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June 1997

THE PRIVATE SECURITIES LITIGATION REFORM ACT: ONE YEAR LATER

By Dan L. Goldwasser and John C. Grosz*

In December 1995, the U.S. Congress enacted, over the veto of President Clinton, the Private Securities Litigation Reform Act of 1995 (the "Reform Act") which was intended to curb abusive securities law class action litigations. This was to be achieved through several measures, including (1) setting a higher standard for pleading fraud, (2) staying all discovery while a defendant's motion to dismiss is pending, (3) establishing a procedure designed to transfer control of the litigation from plaintiffs' counsel to large shareholders, (4) limiting the imposition of joint and several liability, (5) mandating the imposition of sanctions for baseless lawsuits, and (6) encouraging forward-looking disclosures by an issuer of stock by creating a risk-reducing safe harbor. More than a year has now passed since the Reform Act was enacted and the evidence is starting to be collected as to whether the statute will achieve its intended purposes. That evidence, while still inconclusive, suggests that the Reform Act will indeed reduce the incidence of the more abusive variations of securities class action litigation (for example, lawsuits that are based on no more than a fall in the price of a company's stock), but that the Act may also have several side effects, some not foreseen at the time it was adopted.

In April 1997, the Securities and Exchange Commission ("SEC") submitted a report (the "Report") to the President and the Congress on the first year of practice under the Reform Act. In that Report, the SEC relied in part on a study (the "Study") conducted by two Stanford Law School professors, Joseph A. Grundfest and Michael A. Perino, who collected data on securities law class action litigations and published statistics in February, comparing post-Reform Act lawsuits initiated during the period from

December 22, 1995 through December 31, 1996, with those initiated during the previous five years. Although the Grundfest-Perino Study found no significant diminution had yet occurred in the number of securities law class action cases initiated following the enactment of the Reform Act, there are clear signs of qualitative changes which are likely to reduce the number of such claims. There are also signs that the remaining cases will be more vigorously litigated. Whether they will result in larger percentage recoveries for those plaintiffs who do prevail remains to be seen.

Commentators who were looking for an immediate reduction in the number of cases were probably unrealistic in their expectations. Congress did not seek to eliminate securities law class actions, but only to "level the playing field" by curbing certain abuses in such litigation. Even the dramatic rulings by the U.S. Supreme Court in the early 1990s in eliminating "aiding and abetting" liability and imposing a uniform (and generally shorter) statute of limitations for securities law claims have had little noticeable effect on the number of actions brought. The process by which the number of claims will be reduced by the Reform Act is likely to be circuitous and gradual.

In the short term, the number of securities law claims initiated each year is partly a function of the number of plaintiffs' attorneys who specialize in bringing these claims. Until their numbers are diminished, the number of claims brought will also likely remain relatively stable. As more fully demonstrated below, however, the qualitative changes that have taken place as a result of the Reform Act are likely to make this type of litigation more costly and less rewarding to the members of the plaintiffs' class action bar, causing many of them to turn to other areas of practice. When that happens, the number of cases initiated each year will undoubtedly decline.

Impact on the Number of Cases

In the Grundfest-Perino Study, cases were organized by issuer, a methodology which served to minimize multiple-counting of litigations arising out of the same set of operative facts. Grundfest and Perino found that during the five pre-Reform Act years ended December 31, 1995, on average, there were 176 securities class actions initiated each year (with roughly the same number of dispositions lending credence to this figure). This average, however,

did not take into consideration cases filed in state courts which were assumed to have been *de minimis* during the pre-Reform Act period.[1] In 1996, following passage of the Reform Act, although there were only 109 such cases initiated in the federal courts, Grundfest and Perino concluded that this figure did not evidence a reduction in securities class action lawsuits since at least 39 additional lawsuits were initiated in *state* courts, independent of any federal court action. In addition, Grundfest and Perino found that whereas the second, third and fourth quarters of 1996 averaged 31 cases each (28, 34 and 31), the first quarter only registered 16. They concluded that the first quarter was probably aberrational due to two factors: (1) the plaintiffs' bar needed time to adjust to the requirements of the Reform Act, and (2) a higher-than-normal number of suits had been filed immediately *prior* to the adoption of the Reform Act, an acceleration that likely reflected attempts to avoid the Reform Act's impending application. Annualizing the data from the last three quarters, they concluded that the rate of claims during 1996 (federal and state) was between 148 and 163, a rate that does not represent a drop in the number of claims since (1) 1991, 1993 and 1995 were comparable, registering 153, 158 and 162 cases, respectively, and (2) the sustained strong performance of the stock market during 1996 may have tended to depress the number of claims.

