



# D&O Claims Trends:

Q2 2015

July 2015



For the Management Liability Community

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## Executive summary

At the year's midway point, the downward trend in new securities and business litigation filings and enforcement actions is on pace to continue for a fourth consecutive year. This is not to say, however, that the second quarter of 2015 was not an active period for securities and business litigation. In fact, it was quite the contrary. The quarter saw a handful of high profile settlements such as Bear Sterns and Activision Blizzard, interesting circuit court decisions such as the fourth circuit's affirmation of criminal convictions in *U.S. v. Fields* and *U.S. v. Woodard*, and impactful legislation including Delaware amending its general corporation law to authorize exclusive forum provisions and prohibit fee-shifting provisions.

Of the various case types tracked by Advisen, the quarter saw a mix of increases and decreases. Derivative shareholder actions, breach of fiduciary duties suits, merger objection suits, and securities individual actions all saw year-over-year declines, while capital regulatory actions and securities class actions saw increases.

By a wide margin, capital regulatory actions again accounted for the largest percentage of the quarter's new events. The always important category, securities class actions, followed in a distant second but continues to represent an increasing percentage of the total events.

The financial sector remained the top sector for new securities litigation and enforcement actions. Information technology was the second most active sector supplanting the industrial sector, which had retained this spot for the previous four quarters.

Both the number of settlements and settlement values were up year-over-year, but down from the previous quarter. Capital regulatory actions represented the largest number of settlements and derivative shareholder actions had the highest average settlement value.

## 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-related 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:

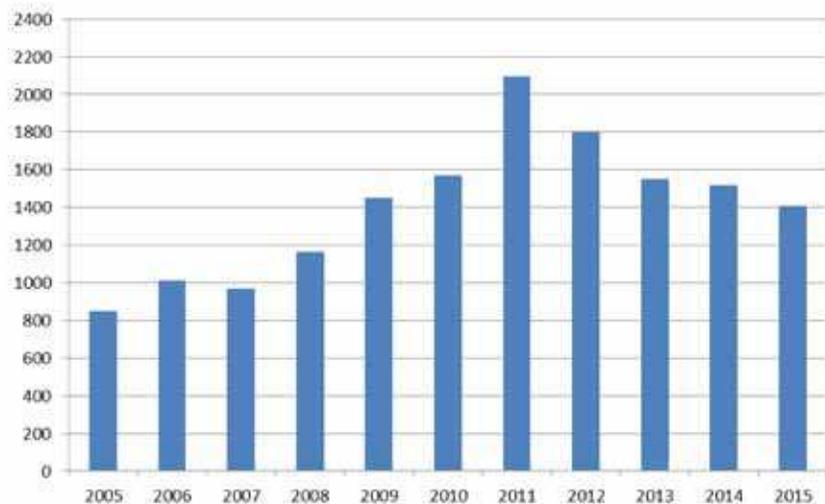
- **Securities Class Actions:** suits alleging violations of federal securities laws, principally the Securities Act of 1933 and the Securities Exchange Act of 1934, filed by a private party on behalf of a class of persons injured by alleged violations, specifically styled as a class action at the time of filing.

- **Capital Regulatory Actions:** actions by the SEC and other regulators against organizations raising capital through issuance of regulated securities. These cases represent a distinct exposure that led Advisen to segment them from the prior type of securities fraud cases.
- **Securities Individual Actions:** cases brought by purchasers of securities that are not styled as a class action at the time of initial filing. This includes non-class action cases involving multiple plaintiffs and later filed as opt-out suits from securities class action settlements.
- **Breach of Fiduciary Duties:** Securities: 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.
- **Merger Objection:** suits filed by disgruntled shareholders of a company that has been, or is about to be, acquired.
- **Derivative Action:** cases against directors and officers brought by shareholders, creditors and Boards of Directors on behalf of the company.

## Summary of findings

At the midway point of 2015, of the various types of lawsuits and enforcement actions tracked by Advisen that could trigger coverage under a D&O policy, the jury is still out as to whether the downward trend in new events will continue for a fourth consecutive year. Although the second quarter saw an eight percent decline in new activity as compared to the same quarter a year ago, total events increased just slightly from the previous quarter. As a result, the year-to-date total is only two percent less than at the same point last year. If this trend continues, the second half of the year could see an increase in litigation activity and an upward adjustment in the annualized estimate displayed in exhibit 1 below. (Exhibit 1)

