Securities Litigation Activity Dips

An Advisen Quarterly Report: Q3 2011

ADVISEN Productivity & Insight for Insurance Professionals

Sponsored by:

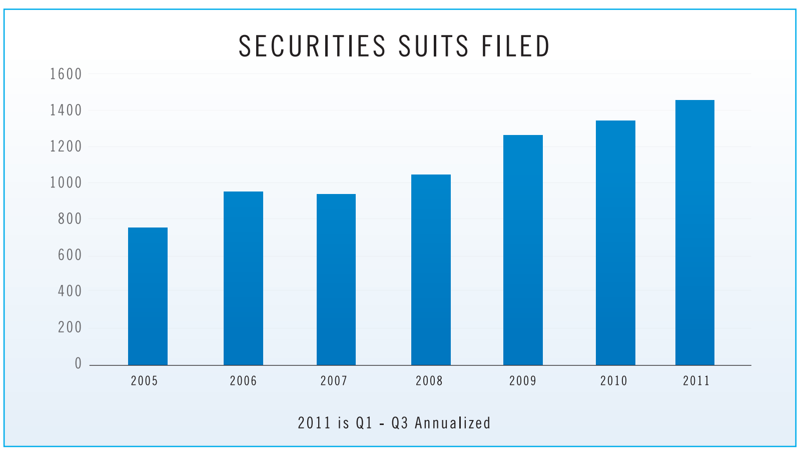
Proskauer

Securities Litigation Activity Dips

An Advisen Quarterly Report: Q3 2011

Executive summary

Perhaps it's a new dawn, as the business community begins to wake from the slumber, and nightmares, of the credit crisis. Or perhaps it's the morning calm before the sun once again rises to shine its light on the next scandal. The credit crisis brought about a rise in litigation activities for all major types of securities suits. After a record first quarter, however, new filings in 2011 demonstrated a steady drop for most types of suits, falling to a pre-2009 level in the third quarter, as 2009 was when credit crisis-related suits began to mushroom. At 316 securities suits filed in Q3 2011, new filings are down from 367 in Q2 and the high of 421 in Q1. The falloff in new filings from Q1 through Q3 resulted initially from the falloff in regulatory actions against financial services firms in Q2, then Q3 saw a sudden drop-off in breach of fiduciary duties cases. Despite these figures, the record-setting first quarter leaves 2011 thus far at an annualized level higher than all previous years, and Q3 annualized was greater than all years prior to 2009. This suggests that post-credit crisis events remain at an elevated plateau even if new filings for the third quarter dipped below the recently established levels.



Securities fraud cases, mostly regulatory actions, became once again the leading type of new securities-suit filing in the third quarter, but government prosecutors' activities remained significantly below the first quarter's level over the past two quarters, and at an annualized rate last seen in 2008. Securities class action suits, although down from the previous two quarters, had a bit of a comeback as far as percentage of total suits filed. Breach of fiduciary duties suits became litigators' bread-and-butter in recent years, and the level remained higher than other types of private litigation, but dropped substantially in the third quarter. Most breach of fiduciary duties suits are so-called merger objection suits, which are filed by shareholders who allege that a company's board of directors sold, or planned to sell, a company at terms unfavorable to the shareholders.

Globalization has had a substantial impact on securities litigation in 2011, particularly in Q2, with filings against non-U.S. companies reaching 19 percent in the quarter. New filings against non-US companies remained historically high in Q3, but down from the blistering pace of new suits witnessed in the previous quarter, dipping to 15 percent in the quarter. Suits filed against Chinese companies represented about 30 percent of these suits in Q3, but down from over 40 percent in the previous quarter.

Master Significant Case and Action Database (MSCAd).

Advisen's MSCAd is the most complete and accurate database of lawsuits and major events, consisting of over 90,000 events and over $4.5 trillion in aggregate losses. MSCAd covers the major source of securities-related suits, categorized by type. Settlement amounts typically do not include defense costs. Information about suits and filing details are available for purchase at Advisen's online store, Advisen Corner, at http://corner.advisen.com/analytics_mscad.html and available at no extra charge to Advisen members through their advisen.com logins.

For more information please call +1.212.897.4800 or email corner@advisen.com.

Securities suits defined

The purpose of this report is to examine all sources of securities-related suits that impact management liability insurance policies other than ERISA liability suits. In addition to securities class action suits, this report encompasses a much broader set of suits, including securities fraud, breach of fiduciary duties, derivative actions, collective actions and Ponzi scheme cases.

