The Evidence on Securities Class Actions[†]

Stephen J. Choi[*]

Abstract

This article examines the theoretical issues and surveys the evidence on the desirability of securities class actions. Class actions offer the promise of energizing private enforcement of the securities laws, including in particular antifraud liability. For shareholders of large, publicly-held corporations, the individual benefits of pursuing a fraud action are often outweighed by the considerable costs of litigation. Without a class action, many potential fraud lawsuits may simply not get litigated. Nonetheless, the article explores three related problems with class actions: (a) the problem of frivolous suits (and the need to allow meritorious suits); (b) the lack of incentives on the part of plaintiffs' attorneys to focus on smaller companies; and (c) the agency problem between plaintiffs' attorneys and the plaintiff class. The article then assesses the existing evidence from the United States (in particular on the impact of the Private Securities Litigation Reform Act of 1995) in addressing these problems and proposes future avenues for research. Understanding the impact of class actions is important not only for the U.S. but also for countries considering the adoption of a U.S.-style securities class action system. As an example, the article discusses whether securities class actions would be beneficial in South Korea, a country with a smaller capital market and fewer large companies compared with the United States.

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[*] Roger J. Traynor Professor, U.C. Berkeley Law School (Boalt Hall). Special thanks to Un Kyung Park. Thanks to the participants of the Korea Development Institute (KDI) Corporate Governance Conference (December 2003) for helpful discussions and comments.

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 less than full incentives 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 duties and rights created under 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 in theory may work to ameliorate the collective action problem confronting shareholders. Instead of each shareholder pursuing an individual action, the entire class may, 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 as well as the benefits from the action. Moreover, in theory representatives of the class can negotiate with and select the best plaintiffs' attorneys as lead counsel to advance the litigation.

While a potentially useful mechanism to discipline opportunistic managers and controlling shareholders, class actions are not a panacea for the shareholder collective action problem. Due to strong pressures to settle on both the part of plaintiffs and defendants, some commentators have argued that plaintiffs' attorneys have a strong incentive to file frivolous complaints. Frivolous suits include suits brought where the plaintiffs have no expectation at all of finding any evidence of fraud or culpability on the part of defendants. Arguably, frivolous

suits also include, more broadly, situations where the plaintiffs' expected costs of undergoing a trial exceed the expected benefits of doing so (but the plaintiffs file suit nonetheless to extract a positive settlement from defendants unwilling to go to trial).[1] 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. Even where lawsuits 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 therefore 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 small 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 simply non-existent.

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 the use of class actions. Naturally, the theoretical problems do not exist in a vacuum and may apply differently in varying countries. The United States enjoys deep and liquid capital markets with substantial trading volumes. The potential damage awards from a class action are therefore relatively higher in the U.S., giving private plaintiffs' attorneys a

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[1] Several have provided formal models of the incentive of plaintiffs' attorneys to file frivolous suits. See David Rosenberg & Steven Shavell, A Model in Which Suits Are Brought for Their Nuisance Value, 5 Int'l Rev. L. & Econ. 3, 3-4 (1985); Lucian A. Bebchuk, Suing Solely to Extract a Settlement Offer, 17 J. Leg. Stud. 437, 437-41 (1988); Avery Katz, The Effect of Frivolous Lawsuits on the Settlement of Litigation, 10 Int'l Rev. L. & Econ. 3, 5 (1990). See generally Robert D.Cooter & Daniel L. Rubinfeld, Economic Analysis of Legal Disputes and Their Resolution, 27 J. Econ. Lit. 1067, 1075- 82 (1989) (summarizing various settlement theories).

greater incentive to pursue class actions. 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 fair outside the United States, the article focuses on the specific case of South Korea. Why Korea? The attraction of class actions has led several legal experts to suggest shareholder class actions as a possibility for Korea.[2] Recently, Korea enacted new legislation providing for class actions against relatively large companies commencing on January 1, 2005 (and other companies from January 1, 2007).[3] 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, Korea has a relatively small number of attorneys per unit population 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 in how to initiate an effective class action system. The problems that plague class actions in the United States, therefore, may take on varying 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.

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[2] See Bernard Black, Barry Metzger, Timothy J. O'Brien, Young Moo Shin, 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) ("Further 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.").

[3] 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. For a survey of the various reforms in Korea see Hwa-Jin Kim, Toward the "Best Practice" Model in a Globalizing Market: Recent Developments in Korean Corporate Governance, 2 Journal of Corporate Law Studies 345 (2002) (describing reforms in the Korean corporate governance regime and the adaptation of Korean corporate governance to global standards).

Part II of the Article sets forth 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 thinking about 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, in enacting the PSLRA, Congress intended to meet 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 party to settle; and (4) the manipulation of class action lawyers of the clients whom they purportedly represent[4]

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.

A. Frivolous Lawsuits

[4] See Conference Report, H.R. Rep. No. 369, 104th Cong., 1st Sess., 31 (1995), reprinted in 1996 U.S.C.C.A.N. 730 (p. 1103).

The PSLRA represents Congress's response to a perceived litigation crisis in the early 1990s. Prior to the PSLRA, according to popular wisdom, 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 fraud on the part of the company or its officials. Why would a company and its directors and officers settle a case they believed frivolous? Getting rid of even frivolous litigation is not cost-free. To the extent 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 attorney's 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.[5] Rather than face this prospect (even if low risk), directors and officers will often settle, relying on the D&O liability insurers to pay most (if not all) of the settlement award.

Several provisions of the PSLRA aim directly at frivolous lawsuits. The PSLRA provides a stay of discovery until after the motion to dismiss.[6] Without the specter of document production, depositions of a company's top officers, and 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

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[5] 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").

[6] See Section 21D(b)(3)(B), Exchange Act.

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).[7] In the case of Rule 10b-5 liability, plaintiffs must plead facts giving a strong inference that the defendants acted with either actual intent or out of recklessness.[8] 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."[9]

The PSLRA also reduces the exposure of defendants to liability related to forward-looking statements. The PSLRA amended the Exchange Act and Securities Act to provide for new Sections 21E and 27A respectively.[10] Both provisions set out certain preconditions for the safe harbor against liability. Only certain defendants are eligible, including Exchange Act reporting issuers and those working on the issuers' behalf.[11] As well, forward-looking statements in certain contexts are excluded from the safe harbor, such as during an initial public offering. For those defendants meeting the eligibility screen and exclusions, the safe harbor then imposes a requirement that the forward-looking statements are identified as such and are accompanied by meaningful cautionary language.[12] However, even for forward-looking statements that fail to meet the meaningful cautionary language requirement, defendants may still take advantage of the safe harbor to the extent the plaintiffs fail to meet the burden of proof

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[7] See Section 21D(b)(2), Exchange Act.

[8] See Ernst & Ernst v. Hochfelder et al., 425 U.S. 185, 194 n.12 (1976) (reserving the question of whether recklessness meets the scienter requirement). The circuit courts have generally held that recklessness meets the scienter requirement of Rule 10b-5. See, e.g., Florida State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 653-54 (8th Cir. 2001); In re Advanta Corp. Sec. Litig., 180 F.3d 525, 535 (3d Cir. 1999).

[9] Section 21D(b)(1), Exchange Act.

[10] See Section 21E, Exchange Act; Section 27A, Securities Act.

[11] See Section 21E(a), Exchange Act.

[12] See Section 21E(c)(1)(A), Exchange Act.

of showing that the defendants had actual knowledge that the forward-looking statement was false or misleading.[13]

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).[14] 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.[15] Even where other defendants are judgment proof or otherwise unable to pay their damages, defendants under the proportionate liability system are only, in most cases, liable to a maximum of 150% of the amount of damages for which they are responsible.[16] The proportionate liability rule works to protect deep pocket defendants who are more remote from the fraud (such as auditors and underwriters). To the extent culpability for most corporate frauds is generally assigned more to corporate insiders (who make the actual decisions on corporate disclosures), the liability facing outsider deep pocket defendants is lessened.[17] Indeed, where corporate insiders are judgment proof or otherwise unavailable, the proportionate liability rule works to reduce the total damage amount plaintiffs may expect (as the remaining defendants are liable only up to 150% 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 exacerbate the impact of proportionately liability. In particular, Sarbanes-Oxley requires corporate CEOs and CFOs to certify financial

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[13] See Section 21E(c)(1)(B), Exchange Act. See Harris v. Ivax Corporations, 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....").

[14] See Section 21D(f), Exchange Act.

[15] See Section 21D(f)(2)(B), Exchange Act. The jury (or if there is no jury the court) is required to make findings of fact on the relative culpability of the defendants. See Section 21D(f)(3), Exchange Act.

[16] See Section 21D(f)(4)(A)(ii), Exchange Act. 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". Section 21D(f)(4)(A)(i), Exchange Act.

[17] See Bernard S. Black, Brian R. Cheffins, Michael Klausner, Outside Director Liability (working paper 2003) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=382422) (discussing the role proportionate liability in reducing the exposure of outside directors to liability).

statements,[18] increasing the likelihood that a jury will find the CEO and CFO more culpable, reducing the liability of all other defendants. Where the CEO and CFO are unable to pay their full award, proportionate liability results in the plaintiff class (and indirectly therefore the plaintiffs' attorneys) receiving a lower return from bringing the class action in the first place.[19]

Finally, the PSLRA provides an explicit requirement that courts must review a class action on the merits (after the "final adjudication" occurs) and impose sanctions (including the defendants' attorney's fees) on frivolous litigation.[20]

Any reform that works successfully to reduce frivolous suits, of course, is hard to argue against. And 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 while also reducing the probability of success for plaintiffs' attorneys. Perhaps more importantly, because these reforms (such as the stay on discovery) reduce the cost to defendants of waiting for the motion to dismiss, defendants will be more likely to seek such motions rather than 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 fixed cost of deciding whether to pursue a securities fraud class action. At a minimum, plaintiffs' attorneys must research a potential class action defendant, draft and file the complaint, compete with other plaintiffs' attorneys to obtain the lead counsel position, and then respond to

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[18] See Section 302, Sarbanes-Oxley Act of 2002.

[19] See id. (discussing how CEO certification works to increase the culpability of insiders, thereby reducing the exposure further of outside directors to liability under a proportionate liability regime).

[20] See Section 27(c), Securities Act.

the inevitable motion to dismiss. Imposing a pleading with particularity requirement (coupled with a stay on discovery) raises the costs considerably for attorneys to pursue even claims that may turn out to be meritorious. The stay on discovery, moreover, dramatically increases the cost of obtaining information (in certain cases to infinity for information known solely within the defendant company). As well, 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 revolving around discovery, among other aspects of pre-trial work, and the cost of going to trial itself 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 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, therefore, may work to raise the minimum size threshold (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 against securities fraud.

