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To: Boalt Workshop Participants
From: Michael Klausner
Subject: Class Action Paper

I have attached a first draft of a paper I am writing on whether securities class actions can be justified as being "supplemental" to SEC enforcement action. As indicated at various points, the paper is incomplete. For the most part, the empirical methods at this point consist of counting in various ways. I may have some additional analysis by the time of the workshop, and in any case I will map out my plan. Any suggestions along those lines would be most appreciated.

I look forward to seeing you.

Are Securities Class Actions "Supplemental" to SEC Enforcement? An Empirical Analysis

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Preliminary draft for Boalt Hall Workshop: February 23, 2009
Please do not quote or circulate.

1. Introduction

Securities class actions, while recognized as problematic in a number of respects, have been justified by the Supreme Court, Congress, the SEC and commentators as "supplemental" to SEC enforcement.[1] Using a newly collected dataset from a sample of class actions and SEC enforcement actions, this paper evaluates that claim. Specifically, I ask two questions. First, to what extent do securities class actions target violations that the SEC does not target, and are those class actions "supplemental" in the sense of being well targeted toward violations that the SEC would target if it had the resources? Second, are class actions "supplemental" in the sense of producing case outcomes that promote securities enforcement policy as reflected in the SEC's enforcement actions? Specifically, does the incidence of officers' contributions to class action settlements correspond reasonably closely to the incidence of sanctions against officers in SEC actions?

The answer to the second question is clearly no, which raises substantial doubt regarding the justification of class actions as "supplemental" to SEC enforcement. **[Note: I am still in the process of collecting data on the first question, some of which I may be able to present at the workshop.]**

[1] [Stoneridge, Tellabs, PSLRA, SEC statement,Coffee]

The dual public-private enforcement regime that applies to public company misstatements is not the product of deliberate policy analysis. When Congress enacted the Securities and Exchange Act of 1934, it evidenced no intent to authorize private enforcement. Enforcement of Section 10(b) of that Act, the primary provision aimed at misstatements by public companies, was assigned to the newly created Securities and Exchange Commission. Nonetheless, beginning in 1946, the lower courts upheld stockholders[2] claims to a private right of action to enforce Section 10(b), holding essentially that private enforcement is available whenever there has been a violation of *any* federal statute—a position that is no longer accepted today.[3] In 1971, the Supreme Court for the first time recognized a private right to sue under Section 10(b)—simply stating in a footnote "[i]t is now established that a private right of action is implied under §10(b)."[4] The Supreme Court recognized this private right of action again in 1975, also without explanation.[5] Since that time, however, Congress has explicitly legislated with respect to securities class actions and the Supreme Court has ruled on a variety of details regarding their prosecution. Each time the Supreme Court or Congress has addressed these suits, they have justified them as a valuable "supplement" to enforcement by an effective, but resource-constrained, SEC. What is meant by "supplemental," however, has not been explained—other than to suggest simply the production of more cases. The SEC and some commentators have taken the same position.[6]

Enforcement of the securities laws, and Section 10(b) specifically, could serve either of two policy objectives: Enforcement could deter public company managers from disseminating false or incomplete information to the markets; and it could compensate

[2] I refer to stockholders here for simplicity. Bondholders are covered by Section 10(b) as well.
[3] Kardon v. National Gypsum, 69 F. Supp. 512 (E.D. Pa. 1946).
[4] Superintendent of Ins. v. Bankers Life & Cas., 404 U.S. 6 (1971).
[5] Blue Chip Stamps v. Manor Drug Store, 421 U.S. 723 (1975).
[6] [cites]

shareholders for losses suffered as a result of such misconduct. SEC enforcement is has historically been focused on deterrence, with Congress authorizing adding sanctions to the SEC arsenal in [1990]. SEC policy statements articulate a goal of identifying individual executives responsible for misstatements and punishing those individuals.[7] The SEC does, however, impose monetary penalties on corporate defendants as well. In addition, since [2002], the SEC has been authorized to use amounts it collects in monetary penalties and disgorgement of gains to compensate shareholder losses.[8] So today, the SEC actions could serve a compensation role as well, although as discussed below the amounts it collects are likely to be small in relation to investor losses.

For class actions to be supplemental to SEC actions, they would have to accomplish these same goals. To deter misconduct, they must impose costs on managers who violate the law. Moreover, they must do so to a sufficient extent that, at the margin, they deter misconduct beyond the degree of deterrence provided by the SEC. And to compensate shareholders, class actions would have to put money into shareholders' pockets.

Do securities class actions actually fulfill this goal of supplementing SEC enforcement? I address that question in a straightforward but perhaps narrow manner, by looking at the outcome of cases in relation to the outcome of SEC enforcement actions. To the extent SEC actions impose personal penalties on officers or directors, I ask whether class actions do the same in similar cases. That is, are class actions targeted at serious violations, and do they impose liability on executives who are responsible for those violations in a manner that is consistent with SEC enforcement practices. This approach may be narrow in that, even if class actions do not impose personal liability on

[7] Statement of the Securities and Exchange Commission Concerning Financial Penalties, Release 2006-4, Jan. 4, 2006.

[8] [Fair Funds]

officers and directors, they may impose ancillary costs, such as lost jobs and reputations. Others have found that class actions indeed have this effect. Whether this effect is well targeted against officers and directors who have actually engaged in misconduct, however, is a separate and much more difficult question. I therefore interpret the supplementation claim more narrowly and focus on the formal outcome of the cases, asking whether these direct outcomes are similar to what we would expect if the SEC had brought an enforcement action.

Commentators have long argued that the incentives of the parties to these suits lead to counterproductive results—results that, if true, are inconsistent with the supplementation claim. First, there are incentives on the plaintiffs' side to settle meritorious cases for less than they are worth rather than taking the risk of going to trial. On the defense side, there is an incentive and often the ability to settle these meritorious suits with company and insurer money, rather than the personal funds of the executives responsible for the misconduct at issue.[9] Second, there are incentives on the defense side to settle even weak cases with funds provided by the company and by its directors' and officers' liability (D&O) insurer. Third, because weak cases settle, plaintiffs have incentives to initiate weak cases. The result of this set of incentives, commentators have opined, is that securities class actions are often nonmeritorious, and even when meritorious they do not deter misconduct because they fail to impose liability on the individual officers who engage in misconduct.[10] If these claims are true, there would be

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[9] There is a large literature that has made these points over the years. [Coffee, Macey & Miller, Easterbrook & Fischel, others]. Even if these cases were litigated and settled consistent with their merits, and even if payments were made by those responsible for the misstatements, it is unclear whether the social benefit of these lawsuits is worth their social cost. That social cost is not measured by the loss to the shareholder class because their loss is exactly offset by the gain to their (innocent) counterparties who traded the company's shares in the public markets at prices influenced by the misstatement. The social cost of misstatements is the misallocation of resources that results, a cost that is not measured by damage rules in these suits, and that would be very hard to measure. This issue is not addressed here.

[10] [Coffee, Macey & Miller]

ground to question whether securities class actions can be justified as supplemental to SEC enforcement. But none of these claims has been empirically investigated.

Commentators have also long pointed out that the compensation goal of securities enforcement is problematic with respect to class actions. To the extent the corporate defendant and its D&O insurer pay to settle cases, the cost of those payments is borne by shareholders. From a compensation perspective, therefore, unless officers or third parties such as accounting firms and investment banks pay into a settlement, these cases constitute a net cost to shareholders. As a practical matter, however, even if these suits did extract payments from culpable officers, officers are rarely wealthy enough to compensate shareholders for more than a small fraction of shareholder losses. Consequently, unless a case involves large third party defendants, compensation of shareholder losses is not a realistic goal, and the potential benefit of securities class actions is deterrence alone.