Several analytic firms publish tallies of securities class action suits filed, but rarely do these tallies agree. In addition to the broad array of securities suits other than securities class actions that Advisen covers, another difference is the way events are counted. In some cases, multiple companies (and their respective directors and officers) are named in the same complaint. Advisen counts each company for which securities violations are alleged in a single complaint as a separate suit. Advisen also includes in its tally securities class action suits that are filed in state courts.

The specific definition of each type of suit can vary as well, resulting in different lawsuit tallies. Advisen defines the major types of suits in this report as follows:

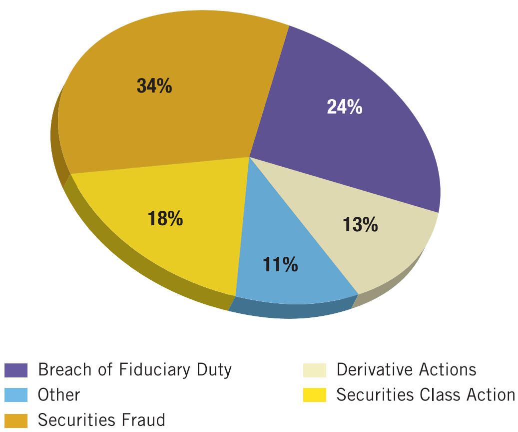
- **Securities Class Action:** suits alleging violations of federal securities laws, principally the Securities Act of 1933 and the Securities Exchange Act of 1934, filed by a private party on behalf of a class of persons injured by alleged violations.
- **Securities Fraud:** suits filed by regulators or law enforcement agencies charging violations of securities fraud laws. Also included are cases brought by private parties alleging violations of securities laws that are not styled as class actions, and where more specific securities law violations are not made.
- **Collective Action:** similar to Securities Class Action; used in jurisdictions, outside of the U.S., where class action laws do not exist.
- **Breach of Fiduciary Duties:** suits alleging breach of fiduciary duties owed under the federal securities laws, primarily 15 USC Sec. 80a-35, or direct claims of breach related to securities and products whose sale or transfer is covered by securities laws. This includes merger, privatization or other transactions that involve public companies.

Suits filed

Securities suits for Q3 2011, at 316 new filings, were down from the first half of the year, and at the lowest annualized level since 2008. At an annualized rate of 1,264 suits, however, the quarter would remain higher than 2008, which was a record year at the time.

The number of new securities class action suits filed in Q3 2011 was down from the previous quarter, from 61 to 56 suits, or 18 percent of total suits. This was higher than the average of 47 per quarter in 2010, and flat from 56 suits per quarter in 2009. Over the past couple of years, this type of suit represented a smaller percentage of all securities suits filed as compared to earlier years, but the percentage is up from the 2010 level of 14 percent. Securities class action suits comprised about a third of all securities lawsuits before 2006, but have been steadily trending downward as a percentage of securities suits filed despite a modest rise over the past two quarters. Over 70 percent of securities class action suits in Q3 2011 named as defendants companies from four sectors, and their directors and officers. The four sectors were: information technology, healthcare, financial, and industrial.

SUIT TYPE - Q3 2011

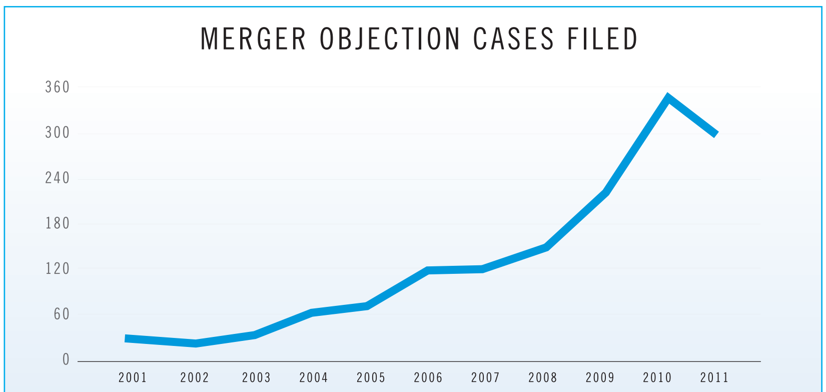


Securities fraud suits, a category defined by Advisen to be comprised principally of suits by regulators and law enforcement agencies, was the most active category. The number of filings was substantially down from 156 in Q1 2011 to 101 in Q2 and 109 in Q3. The Q3 annualized rate of 436 suits filed was down from 464 in 2010 and 576 in 2009. Securities fraud suits accounted for 34 percent of the total securities suits filed in Q3 2011, up from 28 percent in the previous quarter, but down from 37 percent in Q1 2011, flat with 34 percent for all of 2010, as well as down from 44 percent in 2009 in the wake of the credit crisis. Financial firms and their directors and officers continued to be the most often named as defendants in this category, at slightly less than half of these suits. Industrial and consumer discretionary firms, and their directors and officers, together accounted for a quarter of securities fraud suit filings in the third quarter.