Lawsuits Being Initiated in State Courts

The SEC, in its Report to the President and the Congress, similarly concluded that the first-year drop in the number of federal actions may not be significant, particularly in view of the increase in state court securities class actions, including not only the 39 "stand-alone" cases referred to above but also the several state court cases that have been filed "parallel" to federal court cases. Indeed, the SEC has commented that the initiating of such parallel state cases — representing an apparent attempt to avoid the Reform Act's stay of discovery pending a motion to dismiss — "may be the most significant development in securities litigation post-Reform Act."

Although the average number of securities class actions initiated in state courts prior to the Reform Act is not a readily available figure, Grundfest and Perino suggest that prior to the adoption of the Reform Act, the level of state court actions was "*de minimis.*" By contrast, in 1996,

following adoption of the Reform Act, over 26% of all securities class action litigations were filed solely in state court, and an additional 20% of the federal court cases had parallel actions brought in state court. Considering the efforts of the plaintiffs' bar in opposing the adoption of the Reform Act (and their concomitant, but unsuccessful, championing of Proposition 211 in California, which sought to strengthen California securities law to provide an alternative, non-federal forum), the increased number of state court filings should have been readily foreseeable.

The newly found popularity of state court actions among the plaintiffs' bar is likely to be a function of the Reform Act's more stringent pleading standard as well as its stay of discovery pending the resolution of motions to dismiss. These obstacles almost invariably do not exist in state court actions. Moreover, the Reform Act's safe harbor for forward-looking disclosures, on its face, does not apply to cases brought under state law. On the other hand, discovery in state courts may be more limited than under the Federal Rules of Civil Procedure and the scope of potential class membership may be more limited (for jurisdictional reasons). Thus, the changes effected by the Reform Act, in many cases, could have tipped the balance in favor of proceeding in state court. This conclusion seems to be supported by the relatively large percentage of 1996 cases (20%) in which parallel state court actions have been brought.

Drop in Average Capitalization of Issuer Defendants

Despite the quantitative finding that securities class actions have not been significantly reduced in number by the Reform Act, the SEC Report and the Grundfest-Perino Study have revealed some important *qualitative* changes in the cases initiated during 1996. Perhaps most unexpected was the sharp drop in the average market capitalization of the issuer-defendants. With respect to the pre-Reform Act cases, the average market capitalization of issuer-defendants was $2.08 billion over the 1990-95 period, as compared to $529 million for the 1996 post-Reform Act cases. Indeed, the post-Reform Act cases studied did not include a single company with a market capitalization in excess of $5 billion, whereas over 8% of the pre-Reform Act cases involved companies with market caps in excess of that figure.

While it is not clear what accounts for this dramatic drop,

there are a number of possibilities. First, the shares of large-cap companies were performing much better than small-cap stocks during 1996 and, therefore, presented fewer opportunities for claims. A second possible factor is that members of the plaintiffs' bar did not wish to challenge large, well-financed companies until they became more comfortable with the requirements of the Reform Act. Grundfest and Perino think that a more likely possibility is that large-cap companies have more sophisticated internal controls and, therefore, are less prone to financial misstatements, an alleged wrong that appears more frequently in the post-Reform Act complaints. Similarly, large-cap companies rely less on stock options for their executive compensation, thereby reducing the incentive placed upon executives to trade on insider information, another allegation present in a disproportionate number (more than half) of the post-Reform Act cases.

Clearly, the dramatic differential in the average capitalizations of the issuers in pre- and post-Reform Act cases is a function of the fact that the pre-Reform Act five-year sample studied contained 14 companies with market capitalizations in excess of $5 billion whereas the post-Reform Act sample contained no such companies. One company in the pre-Reform Act sample may have been IBM, whose market cap in the early 1990s was approximately $80 billion; if included, IBM alone would have increased the annual per-case average by almost $100 million. Indeed, it is noteworthy that the diminution in the highest-cap defendants is not matched by a reduction in the *median* capitalization of defendants. On the contrary, the market cap of the median issuer sued during the two periods actually increased from $180 million during the pre-Reform Act period to $193 million during the post-Reform Act period. While Grundfest and Perino may be right in their suppositions as to why no cases were brought against companies with very large capitalizations in the post-Reform Act period, it is also possible that the absence of such cases was simply a function of the rather small sample involved in this section of the Study (45 cases).