Returning to the question whether class actions can be justified as supplemental to SEC enforcement, that question turns on three empirical questions. First, and most basically, to what extent are class actions targeted against violations that the SEC has not targeted? Second, do these arguably supplemental cases target serious violations that the SEC would target if it had the resources, or are these cases commonly nonmeritorious, as commentators fear? Third, where class actions target the same violations that the SEC targets, and the two actions run parallel to one another, does the class action provide any supplementation. Finally, are commentators correct in their claim that securities class actions settle entirely with corporate and insurer funds, with alleged wrongdoers making

no payments?[11] I address these questions below. To a large extent these questions can be answered with simple statistics—in fact, just counting in various ways. [Nonetheless, as indicated at certain points below, I am in the process of applying somewhat more sophisticated methods to demonstrate the same points (plus some more).]

2. Previous Research [Incomplete]

This paper is most closely related to the law review literature that argues without data that misaligned incentives in securities class actions lead to "collusive settlements" between plaintiffs' lawyers and defendants in which the company and the insurer foot the bill for settlements, and the executives alleged to have violated the law pay nothing. (Coffee (19__), Coffee (2006), Macey & Miller (19__)) This is the first study that investigates who actually pays in class actions settlements.

This paper also relates to the literature on the extent to which the merits matter in securities class actions. Alexander (199_) used a small set of examples to suggest that these cases settle at levels below the limits of the D&O insurance available, regardless of merit. Choi, Nelson and Pritchard (2007) show that the Public Securities Litigation Reform Act (PSLRA) reduced the filing and increased the dismissal of less meritorious cases, but that it also had a similar but lesser effect on more meritorious cases. Their measure of merit was the presence of a restatement or parallel SEC action. I use a

[11] In an earlier article, my coauthors and I investigated the incidence of out-of-pocket payments by outside directors in securities class action settlements (that is, unindemnified and uninsured). We reported that such payments by outside directors are exceedingly rare, having found only eight cases in which outside directors made personal payments in securities class actions out of thousands of cases filed since 1980. We found a total of 13 cases in which outside directors made personal payments in any type of lawsuit—securities class actions, SEC enforcement actions, and state corporate law suits. We concluded that the near-immunity of outside directors for oversight failures is sensible from a policy perspective. But the policy considerations with respect to officer liability are different. Unlike outside directors, officers are actively involved in managing the company, implementing its internal controls, and making accounting and other disclosure decisions, and they are well compensated for their services. Consequently, penalizing officers when they violate the securities laws is important from a deterrence perspective. Black, Cheffins & Klausner, Outside Director Liability, 58 Stan. L. Rev. 1055 (2006).

measure of merit that looks at the seriousness of the restatement and asks whether the targeting of class actions is comparable to the targeting of SEC actions—and hence whether the former can be said to be supplemental of the latter.

This paper also relates to studies in the finance literature that look at the ancillary impact of securities class actions and SEC actions on the officers and directors of the defendant corporation. Rather than looking at the ancillary impact, however, I look at the direct impact of these cases. Do officers and directors pay in class actions? In SEC actions? How do the two types of cases compare in this respect?

Baum, Bohn, and Chakraborty (2007) analyze whether securities class actions lead to the termination of officers and directors. They find that officers as well as board members who are lawyers, bankers and other consultants to the company tend to leave the company at a higher rate when a class action is settled than when it is dismissed. This effect is strongest for CEOs. They interpret this higher rate of termination in settled suits to be a reflection of the merits of suits that are settled. An alternative interpretation is that the terminations are attributable to the existence of the suit itself, and the fact that it has not been dismissed, rather than to the validity of the underlying claims.

Fich and Shivdasani (2007) study the reputational effect of securities class actions on outside directors. Their measure of reputation is the extent to which directors of firms that are sued experience an increase or decrease in outside directorships on other companies' boards. They find that outside directorships decline for directors following a securities class action, suggesting that these suits have a negative reputational effect on outside directors. On the other hand, Helland (2006) finds that outside directorships actually increase. Fich and Shivdasani explain the difference in results as being linked to the fact that Helland's sample goes back in time to a period prior to the Private Securities

Litigation Reform Act (PSLRA), when fewer securities class actions were dismissed, and securities class actions of lesser merit resulted in settlements.

Karpoff, Lee and Martin (2007) have recently examined the effect of enforcement actions by the Securities and Exchange Commission (SEC) against officers. They find that the SEC frequently imposes fines on officers and bars them from serving as officers or directors of public companies. They further find that officers frequently lose their jobs, regardless of whether the SEC bars them from service. Finally, they find that officers targeted by the SEC are sometimes prosecuted and convicted in criminal actions by the Department of Justice. Feroz, Park, and Pastena (1991) similarly find that officers tend to be fired in wake of SEC investigations.[12] Comparing these results to Baum et al, officers appear to lose their jobs more frequently following SEC actions than following settlements in securities class actions.

3. The Anatomy of a Securities Class Action

This section explains how class actions work and how incentives can lead to counterproductive results. Readers familiar with the argument may want to skip to the empirical analysis, which begins with Section 4.

Private suits to redress misstatements by public companies generally take the form of a class action in which the plaintiffs are the shareholders who were adversely affected by the misstatement (typically by buying at an inflated price). The primary statutory prohibitions on which these cases are based appear in Section 10(b) of the Securities and Exchange Act and Section 11 of the Securities Act. Section 10(b) applies to any misstatement. Typical violations include accounting misstatements in a

[12] Relatedly, Desai, Hogan and Wilkins (2006) find that officers tend to lose their jobs following accounting restatements regardless of whether an SEC enforcement action ensues.

company's quarterly or annual financial statements, or in a press release regarding the company's business. In many cases the suit follows a restatement of financial. Section 10(b) requires a plaintiff to prove that a misstatement was made with "scienter," meaning intentionality or a high degree of recklessness. Officers and directors of a company, the company itself, and third party advisors to the company such as accountants and investment banks are potentially liable under Section 10(b). Section 11 applies only to misstatements related to a public offering of securities. Cases governed by Section 11 are far less common than Section 10(b) cases. A typical Section 11 case would involve a misstatement in the prospectus of a company going public. The parties subject to Section 11 are the same as those subject to Section 10(b). Section 11, however, does not require proof of intent or recklessness. Officers, directors and third party advisors to a company are liable under a negligence standard,[13] and the company itself is strictly liable—all a plaintiff must prove to collect from the company itself is that there was a material misstatement.

A securities class action may begin with a revelation that a company has issued information to the market that was inaccurate—for example, an overstatement of earnings in its financial statements or an exaggeration of a product's success in a press release. That revelation results in a drop in the price of the company's shares. Shareholders that had purchased the shares at a price inflated by the prior misstatement suffer a loss equal to their purchase price minus the price of the shares after the misstatement has been revealed (assuming for simplicity that that difference was caused by the misstatement). Alternatively, the predicate to a securities class action may be a report of a bad event at a company and an accompanying stock drop that had not been foreshadowed by earlier

[13] [Explain due diligence defense]

disclosures. Arguably the failure to have disclosed facts that lead to the bad event constituted a material omission in violation of Section 10(b).[14] In response to a alleged misstatement or an omission, if a lawyer believes he can prove that one or more officers of the company acted with sufficient intent (in the case of a Section 10(b) case), the lawyer files a complaint in court on behalf of all shareholders that suffered a loss as a result of the misstatement. The only requirement the lawyer faces at this point is to name a representative shareholder to serve as a lead plaintiff for the class of shareholders who bought the company's shares at a priced that reflected the incorrect information. Often several lawyers file suits in response the discovery of a misstatement, each with a different shareholder offering to serve as a representative plaintiff. The courts ultimately select a representative plaintiff and an accompanying lawyer based on each would-be plaintiff's financial interest in the potential recovery, which is assumed to correlate with a willingness to oversee the litigation. While some lead plaintiffs exercise oversight, the lead counsel is understood to control the litigation, including decisions to settle.[15] The potential damages in the lawsuit are equal to the sum of all losses the class members suffered as a result of purchasing the company's shares at the inflated price. The lead counsel is typically awarded a fee equal to 20% to 30% of the recovery.

