SUMMER 2017
riskINSIGHTS

First Half 2017 Securities Suit Filings Continue at Exceptional Levels

Largely as a result of the continuing upsurge in the number of federal court merger objection lawsuits, securities class action lawsuits were filed at historic levels during the first half of 2017 and well above last year's elevated pace. Though the number of filings in this year's second quarter were slightly lower than in the first quarter, the total number of filings in the first six months of the year overall were on pace for the highest annual number of securities class action lawsuits since 2001.

THE NUMBER OF FIRST HALF SECURITIES SUIT FILINGS

There were a total of 225 securities class action lawsuit filed in the first half of 2017, which projects to a year-end total of 450 securities class action lawsuits. This projected year-end total, if realized, would represent the highest number of securities class action lawsuit filings since 2001, when the filing numbers (498) were inflated by a flood of IPO laddering suits. A year-end total of 450 securities suit filings would far exceed the 272 securities suit filings in 2016, which was itself an exceptionally high annual number of securities suit filings. 450 securities suit filings would also be more than double the 1996-2015 annual average number of filings of 188. Indeed, the 225 filings in the first half of 2017 are already nearly 20% greater than the 1996-2015 full-year average.

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There were 132 traditional securities class action lawsuit filings in the first half of the year, which implies 264 traditional securities class action lawsuits by year end.

THE CONTINUED UPSURGE IN MERGER OBJECTION LAWSUIT FILINGS

A significant factor in the number of securities class action lawsuit filings in the first six months of the year was the number of merger objection lawsuits filed as class actions in federal court and alleging violations of the federal securities laws. There were 93 federal court merger objection lawsuit filings in the first half of 2017, representing 41% of all first half securities suit filings. The merger objection suits represented 48% of all securities suit filings in the just-completed second quarter.

The flood of merger objection lawsuit filings seems to be increasing. The 93 federal court merger objection lawsuits filed in just the first six months of 2017 already is more than the 80 federal court merger objection lawsuit filed in all of 2016.

The surge in the number of federal court merger objection lawsuit filings is a direct result of a series of Delaware state court rulings, culminating in the January 2016 ruling in the *Trulia* case, in which a series of Delaware judges evinced their hostility to the type of disclosure only settlements that frequently characterize the resolution of merger objection lawsuits. As a result of the unfavorable climate in the Delaware courts, the plaintiffs' lawyers have shifted their filings of many of these suits to federal court.

THE NUMBER OF TRADITIONAL SECURITIES CLASS ACTION LAWSUIT FILINGS

Even if the merger objection lawsuit filings are disregarded, the number of securities class action lawsuit filings in the first half was at elevated levels. There were 132 traditional securities class action lawsuit filings in the first half of the year, which implies 264 traditional securities class action lawsuits by year end. While that projected figure is slightly below last year's total of 272 securities suit filings, last year's filing totals also were inflated by 80 merger objection suits. This year's projected 264 traditional securities suits, if realized by year end , would far exceed the 192 traditional securities suit filings in 2016 and would exceed the annual number of securities suit filings in every year since 2002.

THE QUARTER TO QUARTER FILING PACE

The filing pace did slow slightly during the second quarter. There were 125 securities suit filings (inclusive of the merger objection suits) during the first quarter, while there were 100 in the second quarter (again including the merger suits). Most of the second quarter filing slowdown took place in April. There were a total of 44 securities suits filed in March; the number of filings in April fell by half to 22. The drop off of filings in April accounts for almost all of the difference in the number of filings between the first quarter and the second quarter.

SEMIANNUAL FILINGS LEVELS

Despite the slight slowing in this year's second quarter, the 225 first half securities suit filings far exceeds the number of securities suits filed in any half year period since 1996. During the period 1996-2016, the semiannual period with the highest number of securities suit filings was the second half of 2016, when there were 148 filings. In other words, the number of filings in the first half of 2017 is 52% greater than the previous semiannual period with the highest number of securities suit filings. The first half filings were also far greater than the long-term semiannual filing average. The average semiannual number of securities suit filings for the period 1996-2015 is 94. The 225 first half filings is nearly two and a half times greater than this long term semiannual average.

