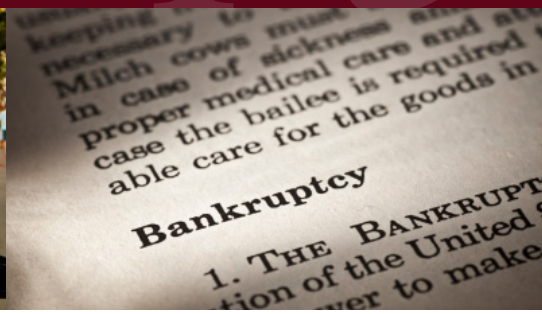
D&O 2013
CLAIMS TRENDS







D&O Claims Trends: Q2 2013

July 2013

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D&O Claims Trends: Q2 2013

Executive summary

The number of new securities and business litigation and enforcement actions were down dramatically as compared with the first quarter of 2013 and are on pace for the lowest annual total since prior to the credit crisis. Three of the four major categories (breach of fiduciary duty, derivative shareholder action & securities fraud) were down from the first quarter. Securities class action was the only major category that saw a slight uptick in new filings, but it still remained well below the yearly average of the prior four years. For the first quarter since Advisen has been keeping records, the total number of breach of fiduciary duties filings exceeded securities fraud filings.

The financial sector remained the top sector for new securities litigation and enforcement actions in the second quarter. However, as the credit crisis recedes into the past, actions against financial firms and their directors and officers, as a percentage of all events, continues to fall.

Although the number of settlements increased slightly, the settlement values dropped. In the first quarter securities class action suits had experienced a blip in the longer term trend of decreasing settlement values, but with a significant drop in the second quarter, it appears the trend continues.

This report also contains a special section on D&O liabilities arising from cyber issues. With cyber threats becoming increasingly frequent and sophisticated, corporations are realizing that their defenses are often a step behind. Theft of intellectual property, operational disruption and damage to IT infrastructure are only a few of the consequences of such attacks. These can have a material impact on the financial performance and health of an organization and, as a result, directors & officers are faced with an ominous new threat landscape comprised of an evolving set of exposures.

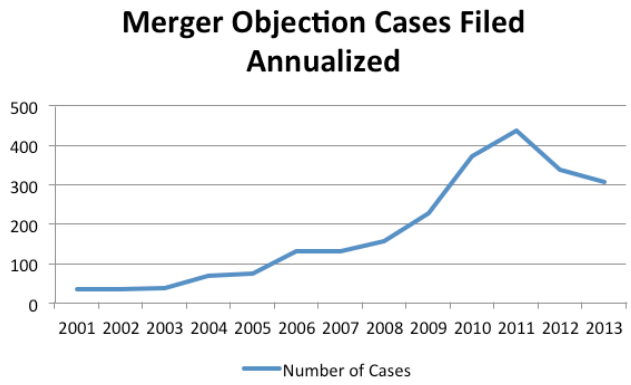
Summary of findings

The downward trend in the various types of lawsuits and enforcement actions that could trigger coverage under a D&O policy continued in the second quarter of 2013. In fact, at the current rate of decline, 2013 will have the lowest annual total of filings since 2006. The second quarter saw a 41 percent decrease in new activity as compared to the first quarter with new events falling from 352 to 234. Percentage wise, this was the largest quarterly decline since before the financial meltdown of 2007/08. The drop was even more dramatic if being compared with the same quarter a year ago, decreasing 55 percent. The 234 total events are the lowest quarterly total since prior to 2009.

Securities fraud cases, which were the leading type of new securities-suit filing in Q1, saw the number of new filings fall 59 percent in the second quarter (149 Q1 to 61 Q2). Other areas that saw quarterly declines included derivative shareholder actions (43 Q1 to 37 Q2) and breach of fiduciary duties (99 Q1 to 71 Q2).

Most breach of fiduciary duty cases are so-called merger objection suits, which are filed in the wake of an announcement of a merger or acquisition. The total number of merger objection suits had been increasing on an annualized basis until 2011 but decreased in 2012 and are on pace to do so again in 2013. (Exhibit 1) In the second quarter, of the 71 to breach of fiduciary duties cases, 65 were classified as merger objections.