The defendants in a securities class action typically include a company's CEO and other officers of the company. In addition, the company itself is essentially always named when it is solvent. This puts the company in a position to pay an entire settlement. Additional defendants can include the company's outside directors as well as its accountant, investment bank or other third-party advisors to the extent the plaintiff alleges that they were involved in issuing the misstatement.

[14] For simplicity, references to a misstatement include a misstatement or an omission.
[15] [Choi,lead counsel paper]

In response to the complaint, the defendants file a motion to dismiss the suit. This is a key moment of the lawsuit. In order to survive a motion to dismiss, the plaintiff must allege specific facts that support a "strong" inference that each defendant acted with sufficient intent or recklessness to meet the requirement of Section 10(b) described above. The hurdle for a Section 11 case (involving a misstatement in a public offering) is not has high. If court denies the motion to dismiss, the case proceeds to discovery, where the costs to both sides range into the millions of dollars, and potentially to trial. It is rare, however, that securities class action go to trial.

Nearly all cases that are not dismissed are settled. Trials are very rare. A settlement can occur at any time after a complaint is filed, but most settlements occur after a motion to dismiss has been denied. It is the logic of settlement in securities class actions that raises the concern that officers and directors responsible for violations may not shoulder the appropriate burden in settling shareholders' claims. That logic is a function of two sets of factors: the parties present at the settlement table; and the incentives created by certain legal rules impinging on those parties.

On the defense side of the settlement negotiation, there are the officers and directors who have been named as defendants, and there is the company. The CEO is nearly always named as a defendant. (For simplicity, I assume no third party defendants such as accounting firms or investment banks.) Unless management of the company has turned over since the time of the alleged violation, the company's position with respect to settlement is determined, or at least strongly influenced, by the CEO and perhaps other officers who have been named as defendants. The danger is that those officers will readily have the company pay a settlement rather than paying themselves, even if it was

their misconduct that resulted in the lawsuit. This danger is even greater if the company's outside directors are named in the suit as well.

The other key party on the defense side is the D&O insurer. Unless the insurer has grounds to deny coverage, it will pay on behalf of all defendants—officers, directors, and the company itself—the amount to which the defendants agree up to the limit provided for in the insurance policy. The terms of the D&O insurance policy provide that the insurer's obligation to pay a settlement is contingent on the insurer's approval of the settlement, but for reasons described below, it is difficult for the insurer to resist a settlement that the defendants favor.

There is strong pressure on the defense side to settle a case rather than going to trial, even if the defendants' believe their prospects at trial are good. The defendant officers and directors face financial ruin if the judge or jury rules against them at trial. Potential damages in these cases are generally greater than the personal wealth of even the richest CEOs. The company can also face a devastating blow to the extent it pays the damage award after trial.[16] Moreover, litigation expenses in securities class actions are high. A case that goes to trial can cost between $10 and $20 million.[17] Thus, even leaving aside other factors, the defense side has a strong incentive to settle.[18]

There are in addition factors unique to securities class actions that create even greater pressure to settle. By contract or bylaw, a company is generally obligated to indemnify its officers and directors for costs they incur in connection with these suits, including litigation expenses and amounts paid in settlement, so long as an officer has acted in "good faith and in a manner such person reasonably believed to be in or not

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[16] All defendants share responsibility for the damage award. The rules for sharing a damage award among the corporate and individual defendants are both complex and unclear, and since so few cases go to trial, courts have had no opportunity to clarify them.

[17] [Baker & Griffith]

[18] This is reflected in the fact that approximately 95% of civil cases of all types settle.

opposed to the best interests of the corporation."[19] From an officer's or director's point of view, settlement is essential. If a case goes to trial and the officers or directors lose, there is a real danger that evidence will have emerged suggesting that they their conduct did not meet the "good faith" requirement for indemnification. On the other hand, if the case settles, the officers and directors will be indemnified. Thus, from the officers' and directors' perspective there is no cost entailed in a settlement, and a potentially devastating cost entailed in going to trial.

From the company's perspective, the D&O insurance policy has a similar impact. The insurer is obligated to reimburse the company for amounts it pays to indemnify its officers and directors, for the company's own litigation expenses, and for amounts paid to settle a case. The policy excludes from coverage losses arising out of "deliberately fraudulent" conduct, but only if there has been a "final adjudication" of the underlying lawsuit that supports a finding that such conduct occurred.[20] At least in a Section 10(b) suit, where the plaintiff must prove that a defendant committed the misstatement intentionally or with a high degree of recklessness, a loss at trial is likely to provide grounds for the insurer to deny coverage under the policy. Thus, if a case goes to trial, the company risks losing its D&O coverage. On the other hand, if the company settles, it has a stronger basis for keeping its insurance protection.

If the company is bankrupt, the settlement incentives do not change. The insurance policy will cover the officers, subject to the "deliberate fraud" exclusion described above. Thus, just as the officers do not want to risk a finding of bad faith for purposes of indemnification when the company is solvent, they do not want to risk a final

[19] Delaware General Corporation Law, §145(a).

[20] The insurer can deny coverage as well under the concept of fraud in the application, meaning that the company and its officers failed to inform the insurer of the company's true financial condition when they applied for the insurance policy.

adjudication of deliberate fraud and the loss of their D&O coverage when the company is bankrupt. Consequently, their incentive is to settle within the limits of the insurance policy.

The D&O insurer is not a party to the litigation, but it is potentially a key factor on the defense side. As stated above, the insurer's obligation to pay a settlement is contingent on its approval of the settlement. On the other hand, the insurance policy provides that such approval will not be "unreasonably withheld." Moreover, there is an insurance law doctrine of "bad faith refusal the settle," which requires an insurer to pay the full amount of damages assessed after trial, regardless of the policy limits, if the insurer is found to have wrongfully refused to settle on terms to which the plaintiffs and defendants had agreed. Thus, if the insurer approves a settlement, it must pay the settlement up to the limit provided for in the insurance policy, but if it declines to approve a settlement and allows a case to go to trial, the insurer risks having to pay the entire judgment. If the insurer believes it has grounds to deny coverage on the basis of the deliberate fraud exclusion or other grounds[21] but does not want to risk litigating the issue, it will try to negotiate a deal in which the case settles, the insurer pays an amount less than the policy limits, and the company (and potentially the officers and directors) pay the rest.

On the plaintiffs' side there are incentives to settle as well. The lead counsel or his firm must finance the litigation itself—it has no client paying it by the hour. If the case goes to trial and the plaintiff loses, the lead counsel gets nothing and will have lost many millions of dollars. If the case settles, however, the lead plaintiff will get between 20 and 30 percent of the amount paid to the plaintiff class. An interest in avoiding further

[21] There are other exclusions in the policy that allow the insurer to deny coverage. In addition, an insurer may be able to rescind the insurance policy based on the claim that the company and its officers fraudulently induced the insurer to provide the issue the insurance policy.

litigation costs along with risk aversion on the lead counsel's side will lead to a willingness to settle for less than the expected value of the case. If the lead plaintiff is an institutional shareholder, it may have some influence over the terms of the settlement. The lead counsel will want to maintain good relations with the lead plaintiff so that the two can work together in future cases. Thus, an institutional plaintiff may be able to extract a larger settlement from the defendants than a non-institutional plaintiff can, or the lead plaintiff may be able to extract a contribution to the settlement from culpable officers. But ultimately, especially in light of the lead counsel's familiarity with the strength of the plaintiffs' case, the influence of the lead plaintiff is limited.

The incentives of the parties involved in settlement negotiations suggest that class actions may suffer from a number of maladies that would undermine the claim that they supplement SEC enforcement. First, the logic of these incentives implies that class actions will be settled, not tried. Second, this logic implies that settlements will be funded largely or entirely by the company and its D&O insurer, and that officers will rarely if ever pay into a settlement. Moreover, unless the defendants can have a case dismissed, there is a reasonable concern that the company will settle even a weak case, and that it and the company and the insurer will pay the full settlement. This possibility in turn raises the question whether plaintiffs' lawyers file weak cases in the hope of obtaining a settlement. A class action regime that generates nonmeritorious cases that fail to result in culpable officers being found liable or contributing to settlements offers questionable supplemental value to securities law enforcement.

