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Disaggregated Classes

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DISAGGREGATED CLASSES

Benjamin P. Edwards†

ABSTRACT

Federal efforts to reform federal securities class actions now reverberate in state courts and in individual actions. This article explores emerging consequences driven by national litigation trends and the Securities Litigation Uniform Standards Act (SLUSA). I argue that a new dynamic, class disaggregation, has begun to occur. Individual investors may be following institutional investors into state courts in search of better litigation outcomes. Given these developments, I argue that Congress should consider further reforms to level the field and ensure that private parties resolve disputes involving national market securities under consistent standards.

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INTRODUCTION

CONGRESSIONAL inaction and inattention may eventually allow private securities class action litigation to unravel as increasing numbers of plaintiffs opt out of federal class actions in favor of individual actions. Although prior waves of reform have sought to federalize securities fraud class action litigation,¹ the reforms left the door open for plaintiffs bringing individual actions to utilize state law and escape federal procedural constraints. Plaintiffs considering whether to remain within a federal class action or to exit the class in favor of an individual action may elect to pursue state law claims in state courts or federal law claims in federal court. The option to exit to state law and state court may soon draw increasing numbers of opt-out actions seeking to take advantage of friendlier procedures, expansive substantive law, and larger payouts. Despite these strong incentives, federal limitations continue to shape how plaintiffs may opt out.

¹ Earlier waves of reform have sought to address so-called strike suits and forum flight. See Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 293 (1998).

This article is the first to examine critically two new unintended consequences of securities litigation reform and their implications. First, the federal scheme for securities class action litigation has effectively banished many individual state law claims from federal court. This reality, in connection with a well-documented trend toward institutional investors opting out of federal class actions to pursue higher-value individual claims in state court,² has led to the second new and unexplored dynamic: plaintiffs' attorneys have begun to aggregate lower-value individual claims outside of federal class actions, using a technique I call class disaggregation. I define disaggregated classes as collections of dispersed but coordinated state court actions alleging largely duplicative claims that would be precluded by federal law if consolidated into a single action.

While non-class aggregation has been occurring for some time in a variety of contexts, few scholars have addressed the topic.³ This article focuses on non-class aggregation in the securities fraud litigation context and how the rise of these disaggregated classes challenges the current regulatory structure for securities litigation.

These new developments result from past reform efforts. Many plaintiffs' lawyers evaded the federal court procedural restrictions imposed by the Private Securities Litigation Reform Act of 1995 (PSLRA)⁴ by filing securities fraud class actions in state courts. To address this forum-shifting issue, Congress enacted the Securities Litigation Uniform Standards Act of 1998 (SLUSA).⁵ "SLUSA precludes both state and federal courts from adjudicating certain class actions that are based upon state statutory or common law and that allege a misrepresentation in connection with the purchase or sale of [covered securities]."⁶ Noting that SLUSA does not ordinarily apply to individual securities fraud claims, the Supreme Court has explained that SLUSA itself does not displace state law with federal law but

² See, e.g., John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 311 (2010) (explaining that institutional investors are now opting out "on an unprecedented scale"); Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1132 (2011) (discussing trend toward opting out).

³ Elizabeth Chamblee Burch, *Procedural Justice in Nonclass Aggregation*, 44 WAKE FOREST L. REV. 1, 5 (2009) (noting that nonclass aggregation has been little discussed).

⁴ Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

⁵ Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

⁶ Jennifer J. Johnson, *Securities Class Actions in State Court*, 80 U. CIN. L. REV. 349, 349 (2011).

makes some state-law claims nonactionable through the class-action device in both federal and state courts.⁷

Aimed primarily at securities fraud class actions, SLUSA contains exceptions for disputes related to corporate governance.⁸ For instance, under the so-called “Delaware Carve-Out,” SLUSA permits state law class actions “based upon the statutory or common law of the state in which the issuer is incorporated.”⁹

To the extent SLUSA sought to increase uniformity, the statute has only partially achieved its goals. Today, increasing numbers of investors—both institutional and individual—may be using disaggregated classes to escape the federal securities laws and federal class action restrictions in favor of individual state court and state law actions, neatly sidestepping SLUSA’s ban on state law class actions and the PSLRA’s restrictions.¹⁰

Escaping the restrictions imposed by SLUSA and the PSLRA translates into large returns for certain investors, possibly at the expense of investors remaining within the federal class. Professor Coffee notes that institutional investors who opt out of securities fraud class actions to bring their own individual actions may sometimes recover significantly more than they would have as a member of the class.¹¹ In at least one case, investors who pursued individual actions may have recovered more than all of the class members combined.¹² Investors may be able to command higher settlement premiums in these state court actions because they are not subject to federal restrictions and their state law claims are more likely to survive in state court forums.¹³ If the actions are moved to federal court, the reversal of fortune can be dramatic; in many instances, SLUSA forces plaintiffs to forfeit their state law claims in federal court by operation of law.¹⁴

⁷ Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 87 (2006).

⁸ Johnson, *supra* note 6, at 357.

⁹ 15 U.S.C. §§ 78bb(f)(3)(A)(i), 77p(d)(i)(A).

¹⁰ See John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why “Exit” Works Better Than “Voice”*, 30 CARDOZO L. REV. 407, 425–31 (2008) (discussing the accelerating trend in non-class litigation).

¹¹ *Id.* at 417.

¹² *Id.* at 427–28 (discussing *Quest* class action).

¹³ For a more complete discussion of why investors receive a premium for litigating state court actions under state law, see *infra* Part II.

¹⁴ How does this happen? SLUSA expansively defines class actions. 15 U.S.C. § 78bb(f)(5)(B)(ii). Its “covered class action” definition includes any “groups of lawsuits” in the same court that are consolidated or coordinated in any way. When combined with federal consolidation procedures in multidistrict litigation, this provision allows defendants to extinguish state law claims by moving individual actions into the same court. Thus, federal transfer and consolidation motions already effectively transmute

Because federal procedural processes move these opt-out actions within SLUSA's terms, increasing numbers of plaintiffs now seek to litigate state fraud claims in state court so that their cases may not be easily combined. Large institutional investors have led the exodus, but many individual investors may soon be following them out the door. Although most individuals have historically held "negative value claims" that were too costly to litigate on an individual basis, some innovative plaintiffs' lawyers have deployed disaggregated classes to cost-effectively aggregate smaller individual claims for state court litigation.¹⁵ These disaggregated classes allow plaintiffs' lawyers to litigate claims that would otherwise be too small to litigate outside the class action device.¹⁶

These disaggregated classes are not merely a theoretical response to SLUSA's preclusion of state law class actions. They have arisen in litigation related to Enron, Worldcom, and Madoff.¹⁷ For example, in *Newby v. Enron Corp.*,¹⁸ plaintiffs' counsel used a disaggregated class to aggregate state law claims in the aftermath of Enron's collapse.¹⁹ Plaintiffs' counsel represented over 750 plaintiffs, but "artfully avoided [SLUSA] by filing lawsuits in counties across the State of Texas that are not denominated class actions and

individual securities actions into covered classes under SLUSA—resulting in the preclusion of plaintiffs' state law claims. This aggregation process regularly occurs when individual, *i.e.* non-class, securities actions appear in federal court, so SLUSA has effectively exiled many state law claims from federal court. This dynamic is discussed in greater detail in Part I.

¹⁵ Professor Coffee predicted in 2008 that this was a likely implication flowing from higher recoveries in state individual actions than in federal court class actions. Coffee, *supra* note 10, at 435–36 ("Over time, lower cost competitors will almost certainly surface within the plaintiff's bar that are willing to undertake suit for opt out claimants with much smaller losses.").

¹⁶ While disaggregated classes might also arise to evade the Class Action Fairness Act of 2005 ("CAFA"), Pub. L. No. 109-2, 119 Stat. 4 (2005) (codified in scattered sections of 28 U.S.C.), I put CAFA to the side for this article because CAFA exempts the federal securities laws from its provisions and because SLUSA has a lower threshold for its group-of-lawsuits provision. Jeffrey T. Cook, *Recrafting the Jurisdictional Framework for Private Rights of Action Under the Federal Securities Laws*, 55 AM. U. L. REV. 621, 622 (2006) (discussing CAFA's exemption of the federal securities laws).

¹⁷ See, e.g., *Newby v. Enron Corp.*, 302 F.3d 295 (5th Cir. 2002); *In re Worldcom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), 2004 WL 692746 (S.D.N.Y. Apr. 2, 2004); *In re WorldCom, Inc. Sec. Litig.*, 308 F. Supp. 2d 236, 238 (S.D.N.Y. 2004); *In re Tremont Sec. Law, State Law, & Ins. Litig.*, No. 08 Civ. 11117, 2013 WL 4730263 (S.D.N.Y. Sept. 3, 2013).

¹⁸ 302 F.3d 295.

¹⁹ *Id.* at 298.

each with fewer than 50 plaintiffs.”²⁰ In a decision affirming a district court injunction against filing additional state court actions, the Fifth Circuit described this disaggregated class:

[Plaintiffs’ counsel] has thus far filed at least seven lawsuits in state courts throughout Texas, alleging securities fraud arising out of the business failure of Enron Corporation. Each suit stated claims for fewer than fifty plaintiffs in complaints crafted to avoid the provisions of [SLUSA], which made federal court the exclusive venue for class actions alleging fraud in the sale of [national market] securities.²¹

Despite concerns about duplicative suits, the Fifth Circuit refused to “question the filing of suits tailored to avoid federal jurisdiction” in state court.²² However, this disaggregated class did not last. After Enron declared bankruptcy, defendants were able to consolidate the scattered state court cases into federal court by use of bankruptcy jurisdiction. Then, SLUSA’s group-of-lawsuits provision then required the court to dismiss all claims.²³

Proliferating individual securities actions under state law and the use of disaggregated classes raise serious concerns.²⁴ Many concerns fall into two main categories: (1) problems generated by duplicative litigation and inconsistent liability standards for national market securities; and (2) implications of the growing numbers of opt-out plaintiffs for the beleaguered securities class action.

As to the concerns about litigation costs and inconsistent liability, disaggregated classes threaten the policy choices behind the PSLRA and SLUSA. I critically examine the history of private securities litigation and show how these statutes are part of the trend toward federal control over the

²⁰ *Id.* at 302.

²¹ *Id.* at 298.

²² *Id.* at 303. The district court and the Fifth Circuit did enjoin plaintiffs’ counsel from filing additional state court suits because of his “rude refusals to afford opposing counsel the common courtesy of notice” before filing each additional duplicative suit. *Id.* at 303.

²³ *In re Enron Corp. Sec.*, 535 F.3d 325, 342 (5th Cir. 2008).

²⁴ Although writing outside of the securities area, Professor J. Maria Glover has discussed issues associated with non-removable state court actions pending alongside complex multidistrict litigation and found that “little scholarly attention has been devoted to the problem of non-removable state-court actions.” J. Maria Glover, *Mass Litigation Governance in the Post-Class Action Era: The Problems and Promise of Non-Removable State Actions in Multi-District Litigation*, 5 J. TORT L. 3, 5 (2012).

national securities markets. With both the PSLRA and SLUSA, Congress sought to increase uniformity and federal control over the market for nationally traded securities.²⁵ The statutes cannot achieve their goals if investors abandon federal class actions and the federal forum in favor of duplicative individual actions under state law. More practically, extensive pre-trial litigation and discovery in multiple forums leads to inefficient use of judicial resources and the resources of litigants.²⁶ It also increases the likelihood of inconsistent outcomes for similarly situated plaintiffs and defendants litigating in different fora.²⁷

For securities class actions, this means that plaintiffs escaping SLUSA's dragnet may siphon funds away from investors trapped within the class action.²⁸ If more sophisticated institutional investors withdraw to state courts and many individuals with larger claims follow them out the door, the plaintiffs left within the class may struggle to control their counsel because of higher agency costs in monitoring and making informed decisions.²⁹

Given these costs, the rationale seems weak for allowing opt-outs to continue pursuing state law securities fraud claims. Federal authority is best positioned to provide primary oversight of the national securities markets. As more actions move outside the federal courts and federal law, the national interest in moving toward preemption of state laws increases. Shifting more authority to the federal legal system may yield substantial benefits. I break down these benefits and explain how increased federal control aligns with optimal deterrence theory and economic theories of federalism. Reforming the current structure may also improve the conduct of securities class counsel by making it possible for class counsel to keep opt-outs within the class.

While a range of responses might be feasible, I argue that the simplest means of addressing the issue is to make opt-out actions and disaggregated classes removable to federal court. Existing consolidation procedures, combined with SLUSA's group-of-lawsuits provision, already preclude opt-out plaintiffs in federal court from litigating state law claims. Removing state

²⁵ H.R. REP. NO. 105-640, at 9-11 (1998).

²⁶ See, e.g., Glover, *supra* note 24, at 6; Coffee, *supra* note 10, at 408 ("For some time, public policy has been guided by the implicit assumption that an all-inclusive class was desirable" to minimize repetitive litigation and conserve resources.).

²⁷ The odds of inconsistency increase because, instead of having one judge decide an issue, many different judges may be forced to decide nearly identical motions.

²⁸ See Coffee, *supra* note 10, at 409 ("[T]he gains to those class members who exit the class could come at the expense of the smaller shareholders who remain in the class.").

²⁹ See *supra* note 1, at 273-79 (discussing agency cost issues).

court opt-out actions and disaggregated classes to federal court will provide much needed uniformity and a check against inconsistent outcomes.

In Part I of this Article, I critically examine the history of private securities litigation, showing the trend toward increased federal power over national market securities. In Part II, I discuss the accelerating trend toward opting out of securities class actions and the rise of the disaggregated class as a cost-effective vehicle for aggregating lower-value claims. In Part III, I argue that increasing the use of opt-out litigation in state court and under state law would not be a positive reform of securities class actions and that Congress should optimize private securities litigation by consolidating more securities litigation into federal court, effectively precluding the litigation of many state law claims.

I. THE TREND TOWARD FEDERAL OVERSIGHT

Today's securities litigation environment reflects a series of steps toward greater federal power in regulating securities sales and liabilities. This Part describes each in turn.

A. Dual Federal & State Regulation

Initially, securities litigation developed in the state law context. State laws creating liability for securities fraud, known as Blue Sky laws, appeared in the 1910s.³⁰ Prompted by concerns about “the sudden popularity of speculative securities,” Kansas passed the first Blue Sky law in 1911.³¹ Other states soon joined and passed their own laws to protect their citizens from sellers of fraudulent securities.³² In addition to requiring robust disclosures, state Blue Sky laws also often regulated the quality of the securities offered on a merit basis—giving state officials the power to examine whether the securities were substantively suitable for sale.³³

These new laws were controversial. Because securities were generally traded in interstate commerce, many people initially questioned whether the Supreme Court would permit individual states to regulate nationally traded products. In 1917, the Supreme Court put these doubts to rest and upheld

³⁰ Perino, *supra* note 1, at 279–80 (describing history of Blue Sky laws).

³¹ Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 359–60 (1991) (describing the origin of state Blue Sky laws).

³² Perino, *supra* note 1, at 280.

³³ 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.2[2], at 33 (6th ed. 2009) [hereinafter HAZEN, SECURITIES REGULATION].

state securities statutes as constitutional in *Hall v. Geiger-Jones Co.*, effectively recognizing that in the absence of federal regulation, states could validly regulate securities offerings despite any indirect burden on interstate commerce.³⁴ After *Hall*, more states passed their own Blue Sky laws, “saving investors millions of dollars that otherwise would have been lost in fraudulent securities.”³⁵ By 1933, all but one state had passed Blue Sky laws.³⁶

Still, state-by-state regulation could not effectively regulate the entire market.³⁷ Although the Supreme Court had blessed state securities regulation in *Hall*, it only approved state regulation of securities transactions occurring within state borders.³⁸ Because securities could be sold in one state and then mailed into another, states lacked effective power to regulate the national securities market.³⁹ To remedy this issue, many state securities regulators “advised Congress that a supplemental federal law was needed to stop this gap.”⁴⁰

National securities regulation in the interest of consumer protection began only in the aftermath of the Great Depression. In 1933, Congress passed the Securities Act of 1933 (the Securities Act).⁴¹ President Franklin Roosevelt celebrated the law as adding, “to the ancient rule of caveat emptor, the further doctrine, ‘Let the seller also beware.’”⁴² The law created a number of private remedies for investors purchasing securities governed by the Securities Act and has been characterized as “the first true consumer protection law.”⁴³

Notably, the Securities Act left state Blue Sky laws undisturbed and explicitly preserved state regulation of securities. As originally formulated, Section 18 of the Securities Act made clear that the new federal law did not

³⁴ *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 557 (1917) (“There is no doubt of the supremacy of the national power over interstate commerce. Its inaction, it is true, may imply prohibition of state legislation, but it may imply permission of such legislation. In other words, the burden of the legislation, if it be a burden, may be indirect and valid in the absence of the assertion of the national power.”).

³⁵ Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495, 496 (1984).

³⁶ S. REP. NO. 73-47, at 2 (1933).

³⁷ See Macey & Miller, *supra* note 31, at 388.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ Warren, *supra* note 35, at 497 (citation and internal quotation omitted).

⁴¹ The Securities Act is codified at 15 U.S.C. §§ 77a *et seq.*

⁴² H.R. REP. NO. 85, 73-5480, at 2 (1933).

⁴³ HAZEN, SECURITIES REGULATION §1.2[3], at 34.

preempt state law.⁴⁴ Section 18 fostered a dual regulatory system that protected investors and the capital markets with overlapping regulation.⁴⁵

As Congress crafted additional federal securities laws after the Depression, it continued to explicitly preserve state securities regulation. A year after passing the Securities Act, Congress passed the Securities Exchange Act of 1934 (the Exchange Act), which created the Securities and Exchange Commission (the Commission) and provided for ongoing regulation.⁴⁶ Like the Securities Act before it, the Exchange Act also included a savings clause that “was plainly intended to protect, rather than to limit, state authority.”⁴⁷

While the national securities regulatory scheme initially embraced dual state and federal regulation, extensive debates about the merits of a dual regulatory system have continued. Supporters have celebrated the dual system for successfully protecting investors and fostering the growth of the capital markets.⁴⁸ Detractors contend that the dual regulatory system raised the cost of capital by forcing financial institutions engaged in a principally national business to comply with duplicative and often complex regulation in every state in the nation as well as with the demands of their federal regulators.⁴⁹ While the proponents of dual regulation initially won the day, significant later regulation has moved to increase uniformity under federal oversight.