**Exhibit 1: Suits and Enforcement Actions (Annualized)**

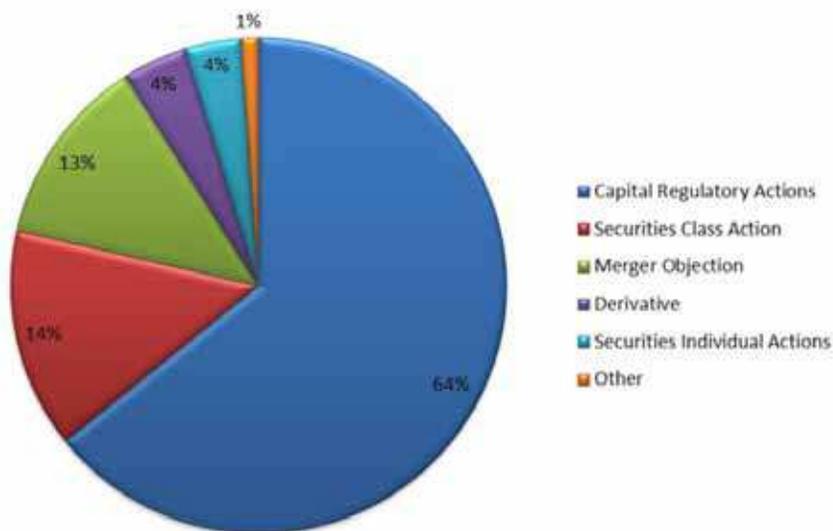


The major case types that saw year-over-year (Q2 2014 vs. Q2 2015) declines in activity were shareholder derivative actions falling 77 percent, breach of fiduciary duties suits (75 percent), merger objections (31 percent), and securities individual actions (7 percent). Conversely, capital regulatory actions (21 percent), and securities class actions (9 percent) saw year-over-year increases. Foreign corrupt practices act (SEC) enforcement actions remained flat year over year.

As noted in previous reports, the declines in the aggregate total of new events over the previous three years continue despite some plaintiff firms being highly capitalized from huge financial crisis era settlements. Experts suggest that this can be attributed to a combination of factors including less financial crisis-related litigation, fewer U.S. public company targets, and fewer mediators to assist with settlements.

Accounting for 64 percent of the quarter's total filings, an increase of four percent from the first quarter, capital regulatory actions by far remained the leading source of new securities suit filings in the second quarter. In a distant second, securities class actions accounted for 14 percent, followed by merger objection suits at 12 percent. (Exhibit 2)

**Exhibit 2: Events by Type – Q2 2015**



Financial services companies and their directors and officers remained the leading targets for new filings accounting for 30 percent of the quarterly total. This represented an increase of 2 percentage points from the previous quarter and a 5 percentage point increase from the 2014 average. Although the spike in financial services-related suits that was experienced during the height of the financial crisis has subsided, the sector remains a lightning rod for D&O related litigations. Other active sectors in the second quarter included information technology at 18 percent, and industrials at 17 percent.

The second quarter saw 145 settlements. This was up from 126 the same quarter a year ago but down from 184 the previous quarter. "Settlement" includes, in addition to final approved settlements, proposed and tentative settlements, plus jury awards.

The average settlement for all types of suits was \$15 million. This was down substantially relative to the previous quarter's average settlement value of \$119 million, which was inflated in part to a massive \$16.7 billion settlement.

## New events

### By type of event

#### Capital regulatory actions

Capital regulatory actions remained the leading cause of D&O-related lawsuits in the second quarter of 2015 accounting for nearly two-thirds (64 percent) of all recorded events. The capital regulatory action event type was introduced by Advisen in the third quarter of 2013 and includes a majority of cases previously categorized as securities fraud.

Reversing a three year stretch of declines, 2014 saw an uptick in capital regulatory action events. This upward trend will likely continue for a second consecutive year. So far in 2015 there has been a 27 percent increase in capital regulatory events compared with the same period (Q1 & Q2) a year ago. The increase is likely a direct result of a financial fraud task force created by SEC Chair Mary Jo White for the purpose of identifying and prosecuting individuals involved with financial and reporting fraud.

Now a few years on since the implementation of the Dodd-Frank whistleblower protections, claims are maturing and likely contributing to an increase in actions in this area. It also seems probable that actions in this category will continue to grow for the same reason. Other causes of more actions could surround insider trading and the SEC's concern about the Second Circuit's decision in the U.S. vs. Newman and Chiasson, as well as a renewed SEC focus on violations of Section 16 filing requirements.

#### *Securities class actions*

Prior to the financial crisis, securities class action suits represented about a quarter of the D&O related events tracked by Advisen. Since 2007, growth in the number of other types of suits has caused securities class actions to steadily decline as a percentage of all events, from 23 percent in 2007 to a low of 10 percent in 2011.

Over the past three years, however, securities class actions have crept up slowly as a percentage of all events. For example, in 2014 they accounted for 13 percent of the annual total. Midway through 2015, securities class actions are on pace to continue this upward trend currently accounting for 14 percent of all the enforcement actions tracked by Advisen.

