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Have Institutional Fiduciaries Improved Securities Class Actions? A Review of the Empirical Literature on the PSLRA's Lead Plaintiff Provision

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Abstract

In 1995, Congress substantially revamped the governance of securities class actions when it created the lead plaintiff provision as part of the Private Securities Litigation Reform Act. This paper reviews the empirical literature evaluating that provision. The story that emerges from these studies is of a largely successful statutory innovation that has markedly improved the conduct of these cases. There is little doubt that passage of the PSLRA spurred institutions to become more active in securities class actions. Overall, the results of that participation are positive. Existing studies demonstrate that cases with institutional lead plaintiffs settle for more and are subject to a lower rate of dismissal than cases with other kinds of lead plaintiffs, although some questions remain regarding whether these results are driven by institutional self-selection of higher quality cases. One study has shown that institutional participation is correlated with at least some improvements in corporate governance. Institutional lead plaintiffs have had their largest impact on attorneys' fees. Not only is institutional participation correlated with lower fees and greater attorney effort, but there is evidence to suggest that institutions have created an economically significant positive externality—a reduction in fee awards even in cases without institutional plaintiffs. Institutional participation, however, has not been an unalloyed good. Other studies suggest that institutional investors are subject to their own agency costs, particularly in the form of pay-to-play arrangements with plaintiffs' law firms. Those arrangements appear to eliminate some of the beneficial effects associated with institutional service as lead plaintiffs.

1. Introduction

Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA) to address perceived problems in securities class action litigation. A key feature of the PSLRA was the lead plaintiff provision. Prior to passage of the statute, representative plaintiffs were invariably small shareholders, often with long-term relationships with class counsel (Perino 2008). As a result, these class members typically had insufficient incentives to monitor class counsel, creating the opportunity for attorneys to act in their own best interests rather than the best interests of the class. Inspired by the work of Weiss and Beckerman (1995), Congress created the lead plaintiff position in the hope that institutional investors would volunteer to serve as representative (now dubbed lead) plaintiffs. Weiss and Beckerman argued and Congress expected that because of their larger, often long-term, financial stakes and greater sophistication, institutions would provide the monitoring necessary to curb the agency costs that had been endemic to securities class actions.

Whether institutions would take up this invitation, however, was an open question. While collective action problems make institutional passivity the norm, investment managers are fiduciaries and as such have a duty to keep "informed of rights and opportunities associated with [their] investments" and to initiate and participate in litigation on behalf of the trust under certain circumstances (Restatement (Second) of Trusts § 177). Under basic common law principles, the decision to pursue litigation is contingent, in part, on whether the expected gain from litigation will exceed the expected cost. The Employee Retirement Income Security Act (ERISA) imposes a similar duty of care on ERISA trustees, although some commentators have argued that serving as lead plaintiff could itself violate those duties (Martin and Metcalf 2001). To further complicate matters, the decision not to pursue the lead plaintiff position could implicate duty of loyalty issues to the extent that the decision is premised on the investment managers' interests as opposed to those of the beneficiaries.

Weiss and Beckerman and other commentators argue that these cross-cutting fiduciary considerations require investment managers, at a minimum, to conduct a careful cost-benefit analysis to determine whether participation as a lead plaintiff in a securities class action is in the best interests of the fund's beneficiaries. In making this decision, institutions could take a narrow focus, in effect making case-by-case determinations of their expected impact. Consistent institutional participation, however, could have broader systemic benefits such as increased average settlements, lower average attorneys' fees, improved corporate governance practices, or greater deterrence—matters that might also warrant consideration for an investment manager exercising its fiduciary duty. It is with respect to these systemic effects (as well as the expected impact of participation in an individual case) that fund fiduciaries should consider the growing body of empirical studies generated in the last decade, which have sought to quantify the impact of the lead plaintiff provision. Those studies examine a question that is simple to state but difficult to quantify—has institutional participation as lead plaintiffs under the PSLRA had a beneficial impact in securities class actions? The story that emerges from a review of these studies is of a largely successful statutory innovation that has markedly improved the conduct of these cases.

This chapter proceeds as follows. Section 2 provides a brief sketch of the agency cost problems typically associated with securities class actions and provides an overview of how the lead plaintiff provision was intended to alleviate those concerns. Section 3 discusses the empirical evidence on institutional participation in securities class actions. There is little doubt that passage of the PSLRA spurred institutions to become more active in these cases. Overall, the results of that participation are positive. Existing studies demonstrate that cases with institutional lead plaintiffs settle for more and are subject to a lower rate of dismissal than cases with other kinds of lead plaintiffs, although some questions remain regarding whether these results are driven by institutional self-selection of higher quality cases. One study has shown that institutional participation is correlated with at least some improvements in corporate governance. Institutional lead plaintiffs have had their largest impact on attorneys' fees. Not only is institutional participation correlated with lower fees and greater attorney effort, but there is evidence to suggest that institutions have created an economically significant positive externality—a reduction in fee awards even in cases without institutional plaintiffs. Institutional participation, however, has not been an unalloyed good. Other studies suggest that institutional investors are subject to their own agency costs, which potentially eliminate some of the beneficial effects associated with their service as lead plaintiffs. Section 4 concludes and suggests directions for addition research.

