
Securities Fraud Class Action Dismissal Rate Drops in the Wake of Sarbanes-Oxley

2004-02-18

Federal courts have been far less willing to dismiss securities fraud class actions since Congress enacted the Sarbanes-Oxley Act in July 2002. NERA Economic Consulting recently reported that, in the wake of Sarbanes-Oxley, the dismissal rate has fallen by as much as 30%, thereby subjecting many more public companies to the uncertainty of major-stakes litigation--and with it the lengthy discovery process in which plaintiffs' lawyers seek to build a case by reviewing the issuer's otherwise private internal records and deposing its directors and officers.

The marked drop in the dismissal rate and the heightened litigation risks facing public companies in the post-Sarbanes-Oxley climate cannot necessarily be attributed directly to the Act itself. (Although Congress dramatically expanded federal securities regulation with the enactment of Sarbanes-Oxley, for the most part the Act did not change the statutory provisions under which these class actions typically are brought.) The courts' reluctance to dismiss cases outright more likely reveals evolving attitudes toward these cases, perhaps reflecting concern that shareholder claims should not be resolved at an early stage of the litigation process, and a greater skepticism of public companies and their management.

In other respects, the securities fraud landscape in 2003 resembled that of prior years. The volume of lawsuits slowed somewhat from 2002; last year, on average, a new class action was filed every 1.75 days, which was consistent with the pace of filings prior to Sarbanes-Oxley, excluding one-time waves of litigation, such as lawsuits alleging that research analysts compromised their objectivity to sell banking services. As in the past, of the twelve federal circuits, the greatest number of securities fraud lawsuits were filed in the Second Circuit (which includes New York) and the Ninth Circuit (West Coast), followed by the First, Third and Eleventh Circuits (New England, New Jersey/Pennsylvania and the Southeast, respectively).

More class actions were settled in 2003 than in 2002 (163 versus 122), which is not surprising given that fewer cases are being dismissed. The average settlement (\$19.8 million) was lower than in 2002 (\$23.3 million), but still substantially more expensive than in 2001 (\$13.8 million), which was the last full year prior to enactment of Sarbanes-Oxley. Although it is difficult to predict settlement trends, which are driven by an array of factors (including the amount of investor losses,

the nature of the allegations, the issuer's industry and locale, and the attorneys involved), we take little comfort in the small decline in median settlement amounts last year. The statistics suggest that the overall time from filing to resolution of securities class actions may be increasing. The fact that many large cases that are time intensive for plaintiffs' counsel have not been resolved (e.g., Enron) suggests that it is the smaller and weaker cases that are being resolved relatively quickly. If this is true, average and mean settlements will continue to increase over time, and the total transaction costs associated with these cases (which are directly proportional to the time necessary to resolve them) will also increase.

Public companies and their directors and officers continue to face a significant risk of shareholder class actions, and the costs associated with these cases are likely to increase. Assuming consistent filing rates, over a five-year period the average public company faces a 9% probability that it will be the subject of at least one securities class action. Those in certain industries (such as technology and life sciences) are exposed to even greater risk. Although the high volume of class action litigation has remained relatively stable, the marked decline in the dismissal rate since the passage of Sarbanes-Oxley suggests that these problems will become increasingly difficult to resolve.

William H. Paine

william.paine@wilmerhale.com

Authors



William H. Paine

PARTNER

 william.paine@wilmerhale.com

 +1 617 526 6134