James R. Copland
Written Testimony

U.S. House of Representatives Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"America's Capital Markets: Maintaining Our Lead in the 21st Century"

April 26, 2006

Good morning. My name is Jim Copland, and I am the director of the Center for Legal Policy at the Manhattan Institute. The Center for Legal Policy has been studying the civil justice system for 20 years, led throughout that period by my colleagues Peter Huber and Walter Olson, both senior fellows at the Institute. I took over directorial duties at the Center in February 2003 after having been a management consultant at McKinsey and Company. I have a background in law, which I studied at Yale Law School; finance, in which I concentrated my studies at Yale School of Management; and economics, which I studied at the undergraduate and masters level. Since joining the Manhattan Institute, I have led the Center for Legal Policy in new and continuing initiatives, including:

- Publishing a series of reports, entitled *Trial Lawyers, Inc.*, that assess the legal industry as a business. After publishing an initial report in Fall 2003, we have subsequently published industry- and state-focused reports and shorter updates.[1]
- Launching a web magazine, *PointOfLaw.com*, that brings together information and opinion on the U.S. legal system. *Point of Law* publishes columns, sponsors regular discussions, and has ongoing "weblog" commentary from many of the nation's top legal scholars in the field of tort law.
- Continuing efforts to assess empirically the U.S. tort system. Among the Center's works in recent years were a series of 4 reports assessing the problem of forum shopping in class action litigation, the problem that was the focus of the recently enacted Class Action Fairness Act. The Center has also been active in analyzing various specific types of litigation, including medical malpractice, asbestos, and "toxic" mold.[2]
- Formulating policy solutions to the problem of overlitigation. Last fall, we convened a policy working group with some of the nation's leading academics and practitioners to consider ideas for reform that deserve special emphasis. One item of particular interest to emerge from that conference is "loser pays"—the rule in other developed countries whereby the losing party in litigation pays the other's expenses. We are currently developing an in-depth look at how a loser pays mechanism might work in the U.S.; that idea and others to come out of last year's conference will inform the policy portion of my comments.

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[1] All published *Trial Lawyers, Inc.* reports and updates are available at www.triallawyersinc.com.
[2] For a complete listing of Manhattan Institute publications on civil justice, see http://www.manhattan-institute.org/tools/pubs.php.

Introduction

My charge before you today is to discuss my views on how regulation, litigation, and financial reporting are affecting the global competitiveness of U.S. capital markets. I will focus my comments on **litigation**, since that is my area of expertise.

I do note at the outset, however, that the tendency to criminalize corporate conduct in the wake of the collapses of Enron and WorldCom adds substantial new risks to directorship and basic business judgment. Particularly pernicious in my view is the tendency of state attorneys general, often aspiring to higher office, using their broad prosecutorial powers to regulate interstate commerce in the financial arena. Such prosecutorial overreaching tends to interfere with proper federal regulatory authority vested in the Securities and Exchange Commission and Commodity Futures Trading Commission, and, inevitably, tends to make the United States a less attractive business venue. I would urge the committee to consider investigating to what extent the broad scope of federal regulation under the SEC, CFTC, and other pertinent federal agencies should be clarified to preempt the prosecutorial authorities of state attorneys general in certain respects.[3]

I also note briefly that new financial disclosure requirements in the United States have been criticized by some leading academic scholars in the field, notably Larry Ribstein of the University of Illinois and Stephen Bainbridge of UCLA. Professor Ribstein has suggested that certain reporting requirements, if not modified, could drive capital out of the U.S. and into Europe. I would urge the committee to consider the views of Professors Ribstein, Bainbridge, and others in some depth, with a view toward amending the well-meaning Sarbanes-Oxley reforms to ameliorate unintended side effects of the new regulations.[4]

The U.S. Tort Tax

When it comes to litigation,[5] the American "tort tax"—the percentage of the gross domestic product consumed by tort law costs—is 2.22 percent. As Figure 1 shows, the percentage of our economy devoted to tort litigation has grown astronomically over the last 50 years. In 1950, torts cost $1.8 billion; in 2004, torts cost $260.1 billion. Over that span, the inflation-adjusted tort tax per capita grew almost tenfold. Tort costs grew almost four times as fast as GDP.[6] The American tort tax is estimated to be the equivalent of a 5 percent wage tax, well higher than the corporate income tax, and "far more than enough money to solve Social Security's long-term financing crisis."[7]

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[3] Additional commentary on this topic can be found on the Manhattan Institute's web magazine *PointOfLaw.com*. *See, e.g.*, http://www.pointoflaw.com/cgi-bin/mt-search.cgi?search=spitzer.

