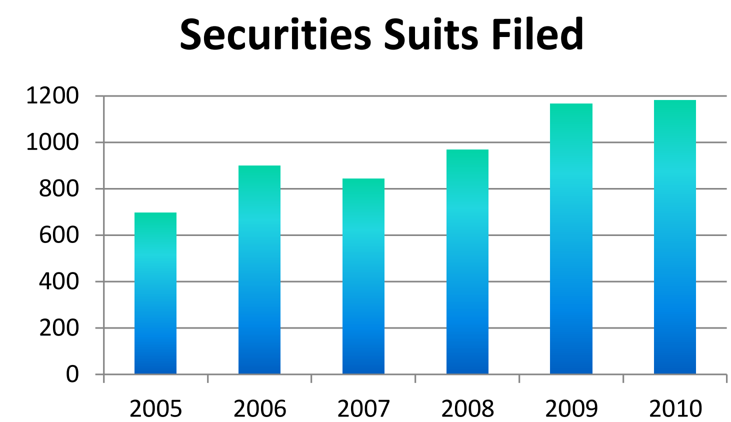
2010 a Record Year for Securities Litigation

An Advisen Quarterly Report – 2010 Review

Executive summary



With the credit crisis subdued, and the depths of Great Recession left behind, 2010 was a year of healing, albeit at a modest GDP growth-rate and scant jobs growth. The year saw credit crisis-related suits wind down and previously white-hot filings of Madoff-related cases cooled. After a light first quarter for new securities litigation filings, many expected 2010 to be a down-year before the next litigation-laden crisis. They were wrong. Activity began to pick up in the second quarter: the Deepwater Horizon oil spill brought a spate of suits, as did Goldman Sachs' much publicized synthetic collateralized debt obligations (CDO) incident. Even without an overarching scandal or economic crisis, litigators and plaintiffs nonetheless found ample reasons for new filings beyond these short-lived events as the year progressed, and 2010 came in at a record pace of 1196 lawsuits filed, eclipsing the credit crisis years.

This total for 2010 came in slightly higher than the 1171 suits filed in 2009, which was considered a blistering pace due to credit crisis- and Madoff-related filings. New filings for 2010 were also 24 percent higher than the previous high year of 2008, and 71 percent higher than the relatively calm 2005. The fourth quarter of 2010, coming off a record-setting third quarter, was down 17 percent from the previous quarter, dropping from 363 suits in Q3 to 301 suits in Q4. The fourth quarter was in line with an escalated second quarter, and 29 percent higher than Q1. On an annualized basis, Q4 2010 was similar to 2009, a record year prior to 2010. Furthermore, the average settlement value was at an all-time high in the fourth quarter, at $79 million.

As new filings of credit crisis- and Madoff-related suits wound down, securities class action suits slid to 16 percent of suits filed in 2010, and securities fraud cases were at pre-credit crisis levels. By the fourth quarter, securities fraud suits represented a mere 30 percent of all new filings, down from over 40 percent in 2009. Litigators moved onto breach of fiduciary duties suits as their mainstay, accounting for a third of all new suits in 2010, and nearly 40 percent in the fourth quarter. These suits are frequently brought by shareholders of an acquired company claiming that directors and officers accepted a "low-ball" bid. Although somewhat resurging M&A activities in the U.S. have contributed to this phenomenon, it appears the most significant driver is plaintiffs' attorneys seeking new revenue streams. Low company valuations in a tough economic environment, coupled with frugal buyers demanding value, have added fuel to the fire for shareholders feeling cheated.

Financial firms represented a smaller share of total filings for 2010, at 30 percent, down from around 40 percent the previous two years and close to half of all filings in certain quarters. The financial sector, however, held on stubbornly as the leading sector thanks largely to troubled banks. New lawsuits were more evenly dispersed among other sectors such as information technology and healthcare. Credit crisis- and Madoff-related suits did continue in importance as their aftermath lives on in settlements, with some sizable sums resulting from these lawsuits in 2010.

Newly U.S.-listed firms from China found a negative consequence of listing on U.S. exchanges beyond increased regulatory scrutiny: the litigious U.S. court system. As the number of China-based firms listed on U.S. exchanges increases, so do lawsuits from shareholders. Also related to globalization, 2010 saw a notable increase in enforcement actions by the Securities and Exchange Commission (SEC) and Department of Justice (DOJ) for violations of the Foreign Corrupt Practices Act (FCPA). The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) may bring a significant, though at this point unquantifiable, impact on securities litigation, though some analysts say its effect will be limited.

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, such as securities fraud, breach of fiduciary duties, derivative actions, collective actions and Ponzi scheme cases, among others.

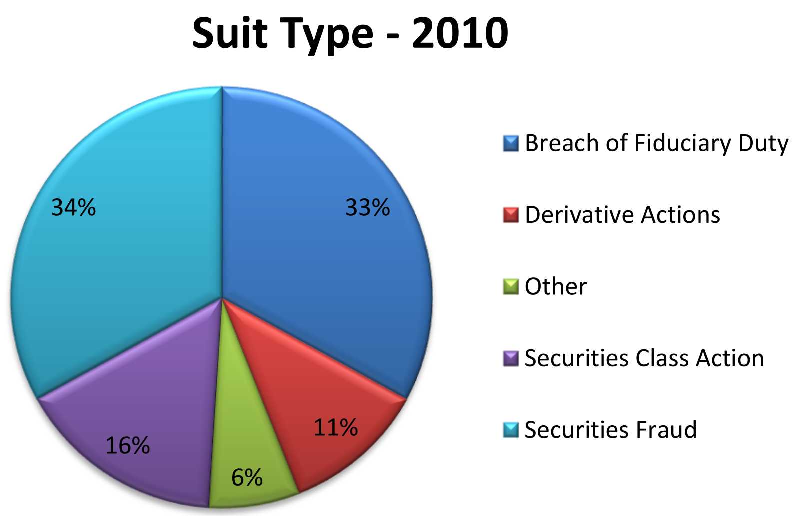
Several analytic firms publish tallies of securities class action suits filed, but rarely do these tallies agree. In addition to the broad array of securities suits other than securities class actions that Advisen covers, another issue is the way events are counted. In some cases, multiple companies (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 securities class action suits filed in state courts in its securities class action tally.

