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VANDERBILT LAW REVIEW

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The Evidence on Securities Class Actions

Stephen J. Choi[*]

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I. INTRODUCTION

Shareholders of large publicly held corporations face a well-known collective action problem. To the extent an individual shareholder bears all the costs of activities that benefit the entire group of shareholders (giving the individual shareholder only a fraction of the benefits), the individual shareholder will have marginal incentive to pursue such collective activities. Corporations owe their shareholders specific duties and rights. However, due to the collective action problem, no single shareholder may seek to litigate these rights. In the context of the federal securities laws within the United States, the U.S. regime provides a solution: private class actions. This Article discusses the American experience with securities class actions and future possibilities for class actions in other countries.

Class actions, at least in theory, work to ameliorate the collective action problem confronting shareholders. Instead of each shareholder pursuing an individual action, the entire class may, by relying on the efforts of the plaintiffs' representatives and attorneys, pursue a single, unified action against a corporation and related defendants. The class as a whole then internalizes both the full costs of pursuing the action and the benefits from the action. Moreover, representatives of the class can negotiate with and select the best plaintiffs' attorneys as lead counsel to advance the litigation.

While class actions are a potentially useful mechanism to discipline opportunistic managers and controlling shareholders, they are not a panacea for the shareholder collective action problem. Due to strong pressures to settle from both plaintiffs and defendants, some commentators have argued that plaintiffs' attorneys have a strong incentive to file frivolous complaints.[1] Frivolous suits include suits in which the plaintiffs have no expectation of finding any evidence of fraud or culpability on the part of defendants. Arguably, frivolous suits also include, more broadly, situations in which the plaintiffs' expected costs of undergoing a trial exceed the expected benefits of

1. *See* Lucian A. Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEG. STUD. 437, 437-41 (1988) (providing a formal model of the incentive of plaintiffs' attorneys to file frivolous suits); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. L. & ECON. 3, 5 (1990) (same); David Rosenberg et. al., *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3, 3-4 (1985) (same). *See generally* Robert D. Cooter & Daniel L. Rubenfield, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LIT. 1067, 1075-82 (1989) (summarizing various settlement theories).

doing so (but the plaintiffs file suit nonetheless to extract a positive settlement from defendants unwilling to go to trial).[2]

Even in lawsuits that are more clearly meritorious, the interests of plaintiffs' attorneys and the shareholder class members may diverge, both over the size of the attorney fee award and the effort that the attorneys expend in litigating the class action. In addition, private class actions pose yet another problem: plaintiffs and plaintiffs' attorneys, unlike government officials, act as profit maximizers and will file suit only where profitable. Because many of the costs of pursuing a class action are fixed, plaintiffs' attorneys will not file actions for instances of securities fraud and managerial breach of fiduciary duties involving relatively insignificant sums of money. A minimum size effect therefore exists in determining the incidence of securities class actions (whether frivolous or, importantly, meritorious). For smaller firms, private class action litigation is exceedingly rare.

In assessing securities class actions in the United States and the desirability of other countries adopting provisions allowing for class actions, this Article discusses the theoretical problems surrounding class action use. Naturally, the theoretical problems do not exist in a vacuum, and they may apply differently in varying countries. The United States enjoys deep and liquid capital markets with substantial trading volumes. The large market capitalization of many firms in the United States combined with high trading volumes lead to greater potential damage awards from a class action, giving private plaintiffs' attorneys sufficient incentives to pursue numerous class actions annually. The U.S. also possesses large numbers of institutional investors and professional, specialized plaintiffs' attorneys, both of which may affect the impact of class actions.

To provide a concrete example of how U.S.-style class actions may fare outside the United States, the Article focuses on the specific case of South Korea.[3] The attraction of class actions has led several legal experts to suggest the possibility of shareholder class actions in Korea.[4] Recently, Korea enacted new legislation providing for shareholder class actions against relatively large companies

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2. For exposition purposes, this Article treats as frivolous those claims that have absolutely no merit as well as claims with only a de minimis chance of winning at trial.

3. The Article will refer to South Korea simply as "Korea."

4. *See* Bernard Black, et. al., *Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea: Introduction to the Report*, 26 J. CORP. L. 546, 569 (2001) (stating that "[f]urther consideration should be given to the adoption of class action lawsuits to permit shareholders to pursue violations of the Commercial Code, Securities and Exchange Act and other provisions of Korean law relating to corporate governance.").

commencing on January 1, 2005 (and other companies from January 1, 2007).[5] Korea, nonetheless, provides a very different context than the U.S. for class actions. Not only is Korea's economy smaller with fewer large companies, but Korea also has a relatively small number of attorneys per capita compared with the U.S. (and no professional plaintiffs' attorneys). Moreover, a lack of experience in dealing with class actions among attorneys, investors, and the courts poses institutional challenges regarding the initiation of an effective class action system. The problems that plague class actions in the United States, therefore, may vary in importance when applied in a country such as Korea. More generally, the case of Korea sheds light on concerns lawmakers of other countries should take into account in considering whether to adopt a U.S.-style securities class action regime.

Part II delineates the theoretical issues with respect to implementing a securities class action regime. Part III surveys the empirical evidence in the United States on securities class actions involving the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). Part IV discusses the implications for Korea and the recently adopted class action law in Korea.

II. THEORETICAL ISSUES WITH SHAREHOLDER CLASS ACTIONS

Several theoretical issues exist in contemplating the value of private securities class actions in the United States. In the mid-1990s, the U.S. enacted the Private Securities Litigation Reform Act of 1995 (the "PSLRA") that sought to address many of these issues. In particular, by enacting the PSLRA, Congress intended to address the following concerns:

> (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only a faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized

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5. *See infra* Part IV.D (discussing the new Korean class action law). The move toward enabling securities class actions in Korea is part of a larger movement toward strengthening corporate governance generally in Korea. *See also* Hwa-Jin Kim, *Toward the "Best Practice" Model in a Globalizing Market: Recent Developments in Korean Corporate Governance*, 2 J.CORP. L. STUD. 345, 345 (2002) (describing reforms in the Korean corporate governance regime and the adaptation of Korean corporate governance to global standards).

party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.[6]

The first three of these concerns are related to the problem of frivolous litigation. The fourth concern deals instead with the relationship between the professional plaintiffs' attorneys and the plaintiff class of investors. Importantly, Congress also sought to "encourage plaintiffs' lawyers to pursue valid claims and defendants to fight abusive claims."[7]

A. Frivolous Lawsuits

The PSLRA represents Congress's response to a perceived litigation crisis in the early 1990s. Before its enactment, popular wisdom held that companies that experienced little more than a large drop in their stock price in a short period of time faced a high likelihood of a securities fraud class action, regardless of the existence of any actual fraud on the part of the company or its officials. Why would a company and its directors and officers settle a case they believed to be frivolous? Getting rid of even frivolous litigation is not cost-free. If a court is unable to verify whether litigation is meritorious at the start of the litigation, a class action suit may last a considerable amount of time. During this time, defendants will incur attorneys' fees as well as the distraction of dealing with discovery (including lengthy depositions of the top officers) and negative publicity affecting relations with both customers and suppliers. Settling even nuisance litigation allows a company to avoid such costs. In addition, many companies have liability insurance policies for their directors and officers, many of which will not pay if the directors or officers are found culpable at trial for violating the securities laws.[8] Rather than face this prospect (even if unlikely), directors and officers will often settle, relying on the directors and officers (D&O) liability insurers to pay most, if not all, of the settlement award.

Congress directed several provisions of the PSLRA at combating frivolous lawsuits. The PSLRA provides for a stay of discovery until after the motion to dismiss.[9] Without the specter of document production, depositions of a company's top officers, and

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6. H.R. REP. NO. 369, at 31 (1995), *reprinted in* 1996 U.S.C.C.A.N. 730, 1103.

7. S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 688.

8. *See* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation*, 7 J. L. ECON. & ORG. 55, 57 (1991) (arguing that "differential indemnification rights, insurance policy exclusions, and plaintiffs' counsel as the real party-in-interest create powerful incentives for settlement").

9. 15 U.S.C.A. § 78 v-4(D)(3)(B) (1934).

other aspects of discovery, defendants of a class action may be more willing to wait and see whether they can win on a motion to dismiss rather than settle a claim with little merit. The PSLRA also increases the probability that defendants will succeed on a motion to dismiss. Plaintiffs must plead with particularity facts giving rise to a strong inference of the defendants' required state of mind for antifraud actions under the Exchange Act, including, for example, Rule 10b-5.[10] In the case of Rule 10b-5 liability, plaintiffs must plead facts giving a strong inference that the defendants acted either with actual intent or out of recklessness.[11] For Exchange Act claims, plaintiffs must also "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading and, if an allegation regarding the statement or omission is made on information and belief . . . [plaintiffs] must state with particularity all facts on which that belief is formed."[12]

The PSLRA also reduces defendants' exposure to liability related to forward-looking statements.[13] The PSLRA amended the Exchange Act and Securities Act to provide new safe harbor provisions under Sections 21E and 27A respectively.[14] Only specified defendants are eligible, including Exchange Act reporting issuers and those working on an issuer's behalf.[15] Forward-looking statements in certain contexts are ineligible for the safe harbor, such as during an initial public offering. The safe harbor imposes a requirement that the forward-looking statements are identified and are accompanied by meaningful cautionary language.[16] However, even if a forward-looking statement fails to meet the meaningful cautionary language requirement, the defendants may still take advantage of the safe harbor to the extent that the plaintiffs fail to meet the burden of

10. 15 U.S.C.A. § 78 v-4(b)(2).

11. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976) (reserving the question of whether recklessness meets the scienter requirement). *But see* Fla. St. Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 653-54 (8th Cir. 2001) (holding that recklessness meets the scienter requirement of Rule 10b-5.); *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 535 (3d Cir. 1999) (same).

12. 15 U.S.C.A. § 78v-4(b)(2).

13. The federal securities laws define a forward-looking statement to include, among other things, "a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items" and "a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer." *Id.* at § 78v-5(i)(1).

14. *Id.* at § 78v-5.

15. *Id.* at § 78v-5(a).

16. *Id.* at § 78v-5(c)(1)(A).

proving that the defendants had actual knowledge that the forward-looking statement was false or misleading.[17]

The liability facing particular defendants is further limited under the PSLRA's imposition of proportionate damages for Rule 10b-5 claims (among other Exchange Act causes of action).[18] Under the proportionate liability rule, defendants who do not have actual knowledge of the fraud are liable only up to their percentage of culpability for the fraud.[19] Even if other defendants are judgment-proof or otherwise unable to pay their proportion of damages, paying defendants under the proportionate liability system are generally only liable to a maximum of 150 percent of the amount of damages for which they are responsible.[20] The proportionate liability rule works to protect deep-pocket defendants, such as auditors and underwriters, who are more remote from the fraud. Because more culpability for most corporate frauds is generally assigned to corporate insiders (who make the actual decisions on corporate disclosures), the liability facing outsider deep-pocket defendants is lessened.[21]

Where corporate insiders are judgment-proof or otherwise unavailable, the proportionate liability rule works to reduce the total amount of damages that plaintiffs may expect, as the remaining defendants are liable only up to 150 percent of the damages related to their culpability and not for the entire unpaid amount on the part of judgment-proof insiders. Related reforms from the Sarbanes-Oxley Act of 2002 further increase the impact of proportionate liability in reducing the liability facing non-insider defendants. In particular, Sarbanes-Oxley requires corporate CEOs and CFOs to certify financial statements,[22] which increases the likelihood that a jury will find the CEO and CFO more culpable and thus reduces the proportionate liability of all other defendants.[23] Where the CEO and CFO are

17. *Id.* at § 78v-4(c)(1)(B). *See also* Harris v. Ivax Corp., 182 F.3d 799, 803 (11th Cir. 1999) (stating that "if a statement is accompanied by 'meaningful cautionary language,' the defendants' state of mind is irrelevant. . . .").

18. 15 U.S.C.A. § 78v-4(f).

19. *Id.* The jury (or if there is no jury the court) is required to make findings of fact on the relative culpability of the defendants. *Id.* at § 78v-4(f)(3).

20. *Id.* at § 78v-4(f)(4)(A)(ii). Defendants are jointly and severally liable to plaintiffs, however, who have a net worth below $200,000 and "whose recoverable damages under the final judgment are equal to more than 10 percent of the net worth of the plaintiff." *Id.* at § 78v-4(f)(4)(A)(i).

21. *See* BERNARD S. BLACK ET. AL., OUTSIDE DIRECTOR LIABILITY (working paper 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=382422 (discussing the role of proportionate liability in reducing the exposure of outside directors to liability).

22. 15 U.S.C.A. § 7241 (2002).

23. Certification may also increase the ability of plaintiffs to meet the pleading with particularity requirement for scienter under a Rule 10b-5 action. A plaintiff may argue that

unable to pay their full damage awards, proportionate liability results in the plaintiff class (and indirectly the plaintiffs' attorneys) receiving a lower return from bringing the class action.[24]

Finally, the PSLRA contains an explicit requirement that courts must review a class action on the merits – after the "final adjudication" occurs – and impose sanctions, including the defendants' attorneys' fees, on frivolous litigation.[25] The PSLRA's sanction provision refers to Rule 11 of the Federal Rules of Civil Procedure. Some courts have held that the provision simply emphasizes the applicability of Rule 11 without changing the standard for sanctions.[26]

Any reform that works successfully to reduce frivolous suits, of course, is difficult to condemn. While frivolous suits may still be possible after the enactment of the PSLRA, the prospect of mandatory sanctions, stayed discovery, and pleading with particularity (among the other reforms) certainly raise the costs for such litigation in addition to reducing the probability of success for plaintiffs' attorneys. Perhaps more importantly, because these reforms such as the stay on discovery reduce the defendants' cost of waiting for the motion to dismiss, defendants will be more likely to seek such motions rather than to settle. The pleading with particularity requirement then increases the probability of defendants winning the motion to dismiss.

While the PSLRA may very well reduce the impact of frivolous litigation, however, the Act may also work to chill meritorious litigation. At the start of litigation, plaintiffs' attorneys may not know enough facts to determine the merits of the litigation. Plaintiffs' attorneys face a relatively high fixed cost in pursuing a securities fraud class action. Regardless of the size of the class action, plaintiffs' attorneys must research potential class action defendants, draft and

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certification on the part of the CEO or CFO, despite the presence of a material misstatement or omission, is particularized evidence of recklessness. *See* Kourtney T. Cowart, *The Sarbanes-Oxley Act: How a Current Model in the Law of Unintended Consequences May Affect Securities Litigation*, 42 DUQ. L. REV. 293, 309-13 (2004) (arguing that the Sarbanes-Oxley "certification provisions requiring the establishment and maintenance of internal control systems may persuade courts that a strong inference the defendant acted with the requisite scienter exists. . ."). *But see* Richard A. Rosen & Daniel J. Kramer, *Litigation Implications of the CEO and CFO Certification Requirements of the Sarbanes-Oxley Act*, 17 NO. 1 INSIGHTS 2, 4-5 (2003) ("[A]pplication of well-settled principles should support the conclusion that Section 302 certifications have no bearing on the adequacy of scienter allegations.").

24. *See* 15 U.S.C.A. § 7241 (discussing how CEO certification works to increase the culpability of insiders, thereby reducing the further exposure of outside directors to liability under a proportionate liability regime).

25. 15 U.S.C.A. § 78v-4(c).

26. *See* Hartmarx Corp. v. Abboud, 326 F.3d 862, 866-67 (7th Cir. 2003) (holding that the PSLRA's sanction provision emphasizes the applicability of Rule 11 without changing the standard for sanctions).

file the complaint, and then respond to the inevitable motion to dismiss. Imposing a pleading with particularity requirement, coupled with a stay on discovery, raises these fixed costs considerably for attorneys to pursue even claims that may turn out to be meritorious. The stay on discovery dramatically boosts the cost of gathering information. Where information is known solely within the defendant company, such as an internal corporate memorandum, the plaintiff may not have any ability of obtaining the information absent discovery. Furthermore, the expected return from filing a class action is reduced by the pleading requirements (to the extent the probability of dismissal is increased). Cases that survive the motion to dismiss then introduce additional costs to the plaintiff primarily through discovery and the cost of going to trial if the case fails to settle.

Because pursuing a class action is costly, plaintiffs' attorneys may opt not to file suit against some companies that potentially may have engaged in actual fraud. Particularly for companies offering only a small dollar amount of securities and, in the case of secondary market fraud, companies that have only a small market capitalization and trading volume, plaintiffs' attorneys may find that the expected return from filing suit does not exceed the expected cost. For smaller companies, therefore, private securities class actions may provide neither the danger of frivolous suits nor the deterrence of meritorious suits. The increase in costs due to the PSLRA may elevate the minimum size threshold for plaintiffs' attorneys (whether in terms of offering amount, market capitalization, or trading volume depending on the type of securities claim), leaving an even greater fraction of companies without any private enforcement mechanism against securities fraud.

Ideally, regulatory reform would encourage, and indeed subsidize, plaintiffs' attorneys who pursue meritorious lawsuits while it would hinder plaintiffs' attorneys who pursue frivolous suits.[27] To an outside observer such as a court, however, whether a lawsuit is frivolous or meritorious is far from clear at the outset of a case. Plaintiffs' attorneys will always say that their claims are meritorious. In contrast, defendants and their attorneys will always claim that the lawsuit is frivolous. No magic way of distinguishing between frivolous and meritorious suits has yet been found.