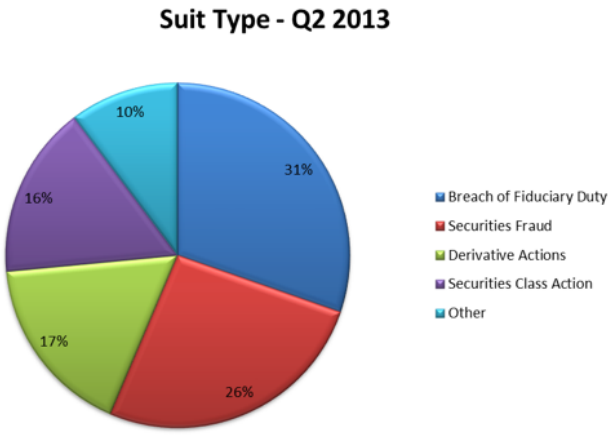
Exhibit 1



Securities fraud and breach of fiduciary duty filings remained the two most common types of filings, but switched places in the second quarter. Securities fraud represented 26 percent and breach of fiduciary duty accounted for 30 percent of the total events. In prior quarters and years, securities fraud cases consistently were the most common type of filing. Although the annual total (Q1 & Q2) to date of securities fraud filings (210) still exceeds breach of fiduciary duty filings (170), this is the first quarter since Advisen has been keeping records that there were more breach of fiduciary duty filings than securities fraud filings.

The third most common filing, shareholder derivative suits, represented 17 percent of the total. Although the absolute number of new shareholder derivative suit filings was down, this was a 4 percentage point increase from the first quarter due to the steep decline in the total number of filings of all types. Rounding out the top four, securities class action suits represented 16 percent of the total, a 6 point increase compared with the first quarter. (Exhibit 2)

Exhibit 2



At 25 percent of the total, the financial services sector and their directors and officers remained the leading source of new filings in the second quarter. However, the downward trend in new financial services filings continued. While subprime and credit crisis litigation is not yet dead, the declining number of new events in the financial service sector represents a winding down of subprime and credit crisis-related activity.

As a percentage of the total new filings, the industrial sector saw the largest decline from 16 percent to 9 percent. Conversely, the healthcare sector saw the largest increase from 7 percent in Q1 to 13 percent in Q2. Other active sectors included information technology at 14 percent and consumer discretionary also at 12 percent.

The average settlement in Q2 for all types of suits was $37.2 million which was significantly down from the recently updated $69.3 million reported in the first quarter. “Settlement” includes, in addition to final approved settlements, proposed and tentative settlements, plus jury awards.

Securities suits defined. The purpose of this report is to examine all sources of securities-related suits that impact the underwriting and placement of management liability insurance other than ERISA liability suits. In addition to securities class action suits, this report encompasses a much broader set of suits, including securities fraud, breach of fiduciary duties, derivative actions, collective actions and Ponzi scheme cases.

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 class actions that Advisen covers, another difference 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.

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 the report as follows:

- **Securities Class Action:** suits alleging violations of federal securities laws, principally the Securities Act of 1933 and Securities Exchange Act of 1934, filed by a private party on behalf of a class of persons injured by alleged violations.
- **Securities Fraud:** suits filed by regulators or law enforcement agencies charging violations of securities fraud laws. Also included are 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.
- **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 of transfer is covered by securities laws. This includes merger, privatization or other transactions that involve public companies.
- **Derivative Action:** cases against directors and officers brought by shareholders on behalf of the company.

New events

By type of event

The downward trend in securities fraud cases in prior quarters continued in the second quarter and reached a tipping point, relinquishing its spot as the leading source of D&O suits. As previously mentioned, breach of fiduciary duty overtook its place at the top, at least temporarily. Breach of fiduciary duty suits accounted for 30 percent of the total new D&O-related events and securities fraud accounted for 26 percent.