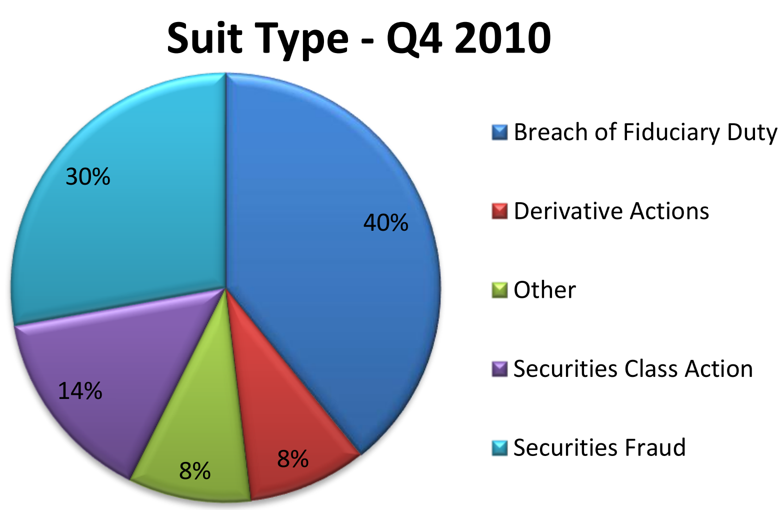
The specific definition of each type of suit can vary as well, resulting in different lawsuit tallies. Advisen defines the major types of suits in this report as follows:

- **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 charging violations of securities fraud laws filed by regulators or law enforcement agencies. They also include 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 suit filings for 2010 were higher than 2009: 1196 versus 1171. This compares to 965 suits filed in 2008 and 845 in 2007. For Q4 2010, the 301 suits filed were at an annualized rate of 1204 suits, in line with the elevated 2009. Before the credit crisis, new filings averaged about 800 per year.





The number of new securities class action suits filed in 2010 was down from 233 suits in 2009 to 193, as this type of suit continued to represent a smaller percentage of all securities suits filed than in years past. 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. The percentage dropped to 20 percent of all securities suits in 2009 and 16 percent of the total in 2010, including 14 percent for the fourth quarter. Over 80 percent of securities class action suits in Q4 named companies from four sectors, and their directors and officers, as defendants. The four sectors were: consumer discretionary, financial, healthcare, and information technology.

The number of new securities fraud suits, a category defined by Advisen to be comprised principally of suits by regulators and law enforcement agencies, led all categories but was down in 2010: 405 versus 479 in 2009, and 4Q 2010 was at an annualized rate of 364. As a percentage of total securities suits filed, securities fraud suits accounted for 34 percent of the total 2010, and just 30 percent in the fourth quarter, which is down from 41 percent in 2009 when regulators became more active 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 as well, accounting for 43 percent of the total. Information technology, healthcare, and consumer discretionary firms and their directors and officers each accounted for 10 percent of securities fraud suit filings in the quarter.

The second largest number of suits for the full year occurred in the breach of fiduciary duties category, accounting for 398 suits in 2010, or about a third of all securities suits filed during the year.

By the fourth quarter, the category passed securities fraud as the leading type of securities suit filed, with 120 suits, at a 480 annualized rate. Over 55 percent of these suits were filed in state courts in the fourth quarter. 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 40 percent in Q4 2010.

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. They often are filed in the wake of a merger or an acquisition by shareholders of the acquired company who believe the directors did not obtain an adequate price. Breach of fiduciary duties suits were broadly distributed among industry groups in the fourth quarter, with information technology companies, at 27 percent, representing the highest concentration of suits, followed by industrials at 18 percent, and healthcare and financial firms each at 12 percent.

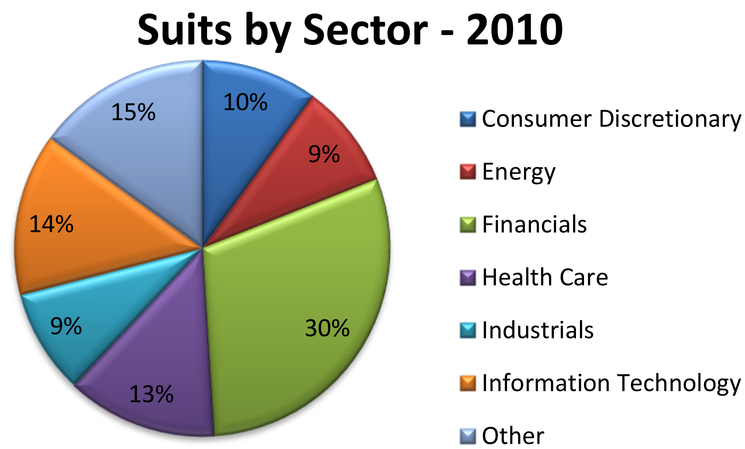
The year saw a 39 percent increase in derivative action (brought by shareholders on behalf of the corporation) filings: 129 suits were filed in 2010 as compared to 93 in 2009. This represents 11 percent of all securities suit filings in 2010, with the fourth quarter at 8 percent. The second and third quarters saw higher activity in derivative actions, at 12 percent and 13 percent, respectively, of total new suits. The increase in those quarters was due largely to suits filed against directors and officers of companies in the energy industry, and primarily were triggered by the Deepwater Horizon oil spill. Many were filed by BP shareholders. In Q4 2010, the numbers were more distributed, with the healthcare sector representing about a quarter of all new suits filed, and the consumer discretionary sector at 21 percent.

