2008 Mid-Year Update

2008 Trends: Subprime and Auction-Rate Cases Continue to Drive Filings, and Large Settlements Keep Averages High

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Introduction

After a decrease in 2006, filings began to increase in 2007. This trend has continued into 2008: currently, filings are on pace to reach almost 280 for the year, a level not attained since 2002.

What’s driven the increase in filings? Clearly, the current subprime and credit crisis is a major factor in the recent surge in shareholder class action filings. In 2008, 51% of filings through June 30 have allegations related to the subprime collapse.

To test another potential driver of filings, NERA analyzed the impact of market volatility on longer-term patterns of class action filings. We find that high market volatility is positively correlated with the number of filings: if market volatility is higher during a quarter, controlling for market returns, filings are likely to be higher in that same quarter.

We have also examined the likelihood of a company facing a class action filing following a large drop in the company’s stock price during the period from 2005 through 2007, as measured by a net-of-market one-day price decline of 20% or more. We find that the probability of a filing over the three months following such price drops increases with the size of the drop.

Even as filings were increasing in 2007 and 2008, average settlement values remained around $30 million. Removing settlements over $1 billion from the calculation, the 2008 average settlement actually fell to $10 million, well below the level of recent prior years, and much closer to the 2008 median of $6 million.

Although it is too early to know whether recently filed cases will result in big settlements, there is reason to expect that they will. Investor losses—a powerful determinant of settlement size—for cases filed in the first six months of 2008 have a median value in excess of $800 million, substantially higher than the approximately $350 million median for cases settled in the 2005-2007 time frame. The sharply higher investor losses of recent cases are largely a subprime phenomenon: median investor losses so far this year are more than 10 times as large in subprime cases as in non-subprime cases.

1 This edition of NERA’s research on recent trends in shareholder class action litigation expands on previous work by our colleagues Lucy Allen, Elaine Buckberg, Frederick C. Dunbar, Todd Foster, Yrinda M. Juneja, Denise Neumann Martin, Ronald I. Miller, and David I. Tabak. We gratefully acknowledge their contribution to previous editions as well as this current version. The authors also thank Jake George, Marcia Kramer Mayer, Robert Patton, and Carl Vogel for helpful comments on earlier drafts of the paper. In addition, we thank Stuart Neilson, Corina Onisoru, Nicole Roman, Kaitlin Simpson, Carlos Soto, Maria Tarasuyk, Steven D. Towler, Jordanka Visokomogiliska, and many other NERA researchers for further assistance. These individuals receive credit only for improving this paper; all errors and omissions are ours.

2 For stocks traded on the NYSE and NASDAQ with market capitalization of $100 million or more.
Filing

Recent Trends
After dipping sharply to a more than 10-year low of 131 filings in 2006, federal shareholder class action filings began to increase in 2007. By year-end, there were a total of 195 filings, surpassing the 2005 level. Through June 30, there have already been 139 filings in 2008. If activity continues at this pace, there will be almost 280 filings in 2008, the highest level since 2002.

Six-month data reveals more about the timing of the collapse and subsequent upsurge in filings. Filings fell precipitously in the second half of 2005, but this drop is masked in the annual data by the relatively high filings in the first half of that year.

While filings started to rebound in the first half of 2007, filings grew most strongly in the second half of 2007. This increase coincided with the first subprime-related filings: there were only nine subprime filings in the first half of 2007, but more than three times as many in the second half. The first half of 2008 brought another 49 subprime-related shareholder class action filings, plus 22 other cases related to auction-rate securities market failures. Although the majority of options backdating cases were filed in 2006, a handful of these contributed to the 2007 and 2008 upswing.

3 We include in this group any shareholder class action that has allegations caused by or related to the subprime meltdown or credit crisis. For more details, see “Subprime Securities Litigation: Key Players, Rising Stakes, and Emerging Trends,” by Dr. Faten Sabry, Anmol Sanha, and Sungi Lee, 3 July 2008. This NERA study may be found here: http://www.nera.com/image/PUB_SubprimeSeries_Part_III_0708.pdf.