These observations about the semiannual levels of filings are largely unchanged even if the merger objection suits are disregarded. The 132 traditional securities suits in the first half of 2017 far exceeds the highest number of traditional lawsuit filings in any prior semiannual period. Before this year, the semiannual period with the highest number of traditional securities suit filings was the first half of 2016, when there were 95 traditional securities suits filed. There were about 38% more traditional securities suit filings in the first six months of 2017 than any prior semiannual period.

THE RATE OF LITIGATION

It is not just the sheer number of securities suits filed in the first half of 2017 that is noteworthy; the *rate* of litigation is arguably even more striking. According to Cornerstone Research (here, page 10), there were 4,593 U.S.-listed companies at the end of 2016. If we project a total of 450 securities suits by year end 2017, that would imply that a litigation rate of 9.53%, far exceeding 2016 record setting litigation rate of 5.6%. Even if the merger objection litigation suits are disregard and we use instead a projected year-end 2017 total of 264 traditional lawsuits, that would imply a traditional lawsuit litigation rate of 5.74%, which again would far exceed the 2016 litigation rate for traditional lawsuits of 3.9%. This implied litigation rate for traditional filings is more than double the 1997-2015 average annual litigation rate for traditional securities lawsuits of 2.8%.

FILINGS BY INDUSTRY

One of the important ways to try to understand the first half 2017 securities suit filings is to take a look at the industries of the companies that were hit. The first-half 2017 securities class action lawsuit filings hit companies across a broad range of industries. The 225 securities class action lawsuit filings during the year's first six months hit companies in a total of 85 Standard Industrial Classification (SIC) codes.

As has been the case for many years, companies in the life sciences experienced the highest number of securities suit filings in the 2017's first half. The 2834 SIC Code category (Pharmaceutical Preparations), with 35 securities suit filings, had the highest number of any single SIC code category. The 283 SIC code industry group (Drugs), which includes — in addition to the 2834 category — the 2833 SIC Code category (Medical Chemicals and Botanical Products) and the 2836 SIC Code category (Biological Products), collectively had a total of 41 filings (representing 18.2% of first half filings), the highest number in any single Industry group. There were also an additional 12 companies hit with first half securities suits in the 384 SIC code industry group (Surgical, Medical and Dental Instruments and Supplies).

The total number of companies across all of the various life sciences categories that were hit with securities suits in 2016 was 53, representing about 23.5% of all first-half 2017 federal court securities lawsuit filings.

The impact of industry grouping is even more significant than these percentage calculations might otherwise suggest, as the denominator in all of the calculations (that is, the number of securities suit filings) is distorted by the mass of merger objection lawsuits. If the merger objection lawsuits are disregarded, the picture for life sciences related industry groupings is even more striking. For example, of the 35 first-half lawsuits filed against companies in the 2834 SIC Code category (representing 15.5% of first half filings) only seven were merger objection suits, with the remaining 28 suits representing traditional filings. The 28 traditional first half filings against 2834 SIC Code companies represented more than one fifth (21%) of all traditional suits filed in the first half.

Another sector that experienced a significant number of securities suits during first half of 2017 was the Industry Group 737: Computer Programming, Data Processing, and Other Computer Related Services. There were a total of 16 companies in this SIC Code Industry Group hit with securities suits in the first six months of 2017, with another eight suits filed against technology companies in the 7389 SIC Code category (Business Services). The 24 suits filed against these technology companies represented just under 11% of first half filings.

These two industry groups, Life Sciences and Computer Programming/Data Processing/Technology, together collected a total of 77 securities suit filings in the first six months of 2017, representing more than one third (34.2%) of all filings during the first half of 2017.