Ideally, regulatory reform could encourage (and indeed subsidize) plaintiffs' attorneys pursuing meritorious lawsuits while hindering plaintiffs' attorneys pursuing a frivolous suit. 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 bullet distinguishing between frivolous and meritorious suits has been found yet.

One could of course say that low value fraud claims are not important. In terms of dollar value, by definition, fraud that impacts the shareholders of low market capitalization firms will have only a limited direct impact on the overall capital markets. However, fraud involving low market capitalization firms often involves initial public offerings and other more new, 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. As well, 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. Plaintiff's 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. Expecting to receive only a fraction of the award, plaintiffs' attorneys may not expend as much effort or invest as much money 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. As well, 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 hand picked 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 overly high fee awards is court review of the fees. To the extent no party after a settlement is present to contest the fee award, however, courts may have few incentives to intervene to reduce the fees.[21]

The PSLRA provides fewer 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 presumption.[22] In particular, the PSLRA imposes a rebuttable presumption that the plaintiff 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.[23] 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".[24] 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.[25] In theory, a lead plaintiff with a large stake in the litigation will have more incentives to monitor the plaintiffs' attorney for effort and also be more willing to resist disproportionately high plaintiffs' attorney fee awards.

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[21] Several examples exist of courts approving the requested attorney fee award. See, e.g., Bonett v. Education Debt Services, Inc., 2003 WL 21658267 (E.D.Pa., May 09, 2003); In re Corel Corp. Inc. Securities Litigation, 293 F.Supp.2d 484 (E.D.Pa.,2003); In re Cylink Securities Litigation, 274 F.Supp.2d 1109 (N.D.Cal.,2003). Nonetheless, courts do, on occasion, reduce the fee award below the amount requested. See, e.g., In re Baan Co. Securities Litigation, 288 F.Supp.2d 14 (D.D.C.,2003) (awarding only 28% of the settlement fund as attorneys' fees despite a request for 32% of the fund)

[22] See Section 21D(a)(3), Exchange Act.

[23] Section 21(D)(a)(3) reads in part 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.

[24] See 21D(a)(3)(vi), Exchange Act.

[25] See Section 21D(a)(3)(v), Exchange Act; See also In Re Cendant Corp. Litigation, 264 F.3d 201, 220 (3rd Cir. 2001) (discussing the lead plaintiff's right to select the lead counsel in a securities class action).

The PSLRA also addresses the problem of plaintiffs' attorney power over the plaintiff class more directly. Under the Act, attorney's fees are limited to a "reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class."[26] The settlement notice sent to the class must specifically delineate the attorney's fees and costs being sought by the plaintiffs' attorneys from the class settlement fund.[27]

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 sue managers in a class action when a company's price drops. Second, other institutional investors – in particular public pension funds – may get involved in litigation not so much to benefit the class but instead to push the political agenda of those politicians with influence over the public pension fund.[28] 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 (e.g., obtaining a settlement right before an election for example 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 exist. Among these questions are:

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[26] See Section 21D(a)(6), Exchange Act.
[27] See Section 21D(a)(7)(C), Exchange Act.
[28] See, e.g., Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 Colum. L. Rev. 795, 799-839 (1993).

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. If the PSLRA, for example, failed to reduce the incidence of frivolous litigation then the cost of allowing class actions may exceed the benefits. On the other hand, even if frivolous suits are reduced by the PSLRA, 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.

A. The Incidence of Frivolous Lawsuits

Whether lawsuit filings are frivolous or meritorious is particularly difficult to assess.[29] Tests of frivolous litigation have focused on a number of indirect measures.

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

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, measuring 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,
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> (b) the House override of the veto on December 20, and
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> (c) the Senate override of the veto on December 22.

One shortcoming of event studies focusing on a particular regulatory event (such as the enactment of the PSLRA), however, is the lack of diversity in event dates. It is possible that some other event occurred at around the same time as the passage of the PSLRA that may have affected particular industries in a way that drive 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.[30]

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.[31] Their study focuses solely on firms in the biotechnology, computer, electronics, and retailing industries, all identified as high litigation risk industries by Francis, Philbrick, and Schipper (1994a).[32] After removing, among others, firms that had confounding firm-specific corporate events, they generate a sample of 1485 firms from the CRSP database.[33] Spiess and Tkac report from their event study that their entire sample of firms experienced a significant negative abnormal return on December 18, 1995, corresponding to rumors that President Clinton would veto the PSLRA.[34] They then 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 took place *after* the market close on December 19). The later Senate override on December 22 received only an insignificant positive abnormal return.[35] Spiess and Tkac interpret their event study results as consistent with the hypothesis that the market viewed the PSLRA as, on net, beneficial to the wealth of shareholders.

Spiess and Tkac also test whether firms with relatively weak corporate governance are benefited more or less by the passage of the PSLRA. Firms with weak corporate governance

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[30] 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.

[31] See D. Katherine Spiess and Paula A. Tkac, The Private Securities Litigation Reform Act of 1995: The Stock Market Casts its Vote…, 18 Manage. Decis. Econ. 545 (1997).

[32] See id. at 550 (citing Francis, Philbrick, and 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). See id. at 550.

[33] See id.

[34] See id. at 554.

[35] See id.

may represent a greater risk to shareholders of fraud; thus, the passage of the PSLRA may reduce the value of such firms by making even meritorious litigation more expensive for plaintiffs to pursue. On the other hand, firms with weak corporate governance structures may also represent "juicier" targets for frivolous suits (to the extent plaintiffs' attorneys may point to the weak governance structure as a justification for even a frivolous suit).[36] To test the impact of the PSLRA on firms with weak corporate governance, they divide 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.[37] While most of their results are inconclusive, they do 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 compared with biotechnology firms with high institutional investor ownership.[38] They interpret 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."[39]

Johnson, Kasznik, and Nelson (2000) (JKN) conduct a similar event study as Spiess and Tkur (1997).[40] JKN focus on a slightly different sample, however, of 489 firms in the pharmaceutical, computer hardware, and computer software industries.[41] As with Spiess and Tkur (1997), JKN use December 18, the day rumors of President Clinton's possible veto started

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[36] See id. at 555.

[37] Spiess and Tkac, however, do not classify "grey" outside directors with consulting and other relationships with the firm. See id. at 551.

[38] See id. at 556-57.

[39] Id. at 559.

[40] See Marilyn F. Johnson, Ron Kasznik, and Karen K. Nelson, Shareholder Wealth Effects of the Private Securities Litigation Reform Act of 1995, 5 Rev. of Accting Studies 217 (2000).

[41] See id. at 218. The SIC Codes are as follows: pharmaceutical (2833-2836), computer hardware (3570-3577), and computer software (7371-7379).

circulating, as the event date to test the impact of the veto on the market. JKN then use the period from December 20 to 22 to gauge the impact of the House override (on Dec. 20) and the Senate override (on Dec. 22). JKN report 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.[42]

JKN then examine the impact of a firm's exposure risk to both frivolous and meritorious lawsuits on the abnormal returns in their event study. They posit 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, firms facing a greater risk of meritorious suits (and thus representing a greater risk to investors of fraud) may experience a more muted (if not negative) response to the PSLRA. They construct 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 (compared with those that did not).[43] For proxies of the risk of a frivolous suit they use a firm's market capitalization, stock market beta, cumulative daily return for the first 11 months of 1995, the minimum return a firm received (measured over any continguous 20 day trading period) during 1994 or the first 11 months of 1995, skewness of raw returns, and turnover of the firm's shares (factors found significant in Francis, Philbrick, and Schipper (1994a) and Jones and Weingram (1996a) detailed below).[44] For proxies of meritorious litigation risk, JKN focus on factors associated with "aggressive" accounting, including factors related to CEO power,[45] the level of oversight of management,[46]

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[42] See id. at 224.

[43] See id. at 223-25.

[44] See id. at 224-25 (noting that "these variables . . . capture many of the characteristics claimed to be indicative of frivolous 'strike' suits.").

[45] 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.

[46] The level of oversight over management is derived from among other things, the presence of a Big 6 accounting firm, whether there exists a separate audit committee and the presence of a block shareholder with at least five percent of the outstanding shares.

the need of the firm for financing, and the leverage of the firm.[47] JKN then weight the firms in their portfolio based on the litigation risk (obtained from their probit model) for the sample firms.[48] They report that while weighting the portfolio based on a combination of the risks of meritorious and frivolous suits results in an overall positive cumulative abnormal return from Dec. 18 to Dec. 22 (indicating a wealth increase from the PSLRA), weighting the portfolio solely based on the risk of a meritorious lawsuit results in an overall negative cumulative abnormal return (significant at the 6% level).[49] JKN state that, "our 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."[50]

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 as well. 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 relatively fixed costs of litigation). As well, JKN's factors for whether a firm faces a high risk of meritorious litigation are not perfect. Even firms with strong corporate governance structures may commit fraud.[51] And the converse is also true, even firms with weak corporate governance may engage in honest financial reporting. Nonetheless, to the extent firms

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[47] See id. at 225.
[48] See id. at 229-30.
[49] See id. at 230.
[50] Id. at 229.
[51] For example, 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. See, e.g., Enron, Def 14A filing (filed Mar. 24, 1997) (available at http://www.sec.gov/edgar/searchedgar/companysearch.html).

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.[52] They examine the abnormal market reaction for firms in the same four industry groups as Spiess and Tkac (1997), deemed to face a high risk of litigation giving 1589 total maximum number of firms in their sample.[53] To gauge the market's reaction to the PSLRA, they focus 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 (all involving actions in Congress moving the PSLRA forward through the legislative process prior to December 20, 1995).[54] The fourth event is centered on December 20, 1995. Unlike Spiess and Tkac (1997) and JKN (2000), Ali and Kallapur interpret 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. They report that the firms in their sample have a significantly positive abnormal return on December 20.[55] While Clinton's veto and the House override of the veto provide two potentially confounding pieces of information to the market, Ali and Kallapur interpret the positive return on December 20, 1995 as consistent with a positive reaction in the market to Clinton's veto of the PSLRA (opposite to

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[52] See Ashiq Ali and Sanjay Kallapur, Securities Price Consequences of the Private Securities Litigation Reform Act of 1995 and Related Events, 76 The Accounting Review 431 (2001).