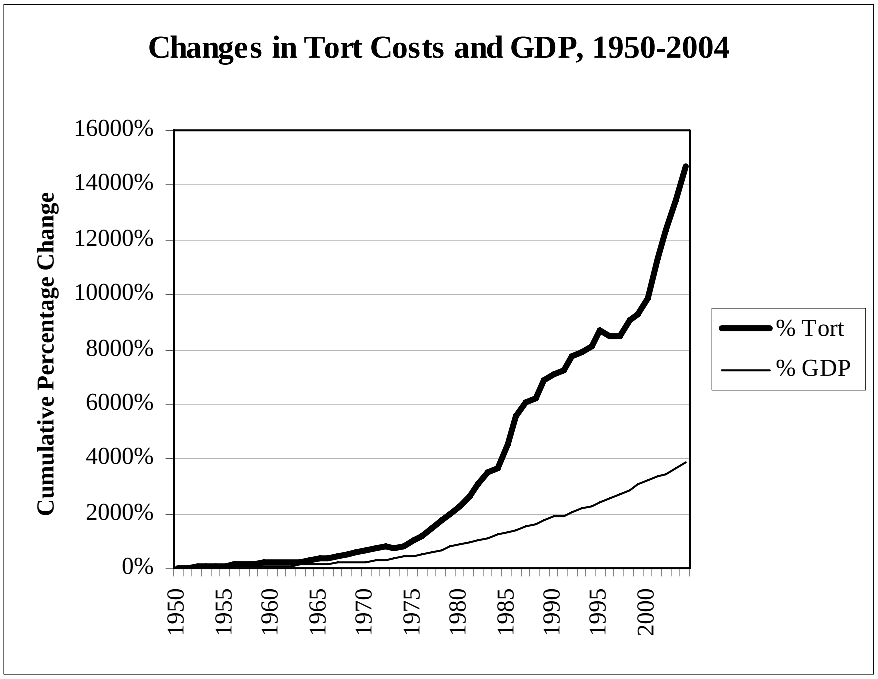
[4] The viewpoints of Professors Bainbridge, Ribstein, and others can also be accessed through *PointOfLaw.com*, at http://www.pointoflaw.com/cgi-bin/mt-search.cgi?search=sox.

[5] The comments that follow are adapted in part, in some cases directly, from earlier of my writings, available at http://www.manhattan-institute.org/html/copland.htm.

[6] Tort tax statistics are taken from estimates derived by the actuarial firm Towers Perrin Tillinghast, *U.S. Tort Costs and Cross-Border Perspectives: 2005 Update*, available at http://www.towersperrin.com/tillinghast/publications/reports/2005_Tort_Cost/2005_Tort.pdf.

[7] *See* Steven Hantler, *The Seven Myths of Highly Effective Plaintiffs' Lawyers*, Manhattan Institute Civil Justice Forum 42, at 6 (April 2004)(citing Council of Economic Advisers, *Who Pays For Tort Liability Claims? An Economic Analysis of the U.S. Tort Liability System* 12, 13 (Apr. 2002)).

Figure 1.



Source: Towers Perrin Tillinghast, supra *note 6.*

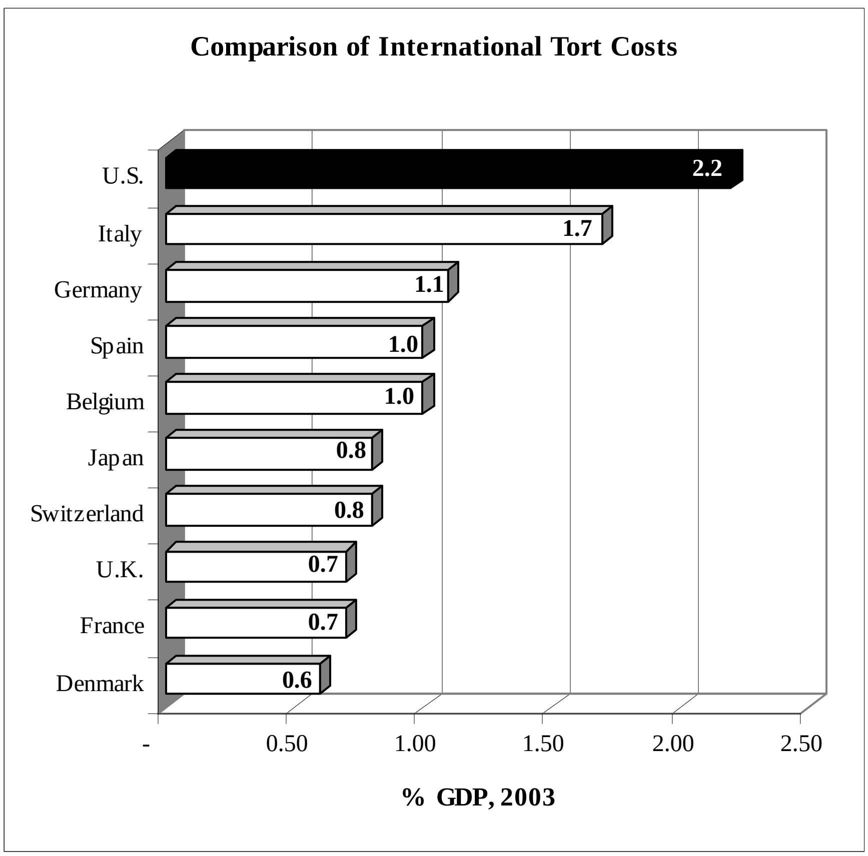
These tort tax estimates come from the actuarial firm Towers Perrin Tillinghast, which has been assessing the costs of tort litigation for several years. A few points are in order. First, the estimates are top-down, derived from insurance company data. "Bottom-up" estimates of tort costs are essentially impossible to construct given the paucity of data; most cases settle, and settlements are typically sealed and protected by attorney-client privilege. Second, the tort tax measured by Tillinghast involves direct transfer payments between parties to litigation, including attorneys, as well as the administrative costs incurred by insurance companies. The tort cost estimates do not reflect the full cost of tort litigation, any more than marginal tax rates reflect the full dynamic effect of taxes on the economy. Reduced research, innovation, and investment are not measured, nor are wasteful nonproductive behavioral responses—such as defensive medicine—that are intended solely to lower litigation risk. Third, even on its own terms, the Tillinghast study does not include all forms of tort litigation. Significantly, the estimates omit punitive damages, most securities litigation, and the multi-state tobacco settlement.