FILINGS AGAINST NON-U.S. COMPANIES

Another important factor to consider in trying to understand the first half filings is to look at home countries of the companies that were sued. As has been the case for the past several years, companies domiciled outside the U.S. were sued in the first six months of 2017 at a greater rate than their domestic counterparts.

Of the first half securities suits, 35 were filed against non-U.S. companies, representing about 15.5% of first half filings. However, only two of these 35 filings were merger objection suits; the remaining 33 filings were traditional suits, representing about one-quarter (24.8%) of first half traditional lawsuits. Whether these suits are considered with or without the merger objection lawsuit effects, the percentages suggest the foreign companies are sued at a greater rate than their presence among U.S.-listed companies would otherwise imply, as (according to NERA Economic Consulting, here, page 7) at year-end 2016 foreign companies represented only 13.4% of all U.S.-listed companies.

During the first six months of 2017, securities suits were filed against companies based in 12 different countries (if Hong Kong is counted with China). Of these countries, the ones with the most securities suit filings in the first half of 2017 were China, with eight (including two against companies from Hong Kong); Canada and Israel, both with five; and Ireland and the U.K. with four each.

Some care must be taken in assessing whether or not the rate of litigation against foreign companies is or is not an independent factor explaining securities class action litigation frequency, as there may be a certain amount of double counting going on here. That is, many of the foreign companies hit with securities suits are in the SIC Code categories identified above as particularly prone to securities litigation. Thus, of the 35 non-U.S. companies hit with securities suits in the first half, eleven are in one of the high risk SIC categories I reviewed above. So to a certain extent, the prevalence of litigation against non-U.S. companies may be a reflection of the fact that many of these foreign companies tend to be in industries with a higher securities litigation risk.

FILINGS BY COURT

The first half 2017 securities suit filings were filed in 45 different federal courts, with the largest number of filings in the Southern District of New York, where 35 suits were filed. The next most active courts were the Northern District of California, with 23; the District of New Jersey, with 21; and the Central District of California, with 17.

The high levels of federal court merger objection litigation filings are having a distorting effect on filing patters. For example, the court with the fifth highest number of securities suit filings in the first six months is the District of Delaware, which had 15 – all of them merger objection lawsuit filings. Another court with a significant number of filings in the first half of 2017 was the District of Minnesota, which had six filings, all of them merger objection suits.

Just the same, as has been the case in the past, filings in the New York and California courts predominate. There were a total of 46 lawsuits in the first half of the year in the Southern District of New York and the Eastern District of New York combined, representing 20% of all first half filings. There were a total of 44 lawsuits filed in the combination of the Northern District of California, the Central District of California, and the Southern District of California, also collectively representing just under 20% of the first half filings. Together these district courts in New York and California accounted for 40% of all first half filings.

IPO LAWSUITS

Another significant factor in securities class action lawsuit frequency in the recent past has been the number of securities lawsuits filed against recent IPO companies. IPO-related litigation was less of a factor in the first half of 2017 than in recent periods, almost certainly because of the relatively lower number of IPOs since 2014, the most active recent IPO year. There eight securities suits in the first half of 2017, representing just about 3.5% of first half filings. Of the eight suits, three were against companies that completed IPOs in 2014; one was against a 2015 IPO company; three against 2016 IPO companies; and one against a 2017 IPO company.

DISCUSSION

The recent upsurge in federal court merger objection lawsuit filings is clearly one of the most important developments affecting the number of federal court securities class action lawsuits. However, there are a couple of important things to keep in mind with respect to the rising numbers of merger lawsuits. The first is that the increase in the number of federal court merger objection lawsuit filings does not necessarily represent an overall increase in litigation activity (although I suspect there is some of that going on as well). Many of the increased numbers of federal court filings represent lawsuits that in the past would have been filed in state court but that have now been diverted to federal court, arguably without an overall increase in the number of merger objection lawsuits.