Of course, one could say that low value fraud claims are not important. In terms of dollar value, fraud that affects the shareholders of low market capitalization firms will have only a

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27. Indeed, this was Congress's intention behind the PSLRA. *See supra* notes 6-7 and accompanying text.

limited direct impact on the overall capital markets. However, fraud involving low market capitalization firms often involves initial public offerings ("IPO") and other newer, entrepreneurial-stage companies. Uncontrolled, fraud in the IPO market may result in investors requiring unduly high discounts to purchase such shares, hurting the ability of newer companies to turn to the capital markets for financing. Even where fraud impacts lower market capitalization value companies disproportionately, the impact of the fraud aggregated over the large number of small companies may be nonetheless significant.

B. Plaintiffs' Attorney Agency Problems

Even for meritorious litigation, plaintiffs' attorneys may not have the same incentives as the class. Typically, plaintiffs' attorneys receive only a fraction of the award given to the class while they bear the full cost of pursuing the class action litigation. Because they expect to receive only a fraction of the award, plaintiffs' attorneys may not expend as much effort or invest as much capital in the litigation as they would if they could obtain the full award for themselves. All other things being equal, plaintiffs' attorneys, therefore, may settle meritorious litigation more quickly and for a smaller amount of money compared with what the plaintiff class as a whole would want. To the extent the plaintiff class is diffuse and the plaintiff representative often only owns only a small fraction of shares (and indeed prior to the PSLRA was often handpicked by the plaintiffs' attorneys), no real bargaining occurs between the class and the plaintiffs' attorneys over attorney fees. Instead, the only real check on attorneys obtaining exorbitant fee awards is court review of the fees. To the extent that after a settlement no party is present to contest the fee award, however, courts may have few incentives to intervene to reduce the fees.[28]

The PSLRA provides certain provisions aimed at aligning the incentives of plaintiffs' attorneys with the plaintiff class. One provision of the PSLRA does significantly affect the relationship of plaintiffs' attorneys and the class: the PSLRA's lead plaintiff

28. *See* Bonett v. Educ. Debt Serv., Inc., No. 01-6528, 2003 WL 21658267, at *8 (E.D. Pa. May 9, 2003) (providing an example of a court approving the requested attorney fee award); *In re* Corel Corp. Inc. Sec. Litig., 293 F.Supp.2d 484, 495-98 (E.D. Pa. 2003) (same); *In re* Cylink Sec. Litig., 274 F.Supp.2d 1109, 1113-17 (N.D. Cal. 2003) (same). *But see In re* Baan Co. Sec. Litig., 288 F.Supp.2d 14, 16-21 (D.D.C. 2003) (awarding only 28 percent of the settlement fund as attorneys' fees despite a request for 32 percent of the fund).

presumption.[29] The PSLRA imposes a rebuttable presumption that the plaintiff, among those seeking to become the lead plaintiff, who has the largest financial interest in the relief sought by the class and is otherwise an adequate representative of the class is presumptively the lead plaintiff.[30] To reduce further the probability of plaintiffs' attorneys handpicking lead plaintiffs with whom the attorneys enjoy a repeat relationship, the PSLRA also provides that a person may act as lead plaintiff in "no more than 5 securities class actions brought as plaintiff class actions pursuant to the Federal Rules of Civil Procedure during any 3-year period."[31] Importantly, the PSLRA and subsequent court opinions have made clear that the lead plaintiff has the power to select and, presumably, fire the lead plaintiffs' attorney.[32] In theory, a lead plaintiff with a large stake in the litigation will have more incentive to monitor the plaintiffs' attorney's effort and also be more willing to resist excessive plaintiffs' attorney fee awards.

The PSLRA also addresses the problem of plaintiffs' attorney power over the plaintiff class more directly. Under the Act, attorney fees are limited to a "reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class."[33] The settlement notice sent to the class must specifically delineate the attorneys' fees and the costs being sought by the plaintiffs' attorneys from the class settlement fund.[34]

While good on paper, the PSLRA's lead plaintiff provision faces at least two problems. First, institutional investors may react to the largest financial interest presumption with rational apathy. Many institutions enjoy long-term repeat relations with public companies. A pension fund manager who depends on the good will of managers at many different companies may eschew developing a reputation as someone willing to file a class action when a company's price drops. Second, other institutional investors, especially public pension funds, may get involved in litigation not so much to benefit the class but

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29. 15 U.S.C.A. § 78v-4.

30. 15 U.S.C.A. § 78v-4 states that:

> the court shall adopt a presumption that the most adequate plaintiff in any private action arising under this title is the person or group of persons that — (aa) has either filed the complaint or made a motion in response to a notice under subparagraph (A)(i); (bb) in the determination of the court, has the largest financial interest in the relief sought by the class; and (cc) otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure.

Id.

31. *Id.* at § 78v-4 (a)(3)(vi).

32. *Id.* at § 78v-4 (a)(3)(v); *see also In re* Cendant Corp. Litig., 264 F.3d 201, 220 (3rd Cir. 2001) (discussing the lead plaintiff's right to select the lead counsel in a securities class action).

33. *Id.* at § 78v-4(a)(6).

34. *Id.* at § 78v-4 (a)(7)(C).

instead to push the political agenda of those politicians with influence over the public pension fund.[35] While such plaintiffs may seek a large class award, they may also be willing to sacrifice some of the award to obtain a political advantage (for example, obtaining a settlement right before an election instead of a larger settlement after the election).

III. EMPIRICAL EVIDENCE

In considering the value of a private securities fraud class action regime and the effectiveness in the U.S. of the PSLRA in improving on this regime, several empirical questions derive from foregoing discussion on the theoretical issues:

1. Did the PSLRA work to reduce the incidence of frivolous suits (and thereby increase the proportion of cases filed based on more meritorious factors related to actual fraud)?
2. Did the PSLRA also work to reduce the incidence of certain types of meritorious suits (in particular those *without* any strong prefiling indicia of fraud such as an accounting restatement) for firms of all sizes?
3. Did the PSLRA raise the cost to plaintiffs' attorneys, resulting in an increased minimum expected return threshold for plaintiffs' attorneys to file suit, leaving smaller companies with lower private deterrence against fraud?
4. Did the PSLRA alter the balance of power between plaintiffs' attorneys and the investor class resulting in lower attorney fees and more vigorous litigation of securities fraud class actions?

Shedding light on these empirical questions related to the PSLRA will help guide future reform on securities class actions. For example, if the PSLRA failed to reduce the incidence of frivolous litigation, then the cost of allowing class actions may exceed the benefits. On the other hand, if the PSLRA also imposes significant costs on potentially meritorious litigation, resulting in a reduction in the *total* number of meritorious suits, the cost of eliminating frivolous suits may not be worthwhile.

This Part canvasses the existing empirical evidence on these four questions and outlines further possible areas of research.

35. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 799-839 (1993).

A. The Incidence of Frivolous Lawsuits

Whether lawsuit filings are frivolous or meritorious is particularly difficult to assess.[36] Tests of frivolous litigation have focused on a number of indirect measures.

1. Event Study Tests

One method of gauging the importance of frivolous litigation and the impact of the PSLRA in reducing the incidence of frivolous litigation is through an event study. An event study measures the impact on shareholder wealth from the shift in the legal environment due to the PSLRA. In theory, if frivolous suits represented a large cost to companies and the PSLRA worked effectively to reduce such frivolous suits, the stock market price of companies should have reacted positively to the enactment of the PSLRA.

The event studies on the PSLRA focus in particular on the following events:

(a) President Clinton's veto of the PSLRA late on December 19, 1995 (after the market close) and rumors prior to this event,

(b) the House override of the veto on December 20, and

(c) the Senate override of the veto on December 22.

Spiess and Tkac (1997) provide an event study test of the market reaction to both President Clinton's veto of the PSLRA and the House override of the veto.[37] Their study focused only on firms in the biotechnology, computer, electronics, and retailing industries, all identified as high litigation risk industries by Francis, Philbrick, and Schipper (1994a).[38] After removing, among others, firms that had confounding firm-specific corporate events, they generated a sample of 1485 firms from the Center for Research in Security Prices database.[39] Spiess and Tkac report that their entire sample of firms experienced a significant negative abnormal return on December 18, 1995 that corresponded to rumors that President Clinton would veto the

36. For example, plaintiffs' attorneys are unlikely to admit to filing a frivolous lawsuit. Indirect proxies for frivolous lawsuits must therefore be found.

37. D. Katherine Spiess et. al., *The Private Securities Litigation Reform Act of 1995: The Stock Market Casts its Vote. . .*, 18 MGMT. DEC. ECON. 545, 545 (1997).

38. *Id.* at 550 (citing Francis, Philbrick, & Schipper (1994a)). The SIC codes corresponding to these industries are as follows: biotechnology (2833-2836 and 8731-8734), computer (3570-3577 and 7370-7374), electronics (3600-3674), and retailing (5200-5961). *Id.*

39. *Id.*

PSLRA.[40] They also report a significant positive abnormal return on December 20 (of smaller magnitude than the negative return on December 18), which Spiess and Tkac attribute to the House override of the veto, despite the fact that Clinton's veto also took place *after* the market close on December 19.[41] The later Senate override on December 22 received only an insignificant positive abnormal return.[42] Spiess and Tkac interpreted their results as consistent with the hypothesis that the market viewed the PSLRA as providing a net benefit to the wealth of shareholders.

Spiess and Tkac also tested whether firms with relatively weak corporate governance are benefited more or less by the passage of the PSLRA. Firms with weak corporate governance may represent a greater risk to shareholders of fraud; therefore, the passage of the PSLRA may reduce the value of such firms by making even meritorious litigation more expensive for plaintiffs to pursue.[43] To test the impact of the PSLRA on firms with weak corporate governance, they divided their sample of firms based on the percentage of institutional ownership, the number of institutional owners, the ownership of insiders in the firm, and the fraction of outsiders on the boards of the firms.[44] While most of their results are inconclusive, they did report that firms in the biotechnology industry with low institutional investor ownership, and therefore weaker corporate governance, received a more negative and significant abnormal reaction to rumors of Clinton's veto on December 18 when compared with biotechnology firms with high institutional investor ownership.[45] They interpreted this result as providing limited evidence that "[t]he cost savings of lessened litigation under the Reform Act apparently outweigh any concern that investors may have about an increased ability for managerial fraud, even in the case of firms with weak monitoring environments."[46]

One shortcoming of the Spiess and Tkac event study (and indeed the other PSLRA event studies) is the focus on one particular regulatory event rather than a series of different events. It is possible that some other event occurred at around the same time as the

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40. *Id.* at 554.

41. The market reaction on December 20 therefore included the market's reaction to Clinton's veto itself in addition to the House's override of the veto.

42. Spiess, *supra* note 37, at 554.

43. *Id.* at 555.

44. Spiess and Tkac, however, do not classify "grey" outside directors with consulting and other relationships with the firm. *Id.* at 551.

45. *Id.* at 556-57.

46. *Id.* at 559.

passage of the PSLRA that may have affected particular industries in a way that drives the event study results. Unlike event studies that focus on multiple dates, event studies focusing just on one calendar event (the enactment of the PSLRA) are unable to diversify away the possibility of an industry-specific confounding event. For example, many of the studies focus on the computer industry. If the computer industry, but not the market generally, experienced an unrelated positive shock in mid-December 1995, this would also generate a positive event study result for the sample of computer industry companies unrelated to the PSLRA.[47]

Johnson, Kasznik, and Nelson (2000) ("JKN") conducted a similar event study as Spiess and Tkac (1997).[48] JKN focused on a slightly different sample, however: 489 firms in the pharmaceutical, computer hardware, and computer software industries.[49] As with Spiess and Tkac (1997), JKN used December 18, the day rumors of President Clinton's possible veto started circulating, as the event date to test the impact of the veto on the market. JKN then used the period from December 20 to 22 to gauge the impact of the House override on December 20 and the Senate override on December 22. JKN reported a significant negative abnormal return for December 18 and a significant positive abnormal return for December 20 through 22, supporting the view that the PSLRA increased shareholder welfare for firms in high litigation risk industries.[50]

JKN then examined the impact of a firm's exposure risk to both frivolous and meritorious lawsuits on the abnormal returns in their event study. They posited that firms with a greater risk of frivolous lawsuits will experience a more positive return from the passage of the PSLRA. On the other hand, the stock price of firms representing a greater risk of fraud may experience a more muted, if not negative response to the PSLRA. They constructed a probit model of litigation risk based on those firms identified in *Securities Class Action Alert* to have faced a suit in 1994 or 1995 and compared them with those that did not.[51] For proxies of the risk of a frivolous suit, they used a firm's

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47. Event studies generally correct for overall movements in the market (through an adjustment based on the expected return as predicted using a market model). Nonetheless, correcting for market-wide movements may not necessarily correct for industry-specific (but not market-wide) shocks unrelated to the PSLRA legislation.

48. *See generally* Marilyn F. Johnson et. al., *Shareholder Wealth Effects of the Private Securities Litigation Reform Act of 1995*, 5 REV. OF ACCT. STUD. 217 (2000) (investigating the reaction of stock prices to the enactment of the PSLRA).

49. *Id.* at 218. The SIC Codes are as follows: pharmaceutical (2833-2836), computer hardware (3570-3577), and computer software (7371-7379).

50. *Id.* at 224.

51. *Id.* at 223-25.

market capitalization, stock market beta, cumulative daily return for the first eleven months of 1995, the minimum return a firm received (measured over any contiguous twenty-day trading period) during 1994 or the first eleven months of 1995, skewness of raw returns, and turnover of the firm's shares.[52] For proxies of meritorious litigation risk, JKN focused on factors associated with "aggressive" accounting, including factors related to CEO power,[53] the level of oversight of management,[54] the need of the firm for financing, and the leverage of the firm.[55] JKN then weighted the firms in their portfolio based on the litigation risk obtained from their probit model for the sample firms.[56] They report that while weighting the portfolio based on a combination of the risks of meritorious and frivolous suits resulted in an overall positive cumulative abnormal return from December 18 to December 22 (indicating a wealth increase from the PSLRA), weighting the portfolio solely based on the risk of a meritorious lawsuit resulted in a statistically significant and overall negative cumulative abnormal return.[57] JKN states, "[O]ur findings suggest that the PSLRA was less beneficial for firms at greater risk of litigation for fraudulent activity, but that these negative effects were dominated, on average, by the positive wealth effects associated with restricting frivolous securities litigation."[58]

One problem with JKN's findings with respect to the probability of litigation risk lies in their definition of frivolous and meritorious suits. While factors such as market capitalization, minimum return, and stock market beta may correlate with a frivolous suit, they may also correlate with meritorious suits. Plaintiffs' attorneys will not wish to file even a meritorious suit against a small market capitalization firm with low stock market turnover to the extent the potential damages from such a suit are low and thus unlikely to compensate the plaintiffs' attorney for the

52. *Id.* at 224-25 (noting that "these variables . . . capture many of the characteristics claimed to be indicative of frivolous 'strike' suits."). These factors were found significant in Francis, Philbrick, and Schipper (1994a) and Jones and Weingram (1996a) detailed later in the Article.

53. The CEO power variable is correlated with, among other things, whether the CEO is also the chairman of the board of directors and also whether the CEO is a founder of the company. *See id.* at 227 (providing descriptive statistics of litigation experience and litigation risk characteristics).

54. The level of oversight over management is derived from, among other things, the presence of a Big 6 accounting firm, the existence of a separate audit committee, and the presence of a block shareholder with at least 5 percent of the outstanding shares.

55. Johnson, *supra* note 48, at 225.

56. *Id.* at 229-30.

57. *Id.* at 230.

58. *Id.* at 229.

relatively fixed costs of litigation. JKN's factors for whether a firm faces a high risk of meritorious litigation are also not perfect. Even firms with strong corporate governance structures may commit fraud.[59] The converse is also true; firms with weak corporate governance may engage in honest financial reporting. Nonetheless, to the extent firms with weak corporate governance structures are more likely to commit fraud, JKN's factors do capture the impact of an increased probability of fraud on the abnormal market reaction to the PSLRA.

Ali and Kallapur (2001) provide contrary event study evidence on the stock market's reaction to the PSLRA.[60] They examined the abnormal market reaction for firms in the biotechnology, computer, electronics, and retailing industries,[61] giving a total number of 1589 firms in their sample.[62] To gauge the market's reaction to the PSLRA, they focused on a number of events in 1995 leading up to the ultimate Congressional override of President Clinton's veto of the Act. Of the six dates they characterize as increasing the probability of the passage of the PSLRA, they report that significant abnormal returns exist on four dates. Three of the dates have significantly negative returns; those dates involve actions in Congress moving the PSLRA forward through the legislative process prior to December 20, 1995.[63] The fourth event is centered on December 20, 1995, with a significant positive abnormal return.[64]

Unlike Spiess and Tkac (1997) and JKN (2000), Ali and Kallapur interpreted December 20 as corresponding to both the release into the market of news of President Clinton's veto of the Act, which occurred after the market close on December 19, and the House override vote on the veto. While Clinton's veto and the House override of the veto provide two potentially confounding pieces of information to the market, Ali and Kallapur interpreted the positive return on December 20, 1995 as consistent with a positive reaction in the

59. Enron had an exemplary (at least prior to the collapse of Enron) audit committee. The chair of the audit committee, for example, was Robert K. Jaedicke, a former dean of the Stanford Business School. Enron, Def 14A filing (filed Mar. 24, 1997), *available at* http://www.sec.gov/Archives/edgar/data/72859/0000950129-97-001155.txt.

60. Ashiq Ali & Sanjay Kallapur, *Securities Price Consequences of the Private Securities Litigation Reform Act of 1995 and Related Events*, 76 ACCT. REV. 431 (2001).