4 See NERA working paper, “Auction-Rate Securities: Bidder’s Remorse?” by Stephanie Lee. This NERA study may be found here: http://www.nera.com/publication.asp?p_ID=3474.
Figure 2. **Federal Filings: Six-Month Intervals**  
January 1, 2002 - June 30, 2008

Note: Other Cases include IPO laddering, mutual fund market timing, and analyst cases.

Figure 3. **Federal Filings by Circuit, Year, and Type of Case**  
January 1, 2006 - June 30, 2008

*The first bar in each set represents 2006, the second 2007, and the third (if any) 1H 2008*
Notably, subprime and auction-rate securities cases alone cannot explain the increase in filings. Since June 2007, standard filings—which exclude auction-rate securities, subprime-related, and options backdating cases—have exceeded the levels of 2006 and the first half of 2007.

Historically, securities class action filings have been concentrated in the Second Circuit (including Connecticut, New York, and Vermont) and the Ninth Circuit (which includes California and certain other Western states and territories). This remains the case in 2008. Year-to-date, the Second Circuit has seen more than twice as many filings as the Ninth, due in large part to subprime and auction-rate cases; the financial institutions that these cases target are concentrated in New York. For standard filings, on the other hand, the Second Circuit is ahead of the Ninth by only 30%.

The concentration of issuers in the Second Circuit is particularly great in auction-rate securities cases, which first appeared in 2008. While seven of these cases are to be found among the Seventh, the Eighth, the Ninth, and the 11th Circuits, the other 15 are all in the Second.

While subprime and credit crisis-related filings are primarily a Second and Ninth Circuit phenomenon, all Circuits have had at least one such case. In 2007, seven subprime filings were filed in the 11th Circuit—which includes Florida, a state associated with some of the earliest subprime-related disclosures—but the 11th Circuit has had only one case filed in the first six months of 2008.
**What drives filings?**

The recent surge in filings is clearly linked to the credit crisis, and, in particular, to the subprime meltdown and auction-rate securities market failures. This crisis alone, however, cannot explain the fact, noted above, that standard filings have increased from their depressed 2006 level. To understand that trend, we consider more general factors that might affect the rate of filings.

**Broad Market Performance**

We analyzed the quarterly relationship between market volatility and the number of federal shareholder class action filings. This relationship is depicted in Figure 5, where market volatility is measured as the annualized standard deviation of daily returns to the S&P 500 Index. We find a statistically significant positive correlation between quarterly market volatility and filings. The positive and statistically significant relationship between volatility and filings holds when we control for returns to the S&P 500. However, as can be seen from the plot in Figure 5, the relationship between volatility and filings is not tight. While filings seem to move with market volatility, controlling for market returns, the two variables together explain only approximately 30% of the variation in quarterly filings.

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5 Specifically, volatility is measured using the standard deviation of daily S&P 500 returns in each quarter, annualized by multiplying by the square root of 252.

6 We regressed quarterly filings on quarterly S&P 500 returns and quarterly S&P 500 volatility over the period from the first quarter of 1996 through the second quarter of 2008. Both independent variables are statistically significant at the 1% level. The adjusted R-squared of this regression is 0.31. Note that in the quarterly count of filings for this analysis we included only standard, options backdating, and subprime cases.
**Incidences of Large Price Drops in Individual Stocks**

Another variable that might help to explain volatility in filings is the number of large price drops in individual stocks. These large drops—rather than the rate at which the broad market moves up and down—may trigger shareholder class action litigation because they often follow disclosures of adverse company-specific news that fuel allegations of fraud.

To test whether filings are related to large stock-specific price declines, we collected data on daily prices and returns for all companies with market capitalization of at least $100 million that traded on either the NYSE or NASDAQ within the period from 2005 through 2007.\(^7\)

From these data, we calculated the number of “large” daily price declines, defined as one-day net-of-market drops of 20% or more in an individual company’s stock.\(^8\)

We merged these data with our historical filings data.\(^9\)

From the matched data, we identified filings that occurred within the three months following a large price decline.

We find that the probability of a suit rises with the size of a large price decline: whereas only 9% of drops of 20-30% are followed by a shareholder class action federal filing within three months, almost 31% of drops of 40% or more are followed by a filing within that time frame. See Figure 6.