[53] 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). See id. at 436.

[54] See id. at 437.

[55] See id.

how Spiess and Tkac (1997) and JNP (2000) interpret the Dec. 20 market reaction).[56] To further support their findings, Ali and Kallapur examine 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).[57] 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%, consistent with the view that the PSLRA reduced shareholder value for such firms.[58]

The event study evidence surrounding the passage of the PSLRA is therefore somewhat inconclusive. One additional event study looks 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) examine 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.[59] Their sample consists of firms in

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[56] See id. at 443. To support their interpretation, Ali and Kallapur provide evidence that the abnormal returns on 12/20/95 are significantly negatively correlated to the abnormal returns on 12/11/95 (when Clinton indicated to the market his intent to sign the bill). The reversal on 12/20/95 of the negative market reaction on 12/11/95 provides evidence that the market reaction on 12/20/95 is due primarily to the market's assessment of Clinton's change of heart in vetoing the PSLRA. See id.

[57] See id. at 446.

[58] Ali and Kallapur also examine the stock market reaction to the defeat of California Proposition 211 in 1996. See 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. See id. As a further check, Ali and Kallapur also look at the market reaction to several Supreme Court decisions affecting the ability of plaintiffs to file private securities causes of actions and find a negative abnormal reaction to the Central Bank v. Denver opinion (114 S.Ct. 1439) eliminating aiding and abetting liability under Rule 10b-5. See id. at 453-54.

[59] In *In Re Silicon*, the Ninth Circuit adopted a "deliberate recklessness" standard for pleading fraud with particularity for securities fraud class actions. JNP (2000) 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 shift to a deliberate recklessness standard as a surprise to the market (and thus a good candidate for an event study). See id.

industries particularly vulnerable to a securities fraud suit including pharmaceuticals, computer hardware, and computer software.[60] Excluding firms already involved in a securities class action, they end up with a sample of 277 firms (93 of which are headquartered in the Ninth Circuit and 184 outside the Ninth Circuit).[61] In their event study,[62] they report a significant positive cumulative abnormal return (CAR) for the period from July 2, 1999 to July 6, 1999 (corresponding to news reports in the Wall Street Journal on the *In Re Silicon Graphics* decision). Moreover, the CAR is 2.79% for firms in the Ninth Circuit while only 1.27% outside the Ninth Circuit.[63]

To determine the differential impact of the new pleading standards on firms with varying risks of facing securities litigation, JNP fit a model of litigation risk. The litigation risk model uses whether a firm faced a lawsuit in the 2 years prior to the passage of the PSLRA as the dependent variable in a probit model.[64] For independent variables they include measures they deem more correlated with "strike suits" such as stock price volatility and stock price performance (including market capitalization, equity beta, share turnover, prior cumulative return, and return skewness).[65] They also include factors likely correlated with the merits of litigation based on the power of the CEO and the monitoring within the company of the CEO (including 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

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[60] The corresponding SICs are: pharmaceuticals (2833-2836), computer hardware (3570-3577), computer software (7371-7379). See id. at 792.

[61] See id.

[62] Expected returns in their event study are calculated using the market model for the 252 trading days in 1998. See id. at 805.

[63] See id. at 794-795. JNP 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. See id.

[64] See id. at 807-808.

[65] See id.

founder).[66] They also include other merit factors related to the motive to commit fraud including 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.[67] Using their litigation risk model, JNP partition their sample firms into four quartiles based on the predicted litigation risk. They find that the firms at highest risk of litigation had a CAR of 2.61% while the lowest risk firms had a CAR of 1.19%. The difference between the two CARs is significant however at only the 10% level.[68] When JNP repartition the sample based solely on their identified "merit"-related litigation risk factors, they find that the highest risk quartile firms have a CAR of 2.68% while the lowest risk quartile firms have a CAR of only 0.51% (difference significant at the 5% level).[69]

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) puts forth the hypothesis that litigation acts as an ex post mechanism to discipline managers of companies with relatively weak ex ante corporate governance control.[70] In her view, litigation and corporate governance act as substitute means to align the incentives of managers and shareholders. Romano tests this hypothesis along a number of dimensions. She examines a pre-PSLRA dataset consisting of 535 randomly selected firms drawn from both currently traded and delisted firms from the NYSE as well as the Nasdaq OTC market. For the firms in her dataset, Romano tracks shareholder suits (including class actions

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[66] See id.
[67] See id.
[68] See id. at 796-97.
[69] See id. at 798-99.
[70] See Roberta Romano, The Shareholder Suit: Litigation Without Foundation, 7 J. L. Econ. & Org. 55 (1991).

and derivative suits) occurring from the late 1960s to 1987.[71] Her results provide mixed evidence on the value of shareholder litigation as a disciplining device on management. She first reports that shareholders suits are an infrequent occurrence, noting that only 19 percent of her sample experienced any suit during the entire period of her study (for a total of 139 suits).[72] Focusing on outcomes, Romano reports that most suits settle (83 of 128 suits with known resolutions).[73] Many of the suits settle with no monetary relief, resulting in only cosmetic changes to the board and attorney fee awards.[74] The lack of monetary relief (aside from attorney's 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 examines whether corporate governance changes occur around the time of a shareholder suit. To control for governance changes that may occur irregardless of a suit, she collects a matching sample of firms (matched based on 4-digit SIC code).[75] Compared with the matching firm sample, Romano reports that the lawsuit sample experienced a significantly greater turnover in the CEO or Chair of the Board positions.[76] Most of the CEO or Chair turnover occurred in the year before the filing of the suit and during the lawsuit itself, but not in

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[71] See id. at 58.

[72] See id. at 59. Romano also conducts 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. See 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 of the need for such changes (lowering the market's valuation of the company). The negative CAR could indicate that effect (b) dominates effect (a).

[73] See id. at 60.

[74] See 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 control of the board among other things. See 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.

[75] See id. at 71.

[76] See id. at 71-72. Romano reports that 55 percent of the CEO or Chair changed for the lawsuit firm compared with 31 percent for the matching sample. See id.

the year after the resolution of the suit.[77] While Romano did not find any significant difference in the change in the overall fraction of outside directors on the board between the lawsuit and matching firms, she did report significant differences in the turnover numbers for individual directors. Lawsuit firms experienced a higher degree of board turnover compared with matching firms (particularly in the year before the lawsuit and during the lawsuit).[78] 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.[79] On the other hand, Romano reports that the change in the number of directorships in other corporations (a proxy for the quality and reputation of a director) held by those directors that departed compared with those who stayed was not significantly different, inconsistent with the hypothesis that turnover of directors is a negative event for the directors.[80] Romano also finds evidence that lawsuit likelihood is significantly correlated with the presence of outside block shareholders,[81] leading her to hypothesize that "litigation is a complement rather than a substitute for outside block ownership as a managerial monitoring device."[82]

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[77] See 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 law suit firms have a significantly greater CEO or Chair turnover compared with the matching firms. See id. at 73-76.

[78] See id. at 72-23, 78.

[79] See id. Romano controlled for the possibility that the board turnover is due to an acquisition and received similarly significant results. See id. at 78.

[80] See 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 decline (from 4.4 to 4.5) and the difference in mean change across the groups is not significant."). Romano concludes: "we cannot interpret the significantly lower board stability of lawsuit firms as confirmation of an organizational response to litigation.". Id. at 79.

[81] Romano provides both a comparison of mean outside block ownership between the lawsuit and matching sample, see id. at 72, 80, and 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), see id. at 82-83. In both tests, she reports that lawsuit incidence is significantly correlated with a greater outside block ownership. See id. at 80-83.

[82] Id. at 80. Romano writes that "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 positive related to a higher probability of a subsequent suit). See id. at 83.

Romano's study does not separate out suits based on their likelihood of being frivolous compared with merit-driven (as many of the event studies on the PSLRA described above do with the event study abnormal returns). While Romano does examine settled versus dismissed cases, within the set of settled cases may exist a mix of both frivolous and meritorious suits. While one may expect that meritorious shareholder litigation may act as a substitute mechanism to monitor managers (resulting in greater corporate governance changes corresponding to the litigation for example), 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 focus 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) examine the determinants behind securities class action filings as well as outcomes.[83] Their study focuses on the chemicals, computer, electronics, and retailing industries, all of which had high numbers of securities litigation from 1988 to 1991 (the time period of their sample).[84] They collect a sample of 91 class actions involving Rule 10b-5 or Section 11 fraud allegations.[85] FPS note that litigation in their sample is "overwhelmingly" focused on the results of operations (e.g., earnings and sales) and on the financial condition of

[83] See Jennifer Francis, Donna Philbrick, and Katherine Schipper, Determinants and Outcomes in Class Action Securities Litigation (Working Paper, 1994).

[84] See id. at p. 1 of the working paper.

[85] See id. at p. 1 of the working paper.

the lawsuit firms.[86] Examining the determinants of litigation, FPS report that size makes a difference in the incidence of securities class action litigation. Compared with industry peer firms (selected based on the same 4-digit SIC code as the lawsuit firms), lawsuit firms have significantly larger assets, sales, market share, and market capitalization among other indicia of size.[87] As well the lawsuit firms pay out higher amounts of dividends compared with the industry peer sample.[88] To focus on determinants other than firm size, FPS construct a matching sample based on the 4-digit SIC and firm size. FPS report that lawsuit firms tend to have higher systematic risk (equity beta) compared with industry peers and matched firms but do not have higher return volatility or more instances of large price drops compared with either the industry peers or matching firms.[89] Lawsuit firms do, nonetheless, experience lower cumulative stock returns in the year of the lawsuit filing.[90]

Looking at various financial performance measures (e.g., earnings per share and return on assets), FPS report no evidence that the lawsuit firms are "less financially prosperous" than either the industry peer or matched firms.[91] 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 itself, protection against shareholder litigation."[92] Lawsuit firms also are audited by Big 6 auditors more frequently than the industry peer firms (significant at the

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[86] See id. at p. 3, 19-20 of the working paper.

[87] See id. at p. 9 of the working paper.

[88] See id. at p.12 of the working paper.

[89] See id. at p. 14 of the working paper. FPS write: "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 p. 15 of the working paper.

[90] See id. at p.25

[91] See id. at p. 11-12.

[92] Id. at p. 3, 23-24 of the working paper. To determine the disclosure environment, FPS look 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. See id.

