

# JUDGES WHO SETTLE

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## ABSTRACT

*This Article develops a construct of judges as gatekeepers in corporate and securities litigation, focusing on the last period—or settlement stage—of the cases. Many accounts of corporate scandals have focused on gatekeepers and the roles they played or, in some cases, abdicated. Corporate gatekeepers, like investment bankers, accountants, and lawyers, function as enablers and monitors. They facilitate transactions and enable corporate actors to access the financial and securities markets. Without them, the transactions would not happen. In class actions and derivative litigation, judges are the monitors and enablers. They are required to oversee the litigation arising from bad transactions and corporate scandals. Unlike other types of private law litigation, where the parties settle and have the case dismissed, judges must approve settlements of class actions and derivative litigation. They are actually charged with fiduciary responsibilities and control the exit stage, or settlement, of the litigation. As a result, the judges' job is to be a gatekeeper.*

*The judges are not, however, doing their jobs. "Doing their jobs" requires actual scrutiny of the role of defense counsel and insurers, both of whom amplify agency costs. It also requires scrutiny of the settlement collusion between defendants and plaintiffs. Yet, traditionally both academics and the courts have failed to analyze those issues in the context of the costs of aggregate and derivative litigation. This Article provides a real cut at those issues. It then develops and explores principles for gatekeeping judges, which, if implemented, will decrease the agency costs of this type of litigation and ensure that the judges are actually functioning as the fiduciaries they are required to be.*

*Securities and corporate laws and regulations rely on gatekeepers to provide merits reviews of corporate disclosures and transactions.<sup>1</sup>*

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1. See, e.g., *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 683, 688–89 (S.D.N.Y. 1968) (analyzing statutory causes of action against accountants, directors, and others as gatekeepers for

*Accountants, lawyers, and investment bankers control access to financing and the securities markets. They certify documents and financials and ensure that corporate actors adhere to their fiduciary, disclosure, and other duties. Independent directors also combat agency costs, monitor their fellow corporate actors, and, in some cases, hire the other gatekeepers and ensure they do their jobs well. Thus, gatekeepers control market access directly—certified accountant reports are required for certain public filings<sup>2</sup>—and indirectly through advice to clients or their companies.*

*Many accounts of corporate scandals have focused on gatekeepers and the roles they played or, in some cases, abdicated.<sup>3</sup> Corporate gatekeepers function as monitors and enablers. Judges oversee the private enforcement that arises from financial gatekeeping failures and scandals. They control access to settlements and therefore are also monitors and enablers. Although no one has previously identified them as gatekeepers, judges are assigned that role for certain types of litigation. They are not, however, doing the job well.*

*This Article develops a construct of judges as gatekeepers and a set of principles to guide them in policing aggregate and derivative litigation. Part I provides an introduction to this type of litigation and the role of*

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cleansing public filings); *Smith v. Van Gorkom*, 488 A.2d 858, 881 (Del. 1985) (stressing value of investment bankers' role in providing fairness opinion to assist in valuing transactions).

2. See Securities Act of 1933, sched. A, paras. 25 and 26, 15 U.S.C. §§ 77aa(25), (26) (2000), and Securities Exchange Act of 1934 § 17(e), 15 U.S.C. § 78q(e) (requiring independent public or certified accountant audits of financial statements).

3. See, e.g., JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006) [hereinafter COFFEE, GATEKEEPERS]; William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002) (arguing that particularly high standards should be applied to accountant gatekeepers); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) [hereinafter *Gatekeeper Failure*]; Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323 (2007) [hereinafter *Beyond Liability*]; Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035 (2003) [hereinafter *Securities Analyst as Agent*]; Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411 (2008); Arthur B. Laby, *Differentiating Gatekeepers*, 1 BROOK. J. CORP. FIN. & COM. L. 119 (2006); Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167 (2003) [hereinafter *Commodification*]; Hillary A. Sale, *Banks: The Forgotten(?) Partners in Fraud*, 73 U. CIN. L. REV. 139, 160–61 (2004); Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583 (2010); John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting* (Columbia Law and Econ., Working Paper No. 191, 2001), available at <http://ssrn.com/abstract=270944> [hereinafter *Acquiescent Gatekeeper*]; John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293 (2003); see also Michael J. Borden, *The Role of Financial Journalists in Corporate Governance*, 12 FORDHAM J. CORP. & FIN. L. 311 (2007) (describing role of journalists in detecting and preventing fraud and analogizing to gatekeepers).

*judges as agency cost monitors. Part II contrasts the “solutions” of this type of litigation with its costs, and explores an area not developed in the legal literature—the agency issues on the defendants’ side of the cases. The development of the role of defense counsel and their collusion with plaintiffs’ counsel illuminates the need for judges to perform their gatekeeping role. Part III explores the role of judges in aggregate litigation, including their fiduciary responsibilities as monitors of the agency costs inherent in these cases. The judicial role maps to the role of gatekeepers more generally. The focus of this Article is on gatekeeping for the “exit mechanism,” or settlement stage of these cases.<sup>4</sup> To develop this gatekeeping role, this Article examines a set of cases in which judges engaged in some gatekeeping, as well as incentives for gatekeeping and for shirking.<sup>5</sup> Part IV then presents a set of gatekeeping principles that judges can deploy to decrease agency costs and improve the effectiveness of the litigation overall. Part V concludes.*

## I. GATEKEEPING AND AGGREGATE LITIGATION

Aggregate litigation is a solution to gaps in the legal system. Administrative law, for example, provides a partial solution to the problems of individual consumers who have insufficient incentives to pursue claims on their own.<sup>6</sup> Resources, however, are unavailable to deal with all of the claims and concerns; thus, private litigation steps in to provide “group redress.”<sup>7</sup> The system is not unified and the result is considerable diversity in outcomes. Scholars have focused extensively on

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4. Judges also control initial access to courts through pleading standards and class certification. See Private Securities Litigation Reform Act (“PSLRA”), Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. § 78u-4(b)(2), (3) (2000)) (codifying the heightened pleading standard in private securities fraud actions); FED. R. CIV. P. 23 (governing the procedure for class actions); see also Richard Marcus, *Reviving Judicial Gatekeeping of Aggregation: Scrutinizing the Merits on Class Certification*, 79 GEO. WASH. L. REV. 324 (2011) (analyzing judges’ role at class certification stage).

5. Financial gatekeepers face actual liability when they fail to perform. See, e.g., Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. ECON. & ORG. 53 (1986) (analyzing gatekeeper liability) [hereinafter Kraakman, *Gatekeepers*]. In addition, reputational liability for financial gatekeepers was long assumed. See COFFEE, GATEKEEPERS, *supra* note 3, at 3. This assumption is subject to debate, but still undergirds the laws and regulations. See *Gatekeeper Failure*, *supra* note 3, at 308–11; John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1300–02 (2003); *Beyond Liability*, *supra* note 3, at 342–52; *Securities Analyst as Agent*, *supra* note 3, at 1078–80; *Commodification*, *supra* note 3, at 1167–70; *Acquiescent Gatekeeper*, *supra* note 3.

6. See Harry Kalven, Jr. & Maurice Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684, 684–86 (1940). It can remedy some problems with injunctions or stop orders. *Id.* at 685.

7. See *id.* at 686.

the problems and solutions of class actions and aggregate litigation. This Article examines two key forms of litigation for corporate and securities law—class and derivative actions, focusing on the settlement stage.

The class action has evolved considerably since the 1940s, when Harry Kalven and Maurice Rosenfield first wrote about it,<sup>8</sup> but it remains an important part of the enforcement mechanism for corporate and securities laws. It is a procedural mechanism available when there is both an underlying substantive claim and when the proposed class of plaintiffs meets certain specifications under Federal Rule of Civil Procedure Rule 23 or its state law equivalent. Derivative litigation, in which shareholders attempt to sue on behalf of the company, does not take the form of a class action because the plaintiffs are attempting to represent the company, not themselves. It does, however, bear similarities to class actions and is subject to some of the same procedural rules, as set forth under Federal Rule of Civil Procedure Rule 23.1 or its state law equivalent. Thus, for the purposes of this Article, the terms class or aggregate litigation refer to both traditional class actions and derivative litigation.

The literature is filled with complaints and concerns about fiduciary issues, agency costs, and other problems at all stages of aggregate litigation.<sup>9</sup> This Article focuses on corporate and securities litigation, providing a brief summary of those issues. The focus is on the fiduciary-like role that judges play at the settlement stage of corporate and securities litigation. These cases are unique. They have specific procedural provisions for federal securities claims and derivative claims. These features were designed to help curb agency problems and to increase the judicial role in combating them. In addition, the injuries in these cases, unlike mass torts, for example, are financial, and, therefore, sometimes receive less attention than they ought.<sup>10</sup> Finally, the agency problems in these cases are similar to the agency problems in the corporate organizations where the underlying violations occur. Indeed, the underlying agency problems are part of the reason why judges end up with the gatekeeping task.

In addition to the extensive analysis of the costs of aggregate litigation, the legal literature is filled with proposed solutions, ranging from

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8. See *supra* note 6; see also Richard A. Nagareda, *Class Actions in the Administrative State: Kalven and Rosenfield Revisited*, 75 U. CHI. L. REV. 603 (2008).

9. See *infra* note 27.

10. See *In re Elscint, Ltd. Sec. Litig.*, 674 F. Supp. 374, 381 (D. Mass 1987) (“Both traditionally and currently, legal protection for financial loss not accompanied by physical harm is less expansive.”).

introducing intermediate advocates—like a guardian ad litem—for classes of individuals, to eliminating causes of actions entirely, to encouraging plaintiffs who were harmed by insufficient settlements to sue their former attorneys, to giving the SEC the power to oversee and prescreen securities causes of action.<sup>11</sup> Focusing on the settlement stage and the specific fiduciary role assigned to the judges who review and permit settlements, this Article examines the gatekeeping role of judges as the enablers of settlements. Unlike other types of private litigation, these settlements require judicial approval.<sup>12</sup> The judges are prescribed a fiduciary-like role to make determinations about settlements before allowing them to proceed. I argue that judges are required to perform this role. Then, I develop a construct of judges as gatekeepers and create a set of principles to provide guidance to them.

## II. THE SOLUTION AND COSTS OF AGGREGATE LITIGATION

Delaware common law reveals that the fiduciary duties of directors and officers are enforced through private litigation.<sup>13</sup> The system relies on private attorneys to take the lead. Delaware is not alone. The federal securities regime also relies on private attorneys to supplement enforcement.<sup>14</sup> In both situations, plaintiffs' attorneys bring the cases and, if successful, receive fees for doing so. These cases, like class-action and aggregate litigation generally, are responses to what is otherwise a systemic failure. As the Supreme Court explained in *Deposit Guaranty National Bank of Jackson, Miss. v. Roper*:

The aggregation of individual claims in . . . a classwide suit is an evolutionary response to the existence of injuries unremedied by the regulatory action of government. Where it is not economically

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11. See *infra* note 30.

12. See FED. R. CIV. P. 23(e) (settlements of class actions require judicial approval before they become effective).

13. See *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (discussing the enforcement of directors' fiduciary duties through derivative actions by shareholders, and in some cases, creditors); *Agostino v. Hicks*, 845 A.2d 1110, 1115–16 (Del. Ch. 2004) (describing the private shareholder's derivative action as “an ingenious device to police the activities of corporate fiduciaries”).

14. See, e.g., Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63 (2008) (arguing that ex post securities litigation is part of attractiveness of a relatively deregulated U.S. market with low entry costs); John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877 (1987); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendation for Reform*, 58 U. CHI. L. REV. 1 (1991) [hereinafter *The Plaintiffs' Attorney*].

feasible to obtain relief within the traditional framework of a multiplicity of small individual suits for damages, aggrieved persons may be without any effective redress unless they may employ the class-action device.<sup>15</sup>

Aggregate litigation, then, provides the potential for remedies, recoveries, and enforcement in situations that might otherwise escape review.<sup>16</sup> Absent the aggregate litigation mechanisms, corporate and securities-related fraud and fiduciary breaches would go unredressed largely for two reasons. First, government resources are insufficient to pursue all of the potential cases.<sup>17</sup> Although the Securities and Exchange Commission has a large enforcement division, the staff is not sufficient to investigate and pursue all of the potentially fraudulent situations. As a result, private litigation is actually the “primary vehicle” for securities and corporate enforcement.<sup>18</sup> The existence of these cases, then, increases incentives for corporate actors to fulfill their disclosure and fiduciary duties or, put another way, helps to deter bad acts.<sup>19</sup>

Second, the available damages in most securities and corporate cases on an individual basis—or in the case of derivative litigation, recovery for the corporation—do not provide an incentive for plaintiffs to pursue matters on their own. Many shareholders hold an insufficient number of shares to make it worthwhile for them to pursue fiduciary or securities breaches individually. Aggregation through derivative or class-action claims, with potential attorneys’ fees, allows for litigation.<sup>20</sup> Thus, the

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15. 445 U.S. 326, 339 (1980).