I note that trial lawyers and their allied advocates typically criticize the Tillinghast numbers, in no small part because they include insurance company administrative expenses for handling tort claims. Since the primary purview of this committee involves insurance as well as capital markets, the insurance cost of litigation is a critical component of the equation. The scope and unpredictability of litigation is destabilizing to insurance markets, with adverse consequences for the American economy and consumer. For example, in medical malpractice cases, the median jury verdict rose from $500,000 in

1997 to $712,000 in 1999 to $1 million in 2000,[8] which precipitated a well-publicized crisis in the medical malpractice insurance industry. In 2001, the medical malpractice insurance industry suffered $3 billion in underwriting losses, including almost $1 billion from the St. Paul Companies, the then-largest malpractice insurer. St. Paul exited the market, as did the Farmers Insurance Group, and physician-owned Pennsylvania insurer PHICO declared bankruptcy.[9] In any event, whether or not insurers' administrative costs should be included in tort tax estimates is really a red herring. Such costs constitute 22.2 percent of tort cost estimates today, as compared with 32.2 percent in the 1950s. In other words, the relative expense of insuring against tort losses, though sizable, has not risen as quickly as tort costs overall.

In assessing the impact of litigation on American competitiveness, it is perhaps most useful to look at how our tort costs compare with those of other nations. The tort tax in the United States is far higher than that in other developed countries. The percentage of its economy that America devotes to tort law is almost twice that of Germany and three times that of France or Britain. Figure 2 shows direct tort law costs as a percentage of GDP in the United States and other industrialized nations.

Figure 2.



Source: Towers Perrin Tillinghast, supra *note 6.*

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[8] Based on statistics from Jury Verdict Research, *see* http://www.juryverdictresearch.com/Press_Room/Press_releases/Verdict_study/verdict_study8.html.

[9] For more details, see http://www.pointoflaw.com/columns/archives/001347.php.

A Cost-Benefit Analysis?

In assessing the American tort tax, we must of course not merely look at the costs of the system. While America may not be appreciably safer than the other industrialized countries, perhaps our tort system is achieving other goals, in terms of safety or equity, that other nation's regulatory systems or welfare states provide. In other words, are we getting bang for our buck? The answer to this question is almost certainly no.

Safety and Deterrence

Let's first consider safety. America is a much safer place, in terms of accidents, than it was fifty years ago, but the evidence shows that the decline in accident rates "has been steady and consistent both before and after the initial expansion of products liability law," with "little, if any, correlation between the decline in accident rates and the expansion in tort liability."[10] A recent study by Professors Paul Rubin and Joanna Shepherd at Emory that looked at rates of accidental death in states from 1981 through 2000 showed that tort reform—including caps on noneconomic damages, a higher evidence standard for punitive damages, product liability reform, and prejudgment interest reform—*saved lives*, to the tune of 22,000 prevented accidental deaths over the time period.[11] In addition, extensive cross-sectional studies of punitive damages for a variety of risk measures (including "toxic chemical accidents, toxic chemical accidents causing injury or death, toxic chemical discharges, surface water discharges, total toxic releases, medical misadventure mortality rates, total accidental mortality rates, and a variety of liability insurance premium measures") have found that "[s]tates with punitive damages exhibit no safer risk performance than states without punitive damages," so that "there is no deterrence benefit that justifies the chaos and economic disruption inflicted by punitive damages."[12]

What explains these results? In the modern American tort system, most people who are injured are not compensated and many who are compensated are uninjured. For example, in asbestos litigation, many of those suffering from mesothelioma, the deadly cancer linked to asbestos exposure, go undercompensated, while those with no cognizable medical injury receive payouts from bankrupt firms and their successor trusts.[13] In medical malpractice litigation, the famous 1991 Harvard Medical Practice Group Study

[10] *See* George Priest, "Products Liability Law and the Accident Rate," in *Liability: Perspectives and Policy* (Robert Litan and C. Winston, eds. 1988).