The longer-term trend of securities class actions representing a decreasing portion of all D&O related claims continues to be a topic of much discussion and speculation among analysts. Over the short time horizon, the general decline may be driven by factors such as a reduction in the number of companies traded on U.S. stock exchanges and the winding down of financial crisis related litigation. The longer term trend, however, may also reflect a change in emphasis by plaintiffs firms, due in large part to a string of Supreme Court decision favoring defendants.

#### *Shareholder derivative actions*

It was noted in the 2014 year-end report that the annual total of shareholder derivative action filings has declined every year since 2011, a year which saw the second highest annual total in the past ten. The 2014 annual total of 180 was significantly below the 10 year average of 233. Early indications are that this downward trend will continue for at least another year. Midway through the year derivative shareholder actions are down a total 55 percent compared with the same period last year (Q1 & Q2 2014). The second quarter of 2015 alone had just 14 derivative shareholder action filings, down from 61 in Q2 2014.

#### *Merger objection suits*

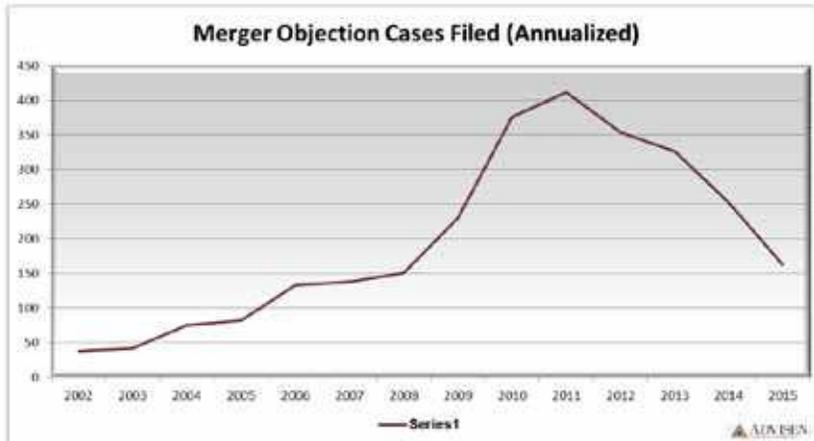
Merger objection suits are usually filed shortly after the announcement of a proposed merger or acquisition by shareholders of the company to be acquired. Shareholders typically demand more favorable terms, such as more bidders or a more transparent auction process.

As has been noted in previous reports, a majority of large M&A's are involved in shareholder lawsuits and most settled cases are 'disclosure only.' It has been suggested that these suits are driven more by plaintiff's attorneys seeking new sources of fee revenue than by the economics of the merger or acquisition.

After experiencing strong and steady growth in new filings between 2006 and 2011, the number of new merger objection filings decreased materially over the past three years, falling 39 percent. With economic conditions in the U.S. improving, interest rates remaining low, employment gaining strength, and equity markets still strong, expectations are for increased

M&A volumes in the coming years, which in theory should drive more merger objection suits. However, through the first two quarter of 2015 there has been a 35 percent decline in merger objection cases compared with the same period a year ago (Q1 & Q2 2014), increasing the likelihood for a continuation of the downward trend. (Exhibit 3)

**Exhibit 3: Merger Objection cases Filed (2015 Annualized)**

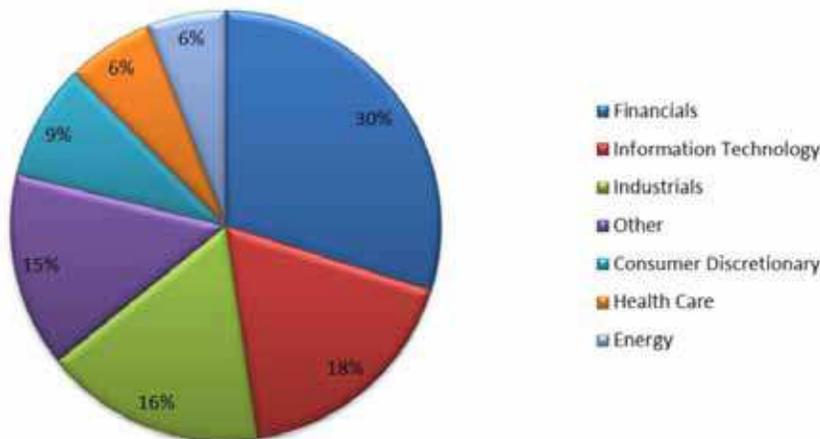


**By industry**

As they have for every quarter since before the financial crisis, financial firms remained the leading source for new filings and enforcement actions. Thirty percent of the new filings in the second quarter named companies and their directors and officers in the financial service sector. (Exhibit 4) While far-and-away the largest source of new filings, they are down substantially from a peak of 40 percent in 2008 and 2009.