16. See, e.g., HERBERT B. NEWBERG & ALBA CONTE, *NEWBERG ON CLASS ACTIONS* § 22–6 (3d ed. 1992) (stating that both “[t]he SEC and the judiciary have recognized that the class action may be the only meaningful and viable method by which securities investors may remedy their claims”).

17. *Securities Investor Protection Act of 1991: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Hous. and Urban Affairs on S.1533*, 102d Cong. 15–16 (1992) (testimony of then-SEC Chair, Richard C. Breeden, that given budget limitations, private attorneys “perform a critical role in preserving the integrity of our securities markets”).

18. *Common Sense Legal Reform Act: Hearings Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong. 1 (1995) (statement of then-SEC Chair Arthur Levitt).

19. See, e.g., H.R. CONF. REP. NO. 104-369, at 30–32 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 730–32 (stating that private litigation deters future wrongdoing by corporate actors and helps ensure they do their jobs properly).

20. Janet Cooper Alexander, *Contingent Fees and Class Actions*, 47 DEPAUL L. REV. 347, 347–48 (1998) (stating that contingent fees are the “nearly universal” type of compensation for plaintiffs’ lawyers in aggregate litigation, and that “no other form” is practicable). Aggregate litigation also evens the playing field by providing economies of scale for plaintiffs that the defendants already enjoy. As Professors Hay and Rosenberg explain, defendants have the incentive and will to spend more on individual cases than plaintiffs who are litigating separately do. The defendants, who could face several individual cases, can plan their litigation strategy by treating all potential plaintiffs as a de

underlying principle of the class action is to “overcome” incentive problems resulting from individually small recoveries by “aggregating the relatively paltry potential recoveries into something worth someone’s (usually an attorney’s) labor.”<sup>21</sup> Aggregation, then, provides a solution to what is commonly referred to as a collective-action problem inherent in shareholder litigation. It makes otherwise “unmarketable” claims “marketable.”<sup>22</sup> By doing so, it creates an enforcement mechanism for plaintiffs.

Aggregate litigation also benefits defendants. Although they complain about aggregate litigation and make strong arguments against the certification of particular classes,<sup>23</sup> an aggregate settlement protects defendants from repeated litigation on the same issues because it can bind all class members.<sup>24</sup> The effect is to prevent future cases on the same set of facts. Preclusion of this sort is very valuable to defendants, and a court-approved settlement agreement buys it.<sup>25</sup> Thus, settlement is important to both sides.<sup>26</sup>

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facto class. See Bruce Hay & David Rosenberg, “Sweetheart” and “Blackmail” Settlements in Class Actions: Reality and Remedy, 75 NOTRE DAME L. REV. 1377, 1383–85 (2000).

21. Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 617 (1997) (quoting Mace v. Van Ru Credit Corp., 109 F.3d 338, 344 (7th Cir. 1997)).

22. Nagareda, *supra* note 8, at 604.

23. See, e.g., *In re* Loewen Grp. Inc. Sec. Litig., 233 F.R.D. 154, 168 (E.D. Pa. 2005) (certifying securities fraud class action after rejecting numerous arguments by defendants that the requirements of Rule 23 were not met); *Rowe v. Morgan Stanley Dean Witter*, 191 F.R.D. 398, 406–16 (D. N.J. 1999) (granting defendant’s motion to dismiss securities class action claims because the requirements for certification were not met); *Endo v. Albertine*, 147 F.R.D. 164, 166, 171 (N.D. Ill. 1993) (certifying securities fraud class action after rejecting defendants’ argument that the claim was “riddled with fatal defects” that prevented certification); see also Todd G. Buchholz, *Lawyers v. S&P 500*, U.S. CHAMBER INSTITUTE FOR LEGAL REFORM (2002), [http://www.instituteforlegalreform.org/get\\_ilr\\_doc.php?docId=1039Todd](http://www.instituteforlegalreform.org/get_ilr_doc.php?docId=1039Todd) (complaining more generally about the “tidal wave of class action litigation” and its harmful effects on corporations).

24. See *Tice v. Am. Airlines*, 162 F.3d 966, 968 (7th Cir. 1998) (noting that defendants argue that “a new group of plaintiffs is barred from bringing an action since the plaintiff in an earlier suit was its ‘virtual representative’”); see also FED. R. CIV. P. 23(c)(3) (providing that judgments in mandatory class actions must “include and describe” the class members, and in the case of (b)(3) class actions, “include and specify or describe” class members who were properly notified and did not opt out); *id.* at 23(e)(1) (requiring notice “to all class members who would be bound by the proposal”).

25. See Nagareda, *supra* note 8, at 605 (characterizing preclusion as a commodity in business transactions); see also Samuel Issacharoff & Richard A. Nagareda, *Class Settlements Under Attack*, 156 U. PA. L. REV. 1649 (2008) (examining preclusion and attacks thereon in class-action context).

26. A 1996 study of class actions in federal court revealed that defendants either acquiesced or stipulated to class certifications in 50 percent of the cases studied. See Thomas E. Willging et al., *An Empirical Analysis of Rule 23 to Address the Rulemaking Challenges*, 71 N.Y.U. L. REV. 74, 117–18 (1996).

Legal solutions, however, often present new problems, and aggregate litigation is no different.<sup>27</sup> At issue here are a series of “gaps” between the “parties,” the lawyers, and the check-writers—generally, the insurers, but sometimes the corporations. On the plaintiffs’ side, the thousands of shareholders, their class representatives, and the lawyers face communication and other issues. On the defendants’ side, the incentive to settle is complicated by the typical funding sources. In short, settlements are rarely supported by personal contributions. Instead, corporate and insurer payments result in agency costs.

These agency problems are not unlike those inherent in corporate law and the separation of ownership and control more generally.<sup>28</sup> Shareholders have stakes too small to engage in regular monitoring of the fiduciaries charged with running the corporations and issuing the disclosures. Those small stakes are at the root of the incentive problem that prevents them from litigating in the first place. They influence the attorney-client relationship as well. The representative plaintiffs arguably have investments insufficient to ensure active monitoring of the class lawyers’ performance or much, if any, participation in the litigation other than what is required. The stakes also are too small to ensure they monitor their attorneys’ fees.<sup>29</sup>

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27. For articles detailing the agency problems in aggregate litigation generally, see John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 COLUM. L. REV. 370 (2000) [hereinafter *Class Action Accountability*]; John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 COLUM. L. REV. 1343 (1995) [hereinafter *Class Wars*]; Samuel Issacharoff, *Class Action Conflicts*, 30 U.C. DAVIS L. REV. 805 (1997); Susan P. Koniak & George M. Cohen, *Under Cloak of Settlement*, 82 VA. L. REV. 1051 (1996); *The Plaintiffs’ Attorney*, *supra* note 14; see also Richard A. Epstein, *Class Actions: Aggregation, Amplification, and Distortion*, 2003 U. CHI. LEGAL F. 475, 480–92 (describing costs and benefits of aggregate litigation and its potential for distortions). Aggregation distortions, while not absent in securities and corporate claims, are not as serious as in other situations in which Congress has, for example, provided a claim that envisioned individual litigation but that can be aggregated. That type of situation can create a massive aggregate claim. See Richard A. Nagareda, *Aggregation and its Discontents: Class Settlement Pressure, Class-Wide Arbitration, and CAFA*, 106 COLUM. L. REV. 1872, 1885–87 (2006) (describing proposed class of claimants under Cable Communications Policy Act of 1984 who had individual statutory remedies available at \$1000 per plaintiff which, when aggregated in a class of 12 million, created potential damages of \$12 billion).

28. See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); see also Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 802 (2001) (analyzing board’s monitoring functions as at “the heart of what the agency cost model of the firm identifies as the central role for the board” preventing shirking and overreaching).

29. The PSLRA included a lead-plaintiff provision designed to help close this gap by statutorily preferring plaintiffs with larger stakes and presumably greater incentives to monitor. See Securities Exchange Act of 1934 § 21D(a)(3)(B)(i), 15 U.S.C. § 78u-4(a)(3)(B)(i) (2000) (providing that “the court . . . shall appoint as lead plaintiff the member or members of the purported plaintiff class that the



Settlement magnifies the agency issues and costs.<sup>30</sup> Consider the potential conflict between the class representatives, or lead plaintiffs in securities litigation, and the class attorneys. The attorneys generally take these cases on the basis of a hoped-for return, or on contingency, advancing the costs of litigation along the way. As a result, a smaller settlement with a “higher ratio to the cost of the work than a much larger recovery obtained only after extensive discovery, a long trial and an appeal,” can be attractive.<sup>31</sup> Thus, the attorneys may prefer to settle rather than go to trial, even if holding out or going to trial would result in a larger payment for the shareholders. Additionally, both the attorneys and representative plaintiffs may prefer settlement to save time and ensure some return, but the remaining members, who are not expending money or time, may have an interest in pursuing the litigation for a longer period in the hopes of a larger settlement.

Rather than providing the assumed adversarial balance, the defendants contribute to these problems. Generally, defendants want “peace.”<sup>32</sup> If they have done wrong, they want out sooner. If they have not, they still want out. After all, litigation imposes transaction and opportunity costs; a day spent in a deposition is a day lost to the corporation.

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court determines to be most capable of adequately representing the interests of class members”). Recent empirical evidence indicates that it may have started to work in some cases. See James D. Cox et al., *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 367–80 (2008) (concluding post-PSLRA lead plaintiffs add substantial value to settlements); cf. James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 871–75 (2002) (discussing the role of institutional investors as lead plaintiffs in securities class actions); David H. Webber, *Is “Pay-to-Play” Drawing Public Pension Fund Activism in Securities Class Actions? An Empirical Study*, 90 B.U. L. REV. 2031 (2010) (investing lead plaintiff provision in context of pay-to-play allegations).

30. Many articles discuss settlements and agency costs and solutions. See, e.g., Alexandra Lahav, *Fundamental Principles for Class Action Governance*, 37 IND. L. REV. 65, 128 (2003) (advocating an active adversarial process during fairness hearings, “a kind of trial on the merits of the settlement”) [hereinafter *Fundamental Principles*]; *id.* at 136 (discussing the use of magistrate judges in negotiating settlements); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1354, 1363 (2008) (developing an “oversight approach” for the SEC in 10b-5 cases); William B. Rubenstein, *The Fairness Hearing: Adversarial and Regulatory Approaches*, 53 UCLA L. REV. 1435, 1452–66 (2006) (examining various proposals for reducing agency costs at the settlement stage, including use of devil’s advocates). In addition, agency cost concerns have been explored at some length in the literature on class certification and settlement classes, or classes certified solely for settlement purposes. See, e.g., *Class Action Accountability*, *supra* note 27, at 372–73. Those concerns and arguments have some salience here, but the focus of this paper is different. I am interested in the context of settlement approval generally.

31. *Saylor v. Lindsley*, 456 F.2d 896, 900 (2d Cir. 1972).

32. Neil Gorsuch, *Panel 2: Tools for Ensuring that Settlements are “Fair, Reasonable, and Adequate”*, 18 GEO. J. LEGAL ETHICS 1197, 1205 (2005).

If the plaintiffs have a strong case, the defendants know it before the plaintiffs. That informational advantage allows them to assess the claims better than the plaintiffs. Avoiding damages and reputational harm and gaining preclusion all provide an incentive to settle. Indeed, in corporate and securities litigation, the specter of personal liability, even though rare, adds to the incentive to settle.<sup>33</sup> The plaintiffs, of course, might do better by holding out and not settling.