The breach of fiduciary duties category accounted for 76 suits in Q3 2011, or 24 percent of all securities suits filed, down dramatically from 130 in Q2. Over 40 percent of these suits were filed in state courts. Breach of fiduciary duties suits have grown rapidly as a percentage of all securities suits filed, from 8 percent in 2004 to 24 percent in 2009 to 31 percent in 2010 to a high of 35 percent in Q2 2011. The third quarter marked the first fall off since the rise began in 2005.

Breach of fiduciary duties suits typically allege that directors, officers or other company representatives failed to fulfill fiduciary duties owed under federal or state securities laws (as well as other corporate governance laws), or as otherwise concerns securities and products covered by securities laws. Many of these suits, often called merger objection suits, are filed shortly following the announcement of a proposed merger or acquisition by shareholders of the acquired company. Typically they demand more favorable terms, such as more bidders or a more transparent auction process. Breach of fiduciary duties suits were more broadly distributed among industry groups than securities fraud suits, with information technology and healthcare companies, at 23 percent, each representing the highest concentration of suits, followed by financial firms at 10 percent, and utility and energy companies each at 8 percent.

The merger objection suits that make up the lion's share of the breach of fiduciary duties category have been the driving force behind the growth of suits in this category. Mushrooming from 23 suits in 2002 to 352 in 2010, these suits have not wavered in their growth trend despite wide fluctuations in M&A activities. Perhaps new filings are driven more by plaintiff's attorneys seeking new sources of fee revenue than by the economics of mergers and acquisitions. In the first three quarters of 2011, 223 suits were filed, at an annualized rate of 297 suits and slightly off the high set in 2010. The slowdown in overall breach of fiduciary duties suits in Q3 is certainly reflected in the 2011 numbers. However, 40 merger-objection investigations have been launched in 2011, likely priming the pipeline for more suits than the 223 filed suits would suggest.



2011 is Q1-Q3 annualized. 2011 does not include 40 new investigations.

Derivative action filings (brought by shareholders on behalf of the corporation) in Q3 were about flat with the previous quarter in 2011, and remained the fourth most frequent type of suit. New derivative action filings accounted for 42 suits in Q3 2011, or 168 suits on an annualized basis, up a bit from 157 in 2010. This represented 13 percent of all securities suit filings in Q3 2011, and was up from 12 percent in 2010. In Q3 2011, companies in the financial and healthcare sectors represented half of all derivative actions.

A recent trend for shareholders is to bring derivative actions against directors and officers for an alleged disconnect between executive compensation and pay-for-performance policies. These suits claim that the directors breached their fiduciary duties because the increases in executive compensation are allegedly not in line with the companies' pay-for-performance policies, invalidating the business judgment defense. In these suits, plaintiffs point to failed say-on-pay votes to back their arguments. The Dodd-Frank Act, however, has a specific provision that say-on-pay votes mandated by the Act do not create additional fiduciary duties for directors. Whether these suits hold up in court is questionable, but defense costs are always significant and the negative spotlight could generate shareholder activity on this issue.

Jurisdiction

By jurisdiction, just 16 percent of securities suits were filed in state courts in Q3 2011, down from 31 percent in the previous quarter. This is primarily due to the falloff of breach of fiduciary duties suits, as well as a higher percentage of these suits filed in federal courts. In the quarter, 17 percent were filed in the traditional stronghold of federal securities litigation, the United States District Court, Southern District, New York. Five percent of new filings in the quarter were filed in courts outside the U.S.