But the logic of class action settlement can only raise theoretical possibilities. Culpable officers may well be forced by their boards to pay at least part of a settlement. Settlements of weak cases may not be common enough to tempt plaintiffs' lawyers to

knowingly file weak cases. The next sections address those questions empirically. More importantly, the next sections analyze these questions at the margin, beyond what the SEC accomplishes.

4. Overview of Study

This study is divided into two parts. The first part looks at the targeting of violations by the SEC and class action plaintiffs. The broad question addressed is whether class actions target violations in a manner that is supplemental to SEC enforcement. To be supplemental in this respect, a class action would at least have to target an alleged violation that the SEC has not identified.[22] In addition, for a class action to be supplemental, it would have to target violations that justify the litigation expenses entailed. It is well known that class actions frequently run parallel to SEC actions, and that those suits tend to withstand motions to dismiss and that they settle for relatively large sums.[23] I verify these facts below. The question of supplementation, therefore, must focus on class actions without parallel SEC actions. The concern in these cases is that plaintiffs' lawyers may target cases with relatively weak merits but potentially high damages. An example would be a large company whose shares have dropped when events turned out to be inconsistent with expectations, where it is arguable that a material omission was responsible for those expectations, a concern that commentators have often expressed. To address this question, I look at class actions and

[22] I currently define a case as identified by the SEC simply as a case in which the SEC has taken enforcement action. Before publishing this paper, I will try to expand this definition to include cases that the SEC has investigated and then chosen to forgo an enforcement action.

[23] [Choi, Nelson, Pritchard, others] Plaintiffs' lawyers may prosecute cases where the SEC is pursuing an enforcement action because they can reasonably infer that the SEC has found strong evidence of a violation. (In contrast to a private suit, the SEC files an enforcement action only after it has completed an investigation.) In addition, the presence of an SEC action may create pressure for the company to settle in order to avoid having additional evidence produced that the SEC can use in its case.

SEC actions based on restatements. I then rank all restatements based on seriousness as measured by measures of accounting aggressiveness,[24] the market reaction to the announcement of the restatement, and abnormal insider trades during the period during which the company's financials were misstated. I then examine the targeting of class actions and SEC actions in relation to the universe of restatements over a given time period.

[This part of the study is not yet complete]

The second part of the study looks at the outcome of securities class actions and asks whether these outcomes are supplemental to SEC enforcement actions. The outcome of a case depends on the defendants charged and the penalties imposed on them. For cases in which there are parallel SEC actions and class actions, I ask whether the outcome of the class action can be said to supplement the outcome of the SEC action against the same company and/or its officers. For cases in which there is a class action but no SEC action, I ask whether the outcomes in those cases are consistent with the policy reflected in SEC actions. As demonstrated below, the outcomes of SEC actions reflect a strong preference for imposing penalties on individual officers rather than corporate defendants. This approach to enforcement is consistent with SEC policy statements and statements of Congress when legislating in this area.[25]

Again, the incentives described above suggest a hypothesis that is inconsistent with the supplementation justification of class actions, a hypothesis that has been frequently stated but never tested: Plaintiffs' lawyers and defendants in these suits enter

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[24] I will be using a proprietary database that creates this measure.
[25] [cites]

into settlements that do not involve payments by individual officers responsible for the alleged misconduct.

5. Data

My sample of securities class actions consists of all cases filed between 2000 and 2003 against public companies and/or officers or directors of public companies for alleged misstatements. I selected the end date for this sample period so that litigation would be completed in nearly all cases in my sample. I selected the starting date because this is the point at which court filings became available in relatively large numbers on PACER. To identify cases filed during this time period, I used the Stanford Securities Class Action Clearinghouse and selected all cases the Clearinghouse identified as "classic," meaning that the defendant is a public company and the basis of the suit is an alleged misstatement. I dropped cases that, upon further examination, did not fit this description. The primary sources of data for each case were court filings and company filings with the SEC. Where data was not available from such sources, I attempted to fill gaps with Google searches and telephone calls to lawyers involved in the suits.

My sample of SEC cases consists of two subsamples. One subsample consisted of SEC cases that paralleled cases in the class action sample, regardless of when the SEC initiated them. For each case in the class action sample, I defined a parallel SEC action as one based on the same alleged misconduct where the timing of the misconduct described in the SEC complaint overlapped with the time period described in the consolidated class action complaint. I made this determination initially based on data compiled by the Stanford Securities Class Action Clearinghouse and in each case verified that both cases focused on the same misconduct. I imposed no constraint regarding the

timing of a parallel SEC action. Thus, a parallel SEC action initiated outside the 2000 to 2003 time period was included in this part of the SEC sample. I also imposed no constraint on whether the SEC action was filed before or after the class action. For all parallel SEC actions, I collected data regarding the defendants charged and the outcomes of the cases. The sources of data were SEC releases and documents filed in litigation.

The second subsample consisted of SEC actions with no parallel class action. My sample period for these cases, like that of the class action sample period, is 2000 to 2003. From this sample, I dropped any SEC action for which there was a parallel class action, regardless of whether the parallel class action fell within my class action period. In order to analyze the extent to which class actions are supplemental to SEC actions, I could have limited my SEC sample to SEC actions with parallel class actions. However, in order to avoid a potential bias stemming from possible differences between SEC actions with and without parallel class actions, I collected this separate sample of SEC actions. Such a bias could lie in the nature of the violation targeted or in the outcome of cases—the two areas in which I attempt to determine whether class actions supplement SEC actions. In addition, because nearly all class actions target companies whose shares trade on a national market (NYSE, AMEX, NASDAQ), I limited my sample to SEC actions against companies whose shares trade on a national market.[26]

As shown in Panel A of Table 1, there were a total of 746 securities class actions filed from 2000 to 2003. Of these, 263 were either dismissed or voluntarily dropped by the plaintiffs. A total of 422 have been settled, and 58 are still pending. Consistent with the discussion above regarding incentives to settle, only 3 of the 746 cases in this sample

[26] In addition, it is difficult to distinguish some public company misstatement cases from pump-and-dump or bucket shop broker dealer cases when the public company is small and traded off the national exchanges. By restricting the SEC sample to companies with shares trading on a national market, I have a more comparable set of cases across the SEC and class action samples.

went to trial. Of those, one settled during trial,[27] and one settled after trial pending appeal.[28] In the third case, the defendants did not appear at trial and a default judgment of $192 million was entered against them.[29] For simplicity in the discussion below, I group these three cases with the 422 cases that settled before trial, and I refer to all 425 cases as settlements. As also shown in Panel A, plaintiffs named third parties such as accounting firms and underwriters in 262 cases (35 percent), and collected from third parties in 77 cases (10 percent). In addition, Panel A provides some descriptive statistics on the content of the allegations in these cases. A majority of cases involved nonaccounting issues, but many of those cases were dismissed, whereas few accounting-based cases were dismissed. Among the 746 class actions in this sample, there were 147 parallel SEC enforcement actions,[30] 142 parallel state fiduciary duty actions, and 51 cases in which the officers were convicted of or plead guilty to crimes.

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[27] [ATT case]

[28] [Clarent case. CEO Jerry Chang paid $900,000]

[29] [Safety Kleen case]

[30] The SEC enforcement action would focus on the same violation at issue in the class action, but in addition to prosecuting for illegal misstatement under Section 10(b) or Section 11, the SEC can include lesser violations such as a failure to comply with internal books and records or internal control requirements. The derivative suit would be based on an alleged violation of the duty of care or, more likely, the duty of loyalty, which can stem from the same underlying act that resulted in a misstatement. For instance, the act of overstating revenues to increase a company's share price would be both a misstatement and a violation of the duty of loyalty if the officers involved sold stock while the share price was inflated.