**Figure 6.** Percent of Net-of-Market Price Drops Followed by a Shareholder Class Action Filing Within Three Months, By Size of Price Drop

January 1, 2005 - December 31, 2007

\(^7\) Source for the price data is FactSet Research Systems, Inc. If a company moved from one of these exchanges to the OTC market or to another exchange, it is not included in this analysis.

\(^8\) In particular, we adjust individual stock price movements for market movements by subtracting the relevant marketplace return from the stock’s return to generate a “net-of-market” return. The NASDAQ Composite Index is used to adjust the price movements of companies that are traded on NASDAQ, and the NYSE Composite Index is used to adjust the price movements for NYSE companies. We do not classify an otherwise eligible drop as “large” if it occurred on a dividend ex-date. For the purposes of applying the $100 million market capitalization minimum, we measure market capitalization immediately after the price drop.

\(^9\) We exclude from filings data cases pertaining to auction-rate securities, preferred stock, bonds, hedge funds, mutual funds, or assets that were not traded on the open market. Thirty-two percent of the filings in our sample were preceded by a net-of-market price drop of 20% or more.
The probability of a suit rises with the size of a large price decline: whereas only 9% of drops of 20-30% are followed by a shareholder class action federal filing within three months, almost 31% of drops of 40% or more are followed by a filing within that time frame.
We examined the relationship between large price drops and same-year filings over the period 2005 through 2007, and find that the relationship has not been stable in recent years. Specifically, in 2005, there were 311 large drops and 177 filings, for a rate of 0.57 filings per large drop. In 2006, there were slightly more large drops, 332, but substantially fewer filings, 128, only 0.39 filings per large drop. In 2007, the number of large drops rose to 473 and the number of filings to 188, making for 0.40 filings per large drop.10 See Figure 7.

Viewed differently, the probability of a class action filing within three months following a large price drop has varied over time, falling from 13.4% in 2005 to 7.5% in 2006, then coming back up to 13.2% in 2007. See Figure 8.

This analysis helps to rule out one hypothesis for the lower number of filings observed in 2006: it was not the lack of large price drops in 2006 that led to the decline in filings. In fact, there were more net-of-market large price drops in 2006 than in 2005, creating potential opportunities for plaintiff firms to file cases. Despite this, the number of class action filings fell sharply in 2006.

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10 Note that these counts of filings are limited to the case types included in this analysis (i.e., only cases pertaining to common stock) and thus are lower than annual counts in Figure 1.
**Trends in Allegations**

Class action cases filed in recent years contain a wide variety of allegations. Figures 9 and 10 group these allegations into seven major categories.

Over the three years from 2005 through 2007, nearly 30% of allegations were related to accounting—i.e., they claimed that defendants had violated Generally Accepted Accounting Principles (GAAP)—and another 25% related to company-specific earnings guidance.¹¹

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¹¹ Most shareholder class action complaints have multiple allegations. All allegations are included in this analysis, such that the total number of allegations exceeds the total number of filings.
This year has seen a shift in the pattern of allegations, with 47% (up from 17%) now related to product or operational defects. Many of 2008’s product and operational defect allegations are raised in the subprime crisis cases, which often allege that financial products related to mortgage securities or credit markets failed to function as advertised. Specifically, the products are often alleged to have been riskier than originally represented.

Allegations relating to company-specific earnings guidance fell most in relative importance as product and operational defect allegations rose. Accounting allegations drop substantially each year from 2005 through 2007, but in 2008 they are running at a higher rate than in any of those years, due in part to their prominence in subprime cases. If accounting allegations continue to be included in complaints at this same rate in the second half of 2008, a total of 104 cases will contain accounting allegations for the year.

Figure 11. Number of Accounting Allegations in Subprime and Non-Subprime Federal Filings
January 1, 2005 - June 30, 2008

12 Specifically, 42% of the 2008 product or operational defect allegations relate to financial products, and only 5% relate to non-financial product defects.
Resolutions

In addition to tracking trends in filings, NERA collects information about how shareholder class action cases are resolved. Of all post-PSLRA filings in our database that have been resolved, approximately 40.4% have been dismissed, and 59.5% have settled with all defendants, with only a very tiny fraction having reached a verdict at trial.\(^\text{13}\)

For cases filed between July 1, 2001 and June 30, 2006, dismissals account for 43.8% of dispositions. The somewhat higher dismissal rate of this sub-group is not strictly comparable to the 40% rate of the group as a whole, however, as it may include dismissals without prejudice that will be reversed by amended and better-pled complaints, dismissals with prejudice that will be successfully appealed, and possibly even dismissals without prejudice that will nonetheless settle.