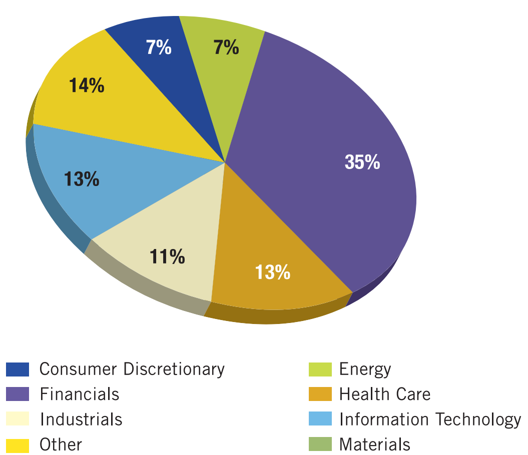
Court for Q3 2011 Filings	% Total
U.S. District Court, Southern District, New York	17%
State	16%
California Federal Districts	8%
Texas Federal Districts	7%
Florida Federal Districts	5%
Non-U.S. Courts	5%
Massachusetts Federal Districts	4%
Illinois Federal Districts	4%
Washington Federal Districts	3%

Suits alleging breach of fiduciary duties, by a wide margin, were the type of suit most likely to be filed in state courts, but the percentage is down from about 60 percent of suits to 40 percent. The Class Action Fairness Act of 2005 (CAFA) requires most large multi-state class actions to be removed to federal courts. Securities class action suits filed in state courts typically rely on the non-removal provision in Section 22 of the Securities Act of 1933, which permits cases alleging violations of the '33 Act to be tried in state courts. Whether the non-removal provisions of the '33 Act or CAFA govern these cases is still being debated in the courts.

Defendant companies and their directors and officers

Financial firms accounted for 45 percent of securities suits filed in 2008 and 41 percent in 2009 due substantially to lawsuits sparked by the meltdown of the subprime mortgage market and the ensuing credit crisis, and by the Bernard Madoff Ponzi scheme. That number fell to 33 percent of securities suits filed in 2010, and was at 37 percent in Q1 2011, remaining stubbornly high. The second quarter of 2011 saw a thawing of suits filed against financial firms, at 27 percent, but the third quarter rose once again to 35 percent.

SUITS BY SECTOR - Q3 2011



The number of suits filed was more broadly dispersed in Q3 2011 than in previous years, especially compared to 2008 and 2009. Information technology and healthcare companies followed financial firms at 13 percent each, and industrials at 11 percent. For the first time since the credit crisis, the financial sector saw a significant drop in suits in Q2, but the number rose again in Q3. Two years after credit crisis- and Madoff-related suits substantially dropped, the stubborn hold that new filings of securities suits has on financial firms reflects a long period of regulatory actions against these firms and private suits that tend to follow such actions.

The financial sector remains the leading sector for attracting securities litigation, as it is historically one of the leading sectors subject to regulatory scrutiny. Many companies specifically involved in the capital markets part of this sector – investment banks and asset managers – continued to attract the attention of plaintiffs' attorneys. They also remain a target for regulatory actions, which in turn attracts suits. Although suits against troubled banks have been generally increasing in recent years, the number of suits against banks has fallen over the past two quarters.

Historically, a large portion of cases against financial firms involve regulatory actions such as suits brought by the SEC. The third quarter was no exception: 48 percent of all cases filed against financial firms and their directors and officers were securities fraud cases, and 12 percent were fines for FINRA (Financial Industry Regulatory Authority) violations. Derivative actions were unusually high at 14 percent for the quarter. Securities class actions suits are usually common for these firms, but were down from previous years, with 9 percent of suits naming financial firms for these types of suits. Breach of fiduciary duties suits, for duties to both shareholders and clients, accounted for just 8 percent, substantially down from previous years.

Lawsuits filed against information technology firms were dominated by securities class action suits (38 percent) and breach of fiduciary duties suits (36 percent). The directors and officers of healthcare companies saw their own mix of filings, with breach of fiduciary duties at 40 percent, securities class action suits at 23 percent, and derivative actions at 20 percent. For industrial companies, 41 percent of the suits were securities fraud, and 24 percent securities class actions.

