

TEN YEARS LATER – THE PSLRA IS STILL THE SUBJECT OF CONTROVERSY

By Thomas Dubbs

The U.S. Chamber of Commerce specifically advocated for institutions to provide leadership in securities cases to do what it could not – police the lawyers and limit the stream of lawsuits facing Corporate America.

A decade ago, legislation was enacted to regulate the class action securities litigation process. This new law, known as the Private Securities Litigation Reform Act of 1995, or the PSLRA, changed the procedural process and requirements in litigating securities class actions—augmenting the pleading standards, imposing a mandatory discovery stay, incorporating the lead plaintiff provision, and establishing limits on damages and fee awards. The PSLRA continues to provide a framework for securities class action litigation today.

In pre-PSLRA days, the practice of securities litigation was no stranger to criticism. For years, many such cases were viewed as “strike suits,” lawyer-driven litigation believed to benefit class counsel, not class members. Those who supported the passage of the PSLRA—mostly business interests like the U.S. Chamber of Commerce—saw this legislation as their rope with which to rein in the lawyers and allow businesses to thrive unencumbered by “meritless” lawsuits. The U.S. Chamber of Commerce in particular was a major proponent of this change, and they specifically advocated for institutions to provide leadership in securities cases to do what it could not – police the lawyers and limit the stream of lawsuits facing Corporate America.

Looking back over the ten years since this legislation was signed into law, over the veto of then-President Clinton, it is clear that the PSLRA has not hampered the prosecution of class actions. Rather, as a result of the PSLRA, not to mention a proliferation of scandalous corporate malfeasance (one has only to think of Enron, WorldCom, Tyco, and AIG), institutional investors now champion private litigation as a useful and important tool in maintaining an efficient market and providing a vehicle for remuneration for financial losses that occur due to fraud. In fact, it seems like the very ones given the tin star—institutional investors—have actually enhanced the strength of the kinds of cases they were meant to close out. The benefit of their participation in these suits is clearly

seen in the rising settlement amounts for cases brought since the PSLRA. Additionally, institutions have used their clout at the settlement table to negotiate for significant corporate governance reforms.

Proponents of the PSLRA Turn Against Their Hired Gun

It would seem that all is well. Even those opposed to class action litigation would have to admit that these changes are beneficial for investors. But a recent study published by Navigant Consulting, with support from the U.S. Chamber of Commerce and the Institute for Legal Reform, begs to differ. The report attempts, through empirical analysis, to unveil certain inequities of the securities laws, by positing that investors that have diversified portfolios, like institutions, may be “enriched” by participating in class action settlements. Conversely, individuals, who they say the laws were meant to protect, are at greater risk. The report surmises that the majority of claimed losses incurred by institutions are offset by profits received through sales of stock in other companies where fraud has also occurred (although not yet revealed). However, the securities laws do not require institutions “to disgorge their ill-begotten gains.”¹

The report argues that, “under the current system, there is no attempt to determine whether compensable losses incurred by diversified investors, such as large institutional investors, are being offset by fraud-related gains realized from transactions in other securities. Indeed, the current one-dimensional approach to determining recompense in these matters creates a situation in which litigation can potentially over-compensate such investors.”²

At first blush, this argument appears compelling. However, one can’t help but consider the source for such claims. Moreover, upon further review, the failings and errors of this report are easily seen. In fact, much of the reasoning to dispute the validity of the report’s claims is based on simple logic, not contrived assumptions.

¹ Anjan V. Thakor, Ph.D. et al., *The Economic Reality of Securities Class Action Litigation* 4 (2005).

² *Id.* at 5.

Individual v. Institutional Investor

It is indisputable that individual investors are less likely to be able to hedge losses incurred in the market, through fraud or otherwise, than are institutional investors. But it must be remembered that institutional investors are an aggregation of individual investors; they collectively serve the individual investor's interests. Any profits made by an institutional investor are distributed to the individuals investing in the fund. Therefore, the premise that individuals lose out more often than institutions is actually referring to a small minority of individuals who choose to dabble in the market without sufficient diversification and therefore, with greater risk.

No Alternative

Remarkably, while it casts stones at the economic theory behind the assessment of damages in securities class actions and the securities laws in general, the report provides no alternative theories for compensating investors' losses due to fraud. This hollow attack does nothing for the institutional investors who have suffered losses into the hundreds of millions of dollars as a direct result of a company's fraudulent actions. Many investors share the sentiments of Cynthia L. Richson, a representative from the Ohio Public Employees Retirement System, co-lead plaintiff in the AIG securities litigation case, who said, "Our losses are very real."

Even more alarming is the inference that regardless of a company's fraudulent actions, a well-diversified investor should not be allowed to recoup its losses because it *may have* profited from selling the shares of another company prior to any disclosure that it too was engaging in fraud. How else should a company be held responsible for its actions? Lisa Rikard, president of the Institute for Legal Reform, who

participated in the study, stated, "We haven't delved into how to fix it."

The Benefits Outweigh any Perceived Problems

Securities litigation is a valuable check in the system. Professor John Coffee, a well-known author and expert on securities litigation, stated, "[Securities class actions] can achieve some general deterrence... We would have more corporate fraud without these suits." There are multitudes of reasons why institutions, specifically public pension funds and union funds, should be actively involved in securities litigation.

In evaluating the ten-year evolution of the securities class action practice since the passage of the PSLRA, many benefits can be seen, including the fact that settlement values have risen, commensurate with increased participation by institutional investors, while attorneys' fee percentages have declined. Institutional investors undeniably provide a necessary service by participating in class actions on behalf of their individual investor beneficiaries.

In the 10 years since the PSLRA became law, settlement values have increased along with tougher corporate governance reforms and increased institutional investor involvement.