A VIEW FROM THE TRENCHES*

Edward Labaton**

I can't be very informative giving a critique of the Carleton, Weisbach, and Weiss study ("CWW Study"),[1] but I can give you another perspective, the perspective of a lawyer who litigates securities class actions on a day-to-day basis. That's not to demean academic studies or suggest that they are not important or useful. They are both.

I do have some comments on specific assumptions in the CWW Study. The assumption that bothered me most was the acceptance of Professor Grundfest's surmise that settlements of less than $2 million generally involved "nuisance" suits.[2] The CWW Study does not use the term "frivolous" suit, but it is not hard to equate a nuisance suit with a frivolous suit. It is undeniable that there are some nuisance suits and there are some frivolous suits, and these include some class actions. But my surmise is that the number of frivolous suits in the class action area is quite small.

My surmise is based on two assumptions: that class action lawyers are neither stupid nor self-destructive. And from my experience frivolous suits are not settled for $1 million or $2 million or for anything. They are dismissed or disposed of by summary judgment and the reasonably intelligent, knowledgeable lawyer who brings a class action suit must assume that dismissal or summary judgment is the likely outcome of a frivolous suit. Dismissal motions have in recent years been granted more frequently than they were in past years, as demonstrated by Dean Seligman's article in the Harvard Law Review.[3]

If a plaintiff in a class action loses a motion for summary judgment or if her case is dismissed, her lawyer has spent a lot of time and a lot of money and has earned nothing. And that doesn't even take into consideration the impact of Rule 11 sanctions, to which every lawyer who practices in this field is highly sensitive.

One of the criticisms of class actions that has been raised, and I think is largely dealt with indirectly but effectively by the CWW Study, is that merits don't matter, that settlements have little relationship to the merits. The CWW

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** BBA, City College of New York, 1952; LLB, Yale University, 1955. Partner in the firm of Goodkind Labaton Rudoff & Sucharow LLP.

1. Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, Draft December 8, 1995. The Study as revised appears at 38 ARIZ. L. REV. 491 (1996).
2. *Id.* at 492.
3. Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438 (1994).

Study not only does not support that hypothesis, but in terms of the dollar volumes that are indicated in the charts, it suggests, on an empirical basis, that merits do indeed matter.

Speaking from my own personal experience—from the trenches—I have no doubt whatever that in every case in which I am involved and in every settlement in which I represent a plaintiff class, the merits matter. The merits are indeed the most critical element in a settlement. Now, what do we mean by merits? Merits do not only mean liability, they also mean the ability to collect a judgment. And there are circumstances where cases are settled for $1 million or $2 million in which there is terrific liability. But the principal culprits may be judgment-proof; the insurance policy available may be very small or the carrier may have disclaimed liability because it claims that the conduct alleged is willful and not merely reckless. As a result, sometimes attorneys settle class actions for less than $2 million. That doesn't mean that the case is not meritorious or that it's a nuisance case when it's brought; facts are often learned after a lawsuit is brought which result in acceptance of a relatively small amount compared to the total loss.

A premise of the American justice system is that most litigations will be compromised. This premise applies not only to the civil system, but also to the criminal system. There are far more plea bargains than there are cases going to trial. There are far more civil cases settled than go to trial. The frequency of compromise doesn't mean that merits don't matter in any of those settlements. Merits are weighed in criminal plea bargains, and in civil settlements entered into by large corporations who have the ability to evaluate the merits of the case, ascertain the likelihood of success, the risk of loss, the time involved in litigation, and all of the other factors that are present in every litigation. To isolate class actions as a subset in which different factors are applied is a serious mistake.

In fact, in class action litigation we do precisely the same type of analysis as in every other type of civil litigation: we weigh liability; we determine the ability to pay; we determine the likelihood of success. We measure all these factors and we negotiate at arm's length.