2. Securities Class Actions and the Lead Plaintiff Provision

2.1 Agency Costs in Securities Class Actions

The debate over the costs and benefits of private enforcement of the federal securities laws is well-known. Proponents of private enforcement argue that securities class actions provide a vital supplement to under-resourced governmental enforcement authorities that deters wrongdoing and provides compensation to defrauded investors (Seligman 1994). Critics counter that plaintiffs' lawyers typically control securities class actions because they are insufficiently monitored by the relatively unsophisticated individual investors who often serve as representative plaintiffs (Macey and Miller 1991). Due to their small stakes in the outcome of the action, such plaintiffs are rationally apathetic. They do not monitor because they would bear all the costs of doing so, but could expect to collect only a small portion of the gains that might accrue from their efforts.

To further exacerbate this problem, long-term relationships frequently existed between attorneys and individuals (known in some quarters as "professional plaintiffs"), who agreed to buy stock in likely litigation targets and to serve as representative plaintiffs in any ensuing action in exchange for payments from the lawyer (Weiss and Beckerman 1995). While such agreements made sense for plaintiffs' attorneys—who were able to reduce the search costs associated with initiating a case by having a ready stable of plaintiffs—these arrangements made it even more unlikely that the named plaintiff would engage in meaningful monitoring. Indeed, to the extent that the lawyers agree to funnel a percentage of their fee to the representative plaintiff, as several prominent class action lawyers admitted in criminal plea agreements, the representative plaintiff may have an incentive to maximize rather than minimize fees (Perino 2008).

Securities class actions thus represent a classic agency cost problem in which loosely monitored plaintiffs' lawyers have incentives to act opportunistically. Among other problems, insufficient monitoring might lead plaintiffs' attorneys to shirk by settling the case too early and too cheaply where the expected increase in attorneys' fees is less than the costs the attorney would incur in continuing to litigate (Coffee 1987). An insufficiently monitored attorney might also barter a low settlement for an agreement that defendants would not oppose the attorneys' fee request (Macey and Miller 1991). In either case, the attorney may not have incentives to maximize net recovery for the class.

The traditional solution to the inadequacy of plaintiff monitoring is *ex post* judicial review of the settlement and fee request, but critics generally thought that solution was also inadequate (Alexander 1991). The primary litigation mechanism available to provide information to the court, adversarial testing of the proposed settlement and fee, may be largely ineffective because settling defendants have no incentive to challenge the terms and objectors from the class, who are subject to the same rational apathy problems as small stakes representative plaintiffs, are relatively infrequent (Weiss and Beckerman 1995). With respect to fees, there was traditionally no readily ascertainable market rate for the services of plaintiffs' attorneys in class actions and therefore courts' fee determinations were inherently imprecise. Indeed, courts may themselves be subject to significant agency costs because they have incentives to clear their dockets of time consuming and difficult cases and thus may give inadequate scrutiny to proposed settlements or fees (Alexander 1991; Macey and Miller 1991).

Finally, traditional representative plaintiffs and their lawyers had no incentive to consider the long-term health of the defendant company. With no or only a small investment in the company, neither had an incentive to strengthen corporate governance structures at the subject companies as a means for preventing future managerial misconduct. Nor could lawyers expect any greater fee for pushing for governance changes in settlement negotiations. Fee awards in securities class actions are almost always based on a percentage of the negotiated settlement as opposed to the value of other non-monetary benefits achieved for the class.

2.2. *The PSLRA's Lead Plaintiff Provision*

The academic debate over the costs and benefits of securities class actions moved to the political arena in the early 1990s when high technology and accounting firms began to complain that they were disproportionately targeted in these suits (Perino 2003). In response, Congress passed the PSLRA. The lead plaintiff provision is a key feature of the act and represents Congress's primary solution to the monitoring problem.

The provision seeks to encourage institutional investors, which to that point had been largely passive in securities class actions (Grundfest and Perino 1996), to assume primary control over the prosecution of these cases. Modeled on the proposal by Weiss and Beckerman (1995), the provision recognizes that because institutions frequently have the largest claims in class actions and typically recover low percentages of their recognized losses, they may be able to capture enough of the gains from active monitoring to at least partially overcome the collective action problem.