Because cases may require more or less time to resolve, and because the probability of dismissal may vary at different stages of a case’s life cycle, we examine resolution statistics in more detail in two alternative ways below.

Resolutions of Cases Filed in 2000

Recognizing that it may take several years for cases to be resolved, we analyze the resolutions of cases filed in 2000. Because this filings cohort has had a fairly long period to resolve, when we look over this longer horizon it provides a more complete picture of the final resolutions.

Of the 235 cases filed in 2000, over 60% have settled or have partially settled (i.e., at least one of the defendants in the case has settled). Another 33% have been (and remain) dismissed. Only about 7%, or 16, have not yet been resolved and are either still pending or have been abandoned by plaintiffs.

For the resolved cases filed in 2000, the average time to resolution was 2.7 years; for dismissals the average was 1.8 years, and for settlements, it was 3.3 years.

Two-Year Dismissal Rates

Another way to look at dismissal rates is to measure the percentage of filings that were dismissed within two years and remain so.\(^\text{14}\) Two-year rates have the advantage of allowing us to use data for cases filed as recently as the first half of 2006.

The two-year dismissal rate for cases filed since July 21, 2001 is 24%. This rate varies by Circuit, as shown in Figure 13, with the highest rates in the Fourth Circuit. The Second and Ninth Circuits—with the most filings—have similar dismissal rates of approximately 24%.\(^\text{15}\)

We find that these two-year dismissal rates have been steady over time, without much change in overall or Circuit-specific patterns.

Trials

As shown above in Figure 12, over 90% of the cases filed in 2000 have been resolved, with the remaining 8% still pending. The vast majority of these cases were resolved with a settlement or dismissal before reaching trial. In fact, only four of the cases filed in 2000 have gone to trial. See Table 1 for details.

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\(^{13}\) Our dismissal statistics include summary judgments and verdicts for defendants but exclude partial dismissals. Due to the nature of dismissal data, on one hand, our dismissal counts in this section may be slightly overstated because they may include some dismissals without prejudice that will be reversed by amended and better-pled complaints, dismissals with prejudice that will be successfully appealed, or cases that will settle after a dismissal without prejudice and before the expiration date for plaintiffs to re-file an amended complaint. On the other hand, dismissal counts may be slightly understated because we currently do not track dismissals with prejudice that subsequently settled or reverted to pending status. These two effects tend to offset one another.

\(^{14}\) Our statistics in this regard do not count in the numerator dismissals of cases that subsequently settled or reverted to pending status.

\(^{15}\) The DC Circuit is not included in Figure 13 due to the small number of cases filed and resolved in that jurisdiction.
Cases that proceed to trial do not always result in a straight plaintiff or defense verdict. In some cases, one or more of the defendants may settle during the trial. In other instances, a clear plaintiff or defense verdict may be reached, only to be appealed and either be reversed or sustained. Still other cases have resulted in a mixed verdict, a hung jury, or even a default judgment.

We have grouped the 21 shareholder class actions that went to trial after the PSLRA and were resolved into mutually exclusive categories in Figure 14. A straight verdict was reached for the defense in six cases, while plaintiffs also prevailed in six. Another six started trial only to have at least one defendant settle before a verdict was reached. Another two had mixed verdicts, and one case resulted in a default judgment.

Details on these cases are presented in Table 1, including the Circuit in which the case was filed, along with file and trial years.