In fact, class action attorneys evaluate every case in a very fact-specific way. In illustrating this evaluation I'll do the unforgivable by presenting a couple of anecdotal situations. First, we've just resolved in principle, subject to a major condition, the Spectrum Technology case,[4] a very high profile case involving lots of insider trading and tremendous liability from our point of view. Except for their contributions to the settlement, which is less than $2 million, the most culpable defendants are virtually judgment proof. They dissipated their assets; we can't reach them. The insurance policy is depleting; the company is in Chapter 11, which will result in the class plaintiffs ending up with half of the company when it emerges from Chapter 11 proceedings. But the settlement from the most culpable defendants is an amount that Professor Grundfest and the CWW Study surmise is a "nuisance value" settlement, about $2 million. The settlement is subject to payment by the carriers of what is left of the insurance policies—about $9,000,000, which in turn depends on the outcome of litigation between the carriers and the insured.

4. Consolidated and Amended Class Action Complaint, *In re* Spectrum Info.

A similar situation occurred in another case involving a Canadian company with a Canadian insurer which also disclaimed liability.[5] The company went into bankruptcy; all of the principal directors are in Canada and we would have to go into Canada to attempt to enforce an American securities law judgment, which is very difficult. We therefore settled for $1.5 million in a case which on the merits warranted a great deal more if the defendants could pay, or we could collect more. Those are not factors that I think Professor Grundfest or the CWW Study take into account in their surmise.

The CWW Study[6] refers to a recent National Economic Research Associates ("NERA") study[7] which I've read with great interest. The NERA study relies on plaintiffs' damages analyses and NERA analyses "computed in a manner similar to the approach sometimes used by plaintiffs in computing damages."[8] What the NERA report doesn't mention and what is also missing from the CWW Study is that in most 10b–5 cases defendants usually prepare their own damages analyses. None of the statistics in the NERA Study presents these damage analyses, and hence there is no way of measuring the recovery achieved against the defendants' damage calculations.

I recall two settled cases in which NERA was retained by defendants as a damage expert. One of the cases is documented in an article in the *Kentucky Law Journal*[9] which includes an appendix with an anonymous case history. I was able to identify it as a case in which my firm was co-lead counsel, the Frank B. Hall case.[10] Frank B. Hall Co. ("Hall") was an insurance agent whose stock was listed on the New York Stock Exchange. The class action complaint alleged violations of Rule 10b–5 in that Hall carried as an asset in the amount of $10,000,000 an investment in an insolvent insurance subsidiary and failed to disclose that the New York Superintendent of Insurance had commenced proceedings to hold Hall liable for $140 million dollars, the amount by which the subsidiary's liabilities exceeded its assets. The complaint further alleged that Hall failed to disclose that it had guaranteed the losses of a reinsurance subsidiary. The guarantee exposed Hall to a liability of $64 million for which there was no reserve. The complaint alleged that Hall stock was artificially inflated during the period that these losses were concealed.

Plaintiffs' experts opined that the 10b–5 damages exceeded $90 million.[11] The amount of insurance coverage was $15 million; the defendant directors had limited assets and Frank B. Hall was in financial difficulty. The defendant's damage experts, NERA and Lexecon, opined to us that the recoverable damages

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Technologies, Inc. Sec. Litig., No. CV–93–2295 (E.D.N.Y. 1993).

5. Amended Class Action Complaint, Weiss v. Harvard Int'l Technologies, No. CV–93–3972 (ARR) (E.D.N.Y. 1993).

6. Carleton et al., *supra* note 1, at 492 n.4.

7. FREDERICK C. DUNBAR ET AL., NATIONAL ECONOMIC RESEARCH ASSOCIATES, RECENT TRENDS III: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? (June 1995) (the "NERA Study").

8. *See id.* at 4–5.

9. Andrew R. Simmonds et al., *Dealing with Anomalies, Confusion and Contradiction in Fraud on the Market Securities Class Actions*, 81 KY. L.J. 123, 180–86 (1992).

10. Second Consolidated Amended Complaint, *In re* Frank B. Hall Co., Inc., Sec. Litig., No. 86 Civ. 2698 (CLB) (S.D.N.Y. 1986).

