

A Closer Look at the 2006 Securities Lawsuits

In the first days of 2007, both the National Economic Research Associates (NERA) and Cornerstone Research (in conjunction with the Stanford Law School Class Action Clearinghouse) released their respective studies of the 2006 securities class action lawsuit filings. Although the two studies differ in some of their numerical details, the two studies agree in most of their important conclusions, including the fact that the number of 2006 filings represents the lowest annual total since the passage of the Private Securities Litigation Reform Act of 1995. Each of the studies has some interesting additional observations about the 2006 filings.

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This article reviews the two studies' observations and also takes a closer look at the 2006 lawsuits to try to better understand the data. In addition, this article reviews NERA's study's conclusions about the 2006 securities class action settlements, assesses the possible reasons for the 2006 filings decline, and closes with some thoughts about the possible impact of the decline on the pricing of D&O insurance.

The Number of 2006 Securities Fraud Lawsuit Filings

The two studies disagree about the precise number of securities lawsuits filed in 2006; the Cornerstone study puts the number at 110, the NERA study says it is 129. Calendaring differences for cases filed at the year's beginning and end may explain part of the disparity. There may be definitional differences between the cases included in each study's count as well. But the two reports numeric findings are directionally consistent – Cornerstone finds that 2006 filings declined 38 percent from the prior year and 43 percent from the trailing ten year average annual number of filing, and NERA concludes that the filings declined 36 percent from 2005 and declined 44 percent from the ten-year average.

Both studies note that the filings drop-off is even more striking when the options backdating lawsuits filings are taken into account. There have been 22 securities class action lawsuits containing options backdating allegations, of which 20 were filed in 2006. The Cornerstone study suggests that the

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backdating lawsuits represent a “one-time event that will not recur in the future” and that if the options backdating lawsuits are excluded from the 2006 total, the remaining “core” lawsuits of only 90 cases (using Cornerstone’s annual total) represents a decline of 53% from the trailing 10-year annual average number of lawsuit filings. In other words, but for the one-time event of the options backdating lawsuits, the 2006 filings would have been 53% below the 10-year average.

According to one measure used in the Cornerstone study, the aggregate amount of the purported investor losses at stake in the 2006 lawsuits, compared to the amount of investor losses at stake in the 2005 lawsuits, represents a decline of 44%.

The Cornerstone study also examines the annual number of lawsuits relative to the number of public companies. This ratio is important because the number of public companies listed on the major U.S. exchanges has declined by 25% since 1996, and so it could be misleading simply to compare the absolute number of lawsuits filed each year. The Cornerstone study examined the ratio of the number of annual lawsuits to the number of public companies at year-end and found that the 2006 annual 1.5% lawsuit frequency rate is the lowest frequency level since 1997 and significantly below the 2.2% annual average frequency rate during the 1996 to 2005 period.

The Cornerstone study also found that the losses in total market capitalization associated with the 2006 lawsuits also declined from the already reduced levels observed in the 2005 filings, and that in 2006, there was a “sharp decline in the incidence of large dollar value claims.” According to one measure used in the Cornerstone study, the aggregate amount of the purported investor losses at stake in the 2006 lawsuits, compared to the amount of investor losses at stake in the 2005 lawsuits, represents a decline of 44%.

The NERA study adds the interesting observation that the percentage decline in the number of lawsuits is not uniform across the federal circuits; the NERA study notes:

While the magnitude of this drop-off in filings is notable, the decline has not been evenly distributed across the circuits. The largest drop in absolute terms has come from the Ninth Circuit, where, compared to a peak of 68 in 2004, there have been only 27 shareholder class action suits filed through December 15, 2006. However, every circuit has fewer standard filings in 2006 than the average level from 1998-2004. The drop is smallest in the Second Circuit, which in 2006 has seen fully 87% of the filings it typically received over 1998-2004. The rest of the circuits as a group have received only about half of their typical 1998-2004 filings. All but two of the circuits had a decline of at least one-third from 2005 to the projected 2006 figures.

Who Got Sued, Where and When

The NERA and Cornerstone reports provide interesting aggregate, top-level information, but at least in their publicly available reports they provide relatively little analysis of the details. However, the data Cornerstone used for its report is available on the Stanford Law School Class Action Clearinghouse website. Sifting through these data permits a number of more specific observations about the 2006 filings beyond those reported in the two studies, including additional information about who got sued, where and when.

