



March 2007

## The Sorcerer, the Apprentice, and the Broom: What to Do about Private Securities Class Actions

By Peter J. Wallison

*Private securities class actions under Rule 10b-5 of the Securities and Exchange Commission (SEC) were created by the courts, not authorized by Congress. For the last thirty years, the Supreme Court and Congress have made strenuous efforts to control and limit these suits, with only limited success. On a cost-benefit basis, a compensation system like this is difficult to justify. It imposes substantial costs on companies, many of which settle even though they have engaged in no wrongdoing. It pays injured shareholders only 2 to 3 percent of their losses, but the settlement comes out of the pockets of the innocent shareholders who still hold interests in the defendant company. It richly rewards lawyers but fails to punish the real wrongdoers (if wrongdoing has actually occurred). It discourages foreign companies from offering their securities in the United States, threatens the viability of the largest global auditing firms, and increases the costs of other regulations by inducing accountants and managements to spend large sums on unnecessary self-protection. All these factors—and more—suggest that private securities class actions should be eliminated by Congress so that Rule 10b-5 will be enforced only by the SEC.*

In mid-February the SEC and the Department of Justice filed a joint friend-of-the-court brief with the Supreme Court, urging the Court to tighten the pleading requirements in securities class actions under Rule 10b-5. This unusual step focused attention on securities class actions and their role in the enforcement of the securities laws. In the government's brief, the two agencies stated:

Meritorious private actions are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by [the Justice Department] and the SEC. At the same time, Congress has recognized a potential for such actions to be abused in ways that impose substantial costs on companies that have fully complied with the applicable laws.<sup>1</sup>

In the measured language of a message to the Supreme Court, the government told the Court that it is necessary to reduce the impact of securities class actions on the economy.

The government brief was only the latest in a long series of steps in which both Congress and the Supreme Court have sought to rein in private rights of action under the SEC's Rule 10b-5. These efforts have had only limited success, and it is now becoming clear that securities class actions have few benefits, if any, while they impose substantial costs on companies and the economy generally. Instead of trying to bring these costly lawsuits under control, Congress should make clear—as it apparently originally intended—that Rule 10b-5 should be enforced only by the SEC.

The inability of the courts and Congress thus far to restrain class actions under Rule 10b-5 calls to mind the tale of the sorcerer's apprentice. The courts are like the apprentice, who learned the magic words that get a broom to fetch water, but never learned how to make it stop. The broom

Peter J. Wallison (pwallison@aei.org) is a senior fellow at AEI.

labors on, as lawyers will, with the water rising around the frantic apprentice. Finally, the sorcerer returns, says the magic words, and shuts down the broom. The tale has a happy ending, as the apprentice is saved from drowning, but in the real world only Congress knows the magic words—and it has not yet reappeared.

## The Court, Congress, and Class Actions

Private rights of action to enforce Rule 10b-5 are not authorized by the securities laws. They were created by a federal district court in 1946,<sup>2</sup> and since then, both the courts and Congress have tried to control and channel them. Although these private lawsuits afford investors some protection against fraud, the question is whether this modest additional compensation system comes at too high a price for companies and our economy.

There are constitutional questions about judicially created rights in a separation-of-powers system, but there are also practical reasons for questioning their validity. Judicial initiatives that create new rights may upset a balance that Congress intended when it adopted the original statute. It is not difficult to see why this might have been true in the case of the securities laws, since Congress created a specially empowered agency, the SEC, to enforce those provisions of the securities laws for which a private right of action was not specifically authorized.

Nevertheless, the private right of action under 10b-5 might never have become a significant source of litigation costs without a parallel development in class action law—again initiated by the courts. The Supreme Court is authorized by Congress to amend the rules of civil procedure applicable to the federal courts. The Court does this on the recommendations of an advisory committee made up of distinguished lawyers, academics, and jurists. In 1966, this group recommended a major change in the rules governing class actions.<sup>3</sup> The new rule permitted a class to be formed by assuming that everyone adversely affected by the defendant's conduct is willing to be a plaintiff unless—after proper notice—he or she “opts out.” In a class action, individuals whose losses would ordinarily not be large enough to warrant litigation can band together as plaintiffs. The rule—another judicial creation—thus made it possible for the plaintiffs' bar to assemble large classes with cumulatively enormous claims

at very little cost. Coupled with the new class action rule, the private right of action under 10b-5 became a powerful weapon for suing or threatening public companies.

