

The Two-Year Lull is Over: Securities Lawsuits Filings Rise

For the 24 months prior to July 2007, securities lawsuit filings were well below historical averages. The apparent persistence of these lower filing levels caused at least one well-respected observer to speculate that perhaps there had been a “permanent shift” to lower securities lawsuit filing levels.

However, in the past four months, there has been a significant increase in filings of securities class actions, to the point where it is now clear that the two-year lull has ended. This article takes a look at the changes in the filing levels and comments on the potential significance of these changes for the D&O insurance marketplace.

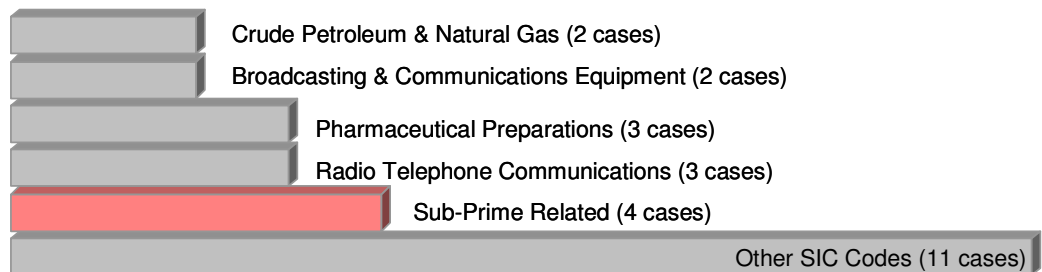
In the past four months, there has been a significant increase in filings of securities class actions... it is now clear that the two-year lull has ended.

Subprime Litigation Not the Sole Explanation for Increased Filings

It might well be presumed that the recent heightened litigation activity is being driven by the subprime meltdown, and to a certain extent that is correct. As many as twenty of the new securities lawsuits filed during the second half of 2007 have been subprime-related.

But while the subprime-related issues clearly are an important factor driving the heightened filing activity, it is not the only factor. For example, during November 2007, which had the highest monthly number of new securities lawsuits in nearly three years, only four of the 25 new securities lawsuits were subprime related.

Judging by the SIC codes, the substantial new securities lawsuits activity during November was not limited to the subprime sector; other sectors saw increased activity.



Filings by SIC Code: November 2007 (25 Cases)

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In other words, while subprime-related litigation activity is an important aspect of filing levels, it is not the sole explanation for their increase. Clearly part of what is going on is that volatility has returned to the financial marketplace. A disrupted credit market and a more volatile financial marketplace have stressed a number of companies, leading to litigation in some cases.

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The Two-Year Lull: July 2005 to July 2007

In July 2007, Cornerstone Research released its mid-year 2007 study of securities class action filing trends, in which it noted that the first half of 2007, “marked the fourth consecutive six-month period with below average securities class action filings.” The Cornerstone report went on to note that the average filing rate since June 2005 was, “40 percent below the average observed during the preceding nine-year period.” The 2006 year-end total of 118 securities class action filings was well below the nine-year annual average of 202 filings for the period 1996 through 2004.

Stanford Law Professor Joseph Grundfest, commenting in the Cornerstone report on the two-year decline, speculated that there may have been a “permanent shift” to a lower level of securities class action filings as a result of post-Sarbanes Oxley governance improvements. The Cornerstone study also contained additional analysis suggesting that historically lower levels of stock market volatility might alternatively explain the recent lower filing levels, and that securities class action filings might return to historical levels if normal levels of stock market volatility were to return.

In September 2007, NERA Economic Consultants also issued a mid-year report of securities class action activities. While the observations in the NERA report are consistent with the findings in the Cornerstone report, the NERA report added the observation that, “filings in the first half of 2007 increased 47% from the second half of 2006, indicating that the trend in filings may be changing direction.”

Securities Lawsuit Filings in the Second Half of 2007

While the NERA report noted that securities class action activity had already started to pick up in the first half of 2007 (relative to the second half of 2006), this increased activity trend has accelerated in the second half of 2007. Securities lawsuit filing levels have clearly returned to historical levels during the second half of 2007.

