

## Recent Lower Securities Class Action Filing Levels: Temporary or Permanent?

In early July, the Stanford Law School Securities Class Action Clearinghouse and Cornerstone Research jointly issued their mid-year Report on securities class action case filings during the first half of 2007.<sup>1</sup> The Report confirms that - so far this year - filings have remained at the same levels as during 2006; but the more interesting aspect of the Report is its discussion of whether or not these continuing lower filing levels are temporary or represent a permanent shift to a reduced level of class action filings. This article takes a look at the Report's observations about the 2007 class action filings, reviews the Report's discussion of whether the current lower filing levels are temporary or permanent, and then analyzes these issues.

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### The Report's Findings

The Report confirms that securities filings remain, "well below historical averages for the fourth consecutive six-month period." According to the Report, there were 59 companies sued in securities class action filings during the first half of 2007 (through June 22, 2007). These figures represent a slight increase over the previous six-month period, but they are significantly below the average six-month rate of 101 filings during the period July 1996 through June 2005.

The Report projects a year-end 2007 filing level of 124 class actions, which is well below the 12-month filing average of 203 class actions for the period from 1996 through 2005. The Report analyses these filing levels by comparing the number of filings to the number of issuer companies. The Report states that the projected "number of filings per issuer" for 2007 is 1.6%, compared to a 2.3% average of filings per issuer during the comparable six month period from 1996 through 2005.

The Report shows that the total market capitalization losses for cases filed in the first half of 2007 are slightly above the losses associated with the 2006 filings. Nevertheless, losses continue at levels well below the losses observed during the era of corporate mega-scandals in 2000-2002.

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The Sights

## The Report's Observations About Likely Future Filing Levels

The Report proposes two alternative (but not mutually exclusive) explanations for the continued lower filing levels. The first is the “less fraud” hypothesis and the second is the “strong stock market” hypothesis. The “less fraud” view, as championed by Stanford Law Professor Joseph Grundfest, is that, “increased enforcement activity and a heightened awareness among corporate insiders may have led to a shift in the incidence of securities fraud litigation.” The “strong stock market” hypothesis is premised upon the observation that we have now enjoyed several years of strong stock market performance characterized by low stock market volatility - thus fewer filings - as volatility has been correlated with securities class action activity.

*The “less fraud” theory suggests that we may be witnessing a permanent shift to lower filing levels, but the “strong market” theory suggests that the current lower level of securities class action filings is only temporary.*

These two possible explanations lead to, “differing expectations for future levels of class action filings.” The “less fraud” theory suggests that we may be witnessing a permanent shift to lower filing levels, but the “strong market” theory suggests that the current lower level of securities class action filings is only temporary. Indeed, the Report specifically quotes one of the Report's co-authors, John Gould, as saying, “if the market goes south, I would not be surprised to see the number of filings move back to the 200 per year level.”

The Report also cites Professor Grundfest's refutation of the view that the prosecution of the Milberg Weiss firm and two of its partners is “chilling” the securities class action plaintiffs' bar. He rejects the suggestion that, “the prevalence of alleged questionable, unethical or illegal kickback or fee splitting activity is so pervasive in the class action bar that the Milberg Weiss indictment chilled other plaintiffs and law firms from instituting class actions.”

## Analysis and Discussion

The Report's presentation of two alternative viewpoints about possible future filing levels allows room for reasonable minds to differ. That said, there are a number of reasons to be skeptical, based on the limited data available, that we have moved to a permanently lower level of fraudulent corporate activity and of securities class actions filings.

First, given the low stock market volatility that the Cornerstone Report itself details, the marketplace's reaction to adverse public disclosure has been more restrained than in periods of great volatility. Indeed, recent media commentary has specifically examined the lack of marketplace reaction to the latest accounting scandals.<sup>2</sup>

Second, the historically low interest rate environment has enabled many companies to use low-cost debt to avert crises that could have otherwise required disruptive disclosures. As interest rates rise and credit becomes less freely available and more expensive, and as volatility levels revert to the historical mean, more companies may be compelled to make more disruptive disclosures and the stock market may prove less forgiving than in the recent past.