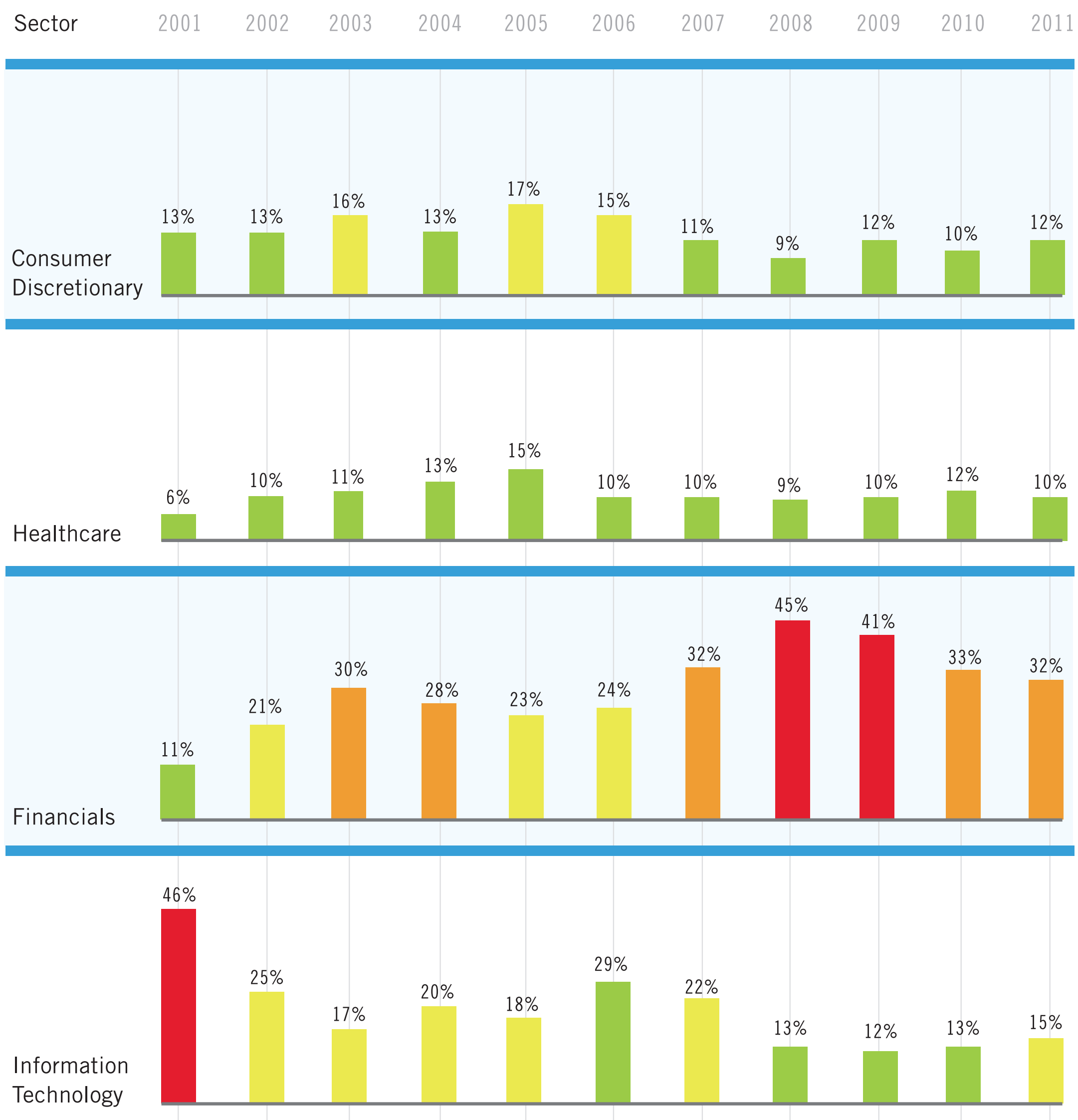
Sector Impact Metric™

Advisen's Sector Impact Metric™ (SI Metric™) measures the distribution of securities lawsuits across industry sectors over the past decade. The Metric provides a visual compass tracking the changing seas of securities litigation. The industries consistently with the greatest number of new suits are financial, information technology, consumer discretionary and healthcare, though the relative percentage each represents of the total shifts over time. Financial and information technology have tended to be the mirror image of one another – securities suits against financial companies wane as suits against IT companies increase, and vice versa. If the pattern holds true, a new round of suits against IT companies may be looming on the horizon if suits against financial companies begin to fall off.

0% - 5%
5% - 15%
15% - 25%
25% - 40%
40%+

The SI Metric™ gives two visual indicators of securities lawsuits in each sector, providing a way to track trends by industry sector. The height of the bars indicates the percentage of securities suits that fell in each sector per year. The bars in the exhibit are color-coordinated to also reflect the frequency of suits per year for each sector: green (0%-5%); light green (5%-15%); yellow (15%-25%); orange (25%-40%); and red (40% and over).

SI METRIC™



Note: The totals for each year do not add to 100 percent because only the sectors with significant lawsuit activity are shown. Other sectors include: consumer staples, energy, industrials, materials, telecommunications and utilities.

