Recent Trends in Securities Class Action Litigation: Will Enron and Sarbanes-Oxley Change the Tides?

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Securities class action lawsuits have served as a vent for public anger at recent stock market losses. Lawsuits have hit not only those companies whose accounting disclosures and subsequent government investigations made headlines, such as Enron, WorldCom, Tyco or Adelphia, but also many companies that announced bad news and experienced a sharp stock price correction in response. While Federal Reserve Chairman Greenspan blamed corporate misdeeds on “infectious greed,” the press and plaintiffs’ attorneys took aim at the Private Securities Litigation Reform Act (“PSLRA”), passed in 1995. They argued that PSLRA, which raised the burden on plaintiffs in securities class actions in an attempt to cut down on frivolous litigation, reduced corporate accountability at the expense of legitimate claimants.

In an effort to deter future fraud and increase the accountability of corporate executives and boards, Congress passed the Sarbanes-Oxley Act (“SOX”) in July 2002. Many of the original supporters of PSLRA argue that SOX is the wrong antidote and may facilitate unwarranted litigation. SOX passed too recently to determine its effectiveness in deterring fraud or to measure conclusively its impact on the volume and merit of securities litigation. This paper tests for changes in securities class action trends since SOX, in search of early effects. We find no statistically significant changes in filing or settlement trends since SOX, but do find a decline in the frequency of dismissals. However, these conclusions are subject to the essential caveat that the absence of early changes may or may not be consistent with the Act’s longer-term impact. NERA will continue to monitor these trends going forward to determine the impact of SOX.

In the near term, as a means to assess the impact of legislative changes on the volume and nature of securities class action lawsuits, we also examine the effects of PSLRA and subsequent events such as Enron, using data on securities class action lawsuits. This paper also reviews and identifies ongoing trends in securities class actions, providing a baseline from which we can assess the impact of both reforms and scandals. The findings in this publication are based on our investigation of securities class action filings and settlements from January 1991 to late June 2003, using NERA’s pro-

1 This edition of NERA’s research on recent trends in securities class action litigation expands on previous work by our colleagues Lucy Allen, Frederick C. Dunbar, Vinita M. Juneja, Denise Neumann Martin and David I. Tabak. We gratefully acknowledge their contribution to previous editions as well as this current version. In addition, the authors thank Patrick E. Conroy, Louis A. Guth, Marcia Kramer Mayer and Stephanie Plancich for valuable input and insightful comments, and Christopher Enright and D.J. Percella for supervising the research effort. These individuals receive only credit for improving this paper; all errors and omissions are ours.
proprietary database\(^2\). NERA updates this research periodically in an effort to provide a consolidated source of information for plaintiff and defense counsel, risk managers, policymakers, and other interested parties.

**Did Enron or SOX Increase Filings?**

Filings in 2001 and 2002 exceeded the previous peak level reached in 1998. Federal courts received 280 filings in 2002, down nearly 45% from the all-time high of 503 filings in 2001. However, the 2001 statistic is deceptive because it includes 303 laddering claims, alleging unfair IPO allocation practices and manipulation of the early aftermarket against newly-public companies and their underwriters. Excluding the laddering cases, 2001 filings totaled 200. Absent the laddering claims, filings likely would have been somewhat higher than 200, as a number of companies that faced laddering suits probably would have otherwise faced standard class action suits, in that they are newly-public companies whose stock fell sharply in value. Similarly, in 2002, the revelation of analyst conflicts of interest added 40 filings against investment banks that recommended certain stocks.\(^3\) Federal courts received 123 filings during January-late June 2003, consistent with an annual rate of 246 filings.

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\(^2\) Statistics in this paper citing the first half of 2003 or January through late June 2003 refer to filings and settlements reported through June 26, 2003. Because filings and settlements may be reported with a lag of several days, our data is comprehensive through June 20, 2003 and includes additional filings and settlements through June 26, 2003, but may not be comprehensive for the June 21-June 26 period. This paper went to final production on June 27, 2003.

\(^3\) Federal courts received five filings alleging analyst conflict of interest in 2001, prior to the May 2002 disclosure of conflicts of interest at Merrill, and 13 analyst case filings in 2003.
Consistent with long-term trends, filings continue to concentrate in the Second and Ninth Circuits.

The heightening of public anger at corporations following the revelation of the Enron scandal has had little if any impact on filings. From November 2001 through late June 2003, filings occurred at an annual rate of 244. However, if we exclude the 53 filings against investment banks associated with analyst conflict-of-interest allegations, post-Enron filings occurred at an annual rate of 212, within the range of recent years’ annual filings.

