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Fewer Securities Class Actions Filed in 2006

Permanent Decline, Part of a Cycle, or Random Variation?

By David Stickney

Investors filed fewer securities class actions in 2006 than in past years. Indeed, according to industry consultants, fewer new cases were filed last year than were filed during any year since the year Congress enacted the Private Securities Litigation Reform Act. The recent decline has been a hot topic as analysts and commentators offer myriad possible explanations for the dip and also speculate whether it is permanent, part of a cycle or a random variation.

The exact reason for the decline in new cases is far from conclusive. Several reasons or combination of reasons might explain the drop-off, such as more cautious corporate behavior in the wake of high-profile recoveries from individuals like in *Worldcom*, the reforms of the Sarbanes-Oxley Act, increased government enforcement of securities fraud or a strong stock market with lower price volatility.

Whatever the reason (or combination of reasons) for the decline in the number of new securities class actions in 2006, investors should not be lulled into a false sense of security. Fewer new cases does not mean that there is less corporate greed and fraud or that the decline is permanent. Such practices often remain hidden in the market for a period of time. Moreover, most of the reasons put forward to explain the decrease in filings during 2006 are not permanent factors, suggesting that the decline is either part of a cycle or a random occurrence.

In this respect, the relative calm in securities litigation is reminiscent of 1996, when the number of reported new cases fell from 213 filed during 1995 to 130 in 1996, before increasing again to 240 new cases in 1998. Now, as Yogi Berra said, “It’s déjà vu all over again” in 2006.

Behind The Numbers

Each year, the National Economic Research Associates (“NERA”) and Cornerstone Research (together with the Stanford Law School Securities Class Action Clearinghouse) issue reports with their findings related to securities litigation during the year. The reports include various statistics and the authors’ observations concerning, for example, the number of complaints filed, the location of such lawsuits, the industries involved and the relative size of lawsuits as measured by the loss of market capitalization.

In January 2007, both NERA and Cornerstone reported that the number of new class actions filed in 2006 fell to the lowest total since 1996. While the specific number of filings differs in the two reports — NERA identified 129 cases; Cornerstone, 110 — the emphasis of the two reports is the same. They both report that 2006 saw the lowest annual total since 1995. As you can see from the graph reproduced at right, Cornerstone reported that new class actions fell by 38 percent since 2005, from 178 filings to just 110 filings. Likewise, NERA reported that filings declined by 36 percent from 2005, from 211 to 129 new cases.

Cornerstone, to underscore its point that “[c]lass action lawsuits plunged to a record low in 2006,” isolated class actions related specifically to the practice of options backdating. Cornerstone identified 22 securities class action lawsuits containing backdating allegations, of which 20 were filed in 2006. Excluding such backdating cases because, according to Cornerstone, such cases are “unlikely to be repeated,” Cornerstone arrives at a “core litigation rate” of 90 companies sued in 2006.

Continued on next page.

Both Cornerstone and NERA are correct that the decline in new securities class actions coincided with the public exposure of the widespread options-backdating scandal. *See* Noam Mandel, "Mirror, Mirror On the Wall, Give Me the Lowest Price of All (Corporate Greed Redux)," *Institutional Investor Advocate* (Second Quarter, 2006). Notably, however, the number of reported class actions relating to such practices understates the amount of litigation. Investors seeking redress for options backdating practices frequently file derivative actions on behalf of the corporation and its shareholders, rather than file a class action. Because reporting services do not report derivative actions at the state level in the same way as securities class actions in federal court, the extent of such litigation focused on options-backdating practices is not fully reflected in NERA's and Cornerstone's reports on securities litigation in 2006. According to media reports, over 150 companies are under investigation, and there are believed to be more than 350 derivative lawsuits arising from the backdating scandal.

In short, both NERA and Cornerstone focus primarily on the cold statistics. They reach no particular conclusions concerning the level of hidden fraud or misconduct in the market. This limitation is significant because fraud often remains concealed for years before detection. For instance, while the number of new securities class actions declined between 1995 and 1996, ongoing fraud unquestionably existed in the market but remained concealed until the widespread corporate scandals at the start of the millennium. At HealthSouth Corporation, for example, executives cooked the books for over ten years until the fraud was revealed in 2003. Since then, five former chief financial officers have pleaded guilty to crimes related to financial fraud.

Cornerstone, NERA and others commenting on the 2006 studies suggest a number of explanations for the decrease in filings during 2006. The possible reasons offered for the decrease include stronger federal enforcement by the Securities Exchange Commission ("SEC") and the Department of Justice, improved corporate governance due to the reforms of Sarbanes-Oxley, and less price volatility in the market with fewer sharp price declines.

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Has Federal Enforcement Eliminated Corporate Greed and Fraud?