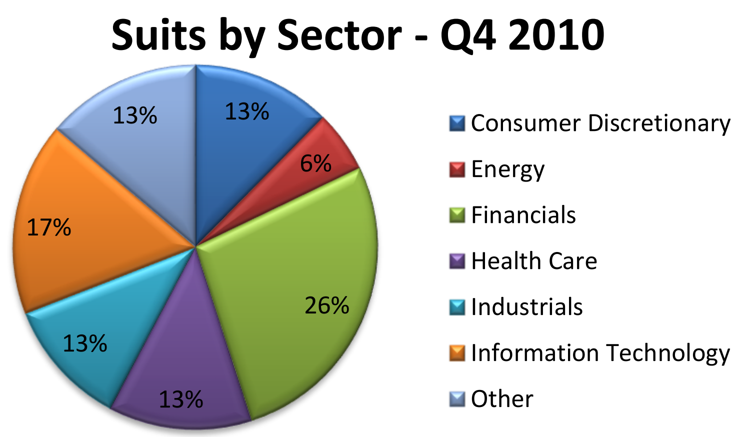
Jurisdiction. By jurisdiction, 28 percent of securities suits were filed in state courts in 2010, and 25 percent in the fourth quarter. In the fourth quarter, about 10 percent were filed in the traditional stronghold of federal securities litigation, the United States District Court, Southern District, New York. This district saw less activity compared to the past two years due to the falloff in credit crisis- and Madoff-related suits, as fewer suits were filed against financial companies with headquarters in the district. Three percent were filed in courts outside the U.S. for both Q4 and all of 2010.

Court for Q4 2010 Filings	% Total
State	25%
California Federal Districts	11%
U.S. District Court, Southern District, New York	10%
Florida Federal Districts	7%
Massachusetts Federal Districts	6%
Illinois Federal Districts	4%
Texas Federal Districts	4%
Nevada Federal Districts	3%
Non-U.S. Courts	3%

Suits alleging breach of fiduciary duties, by a wide margin, were the type of suit most likely to be filed in state courts. None of the securities class action suits filed in the fourth quarter were filed in state courts. 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 about 40 percent of securities suits filed in 2008 and 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 32 percent in the first quarter of 2010, but saw an uptick in the second quarter as financial firms and their directors and officers were named in 37 percent of securities suits filed. The third quarter brought about the continued decline of securities suits filed against financial firms and their directors and officers, down to 27 percent, and the percentage fell slightly more in the fourth quarter to 26 percent. Overall, securities suits filed against financial firms for 2010 was 30 percent of total suits filed.

The number of suits filed was much more broadly dispersed in 2010 than in the recent past, with information technology (14 percent) and healthcare companies (13 percent) coming in a close second and third. Despite the demise of credit crisis- and Madoff-related suits, however, the financial sector held onto a substantial lead in number of new securities suits filed. Jim Pittinger, Vice President of Financial Lines for Starr Indemnity & Liability Company, notes that financial firms are historically more volatile on both the upside and downside of markets. "The significant downward swings in their results are often due to industry-wide contagion events, making it easy to bring almost exactly the same lawsuit against many defendants with – plaintiffs' attorneys hope – significant rewards for them," explains Mr. Pittinger.

Many companies involved in capital markets continued to attract the attention of plaintiffs' attorneys, and they remain a target for regulatory scrutiny, which in turn attracts suits. Furthermore, suits against troubled banks are on the rise: 25 securities suits in Q4 2010 and 20 in Q3, as compared to eight in Q1. The fourth quarter saw the highest number of securities suits filed against banks since Q1 2009, in the aftermath of the stock market meltdown due to the credit crisis. Most of the activity in 2009 was from shareholders, and mostly not for failed banks.

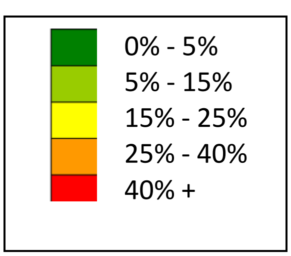
The Federal Deposit Insurance Corporation (FDIC) recently announced that it has authorized lawsuits against 109 directors and officers of failed banks in an attempt to recover $2.5 billion. This is a clear sign that the financial sector will remain in the forefront of securities litigation activity. FDIC suits almost certainly will spark private actions against the same directors and officers. Many of these suits, both FDIC and private actions, could be dismissed if judges conclude that these suits were a result of poor judgment, which does not necessarily mean that rules have been violated. Pittinger remarks "The FDIC is under a lot of pressure to get some recoveries, hence it's advertising that it will bring these suits. We think this is an attempt to scare bank executive defendants in order to get settlements, as the FDIC may have some concerns about the strength of its cases."

Historically, a large portion of cases against financial firms involve regulatory actions such as suits brought by the SEC. The fourth quarter was no exception: 47 percent of all cases filed against financial firms and their directors and officers were securities fraud cases. Securities class actions suits are also common for these firms, but were down from previous quarters and years, with 13 percent of these suits filed in the fourth quarter naming financial firms. Breach of fiduciary duties suits, for duties to both shareholders and clients, accounted for 18 percent, which brought some suits to state courts for these firms. Suits related to proxies and solicitations represented 12 percent.