Both breach of fiduciary duty and securities fraud represented a smaller percentage of the total filings as compared to the first quarter. However, it is the rate of decline – a 22 percentage point drop – of securities fraud filings that is notable. As addressed in prior reports, there has been a downward trend in both the total number, and overall percentage, of securities fraud suits. This trend dates back to Q1 2012 and is due in part to a change of emphasis in SEC enforcement. Although the downward trending has been apparent, it has never been as drastic as it was this past quarter. Only time will tell whether this was an anomaly or a new phase of the downward trend. However, the appointment of Mary Jo White as Chairperson of the SEC and her pledge of a "fair but bold and unrelenting" enforcement program may result in increased actions in this area in the second half of the year.

Despite quarterly fluctuations, on an annual basis securities class actions had been on a steady decline as a percentage of total events since 2007 (from 22 percent in 2007 to 10 percent in 2012). This year, with filings in other categories dropping sharply, securities class actions have thus far accounted for 13 percent of the total filings and are on pace to reverse the trend, at least temporarily.

Other securities class action trends appear to be continuing, however. As noted in prior reports, the annual total of securities class action filings had been trending downward for the past two years. Filings dropped from (221) in 2011 to (184) in 2012. With 74 total filings half way through the year the trend is on pace to continue in 2013. The downward trend in securities class action filings has been the topic of much discussion and speculation among analysts. As noted in previous reports, the decline in securities class action suits over the previous two and half years is attributable to fewer suits involving Chinese firms and the winding down of credit crisis suits.

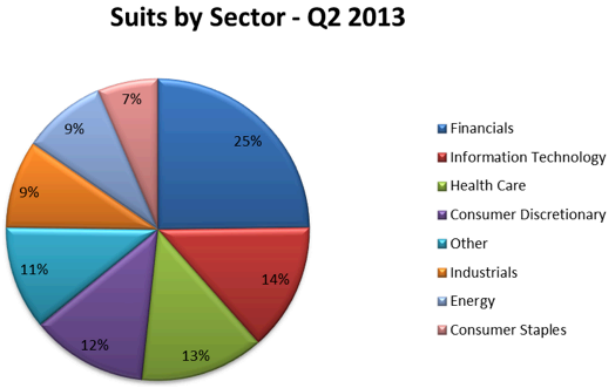
A potential new trend within the securities class action arena that may be worth following is securities class action suits involving accounting allegations. After years of neglect in this area, there are indications that regulators will have a renewed focus on accounting fraud cases in 2013 and beyond. An uptick in accounting fraud cases could reverse the downward trend in new filings.

Breach of fiduciary duty suits are trending in the opposite direction of securities class actions. As a percent of the total suits, this category grew from 9 percent in 2004 to 22 percent in 2012 and now to 30 percent through two quarters in 2013. The increase in these suits over that period was largely driven by a surge of merger objection suits. These suits are filed shortly following the announcement of a proposed merger or acquisition by shareholders of the company to be acquired. Typically they demand more favorable terms, such as more bidders or a more transparent auction process.

By industry

As they have every quarter since the beginning of the credit crisis, financial firms continued to experience the largest number of new filings. In fact, a quarter of all new filings in Q2 named companies and their directors and officers in the financial services sectors. This was essentially unchanged from the first quarter at 26 percent. While still by far the industry with the highest percentage of new filings – 11 percentage points higher than information technology with the second most filings – it has been declining every year since its peak of 43 percent in 2008 (2008 – 43 percent, 2009 – 41 percent, 2010 – 33 percent, 2011 – 32 percent, 2012 – 28 percent and thus far in 2013 – 26 percent). This downward trend is in large part an outcome of the continuing wind down of subprime and credit crisis activity. (Exhibit 3)

Exhibit 3



Suits related to companies in the industrial sector represented 9 percent of the total new events in the second quarter. This was an 8 point decline from Q1 bringing its annual average to 14 percent which is in line with previous years.

Non-U.S. companies

As compared to the United States, securities litigation in Europe, Asia and Latin America is less frequently a matter of public record, making it difficult to get as complete of 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 clear that litigation activity has become increasingly common in recent years in courts outside the United States. Among the common triggers for D&O claims in non-U.S. courts are bankruptcy and regulatory enforcement actions.