[11] *See* "Tort Reform and Accidental Deaths," available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=781424.

[12] W. Kip Viscusi, "The Social Costs of Punitive Damages Against Corporations," 87 *Geo. L.J.* 285, 297-98 (1998); W. Kip Viscusi, "Why There Is No Defense of Punitive Damages," 87 *Geo. L.J.* 381 (1998).

[13] *See* Lester Brickman, "Asbestos Litigation," transcript of comments to the Manhattan Institute, Mar. 10, 2004, available at http://www.manhattan-institute.org/html/clp03-10-04.htm ("[Plaintiffs' lawyers] assert claims on behalf of each client in their inventories who are recruited by screenings, against each of the bankruptcy trusts and a few dozen or more of the solvent defendants. Even if they only collect a few hundred to a few thousand dollars per claim, it adds up. For a single claimant, one without any asbestos-related illness recognized by medical science, this can amount $60,000, even as high as $100,000."); *see also* Lester Brickman, "On the Theory Class's Theories of Asbestos Litigation: The Disconnect Between Scholarship and Reality," 31 *Pepperdine L. Rev.* 33 (2004).

emerged with "two striking findings: most persons with potentially legitimate claims appeared not to file them, but most claims that were filed had no evident basis." [14]

These outcomes are unsurprising. Mass tort cases, like asbestos, tend to overwhelm courts and are subject to abuse, even fraud, as Judge Janis Jack has discovered in looking at silicosis claims and Judge Harvey Bartle has discovered in handling the Fen-Phen settlement trust.[15] In these product liability and medical malpractice cases, lay jurors are unsophisticated even though we count on them to act as final arbiters; jurors' duties today include "redesign[ing] airplane engines and high-lift loaders, rewrit[ing] herbicide warnings, determin[ing] whether Bendectin causes birth defects, plac[ing] a suitable price on sorrow and anguish, and administer[ing] an open-ended system of punitive fines."[16] Moroever, jurors "face accidents up close" without the "broader vision, dominated by the individual case."[17] Little wonder, then, that asbestos dockets are flooded with illegitimate claims[18] and that the medical malpractice bar is dominated by extreme but unlikely cases, such as the claim that an infant's cerebral palsy was caused by asphyxiation in delivery.[19] "When all is said and done, the modern rules do not deter risk: they deter behavior that gets people sued, which is not at all the same thing."[20]

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[14] *See, e.g.*, Troyen A. Brennan, *et al.*, "Incidence of Adverse Events and Negligence in Hospitalized Patients: Results of the Harvard Medical Practice Study I," *New Engl. J. Med.* 324, 370-6 (1991); "The Nature of Adverse Events in Hospitalized Patients: Results of the Harvard Medical Practice Study II," *New Engl. J. Med.* 324, 377-84 (1991). The study reviewed "a weighted sample of 31,429 records" of "nonpsychiatric patients discharged from nonfederal acute care hospitals in New York in 1984." Richard Anderson, "An 'Epidemic' of Medical Malpractice? A Commentary on the Harvard Medical Practice Study," *Manhattan Institute Civil Justice Memo* No. 27 (July 1996), *available at* http://www.manhattan-institute.org/html/cjm_27.htm.

[15] *See* Lester Brickman, "What Did Those Asbestos X-Rays Really Show?", at http://www.pointoflaw.com/columns/archives/002092.php; James Copland, "Fen-Phen Follies," at http://www.pointoflaw.com/archives/000990.php.

[16] Peter Huber, *Liability: The Legal Revolution and Its Consequences* 185 (Basic Books 1988).

[17] *Id.* The juror's closeness to the case is compounded by the cognitive inclination known as "hindsight bias," *i.e.*, "the natural human tendency after an accident to see the outcome as predictable – and therefore, easy to affix blame," Hantler, *supra* note 7, at 3, which "'makes the defendant[s] appear more culpable than they really are.'" *Id.* at 3 (quoting Jeffrey J. Rachlinski, "A Positive Psychological Theory of Judging in Hindsight," 65 *U. Chi. L. Rev.* 571, 572 (1998)).

[18] A study by Johns Hopkins radiologists published last August in *Academic Radiology* found that initial "B" readers contracted by plaintiffs' attorneys to identify lung changes had identified abnormalities in 95.9% of 492 cases; independent readers hired by the radiologists who examined the same x-rays, without knowing their origins, found abnormalities in only 4.5% of cases. *See* Joseph N. Gitlin, *et al*., "Comparison of 'B' Readers' Interpretations of Chest Radiographs for Asbestos Related Changes," 11 *Acad. Radiol.* 243 (2004).

