Vincent C. Ross Institute of Accounting Research
New York University Stern School of Business

Ross Roundtable in Cooperation with NERA Economic Consulting

on

Securities Litigation in the Aftermath of the Crisis:

What Happened in 2010 and What Lies Ahead?

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The NYU Ross Institute of Accounting Research in conjunction with NERA Economic Consulting convened their third annual, and much anticipated, Roundtable on "Securities Litigation in the Aftermath of the Crisis". The speakers included high-profile plaintiff and defense attorneys who provided a "focus" on securities litigation seen through disparate lenses. Regulatory issues were discussed by a high-ranking member of the SEC, and the discussion was complemented by legal counsel representing the banking industry. The statistical foundation and theoretical framework provided by economists and academic scholars provided an unbiased foundation that laid the groundwork for a stimulating and perfectly balanced forum for discussion. Baruch Lev (NYU) and Elaine Buckberg (NERA) moderated the discussion.

Elaine Buckberg noted that although almost four years have past since the problems and bankruptcies related to subprime and structured products started, related cases still take up a prominent share of securities litigation. Litigation is a slow process, and many cases are now in the more advanced stages of the process. We are currently facing a changed legislative landscape that limits private litigation against foreign issuers[1]. However, the SEC is investigating whether the private right of action needs to be reinstated.

Faten Sabry (NERA) presented an overview of trends in credit-crisis litigation, and a breakdown of losses to date by category. Litigation follows what happens in the market, and filings related to the credit crisis mirror the 50% decline (2006-2010) in the S&P financial index. Of the 476 cases filed, approximately half were federal class actions. ERISA cases, private and state actions, and bankruptcies accounted for the balance. Mortgage loans accounted for 38% of the lawsuits in 2007, but only 10% in 2010, whereas collateralized debt obligation cases skyrocketed from 27% (2007) to 53% (2010). To date, settlements have been over $3.2 billion: 60% securities class actions and 26% government regulatory actions.

Primary allegations for losses incurred when underwriting was at issue included fraudulent underwriting, poor lending practices, and fraudulent appraisals. Unlike other credit-crisis related lawsuits, the correlation of underwriting claims with the market index is less clear. Therefore, sensitivity analysis is performed using fluctuations in appraisals, home values, and other relevant variables in estimating the amount of loss related to underwriting irregularities. Dr. Sabry noted that although the number of filings related to the credit crisis has been declining, litigations of many of these cases has just begun.

Jan Larsen (NERA) reviewed Post-SOX trends in SEC settlements. Although the number of settlements have declined since 2006, the dollar amount of the median settlements has risen sharply. The top 10 settlements range from $300 million to $800 million. Micro cap fraud

[1] United States v. Morrison (99-5)

is the most frequent allegation, but misstatement and omission cases receive the most media attention. FCPA[2] cases have been increasing; this may be the result of the SEC special unit created to focus on this area.

As the Chief of the SEC Enforcement's Market Abuse Unit, Daniel Hawke[3] provided "front row" updates on the organization's restructuring efforts. Eliminating tiers of management placed specialized supervisors on the front line of conducting investigations. The establishment of five specialized units[4] resulted in increased focus and productivity. For the first time in the history of the SEC, a state was held liable for violating federal securities law. New Jersey failed to disclose the extent to which their pension obligation was underfunded. Insider trading, historically a friends and family malfeasance, has become the domain of professionals and regulated entities and has thus sparked more intensive investigations by the SEC.

The delegation of authority by the Commissioners to the Director of Enforcement eliminated levels of bureaucracy. In turn, certain senior officers were empowered to issue subpoenas, thus accelerating staff's ability to conduct investigations. Mr. Hawke expects the Dodd-Frank Bill[5] will provide the SEC with high-quality tips leading to more investigations. The lack of inter-agency communication was corrected with the establishment of a centralized referral system. The addition of specialists and the creation of new specialized units provided the intellectual capital to better understand the vagaries of today's markets. The SEC is now part think tank and part investigation and operations oriented.

Mary Billings (NYU) presented the view from academe. Research provides evidence that restatement announcements are the most probable triggers for lawsuits, with decline in share prices and negative forecast earnings following suit. Cross-sectional determinants include the industry, firm size, and volume of shares traded. For IPOs, triggers include under pricing, underwriter quality, and presence of venture capitalists.

At the heart of academic research, is the investigation of the correlation of outcomes with case merits. Some findings provide evidence that the PSLRA[6] strengthened the relationship between merit-related cases and outcome. Others find that the Act has not been a deterrent, but has simply made it more difficult for everyone. "Crisis is a great partitioning variable". Post Enron research finds significant correlation between market downturns and litigation. Fraud is more readily exposed, and courts are inclined to be more sympathetic with investors. Professor Billings'[7] benchmark research on IPO's finds a significant correlation between aggressive, opportunistic reporting and civil penalties. There is also evidence that litigation is triggered when the trading behavior of managers is incompatible with their opportunistic statements. The fallout of the credit crisis in terms of litigation, outcomes, and other variables has yet to be determined by scholarly research, which by its nature, lags behind more timely statistics.