Lawsuits filed against the directors and officers of information technology firms had a much greater presence in state courts, as breach of fiduciary duties cases dominated at 62 percent. The remainder for these firms was securities fraud suits at 16 percent, and securities class actions at 10 percent. The directors and officers of healthcare companies saw their own mix of filings, with breach of fiduciary duties at 38 percent, securities class actions and securities fraud each at 22 percent, and derivative actions at 19 percent. Healthcare providers, pharmaceutical companies and biotechnology companies were hit hardest within this sector.

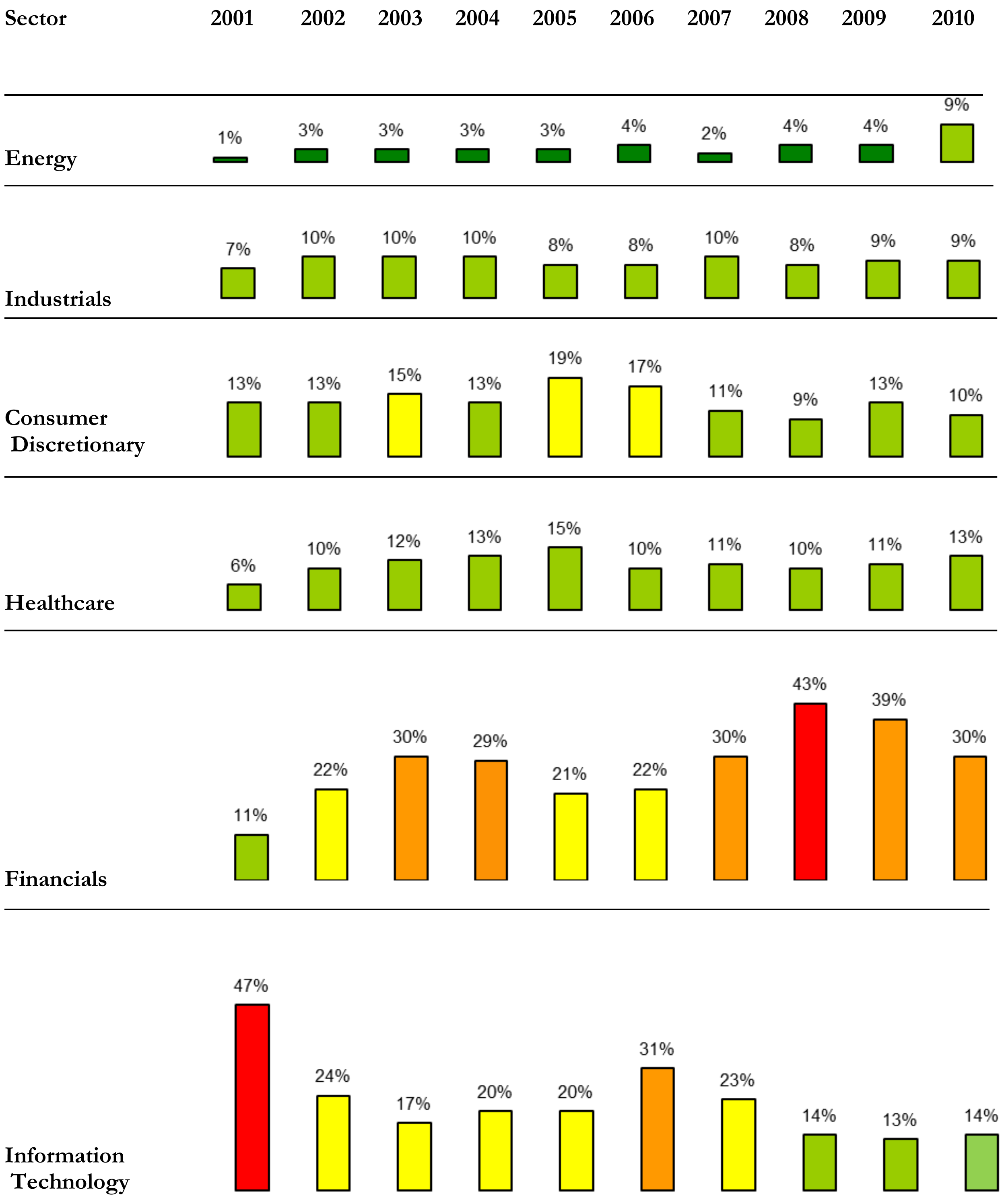
At 10 percent of all securities suits filed during 2010 was the consumer discretionary sector, where for-profit educational services reside. Five of its industry leaders were struck with securities class action lawsuits, alleging improper recruiting practices. These included suits filed against American Public Education, Apollo Group, Corinthian Colleges, Education Management Corporation, and Lincoln Educational Services.

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 is looming on the horizon as suits against financial companies begin to fall off. Perhaps this scenario has begun to play out in the third quarter, when both sectors had nearly the same number of filings.



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: materials, consumer staples, telecommunications and utilities.

Settlements and awards

The average settlement value (including proposed and tentative settlements) of securities suits during 2010 rose from $29 million in 2009 to $37 million. The fourth quarter of 2010, a record quarter for settlements, saw the average settlement value rise to $79 million, up from $21 million in the third quarter. This record level was highly influenced by one settlement for $6.7 billion by Bank of America with the SEC. Without this one settlement, the fourth quarter would have had an average settlement of $30 million, remaining a relatively high quarter. Awarded amounts are included in these averages, though the vast majority of securities lawsuits are settled before going to trial.