Steeper Stock Price Declines

The higher standard of pleading required by the Reform Act may also help account for the steeper one-day stock price declines involved in the post-Reform Act cases. The

average one-day decline associated with post-Reform cases has been 31% as compared to 19% for pre-Reform Act cases. To determine whether this increase is related to the higher pleading requirement under the federal statute, it would be helpful to compare the average decline in federal cases with the corresponding decline in state court cases. Unfortunately, reliable data is not yet available with respect to state court proceedings.

The increase in the average one-day stock price decline is particularly interesting in view of the generally strong stock market performance during 1996. Under such circumstances, one would anticipate that there would be fewer such precipitous market declines. Thus, the increase in the one-day percentage market decline from 19% to 31% may well constitute convincing evidence of the plaintiffs' bar's concern with being able to satisfy the Reform Act's higher pleading standard.

Nature of Industries Singled Out

The Grundfest-Perino Study also found that issuers in high-tech industries continue to be the principal targets of securities class action lawsuits. In fact, the percentage of suits against high-tech companies actually rose from 30.5% to 34%.[2] While this is not a particularly material increase, it is consistent with the larger market price declines (discussed below) associated with post-Reform Act claims, since high-tech company stocks usually have a greater market volatility than those of other companies. Indeed, in a period generally characterized by a rising stock market, one would almost expect that most cases would be brought against companies with highly volatile stock prices as those companies would be the most likely to experience significant market declines.

It should also be noted that there was a sharp decline in the percentage of cases involving companies in the financial services industries. During the pre-Reform Act period, such companies had been involved in 22.4% of the securities class actions, a percentage which declined to 10.1% in the post-Reform Act period. Grundfest and Perino attribute this drop to the end of the S & L crisis rather than to the impact of the Reform Act. (It is also possible that the pre-Reform Act cases included a significant number of suits against investment bankers, such as Prudential Securities, arising out of failed real estate syndications.) On the other hand, the drop in the

number of suits involving financial institutions may have been affected by the Reform Act. Such a drop is highly consonant with a rise in the percentage of cases involving financial reporting improprieties because most companies in the financial services industries have good internal accounting controls as a result of their being required by law to have their internal controls reviewed and reported upon by independent auditors, a requirement which is peculiar to the banking and securities brokerage industries. Thus, such companies, like large-cap companies, are less likely to experience faulty financial reporting.

Increase in Federal Actions Alleging Financial Reporting Improprieties

Another qualitative change noted in the first year following adoption of the Reform Act was the increase in the percentage of cases in which financial reporting improprieties were cited in the complaint. During the pre-Reform Act period, such allegations appeared in 34% of the cases brought under Section 10(b) but, following adoption of the Reform Act, the percentage of cases including such allegations increased to 67%. It is not yet clear what caused this dramatic increase — a development that is perhaps doubly confounding in light of the Study's finding that the percentage of cases naming accounting firms as defendants fell dramatically.

Professors Grundfest and Perino have speculated that the increase in cases asserting accounting improprieties may be due to an attempt on the part of the plaintiffs' bar to include more concrete allegations in their complaints in order to satisfy the higher pleading standards imposed by the Reform Act (i.e., "a strong inference of scienter"), a theory which could be tested by comparing the cases filed in federal court with those filed only in state courts. [3]

Certainly, the increase in the number of cases alleging accounting improprieties is not simply a function of the business cycle. On the contrary, during the period of generally poor operating results in the late 1980s and early 1990s, financial manipulations may have been particularly widespread, so that it is particularly ironic that 1966, a year probably characterized by a *decrease* in financial reporting irregularities, has seen an *increase* in actions alleging such wrongdoing. The theory that this development is attributable to the Reform Act, and especially its higher pleading standards, can (and

undoubtedly will) be evaluated by whether the percentage of cases alleging accounting improprieties continues to increase over the next few years. In any event, for the moment, the message is clear: aggressive accounting practices (especially those involving income recognition), if followed by a sharp decline in a company's shares, are likely, more than ever, to be an invitation to a lawsuit.