11. Plaintiffs' counsels' memorandum of settlement conference held on March 23, 1990. Present were the three authors of the article referred to *supra* at note 9: Professor Ronen and Vinita Juneja were identified as NERA representatives, and Robert Stillman was identified as a Lexecon representative.

for the claims asserted was between $200,000 and $1.9 million. We settled the case for $12 million, $3 million less than the total insurance coverage. Presumably the NERA Study would infer that plaintiffs recovered approximately thirteen percent of the total damages. If their damage analysis was correct, however, we settled the case for at least six times the amount of the recoverable damages.

NERA was also the damage expert for defendants in the Zenith Laboratories case,[12] which was settled after five days of trial. Zenith was in bankruptcy and the most culpable individual defendant was virtually judgment proof. There was another deep pocket defendant (the Chairman of the Board), but we were confronted with a serious scienter issue as to him. The insurance policy was for $15 million. Our damage expert opined that damages were $67 million. The defendant's expert (NERA) opinion was that damages attributable to the 10b–5 claim were about one-tenth of that amount, between $6 and $7 million. We settled for $12 million dollars, less than one-fifth of the damages, based upon our damage analysis. But if one used the NERA damage analysis, we settled for twice the amount of the damages.[13]

Another case in which I was involved was also settled during trial just ten years ago. The case involved Sambo's Restaurants, a company, again which was in bankruptcy.[14] The Directors' and Officers' policies were $10 million, $5 million of which was in dispute because a carrier asserted that the directors failed to inform it of material facts, including commencement of a prior class action suit which included claims similar to ours. Defendant retained Lexecon, a company often retained by defendants in similar class actions to perform damage analyses. Dan Fischel, a principal of Lexecon, testified in his deposition that there were virtually no damages at all attributable to what we claimed was fraudulent conduct. We settled for $7 million.

On the basis of my personal experience, I would suggest that when studies are made by scholars to determine the percentage of recovery by class action plaintiffs, they attempt to obtain damage studies done by defendants. NERA, Lexecon and others have lots of data on cases which have been settled. Evaluating that data and measuring it against plaintiffs' damage analyses and the amount recovered in settlement would cast considerable light on the subject of whether merits matter. Such an evaluation would demonstrate what is obvious to those of us who practice in this area: merits involve liability, ability to pay and compensable or recoverable loss; market loss is not necessarily synonymous with recoverable loss.

I'll close with one more suggestion. From my perspective, from the trenches, from a plaintiff's point of view, the CWW Study suggests an even more pressing need: the need to evaluate the extent to which our securities markets are affected by a comprehensible, enforceable disclosure system. I would ask several questions: 1) Is the deterrent effect of exposure to litigation measurable? 2) What rôle does the private litigant have in assuring that our

12. Consolidated, Supplemental and Amended Complaint, *In re* Zenith Lab. Sec. Litig., Master File No. 86–3241A (DRD) (D.N.J. 1986).

13. Another important element is that we were able to recover 80% of the insurance coverage.

14. Complaint, Kreindler v. Battistone, No. 79 Civ. 4538 (WK) (S.D.N.Y. 1979).

capital markets remain, in the words of the *Market 2000 Report,*[15] the "cleanest, fairest and most efficient in the world"? 3) What is the cost of capital in the United States compared to that of other industrial countries? In other words, do class actions result in hidden cost savings to American industry? 4) Could initial public offerings have raised more than $100 billion in 1993 if the market were less trusted?

You may surmise from these questions that I suspect that class actions work in ways that many of us don't fully understand or appreciate. Class actions not only compensate victims of fraudulent conduct (which should be an important goal in any civil justice system), but they are also an important element in preserving the integrity of markets; the latter benefit has been largely ignored by proponents of so-called legal reform. And finally, I suggest that economic research would develop empirical data, particularly on the cost of capital in the United States compared to other countries, that could demonstrate the validity of my hypothesis.

15. Market 2,000, An Examination of Current Equity Market Developments, Division of Market Regulation of the SEC, *available in* 1994 SEC LEXIS 135 (Jan. 1994).