B. The Rise of Securities Litigation under Rule 10b-5

As federal involvement in securities regulation increased, securities litigation took on an increasingly federal character. Both public and private actors enforce federal and state securities laws through litigation or other means.⁵⁰ Public enforcers include the Commission, the Department of Justice, the Financial Industry Regulatory Authority (FINRA), and state agencies charged with securities enforcement.⁵¹ Private litigants may also

⁴⁴ 15 U.S.C. § 78bb(a)(1) (“[N]othing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person . . .”).

⁴⁵ Warren, *supra* note 35, at 497.

⁴⁶ The Exchange Act is codified at 15 U.S.C. §§ 78a, *et seq.*

⁴⁷ Leroy v. Great W. United Corp., 443 U.S. 173, 182 (1979).

⁴⁸ See Warren, *supra* note 35, at 497.

⁴⁹ *Id.* at 498–99.

⁵⁰ See generally Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173 (2010).

⁵¹ *Id.* at 2175.

bring securities claims and supplement public enforcement of the securities laws.⁵²

Both public and private enforcers rely heavily on claims under Rule 10b-5, a rule the Commission promulgated under Section 10(b) of the Exchange Act.⁵³ Today, the rule stands as a cornerstone of securities enforcement.⁵⁴ It assures the market that information provided about securities is not purposefully false or misleading and imposes liability for dishonesty. The Supreme Court described the cause of action as “a judicial oak which has grown from little more than a legislative acorn.”⁵⁵

While the Rule 10b-5 action is widely used today, Congress did not initially create a Rule 10b-5 cause of action or instruct the Commission to create a private cause of action.⁵⁶ Nearly a decade after the Exchange Act became effective, the Commission enacted Rule 10b-5 to close a loophole in its own enforcement authority.⁵⁷ Although the Commission did not intend to create a new private cause of action,⁵⁸ federal courts found an implied private right of action within it.⁵⁹ Beginning with *Kardon v. National Gypsum Co.*,⁶⁰ an “overwhelming consensus of the District Courts and Courts of Appeals”⁶¹ soon developed, leading the Supreme Court to recognize the private right of action in *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*⁶²

The elements of a private action under Rule 10b-5 for misrepresentation and omission actions are well-established, and resemble traditional common

⁵² *Id.*

⁵³ 17 C.F.R. § 240.10b-5 (2009) (prohibiting, inter alia, the making of “any untrue statement of a material fact . . . in connection with the purchase or sale of any security”).

⁵⁴ For a more thorough review of rule 10b-5’s origin, see Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301 (2008).

⁵⁵ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

⁵⁶ At the outset, Section 10(b) of the Exchange Act merely gave the Commission the power to promulgate regulations banning any manipulative or deceptive devices in connection with the purchase or sale of securities. Pub. L. No. 73-291, § 10(b), 48 Stat. at 891 (codified as amended at 15 U.S.C. § 78j(b)); see also *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976) (“The section was described rightly [by a spokesman for its drafters] as a ‘catchall’ clause to enable the Commission ‘to deal with new manipulative [or cunning] devices.’”).

⁵⁷ See Rose, *Reforming Securities Litigation Reform*, *supra* note 54, at 1308.

⁵⁸ Milton Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967). See also SEC Release No. 34-3230, 7 Fed. Reg. 3804, 3804 (May 22, 1942).

⁵⁹ See Rose, *supra* note 54, at 1308.

⁶⁰ 69 F. Supp. 512, 513–14 (E.D. Pa. 1946).

⁶¹ *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 79 (2006) (internal quotation marks omitted).

⁶² 404 U.S. 6 (1971).

law fraud and deceit actions. A plaintiff must allege: “(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”⁶³

Although Rule 10b-5 claims are similar to traditional fraud and deceit actions, courts have extensively shaped Rule 10b-5. Most importantly, courts relaxed the reliance requirement in certain cases.⁶⁴ In class action litigation, the rule’s fraud-on-the-market presumption often reduces the need to prove individual reliance because of a rebuttable presumption that investors relied on the integrity of the stock’s price.⁶⁵ The fraud-on-the-market presumption depends on the theory that efficient markets incorporate all publicly available information about a stock into its price.⁶⁶ To use the presumption and dispense with reliance, plaintiffs merely need to show that the stock traded in an efficient market and that the alleged misstatements were publicly made.⁶⁷

The fraud-on-the-market presumption’s relaxed reliance requirement made many large securities class actions possible.⁶⁸ Were it not for the presumption, “[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would’ prevent such plaintiffs ‘from proceeding with a class action, since individual issues’ would ‘overwhelm[] the common ones.’”⁶⁹ After the Supreme Court recognized the fraud-on-the-market presumption, the number of possible plaintiffs and damages recoverable in private securities class actions increased dramatically.⁷⁰

⁶³ See, e.g., *Stoneridge Investment Partners, LLC v. Scientific–Atlanta, Inc.*, 552 U.S. 148, 157 (2008).

⁶⁴ Courts commonly dispense with the reliance requirement when the defendant failed to reveal information that she had a duty to disclose. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

⁶⁵ See *Basic*, 485 U.S. 224.

⁶⁶ “The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company’s stock is determined by the available material information regarding the company and its business” *Basic*, 485 U.S. at 241 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160–61 (3d Cir. 1986)).

⁶⁷ *Erica P. John Fund, Inc. v. Halliburton Co. (Halliburton I)*, 131 S. Ct. 2179, 2185 (2011).

⁶⁸ See A.C. Pritchard, *Markets As Monitors: A Proposal to Replace Class Actions with Exchanges As Securities Fraud Enforcers*, 85 VA. L. REV. 925, 948–49 (1999) (“Fraud on the market class actions became a cottage industry post-*Basic* as plaintiffs’ attorneys sought compensation for their defrauded clients and, not incidentally, potentially enormous awards of attorneys’ fees.”).

⁶⁹ *Halliburton I*, 131 S. Ct. at 2185 (quoting *Basic*, 485 U.S. at 242).

⁷⁰ Rose, *supra* note 54, at 1312.

C. Criticisms of the Securities Class Action Take Hold

With increasing federal litigation came complaints and criticism. Advocates initially defended securities class action litigation under Rule 10b-5 as consistent with the public interest for both compensating investors and deterring securities violations.⁷¹ Plaintiffs suing under it were lauded as “private attorneys general” on the belief that the litigation meaningfully advanced these interests.⁷²

Yet the narrative soon shifted and private securities litigation fell into disrepute.⁷³ Critics questioned whether private securities litigation provided meaningful compensation to investors or served a useful purpose. Many scholars argued that the typical secondary market securities class action could not be defended on compensatory grounds,⁷⁴ and especially that most compensation paid is essentially circular and wasteful.⁷⁵ Payments made by an issuer to settle a securities class action effectively transferred wealth from the issuer’s current shareholders to the class period shareholders, diminishing the value of the corporation.⁷⁶ Transferring wealth between accounts in this way is not costless; a sizeable portion of shareholder wealth is awarded to the attorneys involved. A variation of the circularity criticism also exists for well-diversified shareholders. A diversified shareholder may also own equity interests in insurance companies that provide coverage for securities fraud losses and net out gains and losses over time, less attorneys’ fees.⁷⁷

Given the compensatory rationale’s weakness, supporters of securities class action litigation argued that vigilant private enforcement actions would more effectively deter securities fraud than enforcement by the Commission

⁷¹ See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1538 (2006) (“From a policy perspective, the securities class action has two potential rationales: compensation and deterrence.”); Tamar Frankel, *Implied Rights of Action*, 67 VA. L. REV. 553, 557 (1981).

⁷² For a discussion of the term “private attorney general,” see William B. Rubenstein, *On What a “Private Attorney General” Is—And Why It Matters*, 57 VAND. L. REV. 2129 (2004).

⁷³ See, e.g., Rose, *supra* note 54, at 1315–17.

⁷⁴ *Id.* at 1301 (“An academic consensus has emerged that the typical Rule 10b-5 class action cannot be defended on compensatory grounds.”).

⁷⁵ See, e.g., Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 334 (discussing claims that the circularity problem is “socially wasteful because it merely transfers funds from one set of shareholders to another”).

⁷⁶ For a discussion of this dynamic, see David H. Webber, *The Plight of the Individual Investor in Securities Class Actions*, 106 NW. U. L. REV. 157, 168–69 (2012).

⁷⁷ *Id.* at 169.

alone.⁷⁸ Although courts had not emphasized the deterrence rationale when they implied the private right of action, it soon became the predominant justification for private securities litigation.⁷⁹

The deterrence rationale has not persuaded all. Critics of private securities fraud class actions argue that private enforcement over-deters because private plaintiffs pursue all profitable actions.⁸⁰ Unlike a private enforcer, the Commission exercises discretion to temper its enforcement.⁸¹ Thus, a purely public enforcement regime may be less likely to over-deter than an enforcement regime that relies on private enforcers.⁸²

Securities class actions also faced strong, if somewhat self-serving, criticism from corporate defendants who argued that securities class actions were deterring lawful conduct and participation in the capital markets generally. Corporate defendants made three main complaints: (1) vexatious strike suits⁸³ were extorting nuisance settlements; (2) discovery costs were unbalanced and unfair; and (3) litigation fears had led issuers to avoid making any forward-looking statements.⁸⁴ Strike suits had been a concern for some time, leading courts to shrink liability under Rule 10b-5 to address the issue.⁸⁵

⁷⁸ Rose, *supra* note 54, at 1314–15 (discussing the “revisionist justification for private Rule 10b-5 enforcement”).

⁷⁹ Professor Amanda M. Rose explains how the underlying rationale for private securities litigation shifted over the decades. *See id.* at 1310–15.

⁸⁰ Rose, *supra* note 50, at 2200–01.

⁸¹ Paul Radvany, *The SEC Adds A New Weapon: How Does the New Admission Requirement Change the Landscape?*, 15 CARDOZO J. CONFLICT RESOL. 665, 675 (2014) (describing enforcement authority and prosecutorial discretion). Similarly, the Department of Justice, which brings criminal actions, may also exercise discretion.

⁸² Of course, a purely public enforcement regime may also under-deter if it fails to enforce adequately.

⁸³ For a discussion of the “strike suit” issues, see Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2084–89 (1995).

⁸⁴ H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 730 (stating that Congress “heard evidence that abusive practices committed in private securities litigation include: (1) the routine filing of lawsuits . . . without regard to any underlying culpability of the issuer . . . ; (2) the targeting of deep pocket defendants . . . without regard to their actual culpability; [and] (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle”).

⁸⁵ *See, e.g.,* *New England Data Serv. Inc. v. Becher*, 829 F.2d 286, 288 (1st Cir. 1987) (“In the context of securities litigation, we have expressed the fear that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement, rather than in the hopes that the process will reveal relevant evidence.”). Indeed, concern about “strike suits” led the Supreme Court to limit liability under Rule 10b-5 in *Blue Chip Stamps v. Manor Drug Stores, Inc.* when it prohibited

Without questioning the underlying premise that private securities litigation provided meaningful deterrence benefits, academics, courts and lawmakers sought to channel the vexatious securities class action to more productive ends. Led by Professor John Coffee's agency cost scholarship, economic theory illuminated some of the problems with private securities litigation.⁸⁶ The discussion focused on how agency cost issues drove many of the problems.⁸⁷ While a complete discussion of agency cost dynamics is beyond my scope here, agency costs arise in all principal-agent relationships and "consist of (1) the costs of monitoring the agent, (2) the costs the agent incurs to advertise or guarantee his fidelity ('bonding' costs), and (3) the residual costs of opportunistic behavior that is not cost-efficient to prevent."⁸⁸ In the class action context, a common agency cost problem is the sweetheart settlement in which the plaintiffs' attorney increases her fee award at the cost of the plaintiffs' recovery.

Agency cost theories explained why many class action plaintiffs in the pre-PSLRA era did not closely monitor their counsel.⁸⁹ For example, a lead plaintiff with a mere \$26 in losses has little incentive to monitor her counsel closely. To sum up the extent of the problem, consider one plaintiffs' lawyer's provocative boast, "I have the greatest practice of law in the world. I have no clients."⁹⁰

Agency cost problems may also drive over-enforcement of the securities laws. Over-enforcement issues arise when the plaintiffs' counsel would litigate to secure fees and payment even though the litigation would not be in the plaintiffs' long-term interest.⁹¹ Litigation, although profitable for the plaintiffs' counsel, might work against shareholders' interests if it would make the companies sued too risk averse in the future. For example, if private

so-called "holder" claims. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739–40 (1975).

⁸⁶ For a description of Coffee's impact on the debate, see Rose, *supra* note 54, at 1317.

⁸⁷ See John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 883 (1987).

⁸⁸ *Id.*

⁸⁹ *Id.*; Pritchard, *supra* note 68, at 949 ("As a practical matter, plaintiffs' lawyers face little scrutiny of their performance on behalf of their nominal clients . . .").

⁹⁰ S. REP. NO. 104-98, at 6 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 685 (quoting William P. Barrett, *I Have No Clients*, FORBES, October 11, 1993 (quoting William Lerach)).

⁹¹ John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 681 (1986).

litigation invariably followed stock drops, companies might hesitate to take risks.

D. The PSLRA Imposes Procedural Barriers

Aiming to protect the national securities markets from “abusive and meritless suits” and to address agency cost issues, Congress passed the PSLRA in 1995 to reform private securities class actions.⁹² The PSLRA sought to improve private enforcement of Rule 10b-5 by creating a “separate subset of the Federal Rules of Civil Procedure that applies only to securities fraud cases.”⁹³ Among other changes, the PSLRA responded to defendants’ concerns by: (1) imposing the “strong inference” standard, making it much more difficult for groundless actions to survive motions to dismiss; and (2) creating a discovery stay, making it more difficult for plaintiffs to secure discovery.⁹⁴

Of course, the PSLRA’s significant alterations to the rules of civil procedure also raised the fear that otherwise meritorious actions would not be able to overcome these barriers. President Clinton initially vetoed the bill on the concern that “the pleading requirements . . . with regard to a defendant’s state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts.”⁹⁵

The legislation passed over President Clinton’s veto and its new measures significantly altered the landscape for private securities litigation, creating significant challenges for plaintiffs. As other scholars have exhaustively explored the PSLRA,⁹⁶ I only address three of the PSLRA’s key provisions here for context.

⁹² H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 730.

⁹³ Perino, *supra* note 1, at 292.

⁹⁴ For a discussion of the new provisions, see *id.* at 288–98.

⁹⁵ 141 CONG. REC. S19,034, 19,035 (daily ed. Dec. 21, 1995) (President’s message to the House of Representatives returning without approval the Private Securities Litigation Reform Act).

⁹⁶ See, e.g., John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913 (2003); Joel Seligman, *The Private Securities Reform Act of 1995*, 38 ARIZ. L. REV. 717 (1996).

1. The Strong Inference Standard

Perhaps the PSLRA's most controversial provision, the strong inference standard imposes a new pleading requirement designed to make it easier for courts to dismiss unfounded fraud allegations.⁹⁷ The standard applies to both class and individual actions and requires plaintiffs to surmount a high bar. To survive a motion to dismiss, a plaintiff's complaint must: (1) specify which statements were misleading and the reasons why each statement was misleading; (2) state "with particularity all facts on which [any pleading made upon information and] belief is formed;" and (3) "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."⁹⁸

Judicial interpretation has confirmed that this pleading standard substantially exceeds ordinary notice pleading requirements. The Supreme Court has interpreted the standard as requiring that courts "take into account plausible opposing inferences" and only deny a motion to dismiss under the PSLRA "if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."⁹⁹ Although the circuit courts continue to diverge in the ways in which they apply the strong inference standard, the PSLRA's heightened pleading standard has made it more likely that a court will grant a motion to dismiss in a securities fraud case.¹⁰⁰

The ordinary rules of civil procedure are more lenient. Rule 8(a)(2) of the Federal Rules of Civil Procedure merely obligates the plaintiff to make a "short and plain statement of the claim showing that the pleader is entitled to relief."¹⁰¹ While Rule 9(b) requires that pleadings alleging fraud provide a bit more detail, it only obligates the plaintiff to allege the circumstances of fraud with some particularity while allowing allegations of "[m]alice, intent, knowledge, and other conditions of . . . mind" to be averred generally.¹⁰²

⁹⁷ 15 U.S.C. § 78u-4(b).

⁹⁸ *Id.*

⁹⁹ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 323–24 (2007).

¹⁰⁰ Statistical analysis reveals that a higher percentage of securities fraud actions are being dismissed than before the PSLRA. For the Ninth Circuit, while the pre-PSLRA dismissal rate stood at "20.8 percent, it climbed to 34.9 percent by 2003, and in 2005, it stood at 57.1 percent. This suggests that the pleading standard matters, and likely a lot." James D. Cox et al., *Do Differences in Pleading Standards Cause Forum Shopping in Securities Class Actions?: Doctrinal and Empirical Analyses*, 2009 WIS. L. REV. 421, 442 (2009).

¹⁰¹ FED. R. CIV. P. 8(a)(2).

¹⁰² FED. R. CIV. P. 9(b).

Without the PSLRA, a plaintiff would merely need only to establish a “plausible” entitlement to relief to survive a motion to dismiss.¹⁰³

2. *The Discovery Stay*

In addition to a heightened pleading standard, the PSLRA also stays litigation discovery during the pendency of a motion to dismiss.¹⁰⁴ This means that plaintiffs cannot seek information from the defendants to support their complaints until they prevail on a motion to dismiss. By including this provision, Congress sought to reduce plaintiffs’ ability to extort settlements by saddling defendants with costly discovery obligations.¹⁰⁵

The PSLRA’s discovery stay interacts with the strong inference pleading standard to effectively choke many federal securities actions to death. As Professor Geoffrey Miller and others have recognized, the “intersection of [the PSLRA’s] rules puts a plaintiff in a vise: the pleading rules require particularized allegations and a strong inference of scienter, while the discovery stay deprives the attorney of the conventional means to develop this information.”¹⁰⁶ In short, the PSLRA makes it extraordinarily difficult for plaintiffs to obtain enough information to show that they ought to be able to survive a motion to dismiss.