Certain commentators say outright (and others certainly imply) that there is a link between the 36 percent decline in new securities class actions in 2006 and a sustainable decline in the actual level of fraud in the market. Remarkably, in a *Wall Street Journal* piece, a professor of law and business at Stanford Law School, Joseph Grundfest, wrote that "[p]erhaps fewer companies are being sued for fraud because there is less fraud." There is less fraud, Professor Grundfest says, "because there is a new, tougher and superior enforcement mechanism in place." Under this theory, "the government's aggressive criminal and civil enforcement strategy following the Enron and WorldCom frauds has caused corporate boards and management to 'get religion' when it comes to complying with the securities laws."

There are obvious problems with the simplistic notion that corporate America "got religion" due to stepped-up federal enforcement of the securities laws. Leaving human nature aside, the reality is that business groups continue to vigorously resist SEC enforcement programs and lobby against the reforms put in place in 2002 after the wave of corporate scandals. While the previous wave of corporate fraud may have inspired a period of increased federal enforcement, we have experienced a backlash and a major lobbying effort to roll back investor protections. In fact, SEC enforcement actions have declined for three years in a row. According to media reports, the SEC attributed the decline to shrinking staff levels due to a hiring freeze and turnover of senior positions. The SEC reportedly brought just 574 enforcement actions in fiscal 2006, 10% fewer than the prior year, marking a three-year decline from a record high in fiscal 2003. Of these cases, the SEC brought the greatest number against delinquent filers. Notably, for fiscal 2007, the SEC actually cut its requested budget for the staffing of the SEC enforcement division. This, of course, leaves enforcing the securities laws up to investors and their legal representatives, as it has been for decades.

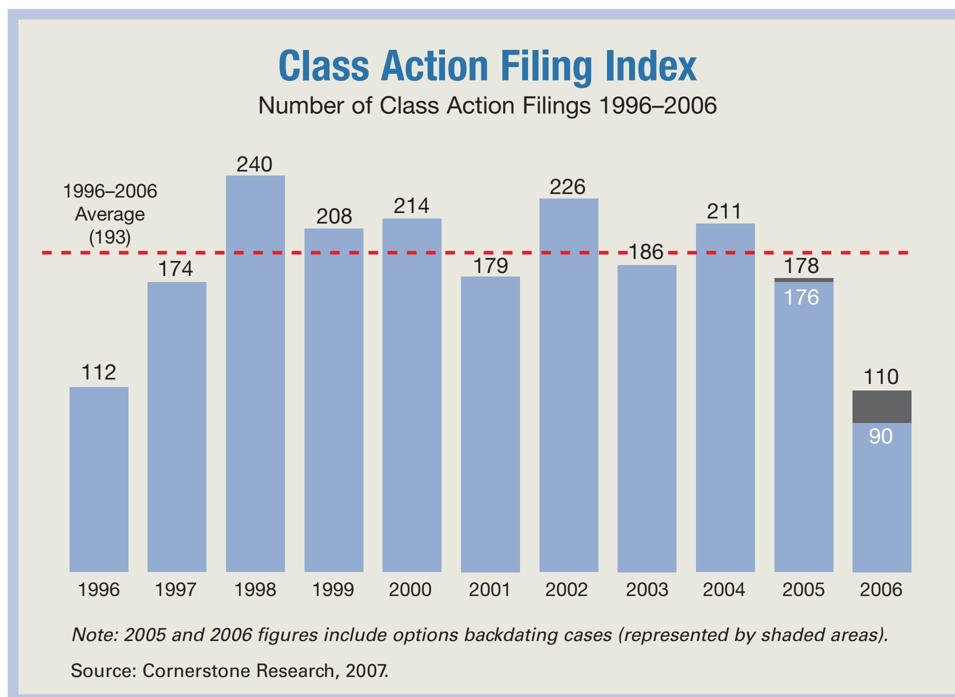
Moreover, the SEC has recently taken steps on two fronts to limit the ability of investors to seek redress for corporate wrongdoing. On February 9, 2007, the SEC filed a brief with the United States Supreme Court in *Tellabs Inc. v. Makor Issues and Rights Ltd*, siding against investors and urging the adoption of a legal standard that will make it even harder for investors to have their day in court. (*See "SEC Flip-Flops at the Supreme Court," in this issue.*) At the same time, SEC Chairman Christopher Cox and the agency's chief accountant stated that they were also considering ways to limit the ability of investors to pursue redress against accounting firms. The need for such added protection is difficult to understand: According to the Securities Class Action Clearinghouse, only one suit was filed against an auditor defendant in 2006, and only five such lawsuits were filed in 2005.

At about the same time the SEC was filing its brief urging the Supreme Court to raise

the pleading standards for defrauded investors, the results were released of a comprehensive independent study into the effectiveness of the SEC and auditors in the detection of corporate fraud. (Luigi Zingales, I.J. Alexander Dick and Adair Morse, *Who Blows the Whistle on Corporate Fraud*.) The authors gathered data on a broad sample of corporate frauds in the United States between 1996 and 2004 at companies with over $750 million in assets. Based on their analysis, the SEC is not particularly effective at revealing corporate fraud. The SEC detected only 6% of the frauds in the study. Interpreting the results, the authors concluded that appointing an official investigator like the SEC is "extremely costly" and "so ineffective" because looking for fraud is like "looking for a needle in the proverbial haystack."