Securities fraud was the type of suit having the highest settlement for the year, with Bank of America settling with the SEC for $6.7 billion in an auction-rate securities-related lawsuit, which included inherited incidences from Merrill Lynch. In another securities fraud case, Goldman Sachs settled with the SEC for $550 million, with $250 million returned to harmed investors and the remainder going to Uncle Sam. Goldman Sachs set up a synthetic CDO, investing in subprime residential mortgage-backed securities (RMBS) in early 2007. Paulson & Company, a hedge fund, was then allowed to select particular pieces of the investment vehicle portfolio, and then effectively shorted the vehicle by entering into credit-default swaps (CDS). This conflict of interest was unknown to the investors, and when the mortgage market dropped, Paulson & Co. made a handsome sum. Goldman Sachs benefited from fees paid by all parties. The average settlement for securities fraud cases in 2010 was $42 million.

Ponzi scheme securities lawsuits had the highest average settlement, $312 million, but consisted of merely four cases. One case was the second highest settlement of the year, as a Madoff feeder, Harley International, entered into a proposed settlement with claw-back-seeker Irving Picard for $1.07 billion. It is hard to see how much money, if any, will be collected from this settlement since the company is in bankruptcy in the Cayman Islands.

Securities class action suits had an average settlement amount of $32 million, and certain eye-popping settlements occurred in the year. In the largest, Bank of America Home Loans (formerly Countrywide Financial) tentatively settled a securities class action suit for $600 million. The settlement with shareholders addresses claims of false and misleading statements regarding the quality of its mortgage portfolio during the waning days of the credit bubble.

The average settlement for breach of fiduciary duties suits was $17 million. In one case, Canadian-based insurer The Great-West Life Assurance Company and its directors and officers were ordered to pay policyholders an award of $456 million for misappropriating their funds. In another breach of fiduciary duties lawsuit, an investment group that took pipeline operator Kinder Morgan private in 2006 tentatively settled with shareholders for $200 million. Three major back-dated option-related cases settled in the third quarter. Maxim Integrated Products, Juniper Networks, and Broadcom brought back memories of a pre-credit crisis scandal. The total settlement for the three cases was over half a billion dollars.

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 recent years, large monetary settlements have become increasingly common. The average settlement for the year was $11 million, significantly lower than the $89 million average in 2009. The 2009-average was disproportionately influenced by one derivative action suit in Q2 2009, which awarded almost $2.9 billion to shareholders derivatively on behalf of HealthSouth Corporation, against its former CEO Richard M. Scrushy. The third quarter of 2010, however, saw a $150 million proposed settlement from AIG's directors and officers, $60 million of which will be paid to former CEO

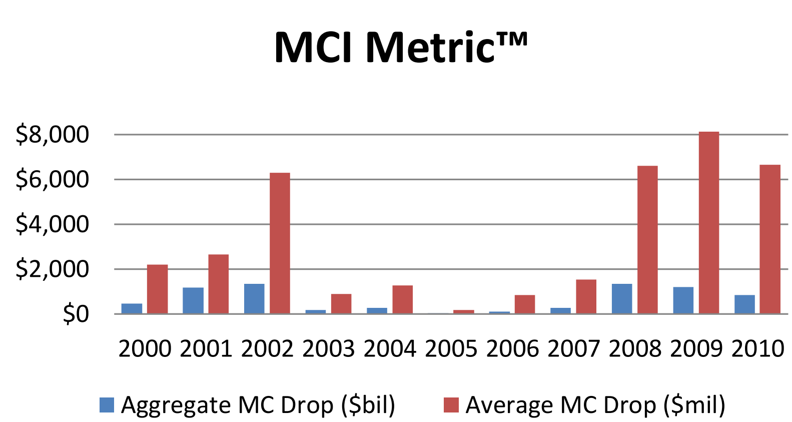
Hank Greenberg and former CFO Howard Smith to cover their legal fees. This case reinforces the trend of significant cash settlements of derivative actions.

Market Cap Impact Metric™ (MCI Metric™)

The Advisen MCI Metric™ projects potential damages under 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.

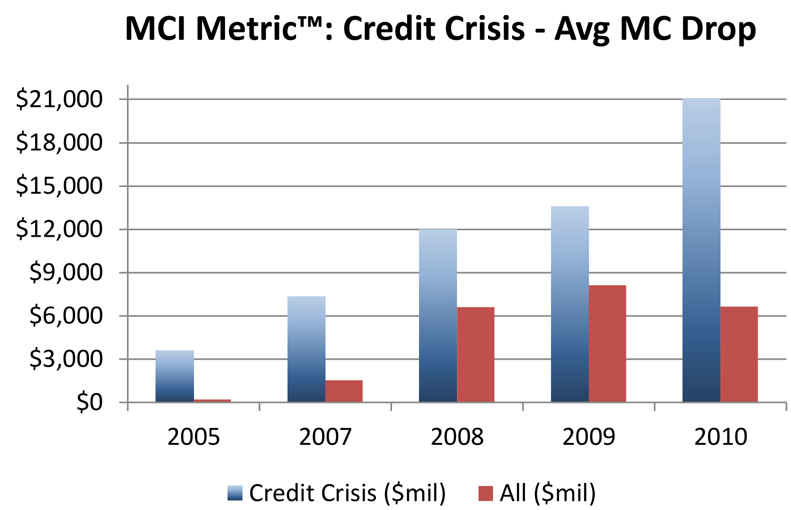
This projected market capitalization loss is calculated for most companies with a securities class action suit filed against them during each year of the past decade, with certain securities class action cases eliminated. Securities class action suits eliminated from the calculations are those whose 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.