While it is still early to evaluate the impact of SOX, from its passage on July 25, 2002 through late June 2003, filings came in at an annual rate of 252, or 214 excluding analyst cases, as compared to the average of 208 for 1996-2001 (excluding 2001 laddering filings). The expected impact of SOX would be an increase in filings, because it extends the statute of limitations to two years after the discovery of a violation and five years after its occurrence, from previous standards of one year and three years, respectively. However, the plaintiffs’ bar is arguably efficient enough to file claims within the old limits; the SOX extension may only impact how quickly they are filed, if that.

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\(^4\) Enron disclosed its false accounting on October 16, 2001. This paper treats dates through October 2001 as pre-Enron and dates in November 2001 and after as post-Enron.

\(^5\) SOX passed on July 25, 2002. This paper treats dates through July 2002 as pre-SOX and dates in August 2002 and after as post-SOX.
While our preliminary finding that SOX did not impact filings may change as more data become available, it is consistent with the negligible impact of PSLRA on filings. Although PSLRA raised the standards that plaintiffs’ filings had to meet, its impact on the rate of filings was only short-lived. For the five years prior to PSLRA, 1991-1995, filings averaged 190 each year. Filings dropped sharply in 1996 to 127—possibly because plaintiffs’ lawyers switched to state courts in an effort to avoid the restrictions of PSLRA—then bounced back to 193 in 1997 and continued to rise.

Excluding the laddering and analyst cases, we find a statistically significant positive trend in federal filings since 1991 but, controlling for that trend, no statistically significant impact of either PSLRA or SOX on filings. Indeed, taking a snapshot of cases filed in 1995 and those filed in 2002 reveals that the likelihood of a public company being sued rose approximately 40% from 1995 to 2002, controlling for the number of public companies in each year. Considering the probability of a dismissal, the odds of a suit that continues beyond the motion to dismiss phase are up 41%. This increase is statistically significant, as is the increase in the probability of a lawsuit.

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| The Probability of Facing a Securities Class Action Is Up 40%, Controlling for the Number of Publicly-Traded Firms |
|---|---|---|
| No. of Publicly-Traded Companies | 1995 | 2002 | Change |
| | 11,688 | 12,192 | 4.3% |

| Annual Filings | | | 46.6% |
| Probability of Filing | | | |
| 1.6% | 2.3% | 40.5% |

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6 Considering filings in federal and state courts combined, we find that filings increased by a statistically significant amount after PSLRA and have decreased by a statistically significant amount since SOX, excluding laddering and analyst cases.
Dispositions: PSLRA Has Slowed Settlements

A marked effect of PSLRA has been a slowing of time to disposition due to later settlements. This effect is striking in that looking at data on filings, dispositions and settlements for 1991 to the present, only for time to settlement do we find a statistically significant effect of PSLRA. Prior to PSLRA, 61% of cases were disposed in three years and 77% in five years; since, only 44% have been disposed in three years and 62% in five years. The difference stems entirely from slower settlements, presumably due to the stay of discovery while the court considers a motion to dismiss: pre-PSLRA, 48% of cases settled within three years and 63% within five; since, only 31% have settled within three years and 48% within five.7

Dismissal rates are statistically unchanged since PSLRA, despite the new, more specific standard of pleading that it set, with 12-13% of cases dismissed within three years both before and after, and few dismissals in subsequent years. Not enough time has elapsed to calculate a reliable dismissal rate on post-Enron or post-SOX filings. However, we can draw conclusions based on the change in the frequency of dismissals since Enron and SOX, without controlling for filing date. Since SOX, the frequency of dismissals has fallen by a statistically significant measure. We also observe...

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7 Settlement statistics also include the few judgments that occur. Judgments account for approximately 1% of the combined settlement and judgment data.
a statistically significant drop in dismissals since Enron, but this result is largely driven by the post-SOX change; we observe little change in the frequency of dismissals between the Enron disclosure in late October 2001 and the passage of SOX in late July 2002.

Fully 80% of federal securities class action lawsuits end in settlement. Approximately 19% of cases are dismissed, and about 1% end in judgments.\(^8\)

Dismissal rates vary substantially by circuit. Comparing the Second and Ninth Circuits, which together typically receive half of all filings, the Second Circuit dismissed 11% of 1996-2000 filings within two years, whereas the Ninth Circuit dismissed only 7%. For some other circuits, the dismissal rates shown in the chart below are based on relatively few filings, and so should not be used to forecast future dismissal rates. However, the Eleventh Circuit’s dismissal rate is notable as the highest dismissal rate based on a sample of reasonable size (79 cases).