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Changed marketplace conditions could lead back to historical filing levels. Until we know for sure whether or not the current filing levels are the result of unusual market conditions, there may be reason to withhold judgment of Professor Grundfest's view that we have passed some epochal threshold on the occurrence of fraudulent activities.

As for the report's comments on the Milberg Weiss investigation, it is important to note that reduced filing levels emerged in mid-2005, at the same time that the grand jury returned its first indictment in the Milberg Weiss investigation. As such, since mid-2005, the two most prominent plaintiffs' securities class action lawyers (Mel Weiss and Bill Lerach) at the two most prominent plaintiffs' firms (the Milberg Weiss firm and the Lerach Coughlin firm), as well as the firms themselves, have been highly preoccupied by the criminal prosecution. In addition, it seems highly improbable that the behavior the Milberg Weiss investigation has targeted (kickback payments to class plaintiffs) was limited exclusively to that firm. These factors suggest that the Milberg Weiss investigation and the scrutiny of kickback practices probably have had some disruptive recent impact on the filing activity levels.

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Finally, it is important to note that the number of securities class action filings is not the sole measure of shareholder litigation. As detailed in the recent PricewaterhouseCoopers study of the 2006 securities class action filings<sup>3</sup>, when shareholder derivative lawsuits are taken into account, the total number of shareholder lawsuits has not declined. By accounting for the derivative lawsuits, "a more stable level of shareholder litigation begins to emerge in relation to prior years." Plaintiffs' lawyers arguably are as active as they have ever been, and a change of marketplace conditions that is more conducive to class action filings could be all that is required for the number of securities class action filings to shift back to historical norms.

Without a doubt, it is a very short step from Professor Grundfest's statement that there may have been a "permanent shift" in the filing levels to the conclusion that there has been a permanent shift in D&O exposure and that D&O pricing levels should be reduced commensurately. But the Cornerstone economist's observation that future changes in market conditions should translate into a return to historical filing levels, represents a strong cautionary warning to the D&O industry. Any carriers that had previously acted upon a presumption of a permanent reduction in D&O risk could quickly find themselves facing substantial losses.

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Perhaps more significant than the number of filings are the Report's observations about the level of investor losses associated with 2006 and 2007 securities class action filings. Most of the recent discussion within the D&O industry about the lower class action frequency levels has usually been accompanied by observations that average severity levels are at all-time highs. But as the level of investor loss associated with class action filings falls below levels from the corporate scandals era, and as the cases associated with the corporate scandals work their way out of the system, the average severity levels should be expected to decline. It may be that in the months and years ahead we will see average severity levels fall below their current record high levels.

### **Conclusion**

The cause and effect of lower levels of securities class action filings remains the subject of significant disagreement, as reflected in the contrasting viewpoints presented in the Cornerstone Report. Because the comparatively low class action filing levels of the past two years may be the result of temporary market conditions and other factors (such as the Milberg Weiss investigation), it may be premature to conclude that we have entered a new and permanent era of reduced corporate fraud and lower class action filing levels. It will be important to watch what happens as market conditions change in the weeks and months ahead. Whether and to what extent the present pattern will continue remains to be seen.

## Footnotes

<sup>1</sup> Cornerstone Research, *Securities Class Action Case Filings: 2007 Mid-Year Assessment*, <http://securities.cornerstone.com/pdfs/2007%20Mid-Year%20Assessment.pdf> (July 2007).

<sup>2</sup> Herb Greenberg, "Accounting Scandals: Not a Problem?" *Wall Street Journal*, Page B-3 (July 7, 2007).

<sup>3</sup> PricewaterhouseCoopers, *2006 Securities Litigation Study*, [http://10b5.pwc.com/PDF/070918%20SEC%20LIT%20STUDY%202006\\_FINAL\\_66948\\_V2\\_CT.PDF](http://10b5.pwc.com/PDF/070918%20SEC%20LIT%20STUDY%202006_FINAL_66948_V2_CT.PDF) (May 2007).

## 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](http://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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