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. Aggregate losses were $1.3 trillion in 2008 and $1.2 trillion in 2009. In 2010, aggregate losses remained elevated at $836 billion. The losses in 2008 and many in 2009 reflect that most of the class periods occurred during the large stock market losses of the past couple of years. Since the beginning of Q2 2009, however, stock markets have generally risen, yet the aggregate losses have remained high, 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 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 has fallen off considerably in 2010, the average drop per case has continued to climb. The average market capitalization drop for these suits rose from $12 billion in 2008, to $14 billion in 2009, and reached $21 billion in 2010.



Dodd-Frank Act goes beyond financial services

In July 2010, the Dodd-Frank Act was signed into law, which represents the largest overhaul of the U.S. financial regulatory structure since Depression-era regulations went into effect. It mostly deals with the financial services industry, such as banning any institution that could be bailed out by the Federal Reserve from operating trading accounts. It also regulates many previously unregulated derivative markets, and provides the Federal Reserve with the tools to unwind financial firms that are failing. The Act creates a Bureau of Consumer Financial Protection within the Federal Reserve, and the SEC will have an office of Investor Advocate, both of which will undoubtedly create more obstacles for financial firms to trip over and potentially lead to lawsuits.

Non-financial firms, however, also can get drawn into these regulations, as the new Financial Stability Oversight Council formed under the Act will have the ability to grant the Federal Reserve regulatory authority over any company that it considers a potentially significant threat to the financial system should it fail. Additionally, the Dodd-Frank Act governance requirements apply to public companies across all industries. Many of the requirements will increase the influence of shareholders in corporate governance matters, such as a non-binding "say-on-pay" vote. This vote on the compensation packages of executive officers will be held at the first shareholders meeting in 2011. It is likely to increase shareholder scrutiny of compensation-committee decisions and their independence.

Executive compensation issues loom large in the Act. In addition to the "say-on-pay" vote, the Act requires that the SEC prohibit securities exchanges from listing any company that does not disclose incentive-based compensation. The Act's incentive-based "clawback" provision, a provision that requires that compensation based on false financial data must be returned, expands beyond the remedy available in the Sarbanes-Oxley Act. The new "clawback" provision extends to all executive officers, and applies to all incentive-based compensation received for three years following filing erroneous financial information. It applies regardless of whether or not the executive officer had knowledge of the conduct that led to restatement of financial statements. The "clawback" provision under Sarbanes-Oxley included just the CEO and CFO, covered just one year of compensation, and "intent" needed to be proven.

Other governance changes include: new proxy access rules that the SEC now has the authority to adopt, heightened independence requirements for compensation committees, enhanced protections and incentives for corporate whistleblowers, new SEC authority to adopt rules increasing transparency of securities ownership, and disclosure requirements of certain corporate policies. The Act also beefed up funding for the SEC, and the SEC now plans to add another 800 employees, which likely will result in more rigorous investigations against public companies and their directors and officers. These new rules and an enhanced SEC might possibly lead to more suits from shareholders, regulatory bodies, and others, but they also might provide a clearer roadmap for companies to follow. Prudent and well-managed companies might find a solace in these rules, and fewer suits might follow.

Senators Dodd and Frank, as well as other contributors to the Act, were certainly also reacting to a recent Supreme Court decision. In *Morrison v. National Australia Bank*, the Supreme Court held that plaintiffs cannot pursue fraud claims under U.S. securities laws for securities purchased on foreign exchanges. The decision effectively put an end to so-called f-cubed cases – suits filed in the U.S. by foreign investors against foreign companies concerning shares bought on foreign exchanges. The Dodd-Frank Act provides broader federal court jurisdiction in certain actions brought by the SEC and DOJ relating to fraud sections of the Securities Act of 1933 and 1934, as well as the Investment Companies Act of 1940. The alleged fraud can involve conduct within the U.S. that constitutes "significant steps" in a violation, even if the securities transaction occurred outside of the U.S. and involves only foreign investors. Federal court jurisdiction is also established if the alleged fraudulent conduct occurred outside of the U.S. but has a foreseeable substantial effect within the U.S.

Does it matter? Many question whether the Dodd-Frank Act will have any impact on directors & officers (D&O) liability claims. Similar to the Sarbanes-Oxley (SOX) Act, it certainly will affect corporate governance best practices, especially for financial institutions. Certain industry observers claim, however, that it is unlikely to drive more D&O claims because no new D&O duties are established. On the other hand, the Dodd-Frank Act clarifies SEC and DOJ jurisdiction in federal courts for non-U.S. companies in a broad set of circumstances, possibly increasing the number of actions against directors and officers of non-U.S. companies. Furthermore, new whistleblower provisions in the Act, providing incentives for whistleblowers to tip off the SEC to wrongdoing, may result in more SEC actions against directors and officers. Finally, the funding for 800 additional SEC employees will mean more regulators lurking about.

Other securities litigation trends and developments

Changing landscape for securities class action suits. Securities class action suits as a percent of all securities suits have been declining since 2004, but they nonetheless remain a vital watermark for securities litigation trends. In addition to remaining one of the most commonly filed types of securities suits, securities class action suits typically produce most of the largest settlements, and often among the most expensive to defend. The average securities class action settlement in 2010 was $32 million, and these suits accounted for some of the largest settlements in 2010, including a

$600 million settlement by Bank of America Home Loan and a $235 million settlement by The Charles Schwab Corporation.

For 2010, 193 securities class action suits were filed, or 16 percent of all securities suits. This compares to 233 suits filed in 2009 and 240 in 2008. The average for 2004-2009 is 227. The decline in 2010 is due substantially to a sharp drop in credit crisis suits.