10% level) but not in comparison with the matched sample by both industry and size.[93] Focusing on outcomes, FPS fail to find a significant linear relationship between settlement amount and estimated damages for the 55 lawsuits where they have sufficient data to estimate the potential damage award.[94] They do nonetheless report a significant relationship (at the 1% confidence level) between log transformations and ranks of settlement amounts and potential damages, indicating a monotonic relation between settlement and damages.

Jones and Weingram (1996a) similarly study the determinants of securities fraud class actions during the pre-PSLRA period.[95] They focus on two questions: (a) what factors lead to a higher probability that a firm will experience a 10% 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% price drop (e.g., not all 10% price drops result in a lawsuit). Combining these two questions allows for an overall determination of how certain factors may affect the risk of securities litigation. Jones and Weingram focus on a sample of firms-days where a firm experienced a 10% price drop from 1989 to 1992. Among the 10% price drop firms, they also identify those firms that also faced a securities fraud class action related in time to the 10% price drop.[96] They then add to their sample a random selection of firm-days consisting of 5% of the total firm-days (for all firms regardless of price drop) during the 1989 to 1992 period.[97] Combining the 10% price drop and random samples, Jones and Weingram provide evidence that

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[93] See id. at p. 10-11.

[94] See id. at p. 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. See id.

[95] See 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).

[96] Jones and Weingram identify securities class actions from Securities Class Action Alert. See id. at p. 23 of the working paper. Their sample consists of 203 Rule 10b-5 lawsuits associated with a 10% price drop.

[97] 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 imllion. See id. at p. 24 of the working paper.

(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 are all significantly correlated with an increased likelihood of a suit.[98] They provide more ambiguous evidence with respect to stock price volatility: more volatility in the 20 trading days leading up to a price drop is positively correlated with greater litigation risk while more volatility during the prior year (excluding the 20 days leading up to the price drop) is negative correlated with litigation risk.[99]

Neither Francis, Philbrick, and Schipper (1994a) nor Jones and Weingram (1996a) focus directly on the question of whether securities litigation is primarily frivolous or meritorious. Many of their identified risk facts (market capitalization, volatility, equity beta, and share turnover) may represent necessary but not sufficient factors for both frivolous and meritorious litigation (to the extent, in the absence of such factors, the expected damage award from litigation may be too low to cover the costs of plaintiffs' attorneys in pursuing litigation).

Other pre-PSLRA studies focus more directly on the importance of merit. Bohn and Choi (1996) use 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.[100] Looking at suit filings, Bohn and Choi construct a logit model for whether a firm in their sample encountered a securities class action related to the IPO.[101] Among independent variables they include controls for the offering amount, the offer price, the R&D over Sales ratio and the Ads over Sales ratio (as industry

[98] See id. at p. 28-29 of the working paper.

[99] See id at p. 28-29, 38 of the working paper. 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.

[100] See James Bohn and Stephen Choi, Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions, 144 U. Pa. L. Rev. 903 (1996).

[101] See id. at 950-52.

controls), and whether the offer was a firm commitment offering. As a proxy for merit, Bohn and Choi include a rating for the quality of underwriter associated with the offering derived from Carter and Manaster (1990).[102] Bohn and Choi hypothesis that to the extent higher quality underwriters associate with higher quality offerings, underwriter quality should be negatively related with the probability of facing a meritorious suit. Bohn and Choi report that, in fact, in the logit model underwriter quality is weakly (at only the 20% confidence level) related to a *higher* probability of suit, weakly consistent with the alternative hypothesis that higher-quality underwriters, as deep pockets, represent desirable targets for frivolous litigation.[103]

Bohn and Choi then examine the ex ante corporate governance structure of the IPO firms as well as insider sales associated with the IPO, comparing the lawsuit firms against a matching sample of firms (matched based on SIC code and sales). They report no difference in the insider sales as a fraction of the IPO offering amount.[104] Consistent with Romano (1991)'s hypothesis that litigation acts as a substitute for ex ante corporate governance, Bohn and Choi do report that the IPO firms facing a lawsuit have weaker corporate governance compared with the matching sample of firms.[105] They find that the lawsuit IPO firms had significantly fewer outsiders sitting on their boards (significant at the 5% level).[106] 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 (significant at the 10% level).[107]

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[102] See id (citing Carter and Manaster (1990)).

[103] See id.

[104] See 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).

[105] See Bohn and Choi, supra note 100, at 962.

[106] See id.

[107] See id. at 966.

Bohn and Choi also analyze those firms that settled their class action suit to determine the influence of merit-related factors on settlement. They fit a regression model explaining the settlement amount as a function of the potential damages available for an IPO securities class action.[108] They then fit an alternative regression model of the settlement amount as a function of the potential damages and 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 hypothesize that the alternative model should provide a better explanatory power for settlement outcomes. Comparing the two regressions using a F-test, however, they find no statistically significant difference in the fit of the two models, consistent with the hypothesis that the merits do not matter for settlement outcomes.

Gilbertson and Avila (1999) focus specifically on securities class actions involving auditors during the pre-PSLRA time period.[109] Their sample consists of 314 securities lawsuits filed from 1990-1993 alleging fraud relating to the defendant company's common stock price as collected from *Securities Class Action Alert*.[110] They first examine 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 contend that plaintiffs' attorneys will tend not to delay but instead file frivolous suits soon in time 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).[111] For their full sample of lawsuit firms they report a mean 78 day delay between the end of the class

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[108] See 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 the 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.").

[109] See L. Gilbertson and Steven D. Avila, The Plaintiffs' Decision to Sue Auditors in Securities Litigation: Private Enforcement of Opportunism?, 24 J. Corp. L. 681 (1999).

[110] See id. at 687-88.

[111] See id. at 690 ("If lawsuits are filed 'within hours or days,' this reinforces the belief that they are filed indiscriminately….").

period and the filing of suit. Within the sample, over 50% are filed within one week of the end of the class period.[112] Importantly, they report no statistically significant difference between the filing times between suits involving and not involving an auditor-defendant (despite their contention that meritorious suits against auditors should require more investigation and work).[113] While these results may indicate 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, 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 however do not control for the type of allegation in the complaint.[114]

Studies also focus on whether the PSLRA resulted in a reduction in more frivolous suit filings after the enactment of the Act. The effectiveness of the PSLRA in reducing frivolous litigation is important for countries considering adopting U.S.-style class actions but fearful of the possibility of nuisance litigation. Johnson, Nelson and Pritchard (JNP) (2002) provide a test of whether merits matter more in the post-PSLRA time period.[115] Their sample focuses only on

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[112] See id. at 692.

[113] See id.

[114] Gilbertson and Avila also provide evidence that auditors tend to be sued more often when the issuer has engaged in a public offering. See id. at 698-700. As well, auditors are sued more often when the issuer is in financial distress. See id. at 700-705. They hypothesis that in cases where the issuer is in financial distress the auditor represents a "deep pockets" source of money for the plaintiffs' attorneys. See 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). See id. at 703-04.

Other studies also focus on the liability of outside parties for securities fraud claims. See Steven P. Marino & Renee D. Marino, An Empirical Study of Recent Securities Class Action Settlements Involving Accountants, Attorneys, or Underwriters, 22 Sec. Reg. L.J. 115 (1994). Among other things, Marino and Marino contend 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.

[115] See Marilyn F. Johnson, Karen K. Nelson, and A.C. Pritchard, 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].

computer hardware and software firms (SIC 3570-3577 and 7370-7379) and includes all firms targeted with a securities fraud class action from 1991-2000, for a total of 119 lawsuits.[116] As a matching sample, JNP collect data on firms with a similar minimum one-day return (corresponding to a large price drop) for the 250 trading days prior to the class period end and from the same industry.[117] Focusing on filings, they fit a logit model using whether a firm faces a lawsuit as the dependent variable. Among independent variables, JNP include 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 then include whether the firm experienced a restatement during the class period, among other measures of aggressive accounting, and insider trading related variables (including 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).[118] To test whether governance matters, JNP include 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.[119] JNP report that in the logit model fitted only for the pre-PSLRA period, while securities fraud class actions are more likely for higher market capitalization firms, among the merit-based variables only insider share holdings correlate with a higher likelihood of suit.[120] In contrast, when the logit model is fit 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

[116] See id. at p. 11-12 of the working paper. They identify sued firms from Securities Class Action Alert and the Stanford Securities Class Action Clearinghouse. See id. 51 lawsuits are from the pre-PSLRA period and 68 are from the post-PSLRA period. See id.

[117] See id. at p. 13 of the working paper.

[118] See id. at p. 16-17 of the working paper.

[119] See id. at p. 17-18 of the working paper.

[120] See id. at 19 of the working paper.

likelihood of a lawsuit.[121] JNP interpret this shift between the pre and post-PSLRA models as consistent with the merits mattering more in the post-PSLRA time period.

As a further test of the importance of the merits in the post-PSLRA period, JNP examine the determinants of allegations made in class action complaints. They construct separate logit models for whether a firm 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.[122] 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.[123] 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.[124]

JNP then look at the outcomes of litigation, fitting a logit model for whether a suit resulted in either a dismissal or low-value settlement (defined as a settlement for $2 million or under and therefore indicative of a nuisance suit) compared with a higher value settlement.[125] The independent variables of the logit model include the same accounting restatement variable

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[121] See id. at 20 of the working paper. JNP also report from their post-PSLRA model that firms with outside directors who sit on more other boards are also more likely to face a suit. See id.

[122] See id. at 20-21 of the working paper. For the logit model for the presence of an accounting allegation, JNP also include the presence of an insider trading allegation. Likewise of the insider trading model, JNP include 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, JNP report 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. See id. at 20-21.

[123] See id. at 21.

[124] See id.

[125] The low-value settlements of $2 million or less are presumed to be "nuisance" settlements paid only to get rid of the distraction of litigation.

JNP 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 id. at p.22 at n.6 of the working paper.

(and other aggressive accounting variables) used in their earlier tests as well as their measures of corporate governance. JNP, however, do not include a measure of potential damages into the settlement model.[126] They note that when fit for the pre-PSLRA time period, only the presence of abnormal insider sales is significant (with a positive relationship with a high-value settlement).[127] When they fit the logit model for the post-PSLRA time period, they note that the presence of an accounting restatement is significantly related to a higher probability of a high-value settlement.[128] In contrast, the insider trading variables (including abnormal insider sales) are not significant in the post-PSLRA model.[129] JNP conclude 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) examine the impact of the PSLRA's heightened pleading standards on the ability of plaintiffs to survive a motion to dismiss.[130] The PSLRA's heightened pleading standard is somewhat ambiguous, leaving different circuits the ability to apply varying standards. Pritchard and Sale's study therefore 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 consists of 150 motion to dismiss decisions (65 Second Circuit decisions and 90 Ninth Circuit decisions) from 1996 to

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[126] In explanation, JNP 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 p. 22 of the working paper.

