclose that they have purchased D&O insurance, but they are not required to disclose any details about their coverage. In seeking to make settlements more de-
pensive on merit, we believe that corporations should be made to disclose their limits and the structure of coverage.

Currently, settlement amounts are matters of public record. And indeed, we discovered that industry sources track individual settlements in securities litigation and also aggregate these settlements to discern trends in settlement.265 Publicly disclosed settlement data, however, currently lack systematic information on how individual settlements are funded. Perhaps most importantly, we do not know what percentage of any given settlement is funded by insurance versus funded by the corporation itself. We also do not know what additional amounts, beyond the total settlement, were spent in defense of the claim.

Combining insurance data with settlement and defense data would create a number of useful comparisons and would improve our ability to assess the impact of the merits on settlement values. Comparing settlement amounts to the limits and program structure would be useful both to evaluate the impact of insurance on settlement values in general, and to develop a sophisticated understanding of the meaning of individual settlements.267 If, as we suspect, both insurance limits and insurance-program structure shape settlements, then indi-


266 See CORNERSTONE RESEARCH, supra note 38 (aggregating securities class action case filings); see also FOSTER ET AL., supra note 72, at 1 (analyzing trends and predicting that settlement sizes might not increase in the near future).

267 For example, all other things being equal, a $150 million settlement paid by the insurers of a defendant with a $100 million D&O program represents a stronger case for the plaintiffs than a $150 million settlement paid by the insurers of a defendant with a $200 million D&O program. At the lower end of the settlement range, we suspect that, all other things being equal, a $5 million settlement that is funded by the $4 million left in the primary policy after paying defense costs plus $1 million from the first layer excess carrier is a weaker case for plaintiffs than a $5 million dollar settlement funded entirely by a primary carrier that sold a $10 million policy. In addition, a settlement amount within limits that is nevertheless partially funded by the company itself may suggest more merit-related elements in the claim—for example, grounds for a potential rescission threat that caused the defendant corporation to contribute its own resources to fund settlement.
How the Merits Matter

Individual settlements could be better interpreted if the limits and structure were disclosed.

Disclosure of this information is vital if securities litigation is to have a deterrent effect. The disclosure of this information would enable market participants to draw conclusions about the likelihood that defendants had engaged in bad acts. With the current opacity of settlement data, it is common to encounter the view in the market that securities lawsuits typically lack merit and are simply the product of greedy plaintiffs' lawyers. If better information about settlement was available, capital-market participants could develop a more nuanced view regarding which securities claims are likely to be meritorious and, more importantly, which corporations are likely to have engaged in bad acts. Those that have engaged in bad acts may find their share prices facing a deeper discount and thus corporations may become susceptible to takeover offers or other market constraints.

Disclosure, in other words, is a necessary prerequisite to allowing the market to carry the deterrence signal of corporate and securities litigation. Because the cost of litigation is funded by insurance, the strength of this signal is severely diminished. Without a market mechanism to deliver the signal, it may be lost altogether. Without

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268 See Jenny Anderson, Lawyer Leaving Firm to Focus on Inquiry, N.Y. TIMES, Aug. 29, 2007, at C2 (“Critics [of Milberg Weiss] contended that many of the lawsuits were frivolous, raising the cost of doing business and delivering little or nothing to aggrieved parties.”); Julie Creswell, One Route Seems Closed, So Lawyers Try Different Lawsuit in Stock-Option Scandal, N.Y. TIMES, Sept. 5, 2006, at C4 (“Many derivative lawsuits are nothing more than efforts by attorneys who are motivated by the desire to generate fees.”) (internal quotation marks omitted) (quoting a defense lawyer from Sullivan & Cromwell)); Julie Creswell, U.S. Indictment for Big Law Firm in Class Actions, N.Y. TIMES, May 19, 2006, at A1 (“Its lucrative business made Millberg Weiss a target for political critics who saw the firm as a symbol of a national litigation industry that had gone out of control. These critics said that many of the firm’s lawsuits against corporations were frivolous, raising the cost of doing business.”); Timothy L. O’Brien & Jonathan D. Glater, Robin Hoods or Legal Hoods? The Government Takes Aim at a Class-Action Powerhouse, N.Y. TIMES, July 17, 2005, § 3, at 1 (“To critics, the lawyers [at Milberg Weiss] embody what they say is amiss with modern class action suits: shifty and belligerent legal tactics, excessive paydays for lawyers and repeated blackmailing of straight-arrow corporations.”); Patty Waldmeir, Supreme Court Curbs Actions Against Companies, FIN. TIMES (U.S. & Can. ed.), June 22, 2007, at 13 (reporting that corporate America hopes that the recent Tellabs decision will reduce frivolous, lawyer-driven litigation).

269 Wrongdoers may, for example, be unable to obtain debt or equity financing on the same terms. On the ability of markets and other nonlegal norms to sanction corporate actors, see Edward B. Rock & Michael L. Wachter, Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation, 149 U. PA. L. REV. 1619, 1645 (2001), concluding that “[w]hen markets are sufficiently competitive, a firm with suboptimal [nonlegal rules and standards] will be driven out of business.”
disclosure, in other words, corporate and securities litigation will not deter. And, if policymakers are unwilling to adopt the disclosure mechanism, they might as well abolish corporate and securities litigation altogether since, without deterrence, it is essentially a waste.