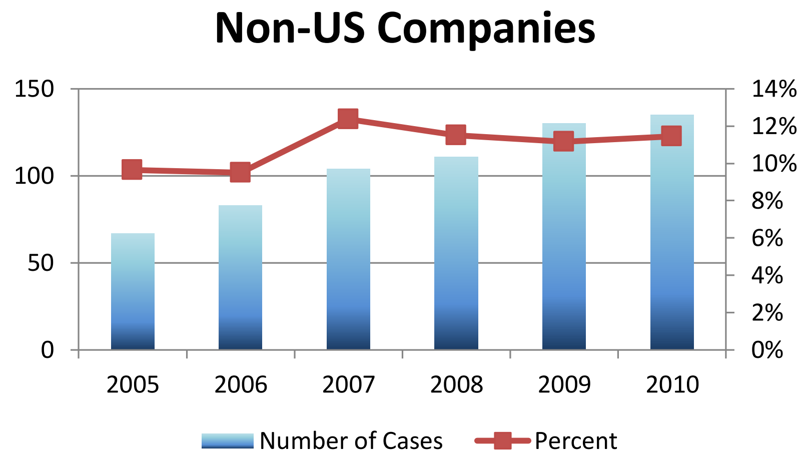
A high percentage of credit crisis suits were filed against financial firms. Although the number of new credit crisis suits has fallen dramatically, financial firms remain near the top for targets of choice for securities class action suits: 23 percent of securities class actions filed in both the third and fourth quarter of 2010 named financial companies and their directors and officers. However, this percentage is down from the majority of these suits in early-2009 and 35 percent from just Q2 2010, and was second to firms in the consumer discretionary sector at 26 percent in Q4 2010. As was true with overall securities suit filings, securities class action filings were much more broadly dispersed than in previous quarters and years.

The average time between the end of the class period and the date the suit is filed for securities class action suits increased substantially during credit crisis-filing years, from 72 days in 2006 to 94 in 2007, 123 in 2008 and 214 in 2009. Potentially large credit crisis suits commanded the attention of plaintiffs' attorneys during this period, so they likely searched as far back as possible for these types of cases, seeking other litigation opportunities. As the number of new credit crisis suits dwindled in 2009, attorneys turned their attention to the backlog of other types of securities class action suits. This phenomenon continued into 2010, with the average time between the end of the class period and the filing date increasing to 289 days by Q2 2010. The age of new suits, however, is on the decline, as the third and fourth quarters of 2010 saw a return closer to historically normal levels at 159 days and 118 days, respectively.

The 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 2010, Advisen recorded 36 securities suits filed in courts outside the U.S., in line with 2006-2008 totals. 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.

Securities suits against non-U.S. companies – both in the U.S. and elsewhere – have accounted for nearly 10 percent or more of total securities suits tracked by Advisen for most years since 2005. In 2010, 11.4 percent of securities suits were filed against non-U.S. companies, up slightly from 11.1 percent in 2009. 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.



The number of suits filed against non-US companies is likely to dip in the short-term, however, 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. The number of securities suits against non-U.S. firms almost certainly will continue to grow in the long-term, but in the aftermath of *Morrison*, and 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 against companies from China in U.S. courts mushroomed in 2010, and mostly after the *Morrison* decision: from four suits recorded by Advisen in 2009 to 21 in 2010, including six in the third quarter and 13 in the fourth quarter alone. These cases, however, are unrelated to *Morrison* 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. Most of these suits 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 any U.S. company must contend with differences between rules set by the Internal Revenue Service (IRS) and SEC, as well as potentially 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.

Bankruptcies, M&A and securities litigation. As a consequence of the global recession, corporate bankruptcies are skyrocketing. According to federal bankruptcy court records, for the twelve month period ending in September, the number of companies filing for bankruptcy skyrocketed 52 percent between 2008 and 2009, and remained at essentially the same elevated level in 2010. Although there has not been the surge in bankruptcy-related securities lawsuits predicted by some analysts, that type of suit has been on the increase.

Advisen research has shown that the conditions that lead to a bankruptcy can be the catalyst for a securities class action suit long before the company files for bankruptcy. For that reason, bankruptcy has been a factor in more cases than the numbers suggest. Viewed another way, companies that have been named in securities class action suits during the past 18 months have a much higher than average probability of filing for bankruptcy in 2011.

As the economy recovers, M&A activity will likely increase, and increased somewhat in the U.S. in 2010, leading to more securities suits, especially breach of fiduciary duties suits. Breach of fiduciary duties suits often are filed by disgruntled shareholders of an acquired company, alleging the company's directors and officers sold the firm too cheaply. Historically, M&A activity falls sharply during a recession, and the recent economic downturn was no exception. However, as recovery accelerates and credit markets are revitalized, M&A activity will increase, driven in part by fire sales of companies damaged by the recession and divestitures to raise sorely needed cash.

Despite only a moderate rise in U.S. M&A activity in 2010, and a lull in these activities the previous two years, breach of fiduciary duties suits have been increasing in number during recent years. Plaintiff's attorneys appear to have sought out new revenue opportunities in favorable state-court forums. Jim Pittinger feels that plaintiffs' attorneys have caught onto the "easy money" that prosecuting these cases have become. He exclaims, "Defendants have been settling too many of these suits in order to not hold up the underlying transaction. It's easy to lose a payoff in the hundreds of thousands, or even low millions, of dollars for plaintiffs' attorneys' 'fees' when you have a deal in the billions or tens-of-billions with fees already in the multimillions for assorted lawyers, underwriters, etc." As M&A activity accelerates, the volume of breach of fiduciary duties suits is likely to grow at an even faster pace.