To assist institutions in identifying cases, the PSLRA requires the plaintiff filing the first complaint to publish a notice informing class members of the lawsuit and that they may seek to become lead plaintiff. The court is then required to appoint the moving party that it determines is most capable of adequately representing the class. The PSLRA presumes that this "most adequate plaintiff" should be the moving party who, among other things, has the largest financial interest in the relief sought by the class. This presumption tends to favor large institutions willing to serve as lead plaintiffs. Once appointed, the lead plaintiff has the power to select a lead counsel for the class, subject to court approval.

Due to their comparative sophistication, the size of their holdings, the fact that they are often long-term investors, and their power to select lead counsel, institutional lead plaintiffs could provide significant benefits to the class. Institutions as repeat players may bring a level of expertise to the prosecution of securities class actions that few individual class members could match. The size of their holdings may make monitoring of plaintiffs' attorneys cost-effective and thus may increase attorney effort and reduce the incidence of quick, cheap settlements (Fisch 1997). As large, long-term investors with diverse, often indexed portfolios, institutions may face significant constraints in selling particular securities. They thus may have greater incentives than individual plaintiffs to demand corporate governance changes at defendant firms, which might benefit themselves and other shareholders by reducing the incidence of managerial misconduct in the future.

At the same time, the PSLRA's presumption that the largest investor selects the lead counsel has the potential to create a competitive market among law firms. Under the PSLRA, plaintiffs' lawyers increasingly have incentives to develop longstanding relationships with institutions willing to become active in class litigation because doing so should increase the number of lucrative lead counsel opportunities.[1] Indeed, since passage of the statute there is evidence of a rise in repeat relationships between the largest law firms and certain institutional investors (Choi and Thompson 2006). Lawyers may thus compete for institutional representation by offering higher quality representation as well as on price. Institutional repeat players, many of which have engaged in substantial arm's length bargaining with prospective counsel or have employed competitive selection procedures, may be able to develop compensation arrangements that reduce both fees and agency costs (Fisch 2002). Institutional investor participation as lead plaintiffs could also positively influence fee setting in cases without institutions.

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[1] Law firms have used a number of techniques to develop these long-term relationships. Firms have hosted lavish conferences to which they invite institutional managers, have volunteered to monitor institutional portfolios for potential lawsuits, and have made campaign contributions in what some have suggested are pay-to-play relationships. The potential impact of pay-to-play is discussed in greater detail below, but all of these techniques raise questions about whether and to what extent institutions are subject to significant agency costs that may impede their ability to serve as effective monitors for the class.

Take, for example, portfolio monitoring arrangements. The potential impact of these agreements is ambiguous and likely highly dependent on the terms of the monitoring arrangement. Employing multiple law firms to monitor an investment portfolio could induce beneficial competition and therefore potentially lower fees. *See* Iron Workers Local No. 25 Pension Fund v. Credit-Based Asset Servicing and Securitization, LLC, 616 F. Supp. 2d 461, 466 (S.D.N.Y. 2009). By contrast, a monitoring agreement that obligated the institution to select a single law firm might have the opposite effect. *Id.* at 465-66. In many cases, the agreement may not technically obligate the institution to retain the law firm monitoring its portfolio. Nonetheless, where only a single law firm provides this service, it is highly likely that the institution will do so, substantially reducing the possibility of competition for the institution's business. *See* United Food & Commer. Workers Union v. Chesapeake Energy Corp., 281 F.R.D. 641, 649-50 (W.D. Okla. 2012).

Such an externality might exist if the fee arrangements institutions negotiate influence fee awards in cases without institutional investor participation.

Although institutional monitoring is theoretically beneficial, using institutions as monitors might be ineffective or problematic for a variety of reasons. Institutions might be disinclined to become lead plaintiffs at all because they do not expect to capture enough of the gains their participation creates. Indeed, two studies (Cox and Thomas 2005; Cox and Thomas 2002) found that a significant number of institutions did not even bother to file claims in settled securities class actions. Institutions are also subject to their own agency costs. Institutional and individual investors may not be similarly situated with respect to the trading they engaged in or the benefits flowing from any proposed settlement (Webber 2012; Chamblee Burch 2011). Institutions with long-term positions in a company may be willing to trade monetary recoveries for corporate governance changes. These or other conflicts could lead institutions to skew settlements in their favor to the detriment of individual investors. There have been, in addition, pay-to-play allegations involving a number of law firms that reportedly contributed heavily to the campaigns of government officials who control public pension funds and who can therefore influence whether the fund will serve as a lead plaintiff and who it will select as counsel. Public officials might also seek lead plaintiff status for publicity purposes rather than to closely monitor class counsel (Romano 1993). Union-affiliated funds or mutual funds may have substantial conflicts of interest in negotiating with management to settle a securities class action. These agency costs potentially create much the same problem that existed prior to passage of the PSLRA, inadequate monitoring of the attorney by a conflicted representative plaintiff.