Settlements and awards

The average settlement value (including proposed and tentative settlements) of securities suits during Q3 2011 was down a bit to $17.4 million, from $22.8 million in Q2 2011 and $18.2 million for all of 2010. A subprime-related case settled for a substantial amount, and was the leading case by settlement amount for the quarter. Awarded amounts are included in these averages, though the vast majority of securities lawsuits are settled before going to trial.

Securities class action suits represented two of the top five settlements, with an average settlement of $45.7 million. They were led by the leading settlement overall of $590 million by Wachovia (now owned by Wells Fargo) and its former directors and officers in a subprime-related case. The case was brought by holders of preferred stock, claiming that the company issued false and misleading statements at the time of the registration of the preferred shares about the value of its mortgage-related assets. Another top securities class action was brought against India-based IT consultant Mahindra Satyam, settling for $125 million, amid accusations that the firm systematically falsified its financial statements, including the level of cash, revenue, and profits.

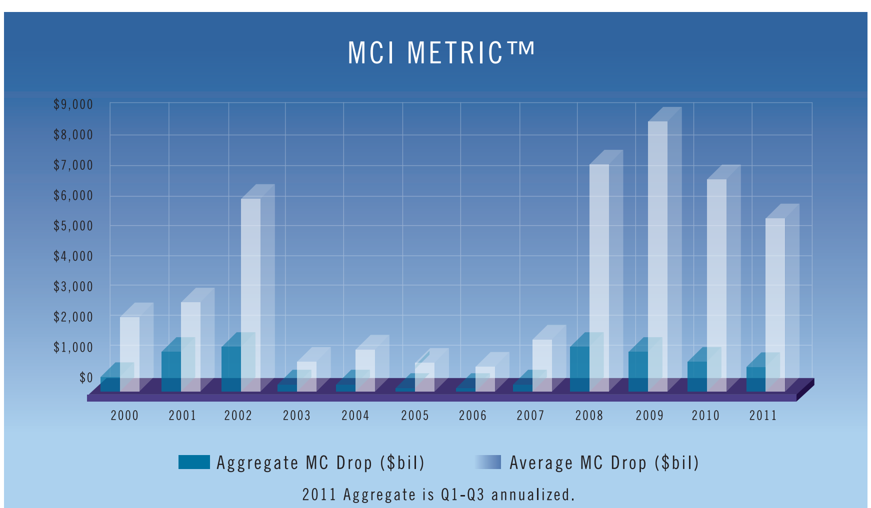
Securities fraud cases averaged $15.1 million in settlements, with two of the top five cases settled for the quarter. Consultant Fraud Discovery Institute settled for $584 million in a case where its owner and chief executive, Barry Minkow, used his relationship with the FBI by making false Ponzi-scheme allegations against another company in order to manipulate its shares and extort funds. JP Morgan Chase's subsidiary JP Morgan Securities settled with the SEC, and other federal and state authorities, for $228 million for allegedly rigging municipal bond reinvestment transactions.

Suits related to proxies and solicitations included one case that settled for $150 million in the quarter, against Securities America, subsidiary of Ameriprise Financial. The claim alleged that the company issued false and misleading offering materials regarding the sale of Provident Securities. Breach of fiduciary duties cases had an average settlement of $3.2 million in the third quarter. Derivative actions settled for an average of $1.2 million, down from $37 million in the previous quarter. In the past, derivative actions principally demanded changes in corporate governance or strategy with monetary awards beyond the plaintiffs' legal costs being rare (but defense costs can be high in these cases). In recent years, large monetary settlements have become increasingly common.

Market Cap Impact Metric™ (MCI Metric™)

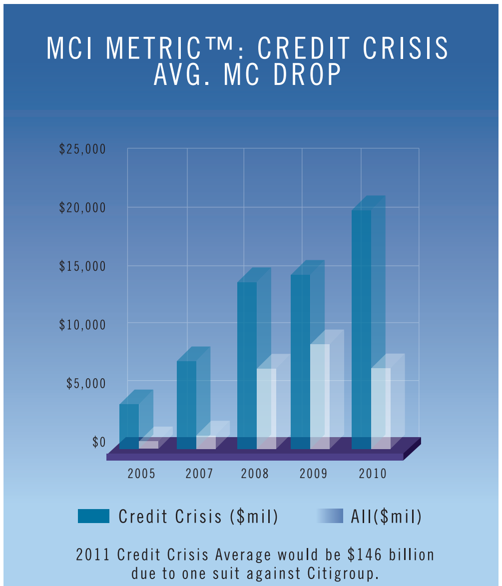
The Advisen MCI Metric™ projects potential damages in securities class action lawsuits. This Metric measures the aggregate and average market capitalization drop around the class period. For cases initiated by shareholders, courts will typically award shareholders who purchased shares in a company during the class period an amount based on their estimated losses due to the alleged wrongful act. The MCI Metric™ calculates the market capitalization loss considering the typical starting and ending points for calculating damages to shareholders. Since claimants in any one case could have purchased shares on any date during the class period, Advisen considers the average market capitalization during the class period as the starting point. Advisen also uses the market capitalization 30 days after the class period end-date as the ending point for considering the company's market capitalization loss.