61. These are the same four industry groups as in Spiess and Tkac (1997). *See supra* notes 37-46 and accompanying text.

62. The four industry groupings are: computers (SIC 3570-3577 and 7370-7374), electronics (SIC 3600-3674), pharmaceuticals/biotech (SIC 2833-2836 and 8731-8734), and retailing (SIC 5200-5961). Ali, *supra* note 60, at 436.

63. *Id.* at 437.

64. *Id.*

market to Clinton's veto of the PSLRA. This interpretation is opposite to how Spiess and Tkac (1997) and JKN (2000) interpreted the December 20 market reaction.[65] To further support their findings, Ali and Kallapur examined the cumulative abnormal returns from the day before the congressional vote on the conference committee bill on the PSLRA, December 4, to the next trading day after the Act's passage into law, December 26.[66] They report that over this time period, firms in their sample of high litigation risk industries experienced a statistically significant cumulative abnormal return of -3.48 percent, consistent with the view that the PSLRA reduced shareholder value for such firms.[67]

The event study evidence surrounding the passage of the PSLRA is thus somewhat inconclusive. One additional event study looked instead at the promulgation by the Ninth Circuit of a new, tougher pleading requirement after the enactment of the PSLRA and the reaction of companies to news of this shift in the Ninth Circuit's pleading requirements. Johnson, Nelson, and Pritchard ("JNP") (2000) examined the shareholder wealth effects of the Ninth Circuit's *In re Silicon Graphics, Inc.* decision (reported on July 2, 1999) that imposed a stringent interpretation of the PSLRA's pleading with particularity standard.[68] Their sample consists of firms in industries

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65. *Id.* at 443. To support their interpretation, Ali and Kallapur provide evidence that the abnormal returns on December 20, 1995 are significantly negatively correlated to the abnormal returns on December 11, 1995 (when Clinton indicated to the market his intent to sign the bill). The reversal on December 20, 1995 of the negative market reaction on December 11, 1995 provides evidence that the market reaction on December 20, 1995 is due primarily to the market's assessment of Clinton's change of heart in vetoing the PSLRA. *Id.*

66. *Id.* at 446.

67. Ali and Kallapur also examined the stock market reaction to the defeat of California Proposition 211 in 1996. *Id.* at 447-49. Proposition 211, if passed, would have significantly watered down the PSLRA (opening the way for greater shareholder litigation). Ali and Kallapur report a significant negative abnormal market reaction in the litigation high-risk industries to the defeat, supporting their hypothesis that the market reacted negatively to measures designed to reduce the ability of shareholders to bring a securities suit. *Id.* As a further check, Ali and Kallapur also looked at the market reaction to several Supreme Court decisions affecting the ability of plaintiffs to file private securities causes of actions and found a negative abnormal reaction to the opinion in *Central Bank v. Denver*, 511 U.S. 164 (1994), eliminating aiding and abetting liability under Rule 10b-5. *Id.* at 453-54.

68. Marilyn F. Johnson et. al., *In re Silicon Graphics Inc.: Shareholder Wealth Effects Resulting From the Interpretation of the Private Securities Litigation Reform Act's Pleading Standard*, 73 S. CAL. L. REV. 773 (2000). In *In re Silicon*, the Ninth Circuit adopted a "deliberate recklessness" standard for pleading fraud with particularity for securities fraud class actions. Johnson and her fellow authors write: "Since the plaintiff cannot use discovery to determine what the defendants knew when they were making the allegedly fraudulent statements, the case will be dismissed unless the defendant can find evidence in public sources of the defendant's fraudulent intent." *Id.* at 776. Because of the Ninth Circuit's more lenient pleading requirements prior to the enactment of the PSLRA, the authors characterize the Ninth Circuit's

particularly vulnerable to a securities fraud suit, which included pharmaceuticals, computer hardware, and computer software.[69] Excluding firms already involved in a securities class action, they ended up with a sample of 277 firms, 93 of which are headquartered in the Ninth Circuit and 184 outside the Ninth Circuit.[70] In their event study,[71] they report a significant positive cumulative abnormal return ("CAR") for the period from July 2, 1999 to July 6, 1999 that corresponded to news reports in the Wall Street Journal on the *In re Silicon Graphics* decision. Moreover, the CAR was 2.79 percent for firms in the Ninth Circuit while only 1.27 percent outside the Ninth Circuit.[72]

To determine the differential impact of the new pleading standards on firms with varying risks of facing securities litigation, JNP fitted a model of litigation risk. The litigation risk model used whether a firm faced a lawsuit in the two years prior to the passage of the PSLRA as the dependent variable in a probit model.[73] For independent variables they included measures they deemed more correlated with "strike suits," such as stock price volatility and stock price performance.[74] They also included factors likely correlated with the merits of litigation, such as the power of the CEO, the monitoring within the company of the CEO, and the motivation to commit fraud.[75] Using their litigation risk model, JNP partitioned their sample firms into four quartiles based on the predicted litigation risk. They found that the firms at highest risk of litigation had a CAR of 2.61 percent while the lowest risk firms had a CAR of 1.19 percent. The difference between the two CARs is significant, however, at only the 10 percent

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shift to a deliberate recklessness standard as a surprise to the market (and thus a good candidate for an event study). *Id.*

69. The corresponding SICs are: pharmaceuticals (2833-2836), computer hardware (3570-3577), and computer software (7371-7379). *Id.* at 792.

70. *Id.*

71. Expected returns in their event study are calculated using the market model for the 252 trading days in 1998. *Id.* at 805.

72. *Id.* at 794-95. Johnson and her fellow authors explain the positive reaction outside the Ninth Circuit as due to the possibility that other circuits and the Supreme Court may eventually adopt the Ninth Circuit's approach. *Id.*

73. *Id.* at 807-08.

74. *Id.* The measures included capitalization, equity beta, share turnover, prior cumulative return, and return skewness. *Id.*

75. *Id.* Factors related to the monitoring of the CEO included the proportion of insiders on the board, the share ownership of outside directors, the presence of an audit committee, the presence of a Big 6 auditor, the presence of an outside block shareholder, whether the CEO is separate from the chairman, and whether the CEO is a company founder. Factors related to the motivation to commit fraud included whether the firm engaged in external financing in the two years prior to the passage of the PSLRA and the debt-equity ratio of the firm. *Id.*

level.[76] When JNP repartitioned the sample based solely on non-merit-related litigation risk factors, they found that the highest risk quartile firms have a CAR of 2.68 percent while the lowest risk quartile firms have a CAR of only 0.51 percent, a difference significant at the 5 percent level.[77]

2. Corporate Governance Changes

Instead of looking at the stock market reaction, another way of measuring the importance of merit-related factors is to consider how corporate governance interacts with securities litigation. Romano (1991) hypothesized that litigation acts as an ex-post mechanism to discipline managers of companies with relatively weak ex-ante corporate governance control.[78] In her view, both litigation and corporate governance act as a substitute means to align the incentives of managers and shareholders. Romano tested this hypothesis along a number of dimensions. She examined a dataset consisting of 535 randomly selected firms drawn from both currently traded and delisted firms from the NYSE as well as Nasdaq. Within this dataset, Romano tracked shareholder suits, including class actions and derivative suits, occurring from the late 1960s to 1987.[79]

Romano's results provide mixed evidence on the value of shareholder litigation as a disciplining device on management. First, she reports that shareholders suits occur infrequently, noting that only 19 percent of her sample experienced any suit during the entire period of her study (for a total of 139 suits).[80] Focusing on outcomes, Romano reports that most suits (83 of 128 suits with known resolution) resulted in a settlement.[81] Many of the suits settled with no monetary relief, resulting in only cosmetic changes to the board and attorney fee awards.[82] The lack of monetary relief, aside from

76. *Id.* at 796-97.

77. *Id.* at 798-99.

78. Romano, *supra* note 8, at 55.

79. *Id.* at 58.

80. *Id.* at 59. Romano also conducted an event study around (among other events) the filing of the suit. She reports that the -1 to 0 day cumulative abnormal return in the event study for class action lawsuits is significantly negative. *Id.* at 66-67. She concludes from the negative CAR that shareholders "do not perceive the filing of a shareholder suit as a wealth-increasing event." *Id.* at 59. In contrast to Romano's conclusion, it is nonetheless possible that the filing of a suit both (a) indicates that corporate governance changes will occur (raising shareholder wealth), and (b) signals to the market the need for such changes (lowering the market's valuation of the company). The negative CAR could indicate that effect (b) dominates effect (a).

81. *Id.* at 60.

82. *Id.* at 61-63. The nonmonetary relief often included minor changes in executive compensation and adding one or two additional outside directors without changing the majority

attorneys' fees, in many of the cases provides some support for the possibility that frivolous suits may drive many shareholder lawsuits.

To determine the relationship of shareholder suits with other mechanisms to discipline management, Romano examined whether corporate governance changes occur around the time of a shareholder suit. To control for governance changes that may occur regardless of a suit, she collected a matching sample of firms.[83] Compared with the matching firm sample, Romano reports that the lawsuit sample experienced a significantly greater turnover in the CEO and Chair of the Board positions.[84] Most of the CEO and Chair turnover occurred in the year before the filing of the suit or during the lawsuit itself, not in the year after the suit's resolution.[85] While Romano did not find any significant difference in the change in the overall fraction of outside directors on the board between the samples of lawsuit and matching firms, she reported significant differences in the turnover numbers for individual directors. Firms having lawsuits experienced a higher degree of board turnover compared with matching firms, particularly in the year before the lawsuit and during the lawsuit.[86]

Romano reports that board turnover is significantly greater for the subset of lawsuit firms that settled compared with those that experienced a dismissal of the suit.[87] On the other hand, Romano reports that the change in the number of directorships in other corporations held by those directors that departed compared with those who stayed was not significantly different.[88] This finding was inconsistent with the hypothesis that turnover of directors is a negative event for the directors.[89] Romano also found evidence that

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control of the board, among other things. *Id.* at 63. Romano explains: "A likely explanation for cosmetic structural settlements is the need to paper a record to justify an award of attorneys' fees to courts. . . ." *Id.*

83. *Id.* at 71. Firms were matched based on the same four-digit standard industrial classification code.

84. *Id.* at 71-72. Romano reports that 55 percent of the CEOs or Chairs changed for the lawsuit firms compared with 31 percent for the matching sample. *Id.*

85. *Id.* at 72. Romano also controls for the possibility that the CEO or Chair turnover is a result of reduced profitability or an acquisition. She finds even after controlling for these factors that lawsuit firms have a significantly greater CEO or Chair turnover compared with the matching firms. *Id.* at 73-76.

86. *Id.* at 72-73, 78.

87. *Id.* Romano controls for the possibility that the board turnover is due to an acquisition and received similarly significant results. *Id.* at 78.

88. Romano uses the number of other directorships held by a particular director as a proxy for the quality and reputation of that director.

89. *Id.* at 79 ("The board memberships of defendant-directors who departed increased (from 4.0 to 4.2), while those of defendant-directors who remained declined (from 4.4 to 4.5) and the difference in mean change across the groups is not significant."). Romano concludes: "we cannot

lawsuit likelihood is significantly correlated with the presence of outside block shareholders,[90] leading her to hypothesize that "litigation is a complement rather than a substitute for outside block ownership as a managerial monitoring device."[91]

Romano's study did not separate out suits based on their likelihood of being frivolous or actually merit-driven, as many of the PSLRA event studies described above do with the event study abnormal returns.[92] While Romano did examine settled versus dismissed cases, a mix of both frivolous and meritorious suits within the set of settled cases may exist. While one may expect that meritorious shareholder litigation may act as a substitute mechanism to monitor managers,[93] the same expectation does not apply to settled suits brought for primarily frivolous reasons.

3. The Filing of Suit and Settlement Outcomes

In addition to looking at event studies and changes in corporate governance, a number of studies have focused on the determinants of securities fraud class action filings as well as the determinants of suit outcomes, including, most prevalently, settlements.

Several studies are from the pre-PSLRA time period. Francis, Philbrick, and Schipper (1994a) ("FPS") examined the determinants behind securities class action filings as well as outcomes.[94] Their study focused on the chemicals, computer, electronics, and retailing industries, all of which had high numbers of securities litigation from

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interpret the significantly lower board stability of lawsuit firms as confirmation of an organizational response to litigation." *Id.* at 79.

90. Romano provides both a comparison of mean outside block ownership between the lawsuit and matching sample. *Id.* at 72, 80. She also provides a logit model of suit incidence (controlling for assets, earnings change, outside directorship representation on the board, inside ownership, and prior settlements, among other factors). *Id.* at 82-83. In both tests, she reports that lawsuit incidence is significantly correlated with a greater outside block ownership. *Id.* at 80-83.

91. *Id.* at 80. Romano writes: "Block ownership can mitigate the free rider problem of shareholder litigation, for with a large enough block, the investor's prorated benefit will exceed a lawsuit's cost." *Id.* In her study, Romano also provides evidence that another important determinant of whether a company faces suit is the presence of a prior settlement fund (which is positively related to a higher probability of a subsequent suit). *Id.* at 83.

92. *See supra* notes 37-67 and accompanying text (discussing event studies on the impact of the PSLRA).

93. The possibility of meritorious litigation, for example, may deter managers from engaging in fraud. Meritorious litigation may also result in corporate governance changes leading to greater alignment of the interests of shareholders and managers.

94. JENNIFER FRANCIS ET AL., DETERMINANTS AND OUTCOMES IN CLASS ACTION SECURITIES LITIGATION (Working Paper, 1994).

1988 to 1991, the time period of their sample.[95] They collected a sample of ninety-one class actions involving Rule 10b-5 or Section 11 fraud allegations.[96] FPS noted that litigation in their sample was "overwhelmingly" focused on the results of operations (such as earnings and sales) and on the financial condition of the lawsuit firms.[97] Examining the determinants of litigation, FPS reported that size makes a difference in the incidence of securities class action litigation. Compared with industry peer firms,[98] lawsuit firms have significantly larger assets, sales, market share, and market capitalization, among other indicia of size.[99] The lawsuit firms also pay out higher amounts of dividends to shareholders compared with the industry peer sample.[100]

To focus on determinants other than firm size, FPS constructed a matching sample based on the same (or close) four-digit Standard Industrial Classification ("SIC") code[101] and firm size. FPS reports that lawsuit firms tend to have higher beta coefficients compared with industry peers and matched firms but do not have higher return volatility or more instances of large stock price drops compared with either the industry peers or matching firms.[102] Lawsuit firms do, nonetheless, experience lower cumulative stock returns in the year of the lawsuit filing.[103]

Looking at various financial performance measures (such as earnings per share and return on assets), FPS reports no evidence that the lawsuit firms are "less financially prosperous" than either the industry peer or matched firms.[104] They do note that the lawsuit firms have a "richer" disclosure environment than the matched firms, indicating to them that "a rich disclosure environment is not, in and of

95. *Id.* at 1.

96. *Id.*

97. *Id.* at 3, 19-20.

98. Industry peer firms were selected based on the same four-digit standard industrial classification code.

99. *Id.* at 9.

100. *Id.* at 12.

101. The Standard Industrial Classification codes group companies into similar industry groups. For those interested in looking up the SIC code for a particular industry, see *http://www.osha.gov/pls/imis/sicsearch.html* (last visited on July 20, 2004).

102. FRANCIS, *supra* note 94, at 14. The author writes : "Thus our results do not support the conventional wisdom that targets of securities class action litigation have inherently volatile returns, at least measured relative to other firms in the same industries." *Id.* at 15.

103. *Id.* at 25.

104. *Id.* at 11-12.

itself, protection against shareholder litigation."[105] Lawsuit firms also are audited by Big 6 auditors more frequently than the industry peer firms,[106] but not more than a sample matched by both industry and size.[107] Focusing on outcomes, FPS failed to find a significant linear relationship between settlement amount and estimated damages for the fifty-five lawsuits in which they had sufficient data to estimate the potential damage award.[108] Even so, FPS does report a significant relationship between log transformations and ranks of settlement amounts and potential damages, indicating a monotonic relation between settlement and potential damages.[109]

Jones and Weingram (1996a) similarly studied the determinants of securities fraud class actions during the pre-PSLRA period.[110] They focused on two questions: (a) what factors lead to a higher probability that a firm will experience a 10 percent or more single day drop in the firm's price, and (b) what factors determine whether a plaintiffs' attorney will file suit against a firm with a 10 percent price drop (for example, not all 10 percent price drops result in a lawsuit). Combining these two questions allowed for an overall determination of how certain factors may affect the risk of securities litigation. Jones and Weingram focused on a sample of firm-days where a firm experienced a 10 percent price drop from 1989 to 1992. Among the 10 percent price drop firms, they identified those firms that also faced a securities fraud class action related in time to the 10 percent price drop.[111] They then added to their sample a random selection of firm-days consisting of 5 percent of the total firm-days for

105. *Id.* at 3, 23-24. To determine the disclosure environment, FPS looked at the number of pages of analyst reports, the number of PR Newswire reports, and the number of press releases put out by a firm. *Id.*

106. The Big 6 auditors during the time period of the FPS study were Deloitte & Touche, Ernst & Young, Price Waterhouse, Coopers and Lybrand, Arthur Andersen, and KPMG Peat Marwick.

107. FRANCIS, *supra* note 94, at 10-11.

108. *Id.* at 28. FPS fit a regression model with the settlement amount as the dependent variable and a constant together with the estimated damage award as the independent variables. They report that the coefficient on the estimate damage award is statistically insignificant in their regression using untransformed settlement and estimate damage award numbers. *Id.*

109. *Id.* (significant at the 1 percent confidence level).

