



CLASS ACTION LITIGATION



REPORT

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SECURITIES

Securities class actions continue to be big news, but economists Elaine Buckberg, Todd Foster, and Stephanie Plancich find little change in either settlement terms or filings over the past 12 years. The Sarbanes-Oxley Act has had little impact on class litigation, the authors say.

Except for a significant drop in 1996 after the passage of the Private Securities Litigation Reform Act, standard filings have hovered around the 200 mark, they point out. However, there was a significant drop in dismissals in 2003.

The headline-grabbing settlements represent extraordinary investor losses, according to the authors. They suggest that modest growth—which should make it more difficult for false accounting schemes to thrive—may limit securities fraud cases more effectively than legislation.

Recent Trends in Securities Class Action Litigation: 2003 Update

By ELAINE BUCKBERG, TODD FOSTER, AND
STEPHANIE PLANCICH

More than two years after the Enron scandal broke and 20 months after the passage of the Sarbanes-Oxley Act (SOX), securities fraud cases continue to make headlines. Indeed, 2003 brought three of the six largest securities class action settlements of all time: Lucent Technologies, DaimlerChrysler, and Oxford Health Plans. But behind these extraordinary settlements are extraordinary investor losses,

the single most powerful predictor of settlement size: These cases ranked first, second and fifteenth in investor losses, respectively, among settled cases. Considering the investor losses, the size of these settlements is less surprising. Overall, settlements are down: A closer look at 2003 settlements shows a downward trend in average and median settlement values and investor recovery rates little changed from their all-time low in 2002.

Since SOX was adopted in July 2002, any immediate effects of the legislation on securities class actions would likely now be evident in the data. While securi-

Top Six Securities Class Action Settlements¹

| Settlement Ranking | Company | Year | Settlement Value (\$MM) | Investor Losses (\$MM) | Investor Loss Ranking |
|--------------------|--------------------------------------|------|-------------------------|------------------------|-----------------------|
| (1) | (2) | (3) | (4) | (5) | (6) |
| 1 | Cendant Corp. ² | 2000 | 3,528 | 17,047 | 4 |
| 2 | Lucent Technologies, Inc. | 2003 | 517 | 106,624 | 1 |
| 3 | BankAmerica Corp.; NationsBank Corp. | 2002 | 490 | 3,449 | 28 |
| 4 | Waste Management Inc. II | 2002 | 457 | 15,911 | 5 |
| 5 | DaimlerChrysler AG | 2003 | 300 | 30,491 | 2 |
| 6 | Oxford Health Plans, Inc. | 2003 | 300 | 4,817 | 15 |

Source:

¹ Data obtained from NERA's Recent Trends Database, updated as of January 1, 2004.

² The settlement value incorporates a \$341 million settlement in the "Cendant Prides" case.

ties litigation continues to increase as a long-term trend, we find that there is no change in the number of filings or the size of settlements as a result of SOX. The only marked change since SOX relates to the frequency of dismissals, which remain down by one-third.

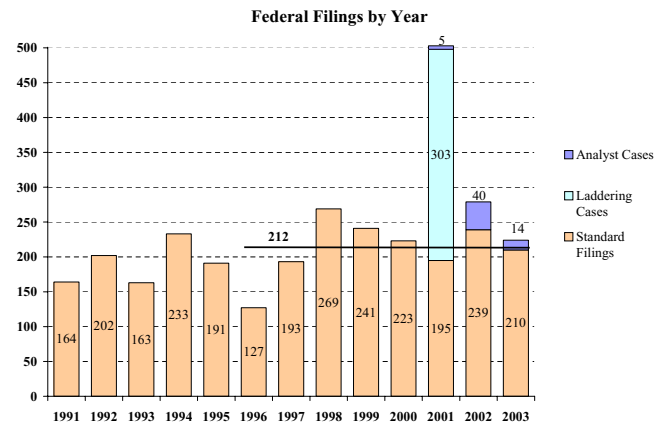
Filings Down Again in 2003

The pace of filings dropped in 2003 for the second year in a row, bringing them back in line with the long-term trend. Federal courts received 224 filings in 2003, down 55 percent from the all-time high of 503 in 2001 and 20 percent from 279 in 2002. However, over these three years, filing rates were affected by the laddering and analyst cases, both of which were likely one-time phenomena. There were only 195 standard filings in 2001, excluding 303 laddering cases and five analyst cases. The laddering cases alleged that newly-public companies and their underwriters engaged in unfair initial public offering (IPO) allocation practices and manipulation of the early aftermarket; the analyst cases alleged that analyst recommendations were influenced by the investment banks' interest in winning business from the recommended companies. The analyst cases accounted for another 40 filings in 2002 and 14 in 2003. If the laddering and analyst cases are excluded from each year's filings, the remaining 210 filings in 2003 are in line with the average of 212 filings each year since the passage of the Private Securities Litigation Reform Act (PSLRA) in December 1995.

