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As investors become vigilant, securities litigation rises

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Executive summary: Securities litigation has increased in the wake of the subprime real estate crisis and other high-profile business corruption cases.

In the 1987 movie "Wall Street," Gordon Gekko, the character played by Michael Douglas, made a speech to his stockholders in which he declared: "Greed is good. Greed is right. Greed works."

In the two decades since that movie, Gekko's mantra seems to have been taken to heart by various business executives, resulting in corporate scandals such as Enron, WorldCom and Qwest, and lately by those in the mortgage industry — lenders as well as speculators — responsible for the subprime "mortgage meltdown."

Predictably, activities in the legal practice area of securities litigation have risen with the crises.

The good news is that most of the driving force behind the increase in litigation can be attributed to improved vigilance.

"With the subprime debacle and the problems we see in the subprime and mortgage markets, it's not surprising that there were more high-profile cases filed in the last 12 months," said Gregg Levin, an attorney working in securities litigation at the Motley Rice law firm in Charleston. "A lot of that has to do with shareholders, particularly the institutional shareholders, being more vigilant."

Levin, who has been with Motley Rice a year, expects his work load to increase, not only from shareholder demand but also because of the firm's reputation in dealing with high-profile cases.

"We had the tobacco lawsuit several years ago, and the securities practice was a logical offshoot of that," he said. "Unfortunately, corporate fraud is an ongoing thing. It didn't stop with Enron or WorldCom. You can see in the headlines almost every day that there is corruption.

"What attracted me to this position is that the Motley Rice firm has always had a deep commitment to the social good and has long sought to hold wrongdoers responsible when they engage in malfeasance."

A shift in perspective occurred back in the 1990s regarding corporate oversight, when institutional shareholders would monitor their investments and decide what to do about the findings, Levin said.

"If they didn't like what was going on, they'd sell and walk," he said. "But today, institutional investors are just doing a better job monitoring their portfolios, and when they see issues rising, they think about how to make it better and how to protect their long-term interests, and with that comes a greater willingness to go to litigation with these matters."

The scandal that erupted over former economics professor Al Parish's shady investment dealings has familiarized many local investors and business people with such litigation. But suing over corrupt business practices, including investments, has become a nationwide recourse.

In April, PricewaterhouseCoopers released its PricewaterhouseCoopers 2007 Securities Litigation Study, an annual review of securities class actions. The findings show a surge in subprime-related litigation in the latter half of 2007 that accounted for an increase in the total number of federal class action lawsuits filed against foreign and domestic companies.

A total of 163 federal class actions were filed in 2007 compared with 109 in 2006. The study noted that, of last year's filings, subprime-related cases numbered 37, or 23% of total filings, with 30 of those filed in the second half of the year, which coincided with downturns in the housing and mortgage-backed securities markets.

Of all subprime cases last year, 51% were against loan originators, 8% against were investment banks and 5% were against rating agencies.

The study predicted the surge of subprime-related filings continuing this year as the Securities and Exchange Commission, the Department of Justice, the Federal Bureau of Investigation and the state attorneys general proceed with investigations into financial institutions.

Major investment banks have reported about $130 billion in losses related to the subprime crisis, according to the study.

"Whenever there's an issue of this type and this magnitude, it permeates so many sectors of the economy," said Levin. "With the subprime mortgage issue, obviously you'll see a rise in filings."

In another study published by RiskMetrics Group, which provides risk management and corporate governance services to the financial industries, the subprime mortgage crisis was targeted as the cause for the increase in shareholder litigation.

The study, "The Subprime Meltdown Heads to Court," points to weak risk oversight, ineffective risk management and the absence of regulation as reasons for the crisis and the resulting lawsuits.

The study predicted an increase in subprime-related securities class action lawsuits in 2008, with litigation spreading beyond the companies with direct ties to the subprime-related fields.

"As the credit markets remain tight, more subprime-related companies may seek bankruptcy protection, leaving class action plaintiffs to look to auditors, underwriters and others for financial recoveries," said Adam Savett, who heads RiskMetric's securities class action services.

Pension funds and other institutional investors also have taken a growing role in securities litigation.

"There's a fiduciary duty to make sure it's a wise investment, and where there are wrongdoings, to correct them," Levin said. "That's obviously a sound business practice especially in the context of a state pension fund or local pension fund."