110. CHRISTOPHER L. JONES & SETH E. WEINGRAM, THE DETERMINANTS OF 10B-5 LITIGATION RISK 3 (John M. Olin Program in Law and Economics, Stanford Law School, Working Paper No. 118, June 1996).

111. Jones and Weingram identify securities class actions from *Securities Class Action Alert*. *Id.* at 23. Their sample consists of 203 Rule 10b-5 lawsuits associated with a 10 percent price drop.

all firms regardless of price drop during the 1989 to 1992 period.[112] Combining the 10 percent price drop and random samples, Jones and Weingram provide evidence that the following were all significantly correlated with an increased likelihood of a suit: (1) cumulative share turnover during the year prior to the price drop, (2) higher market capitalization, (3) lower cumulative returns over the prior year, and (4) a low absolute share price.[113] They provide more ambiguous evidence with respect to stock price volatility: more volatility in the twenty trading days leading up to a price drop is positively correlated with greater litigation risk, while more volatility during the prior year (excluding the twenty days leading up to the price drop) is negatively correlated with litigation risk.[114]

Neither Francis, Philbrick, and Schipper (1994a) nor Jones and Weingram (1996a) focused directly on the question of whether securities litigation is primarily frivolous or meritorious. Many of their identified risk factors – market capitalization, volatility, equity beta, and share turnover – may represent necessary but not sufficient factors for both frivolous and meritorious litigation. Absent these risk factors, plaintiffs' attorneys may view a suit as providing insufficient potential damages to cover the costs of plaintiffs' attorneys in pursuing litigation.

Other pre-PSLRA studies focused more directly on the importance of merit. Bohn and Choi (1996) used a sample of all the IPO firms that went public from 1976 to 1986 (consisting of 3519 IPOs) to test whether the incidence of litigation as well as settlement outcomes are driven by factors relating to the merits of the litigation.[115] Looking at suit filings, Bohn and Choi constructed a logit model for whether a firm in their sample encountered a securities class action related to the IPO.[116] As a proxy for merit, Bohn and Choi included a rating for the quality of underwriter associated with the offering derived from Carter and Manaster (1990) as an explanatory

112. They drop observations for firms that have not been listed for at least 250 trading days or that have a stock price of below five dollars or a market capitalization of below $20 million. *Id.* at 24.

113. *Id.* at 28-29.

114. *Id.* at 28-29, 38. Jones and Weingram also look at the public announcements made around a large price drop to see if any difference exists between those firms that are sued and those that are not. After controlling for other factors that may lead to a lawsuit, however, they find no statistically significant difference. *Id.*

115. James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 912 (1996).

116. *Id.* at 950-52.

variable.[117] Bohn and Choi hypothesized that to the extent higher quality underwriters associate with higher quality offerings, underwriter quality should be negatively correlated with the probability of facing a meritorious suit.[118] Bohn and Choi report that, in fact, underwriter quality is weakly (at only the 20 percent confidence level) correlated to a *higher* probability of suit in the logit model, which is weakly consistent with the alternative hypothesis that higher-quality underwriters, with deep pockets, represent desirable targets for frivolous litigation.[119]

Bohn and Choi then examined the ex-ante corporate governance structure of the IPO firms and the insider sales associated with the IPO, comparing the lawsuit firms against a matching sample of firms.[120] They report no difference in the insider sales as a fraction of the IPO offering amount.[121] Consistent with Romano's (1991) hypothesis that litigation acts as a substitute for ex-ante corporate governance, Bohn and Choi report that the IPO firms facing a lawsuit have weaker corporate governance compared with the matching sample of firms.[122] They found that the lawsuit IPO firms had significantly fewer outsiders sitting on their boards[123] In addition, the number of directorships on other corporations held by the lawsuit IPO firm's directors was also significantly less than for the matching firm's board.[124]

Bohn and Choi also analyzed those firms that settled their class action suit to determine the influence of merit-related factors on settlement. They fitted a regression model explaining the settlement amount as a function of the potential damages available for an IPO

117. *Id.* (citing Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1054-56 (1990)).

118. *Id.* Among other explanatory variables, they also included controls for the offering amount, the R&D over Sales ratio and the Ads over Sales ratio as industry controls, and whether the offer was a firm commitment offering. *Id.* Firm commitment offerings involve offerings in which the underwriter syndicate first purchases the offering from the issuer at a discount and then resells the securities to the public. In a firm commitment offering, the underwriter puts its own money (and reputation) on the line behind the offering.

119. *Id.*

120. Firms were matched based on sales and on the same three-digit standard industrial classification code. *Id.* at 959.

121. *Id.* at 961-62. *See also* CHRISTOPHER L. JONES & SETH E. WEINGRAM, THE EFFECTS OF INSIDER TRADING, SEASONED EQUITY OFFERINGS, CORPORATE ANNOUNCEMENTS, ACCOUNTING RESTATEMENTS, AND SEC ENFORCEMENT ACTIONS ON 10B-5 LITIGATION RISK 7-10, (John M. Olin Program in Law & Economics, Stanford Law School, Working Paper No. 139, 1996) (reporting from their empirical study that insider sales do not increase litigation risk in a statistically significant manner).

122. Bohn & Choi, *supra* note 115, at 962.

123. *Id.* (significant at the 5 percent level).

124. *Id.* at 966 (significant at the 10 percent level).

securities class action.[125] They then fitted an alternative regression model of the settlement amount as a function of the potential damages as the dependent variable. For explanatory variables, Bohn and Choi included whether the complaint alleges fraud in the historical financial statements, the description of business of the ability of management, or both. If merit matters, Bohn and Choi hypothesized that the alternative model should provide greater explanatory power for settlement outcomes. Comparing the two regressions using an F-test, however, they found no statistically significant difference in the fit of the two models, which is consistent with the alternate hypothesis that the merits do not matter for settlement outcomes.

Gilbertson and Avila (1999) focused specifically on securities class actions involving auditors during the pre-PSLRA time period.[126] Their sample consists of 314 securities lawsuits filed from 1990 to 1993 alleging fraud relating to the defendant company's common stock price as collected from *Securities Class Action Alert*.[127] They first examined the time between the end of the class period, presumed to indicate the date when the fraud is revealed to the market, and the filing of suit. Gilbertson and Avila contended that plaintiffs' attorneys will tend not to delay but instead will file frivolous suits soon after the end of the class period due to competition among plaintiffs' attorneys to be the first to file the suit in the pre-PSLRA time period.[128] For their full sample of lawsuit firms they reported a mean delay of seventy-eight days between the end of the class period and the filing of suit. Within the sample, over 50 percent are filed within one week of the end of the class period.[129]

While these results may indicate that filings on the part of plaintiffs' attorneys occur without much investigation, they are not necessarily inconsistent with meritorious litigation. Some types of claims, including those involving accounting restatements, may involve large amounts of public evidence of fraud immediately at the end of the class period, if not before. For such meritorious claims,

125. *Id.* at 971 ("We calculated the potential damages award for each lawsuit IPO as the difference between the offer price and the price at the end of the class period multiplied by the number of shares issued. Although Section 11 and Rule 10b-5 typically calculate the damages award based on the stock price at tbe time of the filing of suit, we used the price at the end of the class period to control for exogenous factors affecting the stock price between the end of the class period and the filing of suit.").

126. L. Gilbertson and Steven D. Avila, *The Plaintiffs' Decision to Sue Auditors in Securities Litigation: Private Enforcement of Opportunism?*, 24 J. CORP. L. 681, 681-86 (1999).

127. *Id.* at 687-88.

128. *Id.* at 690 ("If lawsuits are filed 'within hours or days,' this reinforces the belief that they are filed indiscriminately. . . .").

129. *Id.* at 692.

further investigation on the part of the plaintiffs' attorneys may be unnecessary prior to the filing of suit, leading to short filing times. Gilbertson and Avila did not, however, control for the type of allegation in the complaint.[130]

Studies have also focused on whether the PSLRA resulted in a reduction of frivolous suit filings after the enactment of the Act. The effectiveness of the PSLRA in reducing frivolous litigation is important for countries considering adoption of U.S.-style class actions but fearful of the possibility of nuisance litigation. Johnson, Nelson and Pritchard ("JNP") (2002) provided a test of whether merits matter more in the post-PSLRA time period.[131] Their sample focused only on the computer hardware and software industries[132] and included all firms in those industries targeted with a securities fraud class action from 1991 to 2000, a total of 119 lawsuits.[133] As a matching sample, JNP collected data on firms from the same industry with a similar minimum one-day return (corresponding to a large price drop) for the 250 trading days prior to the class period end.[134] Focusing on filings, they fitted a logit model using whether a firm faces a lawsuit as the dependent variable. Among independent variables, the JNP study included both market capitalization and share turnover measures to control for the potential damages possible in a lawsuit. To test for the impact of merit, they included whether the firm experienced a restatement during the class period, among other measures of aggressive accounting, and insider trading related variables.[135] To

130. Gilbertson and Avila also provide evidence that auditors tend to be sued more often when the issuer has engaged in a public offering. *Id.* at 698-700. As well, auditors are sued more often when the issuer is in financial distress. *Id.* at 700-05. They hypothesize that in cases where the issuer is in financial distress, the auditor represents a "deep pockets" source of money for the plaintiffs' attorneys. *Id.* Confirming this hypothesis, they report that the settlement amount is not related to whether the issuer goes bankrupt (supporting the notion that in such situations the auditor serves as an alternative source of money). *Id.* at 703-04. *See also* Steven P. Marino & Renee D. Marino, *An Empirical Study of Recent Securitics Class Action Settlemcnts Involving Accountants, Attorneys, or Underwritcrs*, 22 SEC. REG. L.J. 115, 115-25 (1994) (focusing on the liability of outside parties for securities fraud claims and contending that an issuer's bankruptcy will not affect settlement so long as "deep-pocket professionals make up the difference in settlement amounts.") *Id.* at 141.

131. MARILYN F. JOHNSON, ET. AL., DO THE MERITS MATTER MORE? CLASS ACTIONS UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT (Working Paper, 2002), *available at* http://papers.ssrn.com /sol3/papers.cfm?abstract_id=349500.

132 SIC 3570-3577 and 7370-7379, respectively.

133. *Id.* at 11-12. They identify sued firms from *Securities Class Action Alert* and the Stanford Securities Class Action Clearinghouse. *Id.* Fifty-one lawsuits are from the pre-PSLRA period and sixty-eight are from the post-PSLRA period. *Id.*

134. *Id.* at 13.

135. *Id.* at 16-17. The insider trading related variables included both the net purchase and sale activity for directors and top executive officers and the abnormal insider trading activity measured as the difference from the one-year prior net trading activity. *Id.*

test the significance of governance, JNP included a number of governance-related variables, including the average tenure of outside directors, the number of other directorships held by outside directors, the independence of the board, and the share holdings of outsiders and insiders.[136] JNP report that in the logit model fitted only for the pre-PSLRA period, while securities fraud class actions were more likely for higher market capitalization firms, only insider share holdings correlated with a higher likelihood of suit among the merit-based variables.[137] In contrast, when the logit model is fitted only for the post-PSLRA period, both an accounting restatement (a proxy for fraud) and the presence of net insider trading (a proxy for the motive to engage in fraud) are significantly associated with an increased likelihood of a lawsuit.[138] JNP interpreted this shift between the pre- and post-PSLRA models as consistent with the theory that the merits matter more in the post-PSLRA time period.

As a further test of the importance of the merits in the post-PSLRA period, JNP examined the determinants of allegations made in class action complaints. They constructed separate logit models for whether a complaint included an accounting allegation or insider trading allegation based on, among other factors, the presence of a restatement in the class period and other aggressive accounting-related variables, as well as their various measures of corporate governance.[139] They report that the presence of a restatement is significantly correlated with a greater likelihood of an accounting allegation in the post-PSLRA period, but not in the pre-PSLRA time period.[140] Similarly, the presence of net insider trading is significantly correlated with a higher probability of an insider trading allegation in the post-PSLRA time period, but not in the pre-PSLRA time period.[141]

JNP then looked at the outcomes of litigation by fitting a logit model for whether a suit resulted in either a dismissal or low-value

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136. *Id.* at 17-18.

137. *Id.* at 19.

138. *Id.* at 20. The JNP study also reports from their post-PSLRA model that firms with outside directors who sit on more other boards are also more likely to face a suit. *Id.*

139. *Id.* at 20-21. For the logit model for the presence of an accounting allegation, the JNP study also includes the presence of an insider trading allegation. Likewise in the insider trading model, the JNP study includes the presence of an accounting allegation. Once a complaint is filed, plaintiffs' attorneys face a low cost to add on more allegations. In the pre-PSLRA period, the JNP study reports a significant positive relationship between the filing of one complaint and the filing of the other. In the post-PSLRA period (with the onset of pleading with particularity requirements and the requirement that each allegation must be specifically stated), they report no significant relationship between the presence of one type of allegation and the other. *Id.*

140. *Id.* at 21.

141. *Id.*

settlement compared with a higher value settlement.[142] The independent variables of the logit model include the same accounting restatement variable and other aggressive accounting variables used in their earlier tests, as well as their measures of corporate governance. JNP, however, did not include a measure of potential damages into the settlement model.[143] They noted that when fitted for the pre-PSLRA time period, only the presence of abnormal insider sales was significant, with a positive relationship with high-value settlements.[144] When they fitted the logit model for the post-PSLRA time period, they noted that the presence of an accounting restatement is significantly related to a higher probability of a high-value settlement.[145] In contrast, the insider trading variables, including abnormal insider sales, are not significant in the post-PSLRA model.[146] JNP concluded that their study provides evidence that the PSLRA worked to increase the importance of factors related to fraud in determining the filings, allegations, and outcomes of securities class actions in the post-PSLRA time period.

Another post-PSLRA study of the merits, Pritchard and Sale (2003), examined the impact of the PSLRA's heightened pleading standards on the ability of plaintiffs to survive a motion to dismiss.[147]

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142. Low-value settlements are defined as a settlement for $2 million or under and are therefore indicative of a nuisance suit. While not a perfect division between nuisance and non-nuisance suits, the $2 million mark provides a rough approximation. To the extent defendants settle nuisance suits to avoid defense litigation costs as well as possible distraction on management and negative publicity, the maximum amount defendants will settle a nuisance claim typically will not exceed $2 million. Joseph A. Grundfest, *Why Disimply*, 108 HARV. L. REV. 727, 740-41 (1995) (contending that "a key statistic in the merits debate is the difference between the observed settlement amount and the amount a defendant would be willing to pay simply to avoid the costs of mounting a defense."). In reviewing settlement data from other studies, Grundfest adopts the rule that settlements for less than a cutoff ranging from $2.5 to $1.5 million are nuisance in the sense that "the merits may not have mattered at all in the resolution of the litigation." *Id.* at 742-43. Johnson and her fellow authors explain that they chose not to fit a more linear model based on the size of the settlement amount due to a possible omitted variables problem – the amount of D&O liability insurance may affect the settlement amount, and for most companies, the D&O policy is unobtainable. *See* JOHNSON ET AL., *supra* note 131, at 22 n.6.

143. In explanation, the authors write: "We exclude the market variables, which are relevant to damages calculations, from this regression because the dependent variable is intended to proxy for merit." *Id.* at 22.

144. *Id.* One could argue, however, that companies able to pay higher damages may settle even nuisance litigation for higher amounts out of a risk averse driven fear of what might happen at trial (and therefore may make a nuisance settlement of greater than $2 million).

145. *Id.* The authors also report that the amount of shares in the hands of insiders is also positively related to a higher probability of a high-value settlement. *Id.*

146. *Id.* at 22-23. The authors write that "[t]he use by plaintiffs' lawyers of this cruder proxy for fraudulent intent is apparently not rewarded." *Id.* at 23.

147. A.C. PRITCHARD & HILLARY A. SALE, WHAT COUNTS AS FRAUD? AN EMPIRICAL STUDY OF MOTIONS TO DISMISS UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT (U. Mich.

The PSLRA's heightened pleading standard is somewhat ambiguous, leaving different circuits the ability to apply varying standards. Pritchard and Sale's study attempts to provide evidence on the importance of law and variances in the law across the circuits in determining dismissal outcomes by focusing on post-PSLRA motion to dismiss decisions in the Second and Ninth Circuits.

Pritchard and Sale's sample consisted of 150 motion to dismiss decisions (65 Second Circuit decisions and 90 Ninth Circuit decisions) from 1996 to 2001 obtained from Lexis and Westlaw searches among other sources.[148] They hypothesized that more concrete accounting claims, particularly related to revenue restatements, are more likely to survive the heightened post-PSLRA pleading requirements. In addition, claims involving a company that recently offered securities or that is involved in a merger, giving the company some motive to overstate the value of its securities, are also more likely to survive. On the other hand, because of the PSLRA's provision of a forward-looking statement safe harbor, they predicted that such complaints are more likely to receive a dismissal.[149]

To test these hypotheses, Pritchard and Sale fitted a logit model with dismissal as the dependent variable and various variables related to the hypotheses as their independent variables.[150] From the logit model, Pritchard and Sale report that while revenue related accounting violations are not significantly related to dismissals, other GAAP allegations are negatively correlated with dismissals, particularly in the Second Circuit.[151] Neither offering nor merger-related variables are statistically significant. On the other hand, somewhat surprisingly, forward-looking statements are correlated with a decreased likelihood of a dismissal in the Second Circuit in particular.[152]

Working Paper #03-011, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=439503.

148. *Id.* at 17.

149. *Id.* at 11-17.

150. *Id.* at 23.