3. Empirical Evidence on Institutional Lead Plaintiffs

3.1 The Frequency of Institutional Participation in Class Actions

Passage of the PSLRA is undoubtedly associated with a substantial increase in institutional investor participation in securities class actions, although that increase took a few years to occur. In the immediate aftermath of the Act, some institutions viewed participation in securities class actions as a logical extension of their activism on corporate governance matters (Grundfest and Perino 1996) and began to seek lead plaintiff status. These initial efforts, however, were quite limited. The SEC (1997) found that institutions served as lead plaintiffs in only eight of 105 cases filed in the first year after passage of the PSLRA. That reluctance continued in the ensuing years, with PricewaterhouseCoopers (2005) finding that union and public pension funds served as lead plaintiffs in an average of 4.8% of the cases filed in the first three years (1996-1998) after passage of the Act.

The explanations institutions offered for their continued passivity suggested that the PSLRA did not do enough to overcome existing free rider problems. Many institutions were uncertain that their participation would yield any tangible benefits and, to the extent that such benefits did exist, they were concerned about whether they would be able to capture a large enough portion of the gains to make participation cost-effective (Grundfest and Perino 1996). Institutions also feared that the costs of participating, including the costs of monitoring plaintiffs' attorneys, the possibility that they would be subjected to burdensome discovery, the adverse reactions from company management, and the potential for liability to other class members, were too high (Fisch 1997).

Participation by public pension funds has increased steadily over time. Cheng, et al. (2010) report statistics for a sample of 1811 cases filed from 1996 to mid-2005. Overall, institutions appear as lead plaintiffs in 15.7% of the sampled cases, with public (5.8%) and union pension funds (3.8%) the most frequent lead or co-lead plaintiffs. Private institutions, including hedge and mutual funds, appear far less frequently; each type is lead plaintiff in less than 1% of cases. Given the low rate of institutional participation in the first years under the PSLRA, these figures represent a substantial increase in institutional participation after 1998. By 2002 public and union pension fund participation had grown to 27.2% of filed cases. The percentage peaked in 2007 at 57%. In subsequent years institutions appeared as lead plaintiffs in just under 40% of filed cases, a substantially higher rate than before passage of the PSLRA (PricewaterhouseCoopers 2012). In cases where institutions compete with other class members for the lead counsel position, courts show a substantial preference for institutions (Cox and Thomas

2006). In only 11.4% of the cases in which individual investors were competing with institutions did the court select individuals as lead plaintiffs.

This increased activism is likely driven in part by changing perceptions of the cost-benefit calculus of becoming lead plaintiff. On the benefits side, in 1998 three public pension funds serving as lead plaintiffs in the *Cendant* litigation obtained a then-record $3.5 billion settlement, which likely suggested to institutions that increased monitoring could yield tangible benefits. Initial institutional experiences as lead plaintiffs also suggested that the costs of institutional participation were not as large as previously anticipated (Cox and Thomas 2006). At the same time, the publicity concerning Enron, WorldCom, and other corporate scandals undoubtedly led some institutions to seek a greater role in securities class actions, either as a means of enhancing deterrence or because participation could lead to valuable publicity for the fund's political overseers.

There is thus no doubt that post-PSLRA institutional participation in securities class actions is greater than it was prior to passage of the Act (Choi, Fisch and Pritchard 2005). The pattern of participation, however, is hardly uniform. Survey evidence suggests that at least some funds appear to consider participation as a lead plaintiff only in those cases in which they have suffered a multi-million dollar loss (Cox and Thomas 2006). That public pension funds rely on such thresholds should not come as a surprise. Monitoring costs are likely relatively insensitive to case size. Because the lead plaintiff provision only partially overcomes the collective action problem, institutions are more likely to serve as lead plaintiffs in cases with larger losses (i.e., a larger stock price drop and longer class periods), larger defendant firms (as measured by market capitalization or total assets), and greater institutional holdings (Cheng, et al. 2010; Cox, Thomas and Bai 2008; Cox and Thomas 2006).[2] Existing research also shows that institutions are more likely to become lead plaintiffs in cases in which the defendant announced an accounting restatement or when the SEC has filed an enforcement action or launched an investigation

[2] This result is consistent with studies of corporate governance activism, which likewise find that institutions tend to target larger firms (Smith 1996).

prior to the filing of the first class action complaint (Cheng, et al. 2010; Cox and Thomas 2006; Choi, Fisch, and Pritchard 2005), suggesting that institutions focus on cases that have obvious indicia of merit. These are the cases in which the institution can reasonably expect that the suit is meritorious and that the potential gains from monitoring will exceed the expected costs.[3]

3.2 Case Outcomes

What, if any, benefits have resulted in the cases where institutions have served as lead plaintiffs is a separate and more difficult question. Class actions that are not dismissed almost invariably settle and so the most obvious question is whether cases with institutional lead plaintiffs settle for more than cases with other kinds of lead plaintiffs. To answer that question, researchers quickly settled on two measures of settlement size—the total dollar value of the settlement or some measure of settlement size as a proportion of total potential damages. To evaluate the individual influence of institutions, researchers then had to account for the myriad other factors that influence settlements. Despite some differences in methodology, the studies almost uniformly find that institutions have had a positive impact on class recoveries.