Note: Because it is not uncommon for judges to take up to two years from the filing date to rule on motions to dismiss, it would be premature to evaluate dismissal rates of cases filed after June 30, 2006.
Table 1. **Twenty-One Shareholder Class Actions That Went to Trial after PSLRA**

<table>
<thead>
<tr>
<th>I. Verdict for Defendants</th>
<th>Federal Circuit</th>
<th>File Year</th>
<th>Trial Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Everex Systems Inc.a</td>
<td>9</td>
<td>1992</td>
<td>2002</td>
</tr>
<tr>
<td>3. Health Management, Inc.</td>
<td>2</td>
<td>1996</td>
<td>1999</td>
</tr>
<tr>
<td>4. JDS Uniphase Corp.</td>
<td>9</td>
<td>2002</td>
<td>2007</td>
</tr>
<tr>
<td>5. Thane International, Inc.b</td>
<td>9</td>
<td>2003</td>
<td>2005</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>II. Verdict for Plaintiffs</th>
<th>Federal Circuit</th>
<th>File Year</th>
<th>Trial Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Apollo Group, Inc.</td>
<td>9</td>
<td>2004</td>
<td>2007</td>
</tr>
<tr>
<td>2. Claghorn / Scorpion Technologies, Inc.</td>
<td>9</td>
<td>1998</td>
<td>2002</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>III. Mixed Verdict</th>
<th>Federal Circuit</th>
<th>File Year</th>
<th>Trial Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Clarent Corp.d</td>
<td>9</td>
<td>2001</td>
<td>2005</td>
</tr>
<tr>
<td>2. ICN Pharmaceuticals, Inc.e</td>
<td>2</td>
<td>1987</td>
<td>1996</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IV. Settled During Trialf</th>
<th>Federal Circuit</th>
<th>File Year</th>
<th>Trial Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. AT&amp;T</td>
<td>3</td>
<td>2000</td>
<td>2004</td>
</tr>
<tr>
<td>2. First Union National Bank / First Union Securities / Cypres Funds</td>
<td>11</td>
<td>2000</td>
<td>2003</td>
</tr>
<tr>
<td>3. Globalstar Telecommunications, Ltd.</td>
<td>2</td>
<td>2001</td>
<td>2005</td>
</tr>
<tr>
<td>4. Heartland High-Yield / Short Duration High Yield Municipal Bond Funds</td>
<td>7</td>
<td>2000</td>
<td>2005</td>
</tr>
<tr>
<td>5. WorldCom</td>
<td>2</td>
<td>2002</td>
<td>2005</td>
</tr>
<tr>
<td>6. Safety-Kleen Corp. (Bondholders Litigation)g</td>
<td>4</td>
<td>2000</td>
<td>2005</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>V. Default Judgment</th>
<th>Federal Circuit</th>
<th>File Year</th>
<th>Trial Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Equisur Inc.h</td>
<td>8</td>
<td>1997</td>
<td>1998</td>
</tr>
</tbody>
</table>

Notes:

- Until otherwise noted, all these cases went to a jury trial. Data are from case dockets.
- a 1998 verdict for plaintiffs was reversed and remanded by the 9th Circuit Court of Appeals; retrial again yielded a verdict for defendants.
- b Bench trial verdict was reversed and remanded by the 9th Circuit Court of Appeals; has not yet been retired.
- c Judge subsequently vacated the jury verdict and approved a settlement.
- d Chairman of Clarent liable, Ernst & Young not liable.
- e Hung jury.
- f At least one defendant settled after the trial began, but prior to judgment.
- g Some director-defendants settled during the trial; default judgment against CEO and CFO who failed to show up for trial.
- h Default judgment against Equisur Inc. who failed to show up for trial.
Why do such a small proportion of shareholder class actions go to trial? As with all litigations, both parties may have an incentive to settle to avoid the risk of an adverse verdict—and to the extent that a shareholder class action case may have received negative publicity, defendants in particular may worry about a potentially large damages award from a jury. For example, in the WorldCom litigation, a highly publicized case, six of the defendants moved to settle within the weeks and days prior to the start of the class action trial on March 23, 2005. In addition, defendant Arthur Andersen LLP settled on April 22, 2005, after almost five weeks of trial and days before closing arguments were to take place.  

Settlements

Trends in Average Settlement

Historically, the majority of cases filed have resulted in settlements, and the average values of these settlements generally have been increasing over time: the average post-PSLRA settlement value from 1996 through 2001 was $17.1 million; since 2001 it is $45.4 million.  

Perhaps more notably, in recent years there has been substantial variation in annual settlement averages, from a high of $82 million in 2006, down to $31 million in 2007. So far in 2008, the average is $32 million.