As initially interpreted, the private right of action under 10b-5 was so open-ended—allowing plaintiffs to seek recovery whenever a company's stock price declined—that by the 1970s the federal courts were flooded with 10b-5 class actions. Recognizing the problem, the Supreme Court began a concerted effort to gain control over this judicial invention. The Court first indicated its purpose in 1975, when it ruled that the private right of action was only available to buyers and sellers of securities—not to those who merely hold onto their shares.<sup>4</sup> This ruling was followed in 1976 by a requirement that the plaintiff show that the defendant actually intended to defraud—in other words, that the loss was not caused solely by the defendant's negligence.<sup>5</sup> And in 1977, in yet another limiting ruling, the Court required that the plaintiff show manipulation or deception by the defendant in order to recover losses.<sup>6</sup>

The Court then seemed to take a breather, perhaps to see whether its previous rulings would cut back the flood of class actions. They did not. In 1991, the Court resumed its pruning effort, shortening the period during which private actions could be brought,<sup>7</sup> and in 1994 declaring that 10b-5 did not cover aiding and abetting a violation of 10b-5.<sup>8</sup> Still,

the flood of class action lawsuits continued, as the resourceful plaintiffs' bar found ways to continue its profitable activity. Class action filings under Rule 10b-5 rose from 164 in 1991 to 233 in 1994.<sup>9</sup>

Congress finally took notice in 1995, adding new and restrictive pleading requirements for securities class actions in the Private Securities Litigation Reform Act (PSLRA). Pleading requirements are important because they specify what a claim must contain before the plaintiff can gain full access to a defendant's materials through the compulsory discovery process. If the plaintiff's claim does not meet the pleading requirements—if, for example, the pleading does not allege facts that show the defendant's intent to defraud—it may be dismissed by the court. If so dismissed, the plaintiff cannot use depositions of the defendant's management and subpoenas for its documents to discover the facts about the defendant's conduct.

These discovery procedures are often a club to beat companies into settlements. The costs—in legal fees and

---

Coupled with the new class action rule, the private right of action under 10b-5 became a powerful weapon for suing or threatening public companies.

---

management time—of complying with discovery requests can be so great that defendant companies often prefer to settle rather than continue with discovery. Added to this is the *in terrorem* effect of class actions. In a case in which a large class has been assembled to claim a huge loss, a defendant that might otherwise prevail in litigation is often reluctant to bet the company on a trial, and for that reason would be willing to settle, even though it had engaged in no wrongdoing. As we will see, these settlements generally reward the lawyers but result in little compensation for the class plaintiffs.

The tighter pleading requirements in PSLRA were Congress's attempt to limit the scope and cost of securities class actions. It required that plaintiffs allege sufficient facts in their pleadings to create a "strong" inference that the defendant acted with intent to defraud. It also denied access to discovery until the court had ruled on the defendant's challenges to the pleadings. For a time, these limitations were effective in reducing private 10b-5 actions, but the number of filings rose from 193 in 1997 to a high of 268 in 1998 and remained at over 200 through 2004, when 220 were filed. By 2004, public companies had a 10 percent likelihood of facing a securities class action within a five-year period. After the passage of PSLRA, dismissals of class actions also increased—one of the objectives of the act—but that did not significantly diminish the chances that a company would face a class action that survived dismissal.<sup>10</sup>

## Costs and Benefits

Congress's concern about class actions was well-founded. Two recent reports have questioned the value of private rights of action and noted their adverse effect on the ability of U.S. financial markets to compete with foreign financial venues. The first, by a group of academics and securities market specialists called the Committee on Capital Markets Regulation (the Capital Markets Committee), was issued as an interim report on November 30, 2006,<sup>11</sup> and the second, by New York City mayor Michael R. Bloomberg and Senator Charles E. Schumer (D-N.Y.), was released in late January 2007.<sup>12</sup> Both studies focused on why U.S. capital markets appeared to be losing business to markets abroad, and both concluded

that excessive litigation risk and regulatory costs—while not the only causes of this loss—were major reasons that foreign companies were avoiding the public securities markets in the United States. This phenomenon and its possible causes were also the subject of the August 2006 issue of *Financial Services Outlook*.<sup>13</sup>

The Capital Markets Committee report contained a great deal of detail about the cost of private securities class actions. In 2004, for example, settlements and judgments in private class actions totaled \$5.4 billion—a huge increase from \$150 million in 1995. In 2004,

---

In private securities class actions, the people who ultimately end up with the bill are often the innocent shareholders of the defendant company and not the actual wrongdoers.