Jonathan Pickhart[8] noted that the decline of credit-crisis class-action suits is due to their being lawyer driven and thus filed more promptly than individual participant litigation. Individuals tend to have a "wait and see" period wherein they weigh the economic consequences of their actions. He predicts we will continue to see mortgage origination suits against

[2] Foreign Corrupt Practices Act
[3] Mr. Hawke is the Director of the SEC Philadelphia Regional Office.
[4] http://www.sec.gov/news/speech/2009/spch080509rk.htm
[5] The Dodd–Frank Wall Street Reform and Consumer Protection Act
[6] Private Securities Litigation Reform Act of 1995
[7] Billings & Lewis (2011)
[8] Quinn Emanuel Urquhart & Sullivan LLP

underwriters as more individuals consolidate. If 25% of investors in a particular instrument form a syndicate, they can gain access to the evidence they need to prove fraudulent activity on the part of the underwriters. With the exception of e.g. Countrywide, claims against the lenders have been a lose/lose situation.

Other forthcoming cases will revolve around the question: "Have banks used CDO's to move residential mortgage exposures off their books unto investors?" The SEC versus Goldman Sachs case is a *poster boy* for these suits. To date, the outcomes in these cases have been mixed. Contracts were written when the world in which they would be interpreted had not been foreseen, and ambiguity has paved the way for opportunistic behavior.

"These are challenging times for companies and their counsels for managing litigation and their expense", James Condren (JPMorgan Chase). We are obligated to make intelligent decisions for our shareholders. Litigation is very expensive; *to resolve or not to resolve, that is the question.* In theory, early dispute resolution is optimal. In reality, early stage settlement is unattainable. Another important aspect of our work in securities dispute resolution is defending the banks and securities entities in FINRA arbitration. A recent study that found a perception among investors of unfairness in FINRA arbitrations that included an industry panelist. In panels of three, the SEC now permits investors to choose a panel that excludes industry members.

What should companies be required to disclose in their public filings about pending litigation?[9] How much is too much? This has been, and continues to be, a very controversial topic. The objective of public disclosure is for the benefit of current and prospective shareholders. Outcome of litigation is difficult to predict, and damages sought incurred are disproportionate to actual losses. Full disclosure related to pending litigation can be detrimental to the firm and hence its shareholders. *Showing your hand* is no way to win.

Although federal shareholder class-action filings in 2010 were not significantly greater than in 2009, Jordan Milev (NERA) noted that the preponderance of cases in the past few years have been filed in the second half of the year. The median investor loss for settled cases was a record high of $604 million in 2010 up from $371 million in 2009. The average settlement in 2010 was a record $109 million. Credit crisis cases continue to be much larger relative to other categories, whereas fewer cases have alleged insider trading to show scienter. Of the 230 credit-crisis related cases (2007-2010) 29% have been dismissed with 63% still pending. Approximately 36% of federal shareholder class actions suits filed in 2000 have been dismissed, with 62% settled[10]. Average settlement in 2010 was higher than other years, but stable when excluding settlements over $1 billion. The median settlement, an indicator of trends, reached an all time-high of $11.1 billion.[11] It is uncommon for these cases to go to trail.

Barry Kaplan[12] commented that in addition to credit-crisis cases, M&A litigation remains significant, followed by cases related to bio tech and missed earnings projections. M&A cases involve multiple plaintiffs and jurisdictions, and are thus very expensive. A new and significant trend has been claims against Board members and pension plan managers for allowing the conditions to exist that led to violations. Some of these cases[13] have resulted in very large settlements, and have had a negative impact on Board member's willingness to serve.

[9] The accounting rules governing disclosure of contingencies are provided in FAS No. 5.
[10] Detailed statistics and analysis are available at www.nera.com
[11] All of the top 10 securities class-action settlements now exceed $1 billion.
[12] Wilson, Sonsini, Goodrich & Rosati, PC
[13] $90 million AIG and $75million Pfizer.

Senate hearings, the FCIC, best-seller books, etc. have changed the dynamics of litigation. Given the mood of the populace and the courts, companies prefer to settle to avoid the possibility of losing their insurance lest the courts find evidence of intention to defraud or recklessness. Mr. Kaplan believes that offering a bounty for whistle blowers not only deprives the organization from resolving problems internally, but is detrimental to the corporate culture.

"The SEC requires public companies to disclose meaningful financial and *other* information to the public." Baruch Lev (NYU) stated his concern that disclosing meaningful financial information appears to have taken a backseat to *"other"* more exotic trading behavior. The fact that the SEC has not hired specialists, nor created a specialty unit, in financial statement fraud provides evidence to support an assumption that investigations in this area are no longer a priority. Have accounting standards become too mundane?

Roman Weil (NYU) echoed the concerns of Baruch Lev, stating that accounting experts have insufficient representation in the agency. After a thorough review of all the crisis-related legislation that has recently been passed, Professor Weil has come to the conclusion that what we now have is more, rather than different, litigation.

Reporter's commentary: The SEC is defending its controversial whistle-blower reward[14]s policy as necessary because "no enforcement issues resulted from SOX." This reporter finds that a poor excuse to bribe employees to by pass existing internal control procedures, and run to "Poppa". The lure of hefty monetary rewards for whistle blowing is detrimental to the corporation, the individuals, and society as a whole. At a minimum, an employee should be required to provide evidence that his/her efforts to rectify the problem internally were being ignored. It is greed that has brought us to where we are…and yet…we keep feeding the animal within.

[14] 10% - 30% of settlements with a threshold of $1 million.