Not only does settlement avoid the risks of trial for both parties, but most companies have Directors and Officers (D&O) insurance that will pay for some or all of a settlement amount. If a finding of fraud is reached by a judge or jury, on the other hand, an insurance company may be able to avoid paying on a D&O policy due to a fraud exclusion, yet another incentive to settle before a verdict is reached. Moreover, if a defendant elects to settle a case, the company may avoid a number of other potential costs besides those directly caused by the litigation, including negative publicity, company reputation, and the drain on company management’s resources. Marty Kaplan, the CEO of JDS Uniphase Corp., described his company’s trial experience as a “massive distraction” for the executives and directors, stating that the case “…took away time with customers, time with employees, and time thinking about moving the business forward.”

The huge variation in these annual averages is driven at least in part by the inclusion of extremely large outlier settlements in the calculation. Just removing the handful of outlier settlements over $1 billion has a huge impact, with these outlier-adjusted annual average settlements in the tighter range of $9 million to $31 million over the period from 1996 to 2008.

18 Unless otherwise noted, tentative settlements and cases in which not all non-dismissed defendants have settled are not included in settlement statistics. We define settlement year to be the year in which the first court hearing related to the fairness of the settlement occurred. For cases with multiple partial settlements, a settlement year is determined by a court fairness hearing date of the last partial settlement that concludes the case.
Figure 15. **Average Settlement Value (SMM), All Cases**
January 1, 1996 - June 30, 2008

Note: Average settlement shown without final settlements over $1 billion: the 2000 Cendant, 2005 WorldCom, the 2006 Royal Ahold, AOL Time Warner, two Nortel Networks, and 2008 McKesson HBOC Inc. settlements.

Figure 16. **Average Settlement Value (SMM), Excluding Settlements over $1 Billion**
January 1, 1996 - June 30, 2008

Average: $45.4

Average: $17.1
Figure 17. Proportion of Settlements of at Least $100 Million
January 1, 1996 - June 30, 2008

**Fewer $100 Million-Plus Settlements in 2008**
Although the range of average settlements narrows after removing the cases over $1 billion, the 2008 average of $10 million is lower than those in recent years. In part, this is due to the lower incidence of settlements of at least $100 million year-to-date. Only 2% of settlements in 2008 cross this $100 million mark, as compared to almost 7% in 2007, and nearly 10% in 2006.

**Top 10 Settlements**
The largest of these mega-settlements—the top 10 securities class action settlements of all time—have involved a total of nearly $28 billion over the last eight years. All but one of these settlements is over $1 billion. The largest settlement, for Enron Corp., is over $7 billion to date and is still only a partial, rather than a final, settlement.

While for several years Cendant—resolved in 2000 for over $3 billion—remained a large outlier, in recent years giant settlements have become relatively more common. Nine of the top 10 settlements have occurred within the past four years, and three of them were resolved in 2008. In addition, the recent announcement of the UnitedHealth Group settlement of $895 million bumped Xerox Corp.’s 2008 tentative settlement of $750 million down to number 11 on the list.

**Most Settlements Are $10 Million or Less**
While large settlements continue to dominate the headlines and skew average values, most securities class action cases settle for much smaller amounts. In 2006, 2007, and 2008, over 50% of cases settled for less than $10 million—in 2008, nearly 70% of settlements fell into this category. Eighty-seven percent of all 2008 settlements have resolved for less than $20 million.
Table 2. Top 10 Shareholder Class Action Settlements

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Company</th>
<th>Settlement Year</th>
<th>Settlement Value ($MM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Enron Corp. *</td>
<td>2008</td>
<td>$7,242</td>
</tr>
<tr>
<td>2</td>
<td>WorldCom, Inc. **</td>
<td>2005</td>
<td>6,158</td>
</tr>
<tr>
<td>3</td>
<td>Cendant Corp.***</td>
<td>2000</td>
<td>3,561</td>
</tr>
<tr>
<td>4</td>
<td>Tyco International, Ltd.****</td>
<td>2007</td>
<td>3,200</td>
</tr>
<tr>
<td>5</td>
<td>AOL Time Warner Inc.</td>
<td>2006</td>
<td>2,650</td>
</tr>
<tr>
<td>6</td>
<td>Nortel Networks (I)</td>
<td>2006</td>
<td>1,143</td>
</tr>
<tr>
<td>7</td>
<td>Royal Ahold, NV</td>
<td>2006</td>
<td>1,100</td>
</tr>
<tr>
<td>8</td>
<td>Nortel Networks (II)</td>
<td>2006</td>
<td>1,074</td>
</tr>
<tr>
<td>9</td>
<td>Mckesson HBOC Inc.</td>
<td>2008</td>
<td>1,033</td>
</tr>
<tr>
<td>10</td>
<td>UnitedHealth Group *****</td>
<td>2008</td>
<td>895</td>
</tr>
</tbody>
</table>