This projected market capitalization loss is calculated for most companies with a securities class action suit filed against them during each year of the past decade, with certain securities class action cases eliminated. Securities class action suits eliminated from the calculations are those whose alleged losses are not tied to defendants' stock price losses, thus their potential damages are not tied to market capitalization losses. For example, Madoff-related securities class action cases with investors that experienced losses due to feeder-fund investments in the Ponzi scheme claim losses that are not tied to the defendants' stock price. Other examples include losses experienced by auction rate securities investors, which are tied to the underlying security as opposed to the stock price of investment banks named in many of these securities class action cases.



Sponsored by: Proskauer

Aggregate losses and average losses are presented within the MCI Metric™. The aggregate loss measures the total fall-off in market capitalization, using the method described, for companies with securities class action suits filed against them for each year. This number is a starting point for calculating damages, and is a useful benchmark for comparing the impact across years. The average loss measures the average fall-off in market capitalization per company and lawsuit. It provides an important new insight into the impact the average securities class action suit could potentially have on the average company for each period.



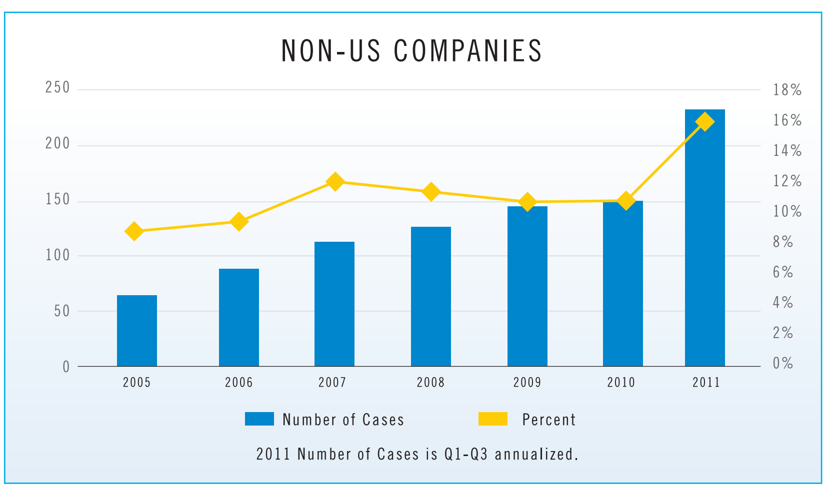
The aggregate and average market capitalization losses shot up in 2008 and 2009, and remained high in 2010, but have begun to fall off in 2011. Aggregate losses were $1.5 trillion in 2008 and $1.3 trillion in 2009. In 2010, aggregate losses remained elevated at $825 billion, but dropped to $657 billion annualized for the first three quarters of 2011. The losses in 2008 and many in 2009 reflect that most of the class periods occurred during the large stock market losses of 2008 and 2009. Since the beginning of Q2 2009, however, stock markets have generally risen, yet the aggregate losses remained high through 2010, affirming that market cap losses for companies named in securities class action suits are far in excess of market cap loss attributable to overall market fluctuations. The level in 2011, although down from previous years, remains higher than most years.

The surge in average market capitalization losses in 2008, 2009 and 2010 was driven largely by credit crisis cases. These cases, on average, have seen much greater destruction of market capitalization, implying that credit crisis suits will ultimately settle for far larger amounts than other types of suits. Although the aggregate drop in market capitalization for credit crisis-related suits fell off considerably in 2010, the average drop per case has continued to climb. The average market capitalization drop for these suits rose from $14.3 billion in 2008 and $15.5 billion in 2009, to $21.1 billion in 2010. Just one credit crisis-related securities class action suit was filed in the 2011 thus far, against Citigroup, connected to $146 billion in market capitalization losses.

