NERA
Economic Consulting

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Do Options Backdating Class Actions Settle For Less?

Part IV of A NERA Insights Series
By Robert Patton, Dr. Branko Jovanovic, and Svetlana Starykh

Previous topics in our options backdating series include:

- The Statistics of Luck
- Accounting, Tax, and Economics
- Options Backdating: A Primer

Despite the widespread attention given to "options backdating" by investors, regulators, the legal profession, and the news media, the issue has not generated the spate of shareholder class action litigation that some observers anticipated. Of nearly 250 companies identified as potentially involved in backdating,[1] only 37 have actually been the target of a related federal shareholder class action lawsuit.[2]

It now appears that backdating class actions may be falling short of expectations in another respect: in the cases that have settled to date, the amounts paid to plaintiffs have been substantially lower than in comparable non-backdating class actions. On average, class actions involving backdating allegations have settled for less than half the amounts forecast by NERA's settlement prediction model.

As only six cases have settled thus far, the reasons for the low settlements are not yet clear. It may be that, generally, suits alleging backdating are viewed as weaker on the merits than other class actions. If true, this would indicate that still-pending backdating-related class actions may also be expected to yield relatively small settlements. Alternatively, it could be that the weakest cases have settled first. This would suggest that, in the future, settlements of backdating-related class actions will be more in line with those in other shareholder class actions.

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[1] Source: database maintained by NERA. NERA's database includes companies identified by the *Wall Street Journal's* Options Scorecard, Reuters Factbox, and news searches. Companies in NERA's database were identified for one or more of the following reasons: (1) the company and/or one or more of its executives were the target of a shareholder class action and/or derivative lawsuit alleging backdating; (2) the company and/or one or more of its executives were the target of a US Securities and Exchange Commission (SEC) and/or US Department of Justice (DOJ) investigation alleging backdating; or (3) the company announced a restatement, charge, internal investigation, and/or executive departure relating to backdating.

[2] In addition, there has been one shareholder class action in state court. Backdating-related derivative suits—litigation brought by a shareholder or shareholders on behalf of a company, usually against its officers and directors—have been considerably more common than class actions.

How Markets Work℠

Options backdating settlements to date

Six federal shareholder class actions with options backdating allegations have fully settled, meaning settlements have been reached with all defendants.[3] For each of these cases, we can compare the size of the total settlement reached to the amount forecast by NERA's shareholder class action settlement prediction model. As described in more detail below, this model predicts the most likely settlement for a case, based on the level of "investor losses" and other lawsuit characteristics.

Table 1 shows that actual settlements to date in backdating class actions have averaged less than 44% of the amounts predicted by the model. While one case, Meade Instruments, Inc., settled for approximately 97% of the amount predicted, the other five cases each settled for less than 60% of the predicted amount, and in one case (Rambus, Inc.), the actual settlement was only about 8% of the predicted amount.[4]

Table 1. Predicted and Actual Settlements to Date for Backdating Class Actions

Issuer Defendant (1)	Class Action Filing Date (2)	Settlement Status (3)	Settlement Date		NERA Predicted Settlement (6)	Actual Settlement	
			Tentative (4)	Final (5)		Amount (7)	% of Predicted (8) =(7)/(6)
Newpark Resources, Inc.	04/21/06	Approved	04/13/07	10/09/07	$23,278,481	$9,240,000	39.7%
Meade Instruments, Inc.	09/27/06	Approved	05/24/07	12/10/07	3,037,964	2,950,000	97.1%
Rambus, Inc.	07/17/06	Approved	09/07/07	05/14/08	217,713,093	18,000,000	8.3%
American Tower Corp.	05/26/06	Tentative	12/13/07	06/11/08	24,386,368	14,000,000	57.4%
KLA-Tencor Corp.	06/29/06	Tentative	01/24/08		210,228,128	65,000,000	30.9%
HCC Insurance Holdings	03/08/07	Tentative	02/08/08	07/17/08	36,443,928	10,000,000	27.4%
						Average	**43.5%**

NERA's Predicted Settlement Model

The model used to predict the settlements in Table 1 was estimated using data on over 700 fully settled class actions filed in federal court since 1 January 1996, excluding backdating cases.[5] It explains over 60% of the variation in settlement amounts across these cases.[6] The single most powerful determinant of settlement value is "investor losses": a simple estimate of the total losses by purchasers of the company's shares during the class period relative to an investment in the S&P 500 index. Settlements also rise with the inclusion in the settlement of each class of security other than common stock (e.g., bonds or options).