\(^8\) The three summary judgments in federal securities class action suits during the January 1991-June 2003 period are not classified as dismissals or judgments and are excluded from the table above.
Top Settlements are on the Rise,
Yet Plaintiff Recoveries Relative to Losses are Declining

Some extraordinarily large settlements have caused a rapid increase in average settlement values in recent years, yet plaintiffs have been typically recovering less, controlling for the characteristics of any given case. Average settlements more than tripled from $8.6 million in 1996 to $27.0 million in the first half of 2003, in nominal dollars. Yet, the median settlement has increased more modestly, from $3.9 million to $5.5 million, a 41% increase. Controlling for inflation, median settlements have increased a more modest 25% from 1996 to the first half of 2003.9 To give a sense of the distribution of settlement values, consider that 70% of settlements in the first half of 2003 fell below $10 million, while only 5% (4 cases) exceeded $100 million.10

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9 In inflation-adjusted terms, average settlements rose 83% from 1991-95 to 1996-late June 2003, compared to a 116% nominal increase.

10 Nuisance suits, which PSLRA was designed to eliminate, are still common. NERA identifies nuisance suits as those settling for less than $2 million, in constant 1995 dollars. Such settlements are down from an average of 28% of settlements of cases filed in 1991-95 to 24% of cases filed in 1996-2002, a statistically insignificant difference.
Explaining Settlements

NERA has estimated a statistical model that explains over 60% of the variation in settlements, using data on cases settling from January 1996 to late June 2003. This section discusses the sensitivity of settlement values to various lawsuit characteristics, based on that model; all the sensitivity measures described are calculated controlling for other characteristics of the suit, including year of settlement, and for inflation.

The rise in median settlement figures is somewhat deceptive, in that the increase in settlement values can be explained by changes in a number of factors. Indeed, controlling for a number of characteristics of the lawsuits, settlements reveal a statistically significant downward trend over 1996 to mid-2003, in both nominal and inflation-adjusted terms; in constant dollars, settlements have been declining by approximately 8% per year. Consider two cases involving $600 million in investor losses, one settling in 1998 and the other in 2002. Holding constant all other case characteristics, our model would predict a $14.1 million settlement in 1998, but a more modest $12.0 million settlement in 2002.

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11 The model does not control for the strength of plaintiffs’ allegations, relative ability of plaintiff and defense counsel, the likelihood of pro-plaintiff or pro-defense rulings in the district or the amount or structure of defendants’ insurance coverage.
Investor losses, an estimate of what investors lost over a class period relative to an investment in the S&P, are the single most powerful determinant of settlements, explaining approximately 50% of the variation in settlements. On average, a 1.0% increase in investor losses results in a 0.4% increase in settlements, such that settlements increase far less than one-for-one with investor losses.

With the crash of the bull market of the 1990s, investor losses ballooned from $140 million in the average suit settling in 1996 to $1.0 billion in the average suit settling in 2002, then fell back to $623 million in the first half of 2003. As a result, the median percentage of investor losses paid in settlement fell from a high of 7.2% in 1996 to 2.7% in 2002, then rose modestly to 2.9% in the first half of 2003.

The inclusion of securities other than common stock in a class action suit results in dramatically higher settlements. Effectively, the claims of the holders of these other securities represent losses above and beyond—and not captured by our measure of—the investor losses on common stock. The inclusion of preferred stock or bonds in a suit nearly doubles settlement value. The inclusion of options adds more than 40%.

Settlements also increase with measures of the depth of defendants’ pockets. For each 1.0% increase in the company’s market capitalization the day after the end of the class period, the settlement will increase 0.1%. In cases with an accounting firm
Cases with accounting allegations result in higher settlements for several additional reasons. The presence of any one of three accounting factors—accounting issues, accounting irregularities or restatements—will raise average settlement values by approximately 20%. More often, two or more of these accounting variables will apply to the same case, such that parsing out their individual effects is difficult. It is clear that they are highly statistically significant as a group and that the naming of an accounting co-defendant, which occurs only in a subset of accounting cases, has the most powerful impact on settlement value.

One of the major objectives of PSLRA, involving institutional investors as lead plaintiffs, has had a marked impact on settlements. Congress intended that institutional investor plaintiffs would be more actively involved in the litigation and therefore generate better outcomes for plaintiffs, as opposed to individual investor plaintiffs who may supervise their counsel less actively. Consistent with Congressional objectives,
we find that settlements are about 20% higher in cases where the lead plaintiff is an institutional investor. This may reflect the retention of more effective plaintiffs’ counsel in those cases, the institutional investor’s more effective supervision of counsel and own contribution to strategy or both. Alternatively, it may reflect a tendency for institutional investors to become involved primarily in more serious cases, in terms of either the merit of allegations or the size of potential damages.

Our model also indicates that settlements increase by approximately one-third if Section 11 claims are involved.

While defendants’ resources and the characteristics of a case affect settlements, the defendant company’s industry does not. We find no statistically significant industry effect, controlling for case characteristics.