3. *The Lead Plaintiff Provision*

With the “lead plaintiff” provision, Congress hoped to induce plaintiffs’ counsel to pay closer attention to their clients’ interests. In a provision designed to address agency cost issues, the PSLRA mandated that the investor or group of investors with the largest claim would become the “lead plaintiff” with the ability to select class counsel.¹⁰⁷ Assigning the largest stakeholder as the lead plaintiff appealed to reformers because they believed that having more at stake would cause the lead plaintiff to monitor class counsel more closely.¹⁰⁸

¹⁰³ See *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 556 (2007).

¹⁰⁴ 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(3)(B) (2012). One limited exception to the stay exists. Courts may permit “particularized discovery” if “necessary to preserve evidence or to prevent undue prejudice to” the moving party. 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(3)(C).

¹⁰⁵ See H.R. REP. NO. 104-369, at 32 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.A.N. 730, 731 (explaining that the discovery stay serves to “prevent unnecessary imposition of discovery costs on defendants”).

¹⁰⁶ Geoffrey P. Miller, *Pleading After Tellabs*, 2009 WIS. L. REV. 507, 530 (2009).

¹⁰⁷ 15 U.S.C. § 78u-4(a)(3).

¹⁰⁸ See Weiss & Beckerman, *supra* note 83, at 2105–06.

In the language of corporate governance, this lead plaintiff provision may be understood as seeking to maximize investors' "voice."¹⁰⁹ Much of this language comes from Harvard economist Albert O. Hirschman's seminal book *Exit, Voice, and Loyalty*.¹¹⁰ Hirschman defined voice as "any attempt at all to change, rather than to escape from, an objectionable state of affairs, whether through individual or collective petition to the management directly in charge, [or] through appeal to a higher authority with the intention of forcing a change in management."¹¹¹

Despite the high hopes for this voice provision to change the management of securities class actions, some judges have gone to "considerable lengths to nullify this power to select class counsel."¹¹² Still, some evidence indicates that the presence of institutional lead plaintiffs does lead to slightly larger settlement recoveries for the class.¹¹³ Despite this, it also appears that investors may be recovering a smaller percentage of their losses than in the pre-PSLRA era.¹¹⁴

E. The National Securities Markets Improvement Act

Continuing the trend toward expanded federal oversight and responsibility for the national securities markets, Congress adopted the National Securities Market Improvement Act of 1996 (NSMIA) and amended the Securities Act to preempt most state Blue Sky laws.¹¹⁵ At a time when significant federal powers had been devolved to state control, NSMIA

¹⁰⁹ Coffee, *supra* note 10, at 408–09.

¹¹⁰ ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* (1970).

¹¹¹ *Id.* at 30.

¹¹² John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 COLUM. L. REV. 370, 414 (2000) (discussing limited application of lead plaintiff provision).

¹¹³ See James D. Cox & Randall Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587 (2006) (finding that while settlement size has not increased, the presence of an institutional investor as a lead plaintiff increases the dollar amount of settlements).

¹¹⁴ *Id.* at 1637.

¹¹⁵ Pub. L. No. 104-290 (1996) (codified as amended at 15 U.S.C. §§ 77z-3, 78mm, 80b-3a (2012)); *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 108 (2d Cir. 2001) ("The primary purpose of NSMIA was to preempt state 'Blue Sky' laws which required issuers to register many securities with state authorities prior to marketing in the state."); H.R. REP. NO. 104-864, at 39 (1996), reprinted in 1996 U.S.C.C.A.N. 3920, 3920 [hereinafter "Conference Report"]; H.R. REP. NO. 104-622, at 16 (1996), reprinted in 1996 U.S.C.C.A.N. 3877, 3877–80.

charted a different course—toward increased federal control.¹¹⁶ In his signing statement, President Clinton praised the legislation as “the most significant overhaul of the securities regulatory structure in decades” and stated that it would “enhance capital formation and the competitiveness of the American economy by eliminating regulatory overlap between the States and the Federal Government, significantly rationalizing [and] simplifying the way mutual funds and corporate securities are regulated.”¹¹⁷

NSMIA amended the federal securities laws in significant ways and stripped states of substantial power. It amended Section 18 of the Securities Act to exempt “covered securities” from any “law rule, regulation, or order, or other administrative action of any State or any political subdivision thereof.”¹¹⁸ The statute defines covered securities broadly as, among other things, securities “listed, or authorized for listing” on national securities exchanges; securities issued by federally registered investment companies; and securities sold to qualified purchasers.¹¹⁹

Despite these broad exemptions, NSMIA also preserved certain state powers. Most notably, to ensure investor protection, it specifically preserved the rights of state securities regulators “to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.”¹²⁰

As it focused on state regulatory requirements, NSMIA did not address private rights of action. Indeed, no evidence indicates “Congress was concerned by state court jurisdiction over conventional securities fraud claims, or had any intent to preempt state statutory or common law causes of action for conventional securities fraud.”¹²¹

F. The PSLRA Triggers Forum Shifting

In a now-familiar narrative, many plaintiffs evaded the PSLRA by walking out of federal court and into state court where the PSLRA’s procedural limitations did not apply.¹²² Although relatively few securities fraud class

¹¹⁶ See Perino, *supra* note 1, at 274–77.

¹¹⁷ PRESIDENT WILLIAM J. CLINTON, STATEMENT BY PRESIDENT OF THE UNITED STATES (1996), *reprinted in* 1996 U.S.C.C.A.N. 3923.

¹¹⁸ 15 U.S.C. § 77r(a).

¹¹⁹ *Id.* § 77r(b).

¹²⁰ *Id.* § 77r(c).

¹²¹ Affidavit of Professor Donald C. Langevoort (July 18, 2001), *available at* 2001 WL 34897554.

¹²² *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001) (“[M]any class action plaintiffs avoided the stringent procedural hurdles erected by PSLRA by

actions had been filed in state court before the PSLRA, post-PSLRA a significant volume of cases simply shifted away from federal to state courts.¹²³ A few years after passing the PSLRA, Congress considered statistical analysis of securities class action filing trends authored by Professors Joseph A. Grundfest and Michael A. Perino. They found that securities class action filings had “declined by about a third in federal courts, but that there has been an almost equal increase in the level of state court activity, largely as a result of a ‘substitution effect’ whereby plaintiffs resort to state court to avoid the new, more stringent requirements of federal cases.”¹²⁴

Moving actions from federal to state court involved significant tradeoffs for plaintiffs. Suits under state law could not ordinarily benefit from the fraud-on-the-market presumption as they could with a Rule 10b-5 action. Despite this, plaintiffs opted to press similar claims under state law because they could still secure substantial damages.

By litigating in state court, plaintiffs regained many of the rights the PSLRA restricted.¹²⁵ Still, flight from the federal forum raised a number of policy concerns. The PSLRA was enacted to reduce the cost of raising capital by limiting supposedly abusive litigation.¹²⁶ The PSLRA could not achieve this goal if plaintiffs circumvented its limitations by filing class actions in state court.

bringing suit in state rather than federal court.”); *see also* Perino, *supra* note 1, at 294–95 (“This pleading standard, and some courts’ strict interpretations of it, create incentives for plaintiffs to file certain categories of cases in state court, where the higher pleading standards do not apply.”).

¹²³ *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 82 (2006) (“Rather than face the obstacles set in their path . . . , plaintiffs . . . began bringing class actions under state law, often in state court. The evidence presented to Congress . . . suggested that this phenomenon was a novel one; state-court litigation of class actions involving nationally traded securities had previously been rare.”).

¹²⁴ H.R. REP. NO. 105-640, at 10 (1998) (citing Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year’s Experience: A Statistical and Legal Analysis of Class Action Securities Fraud Litigation Under the Private Securities Litigation Reform Act of 1995* (John M. Olin Program in Law and Economics Working Paper No. 140, 1997), available at <https://www.law.stanford.edu/publications/securities-litigation-reform-the-first-years-experience-a-statistical-and-legal-analysis-of-class-action-securities>).

¹²⁵ *See* Perino, *supra* note 1, at 292–93 (explaining that the PSLRA “sets the stage for plaintiffs’ attorneys to shift some portion of their cases to state court in order to avoid” the PSLRA’s restrictions).

¹²⁶ S. REP. NO. 104-98, at 4 (1995).

G. SLUSA's Broad Preclusion & Operation

In 1998, Congress decided that the national interest in regulating the national securities markets justified precluding state law class action claims.¹²⁷ By taking state law class actions away, Congress hoped to bring securities litigation back to federal court. Aimed at promoting the uniform adjudication of securities fraud actions and destroying most state law securities fraud class actions, SLUSA precludes (1) statutorily defined class actions that: (2) assert state-law claims; (3) involve a nationally listed security; and (4) allege an untrue statement or omission of a material fact in connection with the purchase or sale of that security.¹²⁸

SLUSA's allocation of authority over class actions closely tracks the allocation of authority between state and federal securities regulation in NSMIA.¹²⁹ Both statutes seek to address securities that are "inherently national in nature" and both use the term "covered securities" to describe these national market securities.¹³⁰ Congress intended that SLUSA would "work in concert with the National Securities Markets Improvement Act of 1996 (NSMIA)" and borrowed many of SLUSA's provisions from NSMIA.¹³¹

SLUSA grants defendants tremendous power. When SLUSA applies to a state court action, defendants may either ask the state court to dismiss the action entirely as precluded by SLUSA or they may remove it to federal court and ask the federal court to dismiss the action as precluded by SLUSA.¹³² After applying SLUSA, many courts will dismiss plaintiffs' state law claims

¹²⁷ H.R. REP. NO. 105-640, at 8-9 (1998); S. REP. NO. 105-182, at 3-5 (1998).

¹²⁸ 15 U.S.C. § 78bb(f)(1). *See also* Atkinson v. Morgan Asset Mgmt., Inc., 658 F.3d 549, 552 (6th Cir. 2011); Brown v. Calamos, 664 F.3d 123, 124 (7th Cir. 2011) (Posner, J.) (summarizing SLUSA's scope). To define "covered securities," SLUSA draws from NSMIA's amendments to the Securities Act and defines "covered securities" broadly as including nationally traded securities listed or authorized for listing on specified national exchanges. 15 U.S.C. § 78bb(f)(5)(E). Notably, the broad definition of covered securities also sweeps in certain unlisted securities if the issuer has issued covered securities. *Id.* SLUSA also contains a carve-out for derivative actions, known informally as the "Delaware carve-out." This provision provides that "a private party may bring a covered class action 'based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity).'" *Madden v. Cowen & Co.*, 576 F.3d 957, 964 (9th Cir. 2009) (discussing 15 U.S.C. § 77p(d)(1)(A)).

¹²⁹ *See* Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101, 108 (2d Cir. 2001).

¹³⁰ H.R. REP. NO. 104-864, at 40 (1996) (Conf. Rep.), *reprinted in* 1996 U.S.C.C.A.N. 3920, 3921.

¹³¹ *Lander*, 251 F.3d at 108.

¹³² *Kircher v. Putnam Funds Trust*, 547 U.S. 633, 646 (2006) (explaining that state courts may also dismiss state court actions precluded by SLUSA).

with prejudice—destroying any ability to replead claims differently to escape SLUSA’s preclusive effect.¹³³

While SLUSA prohibits many state law class actions, the statute does not preempt state law and only partially nationalizes securities litigation involving national market securities. Although often misleadingly described as a general preemption statute, the Supreme Court has stated, “SLUSA does not actually pre-empt any state cause of action. It simply denies plaintiffs the right to use the class-action device to vindicate certain claims.”¹³⁴

Yet, understanding SLUSA’s extensive scope requires a close understanding of how courts interpret the phrase “in connection with the purchase or sale of covered securities.” To show the current range of federal limitations, I first discuss the “in connection with” phrase in relation to the Commission’s enforcement jurisdiction before discussing issues with indirect investments into national market securities and the Supreme Court’s recent decision in *Troice*.

1. The Scope of SLUSA’s Preclusive Effect

SLUSA’s breadth and harsh preclusion provision have generated substantial litigation.¹³⁵ One of SLUSA’s most heavily litigated issues is how broadly courts should extend SLUSA’s reach to protect the national securities markets from vexatious litigation.¹³⁶ In relevant part, the statute provides that SLUSA applies to covered class actions alleging “an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security.”¹³⁷ The statute does not define the term “in connection with,” and substantial controversy has developed over how strong a connection to national market securities must exist before courts may apply SLUSA. Judicial interpretation of SLUSA’s “in connection with” requirement

¹³³ See, e.g., *Atkinson*, 658 F.3d at 556.

¹³⁴ *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 87 (2006). In *Kircher v. Putnam Funds Trust*, the Court further explained that SLUSA’s “preclusion provision is often called a preemption provision; the Act, however, does not itself displace state law with federal law but makes some state-law claims nonactionable through the class-action device in federal as well as state court.” 547 U.S. at 636 n.1.

¹³⁵ See *In re Tyco Int’l, Ltd. Multidistrict Litig.*, 535 F. Supp. 2d 249, 265 (D.N.H. 2007) (“For holder claimants like the Blocks, who have no remedy under federal law, this is a harsh result, but the law is clear on this point.”).

¹³⁶ See Wendy Gerwick Couture, *The End of the Vexatiousness Rationale*, 41 SEC. REG. L.J. (2013). Professor Couture describes the “vexatiousness rationale” as a “policy heuristic” that operates “as a shorthand reason to limit the scope of securities fraud liability.” *Id.*

¹³⁷ 15 U.S.C. § 77p(b)(1).

also necessarily touches on the scope of the “in connection with” requirement in Section 10(b) of the Exchange Act.¹³⁸ The provisions are nearly identical—with one difference. Section 10(b) applies to conduct in connection with *all* securities transactions, while SLUSA only applies to transactions in connection with national market securities.

Adding to the complexity, the private right of action arising under Section 10(b) and Rule 10b-5 has been interpreted more narrowly than the Commission’s public enforcement jurisdiction premised on the same statute and rule. For the Commission’s enforcement purposes, the Supreme Court had interpreted the Exchange Act’s “in connection with” requirement broadly as conferring public enforcement jurisdiction so long as “the scheme to defraud and the sale of securities coincide.”¹³⁹ Yet the court has been less expansive in charting the scope of private securities litigation under Rule 10b-5. In *Blue Chip Stamps*, the Court imposed a standing requirement and barred plaintiffs from litigating so-called “holder claims” under Rule 10b-5, limiting the private right of action to plaintiffs who actually purchased or sold securities.¹⁴⁰ The Court imposed these limitations on private securities litigation because of concerns that private suits by persons who had not purchased or sold the securities at issue presented a special risk of vexatious litigation.¹⁴¹ As similar concerns were not present with public enforcement, the Supreme Court did not similarly limit the Commission’s reach.¹⁴²

The scope of SLUSA’s “in connection with” requirement first reached the Supreme Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*.¹⁴³ The case involved a class action brought by Merrill Lynch brokers claiming that Merrill Lynch had violated state law by providing its brokers with “misleading research.”¹⁴⁴ These misleading research reports purportedly caused the brokers to both mislead their clients and to continue to personally hold securities that they would have sold had they known the truth.¹⁴⁵ To avoid SLUSA and maintain the securities class action under state law, the plaintiffs amended their complaint to specifically focus on “holders” and exclude as potential class members “claimants who purchased in connection with the

¹³⁸ Cf. *IBP Inc. v. Alvarez*, 546 U.S. 21, 34 (2005) (“[I]dential words used in different parts of the same statute are . . . presumed to have the same meaning.”).

¹³⁹ *SEC v. Zandford*, 535 U.S. 813, 822 (2002).

¹⁴⁰ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754–55 (1975).

¹⁴¹ *Id.* at 740.

¹⁴² A similar limitation would also make little sense for the Commission’s enforcement jurisdiction because the Commission does not ordinarily purchase securities itself.

¹⁴³ 547 U.S. 71 (2006).

¹⁴⁴ *Id.* at 75.

¹⁴⁵ *Id.*

fraud and who therefore could meet the standing requirement” for a private Rule 10b-5 action.¹⁴⁶ After structuring their action this way, the class action plaintiffs argued that the Court should interpret SLUSA as inapplicable to state law claims not involving purchasers or sellers because they could not be litigated in a Rule 10b-5 action.¹⁴⁷

The Supreme Court rejected this strict purchaser/seller requirement and found that SLUSA precluded the action. In interpreting SLUSA’s “in connection with” requirement, the Supreme Court traced the history of the PSLRA and SLUSA. It recognized that Congress had been concerned about “abuses of the class-action vehicle in litigation involving nationally traded securities” when it enacted the PSLRA.¹⁴⁸ It also noted that Congress enacted SLUSA to limit private securities class actions in state courts because the PSLRA could not achieve its intended purposes if plaintiffs could easily avoid it by filing class actions in state courts.¹⁴⁹

Deciding on an interpretation in line with these concerns, the Court found that SLUSA’s preclusive scope extended broadly, much like the Commission’s enforcement jurisdiction. It found that SLUSA’s preclusion provision encompassed even actions where the federal private right of action did not reach, effectively extinguishing state law class action claims even when the plaintiffs lack a remedy under federal law.¹⁵⁰ It interpreted the statute’s “in connection with” requirement as satisfied so long as any “fraud alleged ‘coincide[d]’ with a securities transaction—whether by the plaintiff or by someone else.”¹⁵¹ Thus, the Supreme Court seemingly extended SLUSA’s preclusion to match the Commission’s enforcement jurisdiction—and precluded state law class action claims so long as nationally traded securities were somehow involved.

The Court’s decision to interpret SLUSA broadly may be viewed as part of the trend toward allocating regulatory power over national securities markets to the federal government. While NSMIA had preempted state registration requirements for covered securities, SLUSA followed in the same vein and precluded private state law class action liability. In deciding *Dabit*, the Court explicitly trumpeted the federal interest in regulating the national

¹⁴⁶ *Id.* at 77.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 81.

¹⁴⁹ *Id.* at 82.

¹⁵⁰ *See In re Tyco Int’l, Ltd. Multidistrict Litig.*, 535 F. Supp. 2d 249, 265 (D.N.H. 2007) (explaining that SLUSA extinguishes state law class action claims even though it denies “any remedy at all to certain classes of plaintiffs”).