The first study, Choi, Fisch, and Pritchard (2005), came roughly a decade after passage of the PSLRA and studied the impact of the lead plaintiff provision by comparing two relatively small samples of pre- and post-PSLRA settlements. Their study design was actually biased against finding a positive impact from institutional activism because they focused on a post-PSLRA time period (1996-2000) when institutions were just beginning to serve as lead plaintiffs. In that early time period, there may simply have been too few cases to find a statistically significant impact even if one existed. Alternatively,

[3] Institutions' focus on these cases is also likely the result of two provisions in the PSLRA. The act prohibits incentive payments to the lead plaintiff and permits the court to compensate it for costs and expenses directly related to the representation only out of any final judgment or settlement. Any institution considering whether to monitor actively will discount its potential recovery of costs by the probability that it will not prevail in the action. Under these conditions, it is reasonable to expect that risk averse institutions will only become lead plaintiffs in cases with relatively obvious markers of fraudulent activity. Limiting participation in this manner might be consistent with the managers' fiduciary duties because it limits the downside risk of participation. At the same time, however, it might also limit the benefit of the lead plaintiff provision because these may be the cases where institutional participation can be expected to have the smallest marginal effect on recoveries or fees.

institutions just learning how to manage class action lawyers may have developed insufficient expertise to make any difference in outcomes. Nonetheless, the authors found that public pension fund participation was significantly and positively correlated with a dichotomous variable, “high-value outcome case,” which they defined as settlements of more than five percent of the stakes in the case.

While this result suggested that institutional monitoring was effective, the authors noted that, due in part to their small sample size, they were unable to rule out the possibility that the result was driven by self-selection. Public pension funds may have simply chosen to become involved predominantly in high-profile or easier cases where recoverable damages were higher. If institutions were simply “cherry-picking” the most obvious cases of fraud, then it would be hard to conclude that the lead plaintiff provision worked as Congress intended. The challenge for future studies was thus to increase the sample size and to control for as many variables as possible in an attempt to isolate the impact of institutional participation.

Cox and Thomas (2006) and Cox, Thomas and Bai (2008) relied on a larger dataset and found that institutional lead plaintiffs are positively correlated with settlements, even when controlling for a number of variables correlated with settlement size, including a measure of provable losses, defendant’s market capitalization, class period length, and the presence of an SEC enforcement action.[4] The latter study also found variation among institutional types. Both union-affiliated and public pension participation were correlated with settlement size, but the coefficient for the public pension variable was more than twice as large as the coefficient for labor funds, suggesting that public pension funds have a larger effect on settlement size.

These results were consistent with the hypothesis that the lead plaintiff provision had an overall positive impact. By contrast, Cox and Thomas (2006) found that institutional participation was negatively

[4] The authors find no significant increase in settlement size in post-PSLRA cases and thus call into question whether the reforms the act created were worthwhile. Perino (2012), by contrast, finds a positive correlation between post-PSLRA cases and settlement amounts that is significant at the 10% level (probability = 0.062). These disparate findings suggest, at a minimum, that additional research is necessary to evaluate the overall impact of the act on settlements.

correlated with settlements as a proportion of provable damages, a result that was at odds with the findings of Choi, Fisch and Pritchard. Neither paper, however, controlled for other factors that prior research had shown were correlated with settlement size, such as the presence of certain types of allegations and co-defendants, the presence of certain settlement characteristics, and the presence of certain law firms (Simmons and Ryan 2005). The absence of these controls made it more difficult to conclude that the observed correlation was in fact the product of institutional monitoring and not the product of institutional self-selection.

Cheng, et al. (2010) used a large sample and controlled for some of these variables. The study has two significant findings that suggest that institutional participation is correlated with better case outcomes. Compared to cases with individual investors, Cheng, et al. found that cases with any kind of institutional investor had a lower likelihood of dismissal. This result is both statistically and economically significant, with institutional participation associated with a 38.2% reduction in the probability of dismissal. The authors also find significantly larger settlements in cases with institutional lead plaintiffs. Here, too, the result is economically significant. Overall, the presence of an institutional lead plaintiff is correlated with a 58.9% increase in settlement size, even when controlling for institutional investor selection of larger cases with greater potential damages. There is, however, some difference across institutional types. Public pension participation is correlated with the greatest increase in settlement size while union and mutual fund participation is only marginally significant.

