Securities Litigation: Will the Current Crisis Reverse the Recent Downward Trend?

Hosted by

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A panel of experts including economists, lawyers, regulators, the accounting profession and academe convened to examine the implications of the current economic crisis on shareholder litigation and regulatory enforcement. Elaine Buckberg (NERA Consulting) and Baruch Lev (NYU Stern) moderated the session.

In his welcoming remarks, Professor Baruch Lev (NYU Stern) noted that since the passage of the Sarbanes-Oxley Act (SOX), litigation against accounting firms has subsided. The passing of SOX followed a spate of scandals involving the accounting profession. The decline in litigation against the accounting profession provides evidence that SOX was effective. Today, we are facing a new crisis; a financial crisis and economic downturn unprecedented in recent history. Professor Lev invited the participants to join the panelists in discussing their views and expectations of litigation and regulatory developments, providing both insight and recommendations on restoring confidence in our institutions and markets.

Stephanie Plancich (NERA) provided statistics on recent trends in securities class actions. Market volatility and the recession of 2008 led to an increase of 31% in class-action filings since 2007—of which 43% were related to the credit crisis. Half of all filings were against financial institutions. Median settlement values remained relatively stable. Historically, investor losses have been significantly and positively correlated with settlement amounts. However, the fraction of amounts recovered is a declining function of the loss. The high correlation between huge losses and settlement and the settlement ratio may decline, as more and more deep pockets become increasingly shallow.

Jan Larsen (NERA) presented a fourth-quarter (2008) update on the foregoing, noting that although filing were up in 2008, the number of SEC settlements actually decreased to the second-lowest total since SOX. The median settlement value nearly doubled for companies since 2007, but remained stable for individuals in the Post-Sox period. SOX gave the SEC the ability to distribute penalties obtained through enforcement action. After passage of the legislation, there was a 3-year decline in settlements. This trend was reversed in 2007. The extent to which the economic crisis and the ramification of the bailouts will impact the litigation arena is still a work in progress.

Stuart Grant (Grant & Eisenhofer) represents institutional investors. He discussed his expectations regarding developments in litigation and enforcement. The cost/benefit relationship of entering into legal action has taken on new dimensions. Will the target entity still be in existence? As we have seen, this is a real threat. Will the market collapse provide a defense? Given that we do not have the statistics to predict the probability of these outcomes, conventional wisdom dictates a significant decline in class-action lawsuits.

Jamie Levitt (Morrison & Foerster) discussed litigation issues related to the government "bailout" following the collapse of the mortgage industry and financial institutions. The increasing government equity stake in financial institutions and the shrinking traditional shareholder base has changed the litigation arena. Although a negative correlation between litigation and TARP[1] is anticipated, at this time we have to wait for history to unfold.

In response to the question of possible disgorgement, Brian Cartwright (Former General Counsel SEC) replied that corporate law provides no such remedy. However, the SEC Fair Fund may be able to provide investors with some relief by disgorgement of the "ill-gotten" compensation. Whether or not State Attorney Generals will become involved in this issue remains an open question at this time. Mr. Cartwright noted that Class-action suits have become increasingly more difficult. During the past 10 years the courts have, in general, been "anti-plaintiff". The trial courts are currently leaning towards plaintiffs. They are moving away from technicalities to fact-based business issues that have caused real damages. He also predicts changes in the regulatory structure that are not targeted toward litigation.

Mary Billings (NYU Stern) provided a review of scholarly research on litigation risk. Factors that are highly correlated with litigation include firm size, auditor performance, and market and returns volatility. The question of whether the Private Securities Litigation Reform Act (1995) had a significant impact on the correlation between *merit* and litigation *risk* provided mixed results. The findings that litigations are more highly correlated with market conditions than with the legal environment provide a plausible result. Insofar as predictions related to the current crisis, factors that will prove central to the resolution of lawsuits will be: No fraud by hindsight; truth on the market; and loss causation.

The discussion then moved on to "the global economy". International competitiveness is of particular importance when it comes to professional liability. In the major investment and business countries that compete with the U. S., it is only the client that hired the professional, and not third parties, that can file for damages. This difference in both law and culture is a disadvantage to our country. The cost of entering U.S. markets, of which liability is but one component, has been increasing. It was suggested that there is a need to develop an efficient and effective structure for modifying the flow of economic streams to other countries. The fact is that capital will always flow towards the highest return for a given level of risk. The U.S. no longer has a monopoly on "safe" markets. This has reduced the risk premium required for foreign investment. Speed and reduced costs have been stated as primary reasons for obtaining debt in foreign markets.

[1] Troubled Asset Relief Program

Will global regulation replace national regulation? There was a consensus of opinion that although national regulation will continue, global adoption of IFRS will ultimately lead to increased cooperation among nations. To date, litigations against the accounting profession and class-action law suits against corporations has, in general, been limited to the U.S. The current economic crisis, particularly in Europe, has created a sea change. Shareholders are demanding some form of redress, and the panel projected a significant increase in class-action lawsuits against corporate entities across Europe. It is anticipated that the courts will also be more hospitable to these actions.

Concern was expressed that in a global economy, national regulation creates structural problems. Securities move freely across borders and credit is created globally. We have witnessed a 25-year period of steady credit expansion. Domestic debt has grown 3% faster than GDP. In the 1970's, the securities markets started supplanting banks as providers of credit. The exponential growth of "securitization" e.g. mortgages, made the straightforward regulation of credit by the Federal Reserve and FDIC a thing of the past.
There was agreement that in the current global economy, wherein the securities markets are more important and efficient in the generation of credit, either new regulatory institutions will have to be created, or existing ones restructured, to control the system-wide generation of credit. Global risk and credit management remain a daunting challenge.

There has been no shortage of rhetoric on the why's and wherefore's of the current economic crisis. In particular, during this past presidential election year. The complexity of structured financial instruments and the lack of knowledge to both understand and measure the securities have been instrumental in the collapse of the financial markets. With all the talk about the "stimulus package", we have yet to deal with changing the educational requirements for professional licensing. However, as Professor Seymour Jones (NYU Stern), well-known for his straight forward, tell it as it is commentaries, minced no words when he said:

> *It was sheer stupidity coupled with the intemperate greed of both individuals and entities that culminated with the collapse of our economy. It is time for introspection*

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Note: Additional information, as well as an opportunity to share your views and join the discussion, is available at www.securitieslitigation.com