¹⁵¹ *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 85 (2006).

securities markets when it emphatically stated that “[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated.”¹⁵²

2. Indirect Investments in National Market Securities

Although the Court had directed a broad interpretation of SLUSA’s “in connection with” requirement, courts began to split over whether to preclude state law claims when some of the securities at issue do not meet the statutory definition of “covered securities,” such as in cases where uncovered securities allow purchasers to invest indirectly in covered securities.¹⁵³ This issue came into focus in the fracas over whether to apply SLUSA in Bernard Madoff-related cases.

The broad outlines of Madoff’s Ponzi scheme are well-known. Madoff ran a broker-dealer and told his customers that he used a “split-strike conversion” strategy to invest their assets in nationally traded securities.¹⁵⁴ Madoff’s largest customers were so-called “feeder funds,” which provided conduits for investors to place their money with Madoff.¹⁵⁵ By buying securities issued by feeder funds, investors sought to gain exposure to Madoff’s purported purchases and sales of national market securities. Because Madoff exploited prices from national market securities and falsely claimed to be making investments in national market securities, most courts applied SLUSA.¹⁵⁶

Yet courts have split over the indirect ownership issue. For example, in *Anwar v. Fairfield Greenwich Ltd.*, the district court considered whether SLUSA applied to preclude class action claims against a fund that had invested its assets in the Madoff Ponzi scheme.¹⁵⁷ While Madoff had falsely represented that he traded covered securities, the court was concerned that the interests sold by the funds were not themselves covered securities and not closely related enough to “whatever phantom securities Madoff purported to be

¹⁵² *Id.* at 78.

¹⁵³ *See, e.g.*, *Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC*, 750 F. Supp. 2d 450, 453 (S.D.N.Y. 2010) (finding SLUSA inapplicable to claims involving the non-covered securities of a fund which invested its assets in covered securities).

¹⁵⁴ *Barron v. Igolnikov*, No. 09 Civ. 4471(TPG), 2010 WL 882890, at *1 (S.D.N.Y. Mar. 10, 2010) (stating Ponzi scheme’s “well-known” facts).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at *5.

¹⁵⁷ 728 F. Supp. 2d 372, 398–400 (S.D.N.Y. 2010).

purchasing.”¹⁵⁸ Ruling that stretching SLUSA to encompass these claims would snap “even the most flexible rubber band,” it declined to preclude the plaintiffs’ state law claims.¹⁵⁹ Still, most courts applied the “in connection with” requirement more broadly and precluded state law class action claims if plaintiffs attempted to purchase covered securities either directly or indirectly.¹⁶⁰

Despite unanimously extolling the national interest in overseeing the securities markets in *Dabit*, the Supreme Court later split over SLUSA’s reach in *Chadbourne & Parke LLP v. Troice*.¹⁶¹ The case involved Allen Stanford’s Ponzi scheme.¹⁶² Stanford sold high interest certificates of deposit (CDs) supposedly backed by lucrative assets, purportedly including covered securities.¹⁶³ A bank chartered in Antigua issued the CDs that were not covered securities.¹⁶⁴ The defendants attempted to link these bogus CDs to national market securities by pointing out that Stanford had claimed to purchase covered securities with the monies raised through selling the CDs.¹⁶⁵

In an opinion authored by Justice Breyer, the majority focused on the attenuated connection to nationally traded securities. Finding the relationship to national market securities too remote because the plaintiffs were not attempting to purchase any direct or indirect interest in nationally traded securities, the Court attempted to draw a line. It held that a “fraudulent misrepresentation or omission is not made ‘in connection with’ such a ‘purchase or sale of a covered security’ unless it is material to a decision by one or more individuals (other than the fraudster) to buy or to sell a ‘covered security.’”¹⁶⁶

The Court’s delicate language here warrants further scrutiny. The Court did not say that the plaintiff had to buy covered securities.¹⁶⁷ Alternatively phrased, the decision states that SLUSA precludes state law class action

¹⁵⁸ *Id.* at 398.

¹⁵⁹ *Id.* at 399.

¹⁶⁰ *See, e.g., In re Herald*, 730 F.3d 112, 119 (2d Cir. 2013).

¹⁶¹ *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014).

¹⁶² *Id.* at 1059.

¹⁶³ *Id.* at 1064.

¹⁶⁴ *Id.* at 1068.

¹⁶⁵ *Id.* at 1065.

¹⁶⁶ *Id.* at 1066.

¹⁶⁷ Ann M. Lipton, *The Troice Cases—Questions Answered and Unanswered*, BUS. L. PROF BLOG (Mar. 1, 2014), http://lawprofessors.typepad.com/business_law/2014/03/the-troice-cases-questions-answered-and-unanswered.html.

claims whenever the misrepresentation or omission affects *someone other than the fraudster's* decision to attempt to buy or sell a covered security.¹⁶⁸

What this means about the necessary connection to national market securities remains unclear.¹⁶⁹ Because the Court left *Dabit's* holding untouched, it cannot be read as limiting SLUSA preclusion to instances where the “*plaintiff-victim* of the scheme . . . decide[d] whether to buy or sell based on the misrepresentation.”¹⁷⁰ In *Dabit*, which the Court reaffirmed, the broker plaintiffs had explicitly disavowed any claim premised on their purchases or sales of securities.¹⁷¹ They sought damages for business lost because of misleading research reports. Although the brokers were upset about lost business, the misrepresentations at issue had affected decisions about trading national market securities, thus falling within SLUSA's preclusive scope.

The Court's rationale in *Troice* may guide SLUSA's application when a misrepresentation or omission will sufficiently relate to the buying or selling of national market securities. The Court insisted that the relevant misrepresentation's or omission's connection to national market securities must be “a connection that matters.”¹⁷² Expounding on this phrase, the Court broadly defined connections that matter as “where the misrepresentation makes a significant difference to *someone's decision to purchase or to sell a covered security*, not to purchase or to sell an uncovered security, something about which the Act expresses no concern.”¹⁷³

Extending SLUSA preclusion to any misrepresentations or omissions affecting transactions in national market securities seemingly also precludes many state law class action claims involving uncovered securities. Consider, for example, the facts in *U.S. Mortgage, Inc. v. Saxton*.¹⁷⁴ There, the plaintiffs had relied on the defendant's false public securities filings when making loans to the defendant.¹⁷⁵ The plaintiffs extended ordinary loans after reviewing information about the business, including information contained in the defendant's public securities filings. The plaintiffs alleged that they would not have made the loans had the defendant's securities filing disclosed its “true financial condition.”¹⁷⁶ Even though the loans were not covered securities,

¹⁶⁸ Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058, 1066 (2014).

¹⁶⁹ See Lipton, *supra* note 167.

¹⁷⁰ *Id.*

¹⁷¹ Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71, 76, 103 (2006).

¹⁷² *Troice*, 134 S. Ct. at 1066.

¹⁷³ *Id.* (emphasis added).

¹⁷⁴ 494 F.3d 833, 836–39 (9th Cir. 2007).

¹⁷⁵ *Id.* at 837.

¹⁷⁶ *Id.* at 839.

the Ninth Circuit barred the plaintiffs' state law class action claims because "the alleged harm stems from misrepresentations in [the defendant's] public filings and public statements [and because t]hese misrepresentations undoubtedly 'coincide' with the purchase or sale of . . . 'covered securities' under SLUSA."¹⁷⁷

This interpretation aligns with the Court's *Troice* decision.¹⁷⁸ The misrepresentations and omissions about the defendant's financial condition affected decisions to buy or sell national market securities as well as the loans made by the plaintiffs.¹⁷⁹ As the misrepresentations affected decisions of persons other than the fraudster, i.e. the fraudster's shareholders, the Ninth Circuit's decision appears to be good law, even though the victims of the defendant's misrepresentation were not attempting to purchase national market securities.

Yet what about misrepresentations about uncovered securities supposedly backed by national market securities? The Court seemingly held the door open for SLUSA to preclude most indirect claims touching on the national securities markets when it emphasized that prior cases had met the nexus requirement when victims of a misrepresentation or omission attempted to buy or sell "an ownership interest in [relevant] financial instruments."¹⁸⁰ As the dissent pointed out, "[b]y using the term ownership interest instead of ownership," the Court apparently accepted "that indirect ownership . . . suffic[es] in certain circumstances."¹⁸¹ Thus, misrepresentations or omissions inducing an investor to attempt to take an indirect ownership position in national market securities by purchasing uncovered securities would seemingly meet the requirement.

Where does the law on indirect ownership stand now? As discussed above, Madoff proves a clear example of indirect investment into a fraud involving representations about national market securities. Most courts considering the issue before *Troice* found that SLUSA precluded state law claims because Madoff claimed to be purchasing and selling covered securities.¹⁸² After *Troice*, that conclusion appears unchanged. In a recent

¹⁷⁷ *Id.* at 845.

¹⁷⁸ *See* Lipton, *supra* note 167.

¹⁷⁹ *Saxton*, 494 F.3d 833 (9th Cir. 2007).

¹⁸⁰ *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058, 1066 (2014).

¹⁸¹ *Id.* at 1080 (Kennedy, J., dissenting).

¹⁸² *See, e.g., In re Herald, Primeo & Thema Sec. Litig.*, No. 09 Civ. 289(RMB), 2011 WL 5928952, at *5–9 (S.D.N.Y. Nov. 29, 2011); *In re Merkin*, 817 F. Supp. 2d 346, 359–61 (S.D.N.Y. 2011); *In re J.P. Jeanneret Assoc's., Inc.*, 769 F. Supp. 2d 340, 378–79 (S.D.N.Y. 2011); *Wolf Living Trust v. FM Mutli-Strategy Inv. Fund, L.P.*, No. 09 Civ. 1540(LBS),

decision, the Second Circuit applied SLUSA preclusion, finding that “a plaintiff in *Troice* was entirely distinguishable from ‘a victim who took, *tried to take*, or maintained an ownership position in the statutorily relevant securities through ‘purchases’ or ‘sales’ induced by the fraud.”¹⁸³ In contrast, the plaintiffs in *Troice* “were not seeking, directly or indirectly, to purchase covered securities”; rather, they sought to purchase certificates of deposit that did not give them an indirect ownership interest in covered securities.¹⁸⁴ The Court’s language in *Troice* buttresses this conclusion, as it emphasized that the Bank promised that it “would use the victims’ money to buy *for itself* shares of covered securities.”¹⁸⁵

Noting the need to balance power between state and federal securities regulation in *Troice*, the Court also expressed concern about overly limiting state authority.¹⁸⁶ It claimed that a broader interpretation “would interfere with state efforts to provide remedies for victims of ordinary state-law frauds.”¹⁸⁷ By way of example, it argued that interpreting SLUSA any more broadly would potentially “prohibit, a lawsuit brought by creditors of a small business that falsely represented it was creditworthy, in part because it owns or intends to own exchange-traded stock.”¹⁸⁸

In contrast, the dissent, authored by Justice Kennedy and joined by Justice Alito, focused on the need to protect federal control over regulating the national securities markets.¹⁸⁹ Justice Kennedy worried that the Court’s narrower interpretation would “undermine the primacy of federal law in policing abuses in the securities markets.”¹⁹⁰ Approaching the issue from a national policy perspective, Justice Kennedy contended that “state-law litigation will drive up legal costs for market participants and the secondary actors, such as lawyers, accountants, brokers, and advisers, who seek to rely

2010 WL 4457322, at *3 (S.D.N.Y. Nov. 2, 2010); *Newman v. Family Mgmt. Corp.*, 748 F. Supp. 2d 299, 311–13 (S.D.N.Y. 2010); *In re Beacon Assoc.’s Litig.*, 745 F. Supp. 2d 386, 429–31 (S.D.N.Y. 2010); *Barron v. Igolnikov*, No. 09 Civ. 4471(TPG), 2010 WL 882890, at *3–5 (S.D.N.Y. Mar. 10, 2010).

¹⁸³ *In re Herald*, 753 F.3d 110, 113 (2d Cir. 2014) (quoting *Troice*, 134 S. Ct. at 1067).

¹⁸⁴ *Id.*

¹⁸⁵ *Troice*, 134 S. Ct. at 1071.

¹⁸⁶ *Id.* at 1060.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.* at 1068.

¹⁸⁹ *See id.* at 1073.

¹⁹⁰ *Id.* at 1074.

on the stability that results from a national securities market regulated by federal law.”¹⁹¹

The dispute between the majority and the dissent in *Troice* may be understood as the latest round in the long-running controversy over the proper allocation of authority over securities liability between state and federal law. While the majority endeavored to preserve state law liability for claims not directly involving national market securities, the dissent sought to encompass more disputes as involving national securities.¹⁹²

H. SLUSA Precludes Most State Law Claims in Federal Court

Although the Supreme Court has repeatedly interpreted SLUSA’s “in connection with” provision, the practical operation of its class action definition provision has not received as much attention.¹⁹³ The definition extends broadly and includes a “group of lawsuits” provision that allows courts to combine individual suits into class actions.¹⁹⁴ Because SLUSA preclusion extends to actions falling within this “group of lawsuits” provision, its interpretation takes on critical importance.

Under today’s dominant interpretation, plaintiffs’ counsel must be increasingly wary of SLUSA’s group of lawsuits provision and, by extension, federal court. The provision effectively banishes many state law claims from federal court because it requires courts to reclassify individual actions—based on the facts alleged in *other* actions—as class actions. Whenever this happens, individual plaintiffs find that they may not assert favorable state law claims.

1. The Group of Lawsuits Provision

SLUSA’s definition of covered class actions sweeps broadly and includes three different ways to identify covered class actions.¹⁹⁵ The first two definitions are intuitive. First, SLUSA precludes any action under state law

¹⁹¹ *Id.*

¹⁹² The dissent also voiced concerns about how the Court’s opinion would impact the Commission’s enforcement jurisdiction under 10(b). I put this issue to the side here. *See id.*

¹⁹³ Although focused on class actions permitted under the Delaware Carve-Out, Professor Johnson has recognized that SLUSA has been applied repeatedly to individual suits proceeding in the same courts. *See* Johnson, *supra* note 6, at 354–55.

¹⁹⁴ 15 U.S.C. § 78bb(f)(5)(B)(ii).

¹⁹⁵ *Id.* § 78bb(f)(5)(B).

where the plaintiff characterizes her own complaint as a class action.¹⁹⁶ Second, SLUSA also takes effect whenever “damages are sought on behalf of more than 50 persons.”¹⁹⁷

SLUSA’s third covered class action definition extends more broadly to encompass certain groups of lawsuits coordinated or consolidated in the same court.¹⁹⁸ The Eleventh Circuit articulated four elements for SLUSA’s “group of lawsuits” provision: “(1) a ‘group of lawsuits filed in or pending in the same court;’ (2) ‘common questions of law or fact;’ (3) ‘damages are sought on behalf of more than 50 persons;’ and (4) ‘the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.’”¹⁹⁹ When these elements are met, courts will generally classify the lawsuits as part of a “covered class action” under SLUSA.²⁰⁰

2. The Group of Lawsuits Provision in Federal Court

This “group of lawsuits” provision already prevents the litigation of many individual state law claims in federal courts. Significant securities controversies often spawn sprawling individual and class action litigation in both state and federal courts.²⁰¹ Once a sufficient number of related cases enter the federal pipeline, SLUSA flushes them out of court. This happens because federal court procedures allow defendants to combine individual actions together in ways that place them within SLUSA’s group of lawsuits provision.²⁰²

Quite possibly, Congress did not intend to preclude all individual claims within the federal court system.²⁰³ Instead, Congress likely overlooked how

¹⁹⁶ *Id.* § 78bb(f)(5)(B)(i)(II).

¹⁹⁷ *Id.* § 78bb(f)(5)(B)(i)(I).

¹⁹⁸ *Id.* § 78bb(f)(5)(B)(ii).

¹⁹⁹ *Instituto de Prevision Militar v. Merrill Lynch*, 546 F.3d 1340, 1346 (11th Cir. 2008) (quoting 15 U.S.C.A. § 78bb(f)(5)(B)(ii)) (concluding “that this case is part of a ‘group of lawsuits’ covered by SLUSA”).

²⁰⁰ *Id.*

²⁰¹ *See, e.g., In re Residential Capital, LLC*, No. 12-12020, 2013 WL 3286198, at *9 (Bankr. S.D.N.Y. June 27, 2013) (“Many purchasers of [residential mortgage backed securities] have brought claims in state and federal courts against Credit Suisse and Ally Securities, among other underwriters, claiming violations of federal and state securities laws and common-law causes of action.”).

²⁰² As explained in detail below, SLUSA’s group-of-lawsuits provision includes individual actions forcibly consolidated with a class action. *See, e.g., In re Citigroup Inc. Sec. Litig.*, No. 11 Civ. 3827 (SHS), 2013 WL 6569875 (S.D.N.Y. Dec. 13, 2013).

²⁰³ Simply preempting all individual securities fraud claims would have been substantially simpler.

courts would implement SLUSA's provisions, extending its long history of incoherent lawmaking in this area.²⁰⁴

Although possibly unintended, a massive shift in the balance of state and federal power has already occurred. Despite this quiet shift to increased limitations on individual state law claims, the sky has not fallen. Further extending it to many state law claims within state courts seems likely to generate more benefits than harms.

In the two different factual scenarios described below, SLUSA already effectively nationalizes many individual state law securities fraud claims, shifting regulatory power over these securities disputes from dual state and federal oversight toward federal enforcement. These outcomes exist in tension with the Supreme Court's declaration in *Dabit* that SLUSA "does not deny any individual plaintiff, or indeed any group of fewer than 50 plaintiffs, the right to enforce any state-law cause of action that may exist."²⁰⁵

I. The MDL Process Nationalizes State Law Claims in Federal Court

For securities suits in federal court, SLUSA's limited preclusion frequently expands into full preemption through the multi-district litigation (MDL) process.²⁰⁶ The MDL process provides a mechanism for defendants to transfer civil actions involving similar legal and factual issues to a single court (the MDL Court) for consolidated or coordinated pretrial proceedings.²⁰⁷ Overseeing this process, the Judicial Panel on Multidistrict

²⁰⁴ Thomas Lee Hazen, *Allocation of Jurisdiction Between the State and Federal Courts for Private Remedies Under the Federal Securities Laws*, 60 N.C. L. REV. 707, 709 (1982) (discussing inconsistent jurisdictional provisions and noting that the discrepancies may have resulted from "unfortunate legislative apathy or inattention"); Jeffrey T. Cook, *Recrafting the Jurisdictional Framework for Private Rights of Action Under the Federal Securities Laws*, 55 AM. U. L. REV. 621, 625 (2006) ("Given the obvious shortcomings of SLUSA, however, this exemption begs the question: what exactly does Congress intend its jurisdictional 'framework' for securities claims to be?"). As Professor Amanda Rose has observed, "[The current environment] is more the product of historical happenstance than coherent design choices." Rose, *supra* note 50, at 2175.