Perino (2012) employed a large sample of securities class action settlements to determine the impact of institutional investor participation. The sample encompasses time periods of both low and high levels of institutional participation and includes more controls for the case characteristics that have been shown to be correlated with settlement amounts. Although broader in these respects, his study is narrower than some others because he focused on the impact of only one kind of institutional investor, public pension funds. The study found that cases with public pension participation are positively correlated with investor recoveries (measured both in absolute terms and as a proportion of investors' overall market losses), even when controlling for institutional self-selection of larger, more high profile cases. The result with respect to settlements as a proportion of market losses is especially important because it contradicts the results of earlier work by Cox and Thomas (2006), which found that institutional participation was negatively correlated with this measure. That earlier finding, however, must be interpreted with caution given the low explanatory power of the model they employed, which explained only 5% of the variation in their sample of 388 settlements. The Perino model, by contrast, explains 61% of the variation in his larger sample (n = 668). Combined with the earlier results of Choi, Fisch and Pritchard (2005), this finding suggests that institutions do in fact recover a higher percentage of the potential damages than other kinds of lead plaintiffs.

To summarize, existing studies have consistently found that institutional participation is correlated with either greater class recoveries or a lower probability of dismissal. To be sure, it remains possible that these studies all fail to control adequately for self-selection effects and that they are all measuring some form of institutional "cherry-picking" of stronger cases. While this possibility cannot be completely discounted, the consistency of the results despite the differences in methodology among the studies and the wide array of control variables the researchers employed suggest that institutional lead plaintiffs have generally had positive impacts on dismissal rates and recoveries. They also suggest something of a hierarchy among institutions, with public pension fund participation being associated with the largest improvements in settlement size.

3.3 Corporate Governance

As institutional activism through service as a lead plaintiff increased, scattered anecdotal evidence suggested that institutions were negotiating corporate governance changes as part of the settlement package. For example, in one of the first cases with significant institutional investor participation, Cendant Corporation agreed to adopt a stricter definition of board independence, to hold annual election of directors, and to change its stock option re-pricing policies (Green 2011). In a 2008 settlement with UnitedHealth Group involving option backdating, a public pension fund, in addition to obtaining a $925 million recovery, negotiated for "a process for election of a shareowner-nominated director, enhanced standards for director independence," mandated shareholder approval for option re-pricing, and enhanced restrictions for option compensation (Webber 2012). Several other cases involve settlements in which the company has agreed to changes in its board structure or compensation practices (Green 2011).

While such changes were commonplace in state derivative lawsuits, they were a relatively novel feature of securities class actions. Some empirical evidence suggests a connection between institutional participation and corporate governance changes even in cases where the changes were not mandated in the settlement. Cheng, et al. (2010) find that within three years of filing the lawsuit, defendant firms with institutional lead plaintiffs demonstrate greater levels of board independence than those with individual lead plaintiffs. Board independence increases by about 11% over a control sample of non-sued firms and over the sample of class actions with individual lead plaintiffs. Defendant firms are more likely to adopt such corporate governance changes in the wake of accounting restatements, but even controlling for this variable, the presence of an institutional investor as lead plaintiff remains positive and significant. Institutional investor participation, however, had no observable impact on two other corporate governance measures—the level of audit committee independence or the likelihood that the defendant firm would appoint a lead director. As with settlement size, there is some evidence of differences among institutional types, with public pension funds and private institutions having a significant positive correlation with board independence and union-affiliated funds having no such significant association.

3.4 Attorneys' Fees and Attorney Effort

There are several studies that examine fees in securities class actions. Choi, Fisch, and Pritchard (2005) find no significant effect of institutional investor participation on fees, although this result is based on a sample of only 78 post-PSLRA cases taken largely from a time period when institutional participation was in its infancy. Even if such a correlation were found, they point out, unobserved characteristics of the cases public pensions select remain a significant problem. If institutions pick only the largest or easiest cases to litigate, then any evidence of lower fees may be result of the nature of the case rather than the active monitoring of the institutional lead plaintiff.

Using a larger dataset that included more cases from the period of increased institutional activism in litigation, Perino (2012) found that attorneys' fee requests and awards are significantly lower in cases with public pension lead plaintiffs. These reductions are not only statistically significant, but economically significant as well. On average, fee requests are 5.3% less and fee awards 3.4% less than in cases without public pension funds. The average fee award in the sample was 26.6%. That means that average fee awards in cases with public pension fund lead plaintiffs were 12.8% lower than in cases with other kinds of lead plaintiffs. There is also evidence that courts show greater deference to the fees negotiated by public pension funds. Eisenberg, Miller and Perino (2009) find that, all else equal, courts award a greater percentage of the requested fees in cases with public pension lead plaintiffs than cases with other lead plaintiff types.

