



CUG.COMments

A Newsletter from Chicago Underwriting Group, Inc.
Underwriters of D & O and Professional Liability Insurance

Issue 42

January 2006

2005 SECURITIES CLASS ACTION FILINGS: AN EARLY APPRAISAL

In 2005 the number of Securities Class Action filings dropped to 176 from 213¹ in 2004. This number is also lower than the average of "traditional" Securities Class Action filings from 1996-2004, which is 195¹.

Is the Sarbanes-Oxley legislation that addressed corporate wrongdoing having an effect? Did the essentially pro-defendant *Dura*² decision of the Supreme Court eliminate some Securities Class Action cases which otherwise would have been filed?

A reduction in filing frequency might suggest that the burden of public company D&O insurers could be lightening. But other, perhaps more compelling data, suggest that significant challenges remain for this market sector. This edition of CUG.COMments will look at some of these other indicators.

1. Filings per Issuer

In its review of 2005 Securities Class Action filings¹, Cornerstone Research describes a "filings per issuer" statistic, which is the number of Securities Class Action filings for every 100 of public company issuers. For 2005 that number was 2.4, meaning there was a 2.4% chance of an issuer being sued in 2005. Since 1996 the average value has been 2.15% so the chance of an issuer being sued in 2005 was actually slightly above the eight year average. If the chance of issuers being sued was a little higher, so also was the chance of D&O insurers being called upon to pay at the very least defense costs and possibly settlements.

2. Earnings Restatements

According to data from Glass, Lewis & Company quoted in a *New York Times* article on January 5, 2006³, corporate earnings restatements for 2005 were on a pace to double the number of those in 2004. Securities Class Action filings that include allegations of financial restatements have been shown to result in significantly higher settlement values than cases where no restatement is alleged. For the period from 1996 through 2005, one private survey⁴ reveals that for settlements below \$1 billion, those containing restatement allegations resulted in an average payout of \$31.4 million; insider trading lawsuits averaged \$17 million, while lawsuits with neither accounting nor insider trading issues averaged \$10.8 million.

3. Related Lawsuits

Instead of being confronted with one Securities Class Action filing it is common for defendants to be attacked on several fronts. These include (1) "Opt-outs" from the main Securities Class Action where individual investors with the resources and determination pursue an action separate from that of the Class, and (2) derivative actions taken up on behalf of the corporation. These extra sources of conflict - not included in the basic Securities Class Action frequency number - put a greater burden on D&O insurers who must typically fund the policyholders' defense against such actions. Adding to the cost and complexity is that while Securities Class Action cases are filed in federal court, derivative actions are almost always filed in state court.

4. Volatility

It is generally agreed that Securities Class Action filings occur more readily when stock market volatility (the tendency of share prices to rise and fall rapidly over a short period) increases. This makes sense: the risk of investor loss is greater when share prices are bouncing up and down, and a sufficiently disgruntled investor might seek to apportion blame and exact redress. In 2005 stock market volatility was at its lowest level for several years. It is likely that when volatility increases - as it surely will - Securities Class Action filings will increase correspondingly, as historically they have done.

5. The Supreme Court *Dura* Decision

Although *Dura* was cited above as a possible cause for reducing the Securities Class Action filing total, it is quite possible that some cases were not abandoned but merely put on hold while plaintiffs' counsel re-strategized. If so, some of these cases could re-emerge in 2006, suitably tailored in the hope of avoiding potential *Dura*-style dismissal or possible limitations on damages.

6. Severity

Of all the reasons why a simple reduction in Securities Class Action frequency should not cause complacency, loss severity is perhaps the most important. Setting aside the AOL / Time Warner \$2.4 billion amount, one analysis⁴ shows median settlements (the settlement value above and below which are an equal number of settlements) on a calendar year basis as jumping 52% from 2004 to 2005 (from \$5.6 million to \$8.5 million); average settlement values show an increase from \$21.9 million to \$49.9 million. More money is therefore being paid out in Securities Class Action cases, which ultimately means more money paid by D&O insurers.

SUMMARY

Any reduction in the frequency of Securities Class Action filings in 2005 should logically indicate a better environment for D&O insurers. However the simple fact of falling numbers belies a more complex picture, one from which the D&O market can take little comfort. It will be a while before the 2005 drop can be viewed as the start of a new downward trend or a lull that was only temporary. ❖

¹ Cornerstone Research, Securities Class Action Case Filings, 2005: A Year in Review.
² *Dura Pharmaceuticals, Inc. v. Broudo*, No. 03-932 (U.S. April 19, 2005). The *Dura* case is discussed in the May 2005 edition of CUG.COMments. (<http://www.cug.com/cugcom.shtml>)
³ "S.E.C. Agrees on Set of Principles For Fining Companies for Fraud." Floyd Norris, The New York Times, January 5, 2006.
⁴ Woodruff-Sawyer & Company.



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