²⁰⁵ *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 87 (2006); *but see In re Enron Corp. Sec.*, 535 F.3d 325, 336 (5th Cir. 2008) (applying SLUSA preclusion despite argument that "federal courts will be able to manufacture SLUSA preemption by issuing consolidation orders").

²⁰⁶ *In re BP Sec., Derivative & Emp't Ret. Income Sec. Act (ERISA) Litig.*, 734 F. Supp. 2d 1380, 1383 (J.P.M.L. 2010) ("We have frequently included securities and ERISA actions in one MDL docket."). For a discussion of issues associated with multi-district litigation in both state and federal courts, see Glover, *supra* note 24. As Professor Glover's Article succinctly summarizes the MDL process, I track her explanation below.

²⁰⁷ 28 U.S.C. § 1407(a).

Litigation (JPML), a panel of federal judges, evaluates whether transfer will serve “the convenience of parties and witnesses and will promote the just and efficient conduct of such actions and will promote the just and efficient conduct of such actions.”²⁰⁸ The JPML may transfer any federal court action to the MDL Court on its own initiative or at the motion of any party.²⁰⁹ The JPML has the power to transfer the entire action or to “separate any claim, cross-claim, counter-claim, or third-party claim and remand any of such claims” to the originating federal court.²¹⁰ After completing pre-trial proceedings, the MDL Court must, unless the parties agree otherwise, return the action to the originating court for trial.²¹¹ In practice, however, few cases return to the originating court because the pretrial proceedings in the MDL Court usually result in a settlement.²¹²

The federal MDL process stretches SLUSA’s state law class action claim preclusion to apply to individual state law claims by rearranging actions so that they fall within SLUSA’s “group of lawsuits” provision.²¹³ Courts interpreting SLUSA’s “group of lawsuits” provision have repeatedly recognized individual securities actions consolidated through the MDL process as covered class actions, even though the plaintiff had never intended to file a class action or coordinate the action with other actions.²¹⁴

²⁰⁸ *Id.*

²⁰⁹ *Id.* § 1407(c).

²¹⁰ *Id.* § 1407(a).

²¹¹ *Id.*; see also *Lexecon Inc. v. Milberg Weiss Bershad Hynes & Lerach*, 523 U.S. 26, 40 (1998) (holding that the plain reading of 28 U.S.C. § 1407 prohibited transferee courts from using 28 U.S.C. § 1404 to avoid transferring MDL cases back to their original courts).

²¹² *E.g.*, Howard M. Erichson & Benjamin Zipursky, *Consent Versus Closure*, 96 CORNELL L. REV. 265, 270 (2011) (MDL “creates the perfect conditions for an aggregate settlement”); Deborah Hensler, *Has the Fat Lady Sung? The Future of Mass Toxic Torts*, 26 REV. LITIG. 883, 893 (2007) (“[A]lthough formally intended only to streamline the pretrial process, multi-districting usually leads to some sort of aggregative disposition.”); Deborah R. Hensler, *The Role of Multi-Districting in Mass Tort Litigation: An Empirical Investigation*, 31 SETON HALL L. REV. 883, 894 (2001); Glover, *supra* note 24, at 8 (“[R]emand [usually] never occurs because consolidation in the MDL serves to facilitate a global settlement.”).

²¹³ See *In re Regions Morgan Keegan Sec., Derivative, & ERISA Litig.*, No. 08-2757, 2011 WL 2517060, at *5 (W.D. Tenn. June 23, 2011) (“Consolidated cases are considered covered class actions under SLUSA.”).

²¹⁴ Reviewing cases within the Southern District of New York, where SLUSA’s group-of-lawsuits provision had been applied, the court in *Markey v. Citigroup, Inc.*, 09 MD 2070 SHS, 2013 WL 6728102, at *5 (S.D.N.Y. Dec. 20, 2013) cited a string of cases:

See, e.g., *Amorosa v. Ernst & Young LLP (Amorosa II)*, 682 F. Supp. 2d 351, 373–77 (S.D.N.Y. 2010) (“[T]his Court holds that an action need not have been formally joined or consolidated with other actions in order to be a ‘covered class action’ and subject to SLUSA’s preemption provision.”); *Amorosa v.*

An example illuminates this Rube Goldberg process. Consider the facts in *Odom v. Morgan Stanley Smith Barney, LLC*.²¹⁵ Morgan Stanley had employed Wesley Odom “as a financial adviser in its Pensacola, Florida office from 1992 to 2009.”²¹⁶ During that time, Odom accumulated a substantial amount of Morgan Stanley’s equity securities. He continued to hold his stock through a period when Morgan Stanley allegedly misrepresented its exposure to residential mortgage backed securities.²¹⁷ The market later reacted negatively to news about Morgan Stanley’s mortgage-backed securities holdings and Odom lost his job.

Odom’s case began its journey to class action status as an individual action in state court. Seeking to recover his losses, Odom filed suit in Florida state court against his former employer, alleging, among other things, that Morgan Stanley’s misrepresentations about its exposure to mortgage-backed securities caused him to hold securities he would have otherwise sold. Odom filed his complaint in a local state court, including both state and federal law claims. Morgan Stanley removed his case to federal court, permitting the JPML to transfer it to the Southern District of New York to join pending multidistrict litigation. Once in New York, the MDL Court found that

Ernst & Young LLP (*Amorosa I*), 672 F. Supp. 2d 493, 517 (S.D.N.Y. 2009), *aff’d sub nom*, *Amorosa v. AOL Time Warner Inc.*, 409 F. App’x 412 (2d Cir. 2011); *In re Adelpia Commc’ns Corp. Sec. & Derivative Litig.*, 03 MDL 1529 (LMM), 2010 WL 3528872 (S.D.N.Y. Aug. 30, 2010) (“The present action is one of more than 50 actions pending in this district as a multidistrict litigation in which damages are sought for more than 50 people. It is plainly a covered class action which cannot be maintained in this or any state court.”); *In re AOL Time Warner, Inc. Sec. Litig.*, 503 F. Supp. 2d 666, 671–72 (S.D.N.Y. 2007) (“[T]he ‘individual actions,’ once aggregated per SLUSA’s instructions, are a ‘covered class action’ for purpose of SLUSA and are properly subject to the Act’s limitations on mass actions.”); *Gordon Partners v. Blumenthal*, No. 02 Civ. 7377(LAK), 2007 WL 1438753, at *3 (S.D.N.Y. May 16, 2007), *aff’d*, 293 F. App’x 815 (2d Cir. 2008) (adopting Report and Recommendation in *Gordon Partners v. Blumenthal*, No. 02 Civ. 7377(LAK)(AJP), 2007 WL 431864 (S.D.N.Y. Feb. 9, 2007)); *In re WorldCom, Inc. Sec. Litig.*, 308 F. Supp. 2d 236, 245–47 (S.D.N.Y. 2004) (ten suits, several of which alleged only individual claims, were proceeding as a single action when their complaints were virtually identical and they were consolidated for pretrial purposes in the same court). *Cf. In re Refco Inc. Sec. Litig.*, 859 F. Supp. 2d 644, 649 (S.D.N.Y. 2012) (observing that an “MDL proceeding coordinates discovery and other pretrial proceedings, and the actions in it are accordingly proceeding as a single action for numerous purposes”).

²¹⁵ *In re Citigroup Inc. Sec. Litig.*, 987 F. Supp. 2d 377, 380–83 (S.D.N.Y. 2013).

²¹⁶ *Id.* at 380.

²¹⁷ *Id.* at 380–82.

SLUSA precluded Odom's state law claims even though Odom never sought to file a class action and never took any purposeful step toward consolidation with the MDL Court.²¹⁸

The MDL Court did not take into account whether the plaintiff intended to pursue individual state law claims.²¹⁹ It simply applied SLUSA's "group of lawsuits" provision because the statute does not include any requirement that an MDL Court consider "any of these factors."²²⁰

It remains unclear whether Congress intended this result. To be sure, simply precluding the litigation of many state law securities fraud claims in federal court would have been simpler and more efficient. At the least, Senators Sarbanes, Bryan, and Johnson foresaw a variation on the problem. In registering their opposition to SLUSA, they criticized SLUSA's definition of class actions as "too broad" because it might "include State court actions brought by separate individual investors, or by groups of public investors such as school districts or local governments."²²¹ In any event, the wisdom of allowing these cases to proceed under different laws than the class seems questionable.

Of course, SLUSA does not now preclude federal courts from hearing every individual state law claim involving national market securities.²²² Some claims will not fall within its scope. To trigger practical preclusion, the securities controversy must be large enough and have caused enough widespread damage to cause a significant number of plaintiffs to sue. Thus, smaller individual claims, not in connection with a major event might survive in federal court so long as the overall volume of actions in federal court remains low.

J. No Exit—An Opt-Out Quirk for Plaintiffs in the Federal System

As Professor Coffee has explained, the rules of "litigation governance" in actions for money damages require class members to opt out of a class action settlement if they do not wish for a settlement to bind them.²²³ But not all

²¹⁸ *Id.* at 388.

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ S. REP. No. 105-182, at 19 (1998).

²²² *See* SLUSA, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.) (precluding the assertion of certain statutorily defined class action claims).

²²³ *See* Coffee, *supra* note 10, at 407 n.2. The right to "opt out" and exit a class action clearly exists for "class actions certified under Rule 23(b)(3)." *Id.* Even though Rule 23(b)(1) or (b)(2) does not mandate a right to opt out for class actions certified under those

persons seeking to opt out enjoy the same rights. Much depends on whether a federal court has established jurisdiction over them.

Plaintiffs with existing individual actions consolidated with pending securities class actions fare particularly poorly in federal court. As federal courts already enjoy jurisdiction over them, these plaintiffs often remain locked within federal court, unable to pursue their individual state law claims. This is not merely a hypothetical problem. Within the Second Circuit, numerous courts have found that plaintiffs may not opt out of a global class action settlement to pursue individual state law claims because the opt-out litigation is coordinated with the class action litigation, thus triggering SLUSA preclusion.²²⁴

Consider, for example, SLUSA's application to opt-out plaintiffs in litigation arising out of the AOL Time Warner merger.²²⁵ Approximately two hundred plaintiffs represented by William Lerach had opted out of the federal class action.²²⁶ These plaintiffs attempted to avoid SLUSA's reach in federal court by bringing their claims under the law of different states, with fewer than fifty plaintiffs seeking relief under any one state's law.²²⁷ The court dismissed their state law claims under SLUSA anyway because their actions were coordinated into the same court.²²⁸

The lesson to be drawn from these precedents? Opt-outs must avoid federal court if they seek to preserve their state law claims. Once their case enters the federal system, their state law claims may be dismissed for reasons wholly outside their control. Importantly, these state law claims were not dismissed because of any defect in their pleading. Rather, they were dismissed simply because too many plaintiffs sought to litigate state law claims. Thus, the right to litigate many state law claims in federal court remains only so long as fewer than fifty plaintiffs seek relief under state law.

provisions, "most class actions for money damages are certified under Rule 23(b)(3)." *Id.* Accordingly, I put questions about these provisions to the side.

²²⁴ *Amorosa v. Ernst & Young LLP*, 672 F. Supp. 2d 493, 517 (S.D.N.Y. 2009), *aff'd sub nom.*, *Amorosa v. AOL Time Warner Inc.*, 409 F. App'x 412, 417 (2d Cir. 2011) (dismissing opt-out plaintiff's state law claims); *but see* *Ventura v. AT&T Corp.*, No. 05 CIV 5718 LLS, 2006 WL 2627979, at *1 (S.D.N.Y. Sept. 13, 2006) (allowing opt-outs to press state law claims).

²²⁵ *Amorosa*, 672 F. Supp. 2d at 499.

²²⁶ *Id.* As explained below, the opt-out trend instigated by William Lerach has continued to grow. *See* *Coffee*, *supra* note 2, at 311–12 (noting that William Lerach successfully persuaded over one hundred investors to opt out of federal class actions).

²²⁷ *In re AOL Time Warner, Inc. Sec. Litig.*, 503 F. Supp. 2d 666, 672 (S.D.N.Y. 2007).

²²⁸ *Id.*

II. AN ACCELERATING TREND TOWARD STATE COURT LITIGATION AND THE RISE OF DISAGGREGATED CLASSES

Most class actions seeking money damages represent individuals with negative value claims.²²⁹ An individual claim has negative value when the litigation costs to bring it would exceed the possible benefit from suit. Class actions are designed to solve this problem by aggregating negative value claims, lowering per-claimant costs and making it possible for persons with negative value claims to recover damages. Class actions also deter misconduct that scatters harm broadly across many different plaintiffs.²³⁰

Securities class actions differ from other class actions because the plaintiffs have heterogeneous claims.²³¹ Members of a securities class often own different amounts of the security. For instance, while an institutional investor might suffer a multi-million dollar loss, retail investors may have individually experienced much smaller losses. While many class actions include predominantly negative value claims, securities class actions include a range of negative and positive value claims.

The federal securities laws have attempted to use the focused incentive created by concentrated securities positions to overcome agency cost problems in federal class action litigation.²³² In particular, the PSLRA's lead plaintiff provision sought to use this heterogeneous claim distribution to reform the securities class action by making the plaintiff or group of plaintiffs with the largest stake the presumptive lead plaintiff.²³³ With a significant personal stake, the investor with the largest claim seemingly has a strong incentive to monitor her counsel.

Yet, instead of driving reform, this heterogeneous claim distribution may now cause the securities class action to unravel as increasing numbers of plaintiffs opt out of the class device. To put this in context, I first present the accelerating trend toward opting out of federal class actions before discussing the rise of disaggregated classes—a new development making it possible for

²²⁹ See David Marcus, *Making Adequacy More Adequate*, 88 TEX. L. REV. 137, 143 (2010) (discussing negative value claims).

²³⁰ See Burch, *supra* note 2, at 1132 (“[C]lass actions are designed to serve clients with small-stakes claims or—where cases are economically viable but difficult to litigate effectively on an individual basis—to amass claims and thereby create a credible threat.”).

²³¹ See, e.g., Coffee, *supra* note 2, at 314.

²³² See Weiss & Beckerman, *supra* note 108, at 2056.

²³³ See 15 U.S.C. § 78u-4(B)(i).

plaintiffs' counsel to aggregate negative value claims in state courts without filing a class action.

A. Institutional Investors Take the Exit Option

As many scholars have noted, increasing numbers of plaintiffs are opting out of federal securities class actions to pursue individual claims.²³⁴ Institutional investors with the largest positive value claims have led this trend and captured significantly larger recoveries than they would have received had they participated in the federal securities class action settlement.²³⁵

From both corporate and litigation governance perspectives, the “exit” option has been praised as a tool for disciplining management and class counsel, respectively.²³⁶ In the corporate governance context, dissatisfied shareholders “exit” by selling their shares and reducing the stock’s market price allowing the market to hold management accountable.²³⁷

Similarly, in the class action context, opting out allows a plaintiff to remove the value of his or her claim from the portfolio of claims represented by class counsel, thus reducing the class action’s leverage and class counsel’s potential fee award as fee awards are generally derived from settlement size.²³⁸ The opt-out threat should drive lead counsel to seek better settlements. In theory, this threat will motivate class counsel because opt-outs may retain class counsel’s rivals to represent them, creating competition and shifting fees away from class counsel.²³⁹ Defendants often negotiate for “blow provisions” in class-action settlements that allow them to walk away from a settlement agreement if a certain percentage of claimants opt out.²⁴⁰ Because a blow provision threatens potential settlement and the class counsel’s resulting fee payment, it creates an incentive for class counsel to negotiate for terms that will keep class members from opting out of the class.

Putting litigation governance issues to the side for now, the economic incentive for institutional investors to exit federal class actions appears

²³⁴ See, e.g., Coffee, *supra* note 2, at 311 (explaining that institutional investors are now opting out “on an unprecedented scale”); Burch, *supra* note 2, at 1132 (discussing trend toward opting out).

²³⁵ Cf. Burch, *supra* note 2, at 1132.

²³⁶ See Coffee, *supra* note 2, at 308–09.

²³⁷ Short-sellers may even borrow shares to use the “exit” option in anticipation of shareholders exiting.

²³⁸ Coffee, *supra* note 10, at 415–17.

²³⁹ *Id.*

²⁴⁰ See, e.g., Nilson v. Prudential Secs. Inc., 107 F.3d 3 (2d Cir. 1996) (unpublished table decision) (noting blow provision).

reasonably strong.²⁴¹ Professor Coffee has recognized opt-outs' superior performance, explaining that opt-outs' "recovery levels . . . dwarf the typical two to three percent recovery rate in most securities class actions[.]"²⁴² By opting out of the AOL Time Warner class action, some institutional investors achieved recoveries between seven to fifty times better than they would have received had they remained in the class.²⁴³ In at least one instance, opt-outs may have recovered more funds, overall, than the class action.²⁴⁴

Opt-out actions may enable plaintiffs to recover larger sums than federal class actions for a variety of procedural and substantive reasons. Some of the recovery differential may be explained by the inherent advantages that opt-out litigation will always possess over class action litigation. Another portion of the disparity may be explained by strategic legal and procedural advantages opt-out actions currently enjoy over class action litigation.

1. Inherent Advantages

Opt-out actions enjoy significant advantages simply by being more nimble, individualized actions. To be sure, opt-out actions generally avoid complex issues and costs associated with class certification issues.²⁴⁵

Opt-out plaintiffs may also compensate their counsel in ways that deviate from the payment system for class counsel. For instance, an opt-out plaintiff with a claim for \$500 million in damages may prefer to pay its counsel by the hour rather than as a percentage of the recovery.