[127] See id. at 22 of the working paper. 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).

[128] See id. at 22 of the working paper. JNP 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. See id.

[129] See id. at 22-23 of the working paper. JNP write that "The use by plaintiffs' lawyers of this cruder proxy for fraudulent intent is apparently not rewarded." Id. at 23 of the working paper.

[130] See A.C. Pritchard and Hillary A. Sale, What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act (University of Michigan Working Paper #03-011) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=439503).

2001 obtained from Lexis and Westlaw searches among other sources.[131] They hypothesize that more concrete accounting claims (particularly related to revenue restatements) are more likely to survive the heightened post-PSLRA pleading requirements. As well, 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, Pritchard and Sale predict that such complaints are more likely to receive a dismissal.[132] To test these hypotheses, they fit a logit model with dismissal (or not) as the dependent variable and various variables related to the hypotheses as their independent variables.[133] 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 in particular the Second Circuit (significant at the 5% level).[134] 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 (significant at the 5% level).[135]

While demonstrating the differences certainly exist among the circuits, Pritchard and Sale's study falls short in providing information on the impact of the PSLRA itself. Rather than

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[131] See id. at p. 17 of the working paper.

[132] See id. at p. 11-17 of the working paper.

[133] See id. at p. 23 of the working paper.

[134] See id. Pritchard and Sale also report that insider-trading related claims are significantly and positively correlated with a dismissal. See id. They write that this results 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 p. 25 of the working paper.

[135] See id. 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 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.

compare motions to dismiss prior to the PSLRA against such motions after the PSLRA, the authors instead focus on post-PSLRA dismissal motions in the Second and Ninth Circuits. The study therefore 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.[136] Their sample consists of 2,167 federal court securities filings and 579 state court filings.[137] Using this sample, BMS first report that federal court filings dropped immediately after the passage of the PSLRA in 1996 (to only 119 filings compared with 191 in 1995). By 1998, however, the number of federal court filings was at a sample high of 248 filings.[138] 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.[139] While BMS fail 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 report that the fraction of cases settling within 4 years of the filing date dropped from 57.59% pre-PSLRA to only 26.06% post-PSLRA.[140] In addition, while 2.67% of cases settled within 1 year pre-PSLRA, only 0.67% settled within 1

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[136] See Mukesh Bajaj, Sumon C. Mazumdar, and Atulya Sarin, Securities Class Action Settlements, 43 Santa Clara L. Rev. 1001 (2003).

[137] See id. at 1003.

[138] See id. at 1004-05.

[139] See id. at 1006-07. The authors also report that the number of cases filed against auditor and accountants dropped in 1998 and 1999 compared with earlier years. See id. at 1008.

[140] See id. at 1010.

year post-PSLRA.[141] To the extent defendants will settle an even frivolous lawsuit to avoid the 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 provide no test of statistical significance). BMS then examine settlement amounts after the enactment of the PSLRA. They report higher mean and median settlement amounts post-PSLRA.[142] Moreover, particularly in the post-PSLRA period, BMS report that the mean and median settlement amounts tend to increase the longer it takes for settlement to occur.[143] Put another way, cases settling within 1 year of the filing date (representing potentially frivolous suits) settled for the lowest amount of money, supporting the hypothesis that defendants settle such suits quickly simply to rid themselves of the nuisance of defending the suit.[144]

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[141] See 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% pre-PSLRA down to 5.79%. See id. at 1011.

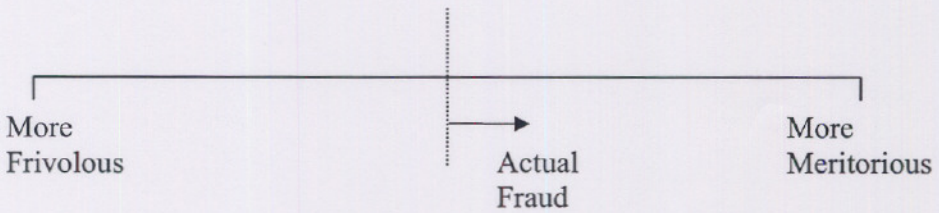
[142] See id. at 1022-23. The mean settlement amount post-PSLRA is $18.09 in their sample (compared with $8.01 million pre-PSLRA). The median settlement amount was $4.24 million in their sample post-PSLRA (compared with $3.5 million pre-PSLRA). See id.

[143] See id. at 1012. The median settlement amount for cases settled within 2 years of the filing date is equal to $6.3 million. See 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 and $4 million). See id. at 1027.

[144] 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 Dec. 22, 1995 involving an allegation that fraud inflated a company's stock market price and that also settled by December 2001). See id. at p.15 of the monograph. For the pre-PSLRA period, she collects 125 Rule 10b-5 related cases filed between January 1, 1994 and December 31, 1994. See 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. See id. at p.2 of the monograph. 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. See id. In addition, the settlement amount as a percentage of the potential plaintiff's damage award is reduced in the post-PSLRA time

In sum, the existing literature on filings and settlements in the post-PSLRA time period provide evidence that (a) frivolous suits existed prior to the PSLRA and that (b) 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.

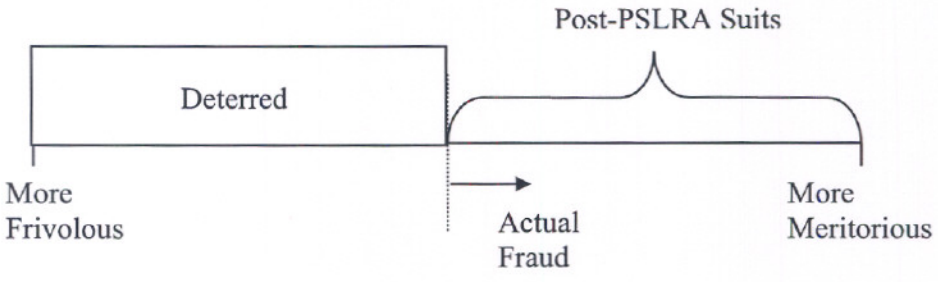
A question that arises from these empirical results, however, is that while frivolous suits may very well be less prevalent in the post-PSLRA period, are meritorious suits also less prevalent? Imagine that the suits in the pre-PSLRA time period are arrayed as follows:[145]



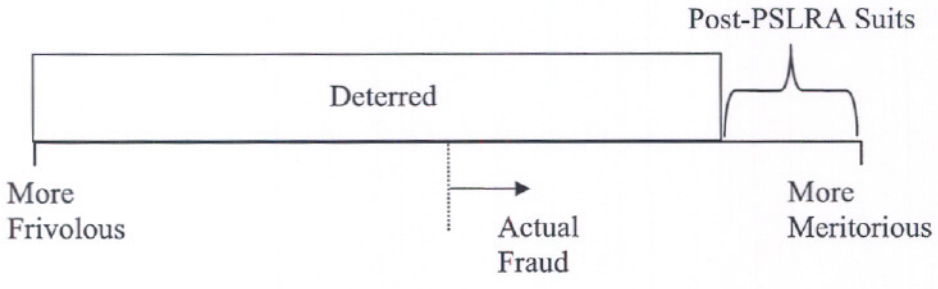
period. See id. at p. 4 of the monograph. The mean settlement amount as a percentage of the potential damage award is equal to 5.1% in the post-PSLRA time period and 7.2% in the pre-PSLRA time period. See id. Simmons does not provide any statistical tests of her results; thus, it is difficult to ascertain 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 damage award compared with cases not involving these factors. See id. at p.6 of the monograph. 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. See id. at p. 7 of the monograph. 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). See id. at p. 8 of the monograph.

[145] The diagram posits a dividing line between frivolous and meritorious suits denoted as the "Actual Fraud" point. As discussed in the Introduction, this position of this point is debatable. 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.

The fact that post-PSLRA merits matter more 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 which case the PSLRA is unambiguously welfare increasing (at least before taking into account the costs of implementing the PSLRA).



Second, both frivolous suits drop out as well as a large portion of the meritorious suits, leaving primarily meritorious suits again in the set of firms that are sued, but with far different welfare implications.



If the second alternative is the case, lawmakers must then balance the gain from the loss of the frivolous suits against the loss from the reduction in meritorious suits to determine whether the PSLRA in fact is worthwhile.[146]

As discussed earlier, one reason why the PSLRA may result in even meritorious suits dropping out post-enactment is the higher costs for plaintiffs' attorneys pursuing such litigation. Because of the lack of discovery and the enhanced pleading with particularity requirements, plaintiffs' attorneys who suspect actual fraud and might have been willing prior to the PSLRA to take the risk of not finding sufficient evidence to prove fraud even after discovery may simply choose not to file suit at all once discovery is stayed until the motion to dismiss post-PSLRA. 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. After the post-PSLRA, 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 pre-filing 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 face a securities class action. Simply put, such actions are not cost effective for attorneys facing a high fixed cost of litigation.

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[146] See Lynn Stout, Type 1 Error, Type II Error, and the Private Securities Litigation Reform Act, 38 *Arizona Law Review* 711-15 (1996) (putting forth the hypothesis that the PSLRA may have negatively impacted meritorious litigation as well as frivolous suits).

Jones (1980a) assembles a dataset of 190 public corporations (80 chosen from among large firms based on Fortune rankings and 110 randomly selected firms) and examines the frequency with which these firms faced a shareholder class action or derivative suit from 1971-78.[147] Jones looks to SEC filings for information on shareholder suits.[148] Over the sample time period, Jones reports 228 shareholder suits filed against the 190 firms (for a mean of 1.2 lawsuits per firm).[149] Significantly, Jones reports that the incidence of shareholder suit filings is skewed toward the larger firms in his sample.[150]

Alexander (1991) provides an early test for the presence of frivolous securities litigation.[151] Her sample consists of 17 computer and computer-related companies that went public in the first half of 1983.[152] She calculates to total post-IPO market value loss for each firm from the date of the IPO to March 30, 1984.[153] Alexander reports that every firm with a decline in market value of at least $20 million was sued (for a total of 9 out of her sample of 17 firms).[154] Alexander also looks at the 12 worst-performing IPOs of 1983 (based on market value loss as of March 30, 1984). She reports that all the IPOs with a loss over $33 million are sued while none of the IPOs with a loss of under $33 million are sued.[155] Alexander concludes that her evidence "strongly suggest that suits alleging securities violations were filed whenever the

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[147] See 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).