The mere existence of accounting-related allegations, as in a backdating case, tends to increase settlement size, as does an investigation relevant to the allegations by any official body (such as the SEC, the NASD, or a state Attorney General) and an admission by the defendant company of accounting "irregularities" related to the allegations.[7] All six of the companies in Table 1 were the subject of at least one official investigation, and two—Rambus, Inc. and KLA-Tencor Corp.—admitted to accounting irregularities in connection with options backdating.

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3   At the time this article went to press, three of the six full settlements had been approved by a court and three were tentative. In two additional cases (Mercury Interactive and Vitesse Semiconductor) some, but not all, defendants had settled.

4   One of the cases in Table 1, Newpark Resources, Inc., involved allegations in addition to backdating; moreover, the settlement covered a related derivative lawsuit as well as the securities class action. However, excluding this case does not substantially change the average presented in Table 1: for the other five cases, settlements were on average 44.2% of the predicted amount.

5   For more detail on the predicted settlement model, see Todd Foster, et al, "Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High—But Are These Trends Reversing?" NERA study, September 2007.

6   Technically, the model explains over 60% of the variation in the *logarithm* of predicted settlement.

7   In addition, settlements are found to increase with the potential depth of defendants' pockets: the higher the defendant company's post-class period market capitalization, for example, the higher the settlement tends to be. Also, settlements tend to be higher if an accounting firm is a co-defendant. Settlements are generally lower, however, if the issuing defendant has declared bankruptcy or has a stock price of less than $1.00 per share at the time of the settlement. Finally, cases tend to settle for more if the lead plaintiff is an institutional rather than a retail investor, as well as if an IPO is involved.

Testing a backdating variable

We conducted a formal test to determine whether a backdating variable, added to NERA's existing predicted settlement model, was statistically significant. We added the six settlements listed in Table 1 to our model estimation sample and introduced an "indicator" variable that takes a value of one if a settled case involved backdating allegations, and zero otherwise. The backdating indicator variable is estimated to be negative and statistically significant (at the 5% level). The estimate implies that, controlling for all the other variables, the settlement in a backdating case is about 52% of the settlement in a non-backdating case with a similar level of investor losses and other characteristics captured by the model. This finding is broadly consistent with the results presented in Table 1.[8]

Implications

Why do shareholder class actions that allege options backdating appear to settle for less than comparable non-backdating cases? One possibility is that shareholder suits with backdating allegations are perceived as weaker on the merits than other class actions. This would suggest that ongoing class actions alleging backdating should also be expected to settle for relatively low amounts. Alternatively, it may be that the weakest cases have been the first to settle. If this is true, then, in the future, settlements in backdating-related class actions may be more in line with settlements in other types of shareholder class actions. NERA will continue to track these settlements, and as the cases make their way through the courts it should become more clear which hypothesis is correct.

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[8] As noted above, the Newpark Resources, Inc., case involved allegations in addition to backdating and the settlement of that case covered a related derivative lawsuit as well as the securities class action. Excluding Newpark Resources, however, the dummy variable is still negative and statistically significant, and indicates that the settlement in a backdating class action should be 51% of the settlement in a non-backdating class action.

Contact

For further information and questions, please contact the authors:

Robert Patton
Senior Consultant
+1 212 345 3269
robert.patton@nera.com

Dr. Branko Jovanovic
Senior Consultant
+1 212 345 1972
branko.jovanovic@nera.com

Svetlana Starykh
Consultant
+1 212 345 8931
svetlana.starykh@nera.com

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