[19] A January 2003 report issued by the American College of Obstetricians and Gynecologists and American Academy of Pediatrics found that "that use of nonreassuring fetal heart rate patterns to predict subsequent cerebral palsy had a 99% false-positive rate." *Neonatal Encephalopathy and Cerebral Palsy: Defining the Pathogenesis and Pathophysiology* (American College of Obstetricians and Gynecologists and American Academy of Pediatrics Jan. 31, 2003), available at http://www.acog.org/from_home/Misc/neonatalEncephalopathy.cfm (executive summary). Presumably, juries assessing dueling experts, after witnessing a child born with a tragic defect, are particularly ill-equipped to determine whether the case before them falls into the rare category of cases in which a lack of oxygen in delivery was responsible for the cerebral palsy.

[20] Huber, *supra* note 16, at 164.

Equity and Administrative Cost

The basic inability of our tort system to deliver accurate results also, in and of itself, throws into question how well the law in this arena is fulfilling its equitable function. Moreover, by any measure, the administrative costs of the tort system are astronomical:

> If viewed as a mechanism for compensating victims for their economic losses, the tort system is extremely inefficient, returning only 22 cents of the tort cost dollar for that purpose. . . . Of course, the tort system also provides compensation for victims' pain and suffering and other noneconomic losses. Even including these benefits, the system is less than 50% efficient. [21]

In short, tort awards are random, slow, and inequitable. The tort law system shows no evidence of deterring specific risky behavior such that actors economically internalize the cost of accidents, deters instead innovation and products and behaviors that are useful but novel with unknown risk profiles, and is incredibly expensive to administer.

Securities Litigation: The Post-PSLRA Picture

How such costly litigation affects the competitiveness of American *capital markets*, however, is a more complex question. As already noted, insurance companies bear a significant burden from unpredictable litigation exposure, a burden that should not be disregarded. To that extent, reforming our tort law should shore up insurance company stability and competitiveness. But beyond the insurance component, many of the perverse effects I have previously mentioned are specifically relevant to the competitiveness of American manufacturers, and to the health and safety of American consumers, more than to capital markets competitiveness *per se*.

To understand capital markets competitiveness, we should look specifically to the field of securities litigation. When Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA), there was substantial concern that securities lawsuits were adversely affecting U.S. capital markets. Academics who studied securities litigation found that the value at which securities lawsuits settled was not related to the merits of the underlying suit.[22] Securities lawyers were deemed to be filing "strike suits" whenever a stock price declined. Such stock price drops were regular occurrences in the high-technology sector, since high-tech stocks naturally trade at high multiples of current earnings, if any, and are priced based on speculative assumptions about future earnings growth. Also, securities lawyers were observed often "rushing to the courthouse door" to file a suit and gain control of litigation, since they merely had to find a named plaintiff on behalf of a prospective class.[23] The excessive cost of discovery in securities class action litigation

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[21] *See* Towers Perrin Tillinghast, *U.S. Tort Costs: 2003 Update, Trends and Findings on the Cost of the U.S. Tort System*, at 17 (2003).

[22] *See, e.g.*, Janet Cooper Alexander, "Do the Merits Matter? A Study of Settlements in Securities Class Actions," 43 *Stan. L. Rev.* 497 (1991).

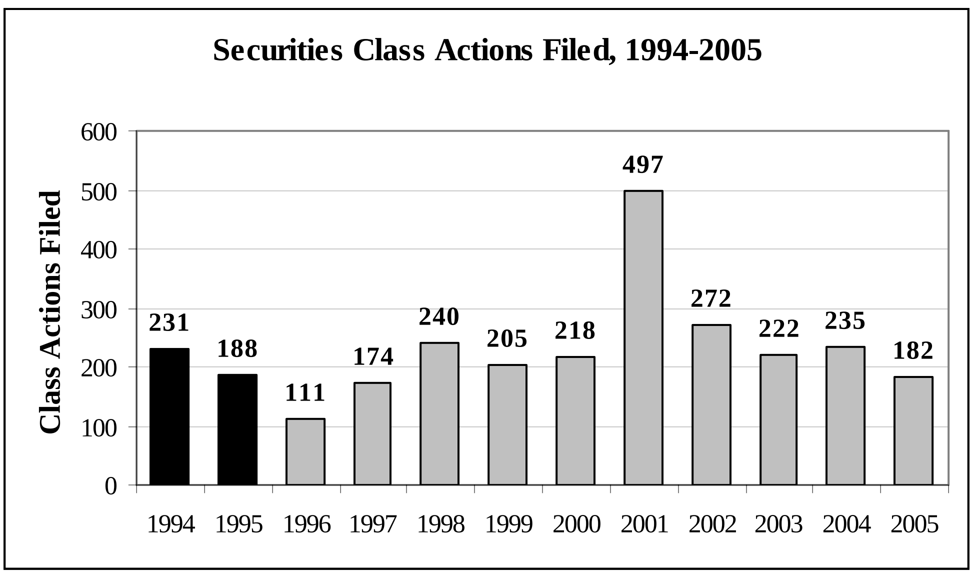
[23] Such behaviors were not only unseemly, but perhaps even fraudulent. The Department of Justice is reported to be investigating whether one of the nation's top securities litigation firms made "payments to a

combined with minimal pleading standards to enable plaintiffs' attorneys to extract substantial settlement values from defendant firms, regardless of case merits.