After four consecutive quarters as the second most active sector, industrials was replaced by information technology in the second quarter. (Exhibit 4)

**Exhibit 4: Suits by Sector**

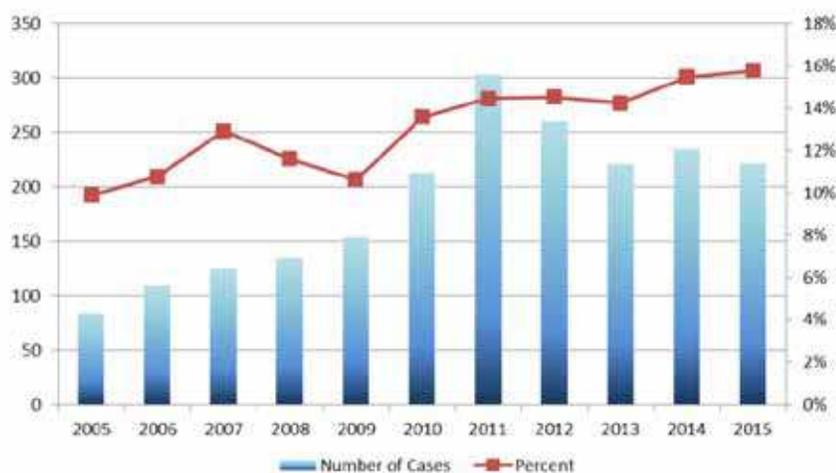


## Non-U.S. companies

Securities litigation in Asia, Europe, and Latin America is less frequently a matter of public record as compared to the United States, making it more 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 limitations, it is increasingly clear that litigation activity outside the United States has become more common in recent years. Among 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 14 percent of the total. This was the same percentage as the second quarter in 2014 but 4 points lower than the previous quarter (Q1 2015). (Exhibit 5)

**Exhibit 5: Non-U.S. Companies**



## Settlements and awards

Capital regulatory actions continued to be the leading source of settlements in the second quarter accounting for 77 percent of the 145 total. Including proposed and tentative settlements, the average settlement cost for all case types was \$15 million, down substantially from \$119 million reported in the first quarter, but up slightly from \$14 million in Q2 of 2014.

Derivative shareholder actions were the most significant source of large losses with an average settlement value of \$96 million. Securities class actions had the second highest average settlement value at \$37 million, followed by merger objections at \$30 million, FCPA (SEC) at \$17 million, and capital regulatory actions at \$6 million.

The total number of settlements was up year over year from 126 in Q2 2014 to 145 this quarter, but down from 184 in the previous year. The only major case type that saw a year-over-year increase in the total number of settlements was capital regulatory actions increasing from 82 in Q2 2014 to 111 in Q2 of this year. The spike in capital regulatory action settlements was likely a result of increased focus from the SEC's financial fraud task force ordered to pursue even small infractions.

The number of shareholder derivative action, FCPA (SEC), and merger objection settlements all remained flat year-over-year with six, two, and nine settlements respectively. Finally, the number of securities class action settlements dropped year over year from 24 to 17.

Securities class action suits are typically heavily represented among the largest settlements. This was again the case in the second quarter. The largest settlement was a \$505 million securities class action against Bear Stearns Companies LLC

that was given final approval on May 27th. The settlement put to rest a financial crisis related mortgage-backed securities (“MBS”) suit that claimed Bear Sterns had no incentive to perform the due diligence required under the Securities Act of 1933 because it was receiving millions of dollars in fees upon the completion of massive MBS offerings.

The quarter’s second largest settlement was a shareholder derivative action against Activision Blizzard, Inc. for \$275 million which was granted final approval of settlement of May 21st. The settlement resolved a complaint that Activision Blizzard violated certain provision of the company’s certificate of incorporation by failing to submit the matters contemplated by the stock purchase agreement by and among the company, Vivendi and the ASAC Entities for stockholder approval by a majority of its stockholders.

Also notable in the second quarter was a final capital regulatory action settlement of \$190 million against Computer Science Corporation (CSC). The Securities and Exchange Commission charged Computer Sciences Corporation (CSC) and former executives with manipulating financial results and concealing significant problems about the company’s largest and most high-profile contract. The SEC additionally charged former finance executives involved with CSC’s international businesses for ignoring basic accounting standards to increase reported profits from year 2009 through 2011.

It should be noted the 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 recovered. ■

This report was written by Josh Bradford, Senior Editor, Specialty Editorial at Advisen Ltd.

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