As with settlement amounts, there is evidence that institutional investors are not monolithic when it comes to their ability to bargain for lower fees. Choi (2011) breaks institutional investors into two categories: (1) institutions that sought lead plaintiff status in less than five cases and (2) institutions that sought lead plaintiff status in five or more cases. While the coefficients for both were negative, it was only significant for the frequent lead plaintiff movants.[5] On average, frequent institutional movants were correlated with a 3.3% reduction in fee requests. In other words, on average fee requests in those cases were 12.4% below the average fee request of 26.6% observed in the sample. Choi, Johnson-Skinner and Pritchard (2011) find no statistically significant correlation between union-affiliated funds and attorneys' fees. They also find that larger institutions negotiate for lower fees, a finding that makes great intuitive sense. Larger institutions will tend to have the largest financial interest in a particular case, making it

[5] The lack of significance for the infrequent institutional investor variable may be the result of the small sample size (n = 127) Choi employed compared to the Perino (2012) study (n = 698).

more likely that they will be selected as lead plaintiffs and giving them greater bargaining leverage with potential law firms eager to capture the role as lead counsel.

These findings on decreased fees become even more intriguing in light of the available data on the relationship between attorney effort and institutional participation. Choi (2011) found some evidence that attorneys work more hours in cases with institutional lead plaintiffs than in other securities class actions. In one specification of his model, which controlled for case strength, attorney hours in cases with institutional lead plaintiffs were 40% higher than in cases with other kinds of lead plaintiffs. That result is consistent with unpublished work by Perino (2006), which found that attorney effort (measured by docket entries in the case) was significantly higher in cases with public pension fund lead plaintiffs even when controlling for variables associated with case complexity. Taken together, these studies of fees and attorney effort suggest that institutional investors are able to significantly reduce the agency costs traditionally associated with securities class actions.

The available empirical evidence also suggests that institutional investor participation has broader beneficial effects that extend beyond the particular cases in which they are involved. Perino (2012) provides evidence of a substantial positive externality associated with institutional activism in securities class actions. As public pension fund activism became more widespread, fee awards in cases without public pension lead plaintiffs declined significantly as well, suggesting that the fees institutions negotiated influenced fee setting more generally. Here too the decline was economically significant; in cases without public pension lead plaintiffs that were settled after 2002, fee awards dropped on average 2.2%. In their analysis of fee awards, Eisenberg, Miller and Perino (2010) included fixed effects for the year in which fees were awarded. Starting in 1998 and for each year thereafter the coefficients were negative and significant, indicating that fee awards in these years were lower than the reference year for the study, 1991. The emergence of this correlation in 1998 coincides with the increased participation of institutions as lead plaintiffs, lending additional support to the hypothesis that institutions have contributed to a secular decline in fee awards. Together, these findings suggest that public pension funds act as more effective monitors of class counsel than traditional representative plaintiffs, that the lead plaintiff provision has reduced the transactions costs associated with securities class actions, and thus that the lead plaintiff provision has largely been successful.

Despite these benefits, public pensions are still agents subject to their own agency costs. By far, the largest concerns involve pay-to-play. Are law firms making campaign contributions to increase the likelihood of being selected as lead counsel for the fund and, if so, what if any impact does this practice have on attorneys' fees? Webber (2010) provides some evidence that pay-to-play may not be widespread and that it may have little influence over counsel selection. In particular, he finds that political control over pension funds is negatively correlated with lead plaintiff appointments while beneficiary control of fund boards and the degree of the pension fund's underfunding are positively correlated with such appointments. From these data, Webber concludes that beneficiary board members, not politicians, drive pension fund pursuit of lead plaintiff appointments and that their motivation for doing so involves the financial soundness of the fund. The more underfunding at the pension fund, the more likely the fund is to pursue lead plaintiff appointments. Webber's study, however, is indirect—without looking at actual campaign contributions (which he does not do) it is difficult to draw firm conclusions on the role contributions play in the selection of counsel. Johnson-Skinner (2009), by contrast, provides summary statistics demonstrating that law firms in fact appear to contribute to the campaigns of officials who select them as lead counsel. The study found law firm contributions in 55% of the cases in the dataset involving funds controlled by state level officials (41 or 74 cases).

A more recent study by Choi, Johnson-Skinner and Pritchard (2011) evaluates the impact of these campaign contributions and concludes that they make public pension funds far less effective monitors of law firms. They find that the state pension funds whose officials received the largest campaign contributions negotiated fees that were statistically indistinguishable from the fees negotiated by individual lead plaintiffs. In other words, pay-to-play appeared to eliminate all of the beneficial effects on attorneys' fee awards. Similarly, if the pension fund tended to rely on a single law firm that made campaign contributions, fees were significantly higher, suggesting that the fund provided little effective monitoring. Pay-to-play, however, did not appear to recreate all of the problems Congress sought to redress when it passed the PSLRA. Campaign contributions were, for example, uncorrelated with pension funds bringing weak, low-value claims. Still, these findings suggest that courts should take seriously pay-to-play allegations and should require disclosure of contributions and assess whether those contributions render the fund inadequate to serve as lead plaintiff. Alternatively, in the presence of such contributions, courts should more vigorously monitor any fee request.