[148] See id at 308.

[149] See id. at 312. Many of the suits involved multiple suits filed against the same firm with substantially the same claim. See id. at 313. Looking only at disputed issues, only 87 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 8-year period). See id. at 312-313.

[150] See id. at 316. While the 80 large firms faced a shareholder suit on average 2.23 times during the 8-year sample time period, the 110 randomly selected firms faced a suit only 0.45 times during the same period. See id.

[151] See Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stan. L. Rev. 497 (1991).

[152] See id. at 510. Alexander obtains list of IPOs from Venture Capital Survey. See id. at 510 n. 38.

[153] See 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. See id.

[154] See id.

[155] See id.

stock price declined sufficiently following the IPO to support an award of attorneys' fees that would make it worthwhile to bring a case."[156]

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.[157] As discussed above, they examine a comprehensive sample of all initial public offerings from 1976 to 1986, for a total of 3519 IPOs.[158] Obtaining information from SEC filings, they report that 123 of the IPO firms encountered a securities fraud class action related to the IPO.[159] Importantly, only IPOs over a minimum offering size faced an appreciable number of class actions. In their sample, less than one 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 1 faced a securities class action.[160] In contrast, for those IPOs above approximately $40 million in offering amount, over 12% were sued with a securities fraud class action.[161] 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.

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[156] Id. at 513. Weighing in also 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. See 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. See id. at 516. Alexander reports that five of the cases settled for between 24.5% and 27.5% of the potential litigation stakes. See 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.

[157] See James Bohn and Stephen Choi, Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions, 144 U. Pa. L. Rev. 903 (1996).

[158] See id. at 927.

[159] See id. at 929.

[160] See id. at 936 ("The most striking result from this summary data is that smaller sized offerings hardly ever experience a securities-fraud suit.").

[161] See id. at 936.

Grundfest and Perino (1997) provide summary statistic evidence on the early post-PSLRA experience, covering 1996.[162] Relevant for the question of whether size matters in securities class actions, Grundfest and Perino report an increase in the average price decline for firms facing a lawsuit in the post compared with pre-PSLRA time period.[163] They explain the increase in the price decline is necessary to show more "wrongdoing" due to the greater obstacles the PSLRA places before plaintiffs.[164] On the other hand, Grundfest and Perino also provide evidence that the mean market capitalization of sued firms decreased in the post-PSLRA time period.[165] The Grundfest and Perino study however does not provide tests of statistical significance.

C. Plaintiffs' Attorney Agency Problems

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[162] See Joseph A. Grundfest and Michael A. Perino, Securities Litigation Reform: The First Year's Experience, 1015 PLI/Corp 955 (1997). Similar with JNP (2002) and BMS(2003), Grundfest and Perino also they report a shift in the types of claims from the pre-PSLRA time period to primarily accounting irregularities and insider trading claims. See id. at *973-*974. 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-third involved such allegations in the post-PSLRA period. See id. Grundfest and Perino also note a shift in the filing of claims toward state court. See id. at *966-*968. 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, they note a large fraction of claims involving false forward-looking statements despite the implementation of a forward-looking statement safe harbor under the PSLRA. See id. Grundfest and Perino report that 60.9% of the Rule 10b-5 cases involved an allegation of a false of misleading forward-looking statement in the post-PSLRA period. See id. See also Joseph A. Grundfest, Michael A. Perino, Paul Lumio, Erika V. Wayne, and Rilla Reynolds, 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).

[163] See Grundfest and Perino, supra note 162, 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%. See id.

[164] Id. at *972.

[165] See id. at *969. The mean market capitalization of a lawsuit pre-PSLRA firm was $2,080 million while the market capitalization of a post-PSLRA firm was $529.3 million. See 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 soures of material accounting irregularities or statistically significant trading by insiders." Id. at *970.

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 gain only fractionally 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 as hard as the class may desire, the level of deterrence against firms is reduced.

In the pre-PSLRA time period, Jones (1980b) examines litigation outcomes from his sample of shareholder derivative and class actions examined in Jones (1980a) described above.[166] He supplements his sample in Jones (1980a) with 15 additional firms known to have been involved in shareholder litigation during his sample time period from 1971-78.[167] Of the 348 suits in his sample where the resolution is known, he reports that 70.7% resulted in settlement. Among those cases that did not settle, most resulted in a decision for the defendants (and the plaintiffs won judgment at trial in only 0.6% of the cases).[168] Significantly, Jones (1980b) provides limited data on attorney fees. Of the 13 cases in this sample where he has data, Jones reports that the mean attorney fees as a percentage of the settlement award was 16.2%.[169]

Evidence from the post-PSLRA provides indirect evidence that the PSLRA did not work as intended to involve institutional investors more greatly in securities class action litigation. Cox and Thomas (2002) examine the role of institutional investors in both prosecuting securities

[166] Thomas M. Jones, An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits, 60 B.U.L. Rev. 542 (1980).
[167] See id. at 543.
[168] See id. at 545.
[169] See id. at 567.

class actions and filing claims in class settlements post-PSLRA.[170] Through a Westlaw search on the ALLFED database, they collect a sample of court decisions appointing a lead plaintiff from January 1, 1996 to December 15, 2001.[171] In their resulting sample of 33 cases, Cox and Thomas report that 11 of the cases involved a non-institutional lead plaintiff. In an additional 5 cases, an individual was selected over an institutional investor as lead plaintiff.[172] Cox and Thomas's results thus present a puzzle: why institutional investors are not taking more 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 greater for the universe all class actions. Cox and Thomas also provide data drawn from securities class action administrators on the settlement awards that institutional investors claim (as a fraction of the amount the institutional investors are eligible to claim). For the two administrators on which they have data, they report that institutions file only 32.78% and 23.01% respectively of the claims which the institutions are eligible to file.[173]

Further study is required to assess the relative power of plaintiffs' attorneys and the plaintiff class in the post-PSLRA time period. One could for example 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. One could look at the settlement amount over the amount of time it takes to resolve the

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[170] See James D. Cox and 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 (2002).

[171] See id. at 859.

[172] See id.

[173] See id. at 876-77.

case (the "settlement per unit resolution time"). If plaintiffs' attorneys are working hard in an effective manner to benefit the class, a prediction would be 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, consistent with the hypothesis that they are engaged in "make work" to justify maintaining high fees even for relatively straightforward meritorious cases. Another test could examine resolution time as a function of the type of allegation. If cases involving more concrete evidence of fraud (such as an accounting restatement) are easier to prove, one would expect that such cases should have relatively shorter resolution times. In the post-PSLRA time period, if such cases take longer to settle nonetheless compared with the pre-PSLRA period, this may indicate that attorneys are again engaged in "make work".

D. Other Issues

Another indirect way of measuring the impact of securities class actions 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) examine the relationship between the incidence of Rule 10b-5 securities litigation and a corporation's disclosure policy.[174] They first construct a lawsuit sample consisting of 45 firms in the biotechnology, computing, electronics, and retailing industries[175] that were targets of a Rule 10b-

[174] See Jennifer Francis, Donna Philbrick, Katherine Schipper, Shareholder Litigation and Corporate Disclosures, 32 J. Accting Res. 137 (1994).

[175] 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). See id. at 144.

5 lawsuit relating to an adverse earnings report during 1988 to 1992 (identified from *Securities Class Action Alert*). For comparison purposes, FPS also construct a set of 51 "at-risk" firms with quarterly earnings per share and sales decline of at least 20% during the 1987-1991 period as reported in the Compustat database.[176] Interestingly, FPS note that only one firm overlaps between their lawsuit and at-risk sample.[177] Put another way, despite the severe earnings decline in the at-risk sample (statistically greater in magnitude compared with the litigation sample), most at-risk firms are not sued. FPS posit 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 mislead the market prior to the adverse earnings disclosure.[178] To test for inflated prices, they perform an event study around the adverse earnings announcement and report that lawsuit firms both experienced a greater negative abnormal return on the announcement date as well as a significantly greater dollar amount of loss in shareholder value.[179] However, FPS find no correlation between the magnitude of the market decline in value for firms and the tone (e.g., optimistic) or frequency of the pre-announcement disclosures, inconsistent with the hypothesis that inflated prices correlate with a firm misleading the market.[180] To test the role of disclosure in mitigating the risk securities fraud litigation, FPS examine the first disclosure containing precise information about

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[176] See id. at 144-45.

[177] FPS also report that the timing and method 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 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.

[178] FPS write that "we focus on the link alleged by plaintiff that defendant firms' disclosure strategies induced plaintiff to buy stock at inflated prices." Id. at 149.

[179] See 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. See id. FPS 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. See id. at 162-63.

[180] See id. at 157.

adverse earnings for firms in the lawsuit and at-risk samples. A theory exists that early disclosure of fraud helps reduce a company's exposure to fraud.[181] In contrast with this theory, FPS report that the lawsuit sample contained a significantly higher proportion of early disclosures about the fraud.[182] Similarly, FPS also report that they find no significant differences in analyst forecast errors for that at-risk compared with litigation firms.[183] Looking at the magnitude of price declines, FPS do 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 the expected damages in litigation.[184]

Johnson, Kasznik, and Nelson (JKN) (2001) focus specifically on the impact of the PSLRA's forward-looking statement safe harbor from litigation.[185] Their sample consists of 523 firms drawn from the computer hardware, computer software, and pharmaceutical industries.[186] They compare two time periods: pre-PSLRA (consisting of calendar year 1994) and post-PSLRA

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

[182] See id. at 148. FPS 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. FPS recognize this possibility and state that "[t]he possibility remain, however, that such disclosure may provide benefits in the form of reduced litigation-related costs." Id. at 148.

[183] See 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.").

[184] See 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.").

[185] See Marilyn F. Johnson, Ron Kasznik, and Karen K. Nelson, The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms, 39 Journal of Accounting Research 297 (2001).

[186] The corresponding SIC codes are as follows: computer hardware (3570-3577), computer software (7371-7379), and pharmaceutical (2833-2836). See id. at 305.