* This settlement includes seven partial settlements and one tentative partial settlement.
** The settlement value incorporates a $1.6 million settlement in the MCI WorldCom TARGETS case.
*** The settlement value incorporates a $374 million settlement in the Cendant PRIDES cases.
**** This settlement is a partial settlement.
***** This settlement is a tentative partial settlement.

Note that for this summary table only, tentative and partial settlements are included for comparison, and “Settlement Year” in this table represent the year in which the last settlement—whether tentative or final—was announced.

Figure 18. Distribution of Settlement Values (SMM)
January 1, 2006 - June 30, 2008
No Increase in Median Settlement in 2008

Given the skewed distribution of settlement values, the median may be a more useful indicator of general trends in settlements than the average. In 2008, 50% of the settlements were for less than $6.2 million and 50% were for more.

While there was a fairly steady increase in median settlement values from $3.9 million in 1996 to $9.4 million in 2007, the median fell sharply in the first half of 2008 to $6.2 million, the lowest since 2004.

What Drives Settlement Values?

Investor Losses and Settlement Trends

NERA has examined the relationship between settlement size and various case attributes for cases filed since the passage of the PSLRA. We find that investor losses, which can be calculated using publicly available data, historically have been the single most powerful determinant of settlements, explaining approximately 50% of their variation, controlling for other characteristics of the case.

While investor losses are strongly correlated with settlement amounts, the two do not move together at a one-to-one ratio. Instead, as investor losses increase, settlements increase at a much lower rate: a 1.0% increase in investor losses results in an approximately 0.4% increase in the size of the expected settlement, other factors being held constant.

Another way to look at the relationship between investor losses and settlement values is to compare the ratio of the latter to the former for cases with losses of different amounts. Thus, holding all other case characteristics constant, at their respective means, a case with investor losses of $100 million is expected to have a settlement that is around $5.1 million, or 5.1% of investor losses. A case with $1 billion in investor losses is expected to settle for $12 million, only 1.2% of losses.

19 Investor losses are measured by comparing a company’s return to the return on the S&P 500 over the class period, and by using the proportional decay trading model to estimate the number of affected shares of common stock. We use investor losses as a crude proxy for plaintiffs style damages. The relationship between settlement values and investor losses is estimated in logs.

20 This relationship between investor losses and settlements is based on NERA’s settlement prediction model, controlling for other case characteristics and overall price inflation. This model explains almost 64% of the variation in settlements, across almost 800 cases filed after January 1, 1996 and settled through June 30, 2008.
As Investor Losses Rise, Expected Settlements as a Percent of Those Losses Decline

Expected Settlement as a % of Investor Losses

Investor Losses ($MM)

Figure 21. Expected Settlement Rises More Slowly Than Investor Losses

Investor Loss $100 MM
Expected Settlement $ 5.1 MM (5.1%)

Investor Loss $300 MM
Expected Settlement $ 7.5 MM (2.5%)

Investor Loss $1,000 MM
Expected Settlement $ 11.5 MM (1.2%)

Predicted Settlement ($MM)

Investor Losses ($MM)
Trends in Investor Losses

Over the last 12 years, there has been a substantial upward trend in the median investor losses. For cases settled in 1996, median losses were $66 million; since 2004, median losses for cases settled have been more than four times that amount. See Figure 22.

Because settlement values have not increased as dramatically as investor losses post-PSLRA (compare Figure 19 to Figure 22), the median annual ratio of settlement size to investor losses has fallen from 7.1% in 1996 to the 2.2% to 3.2% range since 2002. See Figure 23.