In the second quarter, events involving non-U.S. companies, filed both in the U.S. and elsewhere accounted for 15 percent of the total events on average. This was 4 points higher than the first quarter at 11 percent and 3 points higher than the same quarter a year ago (Q2 2012) at 12 percent.

Settlements and awards

Securities fraud and securities class action represented the largest number of settlements in the second quarter with 49 and 38 settlements respectively. Including proposed and tentative settlements, the average settlement cost for all case types was $37.2 million, which was down significantly from $69.3 million reported in the first quarter. A proxies and solicitation violation settlement for $2.4 billion was by far the largest settlement reported in the second quarter.

Securities class action suits remained the most significant source of large losses with an average settlement of $34.9 million for the quarter. Foreign corrupt practices act (FCPA), consisting of 5 settlements, came in a close second with an average settlement of $32.5 million. An interesting FCPA observation is that in the first two quarters of 2013, FCPA settlements have increased dramatically. The 2013 average FCPA settlement is $36.6 million which is the highest average settlement since 2004. Derivative shareholder actions followed with an average settlement of $17.3 million, followed by securities fraud at $14.7 million and breach of fiduciary duty at $11 million.

The $2.4 billion tentative settlement by Bank of America that was noted in the D&O Claims Trends: 2012 Wrap Up report was approved in the second quarter. The settlement concerns Bank of America's acquisition of Merrill Lynch, which Advisen classifies as a proxies and solicitation violations case. Shareholders accused the bank of providing false and misleading statements about the financial health of Merrill Lynch. Bank of America denied the allegations, but said it agreed to settle in order to put the case behind it. This also was the largest settlement yet of a subprime/credit crisis case.

Last quarter's proposed $601.7 million securities fraud settlement concerning Stamford, Connecticut-based hedge fund advisory firm CR Intrinsic Investors LLC – a firm affiliated with billionaire Steven A. Cohen's SAC Capital Advisors – received final court approval on April 16, 2013. The SEC charged that CR Intrinsic Investors LLC participated in an insider trading scheme involving a clinical trial for an Alzheimer's drug being jointly developed by two pharmaceutical companies.

Additionally, the $473 million tentative securities class action settlement reported last quarter concerning Merk & Co., Inc. subsidiary Schering-Plough entered into a Stipulation of Settlement on June 3, 2013. The settlement was a result of a complaint alleging that during the Class period, the Company and other defendants misled investors regarding the increased efficacy of Vytorin, a combination of Zetia and Zocor, over the cheaper generic form of Zocor (simvastatin), alone, and delayed disclosing result of a study demonstrating the contrary.

Securities class action suits are typically heavily represented among the largest settlements. This again was the case in the second quarter where they represented two of the top five cases. The second case is a $153 million proposed settlement involving Federal National Mortgage Association (Fannie Mae) based on an original complaint that was filed in 2004. The complaint alleged that the company failed to disclose and misrepresented material and adverse facts which were known by the defendants and/or recklessly disregarded.

A suit not previously reported on that settled for a large sum in the second quarter was a foreign corrupt practices act (FCPA) case involving Paris-based oil and gas company Total SA. Total SA was being investigated by the SEC and the DOJ in connection with the pursuit of business in Iran. The inquiry was due to an agreement made by the company concerning gas fields in Iran and whether payments made under this agreement would have benefited Iranian officials in violation of the FCPA and the Company's accounting obligations. The case was settled for $153 million payment to the SEC.

It should be noted that D&O insurance recoveries often are not a matter of public record, so the impact of these and other large cases on the D&O market is not readily apparent from public sources. In many cases, especially those involving fines, penalties, or disgorgement, recoveries are not available under most D&O policies, though defense costs and some costs related to investigations may be covered.

Special Report: Cyber and Directors and Officers

Corporate cyber risks have been growing in both frequency and sophistication. What began as a nuisance for a few is now a major concern for most corporations. Corporate vulnerabilities are continuously exposed from an array of sources and for multiple reasons. Threats span the spectrum from a disgruntled employee seeking retribution for a perceived wrong to a nation-state looking to steal priceless intellectual property. The type and sophistication of the threats are evolving and corporate defenses are frequently a step behind.