Nonetheless, Professor Grundfest suggests that investors should rely on the SEC because the agency has authority to collect funds that can be distributed to shareholders. Real-world experience, however, shows that SEC action is just not as effective as private litigation at compensating victims of fraud. In *Worldcom*, for example, the SEC recovered $750 million for investors. By contrast, the New York State Common Retirement Fund, as the lead plaintiff in the securities class action, recovered $6.156 billion.

Against this backdrop, stepped up enforcement by federal regulators seems an unlikely explanation for the decline in new class actions during 2006, and in any event, certainly not a permanent one.



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The Sarbanes-Oxley Effect

Congress enacted the Sarbanes-Oxley Act of 2002 in the wake of high-profile corporate scandals at Enron, Worldcom and other companies. The reforms enhanced corporate governance, produced more reliable corporate financial statements and has had a positive effect on investor protections. While Sarbanes-Oxley probably cannot fully explain the reduced level of new filings in 2006, it has undoubtedly impacted the litigation environment.

Sarbanes-Oxley increased the awareness and sensitivity of officers and directors to corporate governance, disclosure requirements and financial reporting. Among other changes, Sarbanes-Oxley requires the chief executive officer and the chief financial officer to certify the annual and period reports filed with the SEC. Further, commencing after November 15, 2004, annual reports on Form 10-K must include management's assessment of the effectiveness of its internal control over financial reporting. Such changes have forced officers, directors and auditors to take their responsibilities seriously.

Ironically, prior to its enactment, business groups opposing Sarbanes-Oxley predicted that the reforms actually would spur an increase in securities litigation. *See* Richard B. Schmitt, Michael Schroeder and Shailagh Murray, "Corporate-Oversight Bill Passes, Smoothing Way for New Lawsuits," *The Wall Street Journal,* July 26, 2002. It now appears that the opposite is true.

To the extent that Sarbanes-Oxley may be a contributing factor to the decline in new class actions in 2006, however, the Sarbanes-Oxley effect may not be a permanent factor. Unfortunately for investors, Congress and regulators are considering rolling back the reforms of

Sarbanes-Oxley. Business groups have complained loudly that the requirements of Sarbanes-Oxley add millions of dollars in compliance costs and make life difficult for corporate directors. Along these lines, the Committee on Capital Markets Regulation (a.k.a. the Paulson Committee), advocates that the SEC consider rolling back the provision of Sarbanes-Oxley requiring certification of internal controls for some companies, curtail liability of auditors and outside directors involved in corporate fraud, and permit companies to adopt bylaws preventing shareholders from pursuing class litigation.

Responding to the Paulson Committee, the Council of Institutional Investors, representing 140 pension funds with more than $3 trillion in assets, issued a statement strongly disagreeing with the Paulson Committee's recommendations. "We believe many of the panel's recommendations, if adopted, would undermine the effectiveness of market watchdogs and weaken critical investor protections."

The Market Cycle

Cornerstone and other commentators have observed a statistical correlation between the number of new class actions and the overall volatility of the markets. Put simply, increased stock price volatility typically results in more securities class actions.

Intuitively, this makes sense because disclosure of hidden information often results in large and sudden stock price declines. Such corrective disclosures and ensuing stock-price declines are often evidence of fraud. During 1999 through 2002, for example, the volatility in the market for U.S. stocks was relatively high due to the bursting of the internet bubble and the wave of corporate scandals. During that period, the number of new cases ranged from 208 new cases in 1999 to 226 in 2002, according to NERA. Since mid-2003, however, the stock-price volatility for U.S. stocks has been relatively low. Thus, while NERA reported the filing of 211 new cases in 2004, the number fell to 178 in 2005 and then to 110 in 2006.

Ironically, prior to its enactment, business groups opposing Sarbanes-Oxley predicted that the reforms actually would spur an increase in securities litigation. It now appears that the opposite is true.

During 2006, our financial markets delivered a strong performance, and the Dow Jones Industrial Average approached an all-time high. Relatively low market volatility during the year likely was a contributing factor to the reduced level of filings. The overall market was strong and stable (although investors in particular companies experienced substantial losses due to dramatic price movements when previously-hidden information was revealed, such as what occurred at UnitedHealth Group, Inc.; Safenet, Inc.; and Scottish Re Group Ltd.). While the strength and stability of the market during 2006 likely was a contributing factor to the total number of new cases, historical experience shows that volatility in the market undoubtedly will increase.

Conclusion

Historically, the markets have experienced waves of scandal followed by a period of relative tranquility. While commentators have given a number of reasons to explain the decrease in new cases in 2006, our system is fundamentally unchanged. It continues to provide the same motives for corporate fraud and the same opportunities to carry out such fraud. It is a mistake, therefore, to assume that the relative calm in 2006 means less hidden fraud in the market or that the landscape has permanently changed. History, after all, has a strange habit of repeating itself.

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