The second point about the merger objection lawsuits is that the huge increase in the number of federal court M&A lawsuit should not obscure that fact that even if the merger suits are entirely disregarded, the number of lawsuits and pace of litigation are at their highest level in years. Clearly, there is a lot more going on than just the shift of merger suits from state court to federal court. Any way you slice it, there are a lot more securities suits being filed than there have been for many years.

Looking back at the Cornerstone Research data for the filing on a semiannual basis, it is clear that the current elevated levels of securities lawsuit filings really started to take off in the second half of 2015. The semiannual filings in each of the six month period since then have been higher than the semiannual number of filings in any six month period since at least 2008. That characterization remains accurate even if the federal court merger objection lawsuit filings are disregarded; the semiannual number of traditional securities suit filings for each six month period since the second half of 2015 is higher than the number of semiannual traditional securities suit filings in any prior six month period.

Why is this happening? Why are securities suit filings now so far greater than historic levels? Of all the possible explanations I have seen, the one that seems likeliest is that these levels of securities suit filings reflect changes in the plaintiffs' securities class action bar.

As Prof. Michael Klausner and Jason Hegland of Stanford Law School detailed in a guest post on this blog (here), since 2009, a significantly larger number of securities class action lawsuits (both in terms of absolute numbers of lawsuit filings and in terms of percentage of all lawsuits filed) are now being filed by a group of small plaintiffs' firms that were not previously active in filing securities lawsuits. The activities of these "emerging law firms" appear to account for a large proportion of recent increased numbers of securities class action lawsuits filings. Indeed, and just to complete the picture, these emerging law firms are also responsible for many of the federal court merger objection lawsuits as well.

The trend toward greater securities class action litigation frequency is now well-enough established that it could be argued that long-term securities litigation frequency risks have changed categorically. This means not only that publicly traded companies not only now face an overall greater risk of securities class action litigation than in the past, but it also means that their D&O insurers also may be facing a significantly increased litigation frequency risk as well. To the extent that insurers' pricing models are not taking these increased risks into account, their pricing calculations may result in premium charges that come up short.

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At the same time, however, the analysis above suggests that the increased risks are not distributed evenly throughout the universe of companies. Clearly, some companies represent a greater risk than other companies. As the current heightened securities litigation frequency levels, it is increasingly important for D&O underwriters to understand the differences in risk among all public companies and to segment the risk accordingly.

A FINAL NOTE ABOUT DATA SOURCES AND METHODOLOGY

The data used in the analysis above were compiled from a variety of sources, including media outlets (such as Bloomberg and Yahoo Finance), online legal news services (including Law 360 and Advisen), and other online data services (including the Stanford Law School Securities Class Action Clearinghouse). In addition, during the course of the year, I audited my lawsuit dataset by comparing it to those being compiled by other litigation monitoring services.

In tallying the number of securities class action lawsuits, I count each company sued for the same basic set of allegations only once, regardless of the number of complaints filed, which is different from the methodology used by other prominent securities litigation monitoring sources. At least some of these services count each complaint separately (at least if the complaint is filed in a separate judicial district), unless and until the separate lawsuits are consolidated.

With respect to the merger objection lawsuits, it is important to note that I counted a lawsuit in my tally only if the case was filed a class action lawsuit and only if it alleged a violation of the federal securities laws. By the same token, I did not count lawsuits in my tally if they were not filed as class action lawsuits. I also did not count a lawsuit in my tally if the complaint did not allege a violation of the federal securities laws. This is an important consideration in comparing my tally to other published tallies, as at least some of the other public sources include federal court merger objection lawsuits in their tallies even if the complaints allege only breaches of fiduciary duty and do not allege a violation of the federal securities laws.

The different methodologies used will not only result in different litigation counts, but it could also result in differing analytical conclusions. It is very important to understand the methodologies used by the different prominent securities litigation monitoring services and to understand how the methodologies used will affect analyses of the data.

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