Table 1: Descriptive Statistics: Class Actions

Panel A: Cases and Outcomes

	N	Percent of cases filed
Total number of cases	746	100%
Cases dismissed or volunarily dropped	263	35%
Cases settled	422	57%
Cased tried	3	0.4%
Cases ongoing	58	8%
Cases with third-party defendants (e.g. accountant) named	262	35%
Cases in which third-party defendants paid into settlement	77	10%

	Settled	Dismissed	Ongoing	Total
Cases with parallel SEC enforcement actions	127	12	8	147
Cases with parallel derivative suits	139	1	2	142
Cases in which executives were criminally convicted	51	0	0	51
Cases involving restatements	135	1	2	138
Cases onvolving GAAP violations (including restatements)	230	3	4	237

Panel B: Settlement/Damage Payments[1]

	Mean	Median	N
Amount paid in settlement			
All cases	$82 million	$7.5 million	425
Cases without third party payments	$28 million	$6.3 million	348
Percent of investor losses recovered			
All cases	5.6%	2.6%	425
Cases with over $1 billion in losses	2%	1%	114
Cases without third party defendants	5.3%	2.4%	348
Cases over $1 billion without third party defendants	1.3%	0.9%	83

Panel C: Sources of Settlement/Damage Payments[1]

	Number of Cases	Percent of Cases Settled[2]	N[3]
Company	172	44%	387
D&O insurer	328	86%	383
Officers	27	7%	405
Third party (e.g. auditor)	77	18%	425

	Mean	Median	N[4]
Percentage paid by insurer (where insurer payment > 0)	84%	100%	314
Number of cases in which insurer paid 100% of settlement			187
Percentage paid by company (where company payment > 0)	54%	55%	161
Percentage paid by third party (where third party payment > 0)	28%	18%	77
Percentage paid by individuals (where individual payment > 0)[5]	41%	21%	27
Total amount paid by individuals (where individual payment > 0)	$19.1 million	$3.25 million	27
Percentage paid by each individual (where individual payment > 0)[5]	9%	2%	62
Amount paid by each individual (where individual payment > 0)	$9.6 million	$1.75 million	47[(6)]

[1] These cases include cases settled (422) and tried (3)
[2] Percentages do not add to 100% because in some case there are more than one source of payment.
[3] Excludes cases in which data is not available regarding whether a party paid anything in the settlement
[4] Excludes cases in which data is not available regarding the precise amount of each party's payment.
[5] These percentages are heavily weighted towards small settlements.
[6] N denotes the number of individuals that paid out-of-pocket in the 27 cases.

Panel B of Table 1 provides summary statistics on settlements. The mean and median settlement amounts were $82 million and $7.5 million, respectively. As implied by the difference between the mean and median, there are some extreme "mega-settlements" among these cases, including the $7.2 billion settlement in the Enron case and the $6.2 billion settlement in the Worldcom case. The largest cases tend to include accounting firms, investment banks and other third parties as defendants. Hence the settlement amounts in those cases are larger. If one excludes the 77 cases in which third-party defendants paid into the settlement, the mean figure is much lower. Panel B also shows that the amounts investors recover in securities class actions is generally a small fraction of their losses. The mean recovery across the full set of 425 settlements is 5.6 percent of losses. The median is 2.6 percent. In approximately one quarter of cases that settled, investors lost $1 billion or more. In those cases, mean and median recoveries for investors were lower: 2 percent and 1 percent respectively.

Finally, Panel C of Table 1 reports the sources of funds in settlements. As one would expect from the discussion above, the primary source of funds is the D&O insurer. D&O insurers paid some portion of the settlement in 86 percent of the cases for which these data were available. Of those cases in which the insurer paid some amount, the mean insurance payment was 84 percent.[31] The insurer paid 100 percent of the settlement in 187 of the 314 cases for which data on the amounts of insurer payments are available. The company made payments in 44 percent of settlements. In those cases, the mean and median payments were 55 percent and 54 percent, respectively.

There are three primary explanations for why the insurer would pay less than 100 percent. First, D&O insurance policies provide for "retentions" (known as deductibles in

[31] Of the 425 cases that settled, there were 383 cases in which I was able to determine whether the insurer paid. Of those, there were 314 in which I was able to determine exactly how much the insurer paid.

other types of insurance) that the company must pay before the insurer begins to pay. If, however, those retentions are exhausted prior to the settlement as a result of litigation expenses, the insurer will pay 100 percent of the settlement. Second, if a settlement exceeds the limits on a company's policy, the company will pay any amount over the limit. Third, if the insurer has potential grounds for denying coverage—for example, based on the deliberate fraud exclusion discussed above—the insurer may negotiate an agreement with the company whereby the insurer pays less than the limits on the policy.

Most importantly for purposes of the analysis here, individual officers made payments in only 27 settlements—7 percent of the 405 settlements for which data is available. Much of the discussion below focuses on this fact. One question this raises is whether this low frequency of officer liability is consistent a claim that these suits supplement SEC enforcement. Another is whether these 27 cases represent serious cases of misconduct, perhaps the most serious, or whether there are other explanations for these outcomes. Finally, it is clear from these numbers that securities class actions do not result in compensation to any significant degree. Not only do the company and the D&O insurer pays the vast bulk of the settlements, meaning that shareholders are paying shareholders, but the payments to shareholders amount to very small portions of their losses.

5.2 SEC Enforcement as a Baseline

As a baseline from which to analyze class actions as potentially supplemental to SEC actions, I begin with the sample of SEC actions described above. As explained above, these SEC actions consist of two subsamples. One consists of the 147 cases that

parallel the cases in the class action sample. The second is an additional 43 cases that the SEC filed between 2000 and 2003 but for which there was no parallel class action.[32] Table 2 presents descriptive data on outcomes of SEC actions. [At this point, these data are based on the 147 SEC actions with parallel class actions. I plan to add data from the 43 SEC actions with no parallel class actions.] These data provide a basic picture of SEC enforcement policy as reflected in practice. Several points warrant mention.

First, the SEC frequently imposes penalties on inside managers but rarely on outside directors. Out of 147 enforcement actions in the sample, many of which are still pending, the SEC imposed monetary penalties on CEOs in 32 cases (67% of closed cases brought against CEOs) and on CFOs in 40 cases (65% of closed cases brought against CFOs). It imposed monetary penalties on lower level executives more frequently. Financial officers below the CFO level were assessed penalties in 46 cases (78% of closed cases brought against them), and non-financial officers below the CEO level were assessed penalties in 41 cases (66% of closed cases brought against them). These monetary penalties were imposed on top of amounts assessed as disgorgement of gains from alleged misconduct. Table 3 presents the dollar amounts of monetary penalties and disgorgement.

The SEC also imposes bars on executives serving in the future as an officer or director of a public company. In this sample, it imposed permanent bars on CEOs in 24 cases (50% of closed cases brought against CEOs). It has imposed permanent bars on CFOs in 24 cases (39% of closed cases brought against CFOs). And it imposed permanent bars with similar frequency against financial and nonfinancial officers below the CEO and CFO level.

[32] Between 2000 and 2003, the SEC brought [221] enforcement actions against firms whose shares traded on national markets. Of those, [178] cases had parallel class actions. Thus, during this sample period, there were only 43 SEC actions that had no parallel class action.

Finally, the SEC referred several cases to the Department of Justice for criminal prosecution of particular executives. Among cases that have been closed, there were five referrals of CEOs, eight referrals of CFOs, sixteen cases against financial officers, and eighteen cases against nonfinancial officers.

Table 2
Outcomes of SEC Enforcement Actions

Penalties the SEC imposed on defendants in the 146 SEC actions that paralleled the class actions in my sample (those filed from 2000 to 2003). Numbers refer to the number of cases, as opposed to the number of defendants. For example, there were 27 cases in which one or more financial officers were permanently barred from serving as an officer or director of a public company. Cases are defined as a set of actions against a company and/or its officers and directors. Percentages use resolved cases as a denominator. N refers to the total number of cases that name each type of defendant (for example there were 81 cases that named CEOs as defendants).