Lawsuits by SIC Code: One way to look at the 2006 securities class action filings is to sort them by the Standard Industrial Classifications (SIC Codes) of the companies sued. (The SIC Code is a four digit numerical system for classifying industries that was developed by the U.S. government in the 1930s and is still used by the SEC.) Looking at the 2006 filings by SIC Code shows that the lawsuits were dispersed among a very broad range of industries; the 110 companies in the Cornerstone database of 2006 filings are spread across 66 different SIC Codes.

Though the 2006 filings involved a very broad range of industrial classes, there were certain SIC Codes with a higher concentration of lawsuits. These SIC Codes with higher concentrations are summarized in Table 1.

Table 1: SIC Codes with the Largest Concentration of 2006 Filings

SIC Code	Category	Number of Filings
3674	Semiconductors	10
2834	Pharmaceutical Preparations	8
2836	Biological Products	4
3661	Telephone and Telegraph	4
3851	Ophthalmic Goods	3
4899	Communications Services	3
7372	Prepackaged Software	3

The SIC Code data can also be viewed at the three digit and two digit level to organize the data within larger groupings. For example, within the 2830 series of SIC Codes (“Drugs”), there were 12 lawsuits in 2006. In the 3600 series of SIC Codes (“Electronic and Other Electrical Equipment”) there were 18 filings in 2006. In the 7370 series of SIC Codes (“Computer Programming”), there were 7 filings.

Lawsuits by Industry: A slightly narrowed view of the 2006 filings can be derived by viewing them by “Industry” rather than by SIC Code. The Stanford website identifies each company sued by “Industry,” using a system similar to the Global Industrial Classification System (GICS), which is a numeric system for classifying companies by industry and sector that was developed but Morgan Stanley Capital Information and Standard & Poor’s. Sorting the companies according to these industry identifiers provides an alternative, slightly more refined view of the data.

Under this analysis, the 110 filings divide into 49 different industries. The industries with the most significant concentrations are listed in Table 2.

Table 2: Industrial Groups with the Largest Concentration of 2006 Filings

Industry	Number of Filings
Semiconductors	13
Biotechnology and Drugs	8
Communications Equipment	7
Medical Equipment and Supplies	6
Software & Programming	6
Major Drugs	4
Real Estate Operations	4
Insurance (Property & Casualty)	3
Retail (Specialty)	3

Lawsuits by Sector: An even broader view of the 2006 data can be derived by sorting the filings by GICS Sector. This level of analysis permits the more definite identification of areas of concentration. The 2006 filings distributed by sector are set out in Table 3.

Table 3: 2006 Filings Distributed by Sector

Sector	Number of Filings
Technology	37
Services	25
Healthcare	20
Financial	10
Capital Goods	4
Consumer Cyclical	4
Consumer Noncyclical	4
Basic Materials	2
Energy	2
Transportation	2
TOTAL	110

Some Additional Observations: Of the 110 filings listed in the Stanford website, 8 expressly involved allegations of misrepresentations or omissions in connection with a company’s IPO.

In addition, 11 of the 110 filings involved companies based outside the United States. The countries in which these foreign-based companies were domiciled are listed in Table 4.

Table 4: Country of Domicile of Foreign Countries Sued in 2006

Country	Number of Filings
Bermuda	4
Canada	2
China	1
Greece	1
Hong Kong	1
Korea	1
Spain	1



The 2006 securities fraud lawsuits were filed in 37 different United States District Courts. The District Courts with the largest number of filings are listed in Table 5

Table 5: District Courts with the Largest Number of Filings

District Court	Circuit	Number of Filings
S.D.N.Y.	2 nd	27
N.D. Cal.	9 th	11
C.D. Cal.	9 th	5
D. Mass.	1 st	5
D. N.J.	3 rd	5
S.D. Fla.	11 th	5
D. Minn.	8 th	4
E.D. Pa.	3 rd	4
E.D. Va.	4 th	4

While it is hardly surprising that lawsuits are concentrated in jurisdictions where businesses tend to be based or headquartered, there were also a number of securities lawsuits filed in some unexpected courts in 2006, including D. Utah (2), D.N.M, D. Idaho, and D. Nev. Surprisingly, there was only one securities class action filed in each of the D. Del. and the N.D.Ill.