Large institutional investors have at least three additional economic reasons to opt out of federal securities litigation.²⁴⁶ First, defendants enjoy less negotiating leverage in opt-out actions than they have in securities class actions. While the defendant might threaten to file bankruptcy if the class in a multi-billion dollar action demands too high a settlement price, this threat may carry less weight with an institutional investor or other individual opt out plaintiffs because "no individual opt-out believes that the decision will trigger bankruptcy."²⁴⁷ Second, most institutional opt-out plaintiffs face lower

²⁴¹ See Coffee, *supra* note 2, at 312–13.

²⁴² *Id.* at 313.

²⁴³ *Id.* at 312–13.

²⁴⁴ *Id.*

²⁴⁵ For evidence of the complexity surrounding the class certification stage in securities litigation, see *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2416–17 (2014) (discussing "price impact" at the class certification stage).

²⁴⁶ See Coffee, *supra* note 2, at 316.

²⁴⁷ *Id.*

agency costs because they select and may fire their counsel at will. Third, large institutional investors may enjoy special leverage in settlement negotiations if they hold significant voting power, giving management a reason to placate them.²⁴⁸

Given the advantages and economic premiums institutional investors have gained from opting out of federal class action litigation, it appears surprising that any institutional investor serves as a lead plaintiff at all.²⁴⁹ The seeming superiority of opt-out litigation supports the view that institutional investors serving as lead plaintiffs in federal securities class actions may be “captured” and acting more in their counsel’s interests than their own.²⁵⁰

Various rationales explain why many institutional investors serve as lead plaintiffs in federal securities class actions. Some have charged that a “pay-to-play” process motivates institutional investors to serve as lead plaintiffs because contributions from leading plaintiffs’ lawyers may assist in electing the persons that control them.²⁵¹ One empirical study found that “politicians and political control negatively correlate with lead plaintiff appointments in securities class actions,” challenging the belief that the primary driver of public pension fund activism in securities class actions is “pay-to-play.”²⁵² Alternatively, institutional investors may agree to serve as lead plaintiffs because they make the decision before seeing any settlement proposal and because liability may initially be uncertain. By serving as lead plaintiff, the

²⁴⁸ *Id.*

²⁴⁹ Articulating this sentiment, Professor Coffee has acknowledged that a “plausible case can be made that the institutional investor who has the opportunity to opt out is under a legal obligation to do so” because fiduciary obligations may require them to act to maximize benefits to their investors. Coffee, *supra* note 10, at 438–39.

²⁵⁰ For a discussion of regulatory capture, see Michael C. Nissim-Sabat, *Capturing This Watchdog? The Consumer Financial Protection Bureau Keeping the Special Interests Out of Its House*, 40 W. ST. U. L. REV. 1 (2012).

²⁵¹ See, e.g., *Pay-to-Play Torts*, WALL ST. J., Oct. 31, 2009, <http://www.wsj.com/articles/SB10001424052748704107204574473310387443816> (calling for investigation of purported pay-to-play between plaintiffs’ law firms and public pension funds); Mark Maremont et al., *Trial Lawyers Contribute, Shareholder Suits Follow*, WALL ST. J., Feb. 3, 2010, <http://www.wsj.com/articles/SB10001424052748703837004575013633550087098> (describing campaign contributions made by plaintiffs’ law firms, including contributions to politicians on public pension fund boards who pursued securities class actions with contributing law firms); *Progress on Pay to Play*, WALL ST. J., Feb. 12, 2010, <http://www.wsj.com/articles/SB10001424052748703630404575053460496978800> (praising reforms designed to reduce purported pay-to-play).

²⁵² David H. Webber, *Is “Pay-to-Play” Driving Public Pension Fund Activism in Securities Class Actions? An Empirical Study*, 90 B.U. L. REV. 2031, 2080 (2010).

institutional investor may gain insight into the strength of its claim that it would not otherwise have if it did not participate.

Institutional lead plaintiffs may later accept low settlements for a variety of reasons. Social dynamics may explain some willingness to settle: after building a relationship with class counsel, the institutional lead plaintiff may trust class counsel's judgment. Alternatively, institutional lead plaintiffs may have a particularly low tolerance for litigation risk or a poor personal hand to play.²⁵³

Tempering the conclusion that opt-out actions always beat class actions, a quick narrative about selection effects may also explain the success opt-out actions have had and an additional rationale for why opt-outs recover more than class actions. Institutional investors generally decide whether to opt-out after reviewing a settlement offer, and they do not opt out every time. When the proposed class settlement seems too low, institutional investors may be more likely to opt out. When the proposed settlement seems adequate, opting out may be less attractive. If institutional investors primarily opt out to pursue strong cases and accept class settlement offers when they have weak cases, opt-outs should generally recover more than settlements.

As a practical matter, opt-out plaintiffs enjoy more choices. If a prospective opt-out has strong federal claims and the class has survived a motion to dismiss, it may not oppose consolidation with the federal class. After all, consolidation confers both benefits and disadvantages. It allows the opt-out plaintiff to take advantage of class counsels' work and discovery. Yet if the potential opt-out plaintiff believes its state-law claims superior, it may avoid consolidation and preserve its state law claims by filing in state court.

2. *Advantages Conferred by Divergent Legal Regimes*

While the inherent advantages enjoyed by opt-out plaintiffs explain a significant portion of the recovery differential, a significant portion may also be attributable to differences between the legal regimes governing individual and class litigation. Moving to state court further increases the advantages enjoyed by opt-out plaintiffs. On the procedural front, opt-out plaintiffs that elect to file in state courts do not face the PLSRA's restrictions, meaning that many opt-out actions will avoid the strong inference standard and discovery stay.²⁵⁴ Additionally, opt-out plaintiffs may enjoy the ability to situate their

²⁵³ See Coffee, *supra* note 10, at 436 (discussing reasons for institutional investors to remain with the herd in a class action).

²⁵⁴ For a discussion of the PLSRA's provisions, see *supra* Part I.

action in a favorable forum, conferring significant “home court” advantages.²⁵⁵ Class actions and actions within the federal system may be swept before the MDL Court by procedural motions.²⁵⁶

In addition to these largely procedural rationales, many opt-out actions may also enjoy substantive advantages under state law.²⁵⁷ For example, federal securities class actions under Rule 10b-5 generally cannot assert aiding and abetting liability.²⁵⁸ By suing under state law, opt-out plaintiffs may expand their possible recovery pool and assert claims against defendants that could not be reached under Rule 10b-5.²⁵⁹ Thus, by opting out, plaintiffs gain access to legal rights that either Congress or the courts declined to allow under federal law.

Despite the strong incentive to opt out of federal class action litigation, economic realities limit the abilities of many investors to opt out.²⁶⁰ Plaintiffs will not litigate negative value individual claims because they cost more to litigate than can be recovered. This reality has seemingly checked the expansion of the trend toward state court and state law actions.

In any event, continuing competition amongst plaintiffs’ counsel will undoubtedly increase the number of opt-out actions and drive litigation costs down.²⁶¹ Plaintiffs firms that lose the initial scrum to serve as lead counsel have a strong incentive to solicit class members to opt out and file individual actions. To be sure, they will not receive any fees from the controversy if they do not represent anyone.²⁶² If opt-outs continue to receive significant

²⁵⁵ See Coffee, *Litigation Governance*, *supra* note 2, at 314–15. Opt-outs also avoid the federal multidistrict litigation process and any unfavorable local precedent created by the MDL Court.

²⁵⁶ See *supra* Section I.H.2 for a description.

²⁵⁷ For a discussion of potentially superior state court remedies, see Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395, 421–27 (1993) (“[I]n certain situations, the state blue sky laws may be more favorable to plaintiffs . . .”).

²⁵⁸ *E.g.*, *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (refusing to recognize aiding-and-abetting liability under the Rule 10b–5 cause of action); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008) (“The § 10(b) implied private right of action does not extend to aiders and abettors.”).

²⁵⁹ For a discussion of secondary liability for securities fraud under state law in state court, see Jennifer J. Johnson, *Secondary Liability for Securities Fraud: Gatekeepers in State Court*, 36 DEL. J. CORP. L. 463, 475 (2011) (“The state approach to primary liability for securities fraud is quite different from the federal scheme.”).

²⁶⁰ Burch, *supra* note 2, at 1133 (“[O]pting out is a true option only for institutions and the special few receiving individual legal advice.”).

²⁶¹ See Coffee, *supra* note 10, at 425–27.

²⁶² *Id.* at 425.

premiums for litigating state law claims in state court, plaintiffs' counsel will find it progressively easier to convince institutional investors to opt out.

The trend may also accelerate rapidly if most circuit courts limit the tolling of statutes of limitation or statutes of repose during the pendency of a class action.²⁶³ Under *American Pipe & Construction Co. v. Utah*, institutional investors have been able to take a wait-and-see approach without worrying about statutes of limitations, deciding whether to opt out at the settlement stage.²⁶⁴ Because the Second Circuit recently held that *American Pipe* tolling does not extend to statutes of repose, institutional investors may not be able to wait until seeing a settlement proposal if statutes of repose will foreclose remedies.²⁶⁵

The trend's continuing power will depend on where the breakpoint between negative and positive value claims falls and how many institutional investors opt out. Some evidence indicates that the threshold has grown progressively smaller. Discussing this limitation in 2007, one major plaintiffs' lawyer argued that the breakpoint for an opt-out action was approximately \$1 billion in losses.²⁶⁶ In 2009, the estimate for loss threshold fell to a mere \$10 million.²⁶⁷ As discussed below, the rise of disaggregated classes may lower this threshold further.

B. Emerging Disaggregated Classes: An Opt-In Class Action

Disaggregated class actions may lower the loss threshold for litigating opt-out claims well below \$10 million if the plaintiffs' counsel is able to successfully aggregate enough reasonably sized claims to justify deploying the

²⁶³ See Kevin M. LaCroix, *Supreme Court to Decide Securities Act Statute of Repose Issue in IndyMac MBS Case*, D&O DIARY (Mar. 11, 2014), available at <http://www.dandodiary.com/2014/03/articles/securities-litigation/supreme-court-to-decide-securities-act-statute-of-repose-issue-in-indymac-mbs-case>.

²⁶⁴ 414 U.S. 538, 554 (1974) (holding that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action").

²⁶⁵ *Police & Fire Ret. Sys. of City of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95, 109 (2d Cir. 2013).

²⁶⁶ See Coffee, *supra* note 10, at 435 (citing David Lenckus, *Individual Suits Likely Over Subprime Losses; Some Investors Expected to Opt Out of Class Actions*, BUS. INS., Nov. 19, 2007, <http://www.businessinsurance.com/article/20071118/ISSUE01/100023492?tags=%7C69%7C75>).

²⁶⁷ See Coffee, *supra* note 2, at 314 (citing Stuart Grant, Grant & Eisenhofer P.A., Comments as Panelist at American Bar Association's Litigation Section Conference (May 2, 2009) (responding to question posed by Coffee who was moderator of securities litigation panel)).

tactic. In coining the term “disaggregated class,” I refer to any collection of dispersed but informally coordinated state court actions alleging largely duplicative claims. In the securities litigation context, SLUSA’s group-of-lawsuits provision means that disaggregated classes will consist of multiple state court actions with less than fifty individual plaintiffs alleging exclusively state law claims. Plaintiffs adopt this procedural vehicle to evade removal and SLUSA’s limitations on the collective litigation of state law claims.²⁶⁸ I have chosen the term “disaggregated class” to describe this dynamic because these informally coordinated state court opt-out actions are essentially class actions spread across different courts and proceeding as *de facto* opt-in class actions.

This is not merely a new theoretical possibility but an emerging reality. The tactic has been used repeatedly with varying degrees of success in response to massive securities frauds like those perpetrated by Enron, Worldcom, and Madoff.²⁶⁹

In essence, disaggregated classes allow plaintiffs’ counsel to bring *de facto* opt-in class actions.²⁷⁰ The opt-in model requires claimants to take some affirmative step to join a collective proceeding.²⁷¹ While this opt-in model is used in Europe, federal courts have held that true opt-in class actions are unavailable under Federal Rules of Civil Procedure.²⁷² Without any clear procedural rule, the ad hoc disaggregated class has developed.

To overview issues arising in connection with this new phenomenon, I first analyze concerns and cost issues affecting disaggregated classes before discussing the dangers posed by state-court consolidation motions and by other plaintiffs. I then discuss some of the strategic jockeying likely to occur as more plaintiffs join disaggregated classes in pursuit of the opt-out premium.

1. Disaggregated Class Construction

As an initial matter, disaggregated classes may be more likely to emerge in the wake of large, widely publicized securities frauds. For these actions to

²⁶⁸ *In re Tremont Sec. Law, State Law, & Ins. Litig.*, No. 08 Civ. 11117, 2013 WL 4730263, at *3 (S.D.N.Y. Sept. 3, 2013).

²⁶⁹ *See, e.g.*, *Newby v. Enron Corp.*, 302 F.3d 295, 29–99 (5th Cir. 2002); *In re Worldcom, Inc. Sec. Litig.*, No. 02 Civ. 3288(DLC), 2004 WL 692746, at *5 (S.D.N.Y. Apr. 2, 2004); *In re WorldCom, Inc. Sec. Litig.*, 308 F. Supp. 2d 236, 238 (S.D.N.Y. 2004); *In re Tremont*, 2013 WL 4730263, at *3.

²⁷⁰ *See Coffee*, *supra* note 2, at 301–02.

²⁷¹ *Id.*

²⁷² *Kern ex rel. Estate of Kern v. Siemens Corp.*, 393 F.3d 120, 124–26 (2d Cir. 2004), *cert. denied*, 544 U.S. 1034 (2005) (reversing class certification of opt-in class).

succeed, the potential recovery pie must be large enough to justify the costs and risks associated with disaggregated classes. For example, massive securities controversies like Enron, Worldcom, and Madoff may produce enough opportunities for building disaggregated classes. Widespread media coverage informs potential plaintiffs that they might have a claim and makes it easier for counsel to acquire them as clients. Finally, large frauds generate federal class actions and complaints designed to pass muster under the PSLRA's standards. The public filing of these complaints may provide other attorneys with much useful information. Yet significant transaction costs remain.

a. Client Acquisition & Coordination Costs

A disaggregated class requires many clients. This reality favors firms that have existing relationships with institutional clients. Many of these firms already provide portfolio-monitoring services to institutional investors.²⁷³ When one of their portfolio-monitoring clients suffers a substantial fraud-related loss, the firm may have a large enough stake to justify an opt-out action. After researching and filing the first state court action, the firm faces diminishing marginal costs to file subsequent actions.²⁷⁴

For attorneys without a deep bench of institutional clients, client acquisition and coordination presents a more substantial transaction cost problem. To move to a disaggregated class structure instead of an ordinary opt-out action, the attorney's outreach and client recruitment efforts must be so successful that she gathers more than fifty individual or institutional investors because SLUSA does not apply to actions with less than fifty plaintiffs. Depending on the possible recovery, plaintiffs' counsel may make different decisions about acquiring these clients. In many cases, simplistic online advertisement targeting may suffice and be cost effective.²⁷⁵ Attorneys may also reach potential clients through blog postings, television, newspaper or other appropriate methods if the possible recovery justifies the additional outreach.

Yet, dangers abound and these decisions have ethical implications. Attorneys seeking to form a disaggregated class must also take care to comply with the rules regulating attorney advertising. In aggressively soliciting

²⁷³ Webber, *supra* note 76, at 167.

²⁷⁴ This dynamic may have led to the genesis of the disaggregated class.

²⁷⁵ Coffee, *supra* note 2, at 305 (“[C]hanges in technology also make the opt-in class more feasible than in the past [because] . . . class counsel can solicit potential class members to opt in through websites, emails, and electronic media.”).

potential opt-outs at an early stage, plaintiffs' firms have been chastised for disrupting "the orderly class action process" and forced to issue curative disclosures to potential opt outs that clarified and modified earlier advertisements.²⁷⁶

Ethical concerns continue to apply and raise potential costs even after contacting a sufficient number of investors. Attorneys representing groups of plaintiffs must effectively coordinate action and manage conflicts.²⁷⁷ To solve this problem, some group representation agreement must be in force to coordinate groups of plaintiffs effectively.²⁷⁸

b. Investigation & Drafting Costs

Attorneys contemplating disaggregated classes also face costs in investigating claims and bringing complaints. To a certain extent, counsel may mitigate these costs by leveraging work done by other attorneys. The federal Public Access to Court Electronic Records (commonly known as "PACER") system grants ready access to the complaints and many other documents filed in the federal securities class action for pennies a page. Because the complaint will often include significant detail designed to overcome the PSLRA's strong inference standard, counsel for the disaggregated class may use others' allegations to guide their investigation, effectively piggybacking off the work done by the lead counsel in the federal securities class action.²⁷⁹ In cases where the allegations in the federal class action survived the PSLRA's strong inference standard, they will most likely survive state court pleading requirements.

Of course, ethical concerns apply here as well. Professional ethics require attorneys to conduct their own pre-filing investigation and satisfy themselves that a reasonable basis for liability exists.²⁸⁰ Crudely copying other attorneys' filings may not satisfy this obligation.

²⁷⁶ *E.g., In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1239, 1246 (N.D. Cal. 2000) (directing curative notice).

²⁷⁷ *See* Debra S. Katz, *Legal Ethics in the Representation of Multiple Parties*, SN029 ALI-ABA 1657, 1660 (2007).

²⁷⁸ *Id.* at 1680.

²⁷⁹ Although prior pleadings may help illuminate an area, counsel should take care not to simply pass off the work of others as their own. *See* Iowa Supreme Court Bd. of Prof'l Ethics & Conduct v. Lane, 642 N.W.2d 296 (Iowa 2002) (disciplining attorney for plagiarizing a treatise).

²⁸⁰ In the federal context, Rule 11 requires that attorneys conduct a reasonable investigation into any claim's merits. *See, e.g.,* Brubaker v. City of Richmond, 943 F.2d 1363, 1373 (4th Cir. 1991).

c. Filing & Litigation Costs

Disaggregated classes necessarily involve higher filing costs because attorneys must file multiple complaints in multiple forums. As discussed above, plaintiffs must divide and disperse their actions into groups of less than fifty plaintiffs to avoid SLUSA. However, these filing fees may be *de minimus* if the complaints seek substantial damages.