Figure 22. Median Investor Losses (SMM) by Settlement Year
January 1, 1996 - June 30, 2008
**Other Factors Affecting Settlement Size**

While investor losses are the most important factor affecting settlement values, other case characteristics are correlated with settlement amount as well. All the sensitivity measures described below are calculated controlling for other characteristics of the suit and consumer price inflation.

Settlement values rise dramatically with the inclusion in a settlement of securities other than common stock (bonds or options, for example). Because our measure of investor losses is based on common stock only, losses claimed by investors in other securities can be expected to drive up settlement amounts.

Settlements increase with the potential depth of defendants’ pockets. For each 1.0% increase in the defendant company’s market capitalization on the day after the end of the class period, the settlement is expected to increase by 0.2%. Additionally, if the defendant firm has declared bankruptcy or has a stock price of less than $1.00 per share at the time of settlement, the settlement is expected to be approximately 20% lower. The involvement of professional firms as co-defendants can lead to larger settlements. Cases with an accounting firm as a co-defendant are associated with settlements that are almost two times larger than otherwise.

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*Figure 23. Median Investor Losses and Median Ratio of Settlement to Investor Losses January 1, 1996 - June 30, 2008*
Having an accounting firm as a co-defendant is not the only way that accounting issues may increase settlements. The mere existence of allegations concerning accounting improprieties is associated with an increase in settlement size of approximately 20%. If the defendant company has admitted to accounting irregularities related to the allegations in the complaint, the settlement increases by more than 70%.

We find that cases with any kind of official investigation, consent decree or penalty settle for approximately 20% more than cases without any official action. This includes any announced investigation by any official body (the SEC, the New York Attorney General’s Office, etc.) relevant to the allegations in the complaint. Although many such investigations result in no finding of fault, this broad measure of official action has greater predictive power for settlements than does a measure that considers only cases where there was some finding of fault.

Cases with an institutional investor serving as lead plaintiff settle for approximately one-third more, other things being equal, than cases without such a lead plaintiff. It is impossible to judge whether this correlation reflects the actions of the lead plaintiff or the nature of the cases in which institutions choose to serve as lead plaintiffs. It could be that institutional lead plaintiffs retain more effective counsel, supervise counsel more effectively or provide an independent contribution to the plaintiffs’ strategy. Alternatively, it could be that institutional investors choose to become involved in cases where the allegations have greater merit or the defendants’ capacity to pay is greater. This would only be true to the extent that the merit or capacity to pay is not fully captured by other variables in the statistical model.

Settlements increase by approximately one-third if an IPO is involved, all else equal. Such cases often involve Section 11 claims, which have a lower burden of proof for plaintiffs than do 10b-5 claims.

Conclusion

2008 and Beyond: Where are Filings and Settlements Headed?

Over the past year, filings have increased, led by the surge in subprime cases—a trend that has yet to show signs of waning. What will the settlements look like for these recently filed cases? As a preliminary indication, we estimated median investor losses for cases filed from 2005 through 2008, and compared these to the median losses for cases settled over this same time period.

Over the last few years, median losses for cases settled have come down slightly, fluctuating around $350 million. But for cases filed over the same period, there has been a sharp increase in median investor losses, up to over $400 million in 2007 and over $800 million so far in 2008. See Figure 24.

Taking a closer look at the 2008 filings, we broke the data into two categories: subprime and other cases. See Figure 25. For the non-subprime cases, 2008 median investor losses are in the same range as the losses for recently settled cases. For subprime cases, on the other hand, the investor losses are much higher: the median investor loss—the case at the 50th percentile—for a subprime filing in 2008 is nearly $4.5 billion. Investor losses for some of the largest subprime cases filed in 2008 reach well over $10 billion.

Clearly, there are many other factors that explain the variation in settlement values besides investor losses. In addition, recent filings may be different from settled cases in other dimensions, so that any direct comparison of losses between settlements and filings should be viewed with caution. Even with these caveats, however, based on the size of the investor losses, the preliminary indication is that settlements associated with subprime cases may be well above current median settlement levels.
For subprime cases... the investor losses are much higher: the median investor loss for a subprime filing in 2008 is nearly $4.5 billion.
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