C. Less Entity-Level D&O Insurance

In prior work, we questioned the value of entity-level D&O insurance protection for shareholders, based on our finding that D&O insurance is pure risk-spreading insurance that does not provide monitoring services to the corporations and therefore creates moral hazard.270 The cloud that D&O insurance casts on the role of the merits in the settlement of securities class actions provides yet another reason to question the value of entity-level protection. According to our participants, the amount and structure of the corporate defendant’s D&O insurance affects the settlement value of securities class actions in the ways that we described in Part III.B of this Article, thereby reducing the impact of the merits on the settlement amounts.

Eliminating the entity-level protection would mean that the corporate defendant’s assets would be at stake in every securities class action settlement, increasing the corporation’s incentive to contest the amount of the settlement from the ground up and eliminating the ability of the corporation to cooperate with the plaintiffs to obtain a fully insured settlement. Eliminating entity-level coverage would result in what is referred to in the industry as “pure Side A coverage,” which pays only when a corporation is unable to indemnify its officers and directors—either because the corporation is insolvent or the corporation’s bylaws or applicable law prohibit indemnification of the directors or officers. As we explained, corporations generally are legally permitted, and typically required by their bylaws, to indemnify their officers and directors for the amounts paid to settle securities class actions. As a result, a solvent corporation with only a pure Side A policy would fully fund a securities class action settlement involving its directors and officers. If nothing else, that would give the corporation a greater stake in contesting the merits, and, at least with solvent corpo-

270 Baker & Griffith, supra note 24, at 1841. Our term “entity-level coverage” includes both the Side C coverage that is referred to in the industry as “entity coverage” and Side B coverage. Side B coverage indemnifies the corporation for the corporation’s obligation to indemnify its officers and directors. Side C coverage indemnifies the corporation for its own liability in securities actions. Both Side C and Side B coverage protect corporate assets, not the assets of the individual directors and officers. Thus, both raise the corporate-insurance issues that we analyzed in prior work.
rations, it would eliminate the complicated effect that D&O insurance has on the role of the merits in settlement negotiations.

CONCLUSION

This Article is the culmination of our research on the relationship between D&O insurance and corporate governance. Looking back on the project as a whole, we must ultimately arrive at a fairly pessimistic conclusion about the ability of liability rules to deter bad corporate conduct. Agreeing with most scholars that securities class actions do not effectively serve the objective of compensating investors for loss, our work provides reason to doubt that securities class actions serve a meaningful deterrence objective.

Although some factors influencing the settlement of securities class actions are arguably merit related—such as the “sex appeal” of the facts supporting the liability elements—settlement also depends on factors that clearly are not merit related—such as insurance policy structure and limits, as well as the business exigencies of the corporate defendant and the incentives of the lawyers. Moreover, in the absence of adjudication beyond the motion to dismiss, parties settling securities class actions have no guide apart from other settlements, which are opaque and subject to the same set of nonmeritorious distortions.

Joining the insights of this Article to our prior research, the distorting effect of D&O insurance becomes clear. Not only does insurance cloud the question of merit, but insurance also significantly reduces the deterrent effect of securities litigation, quite simply, by paying for it. Insurers do seek to price their product to risk, but, as we explained in the first Article of the trilogy, the mere fact of buying insurance at a marginally higher price, without disclosure of the price paid, is not likely to deter corporate actors. Because, as we explored in the second Article, insurers do very little to monitor the behavior of their corporate insureds during the life of the policy, the deterrence payoff must come, if at all, in settlement. However, as we have argued here, insurance introduces distortions into the settlement process that insurers are largely unable (or unwilling) to cure. As a result, private

\[271\] See, e.g., Coffee, supra note 25, at 1536.

\[272\] Baker & Griffith, supra note 8, at 533-37 (discussing various mechanisms that make liability fees fall evenly on good and bad firms, undermining deterrence effects).

\[273\] Baker & Griffith, supra note 24, at 1807-13 (summarizing empirical data about insurers’ failure to provide loss-prevention services).
securities litigation, at least as the system is currently administered, is unlikely to deter bad corporate actors.

Disclosure, we have repeatedly argued, would be an important step in improving the situation. Capital-market participants could promote deterrence, but in order to do so they need to know the details of insurance pricing, insurance programs, and securities settlements. Because securities litigation thus fails to deter without such disclosures, it behooves the SEC—the agency charged with promulgating both liability rules and disclosure rules—to either amend its disclosure rules to introduce these additional requirements (and thereby reinvigorate the deterrence function of securities litigation) or, failing that, to eliminate the wastefulness of the current system of liability rules.

274 See generally Baker & Griffith, supra note 8, at 536-37 (“[A] corporation’s D&O premium, if disclosed, would reveal valuable information . . . to capital market participants.”); Griffith, supra note 8, at 1203-07 (“The law should be changed to require disclosure of more details concerning a company’s D&O policies.”).