The PSRLA tried to solve the *in terrorem* effect of discovery compelled by strike suits by requiring more in-depth pleading standards to support a securities claim and by automatically staying discovery while a motion to dismiss is pending. The Act provided a safe harbor provision for forward-looking statements. Finally, the PSLRA forced judges to select as the lead plaintiff in securities cases the investor most likely to protect the class of claimants' interests, typically the largest investor, rather than merely permitting the first plaintiff filing suit to control the litigation. This approach was intended to remedy what legal scholars call the "agency cost" problem inherent in any class action litigation. To understand agency costs, consider that by definition, individual claims are small for class litigation, so no individual plaintiff typically has sufficient interest to monitor or control the class attorneys. Securities class action king Bill Lerach once boasted to *Forbes* magazine, "I have the greatest practice in the world. I have no clients."

Did the PSLRA work as intended? On first glance, no. As Figure 3 makes clear, after an initial one-year decline in securities lawsuit filings, the number of lawsuits filed annually essentially returned to the pre-PSRLA level, and indeed increased slightly.[24]

Figure 3.



Source: Stanford Law School Securities Class Action Clearinghouse.

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former client and lead plaintiff in several class actions." *See* http://www.pointoflaw.com/archives/002319.php.

[24] The one-year spike in filings in 2001 corresponds to the collapse of the "dot-com" stock market bubble. According to the Stanford Securities Class Action Clearinghouse, "Calendar year 2001 differs from prior experience because of the proliferation of 'IPO Allocation' lawsuits. These complaints generally allege that underwriters engaged in undisclosed practices in connection with the distribution of certain IPO shares. These complaints do not allege that issuers have engaged in fraud when describing their own business or financial circumstances."

Studies have shown that since the adoption of the PSLRA, the rate of *dismissals* of cases has roughly doubled, but the *value of monetary settlements* has increased.[25] "High technology issuers remain at significantly greater risk than issuers in other industries. . . . [and] Congress did not achieve its goal of increasing the filing delay in class actions. Actions are filed as quickly now as they were before passage of the Act."[26] An empirical study has shown, however, "a closer relationship between factors relating to fraud and securities class actions after the passage of the PSLRA, suggesting that Congress achieved at least part of its objective in enacting the law."[27]

Two main problems have prevented the PSLRA from living up to its promise. First, not all federal circuits have interpreted the PSLRA's heightened pleading standard in the same way. The Ninth Circuit, encompassing California, adopted a more rigorous pleadings standard in *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970, 974 (9th Cir. 1999), requiring a showing of "deliberate recklessness" and requiring that "a complaint include a list of all relevant circumstances in great detail." Studies have shown that filings in the Ninth Circuit tend to have a higher percentage of facially strong cases and a lower percentage of facially weak cases.[28] Unfortunately, but predictably, the Ninth Circuit has also seen a relative drop in case filings, as plaintiffs' attorneys seek out more lenient jurisdictions.

A second major problem with the PSLRA in practice has been the trial bar's ability to work around the lead plaintiff provision. Presumptively under the PSLRA, such plaintiffs are the shareholders with "the largest financial interest in the relief sought by the class." Plaintiffs' firms quickly realized that the largest shareholders in our economy are typically state employee pension funds, such the California Public Employees' Retirement System and the New York State Common Retirement Fund, and that such state funds are politically directed and thus subject to political influence. According to a study by PricewaterhouseCoopers, securities cases with public pension funds as lead plaintiffs rose steadily from four in 1996 to 56 in 2002.[29]

For an example of how pernicious the connection between political interests and public pension funds' serving as class plaintiffs can become, consider that two law firms that represented a class of plaintiffs suing Citigroup on behalf of WorldCom shareholders and bondholders had, directly and indirectly, been responsible for $121,800 in donations to New York State Comptroller Alan Hevesi. By virtue of his office, Hevesi controlled the lead plaintiff in the suit, the New York State Common Retirement Fund. The firms who had donated to Hevesi stand to gain $144.5 million from Citigroup. Incredibly, the New York Fund that led the suit against Citigroup, on behalf of WorldCom shareholders, owns almost $1 *billion* in Citigroup stock.

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[25] *See* Adam C. Pritchard, "Should Congress Repeal Securities Class Action Reform?", *Cato Policy Analysis* No. 471, at 9 (2003).
[26] Michael A. Perino, **"**Did the Private Securities Litigation Reform Act Work?", 2003 *U. Ill. L. Rev.* 913 (2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=346840.
[27] *See* Pritchard, *supra* note 25, at 11.
[28] *See* Perino, *supra* note 26, at 916.
[29] *See* Steven Skalak & Daniel Dooley, Pricewaterhousecoopers, *Securities Litigation Update: The Pension Fund Factor* 2 (2003).