Even if the defendants believe that the allegations lack merit, when the plaintiffs' claims survive a motion to dismiss, the risk of a trial and the possibility of a bad outcome increase. Defendants who did "no wrong," but made a bad decision, prefer not to take the stand and try to explain the decision away. A claim that lacks merit can still result in a jury finding of liability, which would be subject to an insurance-policy exclusion. Even without liability, trials are expensive and settling can reduce litigation expenses. The defendants, therefore, have many incentives to settle.<sup>34</sup>

Indemnification and insurance complicate the defendants' agency costs. First, although defendants want to settle, they have almost no stake in how the settlement amount is split between the plaintiffs and their lawyers. After all, if they are not paying out of pocket, settlement is "easy."<sup>35</sup> Settlements within the policy limits are therefore prized by all parties.<sup>36</sup> Indeed, the evidence reveals that few defendants ever pay their own defense costs or settlements.<sup>37</sup> Companies indemnify them and retrieve the costs from insurers.<sup>38</sup> With the defendants twice removed from any payments, the insurers become the de facto monitors.<sup>39</sup>

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33. See *Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87 (2d Cir. 1996) (holding that indemnification is not appropriate where conscious misconduct/bad faith is at issue).

34. See Paul G. Mahoney, *The Development of Securities Law in the United States*, 47 J. ACCT. R. 325, 332–37 (2009) (discussing defendants' incentives).

35. See Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 798 (2009) [hereinafter *How the Merits Matter*] (noting that insurers and defense counsel alike understand that settlement with insurance money is "easy" because it is someone else's money); see also DOUGLAS LAYCOCK, MODERN AMERICAN REMEDIES 951 (Aspen 3d ed. 2002) (defendants care only about bottom line, not how it is split between plaintiffs and their lawyers).

36. See *How the Merits Matter*, *supra* note 35, at 806 (noting that plaintiffs' lawyers are willing to settle within the limits and defense counsel agree).

37. Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1068–76 (2006) (between 1980 and 2004, outside directors made out-of-pocket payments in only thirteen settlements, eight of which were securities cases, with notables including Worldcom and Enron).

38. See Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795 (2007) [hereinafter *The Missing Monitor*].

39. Chris Guthrie & Jeffrey J. Rachlinski, *Insurers, Illusions of Judgment & Litigation*, 59 VAND. L. REV. 2017, 2020–21 (2006) (finding preliminarily that insurers tend to make more rational decisions than other litigation participants).

Second, the insurers are not good monitors. They do not monitor corporate governance significantly at issuance or during the life of the insurance contract.<sup>40</sup> They do not set fees in accord with it. They do monitor litigation, and their focus is on their investment return and not, generally, on the validity of the litigation.<sup>41</sup> Instead, they provide the insureds with a “blank checkbook” to cover defense costs.<sup>42</sup> Those costs have a settlement impact. They decrease the amount left for the plaintiffs. Thus, as defense costs increase, available policy funds decrease, and the plaintiffs’ interest in settlement increases, regardless of the merits of the case.<sup>43</sup>

Third, insurers are conflicted. They rarely push back on clients, because they do not want to lose business.<sup>44</sup> Their real focus is protecting their investment. Indeed, insurers are loath to refuse proposed settlements because if they make the incorrect call, they risk litigation and liability themselves.<sup>45</sup> As a result, the insurers are vulnerable to collusion between the plaintiffs and the defendants, with settlement pressure being the outcome.<sup>46</sup>

To be sure, as long as they can sell insurance profitably<sup>47</sup> and can raise rates after paying out, insurers need not assess the true cost of the litigation or the appropriate settlement amount. Individuals do not, however, pay increases in rates. The entity, which deducts them as a business expense, does.<sup>48</sup> The result is further aggravation of the agency

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40. See *The Missing Monitor*, *supra* note 38, at 1820; Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors’ & Officers’ Liability Insurance Market*, 74 U. CHI. L. REV. 487, 527 (noting that although in the immediate post-Enron period insurers pressed on governance issues, the emphasis was likely to fade as the market shifted) [hereinafter *Predicting Corporate Governance Risk*].

41. See *How the Merits Matter*, *supra* note 35, at 818–19 (describing insurers’ financial incentive largely as return on the policy, which flow from investing premia for a sufficient amount of time before paying out on the policy).

42. *The Missing Monitor*, *supra* note 38, at 1820.

43. *Id.* Indeed, one of the recommendations in this Article is for disclosure of defense counsel fees—both to provide transparency and information as well as to provide a check on plaintiffs’ attorneys’ fees. See *infra* at Part IV.

44. *How the Merits Matter*, *supra* note 35, at 801; see also James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 1, 29–36 (1997) (discussing market for insurance).

45. *How the Merits Matter*, *supra* note 35, at 799 (describing bad-faith actions against insurers).

46. *Id.* at 806–07 (describing how defense counsel make insurers into “bad guys” to pressure plaintiffs to settle); *id.* at 809–13 (describing how layers of insurance complicate collusion); see also *Gusinsky v. Bailey*, No. 603126/06, 2008 WL 4490008, at \*3 (N.Y. Sup. Ct. Sept. 17, 2008) (rejecting attorneys’ fees in settlement of case where only “results” were “minor changes in corporate governance” but insurers were willing to pay attorneys’ fees).

47. *The Missing Monitor*, *supra* note 38, at 1842.

48. *Id.* at 1826.

problems. Thus, in the aggregate-litigation context, the defendants' agency gap is at least as problematic as the plaintiffs'.<sup>49</sup>

Settlements are, of course, an important mechanism for resolving disputes without admissions of wrongdoing. They remove cases from the system and help to alleviate pressure on crowded dockets.<sup>50</sup> Importantly, they prevent trials and the significant time and costs associated with those. Thus, they have their place and their value in the dispute resolution process.

Settlements also, however, present general, "non-agency" costs as well. Avoiding trials has costs. First, the entities, not the individuals, usually pay corporate and securities settlements. The result is a reallocation of resources and funds from today's shareholders to yesterday's. This financial shift occurs directly when the entity pays to settle the case or indirectly when the insurers pay. Either way, the current shareholders lose.

Second, because insurance covers both the litigation costs and the settlements of most securities and corporate settlements, the company and the individuals do not face the actual cost of any wrongdoing or the settlement. Indemnification and insurance make the financial impact of the litigation indirect. The company pays for the insurance *before* the claims occur. Any adjustment in insurance rates happens later in time, potentially with officers and directors in place. Further, insurance is a deductible corporate expense, making its bottom-line impact even more diffuse.

As a result, insurance and entity—rather than individual—payments diminish the incentive of any agency cost monitoring on the defendants' side. Indeed, taken together, these factors sever the financial reality of claims and cases from the outcomes and settlements. The result is further erosion of any deterrence effect, potential or actual, of the claims.<sup>51</sup>

Third, if the case is a strong one, the settlement can deprive plaintiffs of a more robust remedy, such as larger payments or damages at trial. The settlement may also deny shareholders in a particular company, and at large, of the incentive effects provided by personal payments from

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49. See *Predicting Corporate Governance Risk*, *supra* note 40, at 543 (arguing that insurance coverage does not help to align manager and shareholder interests).

50. Settlements also have other downsides not explored here. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 567 (1991) (arguing that as more and more securities cases settle, predictions of trial outcomes becomes increasingly difficult); see also Marc Galanter & Mia Cahill, "Most Cases Settle": *Judicial Promotion and Regulation of Settlements*, 46 STAN. L. REV. 1339, 1384 (1994) (arguing that "where most cases settle, legal signals may lose clarity").

51. See *How the Merits Matter*, *supra* note 35, at 762 (noting that insurance "subverts" deterrence value of cases).

insiders. Individual payments avoid the pocket-shifting problems described above, and they can act as deterrents.

Fourth, settlements prevent substantive law from evolving.<sup>52</sup> They often occur before trial and even before significant discovery. Thus, settlements prevent the development of facts and factual findings and diminish and inhibit the development of legal doctrine.<sup>53</sup> In essence, they cap the growth of the law. The result is a stunted understanding of the actual duties and the roles of directors and officers.

Aggregate litigation and its agency costs magnify these negative settlement effects. The plaintiffs are removed from the case, represented by counsel and representative plaintiffs. As a result, they are not engaged in monitoring the case. Insurance and indemnification serve to prevent out-of-pocket payments by defendants and, consequently, diminish the incentive of defendants to monitor the cases as well. The result is collusion. Monitoring for that collusion is the judge's role.

### III. JUDGES AS GATEKEEPERS

As developed in Part II, the settlement process aggrandizes the agency costs present in aggregate litigation. The Federal Rules of Civil Procedure and existing common law seek to counteract these agency costs at settlement by assigning fiduciary-like responsibilities to judges. Indeed, the cases explicitly describe judges as the fiduciary for these cases and task them with being merits reviewers, or monitors and enablers.<sup>54</sup> These responsibilities existed under the old version of Rule 23(e)<sup>55</sup> and the then-existing case law,<sup>56</sup> and are present under the new version of 23(e) as

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52. Settlements account for a very large percentage of cases in court resolved before trial. *See, e.g.*, BRUCH L. HAY & KATHRYN E. SPIER, *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW*, P-2, at 442 (Peter Newman ed., 1998) (reporting that approximately 90 percent of cases filed settle before trial); Judith Resnick, *Trial as Error, Jurisdiction as Injury: Transforming the Meaning of Article III*, 113 HARV. L. REV. 924, 928 (2000) (stating that 60–70 percent of cases settle before going to trial).

53. *See* Leandra Lederman, *Precedent Lost: Why Encourage Settlement, and Why Permit Non-Party Involvement in Settlements?*, 75 NOTRE DAME L. REV. 221 (1999); Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537 (1998); *see also* Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073 (1984); Lawrence B. Solum, *Procedural Justice*, 78 S. CAL. L. REV. 181 (2004).

54. *See infra* notes 55–63 and accompanying text.

55. Prior to December 1, 2003, Federal Rule of Civil Procedure 23(e) stated:

Dismissal or Compromise. A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs.

56. *See* Joel A. v. Giuliani, 218 F.3d 132, 138 (2d Cir. 2000) (noting that before approving a settlement under Rule 23(e), “the district court must determine that a class action settlement is fair,

well.<sup>57</sup> It is through this role that judges become gatekeepers. Without their approval, cases cannot settle.

Unlike individual private cases, like a contract dispute, aggregate and derivative parties cannot simply settle the case and dismiss their claims.<sup>58</sup> Instead, the judges must evaluate the settlement proposals and approve them. The purpose is to protect the absentee class members and minimize agency costs. In essence, the judges are tasked with filling the gaps the litigation mechanism creates. Judges must monitor the litigation and review and approve settlements. Their job is to adjust for and counteract the agency problems and litigation gaps.<sup>59</sup> It is through this process that the judges become settlement gatekeepers.

The language of Federal Rule of Civil Procedure 23(e) and Delaware's equivalent both assign this fiduciary-like role to judges.<sup>60</sup> This Article constructs it as a gatekeeping role because of the specific monitoring and enabling functions the judges must perform. Their job is to protect the class members.<sup>61</sup> Before approving a binding settlement under 23(e)(2),

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adequate, and reasonable, and not a product of collusion"); *Grunin v. Int'l House of Pancakes*, 513 F.2d 114, 123 (8th Cir. 1975) (citations omitted) ("Under Rule 23(e) the district court acts as a fiduciary who must serve as a guardian of the rights of absent class members. The court cannot accept a settlement that the proponents have not shown to be fair, reasonable, and adequate.").

57. As amended effective December 1, 2009, Federal Rule of Civil Procedure 23(e) states:

The claims, issues, or defenses of a certified class may be settled, voluntarily dismissed, or compromised only with the court's approval. The following procedures apply to a proposed settlement, voluntary dismissal, or compromise:

- (1) The court must direct notice in a reasonable manner to all class members who would be bound by the proposal.
- (2) If the proposal would bind class members, the court may approve it only after a hearing and on finding that it is fair, reasonable, and adequate.
- (3) The parties seeking approval must file a statement identifying any agreement made in connection with the proposal.
- (4) If the class action was previously certified under Rule 23(b)(3), the court may refuse to approve a settlement unless it affords a new opportunity to request exclusion to individual class members who had an earlier opportunity to request exclusion but did not do so.
- (5) Any class member may object to the proposal if it requires court approval under this subdivision (e); the objection may be withdrawn only with the court's approval.

FED. R. CIV. P. 23(e).

58. See FED. R. CIV. P. 23(e) (requiring court approval of proposed settlements); DEL. SUPER. CT. R. CIV. P. 23(e) (same).

59. See Jonathan R. Macey & Geoffrey P. Miller, *Judicial Review of Class Action Settlements*, (NYU Law and Economics Research Paper No. 07-34, 2007), available at <http://ssrn.com/abstract=1017266> (noting that judicial review is the "most important safeguard" over class counsel agency costs).

60. See Chris Brummer, Note, *Sharpening the Sword: Class Certification, Appellate Review, and the Role of the Fiduciary Judge in Class Action Lawsuits*, 104 COLUM. L. REV. 1042, 1042 (2004) (stating that in class actions the judge should act as a fiduciary to the absent class members).