Cyber-attacks can expose businesses to catastrophic losses. Class action lawsuits, breach notification costs and reputational damages are only a few of the costly consequences. These losses, in the most severe cases, can lead to bankruptcy, and depending on the size and nature of the company, could have broader economic and national security implications. For this reason, federal and state governments are taking an increasingly active role in addressing the cyber issues faced by the private sector.

Cyber risks are complex and constantly evolving, but as corporate leaders it is important that directors and officers attain at least a basic understanding of the threats and the potential impacts they may have on their organizations. The expectation is that they will increasingly be held accountable by both shareholders and regulators.

Examples of emerging cyber-related exposures to corporate directors and officers include:

- **Expanded disclosure obligations relating to cybersecurity risks and incidents.** SEC Disclosure Guidance CF Disclosure Guidance: Topic No. 2 (October 13, 2011) does not alter the disclosure requirements already in place, but expands on them by including cybersecuirty risks. The updated disclosure guidance puts the onus on every public company to disclose in their securities fillings exposures to a data breach or attack or other cyber incident that a reasonable investor would consider important to an investment decision.

  Enforcement of this guidance is likely to increase. In May of this year, recently appointed SEC Chairman Mary Jo White issued a letter stating that her staff has been reviewing whether companies have been complying with the guidance over the past year. The letter is an indication that the SEC is prioritizing cybersecurity disclosure requirements.

- **FTC "Red Flag Rule."** This regulation requires many companies to adopt an Identity theft protection program that identifies warning signals of identity theft. The objective is to detect an incident before it escalates into an expense identity theft episode, and to take appropriate action. The rule requires the program be approved by the board of directors or a committee designated by the board.[1]

- **Increased compliance obligations for network security practices.** When President Obama issued an executive order on cybersecurity earlier this year, one of the steps was to have the National Institute of Standards and Technology (NIST) create a framework for cybersecurity practices of critical infrastructure such as telecommunications, energy and financial. While this appears to have a limited reach, some sector specific agencies are reviewing the security practices for the industries they regulate.[2]

- **Heightened involvement by government agencies and law enforcement** in network security incidents that require organizations to manage a diverse set of information requests.[3]

Lawyers warn that shareholder litigation related to data breaches and other cybersecurity issues is inevitable. A company that experiences a data breach may become the target of a securities class action if disclosure of the breach can be linked to a statistically significant drop in the company's stock price. Shareholders also may pursue shareholder derivative litigation alleging, for example, that the directors of an organization that experienced a data breach breached their fiduciary duties to the organization by failing to ensure adequate security measures.

Although there have only been a handful of shareholder lawsuits associated with cyber issues to date, there have been some notable cases. Examples are listed in Exhibit 4.

Exhibit 4

Company	Type	Status	Settlement
The TJX Companies Inc.	Securities/Derivative Shareholder Action	Proposed Settlement	$595,000
The Dun & Bradstreet Corp	Cyber/Identity Risk/Improper Collection of Digital Data	Settled	$160,640
Heartland Payment Systems	Cyber/Identity Risk/Digital Brach, Loss, or Theft	Dismissed	$0

Expectations are that the frequency and severity of cyber-related D&O suits will grow due to increased regulatory scrutiny. Consequently, D&O underwriters will be increasingly interested in their customers' and potential customers' cybersecurity practices. For this reason, directors' and officers' should work closely with their brokers and insurers to identify their exposures and be sure that their D&O policy provides adequate coverage in the event a cyber-related lawsuit targets management.

NOTES:

[1] Dan Bailey, Bailey Cavalieri, The D& O Diary, "Cyber Risks: New Focus for Directors", (February 20,2013), http://www.dandodiary.com/2013/02/articles/corporate-governance/guest-post-cyber-risks-new-focus-for-directors/

[2] Skadden, "Privacy & Cybersecurity Update," (2013), www.skadden.com

[3] Skadden, "Privacy & Cybersecurity Update," (2013), www.skadden.com