To an extent, counsel may reduce a disaggregated class's litigation costs by implementing a staggered filing schedule. After drafting and filing the first complaint, plaintiffs' firms may stay later-filed actions to avoid incurring litigation costs while pursuing discovery in the first action. While confidentiality orders may preclude using discovery material from the first filed action in other actions, plaintiffs' counsel will know about the material and gain an information advantage. In any event, plaintiffs will likely be able to obtain the same discovery in other actions.

2. State Court Consolidation & Proliferation Risks

Disaggregated classes may be glass cannons, dangerous but vulnerable. Although not as efficient as the federal multidistrict litigation process, many state court systems allow defendants to move to transfer cases from one state court to another in certain circumstances.²⁸¹ Because these ordinary procedural motions to transfer and consolidate may trigger SLUSA's group-of-lawsuits provision, a disaggregated class may face dismissal if defendants consolidate pieces of the disaggregated class or if unsophisticated plaintiffs file related actions within the same court.

To illustrate the risk of consolidation, consider the facts in one set of Florida-based actions comprising a disaggregated class. In litigation against a group of hedge funds for losses arising out of Madoff's Ponzi scheme, a single plaintiffs' firm created a disaggregated class by filing largely duplicative actions in multiple Florida state courts.²⁸² In response, defendants moved to transfer and consolidate the actions within Florida's state court system, effectively restructuring the disaggregated class action and bringing it within SLUSA's scope by consolidating more than fifty plaintiffs into a single state

²⁸¹ *E.g.*, *Brown v. Hillsdale Cnty. Rd. Comm'n*, 337 N.W.2d 318, 320 (1983) (discussing change of venue within Michigan state courts).

²⁸² *In re Tremont Sec. Law, State Law, & Ins. Litig.*, No. 08 Civ. 11117, 2013 WL 4730263, at *3 (S.D.N.Y. Sept. 3, 2013) (describing disaggregated class where "all of [the plaintiffs were] . . . represented by the same law firm").

court.²⁸³ Once brought within the reach of SLUSA's group-of-lawsuits provision, the defendants removed the disaggregated class and transferred its constituent actions to the Southern District of New York through the MDL process.²⁸⁴ The plaintiffs' state law claims were then dismissed.²⁸⁵

Illustrating the issue from a different angle, plaintiffs within a disaggregated class and uncoordinated plaintiffs face risks from additional plaintiffs filing suit. For example, if a disaggregated class has deposited forty-eight of its plaintiffs in a particular state court and an uncoordinated group of five plaintiffs sues in the same court, all plaintiffs within the court would likely lose their state law claims because the additional plaintiffs would move the action within SLUSA's scope.

3. Strategic Behavior

As should be apparent by now, SLUSA drives irreconcilable procedural conflicts. Plaintiffs will seek the expanded rights and remedies available through individual or otherwise uncovered actions. Defendants will vigorously litigate any borderline actions, attempting to push them individually or collectively into SLUSA's scope because SLUSA's application forces plaintiffs to litigate under more restrictive federal securities fraud action rules. As each side stands to gain or lose measurably depending on SLUSA's application, substantial resources will be expended in efforts to bring it into or keep it out of play.

Once an attorney represents more than fifty plaintiffs, playing these strategic games may become alluring.²⁸⁶ Attorneys often view the ethical rules as requiring them to advocate zealously within the vague bounds of the law.²⁸⁷ Because SLUSA precludes state law class action claims and effectively precludes individual state law claims in federal court, a plaintiff may have an incentive to file higher value individual claims in state court. When attorneys represent more plaintiffs, they will likely use ethical rules to justify structuring their actions in ways that preserve these claims.

Of course, different interpretations of ethical rules may also limit the rise of disaggregated classes. While notions of zealous advocacy may lead

²⁸³ *Id.* at *1.

²⁸⁴ *Id.*

²⁸⁵ *Id.*

²⁸⁶ See, e.g., *Newby v. Enron Corp.*, 302 F.3d 295, 303 (5th Cir. 2002).

²⁸⁷ Paula Schaefer, *Harming Business Clients with Zealous Advocacy: Rethinking the Attorney Advisor's Touchstone* 10–11 (University of Tennessee Legal Studies Research Paper No. 101, March 9, 2010), available at <http://ssrn.com/abstract=1567657>.

attorneys representing more than fifty plaintiffs to create disaggregated classes, the ethics rules do not blink into existence after an attorney crosses the fifty-plaintiff threshold. The decision to recruit additional plaintiffs for duplicative actions in nearby courts also has ethical implications. The inclusion of additional plaintiffs may be in tension with the duty of loyalty owed to existing plaintiffs.²⁸⁸

In response to these incentives, plaintiffs and defendants will behave strategically in SLUSA's shadow, driving up public and private costs.²⁸⁹ A disaggregated class must remain dispersed to survive, so plaintiffs will likely develop new strategies to address known or anticipated consolidation risks and to reduce the risks they face from uncoordinated plaintiffs.²⁹⁰ As discussed below, much of this activity is likely to involve expanded geographic dispersal or delayed filing tactics.

a. Expanded Dispersal & Distribution Effects

To avoid SLUSA, plaintiffs with the ability to file in multiple states may begin scattering their cases across jurisdictional barriers, effectively mitigating the dangers posed by consolidation motions. Because state courts generally cannot transfer cases from one state court system to another, organized groups of plaintiffs may simply scatter their actions across state lines.²⁹¹

While dispersing their cases, plaintiffs may also make strategic choices when selecting the ideal forum state. Plaintiffs may further mitigate consolidation risks by filing disaggregated classes within state court systems without formal consolidation or coordination mechanisms for intra-state cases.²⁹² The lack of any effective procedural mechanism to consolidate cases may limit defendants' ability to rearrange actions to fall within SLUSA's scope.

²⁸⁸ The rise of disaggregated classes poses complex ethical questions requiring additional analysis. Attorneys considering adopting disaggregated classes must proceed carefully to ensure that they do not breach duties to existing clients by seeking additional plaintiffs.

²⁸⁹ See Rose, *supra* note 50, at 2182–93, for a discussion of social costs in securities fraud enforcement.

²⁹⁰ See Glover, *supra* note 24, at 37 n.124 (noting that dispersed state court actions will give rise to the “largely undesirable, though likely inevitable reality of jurisdictional strategy and gamesmanship”).

²⁹¹ Of course, factual realities may limit plaintiffs' ability to scatter their cases. State courts with little connection to the dispute may be receptive to motions to dismiss on *forum non conveniens* grounds. I put possible prudential or jurisdictional limitations on this strategic behavior to the side for this Article.

²⁹² See Glover, *supra* note 24, at 10–12 (noting state court consolidation deficiencies).

b. Timing Effects

SLUSA may also cause organized groups of plaintiffs to stagger the filing of their actions, further deconstructing their disaggregated class by breaking it apart across time. To exploit timing, disaggregated classes may initially proceed as a single action brought by a subset of the possible plaintiffs, with the remaining plaintiffs waiting in the wings. From the defendants' perspective, the disaggregated class's spear point may appear to be an ordinary individual action.

Exploiting timing may carry significant advantages. If a test case succeeds, additional cases may be filed in the same jurisdiction to take advantage of any discovery or favorable precedent secured. In the event that a test case fails, the remaining plaintiffs may file their cases in a different jurisdiction. In the alternative, a later group of plaintiffs might seek to recover under different legal theories. This may give coordinated groups of plaintiffs significant advantages. Of course, this tactic could only be used so long as statutes of limitations and repose do not foreclose additional attempts.

C. Public Costs Imposed by Disaggregated Classes

To endorse the status quo, policymakers must conclude that the benefits provided by disaggregated classes and increased opt-out litigation outweigh the public costs imposed. As more investors make use of the "exit" option, these costs will increase. While room for further exploration exists, I set out three different public cost issues below.

1. Potential Regressive Subsidies

Because institutional investors and disaggregated class members may possess higher value claims than the negative value claims included within the federal class action, gains to investors outside the class action may come at the expense of investors unable to join disaggregated classes.²⁹³ If this trend continues, the securities class action may grow less relevant and simply serve as "a vehicle of last resort for smaller retail investors."²⁹⁴ Divergent outcomes

²⁹³ See *Coffee*, *supra* note 10, at 409.

²⁹⁴ *Id.* at 429.

for the rich and poor for claims involving the same securities challenge basic fairness norms and may amount to regressive subsidies.²⁹⁵

Nonetheless, the distributional impact of any regressive subsidy may be difficult to quantify. Many institutional investors—pension funds and retirement plans—hold their assets for the benefit of the middle and lower-middle class. If these institutions experience outside litigation gains, the returns do not flow to society's wealthiest enclaves.

2. Increased Litigation Costs

As more investors opt out of federal securities class actions, litigation costs will undoubtedly escalate and cases will occupy increasing amounts of judicial time. Parties internalize some, but not all, of these costs. Defendants will buy increasing amounts of attorney time to defend against multi-jurisdictional litigation. Because the PSLRA's discovery stay does not apply in state court actions,²⁹⁶ the parties will likely engage in increasing amounts of discovery. In many instances, the litigation and discovery will largely duplicate litigation and discovery occurring in other dispersed state court actions or in federal court actions, causing the parties to dissipate their own and judicial resources.²⁹⁷

Notably, as the use of disaggregated classes expands, public costs increase more rapidly than private costs. With each additional action, the attorneys involved may draw on their experience framing and litigating other actions within the disaggregated class, growing increasingly efficient. In contrast, each court involved must familiarize itself with the issues and make its own decisions. While courts will take guidance from precedent generated through this process, they do not benefit to the same extent as the litigants do from the repetition.

Expanding state court securities litigation will lead to inconsistent outcomes for defendants and plaintiffs.²⁹⁸ This inconsistency may be

²⁹⁵ David H. Webber, *Shareholder Litigation without Class Actions*, 57 ARIZ. L. REV. (forthcoming 2015).

²⁹⁶ See Perino, *supra* note 1, at 292.

²⁹⁷ The Supreme Court recognized this danger in *Dabit*, although as a threat posed by state law class actions and not individual actions. *Dabit*, 547 U.S. at 86 (stating that limited application of SLUSA "would give rise to wasteful, duplicative litigation. . . . The prospect is raised, then, of parallel class actions proceeding in state and federal court, with different standards governing claims asserted on identical facts."); see also Glover, *supra* note 24, at 6 ("[D]uplicative discovery and other pre-trial litigation wastes the time and resources of both the judiciary and of the parties.").

²⁹⁸ See Glover, *supra* note 24, at 10.

pernicious and driven by different judges within the same state court system making different decisions to interpret the same state laws, subjecting defendants to conflicting rulings.²⁹⁹ In this sense, expanding opt-out litigation increases the likelihood of piecemeal litigation, contravening federal policy goals.³⁰⁰

3. Increased Capital Costs & Inefficient Capital Allocation

When securities litigation over-deters, it raises the cost of capital.³⁰¹ If civil liability becomes too expensive by imposing high costs in exchange for limited benefits, investors may be less likely to allocate capital to a particular securities market, instead preferring more efficient markets.³⁰² Increasing numbers of opt-out actions likely raise the cost of capital further by forcing defendants to pay more in total damages and by increasing defendants' litigation costs.³⁰³

Opt-out litigation that proceeds under state law in state courts may be particularly likely to increase the cost of capital because it increases liability for parties who could not be reached through the Rule 10b-5 cause of action. For example, the Supreme Court has sharply limited aiding and abetting liability under Rule 10b-5.³⁰⁴ In contrast, state law will often permit recovery for aiding and abetting.³⁰⁵ In practice, this means that accountants, lawyers,

²⁹⁹ Further inconsistency is likely to result when a disaggregated class stretches across jurisdictional lines or exploits timing effects to proceed under different legal theories.

³⁰⁰ *Colorado River Water Conservation Dist. v. United States*, 424 U.S. 800, 818 (1976) (recognizing federal policy preference to avoid piecemeal litigation).

³⁰¹ See Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 947 (1993).

³⁰² *Id.* at 948.

³⁰³ For a discussion of how inefficient securities litigation makes raising capital more difficult, see Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 733 (1995) ("An inefficient litigation regime therefore increases the cost of capital for everyone, even companies that are never sued. In addition, because it is impossible to determine ex ante whether yet-to-be-filed litigation is meritorious, it is impossible to demonstrate that an offering failed specifically because of the threat of non-meritorious litigation.").

³⁰⁴ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N. A.*, 511 U.S. 164, 177 (1994) (refusing to recognize aiding-and-abetting liability under the Rule 10b-5 cause of action); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008) ("The § 10(b) implied private right of action does not extend to aiders and abettors.").

³⁰⁵ Richard C. Mason, *Civil Liability for Aiding and Abetting*, 61 BUS. LAW. 1135, 1177 (2006) ("[State] courts long have recognized aiding-abetting liability in connection with securities actions brought pursuant to state law.").

and others who provide services to issuers will increase the cost of their services to incorporate the cost of state law liability.³⁰⁶

In the same vein, defendants facing waves of opt-out litigation may struggle to accurately calculate their liability, forcing them to hold more funds in reserve to pay liabilities instead of reinvesting those funds or distributing them more efficiently to shareholders. This uncertainty may prevent capital from flowing through the economy as efficiently as it would without the risk of unpredictable state law liability.

III. OPT-OUT ACTIONS BELONG IN FEDERAL COURT

Given the dynamics discussed above, it seems likely that the number of opt-out suits will continue to increase.³⁰⁷ As their impact grows, their costs must be weighed against their benefits. To be sure, disaggregated classes and state court opt-out actions allow certain plaintiffs to secure significant benefits. Through opt-out actions, some claimants may raise claims that would otherwise be too costly to litigate and may recover more than they would as part of the federal class. Yet the benefits provided by disaggregated classes seemingly come at high public and private costs. If these actions continue to multiply, Congress will likely consider measures to bring opt-out actions into federal court.

As discussed above, disaggregated classes appear to come with high costs for both private parties and for the public. Furthermore, while new litigation strategies may provide additional deterrence benefits, disaggregated classes may significantly inflate costs without providing corresponding benefits. Disaggregated classes and opt-out actions follow in the wake of securities class actions. These follow-on actions increase the costs of defending against already sprawling private securities litigation.³⁰⁸ As the severity of the sanction increases, so too does the risk of overdeterrence.³⁰⁹

The simplest remedy may be to allow the JPML to remove opt-out actions and disaggregated classes to federal court. Expanded removability has been considered as a potential response before. Although not recommending it himself, Professor Coffee spotlighted increased removability as a possible

³⁰⁶ Cf. *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058, 1068 (2014) (“[T]he federal securities laws have another purpose, beyond protecting investors. Namely, they also seek to protect securities issuers, as well as the investment advisers, accountants, and brokers who help them sell financial products, from abusive class-action lawsuits.”).

³⁰⁷ See *supra* Part II.

³⁰⁸ See *Rose*, *supra* note 50, at 2188–90 (discussing the severity of sanctions).

³⁰⁹ *Id.*

measure to slow the “growing rate of opt outs” in 2008.³¹⁰ At that time, he suggested that “the most effective and feasible measure would be to give the JPML the power to consolidate state court individual actions with the federal class action for purposes of pretrial discovery.”³¹¹

Increased removability would effectively federalize a great deal of securities fraud litigation. As explained above, once opt-out actions enter the federal system, consolidation procedures sweep these actions within SLUSA’s scope, effectively precluding the plaintiffs from litigating state law claims.³¹²

In addition to these cost-benefit concerns, three strong arguments weigh in favor of making opt-out actions removable. In Section A below, I discuss optimal deterrence theory and how calibrating deterrence appears impossible when litigants may simply opt out to pursue state court suits. In Section B below, I review federalism concerns and note that it may be most appropriate to regulate the national securities markets on a national basis.³¹³ In Section C, I analyze disaggregated classes and the effects divergent liability standards may have on the conduct of securities class actions. Ultimately, I conclude that more uniform liability under federal law would likely make class counsel more responsive to opt-out threats and more susceptible to voice-based reforms.

A. Optimal Deterrence

Making opt-out actions and disaggregated classes removable will also allow the federal government to better calibrate liability provisions in pursuit of optimal deterrence. As it stands, the ability of parties to opt out of federal law and federal courts limits the ability of federal regulatory bodies to properly calibrate liability provisions in pursuit of optimal deterrence.

Ideally, capital markets benefit society by allocating capital to productive uses, creating savings mechanisms and liquidity.³¹⁴ The U.S. securities market is an enormously important national asset and protecting its efficient operation is a regulatory priority. As the Supreme Court has recognized, the “magnitude of the federal interest in protecting the integrity and efficient

³¹⁰ See Coffee, *supra* note 10, at 442–43.

³¹¹ *Id.*

³¹² See *supra* Part II.

³¹³ Erin O’Hara O’Connor & Larry E. Ribstein, *Preemption and Choice-of-Law Coordination*, 111 MICH. L. REV. 647, 661 (2013) (“[I]n some cases the states’ lack of coordination will call for broad application of federal laws.”).

³¹⁴ Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 767 (1985).

operation of the market for nationally traded securities cannot be overstated.”³¹⁵

Although integrity and efficiency generally walk side-by-side, their paths sometimes diverge in the land of private securities litigation. In the secondary market, securities fraud often transfers wealth among equally blameless investors.³¹⁶ This happens because non-trading fraudsters often supply misinformation to the secondary market. When this happens, a security’s secondary market value will rise or fall because of the misinformation.³¹⁷ Many scholars have argued that it makes little sense to spend significant enforcement resources to recover fraud losses in this context because well-diversified investors will likely experience roughly equivalent losses and gains from fraud over time.³¹⁸ Seeking to maximize market integrity would be extraordinarily inefficient and leave everyone poorer for it.³¹⁹

Using slightly different language, supporters of private securities litigation generally advance two rationales to support the maintaining liability: investor compensation and deterrence.³²⁰ Academics generally focus on the deterrence rationale because the compensatory rationale has well documented weaknesses.³²¹

The deterrence rationale has a history of judicial support. In recognizing an implied right of action under Section 14(a) of the Exchange Act, the Supreme Court argued that “[p]rivate enforcement of the proxy rules provides a necessary supplement to Commission action” because the Commission did not have the resources to closely vet proxy materials.³²² The Court extended this rationale repeatedly in subsequent cases and, at times, explicitly sought to protect “the deterrent value of private rights of action”

³¹⁵ Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71, 78 (2006). *See also In re Herald*, 730 F.3d 112, 117 (2d Cir. 2013) (stating that abuse of private securities actions “may . . . injure the efficient operation of [financial] markets and this country’s competitive position in the world’s economy”).