61. *Id.* (urging that in accordance with his fiduciary role, a judge may be required to "pierce the surface" of the complaint to protect class members).

for example, judges must determine that the proposal is “fair, reasonable, and adequate.”<sup>62</sup> This is a unique role tied to the agency concerns. Judges have the power and the responsibility to guard against the agency issues and protect the interests of the shareholders and class members.<sup>63</sup> No approval, no settlement. Consider the three cases below. I use them to construct the role of gatekeeping judges.

*In re Caremark International Inc. Derivative Litigation.*<sup>64</sup> In this case, Chancellor Allen exhibits a limited example of settlement gatekeeping. The *Caremark* plaintiffs alleged a breach of fiduciary duty: the board failed to monitor and oversee compliance with health care regulations.<sup>65</sup> The main issue was whether the board had paid sufficient attention to possible “kickback” payments to physicians in exchange for referrals to Caremark facilities for treatment.<sup>66</sup> Caremark had guidelines and policies preventing *quid pro quo* payments but allowing for consulting and research contracts with doctors who recommended or prescribed Caremark services and products.<sup>67</sup> The Health and Human Services Office of the Inspector General investigated Caremark for violations, joined by the Department of Justice and several other federal and state agencies and, later, indicted the company and several officers.<sup>68</sup>

Caremark settled various federal and state matters pending against it.<sup>69</sup> Not only were no senior officers or directors cited for wrongdoing, but the Department of Justice also stipulated that no “senior executive of Caremark participated in, condoned, or was willfully ignorant of wrongdoing in connection with the home infusion business practices.”<sup>70</sup> The entity itself, however, paid significant criminal and civil fines.<sup>71</sup> It

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62. FED R. CIV. P. 23(e).

63. See, e.g., James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 524 (1997) (urging judges to review settlements more actively); Judith Resnik, *Money Matters: Judicial Market Interventions Creating Subsidies and Awarding Fees and Costs in Individual and Aggregate Litigation*, 148 U. PA. L. REV. 2119, 2175–77 (2000) (pressing for increased judicial intervention in settlements and fee petitions).

64. 698 A.2d 959 (Del. Ch. 1996).

65. *Id.* at 961–62.

66. *Id.*

67. *Id.* at 962.

68. *Id.* at 962–63. In fact, when initiated, the investigation was of Caremark’s corporate predecessor. *Id.*

69. *Id.* at 964.

70. *Id.* at 965.

71. *Id.* at 965 n.10.

also formally agreed to make some internal changes that would enhance compliance.<sup>72</sup> Civil litigation and a settlement proposal followed.<sup>73</sup>

When Chancellor Allen reviewed the settlement proposal, he found that the board actually had been involved in overseeing its physician relationships, had consulted with legal advisors, and had adopted policies and programs to train employees about the various laws and regulations. The proposed settlement was non-monetary and contained only one significant aspect: the formation of a Compliance and Ethics Committee to report to the board on monitoring and compliance systems.<sup>74</sup> The Chancellor noted that Caremark's liability was significant and criminal, but he questioned the board's ability to prevent the problems—beyond the monitoring in which it had engaged. Thus, he found the plaintiffs' breach of fiduciary duty claims were "extremely weak."<sup>75</sup> Then, although he approved the settlement—finding that the plaintiffs' attorneys had "gotten" something—he termed the benefits of the proposed settlement "modest."<sup>76</sup> This finding lays the groundwork for the Chancellor's gatekeeping act.

Chancellor Allen next evaluated the plaintiffs' attorneys' fees. He applied the following factors:

The financial value of the benefit *that the lawyers [sic] work produced*; the strength of the claims (because substantial settlement value may sometimes be produced even though the litigation added little value—*i.e.*, perhaps any lawyer could have settled this claim for this substantial value or more); the amount of complexity of the legal services; the fee customarily charged for such services; and the contingent nature of the undertaking.<sup>77</sup>

He determined that the only factor "point[ing] to a substantial fee, [was the] . . . amount and sophistication of the lawyer services required."<sup>78</sup> He found that the requested fee exceeded the value of the services provided. The Chancellor therefore reduced the fee by about 20 percent, which reflected actual attorney hours with a premium for the limited contingency.<sup>79</sup>

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72. *Id.* at 965.

73. *Id.* at 964.

74. *Id.* at 966.

75. *Id.* at 972.

76. *Id.*

77. *Id.* (emphasis in original).

78. *Id.*

79. *Id.* Of course, the settlement had considerable other value, such as revamping the corporate



Reducing the attorneys' fees in this manner is a simple form of gatekeeping.<sup>80</sup> When the Chancellor adjusted the fees, he made clear that the defendants had "given away" too much. Indeed, although the opinions and literature appear to assume that the defendants are monitoring their attorneys, this Article points out both that defendants lack an incentive to do so and that, as a result, in order to fulfill their gatekeeping role, the courts cannot monitor only plaintiffs' counsel.<sup>81</sup> As the *Caremark* proposed settlement makes clear, rational defendants may have viewed the settlement as being for nuisance value. The court's opinion and the decrease in attorney's fees, however, makes clear that the actual nuisance value was less than what the defendants willingly accepted.

*Reynolds v. Beneficial National Bank.*<sup>82</sup> The *Reynolds* opinion also helps lay the groundwork for the construct of gatekeeping judges. In *Reynolds*, Judge Posner applied Rule 23(e) to a district court-approved settlement, stating that the district court needed to "determine that a class action settlement [wa]s fair, adequate, and reasonable, and not a product of collusion."<sup>83</sup> The court held that the key issue was whether the "district judge discharged the judicial duty to protect the members of a class in class action litigation from lawyers for the class who may, in derogation of their professional and fiduciary obligations, place their pecuniary self-interest ahead of that of the class."<sup>84</sup> As the discussion below points out, this gatekeeping statement fails to examine fully the defendants' role in the collusion. True gatekeeping requires better scrutiny of both sides.

The Seventh Circuit applied the abuse-of-discretion standard to conclude that the district court failed to analyze the settlement details, and then reversed and remanded for review. The court held that the district judge failed to provide a record to support its finding that the settlement

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duty to monitor. This result, however, seems properly attributed to Chancellor Allen, and not to the plaintiffs' lawyers.

80. See also *Helaba Invest Kapitalanlagegesellschaft mbH v. Fialkow*, No. 2683-VCL, 2008 WL 1128721, at \*5 (Del. Ch. Apr. 11, 2008) (finding that fees of \$500,000 rather than the \$1.5 million requested were appropriate compensation for plaintiffs' counsel where benefit to class resulted from various factors and not just the role of plaintiffs' counsel); *In re Ramp Corp. Sec. Litig.*, No. 05 Civ. 6521, 2008 WL 58938, at \*4 (S.D.N.Y. Jan. 3, 2008) (awarding plaintiffs' counsel \$310,000 in fees instead of \$520,000 requested).

81. See *Goldberger v. Integ. Res., Inc.*, 209 F.3d 43, 44–45 (2d Cir. 2000) (finding that district court did not abuse discretion in awarding fees substantially below those requested); *Gunter v. Ridgewood Energy Corp.*, 223 F.3d 190, 197–200 (3d Cir. 2000) (setting out new standards for class-action fee award practices).

82. 288 F.3d 277 (7th Cir. 2002).

83. *Id.* at 279.

84. *Id.*

met Rule 23(e)'s strictures.<sup>85</sup> At the time the lower court approved the settlement most of the then-filed cases had "failed."<sup>86</sup> A couple had survived pre-trial motions, and one was scheduled for trial.<sup>87</sup>

According to the complaints, H&R Block ("Block") and Beneficial National Bank violated consumer-finance laws and breached fiduciary duties in the context of tax refund anticipation loans.<sup>88</sup> Block offered loans to customers for the time period between filing a tax claim and their refund.<sup>89</sup> The annual interest rate on the loans exceeded 100 percent.<sup>90</sup> Block arranged the loans, but Beneficial provided the money and paid Block.<sup>91</sup> Block clients were not told of Beneficial's role or that Block owned part of the loans.<sup>92</sup> Thus, the arrangements created the impression that Block was a fiduciary when it was, in fact, engaged in self-dealing.

Consider the settlement and the circumstances surrounding it. Three plaintiffs' lawyers, none of whom had cases pending, had lunch with a key defense lawyer for Beneficial.<sup>93</sup> Beneficial's lawyer proposed a "global settlement"<sup>94</sup> of approximately \$23 to \$25 million.<sup>95</sup> The plaintiffs' lawyers then filed a class-action complaint against Beneficial and Block.<sup>96</sup> The plaintiffs voluntarily dismissed Block, but when settlement negotiations officially ensued, Beneficial, which had agreed to indemnify Block, insisted Block be included.<sup>97</sup>

This settlement negotiation is collusive. Defense counsel wanted a settlement and was actively pursuing it. The result was a settlement agreement that, among other things, required the filing of a new complaint with the Block entities as defendants.<sup>98</sup> Beneficial and Block agreed to split a payment of \$25 million, with a \$15 million cap for any individual plaintiff, to disclose refund-anticipation loan details in the future, to pay the costs of notice to the class members, and to pay the plaintiffs'

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85. *Id.* at 286.

86. *Id.* at 280.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.* at 280.

95. *Id.* at 281.

96. *Id.*

97. *Id.*

98. *Id.*

attorneys' fees separately from the settlement.<sup>99</sup> They also agreed that any uncollected funds would revert to the defendants.<sup>100</sup>

The district court approved the settlement, rejecting the reversion clause. It also insisted on an increase in the individual cap to \$30 million because a majority of class members had received two refund-anticipation loans.<sup>101</sup> According to the Seventh Circuit, the district judge found the settlement amount adequate, but relied on unsworn testimony from an accountant without questioning the methodology.<sup>102</sup> In fact, after class notices went out to seventeen million people, one million filed claims, completely exhausting the fund.<sup>103</sup>

Would-be plaintiffs objected to the settlement, calling it the result of a "reverse auction."<sup>104</sup> They argued that the defense attorneys selected the most "ineffectual" class lawyers to negotiate a weak settlement with preclusive effect—a valuable result.<sup>105</sup> The Seventh Circuit criticized the district judge for failing to scrutinize the settlement circumstances.<sup>106</sup> In fact, Block had substantial financial exposure in a pending Texas fiduciary-duty case with a disgorgement demand of all fees paid, up to \$2 billion dollars.<sup>107</sup> In short, the defendants had a huge incentive to settle—particularly in light of the district judge's willingness to enjoin the Texas case.<sup>108</sup> Indeed, they were "happy to pay generous attorneys' fees since all they care[d] about [was] the bottom line—the sum of the settlement and the attorneys' fees—and not the allocation of money between the two categories of expense."<sup>109</sup>

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99. *Id.* As a result, the fees would not directly diminish the settlement amount. *See id.* at 282.

100. *Id.* at 281.

101. *Id.* at 282.

102. *Id.*

103. *Id.*

104. *Id.* For discussions of how defense attorneys have attempted to conduct informal auctions in aggregate litigation, see Jonathan T. Molot, *An Old Judicial Role for a New Litigation Era*, 113 *YALE L.J.* 27, 50–51 (2003); *Class Wars*, *supra* note 27, at 1347. These concerns are not generally present in securities litigation where court-appointed lead plaintiffs control the selection of counsel.

105. *Reynolds*, 288 F.3d at 282.

106. *Id.* at 283.

107. *Id.*

108. *Id.* Further, the total settlement amount paid was the same as what Beneficial alone had apparently indicated it was willing to pay two years earlier. *Id.*

109. *Id.* at 282. Note, however, that the statement that the defense attorneys do not care about more gives short shrift to their clients' concerns. To the extent that defendants are or are likely to be repeat class action players, they should care more about paying off the plaintiffs' attorneys and focus more on the portions of the settlements rather than the bottom line. Indeed, the defense attorneys arguably have a fiduciary interest in objecting even to nuisance settlements if their clients are likely to be repeat players.