Theoretically, SOX could have led to either an increase or a decrease in filings. The act extended the statute of limitations to two years after the disclosure of fraud and five years after its occurrence, from one and three years, respectively. As such, plaintiffs' attorneys could have responded to the passage of SOX by filing additional suits for cases on which the pre-SOX statute of limitations had expired—perhaps cases with weaker merits that had not ranked as high on their priority lists as the heavy load of laddering and analyst cases.¹ Alternatively, the plaintiffs' bar could have been more lei-

¹ It is not clear whether SOX extended the statute of limitations for cases in which the previous limit had already run out. However, plaintiffs could have filed cases in the hope that the case would be allowed to proceed under the extended statute of limitations.

surely about filing cases involving disclosures within the year before or since SOX's passage. However, we find no change in the level of filings due to SOX.



The limited short-term impact of SOX contrasts with the powerful but short-lived effect of the Private Securities Litigation Reform Act of 1995 (PSLRA). Filings dropped sharply in 1996 to 127, from a five-year average of 190, then rebounded to 193 in 1997 and continued to rise thereafter.

Over a five-year period, we find that, if the 2003 filing rate continues, the average public corporation will face a 9 percent probability that it will face at least one securities class action lawsuit. The 1.8 percent annual likelihood of facing a suit in 2003 is statistically unchanged since 1995, controlling for the number of public companies. Note that this is a substantial drop from 2002, when the probability of facing a suit reached 2.3 percent.

Since SOX, Fewer Dismissals

Fully 80 percent of federal securities class action lawsuits end in settlement. Approximately 19 percent of cases are dismissed, and about 1 percent end in judgments. The only marked change since SOX has been in the rate of dismissals, which has fallen by about one-third. Twenty-six cases have been dismissed since SOX was adopted; had the number of dismissals kept pace with dismissals in the post-PSLRA, pre-SOX period, we

Companies Face a 2% Chance of a Suit, Each Year

| | 1995 | 2002 | 2003 |
|----------------------------------|-------------|-------------|-------------|
| No. of Publicly Traded Companies | 11,688 | 12,192 | 12,418 |
| Annual Filings | 190 | 280 | 225 |
| Likelihood of Filing | 1.6% | 2.3% | 1.8% |

would have predicted 39 dismissals since SOX. The lower rate of dismissal suggests that either cases are proceeding more slowly or that judges are being more generous at the margin in evaluating the merits of cases on their desks, allowing a few more cases to proceed. That said, the pace of dismissals picked up in the second half of 2003; through June, dismissals had been down by half. If the accelerated pace of dismissals of late 2003 continues, the post-SOX dismissal effect may not be sustained in 2004.

Blockbuster Settlements Mask Falling Average Settlements

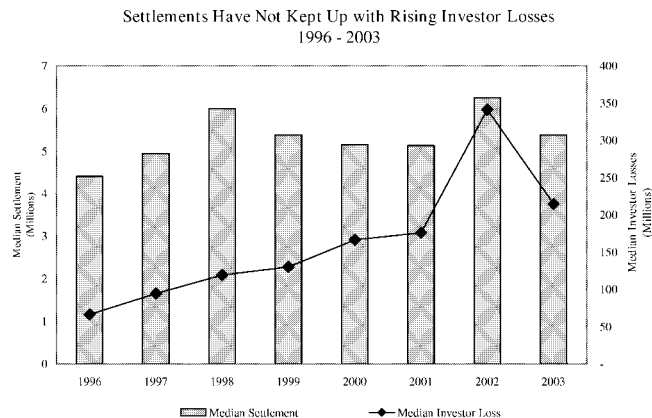
While there were a handful of blockbuster settlements in 2003, the overall picture reveals a drop in average and median settlements in 2003. The average settlement fell 15 percent in 2003 to \$19.8 million from \$23.3 million in 2002, while the median settlement fell a slightly more modest 14 percent to \$5.4 million from \$6.3 million in 2002. Falling average settlements in 2003 have countered a former upward trend in settlements by year. Although there were six settlements over \$100 million in 2003, two-thirds of settlements were under \$10 million.

Explaining Settlements

We have built a statistical model to explain the value of settlements, using data on cases since the passage of PSLRA. This model allows us to identify some of the factors that determine the amount for which a case will settle. However, the model does not control for the strength of plaintiffs' allegations, the relative ability of plaintiff and defense counsel, the likelihood of pro-plaintiff or pro-defense rulings in the district or the amount or structure of defendants' insurance coverage.