The total of 81 new securities class action lawsuits during the four-month period between August 1, 2007 and November 30, 2007 represents the highest level of new lawsuit filings in a four month period since July – October 2004. Indeed, the 25 new securities class action lawsuits filed during November 2007 represents the highest

monthly total since January 2005. Further, if the current rate of 81 cases in four months were to continue, it would imply an annualized rate of 243 class actions, which — were it a year-end total — would represent the highest annual filing rate since 2002, the year of many of the major corporate scandals.

The apparent upward trend in securities class action filings during 2007 (year over year) is particularly striking when the specifics of the 2006 filing activity is taken into account. The number of filings during 2006 was significantly inflated by the number of options backdating-related securities class action filings during 2006. Of the 34 options backdating-related securities class action lawsuits that have been filed, almost all were first filed during 2006, and so the options backdating cases represent a significant portion of the total of 118 class action lawsuits filed in 2006. The influx of options backdating cases ended in early 2007, so the fact that the 2007 numbers have increased over 2006 is significant — even though the 2006 numbers were increased by the short-term effect of the options backdating scandal. It now appears that the two-year lull in securities lawsuits filings was simply a side effect of an unusually stable financial marketplace. While we would all like to believe Professor Grundfest’s optimistic assessment that — as a result of corporate reforms — there is now less fraud, it seems that his proclamation of a permanent shift to a lower level of securities class action activity was incorrect.

Securities lawsuit filing levels have clearly returned to historical levels during the second half of 2007.



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The D&O Insurance Marketplace’s Response

Given the recent changes in the securities litigation landscape, you would expect there to be some response or reaction from the D&O carriers. Without a doubt, the D&O insurance environment for financial institutions has changed, where renewals have become more challenging, pricing has become higher than even a short time ago, and underwriting has become much more rigorous. D&O underwriting managers are currently spending a lot of time talking to their senior management trying to provide an assessment of their portfolio’s exposure to subprime risk. These current attitudes were implicitly expressed in the recent press release of one D&O carrier, in which the carrier stated that it, “does not believe that its insurance and reinsurance portfolio is materially exposed to potential claims arising from subprime-related issues.” The

statement also noted that the company had, “in the past largely withdrawn from business classes, such as financial institutions E&O and Fortune 500 D&O liability, that appear most likely to be affected” by subprime-related issues.

This latter statement obviously assumes that subprime-related D&O risks are concentrated in the Fortune 500, an assumption that may or may not be warranted given the uncertainty about how broadly the subprime risks will spread. But the deeper significance of this statement is that the company felt compelled to make this disclosure at all; it clearly bespeaks an awareness at the senior management level that subprime risks are (and perhaps should be) a serious concern for investors. These kinds of concerns are likely to surround other carriers who may (or whose investors are concerned that they may) be exposed to significant subprime risks.

For now, the marketplace (outside the financial institutions arena) remains competitive and there is ample capacity available to address most risks. But as the above discussion shows, the changing circumstances in the D&O liability arena are not limited just to subprime. The carriers are rightly focused on subprime as a very significant exposure that could produce some very negative returns. But if the industry concentrates narrowly on subprime-related concerns alone without taking these larger issues into account, there could be some very serious negative consequences down the road.

Conclusion

Recent turbulence in the financial markets, among other factors, has led to renewed securities litigation activity at— or even above — historical levels. The likelihood of continued financial marketplace instability suggests that litigation levels may remain elevated for some time to come. The D&O insurance marketplace is clearly wary of these changing circumstances. Thus far, the underwriting response has been limited to the financial institutions sector. But if the heightened activity levels persist, and lawsuits are not limited to a single sector, underwriters may assume a more restricted underwriting approach across a broader range of risks. For now at least, the marketplace outside of the financial institutions arena remains competitive; but, as this article has attempted to illustrate, a lot can change in a mere four months.

It now appears that the two-year lull in securities lawsuits filings was simply a side effect of an unusually stable financial marketplace.

About the Author

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A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You can access the blog via our website at www.oakbridgeins.com. To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to refer to The D&O Diary regularly.

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