---

securities class actions accounted for 48 percent of the 5,179 class actions pending in the federal courts. Although the filing rate for securities class actions fell in 2005 and 2006—possibly as a result of the generally favorable stock market—settlement costs rose substantially over prior years. Excluding the huge settlements in the Enron and WorldCom cases, total settlements reached \$3.5 billion in 2005 versus \$2.9 billion in 2004 and slightly over \$2 billion in 2003. The average class action settlement in 2005 was over \$71 million, a substantial increase over the \$27.8 million average in 2004. As a result of these growing costs, rates for directors'

and officers' liability insurance in the United States are six times higher than in Europe, where class actions do not exist.

Yet in the case of private securities class actions, the people who ultimately end up with the bill are often the innocent shareholders of the defendant company and not the actual wrongdoers. As the Capital Markets Committee noted:

Securities class actions are fundamentally different from class actions for other kinds of cases, such as environmental, consumer or antitrust actions where third parties incur harm. In securities class actions, one is fundamentally dealing with a suit by shareholders victimized by fraud against shareholders who happen to own the company at the time the suit is brought.<sup>14</sup>

This transfer of value from one group of shareholders to another does not penalize the wrongdoers, who are often indemnified by the company or covered by insurance paid for by the company.

In any event, there is little evidence that securities class actions effectively compensate the victims of fraud. A study by NERA Economic Consulting found that most plaintiffs recovered only 2 to 3 percent of their economic losses in class actions, while their lawyers received fees that range from 19 percent of the larger settlements to 35 percent of the smaller ones.<sup>15</sup> Because the size of settlements has grown, the fees that lawyers collect have risen.<sup>16</sup> Other studies suggest that defense costs are in the same range as the fees of plaintiffs' counsel.<sup>17</sup> Adding counsel fees to the business disruption associated with the suits and the cost of directors' and officers' liability insurance, the Capital Markets Committee concluded that "it is not clear that there is *any positive recovery* in the average securities class action."<sup>18</sup> Accordingly, while the private class action process in the United States imposes substantial costs, the Capital Markets Committee found little evidence that it produced any significant benefits for either plaintiffs (who had otherwise diversified their holdings) or the U.S. economy.

The Bloomberg-Schumer report, in addition to reporting the huge growth in securities class actions, used a survey of U.S. and foreign business leaders to demonstrate that "a high propensity toward litigation"—especially the growth in private securities class actions—was impairing the New York and U.S. economies generally. The report noted:

When asked which aspect of the [U.S.] legal system most significantly affected the business environment, senior executives surveyed indicated that the propensity toward legal action was the predominant problem. . . . Above and beyond the costs associated with a litigious society, recent legal developments have further added to the negative reputation of America's legal system abroad. First, it has become increasingly clear that, rather than being just an incremental cost of doing business, the mere threat of legal action can seriously—and sometimes irrevocably—damage a company.<sup>19</sup>

In addition to direct monetary costs, the existence of a private right of action enhanced by liberal class action rules is a major reason that the Sarbanes-Oxley Act has

had such a substantial impact on U.S. companies. The act has several features that could produce liability for any company if its stock price should fall as a result of a need to restate its financial reports or the discovery of an error in its financial reporting. Section 404 of the act—which requires public companies to develop internal controls that are supposed to assure more accurate financial reporting, and requires auditors to certify that the controls so adopted are adequate for their purpose—provides a good example of how anticipating the possibility of class action liability will cause companies to pay needless costs. The costs of Section 404 compliance have been far greater than anyone anticipated, averaging in some studies more than \$4 million per company. The SEC's original average per-company cost estimate was \$91,000.

Although the SEC has begun to back away from the stringent standards it established for compliance with Section 404—recently proposing a regulation that attempts to reduce the detailed internal controls seemingly required by its original Section 404 regulation—there is little likelihood that this proposal, assuming it is adopted, will substantially reduce the costs of Section 404 compliance. This is because both companies and accountants, under the threat of class actions, have incentives to create the most detailed internal controls possible in order to protect themselves from liability. In other words, the existence of a class action potential in this case operates much like the phenomenon known as defensive medicine, in which a doctor orders more tests than necessary in order to protect himself against possible liability. Like defensive medicine, the extra and unnecessary costs of Section 404 are a dead weight on companies and the U.S. economy.

Accordingly, as suggested in the Bloomberg-Schumer report, private securities class actions, by adding leverage to regulations that are already excessively costly, may be the most significant factor in the decline in the U.S. position as the predominant financial market in the world.

### Accounting Firms' Separate Liability

Both the Capital Markets Committee report and the Bloomberg-Schumer report also took note of a serious problem in the accounting industry that arises out of

---

The existence of a class action potential operates much like the phenomenon known as defensive medicine, in which a doctor orders more tests than necessary in order to protect himself against possible liability.