(calendar year 1996).[187] Looking first at how firms changed their voluntary reporting of earnings and sales forecasts, JKN report that the number of firms issuing at least one forecast as well as the total number of mean forecasts per firm increase significantly from the pre to post-PSLRA time period.[188] They also report 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.[189] To control for other possible factors that may affect a firm's decision to issue a forecast, JKN fit a logit model using whether a firm issued at least one forecast during a particular year as the explanatory variable. For independent variables, they include whether the year is pre or post-PSLRA as well as variables related to change in earnings, the asset size of the firm, and whether the firm engaged in a public offering in the year (or following year).[190] From the logit model, JKN report a significant positive coefficient on the dummy variable for the post-PSLRA time period for the subsamples consisting positive forecasts covering a long-term horizon and bad news forecasts with a short-term horizon, lending some support to the hypothesis that forecasts increased post-PSLRA.[191]

Other factors may affect a firm's incentive to disclose between the pre and post-PSLRA time period. To focus specifically on litigation risk, JKN develop a probit model of litigation risk based on market volatility, market drop in value, CEO power, board monitoring, firm

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[187] See id. at 305.

[188] See id. at 306-07. Earnings and sales forecasts are obtained through searches on Lexis/Nexis. See id. at 305-06. Comparing the pre and post-PSLRA time periods, JKN report that 44 percent of firms issued an earnings forecast pre-PSLRA compared with 50 percent post-PSLRA. See 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 in the pre-PSLRA). See id. at 313.

[189] See id. The proportion of bad news forecasts increased from 30 percent pre-PSLRA to 37 percent in the post-PSLRA time period. See id. at 306-07.

[190] See id. at 308.

[191] See id. at 315. The coefficient on the post-PSLRA time period is positive but significant at only the 20% level for the sample covering all types of forecasts. See id. at 315.

refinancing, and firm leverage (similar in specification as the JNP (2002) study).[192] Using this litigation risk model, JKN report that the increase in the reporting of earnings and sales forecasts during the post-PSLRA period is greater for firms with more predicted litigation risk.[193] One fear of the forward-looking statement safe harbor is that firms may disclose lower quality (e.g., more error prone) forecasts once the possibility of litigation is reduced or eliminated under the PSLRA. JKN, however, report that forecast errors are not significantly different in the pre and post-PSLRA periods.[194] JKN conclude: "Taken together, our evidence does not support allegations that the safe harbor provides a 'license to lie.'"[195]

IV. Implications for Korea

So what should we make of the evidence on the experience of the U.S. with private securities fraud class actions? And 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, education system, and so on. Rather than engage in a comprehensive analysis of how class actions would perform generally across the world, this article focuses on one specific example: South Korea. Korea has often

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[192] See id. at 323-26.

[193] JKN 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 their 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. See 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. See id. at 317-18.

[194] JKN report that the mean forecast error (measured by the actual earnings (or sales) minus the forecast scaled by lagged total assets) in the pre-PSLRA tie period is -0.019 and the forecast error in the post-PSLRA period is -0.021 (and neither is statistically significant from zero). See id. at 320. To control for other factors affecting the quality of forecasts, JKN fit a model with the explanatory variable equal the forecast error defined above. See 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 firms performance. See 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. See id.

[195] Id. at 298.

looked to the U.S. securities regime as a model in how to regulate the Korean securities markets. Shortly after the U.S. SEC promulgated Regulation FD, for example, in 2000, Korea followed suit with its own version of prohibitions against selective disclosures.[196] 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.

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 almost never sued in a securities fraud class action. The impact of the PSLRA in raising the costs (while reducing the expected benefits) to attorneys filing class actions likely further raised the minimum potential damage award plaintiffs' attorneys require before they will file suit.

Consider the range of companies trading on the Korean Stock Exchange (KSE). In 2002, there were 683 companies listed on the KSE.[197] That largest company listed on the KSE, Samsung Electronics, had a market capitalization of U.S. $39.1 billion.[198] Market capitalizations dropped rapidly however after Samsung Electronics. The 10th largest firm, Samsung Electro-Mechanics, had a market capitalization of U.S. $2.5 billion in 2002.[199] After taking away the 30

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[196] 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).

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

[198] See 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.wikipedia.org/wiki/Table_of_historical_exchange_rates (visited on Nov. 30, 2003).

[199] See id.

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 50 largest listed NYSE companies in 2002 was $88.7 billion.[200] Looking at the broader NYSE market, the market has a total market capitalization of approximately $15 trillion with about 2800 listed firms, for an average market capitalization of $5.35 billion.[201]

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 therefore at least an order of magnitude greater 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.[202] 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 30 listed firms on the KSE.

At least two possible caveats are possible to the problem of firm size for implementing a securities class action regime in Korea. First, even if private class actions target only companies such as Samsung Electronics, this nonetheless may have a significant impact on shareholder wealth in Korea. Samsung Electronics alone accounts for 20% of the overall market

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[200] See NYSE Fact Book 2002 available at http://www.nysedata.com/factbook/viewer_edition.asp?mode=tables&key=34&category=5.

[201] See http://www.nyse.com/listed/p1020656067970.html?displayPage=%2Flisted%2Flistedcofaqs.html.

[202] 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 11 former and current directors of Samsung Electronics).

capitalization for *all* listed companies.[203] This is unlike in the U.S. where no single company represents a significant fraction of the total market capitalization. Providing class action-style deterrence against solely Samsung Electronics, therefore, may have some value for overall shareholder welfare in Korea.

Second, many companies are members of Chaebol groups in Korea.[204] 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 not against individual companies but against classes of companies belonging to the same Chaebol. 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, as discussed below, the Chaebol ownership structure immediately interposes shareholders with significant holdings (e.g., other member corporations of the Chaebol) who may take a pro-defendant stance and at the least, reduce the potential class award available by opting out of any class action and, at the worst, actively work to intervene to hinder and stop any class action.

B. Regime Choices

Securities fraud class actions in the abstract may seem like an all or nothing alternative. However, the U.S. experience with the PSLRA and other reforms has demonstrated that several choices exist in how to operate a securities class action regime. The difficulty with adjusting the

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[203] See Korea Stock Exchange Fact Book 2002, at 33 (2003) (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) available at http://www.kse.or.kr/webeng/what/what_index.jsp (visited on Dec. 3, 2003).

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

class action regime, however, is that (as discussed above) at least three separate problems face the class action system: (a) the problem of blocking frivolous suits (while allowing 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. Solutions to one problem often make worse one (or both) of the other problems. Reforms, such as the PSLRA, for example, aimed at reducing 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 more "soft" meritorious suits not based on hard indicia of fraud (e.g., an accounting restatement) publicly known prior to the filing of suit.

The balance struck among these three competing considerations in the U.S., moreover, may not match the balance that is optimal for Korea (or other countries contemplating securities class actions). Indeed, tweaking the various litigation options available in implementing a U.S.-style class action regime may help tailor such actions for the Korean context. For example, to the extent the Korean bar is more tightly knit that the bar in the U.S. and the Korean government has more indirect and informal means of sanctioning plaintiffs' attorneys who knowingly engage in frivolous suits, the risk of a frivolous suit may be reduced in Korea. Ham Jong-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."[205] The small number and relative homogeneity among attorneys reinforces the power of reputation and group peer pressure in moderating

[205] 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 that "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.

attorney behavior.[206] Given this view, plaintiffs' attorneys arguably may be more disinclined against filing purely frivolous lawsuits (to the extent such actions will gain the attorneys a negative reputation among their peers).[207]

Conversely, 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, increasing the value of a more liberal securities class action regime (from the perspective of investor welfare) than in the U.S. Given a possibly lower risk of frivolous suits and a greater need to protect investors against actual fraud, Korea therefore may wish to tilt toward reducing the impediments against a class action compared with the U.S. to induce more suits against actual fraud.

Consider the following, non-exhaustive 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 take a uniform approach to who should be defendants in class actions. Section 11 of the Securities Act defines a list of defendants, including underwriters, directors, and the auditors (but only with respect to the audited financials).[208] Section 12(a)(2) of the Securities Act, on the other hand, provides no such

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[206] 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.

[207] Kim notes, however, that the homogeneity puts a premium on personal connections and may help foster corruption among attorneys. See id. at 48-49.

[208] See Section 11(a), Securities Act.

definition.[209] 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.[210]

Providing for a wide range of potential defendants, all other things being equal, will increase the expected return from litigation, inducing more class actions. Deep pocket defendants such as underwriters and auditors hold forth 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. Korea, for example, could choose not to follow the tracing rule of Section 11 of the Securities Act in the United States to create a larger class for fraud in the context of Korean IPOs.[211]

The same financial reward designed to attract plaintiffs' attorneys to file suit against truly fraudulent companies, however, may also induce a greater number 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 litigation are less to start with in among Korean attorneys (perhaps due to the tight knit community of attorneys in Korea which may result in peer pressure against such suits); (b) the Korean government has better means of detecting and disciplining attorneys specializing in frivolous litigation than in the U.S. (due to the higher level of intervention the Korean government makes in the Korean economy); or (c) the threat of actual

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[209] See Section 12(a)(2), Securities Act. Instead, the Supreme Court has detailed (in a case involving the related Section 12(a)(1)) that those in privity as well as those who solicit offers to buy may be defendants. See Pinter v. Dahl, 486 U.S. 622, 647 (1988) (holding that "liability 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.").

[210] Rule 10b-5, Exchange Act.

[211] Courts have interpreted Section 11 as requiring that plaintiffs be able to trace their shares to the registration statement in which fraud is being alleged. See, e.g., Abbey v. Computer Memories, Inc, 634 F.Supp. 870 (N.D. Cal. 1986).

fraud is greater in Korea (either because investors are less sophisticated or corporate managers lack a norm of catering to shareholder interests).

Elements of the Cause of Action. The U.S. securities laws require plaintiffs to prove different things depending on what type of antifraud 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).[212] Section 12(a)(2) similarly requires a material misstatement or omission and that the fraud occur "by means of a prospectus".[213] Rule 10b-5 on the other hand requires plaintiffs to show not only materiality but also scienter on the part of the defendants, reliance, and loss causation.[214] The incentive of plaintiffs' attorneys to bring a class action turns 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 requirements plaintiffs are required to prove (including scienter, reliance, loss causation), the lower the threat of a class action and the less incentive plaintiffs' attorneys will have to file the action in the first place. On the other hand, the easier case plaintiffs' have, arguably the greater the risk of frivolous litigation. As with the question of who should have standing to sue and who should be defendants in a securities class action, Korea 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.) in deciding upon what antifraud causes of action to make available for private securities class actions.

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[212] See Section 11, Securities Act.

[213] See Section 12(a)(2), Securities Act.

[214] For a survey of the various elements of a Rule 10b-5 cause of action see James D. Cox, Robert W. Hillman & Donald C. Langevoort, Securities Regulation: Cases and Materials 701-97 (3d ed. 2001).