The contemporaneous drop in the number of claims against accounting firms may have also been the result of the Reform Act's higher pleading standards. The members of the plaintiffs' bar have long contended that, in view of the vigorous defense which they know they will encounter from accounting firms, they only name accounting firms as defendants when there is overwhelming evidence of an audit failure (a claim viewed with skepticism by most large accounting firms). In this connection, it must be appreciated that the existence of false financial statements is not necessarily evidence of an audit failure since a properly performed audit provides no guarantee that a financial fraud will be discovered. Thus, it is quite possible that many plaintiffs simply chose not to name the issuer's accountants as defendants at the outset of a litigation because they had not had an opportunity to obtain and review the accountants' work papers.

Increase in Federal Actions Alleging Insider Trading

The Grundfest-Perino Study also found a dramatic increase (from 20.7% to 56.5%) in the number of cases under Section 10(b) which include allegations of insider trading, i.e., claims that one or more senior executives or directors of the issuer sold substantial blocks of the issuer's shares during the period that the price of those shares was alleged to have been fraudulently inflated. Such charges have long been a favorite means for the plaintiffs' bar to create an inference of an intentional motive to misrepresent the value of the issuer. While there are undoubtedly numerous reasons why an executive might choose to liquidate a portion of his holdings, the plaintiffs' bar usually equates the timing of such sales with an attempt to take advantage of a knowingly inflated market price. This sharp increase is consistent with the conclusion that such allegations, like allegations of financial statement misrepresentations, reflect an effort to satisfy the "strong inference of scienter" pleading requirement imposed by the Reform Act.

No Increase Discerned in Forward-Looking Disclosure

Another important finding of the Grundfest-Perino Study is that there has been a substantial drop (from 14% to 6.5%) in the percentage of federal cases alleging fraudulent financial *projections*. This is undoubtedly the result of the adoption of the new safe harbor for forward-looking information. The ultimate extent of the decline cannot be readily measured since it is entirely possible (and logical) that such cases would now be brought in the state courts, a subject the Study did not seek to analyze. In any event, this change does provide a clear example of how the Reform Act is changing the landscape of securities litigation.

The SEC, after noting that Congress intended to encourage companies to provide more and better disclosure of forward-looking projections, reports with evident disappointment that "the staff believes that, in general, companies have been reluctant to provide significantly more forward-looking disclosure than they had prior to enactment of the safe harbor."

The ultimate impact of the Act's safe harbor provision will also depend on how the courts interpret the requirement that forward-looking statements, in order to be protected, be accompanied by "meaningful cautionary language." Members of the SEC staff have indicated their concern that many issuers are (i) labeling a wide variety of statements in their reports as "forward-looking" data and (ii) only including "boilerplate" warnings in those documents. Should the courts place a narrow interpretation on the safe harbor, the impact of this provision could be minimal.

Designation of Lead Plaintiffs and Lead Counsel

One of the most marked changes brought about by the Reform Act has been its impact on the designation of class representatives and the selection of plaintiffs' counsel. One of the chief criticisms made against class action litigations in the Congressional hearings was that such actions are too often initiated for the benefit of members of the plaintiffs' bar. In enacting the Reform Act, Congress adopted a mechanism for notice to all members of the class designed to enable shareholders with the greatest financial interest in the litigation to come forward and serve as lead plaintiffs, rather than those named as plaintiffs when the

suit was first filed.

While many members of the defense bar may have been looking forward to the possibility that, as a result of these new procedures, their traditional adversaries might be unseated as class counsel, it appears clear by now that such wishes will not become reality. Indeed, there have only been a few efforts to prevent traditional members of the plaintiffs' bar from serving as class counsel.

Congress also envisioned that institutional investors owning hundreds of thousands of shares would replace individuals having only nominal investments in the issuer's securities as lead plaintiff. To date, however, there has been little evidence that institutional investors are stepping forward to assume this responsibility (confirming the expectation which the plaintiffs' bar had voiced throughout the Congressional debates). Indeed, the only institutional investors that have shown any willingness to assume this responsibility have been state pension funds such as Calpers and the State of Wisconsin Investment Board; mutual funds have generally shunned the class representative role, even when expressly invited by plaintiffs' counsel to assume that role.