Some smaller state retirement funds have also become notorious as repeat plaintiffs for the securities bar. An Ohio judge found that the Teachers' Retirement System of Louisiana was a "professional plaintiff" and that it wastefully sought to appoint four separate firms as counsel for a case. As of 2004, the Louisiana pension fund had been involved in no fewer than 60 class-action suits in the preceding eight years.

Options for Reform

Reform options for the tort system as a whole are many and complex. Moreover, given that so much of tort law is at the state level, federal options are complicated.[30] I will thus limit these suggestions to those that might be appropriately adopted in the context of securities law, and therefore appropriate for this committee's consideration.

1. *Embrace a "Loser Pays"-Style Fee Shifting Principle.* Central to the filing of weak claims in American law is our nation's refusal—essentially unique among developed countries—to hold the loser of lawsuits financially accountable for the costs imposed on the other side. In regular litigation, minimal "notice" pleading standards enable plaintiffs to file lawsuits at very low cost; defendants then assume the very expensive burden of discovery. Even for meritless claims, defendants have a significant incentive to settle, since their costs are substantial, win or lose. Other countries strongly deter weak lawsuits by forcing plaintiffs to internalize the cost they impose on defendants in the event of loss.

   The PSLRA does reduce these problems, in theory, for securities claims, by heightening pleading standards and staying discovery. Nevertheless, the evidence on filings suggests strongly that weak claims continue to be filed.

   A clear mechanism exists for deterring weak lawsuits in federal courts. Federal Rule of Civil Procedure 68 provides an offer-of-judgment provision as follows:

   > At any time more than 10 days before the trial begins, a party defending against a claim may serve upon the adverse party an offer to allow judgment to be taken against the defending party for the money or property or to the effect specified in the offer, with costs then accrued. If within 10 days after the service of the offer the adverse party serves written notice that the offer is accepted, either party may

[30] Lawyers among you will know well that there is no federal common law, under the Supreme Court's long-standing, seminal decision in *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938). Cross-state and state-federal forum shopping remains a significant problem for tort law overall, particularly in products liability cases—although the Class Action Fairness Act of 2005 should reduce the "magnet court" problem for class action suits. Notwithstanding *Erie*, Congress could reduce forum shopping, constructively align tort law with federalist principles, and improve the quality of litigation overall through changes to federal diversity jurisdiction and adoption of appropriate federal choice of law rules. *See, e.g.*, Michael Krauss, "Product Liability and Game Theory: One More Trip to the Choice-of-Law Well," 2002 *B.Y.U. L. Rev*. 759; *see also* Doug Laycock, "Equal Citizens of Equal and Territorial States: The Constitutional Foundations of Choice of Law," 92 *Columbia L. Rev.* 249 (1992).

> then file the offer and notice of acceptance together with proof of service thereof and thereupon the clerk shall enter judgment. An offer not accepted shall be deemed withdrawn and evidence thereof is not admissible except in a proceeding to determine costs. If the judgment finally obtained by the offeree is not more favorable than the offer, the offeree must pay the costs incurred after the making of the offer. The fact that an offer is made but not accepted does not preclude a subsequent offer. When the liability of one party to another has been determined by verdict or order or judgment, but the amount or extent of the liability remains to be determined by further proceedings, the party adjudged liable may make an offer of judgment, which shall have the same effect as an offer made before trial if it is served within a reasonable time not less than 10 days prior to the commencement of hearings to determine the amount or extent of liability.

On its face, FRCP 68 reads like a loser pays provision; however, the "costs" covered by the Rule are only "statutory costs" and do not typically include attorneys' fees and expenses—the bulk of costs in most litigation. Amending FRCP 68 to shift all attorneys' fees and expenses if a plaintiff proceeds with a claim and receives less than the defendant's offer should sharply discourage weak claims and promote reasonable settlement. Based on other countries' experience, the value in such an approach would likely outweigh the administrative costs to determine fees—particularly given that most cases settle. The calculus for filing (and settling) claims would be substantially shifted were plaintiffs required to internalize defendants' costs.[31]

The typical reaction against loser pays systems is that they are alleged to "shut the courthouse door" on less-well-heeled plaintiffs, who would be unable to bear the risk of bearing the defendants' costs. Such concerns are generally overblown; other countries have insurance systems, including legal expenses insurance and "after-the-event" insurance, to defray such risks.[32]

Regardless, such concerns are wholly inapplicable to securities litigation, in which plaintiffs are dispersed. Securities litigation is dominated by large, well-financed, diversified law firms with broad access to capital. Moreover, under the PSLRA, the lead plaintiff is presumptively a large, often institutional investor. It is hard to imagine that a large institutional investor and large diversified law firm could not, at arms' length, negotiate a reasonable strategy to assume the risk of paying defendants' costs in the event of loss. Securities law thus provides a compelling template for experimenting with a strong-form Rule 68.