This settlement presents a dramatic instance of an agency problem, with the defendants initiating the bad outcome. Unfortunately, on appeal, the Seventh Circuit failed to address that issue. It did, however, engage in some strong gatekeeping on other aspects of the settlement, including an injunction preventing notice to the Texas class members about the status of the litigation or whether to opt out of the settlement.<sup>110</sup> It also chastised the lower court for requesting fee applications be submitted *in camera*, without any sound basis.<sup>111</sup> Finally, the Seventh Circuit smacked the district court for failing to provide a record for appellate review of the allowed fees or the settlement itself.<sup>112</sup> As a result, the Seventh Circuit concluded that the district court had abused its discretion and remanded the case to a *different* judge for a new Rule 23(e) review.<sup>113</sup>

All of these actions are gatekeeping. They provide examples of monitoring the settlement before enabling it. In contrast with the fee-adjustment in *Caremark*, this case shows a more forceful form of gatekeeping, rejection of the settlement with a remand to a different judge.<sup>114</sup> In the gatekeeping process, the court verified the information before it and reviewed the merits, or lack thereof, of the proposal.

This judicial due-diligence process, then, adds to the construct of judicial gatekeeping. Importantly, the court's rendition of the facts surrounding the collusive settlement process is extremely valuable. Counsel on both sides had an incentive not to reveal those circumstances and only the appeal, pressed by different plaintiffs' counsel, exposed it. Thus, the opinion provides evidence of the collusion that actually created the circumstances for the settlement in the first place. The gatekeeping outcome would be stronger, however, if the court had focused on the defense counsel's significant contributions to the collusive settlement. The next case study also reveals collusion.

*In re TD Banknorth Shareholders Litigation.*<sup>115</sup> Delaware delegates the role of enforcing director and officer fiduciary duties to private litigation.

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110. *Id.* at 284.

111. *Id.* at 286.

112. *Id.* at 284.

113. *Id.* at 286.

114. *Id.* at 289. On remand, the new district judge rejected the settlement, found that the class plaintiffs and counsel had been inadequate representatives, and ordered that the settlement counsel would not continue to represent the class. 260 F. Supp. 2d 680, 694–95 (N.D. Ill. 2003). Proceeding with new counsel, the parties again attempted to reach a settlement, which was rejected by the district court. *See Carnegie v. Household Int'l, Inc.*, 445 F. Supp. 2d 1032, 1034 (N.D. Ill. 2006) (describing procedural history of the case). Finally, on the eve of trial, the parties reached a third settlement, which the district court approved. *Id.*

115. 938 A.2d 654 (Del. Ch. 2007).

To ensure enforcement, Delaware provides for fee shifting to successful attorneys.<sup>116</sup> The system thus relies on private attorneys to take the lead, assuming that if they do so well, the fees they receive will provide them with sufficient incentive to continue doing so.

In *TD Banknorth*, Vice Chancellor Lamb reviewed a proposed settlement arising out of claims surrounding a merger between Toronto-Dominion Bank, which already held a majority interest in Banknorth, and TD Banknorth, Inc.<sup>117</sup> To accomplish the merger, Toronto-Dominion acquired the remaining publicly traded shares of Banknorth.

As is the norm, the proposed settlement released the defendants from any potential liability. In return, it provided three things to the plaintiff class. The first was \$0.03 per share in monetary consideration, an increase of less than one-tenth of one percent in the merger price per share, payable to former minority shareholders *and to the defendant shareholders*.<sup>118</sup> The second was an exclusion of only 11,596, out of over 96 million, shares from the vote requiring approval of the transaction by a majority of the minority.<sup>119</sup> The third item comprised four additional disclosures to shareholders, including some that had actually occurred prior to the settlement agreement.<sup>120</sup> In addition, the attorneys for the class submitted a request for \$1,045,000 in costs and fees.<sup>121</sup> There were formal objectors to the proposed settlement who argued the court should reject it because the plaintiffs had “viable contractual and entire fairness claims” that they were exchanging for “insubstantial consideration.”<sup>122</sup>

The Delaware standard of review for settlement proposals is very similar to the standard under Federal Rule of Civil Procedure 23(e). The court must determine “whether, in the exercise of its own business judgment and in light of the facts and circumstances presented, the proposed settlement is a fair and reasonable resolution” of the litigation.<sup>123</sup> The focus is on whether the outcome redresses any wrong done to the corporation (in a derivative case) or the shareholders (in a direct case). In addition, judicial gatekeepers must balance the then-existing facts and

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116. See *Tandycrafts, Inc. v. Initio Partners*, 562 A.2d 1162, 1164–65 (Del. 1989) (describing the standards controlling when the court may award attorneys’ fees to successful plaintiffs).

117. *TD Banknorth*, 938 A.2d at 656–57.

118. *Id.* at 657 n.1.

119. *Id.* at 657.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

discovery with the reality of incomplete discovery and a case that is not trial-ready.

The *TD Banknorth* court examined the factual record describing the parties and their claims. There were two corporate defendants, TD Banknorth and the Toronto-Dominion Bank. Key individual defendants included W. Edmund Clark, the president and CEO of Toronto-Dominion; William J. Ryan, the chair, president, and CEO of Banknorth (until he was replaced as president in September 2006 and as CEO in March 2007); and P. Kevin Condron, the chair of Banknorth's committee of independent directors [Special Committee].<sup>124</sup>

The following facts are important to the gatekeeping. In March of 2005, Toronto-Dominion acquired a 51 percent ownership interest in Banknorth for \$42.23 per share.<sup>125</sup> The banks executed a shareholders' agreement (the Agreement) to prevent Toronto-Dominion from acquiring more than 66.7 percent of Banknorth's publicly held stock, except in compliance with the Agreement. The purpose of the restriction was to prevent Toronto-Dominion from initiating a going-private transaction before March of 2007, *unless* the Special Committee invited it.<sup>126</sup>

Yet, about nine months after the Agreement, six Toronto-Dominion representatives, including a Banknorth officer and director, attended a Banknorth Special Committee meeting.<sup>127</sup> The Special Committee considered a going-private transaction and tasked its chair, Condron, to study "how a process would work in the event that" it decided to invite Toronto-Dominion to purchase the minority shares.<sup>128</sup> The Special Committee hired its own legal and financial advisors.<sup>129</sup> Shortly thereafter, Ryan urged a going-private discussion at a Special Committee meeting<sup>130</sup> and at an executive session of the board. At the meeting, Clark stated that Toronto-Dominion "might be interested in pursuing exploratory discussions if invited to do so by the [Special Committee]."<sup>131</sup>

These discussions continued for quite a few months before the Agreement period had ended, with Clark again indicating Toronto-

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124. *Id.* at 658.

125. *Id.* Following the 51 percent transaction, Toronto-Dominion continued to acquire Banknorth shares until it held approximately 59.5 percent. *Id.* at 659.

126. *Id.* at 658–59.

127. *Id.* at 659.

128. *Id.*

129. *Id.* Later that month or in early May, Private Capital Management, a 7.6 percent shareholder of Banknorth contacted Ryan and Clark, the president and CEO of Toronto-Dominion, about a privatizing transaction. *Id.* at 659–60.

130. *Id.* at 660.

131. *Id.* He also told the Special Committee about the Private Capital Management discussions.

Dominion's interest in a transaction "if invited"<sup>132</sup> and keeping tabs on discussions and meetings.<sup>133</sup> Negotiations occurred, with Condron rejecting Clark's offer and Clark refusing to offer more.<sup>134</sup> Condron terminated the negotiations at the end of September 2006 "in the best interests of Banknorth's minority stockholders."<sup>135</sup> Shortly thereafter, however, negotiations resumed. In the interim, Banknorth had lowered its earnings estimates, causing the Special Committee's financial advisor to adjust the transaction price down. The result was a November proposal to "invite" Toronto-Dominion to offer \$32.33.<sup>136</sup> Both boards immediately approved the transaction.<sup>137</sup>

Multiple class actions in Delaware, New York, and Maine followed. The key question was whether the discussions between conflicted Banknorth officers/directors and those of Toronto-Dominion violated the prohibition on discussions without an invitation. Although the Delaware plaintiffs served a document request, they agreed to an extension for an indefinite period.<sup>138</sup> Banknorth filed its preliminary proxy statement and forms with the SEC "documenting" the fairness report on which the Special Committee relied, and plaintiffs' counsel reviewed and analyzed them.<sup>139</sup>

The Maine plaintiffs, however, moved for expedited discovery. The Maine judge set a hearing date, prompting the Delaware plaintiffs to file a consolidated complaint and issue a settlement proposal—despite the fact that they had not reviewed any documents other than the publicly filed SEC forms. The first offer was for corrective disclosures without any monetary demands.<sup>140</sup>

The Maine plaintiffs continued to do discovery, prompting the Delaware plaintiffs to make a settlement demand of a \$0.05 per share increase in the merger consideration. The parties agreed to \$0.03. Banknorth also filed a revised proxy statement with additional disclosures.<sup>141</sup> In April, the Banknorth shareholders approved the merger

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132. *Id.*

133. *Id.*

134. *Id.* at 660–61.

135. *Id.* at 661.

136. *Id.*

137. *Id.*

138. *Id.* at 662.

139. *Id.*

140. *Id.*

141. *Id.*

with 95 percent of the minority shareholders voting in favor. Banknorth went private that month.<sup>142</sup>

The Delaware plaintiffs' counsel attended the Maine depositions, dubbing them "confirmatory" discovery and, presumably in hopes of a good settlement for all, the Maine plaintiffs then stipulated to a stay of their action. Objectors to the Delaware case filed a motion to intervene and to preliminarily enjoin the merger vote. But the Delaware parties entered into a stipulation of settlement, and the court denied the objectors' motions.<sup>143</sup> The result of all of these maneuvers was a completed transaction, followed by objections to the proposed settlement.<sup>144</sup>

Vice Chancellor Lamb examined both the facts and the proposed settlement to determine whether it was fair and reasonable to the class.<sup>145</sup> He was aided by the presence of objectors who made a case that the Delaware plaintiffs were releasing apparently strong breach of contract claims.<sup>146</sup> Vice Chancellor Lamb considered the roles of the conflicted Banknorth representatives and those from Toronto-Dominion, as well as the plain meaning of terms like "propose" and "initiation" in the agreement, and rejected the argument that only a formal proposal would violate the agreement.<sup>147</sup> Instead, the vice chancellor noted that the agreement may have been drafted to prevent exactly the fact pattern that occurred.<sup>148</sup> Thus, he concluded that there was "substantial evidence to support a claim that the merger agreement [was] the product of the defendants' violation of the stockholders' agreement."<sup>149</sup>

Vice Chancellor Lamb then turned to the proposed settlement terms. This portion of the opinion spotlights his gatekeeping role. He focused on the timeframe allowed for negotiations under the Agreement, noting that it would have been considerably later than the date of the questioned

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142. *Id.* at 663.

143. *Id.* at 662.

144. *Id.* at 663.

145. *Id.* at 657.

146. To reach this conclusion, the court had to address whether the breach of contract claims were direct or derivative in nature. It found that the harm was direct and thus that the claims had not been extinguished by the merger. *Id.* at 666.

147. *Id.* at 665.

148. *Id.* at 665-66 (noting that a waiting period would allow for full integration from the acquisitions Banknorth was planning to undertake after Toronto-Dominion became majority shareholder and would prevent a merger if there were a downturn in the banking market). He also noted that the merger proxy statement supported that interpretation, by stating that the Shareholder Agreement prevented it from initiating or engaging in a going-private transaction before March 1, 2007, unless requested to do so by the Special Committee. *Id.*

149. *Id.* at 666.



transaction.<sup>150</sup> Further, because the transaction was a freeze-out merger, in which all of the Banknorth shareholders were to “disappear,” he found that it was subject to the entire fairness doctrine—requiring analysis of both fair dealing and fair price.<sup>151</sup> The vice chancellor concluded that the timing of the merger and the prima facie violation of the agreement both supported a conclusion that the complaint had a strong “unfair process claim.”<sup>152</sup>

Vice Chancellor Lamb was an engaged gatekeeper. Consider the following:

A reasonable class representative in the plaintiffs’ position certainly would have tried to extract substantial consideration for the settlement of these claims. That plainly did not happen here. Instead, the named plaintiffs and their counsel failed to pursue this claim and, as a result, agreed to settle the case for only *meager* consideration.<sup>153</sup>

He also rejected other aspects of the proposed settlement. He examined in detail the proxy disclosures the plaintiffs asserted resulted from their settlement negotiations, finding that in fact most of the disclosures were actually “in response to SEC comment letters.”<sup>154</sup> “Disclosure-driven” settlements, the vice chancellor reasoned, require the plaintiffs to show that their achievement would assist stockholders in determining whether to support the transaction.<sup>155</sup> The plaintiffs could not meet this burden, however, because the key disclosures did not result from their efforts but from those of the SEC, and others were restatements of previously public information.<sup>156</sup>

Next, the vice chancellor rejected the settlement notice. He found that it omitted an exhibit detailing the disclosures, leaving the stockholders uninformed about a material basis for the settlement.<sup>157</sup> He also pointed out that it failed to explain that the defendants were to share in the cash portion of the settlement, an “unusual” provision.<sup>158</sup> He stated that it was

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150. *Id.* at 667.