---

excessive class action liability. Since the demise of Arthur Andersen in the wake of the Enron and World-Com frauds, there are now only four large accounting firms—known as the Big Four—still available to audit globally active companies. All of these firms are currently subject to private securities class actions that could result in their financial ruin. As the Capital Markets Committee noted:

Currently, there are more than three dozen pending suits involving tens of billions of dollars of claimed potential damages. Claims under state law also seek recoveries of billions of dollars. This liability exposure substantially exceeds the combined partner capital of the Big Four firms. Any future lawsuits would only aggravate the problem. Large audit firms self-insure because third party insurance is unavailable.<sup>20</sup>

Accounting firms are subject to liability under Rule 10b-5 if they know or should have known that the financial statements they certify will be relied upon by people who buy or sell the securities of the company they audited. Some courts have also endorsed liability if the auditing firm is deemed to be a substantial participant in an alleged securities fraud. The Sarbanes-Oxley Act added another source of liability by requiring auditors to certify the adequacy of a company's internal controls. If these are subsequently found to be inadequate, as noted above, the audit firm could be held liable.

Accordingly, private securities class actions not only add costs for companies, but also threaten to drive one or more of the four remaining global auditing firms out of business. The disappearance of any one of the Big Four firms would be a true catastrophe for financial markets as well as for public companies worldwide. The choice of auditors would be substantially reduced, and the requirements for auditor independence might make it impossible for some companies to find a sufficiently skilled independent auditor. In addition, accounting and auditing costs, already sky high, would become an even more costly burden on public companies, reducing profits and driving smaller companies—which bear a disproportionate share of the costs—to privatization.

## What Remedy?

All these factors raise the question whether private securities class actions under Rule 10b-5 should continue to exist. Recently, the Shadow Financial Regulatory Committee (SFRC), a panel of experts on regulation and finance, concluded that private rights of action should be abolished, except for those based on insider trading.<sup>21</sup>

In a statement issued in early February 2007, the SFRC noted the many deficiencies of private class actions as a method of compensating losses or deterring wrongdoing. In addition to imposing costs on innocent shareholders and rewarding only lawyers, private class actions often fail to punish the truly guilty—the corporate officers who were responsible for a financial misstatement or fraud. These officers are frequently indemnified by the company or covered by insurance paid for by the company. This also means that the deterrent value of private class actions is diminished.

Moreover, as the SFRC noted, Rule 10b-5 could be more efficiently and effectively enforced by the SEC:

---

The disappearance of any one of the Big Four accounting firms would be a true catastrophe for financial markets as well as for public companies worldwide.

---

This costly, arbitrary and unpredictable private litigation system exists side-by-side with an SEC enforcement system that could do a better job of punishing wrongdoers and deterring financial manipulation and fraud at much less cost. The SEC has the authority to bring civil and recommend criminal proceedings against corporate managers who engage in manipulative or fraudulent activity. These enforcement steps by the SEC would have far greater impact in preventing wrongdoing than private class actions, and would not impose on public companies the major costs that are probably deterring companies from public offerings in the United States.<sup>22</sup>

The SFRC statement did not deal with the effect of private class actions on accounting firms, but the considerations and conclusions would be much the same. As in the case of suits against public companies, private class actions do not punish the particular auditors who conducted a deficient audit—they punish the entire firm. The SEC and the Public Company Accounting Oversight Board, however, have the authority to discipline individuals—

including, in the case of the SEC, the authority to bar an accountant from SEC practice. The use of this authority to punish wrongdoers would be far more efficient than allowing private class actions to extract huge monetary settlements that reward mostly the plaintiffs' bar.

It is true, of course, that unlike private class actions against companies, settlements and awards against accounting firms do not represent a direct transfer of value from one group of innocent shareholders to another. However, there is an indirect transfer. With only four large accounting firms able to do audits of globally active companies, these firms, assuming they survive, have the ability to pass their litigation and settlement costs on to their clients. Thus, the innocent shareholders of these companies will, through lower profits and lower share values, still bear some of the costs of class action settlements with accounting firms. This is true even if their companies are not parties to the litigation.

Finally, there is the important issue of the effect of a large judgment in a private securities class action against one of the Big Four accounting firms. If such a judgment results in the firm's disappearance, it will impose serious costs on all companies and do significant damage to the U.S. and world economies. This possibility alone—a very real potential outcome in light of the billions of dollars in private class action claims that are now pending against accounting firms—may justify the elimination of securities class actions against accounting firms.