	Criminal Action	Permanent Bar	Temporary Bar	Monetary Penalty	Disgorgement	Resolved	Total cases naming defendant
Company	n/a	n/a	n/a	30 **27%**	11 **10%**	112 **93%**	120
CEO	5 **10%**	24 **50%**	13 **27%**	32 **67%**	27 **56%**	48 **59%**	81
CFO	8 **13%**	24 **39%**	21 **34%**	40 **65%**	60 **97%**	62 **69%**	90
General Counsel	2 **25%**	1 **13%**	2 **25%**	2 **25%**	3 **38%**	8 **89%**	9
Financial Officer	16 **27%**	27 **46%**	29 **49%**	46 **78%**	42 **71%**	59 **64%**	92
Non-Financial Officer	18 **29%**	26 **42%**	19 **31%**	41 **66%**	37 **60%**	62 **82%**	76
Outside Director	0 **0%**	2 **40%**	1 **20%**	4 **80%**	1 **20%**	5 **63%**	8

Table 3
Monetary Penalties and Disgorgement in SEC Actions

Mean and median monetary penalties and disgorgement amounts. Mean and median figures for individuals are given on a per individual basis (as opposed to means and medians of aggregated individual payments on a per case basis).

	Monetary Penalty			Disgorgement		
	Mean	Median	N*	Mean	Median	N*
Company	104,000,000	10,000,000	33	6,989,422	1,000,000	12
CEO	273,321	137,109	31	9,404,312	397,500	28
CFO	149,435	100,000	41	7,587,233	189,464	33
General Counsel	110,000	110,000	2	2,014,351	2,014,351	2
Other Financial	119,979	75,000	66	3,828,786	176,864	62
Other Non-Financial	123,664	60,000	65	3,995,193	150,000	58
Outside Director	84,000	100,000	5	20,000,000	20,000,000	1

Although the SEC appears to focus largely on individual defendants, it also imposes monetary penalties on corporate defendants. This occurred in 30 cases (27% of closed cases that named corporate defendants). The more common sanction against a corporate defendant, however, is an injunction or a cease and desist order against further violations (not listed in Table 2). Each of theses sanction raises the penalty if the defendant commits a violation in the future but results in no immediate cost.

These data on SEC actions provides a base against which to analyze whether class actions provide supplemental enforcement. The next section looks at the violations targeted by class actions relative to the violations that the SEC targets. The following section analyzes outcomes of class actions relative to outcomes of SEC actions.

6. Analysis

The analysis of the supplementation claim consists of two parts. The first part examines the targeting of class actions in relation to the targeting of SEC actions. To what extent do class actions target violations that the SEC does not target? Are those suits targeted toward serious violations? The second part examines outcomes of class

actions in relation to outcomes of SEC actions and analyzes whether the outcome of those cases supports the supplementation claim.

6.1 *Violations Targeted* **[This section is incomplete]**

This section compares the targeting of class actions to the targeting of SEC actions. As a threshold matter, I look at the extent to which class actions target cases that the SEC does not target. I then look at the extent to which those cases survive dismissal. A dismissal does not mean the case necessarily targeted innocent conduct, but at least from an ex post perspective it suggests that enforcement resources were expended to no socially beneficial end. Finally, in order to assess class action targeting more precisely, I look at cases involving restatements to determine whether class actions target relatively serious restatements.

Table 4 provides some simple statistics on these crude measures of targeting. During our sample period, there were 746 class actions filed. Of those, 147 had parallel SEC actions, and 599 had no parallel class action. The class actions without parallel SEC actions were dismissed with far greater frequency (42% of cases) than those with parallel

Table 4
Comparison of Class Actions With and Without Parallel SEC Actions

Breakdown of result in class actions (50 ongoing as of February 2009) separated according to whether or not there is a parallel SEC action.

	Non-Parallel		Parallel	
Total Number of Cases	599		147	
Settled	298	50%	127	86%
Dismissed	251	42%	12	8%
Ongoing	50	8%	8	5%

Mean Total Settlement	$22,100,000	n=297	$223,000,000	
Median Total Settlement	$6,500,000	n=297	$14,000,000	n=127

SEC actions (8% of cases). In addition, among cases that settled, the settlement amounts were far lower among class actions without parallel SEC actions than among those with parallel SEC actions. The mean and median settlement amounts for the former were $22.1 million and $6.5 million, respectively, while the settlement amounts for the latter were $223 million and $14 million, respectively. These results are consistent with Choi, Nelson and Pritchard (2006), which finds that the presence of an SEC action or a restatement is correlated with a reduced likelihood of dismissal and a larger settlement. But based on these comparisons alone, however, I cannot exclude the possibility that stand-alone class actions nonetheless target a reasonable number of serious violations.[33]

[In the remainder of this section, I will look measures of seriousness among the restatement cases to test two alternative hypotheses: (a) that the incentives discussed above bias plaintiffs' lawyers' case selection to cases with high potential damages but not necessarily with serious misconduct; or (b) that plaintiffs' lawyers' pursue cases of serious misconduct. Seriousness will be measured by (a) measures of aggressive accounting during the period that was restated, (b) abnormal insider trading. I limit the analysis of restatement in this section in order to have some commonality on which to rank violations. I use a proprietary ranking system to rank restatements.]

5.3 Case Outcomes

[33] [One gap here that I plan to fill in is the timing of class actions and SEC actions. Generally, the class action precedes the filing of an SEC action because the SEC investigation precedes its filing of an action, whereas the class action follows soon after a potential violation appears. I am currently in the process of collecting data on the timing of SEC investigations to the extent those data are available.]

Even if class actions target serious violations that the SEC does not target, we cannot conclude they supplement SEC actions unless the outcome of those class actions is consistent with the goals of securities law enforcement. In addition, even if a class action targets a violation that the SEC also targets—that is, the class action runs parallel to the SEC action—the class action could conceivably be supplemental to SEC enforcement if the outcome of the class action supplements the outcome of the SEC action in a way that is consistent with the goals of securities law enforcement. This section examines the outcomes of class actions—both stand-alone and those that run parallel to SEC actions—and analyzes the contribution of those outcomes to enforcement.

I begin by asking who the defendants are in class actions and SEC actions, respectively. Figures 1 and 2 present that information. Figure 1 includes all 747 class actions in the sample and all 146 SEC actions. It shows the percentage of cases in which particular defendants are named. Figure 2 includes only the 146 class actions that have parallel SEC actions, and shows how the class actions and SEC actions differ with respect to who is named a defendant. Figure 2 shows the extent to which class actions name defendants that their parallel SEC actions do not name, and the extent to which SEC actions name defendants that their parallel class actions do not name. Defendants common to a parallel class action-SEC action pair are not counted in Figure 2.

Three differences between class actions and SEC actions are apparent in both charts. First, class actions name outside directors as defendants far more frequently than do SEC actions. Second, while the difference is not as pronounced, class actions name CEOs more frequently than does the SEC. And third, class actions name the CFO more frequently than do SEC actions. As shown below, CEOs, CFOs infrequently pay into class action settlements, and outside directors pay even more rarely. One therefore has to

suspect plaintiffs' lawyers name them as defendants for reasons other than their own culpability and their own bank accounts.

Figure 1
Defendants Named in SEC Actions and Class Actions

Defendants named in each SEC action (n=146) and each class action (n=746). Financial Officers and Nonfinancial Officers are officers below the CEO and CFO level.