151. *Id.* (significant at the 5 percent level). Pritchard and Sale also report that insider-trading related claims are significantly and positively correlated with a dismissal. *Id.* They write that this result supports the "contention that courts are skeptical of the rather noisy signal provided by such trades. Recall that these trades are pleaded in many complaints and that the presence of options as a form of pay is likely to increase trades by insiders, and, thereby, the possibility of including them in pleadings." *Id.* at 25.

152. *Id.* (significant at the 5 percent level). The sample of cases facing a motion to dismiss is not necessarily exogenous to the legal regime. The harder it is to pass through a motion to dismiss, the more likely plaintiffs' attorneys may not file a case in the first place. The finding that even with a forward-looking information safe harbor, the allegation of fraud involving a forward-looking statement is correlated with a lower probability of dismissal may simply be due

While demonstrating that differences certainly exist among the circuits, Pritchard and Sale's study does not directly provide information on the impact of the PSLRA itself. Rather than comparing motions to dismiss prior to the PSLRA against such motions after the PSLRA, the authors instead focused on post-PSLRA dismissal motions in the Second and Ninth Circuits. The study does not reveal what factors were important to motions to dismiss *prior* to the PSLRA and how the PSLRA changed such factors.

Bajaj, Muzumdar, and Sarin ("BMS") (2003) provide analysis of summary statistic data related to securities filing and settlement data obtained from *Securities Class Action Alert* from 1988 to 1999.[153] Their sample consisted of 2,167 federal court securities filings and 579 state court filings.[154] Using this sample, BMS first report that federal court filings dropped immediately after the passage of the PSLRA in 1996. Federal court filings went from 191 in 1995 down to 119 filings in 1996. By 1998, however, the number of federal court filings was at a sample high of 248 filings.[155] BMS also note that the types of allegations shifted post-PSLRA, reporting that the number of cases alleging accounting related fraud increased, while cases alleging a more generic failure to disclose decreased.[156] While BMS failed to provide any tests of the statistical significance of these filing trends, they are consistent with the hypothesis that post-PSLRA, plaintiffs' attorneys shifted their focus toward cases where fraud is more easily proven, avoiding more ambiguous instances of fraud that may cost more to prosecute and face a higher risk of dismissal pursuant to the heightened pleading requirements under the PSLRA.

BMS also report data on settlements. They reported that the fraction of cases settling within four years of the filing date dropped from 57.59 percent pre-PSLRA to only 26.06 percent post-PSLRA.[157] In addition, while 2.67 percent of cases settled within one year pre-PSLRA, only 0.67 percent settled within one year post-PSLRA.[158] To the extent defendants will settle an even frivolous lawsuit to avoid the

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to the fact that plaintiffs' attorneys only file very strong forward-looking statement cases in anticipation of the difficulty of surviving a motion to dismiss.

153. Mukesh Bajaj et al., *Securities Class Action Settlements*, 43 SANTA CLARA L. REV. 1001, 1003 (2003).

154. *Id.*

155. *Id.* at 1004-05.

156. *Id.* at 1006-07. The authors also report that the number of cases filed against auditors and accountants dropped in 1998 and 1999 compared with earlier years. *Id.* at 1008.

157. *Id.* at 1010.

158. *Id.* The authors also report that the fraction of filings dismissed within four years after the filing date also diminishes post-PSLRA from 10.89 percent pre-PSLRA down to 5.79 percent. *Id.* at 1011.

high cost of defending such an action over time (in terms of attorney's fees, management distraction, and the cloud of litigation over the company's business), frivolous suit settlements should occur relatively quickly after the filing of a suit. The lower frequency of quick settlements post-PSLRA thus provides some evidence that frivolous suits were reduced after the enactment of the Act, although, again, the authors provided no test of statistical significance.

BMS then examined settlement amounts after the enactment of the PSLRA. They reported higher mean and median settlement amounts post-PSLRA.[159] Moreover, particularly in the post-PSLRA period, BMS reported that the mean and median settlement amounts tend to increase the longer it takes for settlement to occur.[160] Put another way, cases settling within one year of the filing date, representing potentially frivolous suits, settled for the lowest amount of money, which supports the hypothesis that defendants settle such suits quickly, simply to rid themselves of the nuisance of defending the suit.[161]

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159. *Id.* at 1022-23. The mean settlement amount post-PSLRA is $18.09 million in their sample (compared with $8.01 million pre-PSLRA). The median settlement amount was $4.24 million in their sample post-PSLRA (compared with $3.5 million pre-PSLRA). *Id.*

160. *Id.* at 1012. The median settlement amount for cases settled within two years of the filing date is equal to $6.3 million. *Id.* at 1032. Consistent with the notion that more meritorious cases receive higher settlement amounts, suits involving accounting practices (and thus cases with potentially more concrete evidence of wrongdoing on the part of the company) received a higher median settlement amount ($10 million) compared with all other settlements (ranging from $2.675 million and $4 million). *Id.* at 1027.

161. Simmons (2002) also provides a summary statistic view of post-PSLRA settlements compared with settlements prior to the PSLRA. *See* Laura E. Simmons, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2001* (Cornerstone Research Monograph, 2002), *available at http://www.cornerstone.com/fram_res.html.* (Her dataset consists of 303 post-PSLRA settlements for cases filed after December 22, 1995 involving an allegation that fraud inflated a company's stock market price and that also settled by December 2001. For the pre-PSLRA period, she collects 125 Rule 10b-5 related cases filed between January 1, 1994 and December 31, 1994.) *Id.* The pre-PSLRA dataset is described more fully in her earlier monograph, Laura E. Simmons, Securities Lawsuits: Settlement Statistics for 10b-5 Cases (Cornerstone Research Monograph, 1997), *available at http://www.cornerstone.com/fram_ res.html.* She first reports that median and mean settlement amounts are higher in the post-PSLRA time period. *Id.* at 2. On the other hand, the frequency of settlements for less than $1 million (which may indicate a frivolous lawsuit settlement) is not significantly different between the pre- and post-PSLRA periods. *Id.* In addition, the settlement amount as a percentage of the potential plaintiff's damage award is reduced in the post-PSLRA time period. *Id.* The mean settlement amount as a percentage of the potential damage award is equal to 5.1 percent in the post-PSLRA time period and 7.2 percent in the pre-PSLRA time period. *Id.* Simmons does not provide any statistical tests of her results; thus, it is difficult to ascertain the significance of the differences she identifies. Focusing solely on the post-PSLRA time period, Simmons also describes several factors that correlate with higher settlement amounts (measured as a percentage of the potential damage award). She reports that cases involving GAAP accounting allegations, accounting restatements, and auditor defendants all resulted in a higher mean settlement amount as a percentage of the potential

In sum, the existing literature on filings and settlements in the post-PSLRA time period provide evidence that frivolous suits existed prior to the PSLRA and that a shift occurred in the post-PSLRA period toward more meritorious claims. Lawsuits relating to more obvious indicia of fraud, such as accounting restatements, are more prevalent in post-PSLRA filings and are more important in determining outcomes in the post-PSLRA time period. Cases also seem to take longer to settle in the post-PSLRA period, indicating perhaps more work on the part of plaintiffs' attorneys in litigating these suits.

A question that arises from these empirical results, however, is that while frivolous suits may very well be less prevalent post-PSLRA, are meritorious suits also less prevalent? The fact that in the post-PSLRA period merits are more important among firms that are actually sued could result from one of two possibilities. First, primarily frivolous suits drop out, leaving only the meritorious end of the spectrum. In this case the PSLRA is unambiguously welfare-increasing, at least before taking into account the costs of implementing the Act. Second, both frivolous suits and a large portion of the meritorious suits may drop out, leaving primarily meritorious suits again in the set of firms that are sued, but with far different welfare implications.[162] If the second alternative is the case, lawmakers must then balance the gain from the loss of the frivolous suits (reducing Type I errors) against the loss from the reduction in meritorious suits (increasing Type II errors) to determine whether the PSLRA in fact is worthwhile.[163]

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damage award compared with cases not involving these factors. *Id.* at 6. Simmons reports that the presence of a Section 11 claim or an underwriter as a defendant also correlate with higher settlement amounts as a percentage of the potential damage award. *Id.* at 7. On the other hand, she does not find evidence that insider trading allegations or the industry of the issuer correlate with settlement amounts when other factors are taken into account (including the asset size of the defendant company and the presence of GAAP accounting allegations). *Id.* at 8.

162. While this Article was in the editing stages, a couple of papers related to the question of whether the PSLRA also deterred meritorious litigation were posted on www.ssrn.com. *See* STEPHEN J. CHOI, DO THE MERITS MATTER LESS AFTER THE PRIVATE SECURITIES LITIGATION REFORM ACT? (Working Paper, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract _id=558285 (providing evidence that meritorious claims lacking obvious hard indicia of fraud, such as an accounting restatement or SEC action, are less likely to be filed and face a greater likelihood of receiving a dismissal or low-value settlement in the post-PSLRA period); ERIC L. TALLEY AND GUDREN JOHNSEN, CORPORATE GOVERNANCE, EXECUTIVE COMPENSATION, AND SECURITIES LITIGATION (Working Paper, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract _id=536963 (providing evidence that executive compensation and securities litigation work as complements and also reporting evidence inconsistent with the hypothesis that the PSLRA reduced frivolous litigation without also deterring meritorious suits).

163. *See* Lynn Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711, 711-15 (1996) (putting forth the hypothesis that the PSLRA may have negatively impacted meritorious litigation as well as frivolous suits); Hillary Sale,

As discussed earlier, one reason that the PSLRA may result in even meritorious suits dropping out is the higher costs for plaintiffs' attorneys pursuing such litigation.[164] In particular, the PSLRA's pleading with particularity requirements and prohibition on discovery prior to the motion to dismiss raise costs for plaintiffs' attorneys. Plaintiffs' attorneys who suspect actual fraud and might have been willing to file suit prior to the PSLRA may simply choose not to do so post-PSLRA due to these higher costs. Not all cases of actual fraud involve obvious ex ante indicia such as accounting restatements. Indeed, even where financial accounting fraud is alleged, a securities class action itself may help reveal the fraud through discovery, at least prior to the PSLRA, leading to an eventual accounting restatement. Since the PSLRA's enactment, plaintiffs' attorneys face far higher costs and risks from investigating for more "soft" fraud where a restatement or other indicia of fraud does not *already* exist prior to the filing of suit.

B. Class Action Incidence

A separate issue from whether the PSLRA reduces meritorious claims involving less obvious prefiling indicia of fraud for even large companies is the fate of smaller companies. Evidence from the pre-PSLRA time period indicates that smaller companies rarely, if ever, faced a securities class action. Simply put, such actions are not cost-effective for attorneys facing a high fixed cost of litigation.

Jones (1980a) assembled a dataset of 190 public corporations (80 chosen from among large firms based on Fortune rankings and 110 randomly selected firms) and examined the frequency with which these firms faced a shareholder class action or derivative suit from 1971 to 1978.[165] Jones looked to SEC filings for information on shareholder suits.[166] Over the sample time period, Jones reported 228 shareholder suits filed against the 190 firms, a mean of 1.2 lawsuits per firm.[167] Significantly, Jones reported that the incidence of

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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. UNIV. L. Q. 537, 537-38 (1998) (voicing the concern that the PSLRA's heightened pleading requirement for fraud combined with a stay in discovery would unduly restrict meritorious litigation).

164. *See supra* Part II.A (discussing the increased costs for plaintiffs' attorneys due to the PSLRA).

165. Thomas M. Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Suits* 1971-78, 60 B.U. L. REV. 306, 307-08 (1980).

166. *Id.* at 308.

167. *Id.* at 312. Many of the suits involved multiple suits filed against the same firm with substantially the same claim. *Id.* at 313. Looking only at disputed issues, only eighty-seven

shareholder suit filings skewed toward the larger firms in his sample.[168]

Alexander (1991) provided an early test for the presence of frivolous securities litigation.[169] Her sample consisted of seventeen computer and computer-related companies that went public in the first half of 1983.[170] She calculated the total post-IPO market value loss for each firm from the date of the IPO to March 30, 1984.[171] Alexander reported that every firm with a decline in market value of at least $20 million was sued, a total of nine out of her sample of seventeen firms.[172] Alexander also looked at the twelve worst-performing IPOs of 1983, based on market value loss as of March 30, 1984. She reported that all the IPOs with a loss over $33 million were sued while none of the IPOs with a loss of under $33 million were sued.[173] Alexander concluded that her evidence "strongly suggest[s] that suits alleging securities violations were filed whenever the stock price declined sufficiently following the IPO to support an award of attorneys' fees that would make it worthwhile to bring a case."[174]

Bohn and Choi (1996) provide evidence on the incidence of securities class action for firms conducting an initial public offering as a function of the offering amount.[175] They examined a comprehensive sample of all initial public offerings from 1976 to 1986, for a total of

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separate disputed issues were filed against the sample of firms during the sample time period (or a mean of 0.46 per firm for the eight-year period). *Id.* at 312-13.

168. *Id.* at 316. While the 80 large firms faced a shareholder suit on average 2.23 times during the eight-year sample time period, the 110 randomly selected firms faced a suit only 0.45 times during the same period. *Id.*

169. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 497-519 (1991).

170. *Id.* at 510. Alexander obtains a list of IPOs from Venture Capital Survey. *Id.* at 510 n.38.

171. *Id.* at 511-12. The total market value loss is defined as the difference between the offering price and the price on March 30, 1984, multiplied by the number of shares sold in the IPO. *Id.*

172. *Id.*

173. *Id.*

174. *Id.* at 513. Weighing in on the meritorious versus frivolous debate in the pre-PSLRA time period, Alexander also looks to the outcomes for the nine securities class actions she identifies in her sample. She reports that all the cases settle and, importantly, for approximately the same fraction of the potential stakes involved in the litigation. *Id.* at 517. Alexander defines the litigation stakes as the difference between the offering price and the price of the shares on the day after the last day of the class period multiplied by the number of shares sold in the IPO. *Id.* at 516. Alexander reports that five of the cases settled for between 24.5 percent and 27.5 percent of the potential litigation stakes. *Id.* at 517. Alexander writes that "the uniformity of outcomes is even more surprising since it occurred despite significant litigation events in some cases that would ordinarily be expected to have an effect on their outcomes." *Id.* at 519.

175. Bohn & Choi, *supra* note 115, at 903, 927.

3519 IPOs.[176] Obtaining information from SEC filings, they reported that 123 of the IPO firms encountered a securities fraud class action related to the IPO.[177] Importantly, only IPOs over a minimum offering size faced an appreciable number of class actions – less than 1 percent of the IPOs with an offering amount of less than $5 million faced a class action. For the 329 IPOs with less than $1.79 million as their offering amount, only one faced a securities class action.[178] In contrast, for those IPOs above approximately $40 million in offering amount, over 12 percent were sued with a securities fraud class action.[179] Assuming that small issuers are no less inclined to engage in fraud than larger issuers, the size effect for securities class actions indicates a lack of private enforcement for smaller offerings.

Grundfest and Perino (1997) provide summary statistic evidence on the early post-PSLRA experience, covering 1996.[180] Relevant for the question of whether size matters in securities class actions, Grundfest and Perino reported an increase in the average price decline for firms facing a lawsuit in the post compared with pre-PSLRA time period.[181] They explained the increase in the price decline was necessary to show more "wrongdoing" due to the greater obstacles the PSLRA places before plaintiffs.[182] On the other hand, Grundfest and Perino also provided evidence that the mean market

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176. *Id.* at 927.

177. *Id.* at 929.

178. *Id.* at 936 ("The most striking result from this summary data is that smaller sized offerings hardly ever experience a securities-fraud suit."). *Id.*

179. *Id.* at 936.

180. Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience,* 1015 PLI/Corp 955, 957 (1997). Similar with JNP (2002) and BMS (2003), Grundfest and Perino also report a shift in the types of claims in the post-PSLRA time period to primarily accounting irregularities and insider trading claims. *Id.* at 973-74. While about a third of the Rule 10b-5 claims in the pre-PSLRA period involved misrepresentations of financials, Grundfest and Perino report that about two-thirds involved such allegations in the post-PSLRA period. *Id.* Grundfest and Perino also note a shift in the filing of claims toward state court. *Id.* at 966-68. This shift eventually prompted Congress to preempt many of the securities claims going toward state court in the Securities Litigation Uniform Standards Act of 1998. As well, Grundfest and Perino note a large fraction of claims involving false forward-looking statements despite the implementation of a forward-looking statement safe harbor under the PSLRA. *Id.* Grundfest and Perino report that 60.9 percent of the Rule 10b-5 cases involved an allegation of a false or misleading forward-looking statement in the post-PSLRA period. *See id. See also* Joseph A. Grundfest et al.., *Securities Class Action Litigation in Q1 1998: A Report to the Nasdaq From the Stanford Law School Securities Class Action Clearinghouse,* 1070 PLI/CORP 69 (1998) (confirming the continuation of the predominance of accounting irregularity and insider trading allegations).

181. Grundfest & Perino, *supra* note 180, at 971. They report a mean one-day stock price decline around the end of the class period for Section 10(b) litigation pre-PSLRA of 19%. The post-PSLRA mean price decline in comparison was 31%. *Id.*

182. *Id.* at 972.

capitalization of sued firms decreased in the post-PSLRA time period.[183] The Grundfest and Perino study, however, did not provide tests of statistical significance.

C. Plaintiffs' Attorney Agency Problems

Even if the merits do matter more in the post-PSLRA time period, another question to consider is whether this shift has resulted in any substantial benefits for the plaintiff class in cases of meritorious claims. Where plaintiffs' attorneys routinely dictate the terms of attorney's fees and costs, the plaintiff class may only fractionally gain, even for meritorious litigation. Of course, from an ex ante point of view, shareholders may still benefit from the deterrent effect of litigation even where much of the return goes to the plaintiffs' attorneys from the litigation itself. Nonetheless, where plaintiffs' attorneys shirk and fail to pursue a securities class action to the extent the class desires, the level of deterrence against firms is reduced.