151. *Id.*

152. *Id.* at 668. He also compared this claim to a prior and similar Delaware case, finding this one to be stronger. *Id.* at 667–68.

153. *Id.* at 668 (emphasis added).

154. *Id.* at 669. Moreover, he noted that the most substantive additional disclosures were “directly attributable to the work of the SEC’s staff.” *Id.*

155. *Id.*

156. *Id.* at 669–70.

157. *Id.* at 670.

158. *Id.*

an “odd proposition” that those who allegedly violated their fiduciary duties would share in the remedy for that violation.<sup>159</sup>

Finally, the vice chancellor exposed the defendants’ collusion in the outcome. Despite indications that the defendants breached their fiduciary duties, the proposed settlement allowed for dismissal with payments to the plaintiffs’ attorneys and no personal payments by the defendants. The defendants were conflicted, both as to the outcome, a potential finding of personal liability, and the payment source—insurance or their own money. This conflict increased the defendants’ incentive to settle and exacerbated the agency-cost situation.

These three case studies provide examples of gatekeeping judges in various settlement contexts. Settlement is an acute point for active gatekeeping. It is the last chance to examine and control for the agency costs of the litigation. From weighing the fees to weighing both the appropriateness of *any* settlement and that of the proposed one, judicial gatekeepers must monitor before enabling. Part IV of this Article further develops this gatekeeping construct and then creates a set of principles for the gatekeepers.

#### IV. GATEKEEPING PRINCIPLES

Judges are the designated neutral decision-makers for aggregate litigation generally and for settlements in particular. As Part III revealed, a judicial gatekeeper can reduce settlement agency costs and improve the outcomes for the parties and for the legal system. Indeed, as the case studies reveal, some judges at both the trial and appellate level are exercising gatekeeping powers. The remainder of this section develops a set of principles for gatekeeping judges to use in monitoring and enabling settlement proposals.

*Reject Settlements.* Although judges cannot draft the settlement, they have indirect power to do essentially that—through settlement rejection. This power to reject is what Professor Reinier Kraakman described in his Article on financial gatekeepers as the power to “withhold support.”<sup>160</sup> Financial gatekeepers control wrongdoers and exercise control over incentives indirectly by refusing to grant approval for transactions.<sup>161</sup>

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159. *Id.* at 670–71. The plaintiffs argued that the language of the settlement proposal did make this situation clear, but the court flatly rejected that argument. *Id.*

160. See Kraakman, *Gatekeepers*, *supra* note 5, at 100.

161. *Id.*

Judicial gatekeepers who reject settlements also exercise control and can, thereby, establish templates for better settlement terms and processes.<sup>162</sup>

Like the underwriters and accountants who control market access, judges control access to aggregate litigation settlements. No approval, no settlement. Rule 23(e) provides judges with the option to reject settlements. This is real power. Deploying rejection, even rarely, will create pressure for parties to provide better records, both as to their claims and their settlement processes. Inspecting the record, both for its thoroughness and for its reasonableness, is a form of due diligence. Judicial gatekeepers should reject proposals lacking sufficient information upon submission, with time allowed for a revised proposal.

*Improve the Record.* Before approving settlements, judges can use Rule 23(e) to add rigor to the settlement approval process. They can ask more and deeper questions of the parties. They can request better briefings and demand more thorough records. When appropriate, judges can insist on sworn testimony. They can require the parties to present evidence on different levels of potential outcomes with probabilities for comparison.<sup>163</sup> Evidence, sworn testimony, and statements from both parties about case status would enable judges “to translate [their] intuitions about the . . . case” and its value into a “responsible evaluation of the reasonableness of the settlement.”<sup>164</sup>

To be sure, settlement hearings are not, and should not be, “mini-trials on the merits, [but the courts] should explore the facts sufficiently to make intelligent determinations concerning adequacy and fairness.”<sup>165</sup> Settlement “findings and conclusions should not be based simply on the arguments and recommendations of counsel”; rather “[t]here must be some ‘*evidentiary*’ foundation’ in support of the proposed settlement.”<sup>166</sup>

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162. See *Fundamental Principles*, *supra* note 30 (citing *In re Warner Commc'ns Sec. Litig.*, 798 F.2d 35, 37 (2d Cir. 1986) (stating that district court cannot dictate settlement terms). In appropriate cases, the court might require an independent damages expert with the costs shared by the parties. Of course, rejection may not be perfect, but it can result in improvements. Compare *SEC v. Bank of Am.*, 653 F. Supp. 2d 507, 509 (S.D.N.Y. 2009) (discussing proposed consent decree recommending a \$33 million Bank of America/SEC settlement as concocted for absolution and “neither fair, nor reasonable, nor adequate”), with *SEC v. Bank of Am.*, Nos. 04 Civ. 6829, 10 Civ. 0215, 2010 WL 624581, at \*1, \*5 (S.D.N.Y. Feb. 22, 2010) (“reluctantly” approving \$150 million settlement as “considerably greater” but still “very modest” and insufficiently “punitive” with respect to individual wrongdoing).

163. *Reynolds v. Beneficial Nat'l Bank*, 288 F.3d 277, 285 (7th Cir. 2002).

164. *Id.*

165. *Plummer v. Chem. Bank*, 668 F.2d 654, 659 (2d Cir. 1982).

166. *Id.* (internal quotations omitted); see also *Lewis v. Hirsch*, No. Civ. A. 12,532, 1994 WL 263551, at \*7 (Del. Ch. June 1, 1994) (emphasis added) (declining to approve settlement where plaintiffs did not provide evidence that they had investigated what appeared to be significant insider-trading claims before reaching agreement).

Demanding information will provide judges with a basis for better judgments and for making the best use of their intuitions.<sup>167</sup> The result will not be “scientific” or precise, but it would be a significant improvement over current practices.<sup>168</sup> An increased record would increase some litigation costs, but it would also help to decrease agency costs.<sup>169</sup>

Thus, courts should look to the “evidentiary” support for any settlement proposal. Better records are not only required, but would also press on the quality of discovery. Consider *Lewis v. Hirsch*, a Delaware derivative opinion in which the Chancery Court rejected the proposed settlement due to insufficient discovery effort.<sup>170</sup> The allegations included waste and excessive compensation as well as insider-trading/fiduciary duty claims.<sup>171</sup>

The *Lewis* court benefitted from objectors in a case pending elsewhere.<sup>172</sup> The objectors argued that the named plaintiff, Lewis, failed to do an adequate investigation of insider-trading claims before agreeing on a settlement.<sup>173</sup> They pointed to their own allegations detailing what the defendants knew when and in relation to their purchases.<sup>174</sup> They also

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167. Indeed, some studies have compared judges to laypeople and found that judges do better at setting aside biases and decision-making heuristics. See, e.g., Chris Guthrie et al., *Inside the Judicial Mind*, 86 CORNELL L. REV. 777, 816 (2001) (finding that judges, although still susceptible to various decision-making heuristics, were less susceptible to some than laypeople); Reid Hastie & W. Kip Viscusi, *What Juries Can't Do Well: The Jury's Performance as a Risk Manager*, 40 ARIZ. L. REV. 901, 904–08 (1998) (finding similar results, although with a limited group of judges); cf. Andrew J. Wistrich et al., *Can Judges Ignore Inadmissible Information? The Difficulty of Deliberately Disregarding*, 153 U. PA. L. REV. 1251, 1323–24 (2005) (finding that although judges are not able to avoid all influence from relevant but inadmissible information, they are able to do so in some important circumstances).

168. Consider, for example, the case *Miller v. U.S. Foodservice, Inc.*, 361 F. Supp. 2d 470 (D. Md. 2005). In this matter, the Maryland District Court addressed the former CEO, Miller's, lawsuit for compensation he argued was due under his agreement with the company. *Id.* at 472. The company counterclaimed, arguing that Miller had breached fiduciary duties and obligations and that, therefore, the company was not obligated to pay out on the severance and might even be entitled to rescission. *Id.* The court agreed—at least at the motion to dismiss stage. *Id.* at 485. This case, although connected to a massive fraud settlement and later criminal matters, reveals serious concerns that, if not being addressed thoroughly by the company's board, should not be settled. Here, of course, the court respected that and denied the motion to dismiss. The same issues are relevant at the settlement stage.

169. Molot, *supra* note 104, at 113. But see Lisa L. Casey, *Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 BYU L. REV. 1239, 1281–86 (2003) (arguing that judges are not well-suited to this task).

170. 1994 WL 263551.

171. *Id.* at \*1.

172. Objectors come in many flavors. See, e.g., *New Eng. Health Care Emps. Pension Fund v. Woodruff*, 520 F.3d 1255 (10th Cir. 2008) (objectors were defendants excluded from proposed settlement). On the role and value of objectors more generally, see Edward Brunet, *Class Actions Objectors: Extortionist Free Riders or Fairness Guarantors*, 2003 U. CHI. LEGAL F. 403 (2003).

173. *Lewis*, 1994 WL 263551, at \*5.

174. *Id.*

argued that Lewis had not deposed the defendant president/chief executive officer of the company, despite the apparent receipt of over \$78 million through the exercise of stock options.<sup>175</sup>

Thus, the objectors did what the settlement did not: provide the court with a record and an evidentiary foundation to support their argument against settlement. The court exercised due diligence, examining the objectors' complaints and finding they had merit. It then rejected the settlement, finding that the failure to depose defendants and to provide information about documents related to the allegations doomed the settlement.<sup>176</sup>

Although courts apply various factors at this stage of their analysis, they all focus on the likelihood of the plaintiffs' success and the value of the benefits of the settlement to the corporation and the shareholders.<sup>177</sup> To do so, the court must examine the record and assure that it is adequate to allow the court to fulfill its gatekeeping role: determining whether the settlement amount is appropriate in relation to the claims.<sup>178</sup> When the record is insufficient, as in *Lewis*, settlement rejection, pending better discovery, is appropriate.

*Account for the Role of Insurance.* Insurance creates unique concerns in securities and corporate settlements. The case studies in this Article and the research on insurers reveal some of the reasons why these problems occur. Defendants rarely pay out of pocket to settle cases, decreasing their personal incentive to monitor.<sup>179</sup> Defense attorneys' fees and settlements are usually paid out of insurance,<sup>180</sup> which is indirectly paid for by shareholders.<sup>181</sup> The result should be insurers as defense-side monitors. Yet, as analyzed above, they do not fulfill this role. Judicial gatekeepers can correct for this problem by insisting on a record sufficient to ensure that collusion is not occurring.

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175. *Id.* at \*5–6. The court also noted other criticism of deposition testimony and insufficient document requests that would have bolstered the insider-trading claims. *Id.* at \*6.

176. *Id.* at \*7.

177. *Id.* at \*2.

178. *Id.*

179. See Black et al., *supra* note 37, at 1068 (noting the few instances directors have made out-of-pocket contributions to settlements).

180. See *Predicting Corporate Governance Risk*, *supra* note 40.

181. See Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 654–60 (2007) [hereinafter *On Leaving Corporate Executives*] (arguing that enterprise liability is ineffective in meeting either principles of compensation or deterrence goals, but that executive liability, if appropriately structured, might achieve deterrence).

To date, the focus on agency costs has been on the plaintiffs' side of these cases. Defendants' motives are equally mixed and are complicated by insurance. In order to fulfill their gatekeeping role, judges must combat the agency costs on both sides. To begin with, courts should insist on disclosure of, and transparency in, payment information and the source of settlement funds and fees. Collusion and fiduciary issues arise when insurers are paying the costs. Insisting that settlement proposals provide complete and transparent information about the insurance policy and payments would allow potential objectors and all shareholders to understand fully the choices the company and individuals made in agreeing to the settlement. It would also allow the gatekeeper to assess those incentives.

Better gatekeeping would also help level the playing field between the insurers, the parties, and the courts. Currently, a handful of insurers dominate the corporate insurance market. The result is an informational asymmetry. The insurers have information about case values and settlements across jurisdictions. Defendants and the courts have very little. By demanding more information in settlement proposals, gatekeeping judges will educate themselves about whether and when settlements are appropriate.