Class Action Procedure. The PSLRA implemented a 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. In theory, such a provision works best where a large number of institutional investors are 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.[215] 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 than in the U.S.

Safe Harbors. The PSLRA implemented a forward-looking statement safe harbor under Section 27A and 21E of the Securities Act and Exchange Act respectively.[216] Such safe harbors are not necessarily cost free. While decreased liability may reduce the risk of companies from disclosing forward-looking information, more opportunistic companies may take advantage of the safe harbor to disclose less meaningful (if not misleading) forecasts about the companies' future. JKN (2001) nonetheless find no evidence of reduced quality forward-looking statements in the post-PSLRA period.[217] However, 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 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,

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[215] See supra text accompanying notes 170-173.
[216] See supra text accompanying notes 10-13.
[217] See JKN, supra note 185, at 320.

reducing (or indeed eliminating) the forward-looking statement safe harbor may prove more beneficial for investors in Korean.

Liability. The PSLRA implemented proportionate liability for some types of claims, including most notably Rule 10b-5 claims. Under Section 11, however, defendants continue to face joint and several liability (except for outside directors who do enjoy proportionate liability). The proportionate liability system is therefore not uniform in U.S. securities law. 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 (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.[218] Under such conditions, imposing a proportionately liability system may work even more so in Korea to relieve outside defendants (such as underwriters and auditors) from liability than in the U.S.

Even if the Korean situation is the same as in the U.S., proportionate liability still works to reduce the liability of outside defendants generally.[219] Whether reduced liability for underwriters and auditors is desirable then turns on the question of the importance of liability in Korea on inducing underwriters and auditors to police companies ex ante for fraud. The answer may depend on what other incentives underwriters and auditors have to monitor companies in

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[218] 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 (reporting that "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.").

[219] See supra note 14-19 and accompanying text.

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 Anderson provide a counterexample). Domestic, smaller securities professionals may not have the same amount of reputation at stake and therefore require the threat of legal liability to bolster their incentives to police for fraud as well as reputations. Providing joint and several liability for smaller securities professionals will work to raise the legal liability facing these professionals to make up for the lower reputational constraints on such smaller market participants.

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 within 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 your point of view, is afflicted) with an active professional securities plaintiffs attorney bar. The law firms of Milberg Weiss, Berger & Montague, and Stull, Stull & Brody are a few of the many plaintiffs' attorney firms operating within the United States. Specializing in securities class actions gives such firms particular advantages. A specialist firm is able to develop expertise in pursuing a securities class action, reducing the cost of pursuing any one case. As well, the large size and stature of at least some of

the plaintiffs' firms provides a natural focal point for investors unhappy with the performance of their firms. Such investors may help provide information on allegedly fraudulent firms 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 any return for the plaintiffs' attorney firm. Diversification may also occur across firms as several plaintiffs' firms jointly share in the co-representation of different classes across several different lawsuits.

Countries, such as Korea, contemplating private securities fraud class actions must contend with a lack of well developed plaintiffs' attorneys firms. South Korea has only about 5,000 practicing attorneys but a population of 48 million people.[220] In contrast, the state of California has approximately 144,000 active attorneys providing services for a population of 35 million people.[221] Not only are the total number of attorneys limited but many attorneys in Korea are quite fragmented. Compared with the United States, Korea has only a few larger law firms with over a hundred attorneys.[222] Korea, moreover, has resisted allowing foreign law firms to practice law in Korea.[223] The dearth of legal services in Korea is made worse by Korea's difficult bar entrance exam that annually allows in only 1,000 new licensed attorneys per year.[224]

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'

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[220] See 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, The supra note 206, 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.").

[221] See http://members.calbar.ca.gov/search/demographics.aspx (visited on December 3, 2003).

[222] Aurora Law Offices in Korea identifies 5 law firms in Korea with over 120 attorneys including Kim & Chang, Lee & Ko, Shin & Kim, Bae, Kim & Lee, and Woo, Yun, Kang, Jeong & Han. See http://www.auroralaw.co.kr/en/about/otherfirms.html (visited on December 6, 2003).

[223] See Suzuki, supra note 220, at 391-92.

[224] See id.

attorney and less diversification as a result. 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 hard 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 profitable. The smaller size of Korea's capital market, however, necessarily will result in fewer potential litigation targets compared with the United States. 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 (and thereby 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? Korea employs a number of specialized courts. Korea, for example, 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 compared with the U.S. securities class action judicial experience where, in federal court, litigants typically deal with more generalist judges.[225] Specialized judges may develop expertise in distinguishing between frivolous and meritorious claims and therefore become more willing to sanction frivolous suits. Such judges may also more consistently apply certain doctrines, such as proportionate liability, which require

[225] Black et al. also propose a specialized court to handle large or complex commercial and financial litigation set up as a branch of the District Court. See Black et al., supra note 2, at 569.

expertise in assigning culpability across defendants. Litigants faced with the same set of repeat judges may also obtain a higher degree of predictability, leading to more settlements.

On the other hand, the minimum size requirements of plaintiffs' attorneys will likely result in only a small number of class actions yearly (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,[226] the lack of a high volume of class actions will make developing expertise among judges difficult.

3. Shareholder interests

The presence of shareholders able to make decisions with respect to class actions separate from the plaintiffs' attorneys is also important 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% of the trading volume.[227] Korea institutions (including banks, pension funds, among others) accounted for only 4.3% of the trading volume.[228] 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

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[226] See Lee, supra note 202, 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.").

[227] See Korea Stock Exchange Fact Book 2002, at 23 (2003).

[228] See id.

of familiarity with the Korean legal system.[229] Stock ownership patterns present a slightly different picture for listed firms on the KSE. Individuals own only 22.3% of the market value of KSE listed firms.[230] Foreigners account for an additional 36.6%.[231] 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 institutions (banks, securities companies, insurance companies, and investment trusts) in aggregate account for only 15.7% of the stock ownership.[232]

The lack of many large institutional investors leaves the plaintiff class without any potentially large plaintiff's representatives. Absent such a representative, the danger of plaintiffs' attorneys not exerting much effort in class actions and grabbing a lion share of the award for their fees is more acute. Of course, the lead plaintiff provisions in the U.S. have failed to garner much interest from the numerous institutions in the U.S. marketplace.[233] It is therefore unclear if the agency problem between the plaintiffs' attorneys and the plaintiff class in Korea would be any worse than in the U.S.

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

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[229] See id.

[230] See id. at 36.

[231] See id.

[232] See 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 and Policy in International Business 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.").

[233] See supra text accompanying notes 171-173.

government organization), for example, has actively engaged in pro-minority shareholder activities over the past several years, including leading the recent derivative suit against Samsung Electronics.[234] To the extent specialized plaintiffs' attorneys focusing on class actions fail to arise, the PSPD may fill the gap. Indeed, regulators in Korea may wish to 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 a large fraction of shares in the hands of other corporations (17.2%).[235] To the extent many of these other corporations are members of the same Chaebol family, a further complication exists in how to determine who should be the lead plaintiff. Often the shareholders with the largest financial interest in 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 get control over the class action, claiming a right to do so based on their large financial stake in interest. Allowing Chaebol shareholders to obtain control of the class, however, would result in

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[234] See Lee, supra note 202, 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 See Jooyoung Kim and Joongi Kim, Shareholder Activism in Korea: A Review of How PSPD Has Used Legal Measures to Strengthen Korean Corporate Governance, 1JKorean L 51, 53 (2001) (describing the PSPD's shareholder-oriented activities).

[235] See KSE, supra note 227, at 36.

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. Class Actions in Korea

After years of consideration, the Korean government finally enacted a securities class action law in January 2004.[236] Under the new law, companies listed on the Korean Stock Exchange 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 a annual, semi-annual, or quarterly report, insider trading, and market manipulation.[237] 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, however, the new Korean law imposes a minimum shareholding requirement on shareholders seeking to initiate the class action. At least 50 shareholders who, in aggregate, hold 0.01 percent or more of the equity may bring a class action suit against a company.[238] As well, the Korean law 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 even smaller, listed companies to class action suits.[239]

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[236] See Ryu Jin, Assembly Passes Watered-Down Class Action Bill, The Korea Times, Dec. 22, 2003 (available at http:// http://times.hankooki.com/times.htm).

[237] 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).

[238] See Jin, supra note 236.

[239] See id.

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 at least some 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.[240]

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 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 of the securities laws. As well, some positive number of class actions yearly will help develop expertise within the courts in administering class actions (e.g., in selecting a lead plaintiff, dismissing frivolous complaints, etc...), thereby reducing the costs for future class actions. Overtime, more groups in addition to the PSPD may bring class actions and generate economies of scale in pursuing still greater numbers of suits. As the number of class actions grows over time, the constituencies benefited from such actions (investors, attorneys, and plaintiffs advocacy groups such as the PSPD) will gain more influence, giving them the ability 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 within Korea against class actions (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

[240] 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.

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 in aggregate $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 the claims both manageable and economical. And 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 (at least evidenced by a perception that the U.S. markets are relatively free of fraud despite an occasional Enron) 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. And while 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 highlights possibly more important issues with which regulators in the U.S. must contend in charting the course for securities class actions into 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 to meet more easily the pleading with particularity requirement of the PSLRA. This shift, however, may also leave untouched many actual instances of fraud not involving 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' attorney refocusing their efforts on only larger market capitalization companies engaged in obvious (at the time of filing) instances of fraud. Similarly, for all types of claims, whether frivolous or meritorious, the PSLRA may have generally 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 often confront a lack 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 also 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 the regime to their own specific context. However, no easy solution 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 raise 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 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), the problem again arises of plaintiffs' attorneys simply not pursuing class actions against smaller companies.

Securities class actions are also 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 role of the Ministry of

Justice, Securities and Futures Commission, and Fair Trade Commission and other agencies in providing more public enforcement.[241] Public enforcement in particular may be 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 corporations in Korea, class actions directed against such corporations may provide a number of benefits for Korea. In terms of dollar losses for investors, fraud within the largest corporations has the greatest negative impact on Korean investors. As well, the political power of the largest Chaebol makes it difficult for government enforcement to work effectively, giving private class actions an important complementary enforcement role. Other countries with a similar political dynamic (e.g., 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 will develop (including more expert courts and greater numbers of private entities and attorney firms specializing in class actions) that will reduce the cost of pursuing subsequent class actions.

[241] See also Black et al., supra note 2, 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.").

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