Globalization of securities litigation

The increasing number of non-U.S. companies agreeing to securities litigation settlements in excess of $100 million makes it clear that exposure to securities litigation has become a reality of doing business for companies around the world. Any company with shares trading on U.S. exchanges is subject to securities litigation (and other management liability-related litigation) in U.S. courts. Furthermore, many countries around the world, especially in Europe, are "modernizing" their civil legal systems by providing greater access to court remedies through various collective action mechanisms. The end results are systems closer to the U.S. class action system, and ultimately more suits with greater payouts from courts outside of the U.S. In addition, financial regulators around the world have stepped up enforcement efforts in the wake of the credit crisis, and increasingly work in concert with one another, including heightened coordination with U.S. authorities.

As compared to the U.S., securities litigation in Europe, Asia and Latin America is less frequently a matter of public record, making it difficult to get as complete a picture of litigation activity. Typically only the largest cases attract media attention, and non-U.S. companies are far less likely to provide details of litigation in their public disclosures. In spite of these limitations on data collection, it is nonetheless clear that securities litigation activity has been on the rise in recent years in courts outside the U.S. In the first three quarters of 2011, Advisen recorded 55 securities suits filed in courts outside the U.S., 17 of which were in Q3. At 5 percent of total securities suits filed in 2011, this is higher than the 3-percent level recorded in most recent years. The Madoff Ponzi scheme, which drew in a number of non-U.S. investors and banks, led to a spike in non-U.S. securities cases in 2009. Even so, 2009 saw just 4 percent of total securities cases filed in non-U.S. courts.



Securities suits against non-U.S. companies – both in the U.S. and elsewhere – have accounted for about 9 percent to 12 percent of total securities suits tracked by Advisen for most years since 2005. In the first three quarters of 2011, 16 percent of securities suits were filed against non-U.S. companies, up significantly from the 11-percent level of 2009 and 2010. For Q3 2011, the percentage of non-U.S. companies was at 15 percent, down from the 19-percent level in the previous quarter. Credit crisis-related suits and Madoff-related suits were global in nature, but the falloff in these suit-types did not lead to a decline in the percentage of securities suits filed against non-U.S. companies in 2010, and the number has increased in 2011.

Some predict that the number of suits filed against non-U.S. companies could dip in the short-term, as a result of the U.S. Supreme Court decision in *Morrison v. National Australia Bank*, which ends the practice of filing lawsuits in U.S. federal courts as concerns securities purchased on non-U.S. exchanges. The U.S. federal court system has been the venue of choice for securities litigation for shareholders across the globe. This scenario of fewer suits filed against non-U.S. companies, however, has not occurred yet. The number of securities suits against non-U.S. firms almost certainly will continue to grow in the long-term, but as shareholders gain greater access to legal systems elsewhere to litigate securities claims, it is likely that fewer suits against non-U.S. firms will be filed in the U.S.

Cases in U.S. courts against companies from China mushroomed in 2010 and 2011. The number of suits filed against these companies grew from five suits recorded by Advisen in 2009 to 24 in 2010, including 15 in the fourth quarter alone, and this has continued with 55 in the first three quarters of 2011. These cases are unaffected by the *Morrison* decision since they were filed against companies that are listed on U.S. exchanges. As the number of companies from China that choose to list on U.S. exchanges grow, the number of suits is likely to grow as well.

Many of these suits against Chinese companies deal with large discrepancies between revenue reported in SEC-filed financial statements and statements filed with the China State Administration for Industry and Commerce. Companies claim that the differences are due to the differences in tax-accounting rules and financial-reporting rules, as well as different accounting standards. In certain cases, however, revenue in SEC-filed reports is over ten-times greater than reports filed for tax purposes. It appears that many executives in China have a lesson to learn about the scrutiny thrust upon them, by both regulators and plaintiffs' attorneys, by listing on U.S. exchanges.

More information

More information about suits and filing details is available for purchase at Advisen's online store, Advisen Corner, at http://corner.advisen.com/analytics_mscad.html and available at no extra charge to Advisen subscription members through their advisen.com logins. **For more information please call +1.212.897.4800 or e-mail corner@advisen.com.**

This report was written by John W. Molka III, Senior Industry Analyst and Editor, jmolka@advisen.com. David Bradford, Melgar Gascal, Anne Wallace and Jim Blinn of Advisen provided input and assistance. A special thanks to Bill Brown, a consultant, for his professional expertise.

This report was sponsored by Proskauer.