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[31] According to Tillinghast, an estimated 19 percent of all litigation costs/fees are consumed by plaintiffs' attorneys, and 14 percent by defendants' counsel. *See 2003 Update*, *supra* note 21.

[32] *See* Walter K. Olson, "Loser Pays," at http://www.pointoflaw.com/loserpays/overview.php.

2. *Reform the PSLRA's Lead Plaintiff Provisions.* As previously noted, a significant problem with the PSLRA in practice has been the ability of the plaintiffs' bar to co-opt public pension funds as their new professional plaintiffs. Unlike institutional investors whose sole fiduciary duty is to maximize fund-holder return—e.g., mutual funds such as those operated by Fidelity or Vanguard—public employee pension funds are typically led or influenced by politicians who may be in political alliance with the trial bar and/or recipients of trial bar campaign contributions. In short, whereas the incentives of private institutional investors are largely aligned with their fund-holders, public employee pension funds are managed by actors who have diverse interests that may or may not coincide with their investors' returns. As such, the risk for mischief, observed in practice, is inherent in public employee pension funds. A simple solution to this problem would be to amend the PSLRA to clarify that public employee pension funds cannot be the lead plaintiff in a federal securities suit.

   An alternative approach to rooting out class counsel mischief would be to embrace by statute broad acceptance of the practice originated by District Judge Vaughn R. Walker, who auctioned off the rights to class counsel to the plaintiffs' firm willing to accept the lowest fee. Walker's auction practice both reduced contingency fees and resulted in higher average recovery for plaintiffs. Clearly, auctioning the right to serve as class counsel worked better than designating a "large plaintiff" to eliminate the "captive plaintiff" problem. The Ninth Circuit stopped Walker's practice in *In re Cavanaugh*, 306 F.3d 726 (9th Cir. 2002), in which it interpreted the PSLRA's language to "provide[] no occasion for comparing plaintiffs with each other on any basis other than their financial stake in the case." Clarifying the PSLRA to permit and even encourage class counsel auctions would reduce superfluous litigation driven by non-competitive contingency fee arrangements and ensure fuller recovery for legitimate claimants.

3. *Amend the PSLRA to Endorse the Ninth Circuit's Rigorous Pleading Standard.* As discussed above, the Ninth Circuit's rigorous pleading standard has worked to root out bad claims and increase the percentage of strong claims in that circuit. As long as plaintiffs' lawyers are able to shop their cases to alternative fora, however, the national effectiveness of the PSLRA will be largely unrealized. A simple amendment to the PSLRA could clarify that the statute requires, as the Ninth Circuit determined in *Silicon Graphics*, that a complaint "include a list of all relevant circumstances in great detail" and a demonstration of "deliberate recklessness" to survive on the pleadings.

Conclusion

Litigation in America is extremely costly, relative to our history and to other developed nations. Our tort law system fails to justify this cost by meeting its safety-enhancing or equity-producing mandates. As such, the system's distorting effects on economic activity, enormous insurance burden, and high administrative costs are hard to defend.

Securities litigation, despite the PSLRA, remains a significant competitive disadvantage for American capital markets. While private securities lawsuits, rightly conceived, can complement the SEC's regulatory authority, our system continues to permit too many meritless suits, often filed against our highest-growth companies.

Reforms could help align our private law system of enforcement with its object, namely, to encourage open disclosure of information to investors to facilitate accurate market pricing. I propose three simple reforms to this effect: (1) adopting a loser pays' system through the offer of judgment rule; (1) refining the PSLRA's lead plaintiff provision by forbidding lead plaintiff status for public pension funds or by allowing counsel rights to be auctioned off; and (3) amending the PSLRA to strengthen its pleading requirements consistent with the Ninth Circuit's *Silicon Graphics* standard.

Although the United States continues to enjoy the world's most competitive capital markets, such status is not a foregone conclusion. In the early nineteenth century, New Jersey was the locus of business incorporation, until then-Governor Woodrow Wilson drove companies away by trying to use the state's incorporation law as an antitrust law. Just as Delaware took New Jersey's corporate law business, markets in Europe or Asia, likewise, could take U.S. capital markets business.[33] Indeed, PricewaterhouseCoopers released a report last week showing that in 2005, Europe passed the United States on initial public offerings—almost doubling the American float, attracting almost three times the number of listings, and attracting more than five times the number of overseas IPOs.[34] Regulation and reporting rules may be the dominant forces explaining the short-run shift away from American capital markets, but the importance of litigation should not be ignored.

[33] For this argument, I am indebted to Larry Ribstein. *See* http://www.pointoflaw.com/archives/002292.php.

[34] *See* http://www.primezone.com/newsroom/news.html?d=96661; *see also* http://observer.guardian.co.uk/business/story/0,,1744628,00.html.