*Question the Source of Payments.* Before approving settlements, judges should be vigilant about whether it appears that wrongdoing actually occurred. If officers or directors "wronged" the company, the company should be pursuing them, not protecting them. Judges should evaluate whether and when the allegations and discovery at settlement support the possibility of individual wrongdoing. Judges should consider postponing settlement approval until they receive better information. Questions include whether the parties ever discussed personal payments,<sup>182</sup> whether any such payments are scaled to the level of wrongdoing,<sup>183</sup> and whether the officers, and perhaps the directors, should pay back any money received as a result of the wrongdoing.<sup>184</sup>

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182. *See In re Caremark Int'l Deriv. Litig.*, 698 A.2d 959, 965 n.13 (Del. Ch. 1996) (noting that such remedy was considered and rejected by the parties).

183. *See SEC v. Bank of Am.*, 2010 WL 624581 (S.D.N.Y. Feb. 22, 2010) (stating that even negligent wrongdoing can be a basis for personal payments).

184. *See, e.g., SEC v. Yuen*, 272 Fed. App'x 615, 618 (9th Cir. 2008) (affirming lower court order requiring CEO, who was found liable for securities fraud, to disgorge compensation and pay penalties); *see also* Sarbanes-Oxley Act of 2002 § 304(a), 15 U.S.C. § 7243(a) (Supp. 2002) (requiring that CEO and CFO reimburse issuer for certain compensation in periods where misconduct tied to material accounting restatements occur).

When the insurer pays, it is an indirect company/shareholder payment. If wrongdoing occurred, such payments wrong the plaintiffs twice. First, current shareholders pay for wrongs to prior shareholders. Second, corporate settlement payments by companies can decrease the value of the shareholders' stock. When that occurs, shareholders at the time of the alleged harm who own stock at the time of the settlement suffer a second injury. Yet, if the payments come from individuals, the same shareholder actually gains.<sup>185</sup> Thus, the source of payments can be of economic significance to the plaintiffs.<sup>186</sup>

Certain types of settlements can be signals for the possibility of individual wrongdoing, and courts should watch for them. For example, some insurers agree to drop coverage defenses in exchange for corporate contributions. The result is a settlement composed of funds within the insurance policy limits and company funds.<sup>187</sup> In those situations, however, an additional layer of collusion may be occurring—here between the insurer, who wants to avoid coverage litigation, and the defendants, who do not want wrongdoing exposed. For the gatekeeping judge, such a settlement should provoke scrutiny. It should also provoke a demand for more discovery and individual contributions rather than corporate ones—improving deterrence and helping to counteract the corporate and insurance agency gaps.<sup>188</sup> Of course, if courts begin to push in this direction, the conflicts for defendants will increase and their desire to settle will as well.<sup>189</sup> Courts, then, must pay attention to the effects of increased scrutiny and the fact that aggregate litigation can aggravate these problems.

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185. *Id.*

186. *See In re Warner Commc'ns Sec. Litig.*, 798 F.2d 35, 38 (2d Cir. 1986) (Newman, J., concurring); *cf.* *SEC v. Shah*, 1993 WL 288285 (S.D.N.Y. July 28, 1993) (rejecting claim by former company officer that personal payments made to settle private securities litigation claims could be used as offset for disgorgement of profits in SEC matter).

187. *See How the Merits Matter*, *supra* note 35, at 822 (arguing that within-limits settlements combined with corporate contributions may be red flags for the presence of wrongdoing).

188. *See Langevoort*, *supra* note 181; *see id.* at 635 (“The problem is that executives themselves will not be deterred from misconduct when their personal gain from perpetrating or concealing the fraud exceeds the impact they would suffer should the corporation have to pay.”); Black et al., *supra* note 37, at 1070 (noting that Enron and Worldcom directors paid \$13 million and \$24.75 million, respectively, in settling securities fraud cases).

189. Corporate officers should be the main focus of scrutiny. They are the day-to-day corporate-governance watchers. Their access to information and fiduciary responsibilities exceed those of their director counterparts. Even so, personal payments need not be excessive, but should be calibrated to ensure forfeiture of any gains from the wrongdoing. *See HealthSouth Corp. S'holders Litig.*, 845 A.2d 1096, 1105–06 (Del. Ch. 2003) (finding disgorgement appropriate where CEO was unjustly enriched in transaction with his company); *see also On Leaving Corporate Executives*, *supra* note 181, at 643–44 (suggesting that executives forfeit wealth obtained through wrongdoing).

*Scrutinize Substantive Settlements.* Judicial gatekeepers should also regard settlements that are substantive, and not financial, with appropriate skepticism. Substantive settlements, or those which involve little in the way of financial payments other than attorneys' fees, can result in little gain, immediate or otherwise, to the plaintiffs.<sup>190</sup> As in *Caremark*, where the remedy was a board committee, or in *TD Banknorth*, where the proposed remedy was additional disclosures, judges should attempt to assess the real value of the relief. If it does little other than restate the defendants' preexisting obligations, it should be rejected. When substantive relief offers little benefit to the plaintiffs, the defendants have offered little. Judicial gatekeepers should question why the case is settling, be chary of approving fees, and push to find out more. Importantly, the opposite is also true. When the settlement is substantive and produces value, the attorneys have done their job well and should be paid.<sup>191</sup>

*Award Appropriate Fees.* Finally, judges should award fees for cases with returns to shareholders, whether in the form of greater deterrence or financial and other remedies. Empirical evidence reveals that judges exercise far less discretion than they can when it comes to fee setting.<sup>192</sup> Yet fees are a key part of the private-attorneys-general mechanism. The fees are the incentive for bringing the case. Good plaintiffs' lawyers discover fraud and wrongdoing and, by pursuing it, enforce the underlying laws and duties. They also assume the risk that they will "receive no fee (or at least not the fee that reflects their efforts) when representing a class because their fee is linked to the success of the suit."<sup>193</sup> Counsel should be well compensated when their work supports it.<sup>194</sup> When it works, the

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190. See, e.g., *Gusinsky v. Bailey*, 2008 WL 4490008, at \*3 (N.Y. Sup. Ct. Sept. 17, 2008), *rev'd* with respect to attorneys' fees, 887 N.Y.S.2d 585 (N.Y. App. Div. 2009) (approving settlement but rejecting attorneys' fees where plaintiffs were to receive "minor changes in corporate governances").

191. See *Chan v. Diamond*, No. 03 Civ. 8494(WHP), 2005 WL 941477, at \*3 (S.D.N.Y. Apr. 25, 2005) (finding that plaintiffs had achieved actual results that provided for improved governance and approving fee request).

192. See Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards* 28–33 (July 7, 2010), available at <http://ssrn.com/abstract=1442108>. Although it is a case involving the SEC, not private plaintiffs, Judge Rakoff's push for SEC control of certain board consultants pursuant to a consent decree is an example of a judge positively impacting the substantive portion of a settlement. See *SEC v. Bank of Am.*, 2010 WL 624581 (S.D.N.Y. Feb. 22, 2010) (stating that judge had pressed on language that SEC control choices, rather than agree with defendant).

193. *Sutton v. Bernard*, 504 F.3d 688, 694 (7th Cir. 2007) (remanding for revision district court opinion rejecting and lowering plaintiffs' counsels' fee request).

194. See *id.* (noting that where district court calculation failed to account for risk of loss, counsel may have been undercompensated).



theory and the reality meet.<sup>195</sup> Fee setting, then, should support the theory, when it is supported by reality.

Importantly, as the remedies change, the factors relevant to fee setting must include variables beyond the settlement's cash value.<sup>196</sup> Fees should be tied to the lawyers' real value to the plaintiffs and to deterrence more generally. Thus, in a case like *Caremark*, the real value of the derivative litigation was less than it otherwise would have been because the government cases actually wrought most of the changes at the company.<sup>197</sup> Decreasing fees in *Caremark* was appropriate, in part, because it saved costs for the plaintiffs relative to the value of the litigation. In other cases, the opposite may be true, and judges should consider whether increased fees are appropriate.

In addition to the amount of fees, courts should evaluate the proposed timing of fee payments and ensure that lawyers have an appropriate incentive to monitor the settlement resolution. One option is to push for provisions that provide for lawyers to be paid only after the class is paid.<sup>198</sup> This requirement would help to ensure active attorney involvement until the settlement provisions have been implemented and the plaintiffs have been located. Currently, little is known about this aspect of securities and corporate litigation. The payment step is, in effect, a black box, with scant information available about the claims administration process. Gatekeeping judges should demand disclosure about this aspect of the settlement. Agency gaps likely exist here as well, and tying fees to remedy completion, so to speak, would help to decrease those gaps.

Judges should require the disclosure of defense counsel fees as well. The disclosure would function as a check on the reasonableness of plaintiffs' attorneys' fees. Indeed, in some cases combined defense fees might surprise.

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195. See, e.g., *In re Enron Corp. Sec., Deriv. & "ERISA" Litig.*, 586 F. Supp. 2d 732, 789 (S.D. Tex. 2008) (awarding \$688 million in fees to attorneys in Enron case, finding that "in the face of extraordinary obstacles, the skills, expertise, commitment, and tenacity of Lead Counsel in this litigation cannot be overstated," and "[n]ot to be overlooked are the unparalleled results, \$7.2 billion in settlement funds, which demonstrate counsel's clearly superlative litigating and negotiating skills").

196. See *Sutton*, 504 F.3d at 693 (noting that the "degree of success" achieved for class is key to fee setting).

197. See *supra* notes 69–76 and accompanying text; see also *Reynolds v. Beneficial Nat'l Bank*, 288 F.3d 277, 286 (7th Cir. 2002) (stating that attorneys' fees should be connected to incremental change achieved by plaintiffs' lawyers and not simply to overall settlement size).

198. See *Nagareda*, *supra* note 8, at 645 (citing cases in which courts delayed fee awards pending claims administration); *id.* (suggesting that plaintiffs' counsel would do well to volunteer to delay fees as a vouching mechanism).

As the above analysis reveals, the range of gatekeeping principles is broad. Courts can reject settlements—a dramatic response. They can also improve scrutiny of the record, demanding better information about the alleged wrongdoing, the discovery preceding settlement, and the settlement process. They can also scrutinize fees and fee arrangements, ensuring that lawyers executing their jobs well are paid appropriately. Judicial gatekeepers have many options to counteract the agency problems inherent in aggregate litigation. To be sure, as this section also makes clear, the task is time consuming. It is, however, both required and key to decreasing agency costs and collusion and ensuring that the litigation functions as intended. Transparency, disclosure, and pressure will help to decrease actual collusion as well as the arguably perverse effects indemnification and insurance create. Indeed, over time the process will become less time consuming because lawyers will learn what is required and, therefore, execute it before asking the judge for settlement approval.

Further, “[a] high degree of precision cannot be expected in valuing litigation, especially regarding the estimation of the probability of particular outcomes.”<sup>199</sup> Indeed, by definition, settlements are designed to make tradeoffs, including information. These issues are particularly salient in corporate and securities litigation where the injuries are financial and subject to market models, assumptions, and estimation. Precision in damage estimates or even in the likely outcome on underlying claims is dubious. Indeed the high rate of settlements in these cases contributes to the inability to predict trial outcomes. Simply put, not enough cases proceed to trial to allow for robust predictions. Thus, the existence of settlements partially prevents the development of information relevant to settlement.

Yet, even though complete accuracy is unlikely, it can be improved. *Caremark*, *Reynolds*, and *TD Banknorth* provide examples of courts subjecting settlement proposals to scrutiny. To be sure, the judges have an information-asymmetry problem: they have limited information about facts, discovery, and party discussions.<sup>200</sup> Gatekeeping judges, however, have the power to demand more information and, thereby, improve the settlement process and outcomes.<sup>201</sup>

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199. *Reynolds*, 288 F.3d at 285.

200. See *Class Action Conflicts*, *supra* note 27, at 808 (noting that courts have signed off on settlements without demanding information).

201. See *The Plaintiffs' Attorney*, *supra* note 14, at 105–10 (advocating that judges divide class settlements into three classes and apply different levels of scrutiny to each, depending on factors like collusion and fairness).

Of course, if judicial gatekeepers spend more time on settlements, they may increase the amount of time that cases spend on the docket.<sup>202</sup> Busy judges will then face their own personal and professional conflicts with resisting and scrutinizing settlements.<sup>203</sup> Aggregate litigation exacerbates this problem. Judges report that they spend more time on class actions than other civil litigation.<sup>204</sup> This statistic is not surprising. Judges are assigned a different role in these cases. Rule 23(e) requires them to conduct an “independent inquiry,” consider any objections, and weigh “the court’s own concerns.”<sup>205</sup> If the settlement is “unfair, unreasonable, or inadequate,” the court must reject it—even if it appears to “garner[ ] overwhelming approval.”<sup>206</sup> The purpose of assigning this gatekeeping role to judges is, in part, to counter the agency issues discussed earlier in this Article. Indeed, without the judicial gatekeeping role, aggregation is arguably not a solution to the agency costs of corporate and securities litigation. It is, instead, another cost.