This development is not as surprising as it may seem; institutional investors depend heavily on their ability to communicate with the managements of the companies in which they invest. They, therefore, have a legitimate concern that if they agree to serve as a class representative, they may alienate themselves from the managements of their investees and thereby deprive themselves of valuable lines of communication. Also of potential concern is that investment managers could be subjected to cross-examination on the extent of their communications with the issuer's management, raising a danger that disclosures made to them would preclude them from alleging victimization by fraud, and perhaps even give rise to a claim of their having traded on inside information. Although it is not clear whether the courts would permit an institutional investor to be so questioned, none has been eager to find out.

Although the reluctance of institutional investors to serve as lead plaintiffs was predicted by the plaintiffs' bar prior to the adoption of the Reform Act, there have nevertheless been signs that the plaintiffs' bar did not trust its own rhetoric. Grundfest and Perino have found that in the

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initial suits filed under the Reform Act, the required notices to potential class members were worded in general terms and often placed in obscure periodicals, perhaps to avoid attracting institutional investors that might take over control of the case. In the more recent cases, however, the notices have been placed in the *Wall Street Journal* and other widely circulated periodicals and have been far more explicit in their descriptions of the allegations. The Study's authors have suggested that the plaintiffs' attorneys may have concluded not only that institutional investors will not seek to usurp the positions of the original named plaintiffs, but also that such notices can be helpful in attracting additional non-institutional plaintiffs, giving the attorneys initiating the action a greater claim to serving as lead counsel for the class.

The Reform Act's procedure for selecting lead counsel has reduced the prior incentive of lawyers to file class actions with unseemly speed in order to gain control of the action by imposing on counsel the cost of notifying the class of the suit and by backing the higher pleading standards with mandatory sanctions. The SEC has reported that, since the passage of the Act, "[t]he race to the courthouse has slowed somewhat. Although a few cases were filed within days of the release of negative news by the issuer, most were filed after at least several weeks had passed." The SEC suggests also that the Reform Act's higher pleading standard may have contributed to this slowdown.

While the procedural changes in the Reform Act with respect to the selection of lead counsel have brought about few substitutions of plaintiffs' representatives and fewer substitutions of plaintiffs' counsel, one major change has occurred in the selection of class counsel. Milberg, Weiss, Bershad, Hynes & Lerach, the nation's largest and best-known class action law firm — which vigorously fought the enactment of the Reform Act and unsuccessfully fought for the adoption of Proposition 211 in California — ironically appears to have become a principal beneficiary of the Reform Act. According to the Grundfest-Perino Study, the percentage of cases in which Milberg Weiss has become class counsel has increased from 31% of pre-Reform Act cases to 59% of post-Reform Act cases.

One possible cause of this increase may be the greater investment that the Reform Act requirements will cause plaintiffs' counsel to make in each case. Because of Milberg Weiss' previous successes, it is undoubtedly in a

better position to make such investments. Although it is also possible that many members of the plaintiffs' bar (fearing that the Reform Act will make securities class action work less profitable) have chosen to abandon the field, it seems unlikely that such a change would have occurred so early, before it becomes clear what the impact of the Reform Act will actually be.

It has also been postulated that plaintiffs' law firms have been trying to assemble groups of plaintiffs in an effort to persuade the court that their clients represent a substantial interest in the lawsuit, in order to avoid losing control of the case to an institutional investor or a group of investors loyal to another member of the plaintiffs' bar. Thus, it is possible that lesser-known plaintiffs' law firms have enlisted Milberg Weiss to serve as their co-counsel in order to augment their efforts to enlist class representatives. Such a theory is consistent with the indications that the average number of days between the announcement of adverse information and the filing of the class action law suit has increased.

If the Reform Act does cause securities class actions to become less lucrative for plaintiffs' counsel, the size of the plaintiffs' bar will likely diminish. If this occurs, there may be a corresponding diminution in the total number of suits alleging violations of the federal securities laws. While such transformations do not occur overnight, they should be revealed within three to five years, and can be detected by monitoring the number of plaintiffs' law firms that appear in securities suits.