## Say the Magic Words

Clearly, on a strictly cost-benefit analysis it is very difficult to justify the continuation of the private securities class action system. It fails to compensate adequately those who have been injured by fraud. It richly rewards only lawyers while penalizing shareholders who were not responsible for any wrongdoing. The real wrongdoers (in cases in which wrongdoing has actually occurred) are left unpunished.

The securities class action system also imposes substantial costs on companies, many of which settle, even though they have engaged in no wrongdoing. The system also increases the costs of other regulations by inducing accountants and managements to spend large sums on otherwise unnecessary self-protection. These increased costs drive small companies to privatize and discourage foreign companies from entering the U.S. market as public companies. Beyond these tangible and intangible costs, the current system creates a real risk that at some

time a catastrophic judgment will destroy one of the Big Four accounting firms. Finally, all these costs fail to deliver any corresponding benefit that could not be achieved by a more effective SEC enforcement process.

The tale of the sorcerer's apprentice therefore seems an apt metaphor for the history of private rights of action under 10b-5. Congress is the sorcerer, the courts are the apprentice, and the class action bar is of course the broom. As injudiciously as the apprentice, the courts created the private right of action under Rule 10b-5, but have not found a way to gain control of the excesses of the broom. The only recourse seems to be a return of the sorcerer, Congress, to intone the magic words that will reverse the courts' error and leave enforcement of Rule 10b-5—as Congress probably originally intended—to the SEC alone.

---

*AEI research assistant Daniel Geary and editorial assistant Evan Sparks worked with Mr. Wallison to edit and produce this Financial Services Outlook.*

## Notes

1. Brief of Amici Curiae Securities and Exchange Commission and Department of Justice at 1, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484 (U.S. filed February 9, 2007), available at <http://sec.gov/litigation/briefs/2007/tellabsbrief.pdf> (accessed March 5, 2007).

2. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

3. FRCP 23(b)(3). See discussion in John K. Rabiej, *The Making of Class Action Rule 23—What Were We Thinking?* 24 *Miss.C.L.Rev.* 323–92 (2005).

4. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

5. *Ernst & Ernst v. Hochfelder et al.*, 425 U.S. 185 (1976).

6. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

7. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 164 (1991).

8. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1964).

9. Elaine Buckberg, Todd Foster, and Ronald I. Miller, *Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?* (New York: NERA Economic Consulting, 2005), 2.

10. *Ibid.*

11. Committee on Capital Markets Regulation, *Interim Report*, November 30, 2006, available at [www.capmktreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf) (accessed March 5, 2007).

12. Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and the US' Global Services Leadership*, January 22, 2007, available at [www.senate.gov/~schumer/SchumerWebsite/pressroom/special\\_reports/2007/NY\\_REPORT%20\\_FINAL.pdf](http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf) (accessed March 5, 2007).

13. Peter J. Wallison, "The Canary in the Coal Mine: What the Growth of Foreign Securities Markets and Foreign Financing Should Be Telling Congress and the SEC," *Financial Services Outlook* (August 2006), available at [www.aei.org/publication24760/](http://www.aei.org/publication24760/).

14. Committee on Capital Markets Regulation, *Interim Report*, 72.

15. Elaine Buckberg, Todd Foster, and Ronald I. Miller, *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, Is Stabilization Ahead?* NERA Economic Consulting, April 2006, available at [www.nera.com/image/BRO\\_RecentTrends2006\\_SEC979\\_PPB-FINAL.pdf](http://www.nera.com/image/BRO_RecentTrends2006_SEC979_PPB-FINAL.pdf) (accessed March 5, 2007).

16. Elaine Buckberg, Todd Foster, and Ronald I. Miller,

*Recent Trends in Shareholder Class Action Litigation: Are World-Com and Enron the New Standard?* 7.

17. Thomas Baker and Sean Griffith, "Predicting Corporate Governance Risk: Evidence from the Directors & Officers Liability Insurance Market" (working paper, June 15, 2006), 10n28, available through <http://ssrn.com/abstract=909346> (accessed March 5, 2007).

18. Committee on Capital Markets Regulation, *Interim Report*, 79 (emphasis added).

19. Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and the US' Global Services Leadership*, 75-76.

20. Committee on Capital Markets Regulation, *Interim Report*, 87.

21. Shadow Financial Regulatory Committee, "The Competitiveness of U.S. Securities Markets" (statement no. 242, February 12, 2007), available through [www.aei.org/shadowstatements/](http://www.aei.org/shadowstatements/).

22. *Ibid.*