The average number of new lawsuits per month during 2006 was 9.1, with the highest number in April (13) and the lower in December (4). The average number of lawsuits filed each quarter was 27.5, with the highest number (37) filed in the second quarter and the fewest filed in the fourth quarter (19).

Why Did Filings Decline in 2006?

Each of the two studies suggests a variety of possible reasons for the 2006 decline in lawsuit filings, and a number of additional possible reasons have been suggested in the media. The various reasons suggested include the following possibilities:

Strengthened federal enforcement and improved corporate governance as a result of Sarbanes Oxley have reduced the amount of fraud in the market; a strong stock market accompanied by reduced stock price volatility is reducing the kind of sharp stock price drops that attract lawsuits; The shareholder lawsuits from the boom and bust years of the late 1990s and early part of this decade have passed through the system; The two leading plaintiffs law firms are distracted; the Milberg Weiss firm is preoccupied by its criminal indictment, and the Lerach Coughlin firm is distracted by the burdens of the remaining Enron civil litigation as well as by other large cases; As

a result of the Milberg Weiss firm's indictment, plaintiffs' firms no longer feel comfortable using paid plaintiffs in whose name they would otherwise pursue litigation.

Seven of the ten largest settlements ever occurred in 2005 and 2006.

The debate over the causes of the lawsuit decline is inconclusive; in all probability the decline is the result of a combination of causes. The more interesting question is whether the pace of the lawsuit filings will continue at the same reduced level in 2007. Certainly, if the number of lawsuit filings remains at current lower levels, D&O insurance carriers will face increasing pressure to reduce their rates. (More about the potential impact on D&O rates below.)

2006 Securities Class Action Settlements

The NERA study included additional analysis showing that even though the number of securities class action lawsuit filings declined in 2006, the average size of the securities fraud class action settlements in 2006 increased by 37% relative to 2005, even excluding the impact of the mammoth Enron settlement. The NERA study also found that there were more settlements over \$100 million in 2006 than in 2005, which was itself a record breaking year. There were four settlements in 2006 over \$1 billion, even though prior to 2006 there had been only 3 settlements over \$1 billion. Seven of the ten largest settlements ever occurred in 2005 and 2006.

According to NERA, the average securities class action settlement in 2006 was \$86.7 million, which is 17.7% greater than the 2005 average settlement of \$73.6 million. (The annual averages reported in NERA's studies may differ from averages reported elsewhere, because other analysts assign settlements to the year in which they are first reported, while NERA assigns settlements to the year in which they are finally concluded.) These lofty annual averages reflect in part the inclusion of the mega-settlements exceeding a billion dollars.

The \$7.5 million median 2006 settlement is also 21% greater than the five-year average \$6.2 million median settlement for the period 2002-2006.

If the annual averages are normalized by excluding the billion dollar settlements from both the 2005 and 2006 averages, the resulting adjusted 2006 average of \$34 million is still about 37% above the normalized 2005 annual average.

But averages can be skewed by relatively few data points at the extremes. As the NERA study notes, a median is "more descriptive of typical cases." The median settlement also rose to \$7.3 million in 2006, about 4.2% above the 2005 median

settlement of \$7.0 million. The \$7.3 million median 2006 settlement is also 21% greater than the five-year average \$6.2 million median settlement for the period 2002-2006.

The NERA study noted that the single most significant factor in determining settlement size is the magnitude of investor loss; investor losses ballooned from \$140 million in 1996 to \$2.5 billion in 2003. Other factors that can increase the size of the settlement include the involvement as plaintiffs of multiple classes of securities holders (such as bondholders or options investors, as well as equity shareholders); the presence of accounting improprieties (which increase expected settlements by more than 20%) and the presence of an IPO (which increases expected settlements by approximately a third). Companies in the health services sector also pay significantly higher settlements than defendants in other industries.

The study also notes that since the passage of the Private Securities Litigation Reform Act of 1995, the chances are much greater that securities fraud cases will be dismissed. More than 38% of the cases filed between 1999 and 2004 were dismissed (although this figure may be overstated because it includes dismissals without prejudice and cases that are still on appeal).

What are the Implications for D&O Pricing?