In the pre-PSLRA time period, Jones (1980b)[184] examined litigation outcomes from his sample of shareholder derivative and class actions as described in Jones (1980a) above.[185] He supplemented his sample in Jones (1980a) with fifteen additional firms known to have been involved in shareholder litigation during his sample time period from 1971 to1978.[186] Of the 348 suits in his sample where the resolution was known, he reports that 70.7 percent resulted in settlement. Among those cases that did not settle, most resulted in a decision for the defendants: the plaintiffs won judgment at trial in only 0.6 percent of the cases.[187] Significantly, Jones (1980b) provides limited data on attorney fees. Of the thirteen cases in this sample where he had data, Jones reports that the mean attorney fees as a percentage of the settlement award was 16.2 percent.[188]

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183. *Id.* at 969. The mean market capitalization of a lawsuit pre-PSLRA firm was $2.08 billion while the market capitalization of a post-PSLRA firm was $529.3 million. *Id.* Grundfest and Perino report that the drop in the post-PSLRA mean market capitalization is due in large part to the lack of litigation against very large issuers (those issuers with "market capitalization in excess of $5 billion"). *Id.* They explain this drop in litigation as follows: "the preponderance of post-Reform Act litigation involves allegations of accounting irregularities and trading by insiders. Larger, more established firms are less likely sources of material accounting irregularities or statistically significant trading by insiders." *Id.* at 970.

184. *See* Jones, *supra* note 165, at 542.

185. *See supra* notes 165-168 and accompanying text (describing the Jones (1980a) study).

186. *See* Jones, *supra* note 165, at 543.

187. *Id.* at 545.

188. *Id.* at 567.

Indirect evidence from the post-PSLRA period suggests that the PSLRA did not work as intended to involve institutional investors more greatly in securities class action litigation. Cox and Thomas (2002) examined the role of institutional investors in both prosecuting securities class actions and filing claims in class settlements post-PSLRA.[189] Through a Westlaw search of the ALLFED database, they collected a sample of court decisions appointing a lead plaintiff from January 1, 1996 to December 15, 2001.[190] In their resulting sample of thirty-three cases, Cox and Thomas report that sixteen of the cases involved a non-institutional lead plaintiff, five of which were selected over an institutional investor.[191]

Cox and Thomas's results thus present a puzzle: why are institutional investors not taking better active advantage of the Reform Act's lead plaintiff presumption? Indeed, to the extent the ALLFED database represents a biased sample of the universe of all class actions, overly representing larger claims where institutions are more likely to participate, the lack of institutional investor activity is most likely more pronounced for the universe of all class actions. Cox and Thomas also provide data drawn from securities class action administrators on the settlement awards that institutional investors claim. For the two administrators on which they had data, they report that institutions file only 32.78 percent and 23.01 percent, respectively, of the claims which the institutions are eligible to file.[192]

Further study is required to assess the relative power of plaintiffs' attorneys and the plaintiff class in the post-PSLRA time period. For example, one could examine the attorney's fees as a fraction of the overall settlement award to see if this changed from the pre- to post-PSLRA period. Another possibility to consider is whether plaintiffs' attorneys may attempt to "make work" to justify higher fee awards in the post-PSLRA time period under the expectation that courts and the lead plaintiff may scrutinize the work of the plaintiffs' attorneys more closely.

To test the "make work" hypothesis, one could look at the settlement amount over the amount of time it takes to resolve the case (the "settlement per unit resolution time"). If plaintiffs' attorneys are working hard in an effective manner to benefit the class, it might be

189. *See generally* James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Action?,* 80 WASH. U. L.Q. 855, 855-65 (2002) (examining the role of institutional investors in both prosecuting securities class actions and filing claims in class settlements post-PSLRA).

190. *Id.* at 859.

191. *Id.*

192. *Id.* at 876-77.

predicted that the settlement per unit resolution time would increase in the post-PSLRA time period. A reduction in the settlement per unit resolution time, however, may indicate that plaintiffs' attorneys are working less efficiently in the post-PSLRA time period, which is consistent with the hypothesis that they are engaged in making work to justify maintaining high fees even for relatively straightforward meritorious cases.[193]

D. Other Issues

Another indirect way of measuring the impact of securities class actions on corporate policies is to examine how the threat of such actions affects firm information disclosure policy. If the threat of class actions (particularly frivolous suits) causes firms to disclose less, this may reduce the overall amount of information in the market to the detriment of investors.

In the pre-PSLRA period, Francis, Philbrick, and Schipper (1994b) ("FPS") examined the relationship between the incidence of Rule 10b-5 securities litigation and a corporation's disclosure policy.[194] They first constructed a lawsuit sample consisting of forty-five firms in the biotechnology, computing, electronics, and retailing industries.[195] These firms were targets of a Rule 10b-5 lawsuit relating to an adverse earnings report during 1988 to 1992 as identified from *Securities Class Action Alert*.[196] For comparison purposes, FPS also constructed a set of fifty-one "at-risk" firms with both a quarterly earnings per share and sales decline of at least 20 percent during 1987-1991, as reported in the Compustat database.[197] Interestingly, FPS noted that there was only one overlap between firms in the lawsuit sample and at-risk firms.[198] Put another way,

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193. Of course, a drop in the settlement amount per unit resolution time ratio may simply indicate that the PSLRA either increased the amount of time to resolve suits, all other things being equal, or raised the difficulty for plaintiffs' attorneys to obtain any given level of settlement amount. Any study looking at the "make work" hypothesis would have to distinguish among such competing hypotheses.

194. *See* Jennifer Francis et al., *Shareholder Litigation and Corporate Disclosures*, 32 J. ACCTING RES. 137, 137-39 (1994) (examining Rule 10b-5 and its relationship with a corporation's disclosure policy).

195. The SIC Codes for the industries are as follows: biotechnology (2833-2836 and 8731-8734), computers (3570-3577 and 7370-7374), electronics (3600-3674), and retailing (5200-5961). *Id.* at 144.

196 *Id.*

197. *Id.* at 144-45.

198. Francis and her fellow authors also report that the timing and metbod with which poor earnings are disclosed also does not distinguish the lawsuit and at-risk sample of firms, despite the argument made by others that early disclosure of poor earnings may lessen the litigation

despite the statistically greater earnings decline in the at-risk sample, most at-risk firms were not sued.

FPS posited that other factors must determine the incidence of litigation, including possibly the existence of inflated prices prior to the adverse earnings announcement. Inflated prices may indicate that the firm may have misled the market prior to the adverse earnings disclosure.[199] To test for inflated prices, they performed event studies around the adverse earnings announcements and reported that lawsuit firms experienced both a greater negative abnormal return on the announcement date as well as a significantly greater dollar amount of loss in shareholder value.[200] However, FPS found no correlation between the magnitude of the market value decline and the tone (for example, optimistic) or frequency of the pre-announcement disclosures, which is inconsistent with the hypothesis that inflated prices correlate with a firm misleading the market.[201]

To test the role of disclosure in mitigating the risk of securities fraud litigation, FPS examined the first disclosure containing precise information about adverse earnings for firms in the lawsuit and at-risk samples. A hypothesis exists that early disclosure of fraud helps reduce a company's exposure to fraud.[202] In contrast with this hypothesis, FPS reported that the lawsuit sample contained a significantly higher proportion of early disclosures about the fraud.[203] Similarly, FPS also reported that they found no significant differences

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risk. They report that "for 28 of the 45 observations in the litigation sample, the litigation was based on an earnings forecast or a preemptive earnings disclosure, not an earnings announcement. For 46 of the 53 observations in the at-risk sample, the negative earnings news was not disclosed until the formal earnings announcement." *Id.* at 138.

199. The authors "focus on the link alleged by plaintiff that defendant firms' disclosure strategies induced plaintiff to buy stock at inflated prices." *Id.* at 149.

200. *Id.* at 153-54. The mean drop in shareholder value for the lawsuit sample was $140.68 million while the mean drop for the at-risk sample was only $7.87 million. *Id.* The authors also examine whether the lawsuit firms have more optimistic pre-earnings disclosures or analyst forecast errors around the adverse earnings than the at-risk firms and find no significant differences between the two samples. *Id.* at 162-63.

201. *Id.* at 157.

202. At the very least, for example, early disclosure may reduce the class period and thereby reduce secondary market damages for Rule 10b-5 liability.

203. *Id.* at 148. The authors write that "within the at-risk sample, 46 of 53 earnings reports (87%) were quarterly earnings announcements, while with the shareholder lawsuit sample, 28 of 45 similar events (62%) were earnings forecasts or preemptive disclosures." *Id.* On the other hand, the relationship between early mitigating disclosures and the incidence of litigation is likely endogenous. While early disclosures may lead to a lower risk of litigation, a firm facing a higher risk of litigation may choose to engage in more disclosures to mitigate this risk. Thus, observing that lawsuit firms tend to make more early disclosures does not answer the question of whether early disclosures in fact reduce the risk of litigation. The FPS study recognizes this possibility and states that "[t]he possibility remains, however, that such disclosure may provide benefits in the form of reduced litigation-related costs." *Id.*

in analyst forecast errors between at-risk and litigation firms.[204] Looking at the magnitude of price declines, FPS did find some evidence nonetheless that disclosures related to a negative earnings revision, conditioning for the type and tone of the disclosures, can reduce the severity of the price declines for some, but not all, firms and thereby can also reduce the expected damages in litigation.[205]

Johnson, Kasznik, and Nelson (JKN) (2001) focused specifically on the impact of the PSLRA's provision regarding the safe harbor for forward-looking statements.[206] Their sample consisted of 523 firms drawn from the computer hardware, computer software, and pharmaceutical industries.[207] They compared two time periods: pre-PSLRA (calendar year 1994) and post-PSLRA (calendar year 1996).[208] Looking first at how firms changed their voluntary reporting of earnings and sales forecasts, JKN reported that the number of firms issuing at least one forecast, as well as the total number of mean forecasts per firm, increased significantly from the pre- to post-PSLRA time period.[209] They also reported that the proportion of "bad news" forecasts, defined as forecasts worse than prior investor expectations or the prior year's historical results, increased in the post-PSLRA time period.[210]

To control for other possible factors that may affect a firm's decision to issue a forecast, JKN fitted a logit model using whether a firm issued at least one forecast during a particular year as the explanatory variable. For independent variables, they included whether the year is pre- or post-PSLRA, in addition to variables

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204. *Id.* at 139 ("In fact, we observe more negative forecast errors for the at-risk firms than for the litigation firms, and there is little difference in the sign or magnitude of forecast revisions over the preceding year.").

205. *Id.* at 140 ("[A]though we find that the number and tone of prior disclosures had no impact on the *average* market response to adverse earnings news, firm-specific tests show that conditioning on prior and concurrent disclosures significantly reduces the magnitude of percentage price declines observed for a subset of firms.").

206. *See* Marilyn F. Johnson et al., *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms*, 39 J. ACC. RES. 297, 297-99 (2001) (setting forth a focus on the PSLRA's statement regarding safe harbor from litigation).

207. The corresponding SIC codes are as follows: computer hardware (3570-3577), computer software (7371-7379), and pharmaceutical (2833-2836). *Id.* at 305.

208. *Id.*

209. *Id.* at 306-07. Earnings and sales forecasts are obtained through searches on Lexis/Nexis. *Id.* at 305-06. Comparing the pre- and post-PSLRA time periods, the authors report that 44 percent of firms issued an earnings forecast pre-PSLRA compared with 50 percent post-PSLRA. *Id.* at 306. Perhaps more importantly, 31 percent of the sample firms issued more forecasts post-PSLRA (and 62 percent of the firms increasing disclosure issued no forecasts pre-PSLRA). *Id.* at 313.

210. *Id.* The proportion of bad news forecasts increased from 30 percent pre-PSLRA to 37 percent in the post-PSLRA time period. *Id.* at 306-07.

related to change in earnings, the asset size of the firm, and whether the firm engaged in a public offering during the year in question or the following year.[211] From the logit model, JKN reports a significant increase in firms issuing long-term, positive forecasts in the post-PSLRA period. They also report a significant increase in firms issuing short-term, bad news forecasts, lending some support to the hypothesis that forecasts increased post-PSLRA.[212]

One fear of the forward-looking statement safe harbor is that firms may disclose lower quality (for example, more error-prone) forecasts once the possibility of litigation is reduced or eliminated under the PSLRA. JKN, however, reports that forecast errors are not significantly different in the pre- and post-PSLRA periods.[213] JKN concludes: "Taken together, our evidence does not support allegations that the safe harbor provides a 'license to lie.' "[214]

IV. IMPLICATIONS FOR KOREA

So what should we make of the evidence regarding the experience of the U.S. with private securities fraud class actions? Further, what does this evidence tell us about the desirability of implementing a U.S.-style securities class action regime in other countries? Countries vary along a wide variety of dimensions including size, type of government, and education system. Instead of engaging in a comprehensive global analysis of how class actions

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211. *Id.* at 308.

212. *Id.* at 315. The coefficient on the post-PSLRA time period is positive but significant at only the 20 percent level for the sample covering all types of forecasts. *Id.*
The authors also develop a logit model for whether a firm issued more forecasts in the post- compared with pre-PSLRA time period (1=yes; 0=no). They include a measure for predicted firm-specific litigation risk as well as differences in a firm's earnings, assets, and financing activities between the pre- and post-PSLRA time periods as independent variables. *Id.* at 310. In the model, the coefficient on litigation risk is positive and significant for the sample including all forecasts, providing support for the hypothesis that the PSLRA's forward-looking safe harbor helped induce more forecasts particularly for firms fearful of securities litigation. *Id.* at 317-18.

213. The JKN study reports that the mean forecast error (measured by the actual earnings (or sales) minus the forecast scaled by lagged total assets) in the pre-PSLRA time period is -0.019 and the forecast error in the post-PSLRA period is -0.021 (and neither is statistically significant from zero). *Id.* at 320. To control for other factors affecting the quality of forecasts, JKN fit a model with the forecast error defined above as the dependent variable. *Id.* at 311. The model includes as independent variables a dummy variable for the pre- and post-PSLRA time period, log of total assets, whether the firm was engaged in a public offering in the year of or the year following the forecast, the horizon of the forecast, and changes in the firm's performance. *Id.* They report that the coefficient on the dummy variable for the post-PSLRA time period is not statistically significant, in support of the hypothesis that the quality of forecasts remained unchanged in the post-PSLRA period. *Id.*

214. *Id.* at 298.

would perform generally across the world, this Article focuses on one specific country: South Korea.

Korea has often looked to the U.S. securities regime as a model for how to regulate the Korean securities markets. Shortly after the SEC promulgated Regulation FD in 2000,[215] for example, Korea followed suit with its own version of prohibitions against selective disclosures.[216] The recent enactment of a class action law in Korea, moreover, makes the transferability of U.S.-style class actions to another country a particular salient issue for Korea. This Part assesses the desirability of establishing a U.S.-style securities class action system in Korea.

A. The Size Effect

In considering whether to implement a private securities class action system, regulators in Korea must first take into account the importance of size in determining which companies will actually ever face a securities fraud class action. As the existing empirical evidence from the U.S. indicates, firms offering relatively small potential damage awards for plaintiffs are rarely sued in a securities fraud class action. The impact of the PSLRA in raising the costs of litigation while reducing the expected benefits to attorneys who file class actions likely further elevated the minimum potential damage award plaintiffs' attorneys require before they file suit.

Consider the range of companies trading on the Korean Stock Exchange ("KSE").[217] In 2002, there were 683 companies listed on the KSE.[218] The largest company listed on the KSE, Samsung Electronics, had a market capitalization of U.S. $39.1 billion.[219] Market

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215. Regulation FD became effective in the United States in October 2000. *See Selective Disclosure and Insider Trading, Exchange Act Release No. 34-43154,* 2000 WL 1201556 (Aug. 15, 2000). Regulation FD works to level the playing field for information somewhat in tbe secondary markets for certain publicly-held issuers. The issuer and its senior officials among others are prohibited under Regulation FD from making selective disclosures to certain secondary market participants, including investors that are reasonably expected to trade on the information.

216. *See* Kim Yon-se, *Fair Disclosure Rule to Be Enforced Nov. 1,* KOREA TIMES, Sept. 9, 2002 (discussing the adoption of "Fair Disclosure" rules by Korea's Financial Supervisory Service patterned on the U.S. Regulation FD).

217. *See* Stephen J. Choi & Kon Sik Kim, *Establishing a New Stock Market for Shareholder Value Oriented Firms in Korea,* 3 CHI. J. INT'L L. 277, 277-78 (2002) (discussing reform possibilities for the Korean Stock Exchange) .

218. *See* Korea Stock Exchange Fact Book 2002, at 31 (2003), *available at* http://www.kse.or kr/webeng/what/what_index.jsp (last visited on Dec. 3, 2003).