A trend observed over the past year has been an increase in the number of these suit-types filed against the same company for the same triggering event. For example, Aon's acquisition of Hewitt Associates, a human resources outsourcing services firm, attracted four breach of fiduciary duties lawsuits in the third quarter, three of which were filed in state courts. These suits surfaced despite that the price accepted was a 41-percent premium over Hewitt's closing price before the announcement. It is also important to note that a revival of public securities offering activities, such as IPOs, could lead to significant potential liability for corporations and their directors and officers.

Resurgent regulators. Since the credit crisis, and the ensuing political storm, regulatory authorities have stepped up enforcement efforts, beefed up enforcement teams, and began coordinating efforts. The SEC, DOJ and state enforcement officers like attorneys general are more likely than ever to coordinate investigations, sharing evidence and information, making successful prosecution at all levels more likely. The Federal Bureau of Investigations (FBI) is stationing an agent in the SEC's Office of Market Intelligence in order to monitor financial fraud and increase cooperation between the agencies. U.S. regulators and enforcement agencies have also coordinated their efforts with regulatory entities in the EU and elsewhere, and most notably with the UK's Financial Services Authority. These parallel proceedings have contributed to spiraling defense costs, even in cases with no wrongdoing.

The SEC is becoming more proactive and more aggressive in light of recent not-so-stellar events that exposed an image of the SEC as asleep at the wheel. The agency has realigned staff and divisions and moved more authority to the field. The fiscal 2011 budget (began October 2010) calls for 400 additional full-time equivalent employees. The Dodd-Frank Act provides funding for an additional 800 employees and much enhanced SEC authority. The new Republican majority in the House, however, may delay implementation by stalling funding bills.

A prominent area where the SEC and DOJ have become more active is with proceedings related to violations of the U.S. Foreign Corrupt Practices Act (FCPA), a three-decades-old international business anti-corruption law. As globalization meets the era of heightened regulatory scrutiny, these enforcement actions are likely to continue growing. As with any SEC action, enforcement of the FCPA is directly tied to, and is often a driver of, other securities lawsuits, such as securities class action suits and derivative actions. These suits will often allege a waste of corporate assets due to FCPA fines and penalties, as well as the failure to have proper corporate governance safeguards to prevent the violations.

This new era of enforcement has been highlighted by industry-wide sweeps and international regulatory cooperation. For example, the energy sector and those serving it saw many actions taken against it in Q4 2010. Off-shore oil driller Pride International will pay $56.2 million to both the SEC and DOJ for drilling rights off Venezuela, India, Mexico, Kazakhstan, Nigeria, Saudi Arabia, Libya, and the Republic of the Congo. Freight forwarder for energy sector companies Panalpina settled with the SEC and DOJ for $81.9 million for international dealings in Brazil, Russia, and other developing countries. Others related to the energy industry with FCPA penalties in Q4 2010 included offshore marine services company Tidewater ($16 million), offshore driller Noble Corporation ($8 million), and electronics systems maker for the energy and chemicals sector RAE Systems ($1.3 million). The telecommunications sector also took a hit, as Alcatel-Lucent settled with the SEC for $45.4 million and with the DOJ for a criminal fine of $92 million, for telecommunications contracts obtained in Costa Rica.

Cooperation initiative. In January 2010, the SEC threw a curveball at corporate executives and their insurers. The Commission announced a set of tools as part of its new cooperation initiative. These tools, used by the DOJ in criminal proceeding for years, authorize the SEC Enforcement Division to provide limited immunity to many cooperating parties. The three tools include: cooperation agreements; deferred prosecution agreements; and non-prosecution agreements. Cooperation agreements are written agreements that the Enforcement Division could offer to cooperators who provide substantial assistance and agree to cooperate fully. The cooperator must waive statutes of limitation, but does not need to admit or deny any violations. The Division would then recommend to the SEC that the cooperator receive credit for assisting in the investigation, but it is not binding on the SEC.

Deferred prosecution agreements are also written agreements to cooperate fully. The cooperator would agree to either admit or not contest relevant facts underlying the alleged offenses, and to pay disgorgement and penalties. The SEC would agree to forego prosecution during a period of time, not to exceed five years. After the deferred period, the SEC could authorize enforcement, and any admission of facts could be used against the cooperator. Non-prosecution agreements are written agreements with those cooperating fully, where the SEC agrees not to pursue enforcement action against the cooperator. This agreement will be used under “limited and appropriate circumstances,” and the cooperator would agree to pay disgorgements and penalties.

Most assume that more cooperation will result from this initiative, but the degree of cooperation will depend on the details of the agreements. In March, the SEC announced a possible policy change that would work against the tide of cooperation. The SEC might end its long-standing practice not disclosing many details of evidence from cases where companies and individuals cooperated. These details could reveal facts that would prevent indemnification from insurance policies, and possibly open the floodgates to securities class actions and other lawsuits using these facts as a basis for their cases.

Cooperation initiatives could help to lower defense costs and lower insurance policy payments if most officers agree to cooperate – but it also could increase overall defense costs depending on the dynamics of the case for a given company. A change in disclosure policies would make it less likely for officers to cooperate for fear that embarrassing and incriminating evidence would be released. It would at least delay cooperation to ensure that the increased number of facts is reasonably stated, prolonging negotiations with the SEC.

Any agreement that admits to liability could very possibly void coverage of defense costs for most D&O insurance policies. Furthermore, depending on the terms of the policy, if one director does something to void coverage, it creates the danger of voiding coverage for all directors and officers, placing the company and all officers at risk. Looking at the specific restrictive provisions in policies becomes essential when agreeing to cooperation – a review that is best done well before there is any threat of a claim.

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.

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