Although appeals and objectors are not common,<sup>207</sup> they provide an excellent opportunity for appellate courts.<sup>208</sup> They create opportunities for

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202. See *Class Action Conflicts*, *supra* note 27, at 829 (noting that district court dockets are crowded and even “virtuous” judges have incentives to approve settlements); *Under Cloak of Settlement*, *supra* note 27, at 1122–30 (arguing that judges approve settlements to clear dockets); see also Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 374 (1982) (exploring the effects of judicial management). Ironically, district court judges also have an incentive to approve fewer settlements. If certain districts earn a reputation for careful scrutiny and additional demands before approval, they may see a decrease in the cases filed in their jurisdiction. See generally LYNN M. LOPUCKI, *COURTING FAILURE* (2005) (describing incentives of lawyers and courts in bankruptcy setting).

203. The Federal Judicial Center’s recordkeeping may create perverse incentives to move some cases, class actions, too quickly. Noting the time on the docket, without a more substantive analysis of cases and their complexity, may contribute to settlement pressure and, thereby, increase agency costs, rather than supporting judges who want to be active gatekeepers. See Eric Helland & Jonathan Klick, *The Effect of Judicial Expedience on Attorney Fees in Class Actions*, 36 J. LEGAL. STUD. 171, 181 (2007) (analyzing class action settlements and court congestion and finding higher attorneys’ fees in congested courts); Jennifer K. Robennolt et al., *Multiple Constraint Satisfaction in Judging*, (Univ. of Ill. Pub. Law and Legal Theory Research Paper No. 08-22, 2008), available at <http://ssrn.com/abstract=1133184> (pointing to statistic-keeping and its potential for affecting decision-making).

204. Willging et al., *supra* note 26, at 97 n.83 and accompanying text.

205. *Martens v. Smith Barney, Inc.*, 181 F.R.D. 243, 263 (S.D.N.Y. 1998).

206. *Id.*

207. See Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2066 (1995) (stating that “[o]bjectors are rare, and often only ‘straw objectors’”) and Theodore Eisenberg & Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 VAND. L. REV. 1529, 1550 (2004) on objectors. For information on appeals, see Willging et al., *supra* note 26, at 169–70.

208. Of course, appellate judges have mixed incentives as well. See, e.g., Richard A. Posner, *What Do Judges Maximize? (The Same Thing Everybody Else Does)*, 3 SUP. CT. ECON. REV. 1, 21 (1993) (describing ways in which appellate judges “reduce their work” and “avoid . . . politically sensitive issues”). Financial journalists can also help by reporting on settlements and judicial scrutiny, or the

scrutiny, and, where appropriate, reversal, in accord with the principles in this Article. They also create opportunities for change—for a real impact on district court decision-making.<sup>209</sup> And, even an abuse-of-discretion standard requires a finding that the settlement was “based upon well-reasoned conclusions [and] arrived at after a comprehensive consideration of the relevant factors.”<sup>210</sup> Judges care about their reputations<sup>211</sup> and hate reversals.<sup>212</sup> They are sensitive even to the possibility of a reversal. Thus, gatekeeping-by-reversal, or just the threat of it, can be a powerful

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lack thereof. Cf. Michael J. Borden, *The Role of Financial Journalists in Corporate Governance*, 12 *FORDHAM J. CORP. & FIN. L.* 311 (2007) (analyzing and proposing gatekeeping roles in policing fraud and other corporate wrongdoing for financial journalists).

209. See Christina L. Boyd, *The Impact of Courts of Appeals on Substantive and Procedural Success in the Federal District Courts* (2009) (unpublished Ph.D. dissertation, Washington University), available at <http://clboyd.net/dissertation> (providing empirical evidence of impact of remands on outcomes).

210. *In re Warner Commc'ns Sec. Litig.*, 798 F.2d 35, 37 (2d Cir. 1986). For examples of settlement reversals, see, e.g., *Synfuel Techs., Inc. v. DHL Express (USA), Inc.*, 463 F.3d 646, 652–55 (7th Cir. 2006) (reversing the district court's approval of a settlement when the court failed to “adequately evaluat[e] its fairness”); *Staton v. Boeing Co.*, 327 F.3d 938, 959–78 (9th Cir. 2003) (reversing the district court's approval of a settlement when the court did not give sufficient concern to “the possibility that class interests gave way to self-interest” in the treatment of attorney's fees and named-plaintiff payments); *In re Gen. Motors Corp. Pick-Up Truck Fuel Tank Prods. Liab. Litig.*, 55 F.3d 768, 804–19 (3d Cir. 1995) (reversing a district court's “too hastily approved” settlement); *Holmes v. Cont'l Can Co.*, 706 F.2d 1144, 1147–51 (11th Cir. 1983) (reversing district court's approval of a settlement when it failed to give “careful scrutiny” of preferential treatment to named plaintiffs); see also *In re Cmty. Bank of N. Va.*, 418 F.3d 277, 317–19 (3d Cir. 2005) (avoiding review of the settlement approval by remanding on other grounds, but still expressing concern that “there is little in the record to give us confidence that the District Court exercised its fiduciary duty to assure that the settlement process was procedurally fair” or that the court “gave the settlement and its unique characteristics the careful and comprehensive scrutiny required”).

211. Barry Friedman, *The Politics of Judicial Review*, 84 *TEX. L. REV.* 257, 298 (2005).

212. A recent study of settlement practices following a strongly worded opinion in the Second Circuit reveals the power of the *potential* for reversal. In *Goldberger v. Integrated Resources, Inc.*, the Second Circuit warned lower courts that if they did not actually engage in better scrutiny of fee requests, the chance of reversal would increase. *Goldberger v. Integrated Res., Inc.*, 209 F.3d 43 (2d Cir. 2000). Post-*Goldberger* fee changes are small, but noticeable. There does appear to be a link between *Goldberger* and settlement size: fee requests and fee awards both increase at slower rates in cases with larger settlements. See Theodore Eisenberg et al., *A New Look at Judicial Impact: Attorneys' Fees in Securities Class Actions After Goldberger v. Integrated Resources, Inc.*, 29 *WASH. U. J.L. & POL'Y* 5 (2009). In the Eisenberg et al. study, the authors point out that the results are consistent with other possibilities, including institutional plaintiff activism. See generally Lawrence Baum, *What Judges Want: Judges' Goals and Judicial Behavior*, 47 *POL. RES. Q.* 749, 754 (1994).

incentive<sup>213</sup> with significant outcomes.<sup>214</sup> Similarly, lower courts who exercise their gatekeeping powers thoroughly should garner praise.<sup>215</sup>

Finally, gatekeeping opinions can earn citations and recognition for the reversing court or the one affirmed, which is important to judges.<sup>216</sup> Consider Judge Rakoff's 2009 rejection of a proposed Consent Judgment between Bank of America and the SEC.<sup>217</sup> The SEC charged Bank of America with fraud for representations in a proxy statement. The parties agreed to settle for \$33 million, to be paid by the bank—though, actually, by its shareholders. Finding that the proposal was not “fair, first and foremost, because it [did] not comport with the most elementary notions of justice and morality,” the Judge exercised gatekeeping rejection.<sup>218</sup> The result was considerable media attention.<sup>219</sup> Eventually, the court approved a \$150 million settlement, but only after the parties revised the proposal.<sup>220</sup> This opinion, although unusual, makes the point: Judges who gatekeep can earn recognition for doing their jobs well.

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213. Right now, reversals are rare. Willging et al., *supra* note 26, at 170 (reporting a 15 percent reversal rate in three districts studied and 6 percent in a fourth).

214. Recall that in *Reynolds* the remand went to a different court/judge, and the result was rejection of the settlement and a decision that the counsel was ineffective. After new counsel, discovery, and considerable time, a later settlement was approved. *See supra* notes 82–114 describing procedural history of *Reynolds* case.

215. The same sort of review with an affirmance in appropriate cases will provide an incentive to district judges as well—this one of the carrot sort. This sort of review, however, is likely to be rare because disapprovals leave the case pending, and, therefore, not final. *See EEOC v. Pan Am. World Airways, Inc.*, 796 F.2d 314, 318 n.7 (9th Cir. 1986) (concluding that settlement disapproval decisions are not final decisions under section 1291 and are, therefore, not appealable).

216. As of February 25, 2011, the *Reynolds* case had been cited 774 times. The case is also included as a primary case on the topic of assessing the fairness of class action settlements in the leading casebook on class action law. *See* ROBERT H. KLONOFF ET AL., *CLASS ACTIONS AND OTHER MULTI-PARTY LITIGATION* 707 (2d ed. 2006).

217. *SEC v. Bank of Am.*, 653 F. Supp. 2d 507 (S.D.N.Y. 2009) (order denying proposed consent judgment).

218. *Id.* at 509.

219. From September 14, 2009, the date on which Judge Rakoff issued his opinion, to September 16, 2009, a Westlaw media search returned 112 media reports on the decision. As of February 25, 2011, a similar search produced 758 references to Judge Rakoff and the Bank of America judgment. *See, e.g.*, Stephen Bernard, *Judge Rejects Bonuses Deal; Bank of America, SEC to Go to Trial*, *BOSTON GLOBE*, Sept. 15, 2009, at B6; Stephen Foley, *Bank of America Faces Trial Over Bonuses 'Lies'*, *INDEP.* (London), Sept. 15, 2009, at 34; Zachery Kouwe, *Judge Rejects A Settlement Over Bonuses*, *N.Y. TIMES*, Sept. 15, 2009, at A1. *But see* Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 *EMORY L.J.* 83, 95–97 (2002) (arguing that few judges on the lower courts have earned reputations for pushing agendas of any sort).

220. *SEC v. Bank of Am.*, Nos. 09 Civ. 6829, 10 Civ. 0215, 2010 WL 624581 (S.D.N.Y. Feb. 22, 2010).

## V. CONCLUSION

This Article develops a construct of judges as gatekeepers in corporate and securities litigation, focusing on the settlement of these cases. The judges are the enablers of settlement, but are not allowed to grant approval unless they have done their jobs. Importantly, this Article points out that “doing their jobs” requires greater scrutiny of the role of defense counsel and insurers, both of whom amplify agency costs and contribute to collusive settlements. Yet, traditionally both academics and the courts have failed to analyze those issues in the context of the costs of aggregate and derivative litigation.

The principles developed and explored in Part IV reveal that judges both have the power and incentives to control the agency costs by refusing to grant settlement approval in cases that do not meet the standards of Rule 23. Moreover, the decision to grant, or refuse, approval is contingent on fulfilling their gatekeeping/fiduciary responsibilities. Adherence to the principles developed in this Article will help to ensure that judges are in fact functioning as the fiduciaries the law requires them to be.

Active engagement and careful review are the basic hallmarks of judicial settlement gatekeeping. Without judicial approval, litigants cannot exit. There is no remedy. There are no fees. There is no preclusion. The power to grant all of these things is significant. The power to refuse it is as well. Fulfilling this role will create not only a “better” settlement process, but also will result in better substance and outcomes.<sup>221</sup>

Of course, judicial gatekeeping is not a complete solution to the agency problems in aggregate litigation. No single solution is. It is important to recall, however, that aggregate litigation itself provides a solution to gaps in the administrative state and the resulting agency issues. Gatekeeping judges can help to decrease collusion on all sides of the cases. The judicial gatekeeping construct in this Article provides a partial solution to the agency cost issues. It establishes the role and duties of the courts and

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221. Judges have shown that they are well-suited to this task. For example, many of the reforms contained in the Private Securities Litigation Reform Act (PSLRA) were initially adopted (even if at the behest of defense attorneys) by entrepreneurial judges faced with crowded dockets and at least some specious cases. Thus, judges in the First and Second Circuits had pushed the pleading standard for scienter-based cases to increasingly high levels as a mechanism for combating the agency problems inherent in class actions. District courts within the First Circuit had also granted temporary discovery stays, pending the outcome of motions to dismiss that functioned like the statutory discovery stay enacted with the PSLRA. Creative judges can make similar innovations in establishing standards for settlement approval.

reveals how they can protect the authority of the system, the nature of the settlements, and the deterrence effects of the cases. In short, gatekeeping judges have an important role to play and this Article constructs and explicates that role. Now it is up to the judges.