It is also possible that the number of law firms representing plaintiffs in individual securities law cases may change. In the past, there was a tendency for several firms to file class action cases immediately following the publication of adverse news, since some courts took the filing dates into consideration in designating lead counsel for the class. In such cases, it was not unusual for there to be between five and ten law firms representing a single class of plaintiffs. Under the Reform Act, on the other hand, a law firm initiating a case on behalf of a single, insignificant investor might end up with no role in representing the class. Thus, there is a significant likelihood that there will be fewer firms to share the proceeds from each litigation, a factor which could, in turn, further diminish the size of the plaintiffs' bar.

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Early Settlement Data

The Grundfest-Perino Study has also reported the settlement of five post-Reform Act cases. Three of these five cases were resolved for little or no damage payments, while two of them involved sizable settlements (one for $31.3 million). Since the resolution of more serious claims will likely occur only after substantial litigation efforts, it is impossible to draw any conclusions yet as to the impact of the Reform Act on the outcome of securities law class actions. If, in fact, the Reform Act is successful in eliminating the more frivolous claims, one would expect that the average resolution costs for the remaining cases would increase. Evidence of this phenomenon will only be available after greater experience has been recorded.

Court Rulings

In the aftermath of the passage of the Reform Act, the courts are being asked to interpret many of its provisions. With few exceptions, such interpretations have not yet reached the appellate stage, and it will be a few years before the legal issues will be finally determined. Based on the decisions rendered to date, it appears that the Act will be interpreted as follows:

- ✍ The automatic discovery stay will likely apply even with respect to mandatory document exchanges called for under FRCP 26(a);

- ✍ The discovery stay may pertain to parallel suits brought in state court, and possibly even to state court actions for which there is no parallel proceeding in federal court;

- ✍ The pleading standard heretofore employed by the Second Circuit will probably be the standard required by the Reform Act, although at least one court, the U.S. District Court for the Northern District of California in the *Silicon Graphics, Inc. Securities Litigation*, 1996 U.S. Dist. LEXIS 16989; Fed. Sec. L. Rep. (CCH) ¶99, 325 (N.D. Cal., Sept. 25, 1996), has interpreted the Reform Act as rejecting a recklessness standard altogether;

- ✍ The courts, at least in the immediate future, are likely to give plaintiffs an opportunity to replead when the complaint is deemed insufficient (although

the ability to replead is likely to be hampered by the unavailability of discovery); and

- The Reform Act will not be applied retroactively.

The Overall Impact

It is too soon to predict with confidence the overall impact of the Reform Act. For now, it seems clear that cases are being vigorously prosecuted and defended, and that the host of new legal issues raised by the Reform Act is likely to increase the cost of litigating securities class actions, at least for the foreseeable future. In addition, the limitations on joint and several liability and the 90-day assessment period for measuring damages could reduce the total amount of damages in such cases. This, however, is far from a certainty, as the quantum of damages paid in pre-Reform Act cases has often been more a function of the defendants' ability to pay than the amount of damages which the plaintiffs have been able to prove.

It also seems premature to predict that the Reform Act will not reduce the amount of litigation. Although the number of cases seems to have remained relatively constant over the past year, there is strong evidence that actions (at least for the moment) have decreased in size and have been concentrated among fewer law firms. If these trends persist, it is entirely possible that there may be a permanent reduction in the size of the plaintiffs' bar which, in and of itself, will likely be reflected in a reduction in the number of cases.

Of most immediate importance are the decisions addressing whether the limitations on securities class actions contained in the Reform Act will be held to apply to state court proceedings. The clear tendency of plaintiffs to assert their claims increasingly in state court has already spawned proposed federal legislation to preempt the area so as to provide an exclusive remedy in the federal courts. To the extent that the state courts choose to apply the provisions of the Reform Act, the need to adopt such legislation will be obviated.

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[1]The majority of securities law claims include allegations under Section 10(b) of the Securities Exchange Act of 1934, for which exclusive jurisdiction is placed in the federal courts. In addition, the federal courts can more readily accommodate claims involving parties located in several states, whereas state courts typically can only exercise jurisdiction over persons domiciled within the state or subject to the state's long-arm statute.

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[2]Ironically, high-tech companies were among the principal supporters of the Reform Act.

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[3]Such an analysis was not performed owing to the limited quantity of information which Grundfest and Perino were able to amass with respect to state court cases.

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