219. *Id.* at 33. Units in Korean won were converted to U.S. dollars using the 2002 exchange rate of 1317 won to the dollar obtained from *http://en2.wikipcdia.org/wiki/Table_of_historical_exchange_rates* (last visited on Nov. 30, 2003).

capitalizations dropped rapidly, however, after Samsung Electronics. The tenth largest firm, Samsung Electro-Mechanics, had a market capitalization of U.S. $2.5 billion in 2002.[220] After taking away the thirty largest market capitalization firms, the remaining 653 listed firms had an average market capitalization of only U.S. $83.4 *million.* In comparison, the average market capitalization for the fifty largest listed NYSE companies in 2002 was $88.7 billion.[221] In 2002, the entire NYSE had a global market capitalization of $13.4 trillion and about 2783 listed firms, giving an average market capitalization of $4.82 billion.[222]

Whatever the loss in deterrence caused by the tendency of plaintiffs' attorneys to file suit only against larger companies in the U.S., the problem is only magnified in Korea. Samsung Electronics, of course, would probably qualify under even the most stringent size screens employed by U.S. plaintiffs' attorneys. Perhaps not coincidentally, the second derivative suit in Korea where shareholders won a judgment against directors of a Korean corporation was against Samsung Electronics.[223] Nonetheless, Samsung Electronics is an outlier in terms of market capitalization among KSE-listed firms. Without significant changes to the U.S. securities class action regime as adopted in Korea to encourage more actions against smaller firms, it is unclear what impact a class action regime will have in Korea outside of the top thirty listed firms on the KSE.

At least two possible caveats should be noted to the problem of firm size for implementing a securities class action regime in Korea. First, even if private class actions target only large companies such as Samsung Electronics, this nonetheless may have a significant impact on shareholder wealth in Korea. Samsung Electronics alone accounts for 20 percent of the overall market capitalization for *all* listed companies on the KSE.[224] Compare this to the U.S., where no single company represents a significant fraction of the total market capitalization. Providing class action-style deterrence solely against

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220. *Id.*

221. NYSE Fact Book 2002, *available at* http://www.nysedata.com/factbook/viewer_edition.asp?mode=tables&key=34&category=5.

222. *See* http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=268&category=14 (NYSE Overview Statistics for 2004).

223. *See* Boong-Kyu Lee, *Don Quixote or Robin Hood?: Minority Shareholder Rights and Corporate Governance in Korea*, 15 COLUM. J. ASIAN L. 345 (2002) (reporting that "a court of first impression awarded damages of W97.7 billion" against eleven former and current directors of Samsung Electronics).

224. *See* Korea Stock Exchange Fact Book 2002, *supra* note 218, at 33 (noting that the market capitalization of Samsung Electronics was 51,542.5 billion won while the total market capitalization of listed companies was 258,680.8 billion won in 2002).

Samsung Electronics, therefore, may have some value for overall shareholder welfare in Korea.

Second, many companies are members of Chaebol groups in Korea.[225] To the extent fraud and other forms of managerial misbehavior are conducted by the Chaebol as a whole, focusing on individual market capitalizations may be misleading. Plaintiffs' attorneys in Korea may very well bring class actions against groups of companies belonging to the same Chaebol as opposed to class actions against individual companies. Such classes of defendants may give plaintiffs' attorneys the necessary size and potential damage awards to make a class action worthwhile. On the other hand, the Chaebol ownership structure immediately interposes shareholders with significant holdings (for example, other member corporations of the Chaebol) that may take a pro-defendant stance and, at the very least, reduce the potential class award available by opting out of any class action. These holdings may at the worst work to obstruct and stop any class action.

B. Regime Choices

In the abstract, securities fraud class actions may seem like an all-or-nothing alternative. However, the U.S. experience with the PSLRA and other reforms has demonstrated that there exist several choices in how to operate a securities class action regime. The difficulty with adjusting the class action regime for Korea lies in balancing three separate problems: (1) the problem of blocking frivolous suits while allowing meritorious suits, (2) the lack of incentive of plaintiffs' attorneys to focus on smaller companies, and (3) the agency problem between plaintiffs' attorneys and the plaintiff class. Solutions to one problem often heighten one or both of the other problems. Reforms such as the PSLRA, for example, were designed to reduce the incidence of frivolous suits. Such reforms, however, may have also raised costs generally for plaintiffs' attorneys, reducing the incidence of all types of suits, including "soft" meritorious suits not based on hard indicia of fraud (for example, an accounting restatement) publicly known prior to the filing of suit.

The balance struck among these three competing considerations in the U.S. may not match the balance that is optimal for Korea or other countries contemplating securities class actions. Tweaking the various litigation options available in implementing a

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225. The Chaebol are large, family-owned, controlled conglomerates in Korea. Large Chaebol groups include Hyundai and Samsung.

U.S.-style class action regime may help tailor such actions to the Korean context. For example, the Korean bar is more tightly knit than the bar in the U.S. due to the smaller number of attorneys in Korea and the concentration of attorneys in Seoul, the capital city.[226] The Korean government as a result may have more indirect and informal means of sanctioning plaintiffs' attorneys who knowingly engage in frivolous suits, reducing the risk of frivolous suits. Ham Jung-Ho, the President of the Korean Bar Association, wrote that for attorneys in Korea, the "legal profession is regarded as a profession with public duties rather than as a profession which simply provides legal services or even as a commercial business."[227] The small number and relative homogeneity among attorneys reinforces the power of reputation and group peer pressure in moderating attorney behavior.[228] Plaintiffs' attorneys in Korea may be arguably more disinclined to file purely frivolous lawsuits if such actions will result in negative reputation among peers for the attorneys filing suits.[229]

Not only is the risk of frivolous suits arguably lower in Korea, the benefits from meritorious suits may also be higher. To the extent at least some segments of the investor population in Korea are less sophisticated than in the U.S. and fewer individual Korean investors invest through more sophisticated investment funds, the risk of actual fraud is heightened. A more liberal securities class action regime may therefore prove more valuable in Korea.

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226. *See infra* notes 246-250 and accompanying text (discussing the low number of attorneys in Korea).

227. Ham Jung-Ho, *The Unique Characteristics of the Korean Attorneys' System*, 18 DICK. J. INT'L L. 171, 171 (1999). Ham goes on to write tbat "the Korean Attorneys Act defines the term attorney as a legal professional with public duties and provides that the duties of an attorney shall be to protect the fundamental human rights and to ensure that the social justice shall be realized." *Id.*

228. This homogeneity is furthered by a common training system for all lawyers. *See* Jae Won Kim, *The Ideal and the Reality of the Korean Legal Profession*, 2 ASIAN-PAC. L. & POL'Y J. 2, 48 (2001). Kim writes:

> Those who want to be lawyers in Korea must first pass the judicial exam, and only successful examinees obtain the privilege of entering the most elite institution in Korea, the Judicial Research and Training Institute ("JRTI"). At the JRTI, all trainees are treated as functionaries of the government. They not only enjoy official status but also receive a salary from the government. Over a two-year period, the JRTI provides practical training rather than advanced legal education. All Korean lawyers, whether judges, prosecutors or practicing attorneys, receive further training in the same institution.

Id.

229. Kim notes, however, that the homogeneity puts a premium on personal connections and may help foster corruption among attorneys. *Id.* at 48-49.

Consider the following, nonexhaustive list of policy levers available to those seeking to implement a securities class actions regime.

Range of Plaintiffs and Defendants. The U.S. does not adopt a uniform approach in determining who should be defendants in class actions. Section 11 of the Securities Act defines a list of defendants including underwriters, directors, and auditors (but only with respect to the audited financials).[230] Section 12(a)(2) of the Securities Act, on the other hand, provides no such definition.[231] Finally, Rule 10b-5 simply provides that any person who makes an "untrue statement of a material fact or . . . omit[s] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" may be liable to those who "in connection" with the fraud purchase or sell securities.[232]

Providing for a wide range of potential defendants, all other things being equal, will increase the expected return from litigation and induce more class action lawsuits. Deep-pocket defendants such as underwriters and auditors hold the greatest promise of increasing the return for plaintiffs' attorneys. Expanding the range of plaintiffs may also help induce more plaintiffs' attorneys to file suit against relatively smaller Korean companies. For example, Korea could choose not to follow the tracing rule of Section 11 of the Securities Act in the United States and thereby create a larger plaintiff class for fraud litigation in the context of Korean IPOs.[233]

The same financial reward designed to attract plaintiffs' attorneys to file suit against truly fraudulent companies, however, may also induce a greater amount of frivolous litigation. Such a shift in the legal regime, therefore, should be considered only to the extent policymakers in Korea believe (a) the incentives to engage in frivolous

230. *See* 15 U.S.C.A. §77k(a).

231. *See* 15 U.S.C.A. § 77l(a)(2). Instead, the Supreme Court has detailed (in a case involving the related 15 U.S.C.A. § 77l(1)) that those in privity as well as those who solicit offers to huy may he defendants. *See* Pinter v. Dahl, 486 U.S. 622, 647 (1988) (holding that "liahility extends only to the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interest or those of the securities owner").

232. 17 C.F.R. § 240.10b-5.

233. *See, e.g.*, Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 872 (N.D. Cal. 1986) (finding that Section 11 requires that plaintiffs be able to trace their shares to the registration statement in which fraud is being alleged). Korea could also consider expanding the class of potential Rule 10b-5 plaintiffs to include secondary participants under a theory of aiding and abetting liability as rejected in the U.S. by the Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

litigation are less among Korean attorneys,[234] (b) the Korean government has better means of detecting and disciplining attorneys specializing in frivolous litigation than in the U.S.,[235] or (c) the threat of actual fraud is greater in Korea.[236]

Elements of the Cause of Action. The U.S. securities laws require plaintiffs to prove various elements depending on what type of private cause of action the plaintiffs are attempting to bring. Section 11 requires that plaintiffs only show a material misstatement or omission where a duty to disclose exists in the registration statement for a public offering.[237] Section 12(a)(2) similarly requires a material misstatement or omission and that the fraud occur "by means of a prospectus."[238] Rule 10b-5, on the other hand, requires plaintiffs to show not only materiality but also scienter on the part of the defendants, plaintiff's reliance, and loss causation.[239]

The incentive of plaintiffs' attorneys to bring a class action depends on the cost of litigating the case and the probability of winning a judgment (or convincing the defendant to settle for a large monetary amount). The more elements plaintiffs are required to prove, the lower the threat of a class action and the smaller the incentive plaintiffs' attorneys will have to file the action in the first place. On the other hand, the easier the case becomes for plaintiffs' attorneys to prove, the greater the amount of arguably frivolous litigation.

As with the question of who should have standing to sue and who should be defendants in a securities class action, Korean regulators may wish to consider the relative risks of frivolous litigation and actual fraud occurring in the absence of private litigation within Korea and how such risks differ compared with the U.S. The lack of incentives for attorneys to bring class actions against smaller Korean companies, coupled with the difficulty in creating the necessary institutional infrastructure to support class actions

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234. Korean attorneys may have fewer incentives to engage in frivolous litigation perhaps due to the tight-knit community of attorneys in Korea that may result in peer pressure against such suits. *See supra* notes 227-228 and accompanying text.

235. A greater ability to detect and discipline attorneys, for example, may result from the higher level of intervention the Korean government makes generally in the Korean economy.

236. The risk of fraud could be greater in Korea either because investors are less sophisticated or corporate managers lack a norm of catering to shareholder interests.

237. 15 U.S.C.A. §77k(a).

238. 15 U.S.C.A. § 77l(a)(2).

239. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 701-97 (3d ed. 2001) (providing a survey of the various elements of a Rule 10b-5 cause of action). Plaintiffs must also show that the fraud occurred "in connection with the purchase or sale of any security" and take place "by the use of any means or instrumentality of interstate commerce." *Id.*

discussed below, may lead Korean regulators to err on the side of imposing less stringent requirements for an antifraud private cause of action.[240]

Class Action Procedure. The PSLRA implemented the presumption that the lead plaintiff, who among other things selects the lead counsel, is the plaintiff who has the largest financial interest in the litigation (among those seeking the lead plaintiff position). In theory, such a provision works best where a large number of institutional investors exist in the capital markets, providing for a pool of possible institutional lead plaintiffs. In practice, this regime has not resulted in a flood of new institutional lead plaintiffs in the U.S.[241] Korea, which has a far smaller percentage of institutional investors in its capital markets, may wish to consider whether a lead plaintiff provision would have even less of an effect in aligning the interests of the investor class with the plaintiffs' attorneys compared with in the U.S.

Safe Harbors. The PSLRA implemented a forward-looking statement safe harbor under Sections 27A and 21E of the Securities Act and Exchange Act, respectively.[242] Such safe harbors are not necessarily cost-free. While decreased liability may reduce the risk of companies in disclosing forward-looking information, more opportunistic companies may take advantage of the safe harbor to disclose less meaningful, if not misleading, forecasts about the respective company's future. JKN (2001) nonetheless found no evidence of reduced quality forward-looking statements in the post-PSLRA period.[243]

In considering whether to implement a safe harbor such as the one for forward-looking statements in the U.S., Korea should consider whether the risk of such a law encouraging decreased quality forward-looking disclosures is higher in Korea. Where top corporate officers are not accustomed to providing information readily to the market or, more generally, catering to the interests of dispersed public shareholders, the risk may be greater that the top officers may fail to provide accurate or meaningful forward-looking information. In such a situation, reducing or even eliminating the forward-looking statement safe harbor may prove more beneficial for investors in Korea.

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240. *See infra* Part IV.C. (discussing the lack of institutional support for a class action system in Korea).

241. *See supra* notes 189-193 and accompanying text.

242. *See supra* notes 14-17 and accompanying text.

243. JOHNSON ET AL., *supra* note 206, at 322-23.

Liability. The PSLRA introduced proportionate liability for some types of claims, including most notably Rule 10b-5 claims. The proportionate liability system is not uniform in U.S. securities law. Under Section 11, defendants continue to face joint and several liability, except for outside directors who do enjoy proportionate liability.

In implementing a U.S.-style class action system, Korea faces a choice between joint and several as well as proportionate liability. Here again, Korea should consider how its situation differs from that of the U.S. Corporate insiders often are highly culpable when fraud occurs, at least when compared with outside auditors and underwriters. Suppose that in Korea, such insiders arguably have a greater ability to escape liability by leaving the country with their assets than top officers do in the United States.[244] Under such conditions, imposing a proportionate liability system may unduly restrict the ability of investors to obtain damages for securities liability (to the extent the proportional liability of the remaining defendants such as auditors and underwriters is capped at 150 percent of their liability portion as in the United States).[245]

Whether reduced liability for underwriters and auditors is desirable is contingent upon the question of the importance of liability in Korea in inducing underwriters and auditors to police companies ex ante for fraud. The answer depends on what other incentives underwriters and auditors have to monitor companies in Korea. Larger, multinational auditors and underwriters may depend on their reputation to generate future profitable business and thus voluntarily police for fraud to maintain their reputation, although Enron and Arthur Andersen provide a counterexample. Domestic, smaller securities professionals may not have the same amount of reputation at stake and will therefore require the threat of legal liability to bolster their incentives to police for fraud. Providing joint and several liability for smaller securities professionals would help raise the legal liability facing these professionals and compensate for the lower reputational constraints on such smaller market participants.

244. Consider the example of Daewoo founder Kim Woo-joong who fled Korea in the late 1990s. *Cf.* Iggy Kim, *South Korea: Daewoo Motors Workers Strike, available at* http://www.greenleft.org.au/back/2001/437/437p21b.htm ("Since the Daewoo Group's collapse in late 1998, tens of billions of dollars of public funds have been spent to salvage Daewoo Motors. In 1999, Daewoo Group president Kim Woo-joong disappeared with these funds, amounting to a third of the South Korean government's budget.").

245. *See supra* notes 18-24 and accompanying text.

C. Institutional Structure

Aside from the formal law on the books, the presence of sophisticated institutional players is crucial in developing a low cost, economical class action system. The number and sophistication of institutions that could potentially deal with class actions in Korea differ from the United States. In adopting a class action system, regulators in Korea should consider the impact of institutional differences on the effectiveness of class actions.

1. Plaintiffs' Attorneys

The United States enjoys (or, depending on one's point of view, is afflicted with) an active professional securities plaintiffs' attorney bar. Specializing in securities class actions grants such firms particular advantages. Firms that specialize in these suits are better able to develop expertise in pursuing a securities class action, reducing the cost of pursuing any one case. The large size and stature of at least some of the plaintiffs' firms provide a natural focal point for investors unhappy with the performance of their firms. Such investors may help provide information on allegedly fraudulent firms that is useful for the plaintiffs' attorney in determining whether to file a class action complaint. Larger plaintiffs' firms are also able to pursue multiple class actions at any one time, allowing for some diversification of the risk that any one class action may not result in a positive return for the firms. Diversification may also occur across firms, as several plaintiffs' firms may jointly share in the co-representation of different classes across several different lawsuits.

Countries, such as Korea, considering the implementation of a private securities fraud class action regime must contend with a lack of well-developed plaintiffs' attorneys firms. South Korea has only about five thousand practicing attorneys but has a total population of forty-eight million people.[246] In contrast, the state of California has approximately 144,000 active attorneys providing services for a population of thirty-five million people.[247] Not only are the total number of attorneys limited in Korea, but many attorneys are quite fragmented. Compared with the United States, Korea has only a few

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246. Misasha Suzuki, *The Protectionist Bar Against Foreign Lawyers in Japan, China, and Korea: Domestic Control in the Face of Internationalization*, 16 COLUM. J. ASIAN L. 385, 391-92 (2003). *See also* Kim, *supra* notes 228-229, at 46-47 (noting that "Korea has approximately 6,900 licensed lawyers, including roughly 1,400 judges, 1,200 prosecutors, and 4,300 practicing attorneys.").