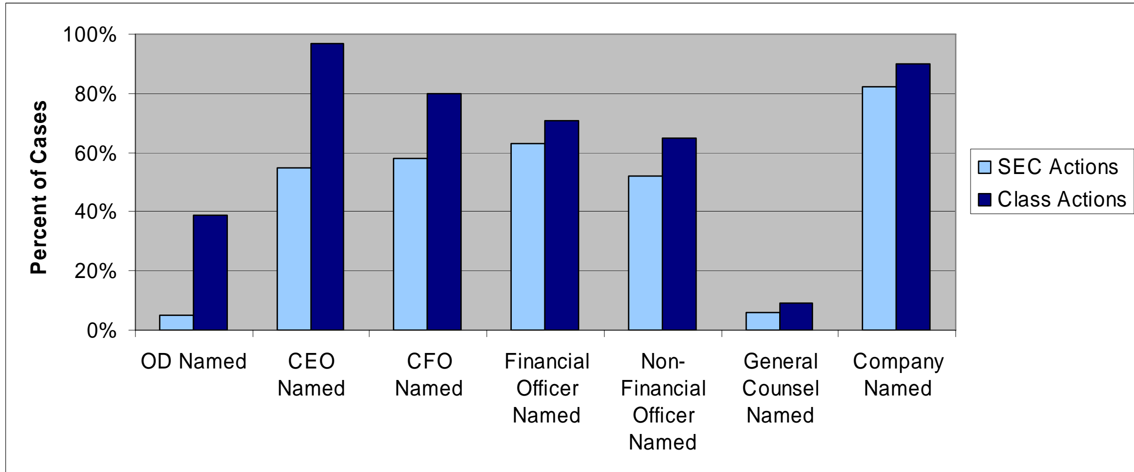
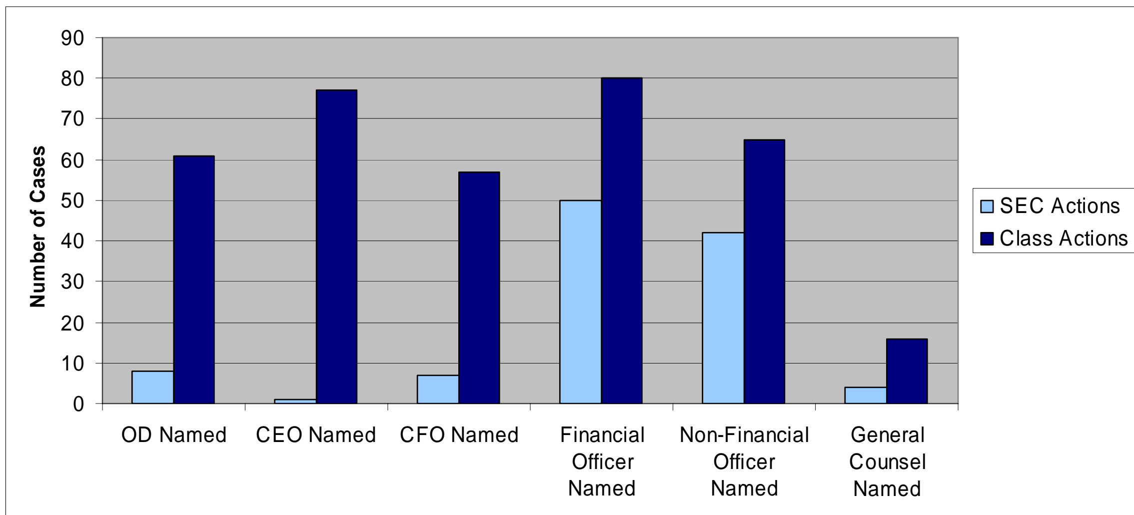


Figure 2
Additional Defendants in Parallel SEC and Class Actions

This chart shows non-overlapping defendants in class actions and SEC actions. For example, in 77 (out of 146) class actions, the plaintiffs named a CEO who was not named in the parallel SEC action.



I next look at the outcomes of class actions, beginning with those for which there is no parallel SEC action—that is, the class actions that, in terms of targeting are potentially supplemental to SEC actions. The basic outcomes are presented in Table 5. Of the 599 class actions that did not have parallel SEC actions, 42% were dismissed, and of the cases that settled, the mean and median settlements were $22.1 million and $6.5 million, respectively. The company and the insurer paid the full settlement in all but nine of these cases. In those nine cases— only 3% of cases settled—officers and directors contributed to the settlement.

Table 5
Outcomes of Class Actions

Outcomes of class actions separated according to whether there is a parallel SEC action. Parallel is defined as a case based on the same allegations during an overlapping time period.

Panel A: Case Status

	Non-Parallel		Parallel	
Total	599		147	
Settled	298	50%	127	86%
Dismissed	251	42%	12	8%
Ongoing	50	8%	8	5%

Panel B: Sources of Payment

	Non-Parallel Settlements			Parallel Settlements		
	Mean	Median	N*	Mean	Median	N*
Total Settlement	$22,100,000	$6,500,000	297	$223,000,000	$14,000,000	127
Officers/Directors Payments	$4,183,382	$415,000	9	$26,600,000	$5,135,000	18
Insurance Recovery (including nonpayments)	75%	100%	255	56%	60%	112
Insruance Recovery (when Insurance Paid >0)	89%	100%	222	73%	91%	92

* Number of cases included in calculation. Missing data is dropped. For instance, there were 222 cases in which the insurer covered at least part of the settlement in non-parallel case and there were 255 cases for which data was available on whether the insurer paid in those cases (it did not in 33).

Turning now to class actions with parallel SEC actions, officers and directors contributed to settlements in 18 of those cases—14% of cases settled. The mean and

median amounts these individuals contributed in these cases were $26,600,000 and $5,135,000 per case, respectively. Thus, the frequency with which officers paid into settlements, and the amounts they paid, were greater in these cases than in cases where there was no parallel SEC action. On the other hand, 86% of these cases involved no payment by an officer or director.

One question raised by the outcomes of class actions that parallel SEC actions is whether payments by officers or directors truly supplement penalties the SEC imposes. It is unclear why they would be needed as a policy matter. The SEC is fully able to assess a penalty in accordance with its own enforcement policies. Furthermore, a comparison of outcomes in these 18 class actions compared to the outcome in the 18 parallel SEC actions casts considerable doubt on whether these class actions can be reasonably described as supplemental to the SEC actions. Table 6 provides a comparison.

Table 6
Penalties in Parallel SEC Cases Where There Were Officer Payments in Class Actions

Of a total of 18 cases where officers or directors paid in the class action, what sanctions did the SEC imposed in its parallel enforcement action?

		Position of Individual Sanctioned Number of Cases (Number of Individuals)				
Penalties imposed on one or more individuals	Number of Cases/ Individuals	CEO	CFO	Outside Director	Other Financial	Other Non Financial
Severe Penalty	13	7 (8)	8 (9)	0	10 (21)	8 (18)
Monetary penalty	12	5 (5)	6 (6)	0	8 (11)	7 (13)
Disgorgement	7	4 (5)	6 (6)	0	6 (12)	4 (9)
Permanent Bar	8	3 (3)	5 (5)	0	6 (9)	4 (5)
Temporary Bar	10	2 (2)	5 (5)	0	4 (6)	4 (5)
Penalties imposed on one or more individuals who did not pay in the class						
Severe Penalty	10	2 (2)	3 (4)	0	8 (16)	6 (13)
Monetary Penalty	7	1 (1)	3 (3)	0	5 (7)	4 (9)
Disgorgement	5	1 (1)	1 (1)	0	5 (9)	3 (6)
Permenent Bar	7	1 (1)	1 (1)	0	6 (8)	4 (4)
Temporary Bar	4	0	1 (1)	0	3 (4)	3 (3)

Total cases = 18
Total individual defendants = 231
* Severe Penaly includes Monetary Penalty, Disgorgement, or Permanent Bar

The outcomes of the 18 cases in which officers paid into settlements differ substantially from the outcomes of the parallel SEC actions. In ten of these cases, the SEC imposed severe penalties on individuals who did not pay at all into the class action settlement. Of those, seven cases involved a monetary penalty. These sanctions were spread among a wide range of officers, with most imposed below the CEO and CFO level. As Table 6 also shows, the SEC did not impose severe penalties in all of these 18 cases. It did so in only 13 of them, 12 of which involved monetary penalties. Thus, one might claim that five of these 18 class actions "supplemented" the outcome of the SEC action. Again, however, it is unclear why the SEC would need such supplementation when it has done its own investigation and agreed to a settlement. On the whole, a better description of the relationship between outcomes in SEC actions and class actions in these cases may be that *SEC actions supplemented the class actions* by imposing individualized penalties on a wide range of officers that it apparently concluded were responsible for the violations involved.