While the lower number of class action filings will undoubtedly lead to pressure on D&O carriers to reduce rates, the question that must be asked is whether the decline in filings represents a secular and not merely a cyclical change. There have been periods in the past when filings cycled down to current levels. For example, in 1996, following the enactment of the Private Securities Litigation Reform Act, securities fraud lawsuit filings fell to levels comparable to those in 2006. Carriers cut their rates then, but when filings jumped in the late 90s, the carriers sustained enormous losses. That prior experience will likely encourage carriers to move slowly on any significant rate changes, at least until the nature and extent of the current decline in filings becomes clearer.

D&O commentator Dan Bailey has said that he views it as “extremely unlikely” that the current downturn will be permanent, and therefore “neither D&O insurers nor insureds should overreact to this seemingly temporary reprieve from higher-frequency securities litigation.” He has also commented that “an over-reactive softening of the market today...will likely cause another significant market correction in a few years.”

D&O insurers can cite the increasing annual average and median settlement levels to counter calls for reduced rates. Indeed, it may be difficult for the carriers to imagine reducing prices while they are funding so many mega-settlements. But if the carriers had been reserving appropriately (admittedly, a big “if”), then they should have posted reserves for these losses years ago. As such, current payouts should not be affecting current calendar year results. In addition, the current settlements involve cases filed years ago; theoretically, the premiums paid now will fund losses to be incurred in the future.

Indeed, it may be difficult for the carriers to imagine reducing prices while they are funding so many mega-settlements.

Further, there are two key facts from the aforementioned studies as it relates to settlements. First, the NERA study documents that the single most significant predictor of settlement size is the magnitude of investor losses. Second, the Cornerstone study documents that the investor losses in cases filed in 2006 are down significantly from the investor losses involved in the cases filed in the late 90s and early part of this decade. When you couple these two facts, it can be determined that future settlements should be expected to start trending downward as the cases filed this year move toward resolution. When you marry the above with the significantly fewer cases to start with, aggregate losses should also be expected to trend downward.

Nevertheless, there may still be compelling reasons why carriers may be justified in continuing to resist price decreases. These other considerations include the fact that while the number of securities fraud lawsuits is down, overall claims activity is up (including, for instance, the nearly 130 shareholder derivative claims filed in connection with the options backdating scandal, and the wave of derivative lawsuits growing out of private equity takeovers and arising from activist hedge fund activity). There are other developing threats as well, including among other things, increased activity under the Foreign Corrupt Practices Act.

For now, the case for and against rating decreases may be mixed. Especially since it is uncertain whether the current filings decline will continue. But if the current filing decline continues, carriers’ resistance to rate decreases will erode and the market will inevitably become more price competitive.

Sources and Data

The NERA study can be found here:

http://www.nera.com/image/BRO_Recent%20Trends_%201288_FINAL_online.pdf.

The Cornerstone study can be found here:

http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf

The Stanford Law School Class Action Clearinghouse database containing the 2006 filings can be found here:

http://securities.stanford.edu/fmi/xsl/SCACPUDB/recordlist.xsl?-db=SCACPUDB&-lay=Search&FIC_DateFiled_Year=2006&-sortfield.1=FIC_DateFiled&-sortfield.2=LitigationName&-sortorder.1=ascend&-max=25&-find

Dan Bailey's comments, cited above, can be found in his article entitled "Why Are There Fewer Securities Suits?" which can be found on his law firm's website here:

<http://www.baileycavalieri.com/CM/Articles/Why-Are-There-Fewer-Securities-Suits.asp>

The Stanford website database sorts each company sued by its "industry" and "sector." In the text above I noted that the Stanford database uses a taxonomy "similar" to the GICS codes. The database's classifications do not match the GICS terminology exactly, so it is not entirely clear whether or not the database is using the GICS system. The Stanford website does not specify its system for industry and sector classification.

In using the Stanford data, I have not performed any qualitative analysis, for example, as to whether or not certain filings do or do not belong in the 2006 filings data. Certainly if the data were to be used for actuarial purposes, certain of the cases would almost certainly be excluded from the data set. For example, one of the cases listed in the Stanford database involves a lawsuit where the company named is a *plaintiff*, not a defendant, in a case where the company alleges that an activist hedge fund and others are conspiring to provide misinformation about the company so the defendants can profit by selling the company's stock short. For purposes of this article, I have simply taken the Stanford data as presented to eliminate the need for potentially complicated and complicating data refinement.

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