247. The State Bar of California, Membership Demographics, *at http://members.calbar.ca.gov/search/demographics.aspx* (visited on December 3, 2003).

large law firms with over a hundred attorneys.[248] Korea, moreover, has resisted allowing foreign law firms to practice law within its borders.[249] Further, the paucity of legal services in Korea is aggravated by Korea's difficult bar entrance exam that annually allows in only one thousand new licensed attorneys per year.[250]

Not only will potential plaintiffs' attorneys in Korea lack the experience to pursue class actions in a cost-effective manner, but the plaintiffs' attorneys will not enjoy the same scale advantages as their U.S. counterparts, resulting in fewer cases for any particular plaintiffs' attorney and less diversification among attorneys. The combination of higher costs and reduced diversification will result in Korean plaintiffs' attorneys focusing their attention even more on only larger dollar value class actions with clear evidence of fraud.

Of course, some larger plaintiffs' attorneys firms may eventually appear in Korea over time, especially if filing class actions in Korea turns out to be profitable. The smaller size of Korea's capital market, however, necessarily will result in fewer potential litigation targets as compared with the U.S. As a result, Korea's market will likely support only a small number of professional plaintiffs' attorneys firms. One consequence of having fewer firms will be less competition among plaintiffs' attorneys to become lead counsel in any particular class action, thereby resulting in higher attorney's fees and a lower recovery for the class.

2. Courts and Judges

If Korea adopts a securities class action system, what courts should handle these types of cases? Presently, Korea employs a number of specialized courts. For example, Korea has a bankruptcy court with specialized bankruptcy judges to help administer and adjudicate bankruptcy proceedings. Employing a similarly specialized court with expert judges may provide significant benefits to a shareholder class action system in Korea, as opposed to the U.S.-based securities class action experience where, in federal court, litigants typically deal with more generalist judges.[251] Specialized judges may develop expertise in distinguishing between frivolous and meritorious

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248. Aurora Law Offices in Korea identifies five law firms in Korea with over 120 attorneys including: Kim & Chang; Lee & Ko; Shin & Kim; Bae, Kim & Lee; and Woo, Yun, Kang, Jeong & Han. *http://www.auroralaw.co.kr/en/about/otherfirms.html* (last visited on December 6, 2003).

249. Suzuki, *supra* note 246, at 391-92.

250. *Id.*

251. *See* Black et al., *supra* note 4 at 569 (proposing a specialized court to handle large or complex commercial and financial litigation set up as a branch of the District Court).

claims and therefore become more willing to sanction frivolous suits. Such judges may also apply certain doctrines, such as proportionate liability, more consistently — a task which requires expertise in assigning culpability across defendants. Litigants faced with the same set of repeat judges may also obtain a higher degree of predictability of judicial outcomes, leading to a greater probability of settlement.

On the other hand, the minimum size requirement before plaintiffs' attorneys file suit will likely result in only a small number of class actions per year, absent significant departures from the U.S. system of class actions to encourage more class actions. While a specialized securities class action court would greatly assist those seeking to bring class actions as well as help weed out frivolous from meritorious claims, the presence of a specialized court alone is unlikely to result in many class actions. Particularly because the present Korean judiciary has a relative lack of experience in business matters,[252] the lack of a high volume of class actions will make developing expertise among generalist judges difficult.

3. Shareholder interests

The presence of institutional investors able to take an active role with respect to class actions also represents an important factor in gauging the probability of success of implementing a new securities class action regime in Korea. Measured as a percentage of trading volume on the KSE, individuals accounted for 71.8 percent of the trading volume.[253] Korean institutional investors, including banks and pension funds, among others, accounted for only 16.7 percent of the trading volume.[254] While foreigners accounted for an additional 11.5 percent of the trading volume, foreigners are unlikely to take an active or effective role in leading a Korean securities fraud class action due to language barriers and a lack of familiarity with the Korean legal system.[255]

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252. *See* Lee, *supra* note 223, at 350-51 ("The judiciary traditionally has been more involved in social, as opposed to business, issues, leaving economic adjudication to the government bureaucrats at the Presidential Secretariat, Ministry of Finance, and Ministry of Trade and Industry. Naturally, without a tradition of litigating economic and management issues, it is probably safe to say that the expertise level of the Korean judiciary is well-short of that of Delaware.").

253. Korea Stock Exchange Fact Book 2002, *supra* note 218, at 23 (2003).

254. *Id.*

255. *Id.* On the other hand, foreigners used to using litigation in their home countries (for example, the United States) may also seek to do so in Korea. The lack of a plaintiffs' attorney bar to help lead such litigation, however, may hinder even the most litigation-prone foreign investor. Even in the U.S., moreover, institutional investors have participated only reluctantly (if

Stock ownership patterns present a slightly different picture for firms listed on the KSE. Individuals own only 22.3 percent of the market value of KSE listed firms.[256] Foreigners account for an additional 36.6 percent.[257] For institutions, however, a similar pattern results: Korean institutional investors have a relatively smaller presence in the KSE compared with U.S. institutions within the U.S. capital markets. Private institutional investors (banks, securities companies, insurance companies, investment trusts, and other financial institutions) in the aggregate account for only 15.7 percent of the stock ownership.[258] The remainder of the shares are in the hands of either the government (or other public body) or another corporation (often a Chaebol affiliate company).[259]

The lack of many large institutional investors often leaves the plaintiff class without any potentially large plaintiffs' representatives. Absent such a representative, the danger of plaintiffs' attorneys grabbing a lion's share of a damages award for their fees in a class action lawsuit without exerting much effort is more acute. Moreover, one possible solution, the lead plaintiff provisions in the U.S., has failed to garner much interest from the numerous institutions in the U.S. marketplace and would be unlikely to apply in Korea (due to the relative dearth of institutional investors).[260]

Two additional interesting features exist with respect to shareholder interests in Korea. First, certain specialized shareholder interest groups have arisen in recent years to pursue derivative suits among other pro-shareholder actions against directors and officers of select Korean firms. The People's Solidarity of Participatory Democracy ("PSPD"), a non-profit government organization, has actively engaged in pro-minority shareholder activities over the past several years, including leading the recent derivative suit against

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at all) in both leading class actions and filing claims for awards as part of settlements. See *supra* notes 189-192 and accompanying text.

256. *Id.* at 36.

257. *Id.*

258. *Id.* Questions exist, as well, as to the independence of Korean institutional investors. *See, e.g.*, Ok-Rial Song, *The Legacy of Controlling Minority Structure: A Kaleidoscope Corporate Governance Reform in Korean Chaebol*, 34 LAW & POL'Y INT'L BUS. 183, 215 (2002) ("[B]anks are in effect controlled by the government, non-bank financial institutions like insurance companies or investment companies are themselves owned by chaebol, and most non-financial institutions are chaebol-affiliated firms locked into a circular-shareholding structure. Therefore, few institutional investors would be willing to monitor controlling families or even the individual managers of affiliated firms.").

259. *Id.*

260. *See supra* notes 222-224 and accompanying text.

Samsung Electronics.[261] To the extent specialized plaintiffs' attorneys focusing on class actions fail to arise, the PSPD may continue to fill the gap. Regulators in Korea should consider allowing an award similar in size to the contingency fees received by plaintiffs' attorneys in the U.S. for pro-shareholder groups who initiate and successfully pursue a securities class action. Of course, the PSPD may not wish to accept any money for fear of tarnishing its social activist reputation. A more generalized bounty nonetheless has the potential of encouraging other more profit-oriented entrepreneurs to step into the vacuum created by the lack of attorneys pursuing derivative suit litigation.

Second, Korean stock ownership patterns reveal that a large fraction of shares in Korean companies are held by other corporations (17.2 percent).[262] To the extent many of these other corporations are members of the same Chaebol family, a further complication arises in how to determine who should be the lead plaintiff. Often the shareholders with the largest financial interest in the litigation may very well be other companies who are members of the same Chaebol group as the company targeted for a securities fraud suit. At a minimum, these Chaebol shareholders may simply opt out of the class, reducing the potential damage awards for plaintiffs' attorneys and thus the incentive of such attorneys to file suit in the first place. At worst, the Chaebol shareholders may attempt to control the class action, claiming a right to do so based upon their large financial stake in the interest. Allowing Chaebol shareholders to obtain control of the class, however, would result in very high incentives on the part of the class to simply drop the suit or settle for a nominal amount to minimize the litigation cost to the Chaebol as a whole.

D. The New Class Action Law in Korea

After years of consideration, the Korean government finally enacted a securities class action law in January 2004.[263] Under the

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261. *See* Lee, *supra* note 223, at 355-56 ("The PEC [a part of the PSPD], established in January 1997, was founded and is led by Hasung Jang, a professor at Korea University. The PEC is comprised of a diverse group of experts, including corporate attorneys, accountants, and academics. The Participatory Economy Committee has three full-time paid and about twenty volunteers, with its budget raised from membership dues and donations."). *See also* Jooyoung Kim and Joongi Kim, *Shareholder Activism in Korea: A Review of How PSPD Has Used Legal Measures to Strengthen Korean Corporate Governance*, 1 J. KOREAN L. 51, 53 (2001) (describing the PSPD's shareholder-oriented activities).

262. Korea Stock Exchange Fact Book 2002, *supra* note 218, at 36.

263. Ryu Jin, *Assembly Passes Watered-Down Class Action Bill*, KOREA TIMES, Dec. 22, 2003, *available at* http://times.hankooki.com/times.htm.

new law, companies listed on the KSE or KOSDAQ, as well as a delineated list of related parties such as directors, auditors, and underwriters, may face a securities class action for, among other things, fraud in a registration statement or prospectus, fraud in an annual, semi-annual, or quarterly report, insider trading, and market manipulation.[264] The new law is patterned somewhat on the U.S. system of class actions, providing for public notice of the class action, court appointment of a lead plaintiff, court certification of the class, and court approval of any settlement arising from the class action.

Unlike the U.S. system, the new Korean law imposes a minimum shareholding requirement on shareholders seeking to initiate the class action. At least fifty shareholders who, in the aggregate, hold 0.01 percent or more of the equity may bring a class action suit against a company.[265] The Korean law also provides that only the very largest Korean companies (those with assets in excess of US $1.67 billion) are exposed to the possibility of a class action suit from the effective date of the law on January 1, 2005. Nonetheless, starting on January 1, 2007, the minimum asset size requirement of US $1.67 billion will expire, exposing smaller, listed companies to class action suits.[266]

The new class action law in Korea marks a step in the right direction for improving the corporate governance environment. Providing for class actions will help lay the foundation for the initiation of at least a modicum of class action suits. As discussed above, the initial number of suits is likely to be small due to the size effect. Even without the initial restriction on class actions to only the largest Korean firms, the size effect will deter many private plaintiffs from pursuing suit against smaller firms.[267]

Even a small number of class action suits may nonetheless enhance investor welfare in Korea. Direct benefits include the deterrent effects on the controlling shareholders of the largest corporations. To the extent that the political power of the largest corporations insulates the controlling shareholders at least partially from government enforcement, private class actions may provide a particularly valuable and complementary enforcement mechanism to the securities laws. Furthermore, some number of class actions each

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264. *See* Young-Cheol Jeong, *Securities-Related Class Actions in Korea, International Bar Association Newsletter* (2003) (describing aspects of the securities class action bill in Korea).

265. Jin, *supra* note 263.

266. *Id.*

267. On the other hand, not all plaintiffs are driven solely by economic concerns. To the extent the PSPD remains a viable force in Korea, the restriction to the largest Korean firms may nonetheless reduce the number of class actions.

year will help develop expertise within the courts in administering class actions (for example, in selecting a lead plaintiff, dismissing frivolous complaints, etc.), thereby reducing the costs for future class actions. Over time, more groups in addition to the PSPD may bring class actions and generate economies of scale in pursuing a greater number of suits. As the number of class actions grows over time, the constituencies that benefit from such actions (investors, attorneys, and plaintiffs advocacy groups such as the PSPD) will gain more influence. Such enhanced influence will assist them in their efforts to, at the very least, block efforts to curtail class actions in Korea and eventually to expand the scope of class actions.

Given the structural biases against class actions within Korea and the importance of encouraging the growth of such actions under the new class action law, the minimum shareholding requirement is troublesome. It is precisely for the very largest corporations that the 0.01 percent shareholding requirement imposes the largest barrier. For a company such as Samsung Electronics with a market capitalization of $39.1 billion, shareholders initiating a class action must hold a total number of shares valued at $3.91 million, a considerable sum out of the reach of many individual investors and associated shareholder advocacy groups such as the PSPD. The minimum shareholding requirement thus undercuts the class action law in the primary area where the law would otherwise have the most impact – for the largest companies.

V. CONCLUSION

Securities class actions have an appealing attraction to those seeking to deter fraud. If a party commits fraud that affects hundreds, if not thousands of dispersed shareholders, allowing a plaintiffs' attorney to aggregate the claims into a single class action makes the pursuit of such claims both more manageable and economical. While most countries do not allow for securities class actions, the United States, with the largest capital market in the world, does. It is therefore tempting to link causally the presence of securities fraud class actions with deterrence against fraud and then finally with large, developed capital markets, as in the U.S.

Nevertheless, problems may emerge when a country blindly adopts U.S.-style class actions. Even within the United States, securities class actions have not garnered uniform praise. During the mid-1990s, Congress responded to the perception that many securities class actions were frivolous with the enactment of the PSLRA. The

PSLRA may very well have increased the importance of merit-related factors in determining which companies will face a securities class action as well as settlement outcomes. Evidence surrounding the consequences of PSLRA nonetheless highlights several important issues with which regulators in the U.S. must contend in charting the course for securities class actions in the future.

In particular, the shift in claims in the post-PSLRA time period toward cases involving more hard evidence of fraud, such as an accounting restatement or SEC enforcement action, may allow plaintiffs' attorneys more easily to meet the pleading with particularity requirement of the PSLRA. This shift, however, may also leave untouched many actual instances of fraud that do not involve such a "smoking gun." By raising the costs of pursuing a securities fraud class action, while also reducing the probability of success, the PSLRA may have resulted in plaintiffs' attorneys refocusing their efforts on only companies engaged in obvious (at the time of filing) instances of fraud. Similarly, for all types of claims, whether frivolous or meritorious, the PSLRA generally may have raised the minimum threshold of company size for plaintiffs' attorneys to pay any attention at all. Particularly for countries with a smaller capital market, and thus fewer large market capitalization companies than in the U.S., implementing a post-PSLRA, U.S.-style class action regime may result in only a relatively small number of firms ever facing the risk of a securities class action.

Countries considering whether to implement U.S.-style class actions must also confront a dearth of several institutional factors that make class actions more viable within the United States. Absent a set of professional plaintiffs' attorneys, the cost to attorneys and other groups of initiating a class action is likely to be higher. Furthermore, lacking securities class action notice firms, such as Gilardi & Company in the United States, the cost to attorneys of notifying the class will be greater. These higher costs, in turn, will exacerbate the tendencies of plaintiffs' attorneys to focus only on larger companies offering greater potential damage awards. Even where some professional plaintiffs' attorneys may arise within a country such as Korea, the small size of the capital markets will necessarily restrict the number and scope of such law firms. Fewer plaintiffs' attorneys firms vying with one another to lead a class action may then result in higher attorney fees as well as less vigorous prosecution of class action claims, to the extent a plaintiffs' attorney only captures a fraction of any award obtained for the class.

To a certain extent, countries considering securities class actions may address some of the concerns of class actions by tailoring

their nation's class actions regime to their own specific context. However, no easy remedy exists that will completely solve (a) the problem of frivolous suits and the need to allow meritorious suits, (b) the lack of incentive of plaintiffs' attorneys to focus on smaller companies, and (c) the agency problem between plaintiffs' attorneys and the plaintiff class. Reforms, such as the PSLRA, that are aimed at mitigating the incidence of frivolous suits tend to elevate costs for plaintiffs' attorneys, thereby reducing the incidence of all types of suits, including meritorious suits. The PSLRA may also have led attorneys to shift away from more "soft" instances of fraud to cases involving hard prefiling indicia of fraud, such as misstatements contained in an accounting restatement. Aligning the incentives of plaintiffs' attorneys with the plaintiff class may at first glance help the class. However, to the extent the profitability of plaintiffs' attorneys is lessened as more value is transferred to the class, plaintiffs' attorneys may further reduce the number of class actions brought against smaller companies.

Securities class actions are not the only way to keep managers and companies honest in their dealings with investors in the market. For example, Korea has a long tradition of highly qualified professionals joining government service. Bureaucrats in Korea often spend their entire careers in government and develop deep and broad expertise in their particular areas. Faced with the probability of a weak and ineffectual private deterrent against fraud (at least in the case of class actions), Korea may wish to consider expanding the roles of the Ministry of Justice, Securities and Futures Commission, and Fair Trade Commission and other government agencies in providing more public enforcement.[268] Such a strategy may be particularly useful for smaller companies, where private litigants may simply lack any incentive to monitor or file litigation.

Nonetheless, securities class actions do hold promise in harnessing private incentives to police for fraud. While private plaintiffs may find class actions economically viable only against the largest Korean corporations, class actions directed against such entities may provide a number of benefits for Korea. In terms of dollar losses, fraud within the largest corporations has the greatest negative impact on Korean investors. In addition, the political power of the largest Chaebol makes it difficult for government enforcement to work effectively, giving private class actions an important

268. *See also* Black et al., *supra* note 4, at 170 ("Consideration should be given to creating a national prosecution unit for commercial, corporate and securities matters and to creating a specialized career path within this unit.").

complementary enforcement role. Other countries with a similar political dynamic (for example, where larger corporations enjoy great political influence) may look to private class actions as a substitute means to enforce the securities laws. Lastly, once even a few private class actions become the norm within Korea, institutions including more expert courts and greater numbers of private entities and attorney firms specializing in class actions will develop, reducing the cost of pursuing subsequent class actions.

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