Turning now to the 128 parallel class actions and SEC actions in which no officer or director paid into a settlement, a pattern again emerges in which the SEC imposes sanctions on individual officers where the class action does not. As shown in Table 7, the SEC imposed severe penalties on defendants in 83 of these cases. It imposed monetary penalties in 64 of these cases, disgorgement in 55 of these cases, permanent officer-or-director bar in 40 of these cases, and temporary bars in 42 of these cases.[34] These SEC sanctions are spread among the full range of officers, with most imposed on executives below the CEO level. Again, the pattern that emerges from a comparison of parallel class actions and SEC actions appears to be the opposite of what is claimed—the SEC seems to

[34] These add to more that 128 because multiple penalties are imposed in a single case and sometimes against a single defendant.

be supplementing private enforcement, which, consistent with what commentators have assumed, is focused almost entirely on extracting funds from the company and its D&O insurer.

Table 7
Penalties in Parallel SEC Cases Where There Were No Officer Payments in Class Action

Penalties in 128 SEC actions that paralleled class actions that settled with no contribution from officers or directors. Numbers refer to cases, not individual defendants. For example, in 54 cases one or more Other Financial Officers incurred severe penalties.

	Number of Cases	Number of Individuals	CEOs	CFOs	Outside Directors	Other Financial	Other Nonfinancial
Severe Penalty*	83	206	38	38	5	54	50
Monetary Penalty	64	146	26	31	4	39	34
Disgorgement	55	122	22	23	1	34	31
Permanent Bar	40	65	20	16	2	22	22
Temporary Bar	42	69	10	15	1	25	18

*Defined to include monetary penalty, disgorgement, or permanent bar

Recall that class actions, to a far greater degree than the SEC, name CEOs, CFOs and outside directors as defendants. Yet, officers and directors pay into settlements infrequently. Instead the corporation and its insurer pay. By contrast, the SEC commonly imposes severe penalties on CEOs and CFOs (but not outside directors). The explanation for these differences appears to be that class action lawyers name top officers and outside directors, not necessarily to obtain settlements from them, but rather because these people will make decisions on behalf of the corporation whether to settle the case and for how much. By naming them as defendants, the plaintiffs' lawyers bring pressure on them personally to have the corporation settle.

The comparisons between parallel class actions and SEC actions raise a question regarding those class actions where there is no parallel SEC action. If the justification for class actions is that they supplement SEC enforcement, these are the important cases. Recall, however, that individual officers contributed to settlements in only 3% of those

cases—and that corporate defendants and their insurers paid mean and median settlements of $22.1 million and $6.5 million, respectively. Judging from the outcomes of SEC actions that run parallel to class actions, it is hard to believe that the SEC would resolve those cases in the same way. Whether those class actions can be considered supplemental is thus questionable if, by supplemental one means they produce results similar to what the SEC would produce.[35]

One final inquiry may shed light on whether officer and director contributions to class action settlements are related to the merits of a case. Litigation consulting firms have constructed models to predict settlement payments based on past settlements.[36] Those models explain a very high proportion of the variance in settlements. As one would expect, they take into account factors that proxy for merits and potential damages. If such a settlement model accurately predicts class action settlements, and if officer liability occurs when the merits of a case are strong, one would expect the same model to predict officer payments.

I construct a settlement model similar to those that NERA and Cornerstone have used and reported in their publications. The explanatory variables in the model are (a) the presence or absence of an SEC action, (b) the presence or absence of a parallel derivative action, (c) whether or not a case involves a restatement, (d) the natural log of damages, (e) whether there is an accountant defendant, (f) whether there is an underwriter defendant, and (g) whether the lead plaintiff is a public pension plan. I first fit that model to all settlements in my sample. Column 1 of Table 8 reports the results of that regression. As expected, the R-squared for this regression is .69 and the coefficients are highly significant.

[35] [I plan to refine this point with propensity analysis]
[36] [NERA, Cornerstone]

I then fit a logit model using the same explanatory variables and a binary dependent variable indicating whether or not an individual officer or director paid into a settlement. The results are reported in Column 2 of Table 8. The fit of this model is poor, and the signs of some coefficients are the opposite of what one would expect. There are two statistically significant coefficients: the presence of a public pension plan as a plaintiff, and the presence of an accounting firm as a defendant. The presence of a public pension plan as a lead plaintiff is consistent with the well publicized demands of public pension plans that officers and directors pay personally when they bear responsibility for misstatements. Where they are present, these pension plans may exert influence over the lead counsel and insist that officers and/or directors contribute to the settlement fund. The presence of an accountant as a defendant may be a proxy for severe accounting misstatements in a case, which may be associated with a higher degree of intentionality on the part of one or more officers, which in turn could create pressure for those officers to contribute to a settlement. These significant positive relationships aside, the weak fit of the model suggests a very attenuated relationship between the merits of a case and the presence of officer or director payments into a settlement. This is consistent with the findings above regarding the differences between outcomes in SEC actions and outcomes in class actions.

Table 8: Settlement Prediction Model as a Predictor of Officer Payments

Model 1 is an OLS regression with the size of a class action settlement as a dependent variable. Model 2 is a logit regression with the dependent variable being presence/absence of an officer or director payment into a class action settlement.

	Model (1) Total Payment	Model (2) Officer Payme
Parallel SEC Action	.3469***	.7605
	(.1192)	(.5507)
Parallel Derivative Suit	.3871****	-.0302
	(.1045)	(.5300)
Restatement	.2341**	-.8217
	(.1063)	(.5253)
Log Damages	.4937****	-.1007
	(.0255)	(.1264)
Accountant Defendant	.3315*	2.306****
	(.1273)	(.5660)
Underwriter Defendant	.5826****	-.1427
	(.1449)	(6413)
Public Pension Plan Lead Plaintiff	.7940****	1.358**
	(.1489)	(.6138)
F-value	117.59	
R^2	0.69	0.16
N	374	337

**** p<.001
*** p<.005
** p< .05
* p<.01

7. Conclusion

The claim that securities class actions "supplement" SEC enforcement is vague. Neither the Supreme Court, nor Congress, nor the SEC has explained what they mean when justifying class actions on that basis. This paper has considered two possible forms of supplementation. First, class actions might target violations that the SEC would target if it had the resources. Second, in those cases, class actions might achieve results similar to what the SEC would achieve if it prosecuted those cases. Of the 746 class actions filed during the sample period used in this paper, 599 were potentially supplemental in that the SEC did not pursue parallel enforcement actions. [Further analysis will be performed to determine whether those cases were targeted against violations that the SEC might have pursued.] Nearly half of those class actions were dismissed, but more importantly, the outcome in all but nine cases was a settlement funded entirely by the company and its D&O insurer. These outcomes stand in stark contrast to the outcomes of SEC actions, which commonly impose monetary and nonmonetary penalties on officers accused of misconduct. While this comparison may not be valid, since the merits in the two sets of cases may be different, a comparison of pairs of parallel class actions and SEC actions supports the conclusion. Where SEC enforcement actions and class actions targeted the same violation, the results in the two sets of cases were entirely different. The SEC enforcement actions resulted in penalties imposed on a wide range of officers—CEOs, CFOs and lower level officers—while the class actions ended 84% of the time in a settlement funded by the corporate defendant and its insurer. There is no basis for concluding that a class action settlement funded by a corporation and its insurer

constitutes supplemental enforcement. Moreover a multivariate analysis showed that the factors that explain settlement amounts with a high degree of accuracy do not explain the incidence of officer and director payments into a settlement. Thus either the merits do not matter in predicting settlements, or they do not matter in predicting officer and director payments. In light of the rest of the analysis, the latter is the better inference.

Securities class actions cannot be justified as supplemental in the way I have interpreted the claim. On the other hand, other studies have found that securities class actions have ancillary effects on officers and directors such as lost jobs and lost outside directorships. It is possible that those ancillary effects are sufficient to consider class actions supplemental. Further analysis of those effects is necessary before one can support that conclusion.