Although certain court circuits are sometimes characterized as more or less plaintiff friendly, the circuit in which the case is filed has no effect on settlement value, controlling for case characteristics. The similarity of settlements differs markedly from the wide range of dismissal rates across circuits. Moreover, it signals that settlements in the Sixth and Tenth Circuits, formerly higher by a statistically significant margin, have equalized with other circuits during the January 1996-late June 2003 period.

One would expect that the recent public anger at corporate fraud might have strengthened the relative bargaining power of plaintiffs and increased settlements. Yet, if we test for Enron and SOX effects in our settlement prediction model, controlling for other characteristics of the lawsuits, we find no statistically significant change in settlements following either Enron or SOX. Average settlements were statistically unchanged after Enron, at $25 million in constant 2002 dollars. While settlements fell modestly in the first ten months after SOX passed (August 2002 to June 2003), the drop from $25.5 million to $22.7 million, again in constant 2002 dollars, is not statistically significant. Future NERA studies will monitor whether a SOX effect develops as more time elapses.

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12 Sixth and Tenth Circuit settlements were statistically higher in the January 1991 to May 2002 time period.
13 As compared to settlements on post-PSLRA filings settled before Enron or SOX, using constant 2002 dollars.
14 All post-SOX settlements are of cases filed before the Act’s passage.
Is There a Rising Tide of Securities Fraud, and Can SOX Reverse It?

The more than 40% increase from 1995 to 2002 in the likelihood that a public company will face a securities class action lawsuit is as dramatic as the recent headline fraud scandals. These trends seem at odds with the suggestions from the plaintiffs’ bar that PSLRA deterred the litigation of legitimate fraud claims and created an environment more permissive of fraud.

Indeed, the 41% higher likelihood that any publicly-traded company will face a suit going beyond a motion to dismiss suggests that the plaintiffs’ bar is pursuing fraud more aggressively since PSLRA, rather than being limited by it. The only alternative explanation—a 41% increase in fraud—would represent a dramatic decline in corporate ethics over the last decade. The truth may be in the middle: a combination of more fraud during the late 1990s and more aggressive litigation of such fraud by the plaintiffs’ bar, as well as more active enforcement by regulators. The requirement of specific pleading may have led plaintiffs’ attorneys to use the requirement of notice of a complaint as a research tool. By using the Internet and other means to publicize fraud allegations, plaintiffs’ attorneys have been able to get better access to company insiders who can provide a lens on the operations and financials of the defendant firm.

Rather than rolling back PSLRA reforms, SOX takes a different approach to deterrence. It relies on three levers to deter securities fraud:

:: Enhancing accountability of company executives and directors by increasing their explicit oversight responsibilities and creating new criminal penalties in the event of fraud;

:: Increasing oversight via enhanced disclosure requirements, stricter auditor independence standards, and creation of the Public Company Accounting Oversight Board; and

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If the effect of PSLRA had been to make it more difficult to sue in cases where there had indeed been corporate malfeasance, then we would have expected to see a decrease in the number of cases that were filed and survived a motion to dismiss. Instead we saw the reverse. The situation is analogous to a tax on a good—when taxes on cigarettes go up people buy fewer of them. If PSLRA were acting like a tax on litigation we would see less litigation, not more.
Extending the statute of limitations for securities fraud claims to two years after discovery of a violation or five years after the violation occurred, whichever comes first.

As such, SOX facilitates criminal litigation against company directors and officers, enhances the accountability of accountants, and allows more time for fraud to be detected or litigation initiated. Effectively, it takes aim at executives’ incentives to commit fraud, and increases the incentives of executives, independent directors and accountants to ensure that no violation goes undetected.

SOX’s very different approach makes it difficult to extrapolate its likely impact based on the impact of PSLRA. Important PSLRA provisions—such as the requirement that plaintiffs plead allegations and scienter with specificity and the stay of discovery during a motion to dismiss—are unaffected by SOX. However, one area where SOX may counter provisions of PSLRA relates to the liability of accountants. PSLRA allowed proportionate liability rather than joint and several liability. This feature was sought by accounting firms because when defendant firms go bankrupt, the accounting firms are often the only defendant left with assets. That said, it is not clear why proportionate liability should have been an insufficient deterrent. While SOX does not reverse the proportionate liability standard, it clearly enhances accounting firms’ incentives to detect fraud. The swift demise of Arthur Andersen in the wake of the Enron scandal, however, is doubtless a more powerful incentive.

The bursting of the stock market bubble of the 1990s, and the aftermath of recent scandals, may be the single most powerful influence on securities litigation going forward. In a rapidly rising stock market and a rapidly growing company, false accounting has a chance of going undetected; but in the face of more modest growth, accounting gimmicks may be difficult to sustain. It is often said that current policy is invariably designed to prevent the last crisis. Should the near future bring less dramatic growth, this alone may limit fraud and filings; the impact of SOX may be secondary.