³¹⁶ Rose, *supra* note 50, at 2180–81.

³¹⁷ *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 642 (1996) (critiquing compensatory out-of-pocket loss measures).

³¹⁸ *See, e.g.*, Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 337.

³¹⁹ As market participants purchase securities to gain wealth, wealth maximization seems a valid criterion in this area.

³²⁰ Coffee, *supra* note 71, at 1538.

³²¹ *See, e.g.*, Rose, *supra* note 54, at 1309 (“[T]he modern Rule 10b-5 class action . . . provides little if any meaningful compensation to investors, and instead finds its primary justification in its potential deterrent effect.”).

³²² *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (“Time does not permit an independent examination of the facts set out in the proxy material.”).

because they “provide a most effective weapon in the enforcement of the securities laws and are a necessary supplement to commission action.”³²³

Effectively deterring securities fraud improves the functioning of the capital markets and corporate governance because it increases the accuracy of information available to investors, improving their ability to allocate capital. To the extent that investors in the primary market suspect that issuers misrepresent facts about their businesses, investors will predictably reduce the amount of money they are willing to pay for securities or shift purchases to a more honest market.³²⁴ Misinformation may also impose social costs in the secondary market by making capital allocation less effective.³²⁵ From a corporate governance perspective, accurate disclosures improve corporate decisions about selecting and managing investment projects.³²⁶

Despite the significant benefits obtainable from deterring fraud, unthinkingly maximizing securities fraud deterrence can result in over-deterrence, which also harms the capital markets and causes inefficiency because legal prohibitions against fraud impose social costs.³²⁷ Extensive private deterrence efforts—especially those exemplified by disaggregated classes—tie up resources in litigation efforts. Excessive deterrence can also increase the cost of capital if companies over-invest in precautionary measures or if financial intermediaries, such as accountants, lawyers and bankers, charge more for their services to reflect the risks posed by state law liability.³²⁸

Optimal deterrence theory seeks to chart a path between rampant fraud in an environment that under-deters and excessive costs in a red-tape-filled world of over-deterrence.³²⁹ Under optimal deterrence theory, for securities fraud liability to be justified, it must “save more in social costs from fraud

³²³ *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986) (internal quotations and citations omitted).

³²⁴ Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673–75 (1984).

³²⁵ Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 DUKE L.J. 977 (1992) (arguing that certain stock price inaccuracies impose social costs and lead to inefficient capital allocations).

³²⁶ Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 253 (2009) (“Disclosure does, however, enhance efficiency by improving corporate decisions relating to which proposed new investment projects in the economy are selected for implementation and how already existing projects are operated.”).

³²⁷ Rose, *supra* note 50, at 2183–84.

³²⁸ *Id.* at 2184.

³²⁹ See generally Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1606 (2010) (discussing optimal deterrence theory); Rose, *supra* note 50, at 2178–93 (presenting a primer on optimal deterrence of securities fraud).

than it creates in enforcement costs.”³³⁰ Although perfectly optimal deterrence may be difficult to achieve in practice, the framework provides a useful guide for evaluating the scope of private securities fraud liability.

A hard-eyed focus on optimal deterrence may lead to some inequitable wealth distribution while maximizing market functioning overall. This happens because a deterrence regime does not focus on distributions of societal wealth and the remedies necessary to ensure compensation may impose more costs than gains produced.³³¹ A deterrence-focused regime might also shift investor behavior, mitigating inequitable distributions. If compensation for many types of fraud were not available or less certain, investors would simply discount the price they were willing to pay “to reflect deterrence’s failure in a certain percentage of cases,” resulting in securities pricing that would be “fair ex ante, even though some investors [would] suffer a loss ex post.”³³²

As Professor Rose has explained, lawmakers seeking to deter securities fraud optimally must make choices about how to structure the liability regime. These choices include: “(1) the scope of the substantive fraud prohibition; (2) the threatened sanctions; (3) the procedural rules governing investigation and adjudication of claims; and (4) the enforcer.”³³³ As these design choices force unavoidable tradeoffs between over-deterrence and under-deterrence, lawmakers must carefully consider how to design an appropriate liability regime.

The private enforcement experience after the PSLRA makes clear that a key additional consideration in a well-designed securities fraud liability framework is the consolidation of enforcement control in a single liability regime without the ability to shift fora. As explained above, Congress passed SLUSA to increase federal control over securities class actions because plaintiffs had been evading the PSLRA’s procedural rules and the substantive scope of federal law by simply filing class actions in state court and under state law.³³⁴ Forum-shifting impedes efforts to tailor the liability regime to better deter securities fraud.

The growing trend toward individual actions under state law in state courts also threatens federal control over liability for activity within the national securities markets. Individual state law actions differ significantly

³³⁰ Rose, *supra* note 50, at 2178.

³³¹ *Id.* at 2180–81.

³³² Fox, *supra* note 326, at 283.

³³³ Rose, *supra* note 50, at 2184.

³³⁴ H.R. REP. NO. 105-640, at 10 (1998); S. REP. NO. 105-182, at 3–4 (1998).

from federal law in terms of the scope of liability, the procedural rules governing litigation, and the identity of the enforcer.³³⁵

These differences mean that liability shifts designed to optimize private securities liability and improve national market functioning will outright fail or secure fewer benefits than contemplated because private enforcement activity will shift to state court.³³⁶

B. Federalism Concerns

The federal government is best situated regulate national market securities. The federal system provides familiar and oft-discussed costs and benefits. As to the benefits, it allows states to address local concerns responsively in keeping with local tastes.³³⁷ As states take different approaches, their efforts create “more innovation and experimentation in government” and may generate superior solutions to problems.³³⁸ Still, these federal benefits also come with significant costs. Inconsistent state and federal laws may interfere with interstate commerce, increase coordination costs and create “spillover” effects when one state’s regulations alter behavior in other states.³³⁹

As Professor Perino and other scholars have concluded, an analysis of these costs and benefits shows that “there is only a weak case for maintaining dual state-federal authority over” the market for nationally traded securities.³⁴⁰ As state law liability for fraud directed at the national securities market

³³⁵ A disaggregated class’s litigation governance is likely to be controlled by the attorneys litigating on its members’ behalf. For example, in securities litigation arising out of HBO’s improper recognition of revenue, attorneys appeared to be attempting to form a disaggregated class by including in their retainer agreement that the plaintiffs were “agreeing ‘to abide by the decisions of the Steering Committee,’ a body appointed by the attorneys, which will consist of an unspecified number of other shareholder clients.” *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1239, 1241–42 (N.D. Cal. 2000) (quoting from retainer agreement).

³³⁶ I put to the side questions about the contours of an optimal deterrence focused federal regime. A federal optimal deterrence framework does not need to be developed to recognize that the goal is likely unobtainable without more exclusive regulatory control.

³³⁷ Michael W. McConnell, *Federalism: Evaluating the Founders’ Design*, 54 U. CHI. L. REV. 1484, 1493 (1987).

³³⁸ *Gregory v. Ashcroft*, 501 U.S. 452, 458 (1991).

³³⁹ See Perino, *supra* note 1, at 321 (summarizing federalism’s costs).

³⁴⁰ *Id.*; see also Rose, *supra* note 50, at 2206 (“This formulation supports assigning the federal government responsibility for deterring fraud in the national securities markets, while assigning state governments responsibility for deterring fraud targeted at their respective local capital markets.”).

implicates more than purely local interests, federal regulation better addresses the problem.³⁴¹

Yet these federalism concerns do not apply with equal force to all securities suits. As mentioned above, SLUSA's so-called "Delaware carve-out" preserves state law class actions for corporate governance suits based on the law of the state of the issuer's incorporation.³⁴² Because the internal affairs doctrine effectively coordinates the choice of law issue for corporate governance disputes, federal preemption is less appropriate.³⁴³

Largely, Congress has embraced this thesis already. Securities regulation and private securities liability has moved gradually toward increased federal oversight with the growth of national securities markets. NSMIA and SLUSA exemplify this trend. Both define national market securities in the same way and shift substantial regulatory power from state to federal law.³⁴⁴

In enacting SLUSA, Congress embraced these arguments with respect to class action litigation.³⁴⁵ The remaining issue is whether many private, individual state law claims now warrant the same treatment. As discussed above, this issue is already settled for many of the individual state law claims now removed to federal court.³⁴⁶

The currently un-removable individual claims lurking within state court systems do not deserve different treatment. The increasing trend toward disaggregated classes and institutional investor opt-out litigation seemingly challenges the merit of distinguishing between individual and class action claims. Making these actions removable would promote greater uniformity and avoid the harms detailed above.

In any event, shifting these claims to federal court and federal law seems unlikely to destroy the ability of opt-outs to litigate their own actions. Opt-outs enjoy tremendous inherent advantages over unwieldy class actions.³⁴⁷

³⁴¹ See Perino, *supra* note 1, at 321.

³⁴² 15 U.S.C. §§ 78bb(f)(3)(A), 77p(d).

³⁴³ See O'Connor & Ribstein, *supra* note 313, at 677 (recognizing that the internal affairs doctrine makes preemption "unnecessary because the states have achieved horizontal coordination of their differing substantive rules through uniformly applied choice-of-law rules").

³⁴⁴ *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 108 (2d Cir. 2001) (noting that SLUSA borrows its definition of national market securities from NSMIA).

³⁴⁵ S. REP. NO. 105-82, at 4 (1998) (stating that the Committee "found the interest in promoting efficient national markets to be the more convincing and compelling" argument over its "affront on Federalism").

³⁴⁶ As discussed above, the federal courts to consider the issue have nearly uniformly concluded that SLUSA properly extends to claims consolidated with related federal court actions.

³⁴⁷ See *supra* Part II(A)(i).

Rather, federalizing securities litigation creates more uniform liability and may lower the cost of capital.

C. Litigation Governance

Making disaggregated classes and opt-out actions removable may also improve the private securities class action. Pruning the exit option to limit opt-outs to federal court and federal law would likely yield significant improvements by motivating sophisticated and significant stake-holding litigants to push for accountability and by making it possible for class counsel to compete on a level field in the market for legal services.

Much of the debate over how to govern securities class actions has drawn heavily from Albert O. Hirschman's seminal book, *Exit, Voice, and Loyalty*, with scholars discussing different ways to improve litigation governance.³⁴⁸ In it, Hirschman argues that persons dissatisfied with any organization must elect between some combination of exit and voice to address their concerns.³⁴⁹ When persons elect to exit, they leave the organization. When they use their voice, they press for change from within.³⁵⁰

Voice-amplifying proposals abound. Professor Webber has argued that courts should attempt to amplify the voices of individual investors by appointing sophisticated individual investors as co-lead plaintiffs.³⁵¹ In the same vein, Professor Burch has argued that courts should appoint additional lead plaintiffs as necessary to protect varied interests within the class.³⁵² The PSLRA even incorporated Elliott J. Weiss and John S. Beckerman's voice-based proposal to designate the largest stakeholders as lead plaintiffs.³⁵³

Focusing on the complementary "exit" option, Professor Coffee has written extensively about the merits of an exit option as a tool for disciplining class counsel.³⁵⁴ He correctly points out that whenever "one detects slack or consistently substandard performance in a market (including a market for professional services), it is usually a safe diagnosis to predict that competition

³⁴⁸ See, e.g., Samuel Issacharoff, *Governance and Legitimacy in the Law of Class Actions*, 1999 SUP. CT. REV. 337, 366–80 (1999) (discussing HIRSCHMAN, *supra* note 110).

³⁴⁹ See HIRSCHMAN, *supra* note 110.

³⁵⁰ *Id.*

³⁵¹ See Webber, *supra* note 76, at 224.

³⁵² Burch, *supra* note 2, at 1134–55.

³⁵³ Weiss & Beckerman, *supra* note 83, at 2105–08.

³⁵⁴ See Coffee, *supra* note 112, at 417–28; Coffee, *supra* note 2, at 306–28; Coffee, *supra* note 10.

is lacking in the relevant market.”³⁵⁵ Reasoning from this premise, he takes the “optimistic perspective” and argues that increased use of the exit option will create competition and improve class counsel’s performance.³⁵⁶

Professor Coffee’s analysis rings true. Yet competition may also be improved by leveling the legal playing field. Class counsel should scrap for larger settlements when the difference obtainable would keep opt-outs within the class. However, even assuming class counsel could litigate more vigorously and double the class settlements recovered, opt-out litigation in state court under state law might still offer claimants a higher return than they might recover by remaining in the class—if the anticipated recovery premium were attributable to differences between state and federal law. Most class action settlements recover approximately two to three percent of losses.³⁵⁷ In contrast, as described above, opt-outs may recover seven to fifty times more, often in a state court action under state law.³⁵⁸

At present, opt-out actions and class actions do not compete on the same playing field. By opting out, investors may gain access to more favorable state substantive law and procedures and may largely avoid insolvency constraints limiting the ability of class counsel to demand significant increases in settlement size.³⁵⁹ Because securities fraud classes generally bring large gross claims, they may be forced to settle for an amount less than they might recover at trial to avoid triggering corporate bankruptcy. In contrast, opt-out plaintiffs may demand a higher percentage recovery without fearing that their settlement demands will bankrupt a defendant.

Preempting state law claims and forcing opt-outs to litigate in federal court under the same law and procedural rules would level the playing field somewhat. It might also enhance the efficacy of the exit option as a tool for keeping class counsel working because class counsel may be more likely to fight when she believes she can win and when goaded by the voices of shareholders unable to resort to alternate forums and substantive laws.

Importantly, pruning back the exit option by making institutional opt-out actions and disaggregated classes removable would not remove all opportunities for exit. Plaintiffs dissatisfied with class counsel’s performance or a particular settlement offer would still enjoy the right to opt out and pursue their own claims under federal law.

³⁵⁵ Coffee, *supra* note 10, at 414.

³⁵⁶ *Id.* at 442; Coffee, *supra* note 2, at 309 (arguing that “in theory, . . . exit may outperform voice in the world of litigation governance”).

³⁵⁷ Coffee, *supra* note 2, at 313.

³⁵⁸ See *supra* Part II.

³⁵⁹ See Coffee, *supra* note 2, at 315–16.

Even with the state law option removed, opt-out plaintiffs will likely still secure larger recoveries than the class. To be sure, limiting the exit option to federal law would not change an opt-out plaintiff's ability to escape insolvency constraints and demand a higher percentage recovery without fear of tipping a defendant into bankruptcy. Additionally, plaintiffs with strong appetites for litigation risk may also opt out of reasonable settlement offers to chase larger individual recoveries. They will likely secure higher returns by accepting more risk. If only a small percentage of class members opt out, class counsel may have accurately gauged the class's appetite for litigation risk—even with a relatively low settlement.

Hirschman captured this dynamic in the final chapter of *Exit, Voice, and Loyalty*. Addressing situations where an “organization is not particularly sensitive to” exit, he wrote that policymakers might consider enabling voice and “raising the costs of exit and even by *reducing the opportunities for it*.”³⁶⁰

By making state court opt-out actions removable and making exit less attractive, class members may be more likely to use their voices to drive change. If unable to secure unique advantages under state law, institutional investors may become more likely to remain within the class and supervise class counsel. In any event, the PLSRA's lead plaintiff provision seems unlikely to succeed if the money, i.e. institutional investors, does not monitor class counsel because it prefers an alternative forum and substantive law.

CONCLUSION

The rise of disaggregated classes poses serious challenges to efforts to regulate federal securities fraud class action litigation. The tactic drives significant public costs that may not be outweighed by any deterrence benefit. Spreading duplicative actions across many courts increases the likelihood of inconsistent outcomes, and dissipates judicial and party resources. Over time, it may also diminish federal law as the dominant source for private securities liability, frustrating the PSLRA's objectives. The state law lawsuits may also drain defendants' coffers, leaving less for the federal class to recover.

As explained above, this has already occurred by process of law for cases that can currently be removed into the federal system. Although this outcome is consistent with Congress's aim to limit state law securities fraud litigation, SLUSA's legislative history does not establish that Congress intended to drive most individual state law claims out of federal court. It also

³⁶⁰ HIRSCHMAN, *supra* note 110, at 122–23 (emphasis added).

seems unlikely that Congress would have endorsed the rise of disaggregated classes or intended that different substantive laws apply to high-value and low-value claims.

Current trends toward disaggregated classes litigating opt-out actions in state court seemingly frustrate the policy goals behind the PSLRA, SLUSA and Supreme Court decisions limiting the scope of private securities liability. For these initiatives to regulate the national securities markets effectively, market participants must not be subjected to alternative systems of regulation and liability. State law liability undercuts these goals because it imposes costs outside federal control and creates instability.

This is not to say that the federal scheme for private securities litigation merits uncritical praise—it too has flaws. Overly restrictive federal court rules may make it too difficult or too costly to prove fraud for informed investors with concentrated positions seeking above-market returns.³⁶¹ By chasing profits, these investors create market efficiency and incorporate disclosed information into stock prices. These investors, who hold concentrated positions, may not be as likely to net out their fraud losses. Moreover, for normative reasons, society may tolerate—or even support—some over-deterrence to ensure compensation for fraud victims.³⁶²

Yet allowing plaintiffs with higher-value claims to access different legal systems than plaintiffs within the federal class does not seem like a satisfying answer to these problems. If anything, an unconstrained exit option may make participating in voice-based reforms less attractive. It may also reduce the incentive to battle against improper limitations on federal liability. A pension fund that regularly recovers substantial damages in state court will not be motivated to lobby for improvements in federal law.

Accordingly, I call for Congress to prune the state law “exit” option and level the playing field by making opt-out actions and disaggregated classes removable. The policy concerns reviewed in this article may guide this complex task.³⁶³ Discussions about this dynamic may also create political conditions permitting Congress to revisit the PSLRA’s wisdom.

³⁶¹ See Webber, *supra* note 76, at 169–70.

³⁶² See Rose, *supra* note 50, at 2181.

³⁶³ See Perino, *supra* note 1, at 277 (“[C]arefully constructed federal preemption may be appropriate because preemption addresses the unintended shift of litigation to state court and because such an allocation of governmental authority comports well with principles of federalism.”).