4. Conclusion

The empirical evidence on the PSLRA's lead plaintiff provision suggests that courts should continue their preference for institutional over individual plaintiffs in securities class actions. On average, cases with institutional plaintiffs are dismissed less, settle for more, and have lower fees than cases with other kinds of lead plaintiffs.

While the existing research answers many important questions about the effectiveness of institutional investors as lead plaintiffs, some significant questions remain. For example, courts tend to treat all institutions uniformly when it comes to appointing lead plaintiffs, an unsurprising result given that the PSLRA draws no distinctions among institutional types. The evidence collected to date, however, suggests that all institutions are not created equal—public pension funds appear to be associated with better case outcomes than other institutional investors. Additional research should analyze whether there is a real difference between institutional types or whether these results are driven by the comparative size of institutional claims in the litigation. If real differences exist, courts should consider this evidence in deciding among institutions competing to serve as lead plaintiff.

Given the substantial evidence that institution participation is correlated with reduced fees, additional research should examine the extent to which courts defer to the fee arrangements institutions negotiate. With respect to the pay-to-play problem, additional research should try to evaluate the impact of the practice on recoveries. Current research shows that campaign contributions have a deleterious effect on the ability of the funds to monitor fees effectively. If a similar effect is observed for settlement amounts, then courts or Congress should consider a range of reforms, including disclosure of campaign contributions. Such information would appear to be relevant in connection with lead plaintiff appointments, settlement approval, and fee awards.

Scholars have likewise raised concerns about whether other institutional conflicts—their use of derivatives trading strategies and their alleged willingness to trade corporate governance reforms for increased settlement dollars—make institutions inadequate plaintiffs when it comes to representing the interests of individual investors. Unfortunately, these perceived conflicts are speculative—no empirical research has been done to evaluate whether individual investors in fact fare worse in cases with institutional lead plaintiffs. The aggregate data on enhanced recoveries and lower fees in institutional investor cases certainly suggests otherwise, but additional research might evaluate whether, for example, monetary recoveries are lower in cases where institutions negotiate corporate governance reforms. Careful analysis of settlement agreements might also reveal whether allowed damages are skewed in favor of institutional claims. Without such data there appears to be little reason to ignore the PSLRA's statutory scheme of appointing the investor with the largest financial interest in favor of appointing mixed groups of individual and institutional investors, as these scholars advocate.

After passage of the PSLRA, some institutions pursued a strategy of opting out of class actions to pursue individual actions. Anecdotal evidence suggests that institutions might be able to obtain higher returns than they would get in a class action, but it is also possible that opt-out actions benefit attorneys who may have lost a bid to win the lead counsel role. Additional research should analyze the effectiveness of this strategy. Research should also evaluate other avenues for institutional investor participation in securities class actions. In several cases, for example, institutions have objected to proposed settlements, most often to attorneys' fee requests.[6] Studies should assess whether such objections represent an effective, low-cost strategy for institutional activism in securities litigation.

Finally, institutions' participation in securities class actions has led to increased involvement by institutions in cases brought under state law involving mergers and acquisitions or corporate governance matters. Unpublished work by Webber (2011) finds results that parallel those of federal securities class actions. Since Delaware adopted a presumption in favor of selecting institutional lead plaintiffs, their participation in these cases has been substantial, with institutions now appearing in 41% of filed cases. As in securities class actions, institutions tend to focus on higher quality cases. Specifically, institutions tend to serve as lead plaintiffs in cases involving lower merger premiums or other unfavorable deal terms. There is also evidence of substantial variation among institutional types both in terms of case selection and outcomes. Public pension funds, for example, tend to serve as lead plaintiffs in cases involving controlling shareholder transactions. The study finds, however, that only public pension fund participation is significantly correlated with improved share prices for target shareholders. More work is necessary to confirm these results and to examine institutional litigation in non-transactional contexts.

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[6] These objections have met with mixed results. *Compare In re Cardinal Health, Inc. Sec. Litig.*, 550 F. Supp. 2d 751 (S.D. Ohio 2008) (reducing requested fee from 24% to 18% based in part on objections lodged by institutional investors) *with In re Adelphia Communs. Corp. Sec. & Derivative Litig.*, 2006 U.S. Dist. LEXIS 84621 (S.D.N.Y. Nov. 16, 2006) (declining to reduce fee request despite institutional investor objection).

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