Trends in investor losses explain both the top settlements of 2003 and the downward trend in the median settlement. Investor losses, an estimate of what investors lost over a class period relative to an investment in Standard & Poor's (S&P), are the single most powerful determinant of settlements, explaining approximately 50 percent of the variation. On average, a 1.0 percent increase in investor losses results in a 0.4 percent increase in the size of the expected settlements, meaning that settlements tend to increase far less than one-for-one with investor losses.

Following the bursting of the 1990s stock market bubble, average investor losses ballooned from \$140 million in the average suit settling in 1996 to \$1.0 billion in 2002 and \$2.3 billion in 2003. The 2003 figure is driven by a few very large cases. The extraordinary settlements in Lucent Technologies, DaimlerChrysler and Oxford Health Plans in 2003 are associated with and partially explained by extraordinarily high investor



losses. However, in more typical lawsuits, losses are down. Investor losses in the median case settling in 2003 *dropped* to \$215 million from \$340 million in 2002, but were more than three times the median of \$65 million in 1996.

The inclusion of securities other than common stock in a class action suit results in dramatically higher settlements. Effectively, the claims of the holders of these other securities represent losses above and beyond—and not captured by our measure of—the investor losses on common stock. The inclusion of preferred stock or bonds in a suit more than doubles settlement value. The inclusion of options adds more than a third.

Settlements also increase with measures which may reflect the depth of defendants' pockets. For each 1.0 percent increase in the company's market capitalization the day after the end of the class period, the settlement value is expected to increase by 0.1 percent. In cases with an accounting firm named as co-defendant, settlements increase by roughly 45 percent, controlling for all other characteristics of the case.

Cases with accounting allegations result in higher settlements for several additional reasons. The presence of any one of three accounting factors—accounting issues, admitted accounting irregularities and/or restatements—will raise average settlement values by approximately 20 percent. The naming of an accounting co-defendant, which occurs in a subset of accounting cases, has the most powerful impact on settlement value.

One of the major objectives of PSLRA, involving institutional investors as lead plaintiffs, has had a marked impact on settlements. Congress intended that institutional investor plaintiffs would be more actively involved in the litigation and therefore generate better outcomes for plaintiffs, as opposed to individual investor plaintiffs who may supervise their counsel less actively. Consistent with congressional objectives, we find

that settlements are about 20 percent higher in cases where the lead plaintiff is an institutional investor. This may reflect the retention of more effective plaintiffs' counsel in those cases, the institutional investors' more effective supervision of counsel, their own contribution to strategy, or some combination of factors. Alternatively, it may reflect a tendency for institutional investors to become involved primarily in more serious cases, in terms of either the merit of allegations or the size of potential damages.

Our model also indicates that settlements increase by about 30 percent if Section 11 claims are potentially involved.

Companies in bankruptcy or with a share price of less than \$1 on the settlement date pay about 25 percent less in settlement, compared to otherwise comparable cases.

How Much Do Investors Get?

Plaintiff recoveries relative to investor losses are declining. In 2003, the median percentage of investor losses paid in settlement remained near its all-time low at 2.8 percent, up from 2.7 percent in 2002, but down from a high of 7.2 percent in 1996. But plaintiffs' counsel typically keeps about one-third, leaving plaintiffs with a recovery of less than 2 percent of investor losses. Even a 2 percent recovery rate will overstate investor compensation to the extent that the company itself pays the settlement.² To the extent that the company pays directly, any current shareholder who was also a dam-

² The company's directors' and officers' insurance providers pay many settlements in large part. It is relatively uncommon that individual defendants contribute to a settlement.

aged shareholder during the class period will gain from the settlement payment he receives, but this gain will be offset because the company's contribution to the settlement will reduce the value of his existing shareholding in the company.

Conclusion

The first year of stock market recovery after the 2000–2002 bear market has brought some changes in securities class action trends. With the laddering and analyst filing deadlines now past, filings have returned to their post-PSLRA norm. The passage of three years since the stock market peak may mean that more cases settling have class periods that began in the bull market and ended in the bear market, driving up average investor losses. These high investor loss cases explain the handful of very high settlements observed in 2003, while at the same time both mean and median settlements fell by approximately 15 percent.

Going forward, the bursting of the stock market bubble of the 1990s, and the aftermath of recent scandals, may be the single most powerful influence on securities litigation. In a rapidly rising stock market and with a rapidly growing company, false accounting had a chance of going undetected. But in the face of more modest growth, accounting gimmicks may be difficult to maintain. The more intense scrutiny by directors and auditors that Sarbanes-Oxley requires will reinforce that effect. It is often said that current policy is invariably designed to prevent the last crisis. Should growth remain more moderate, this alone may limit fraud and filings; the impact of Sarbanes-Oxley may be secondary.