



D&O Claims Trends:

Q1 2015

April 2015



For the Management Liability Community

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Executive summary

New securities and business litigation filings and enforcement actions continued to trend downward in the first quarter of 2015. With one of the lowest quarterly totals in the post financial crisis era, 2015 could be the year filing totals reach pre-crisis levels.

Although overall there was a decline in total filings, of the various case types tracked by Advisen, the quarter saw a mix of increases and decreases. Derivative shareholder actions, merger objections, and security class actions all saw year-over-year declines, while capital regulatory actions, securities individual actions, FCPA, and securities-related breach of fiduciary duties saw increases.

By a wide margin, capital regulatory actions accounted for the largest percentage of the quarter's new events. The always important category, securities class actions, followed in a distant second but represented a larger percentage of the total compared to the same quarter a year ago.

The financial sector remained the top sector for new securities litigation and enforcement actions. And for a fourth consecutive quarter, the industrials sector was the second most active sector.

Both the number of settlements and the average settlement value were higher year-over-year, and quarter-on-quarter. Capital regulatory actions represented the largest number of settlements and had the highest averages 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:

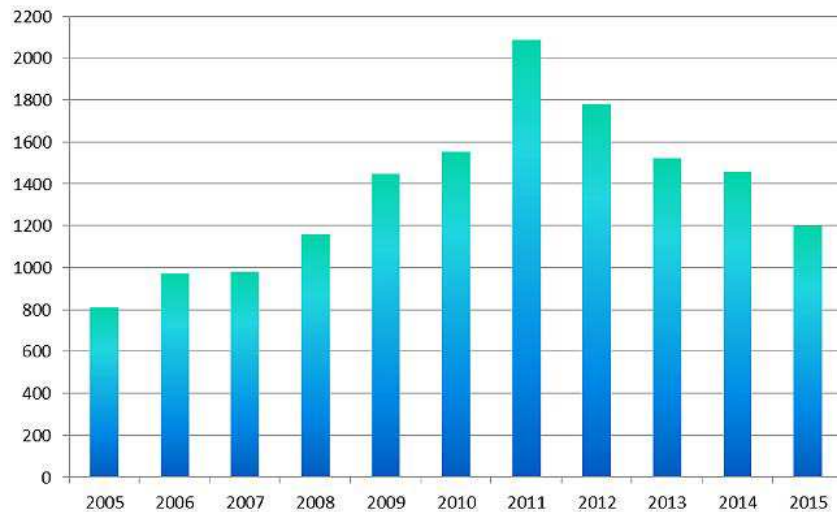
- **Securities Class Actions:** suits alleging violations of federal securities laws, principally the Securities Act of 1933 and the Securities Exchange Act of 1934, filed by a private party on behalf of a class of persons injured by alleged violations, specifically styled as a class action at the time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

As noted in the 2014 end-of-year wrap-up released in January, of the various types of lawsuits and enforcement actions tracked by Advisen that could trigger coverage under a D&O policy, in the aggregate new events fell for a third consecutive year. One quarter of the way through 2015, it appears that this downward trend may continue for at least one more year. The first quarter saw a 9 percent decline in new activity as compared to the same quarter a year ago and an 11 percent drop from the previous quarter (Q4 2014). (Exhibit 1)

Exhibit 1: Suits and Enforcement Actions (Annualized)

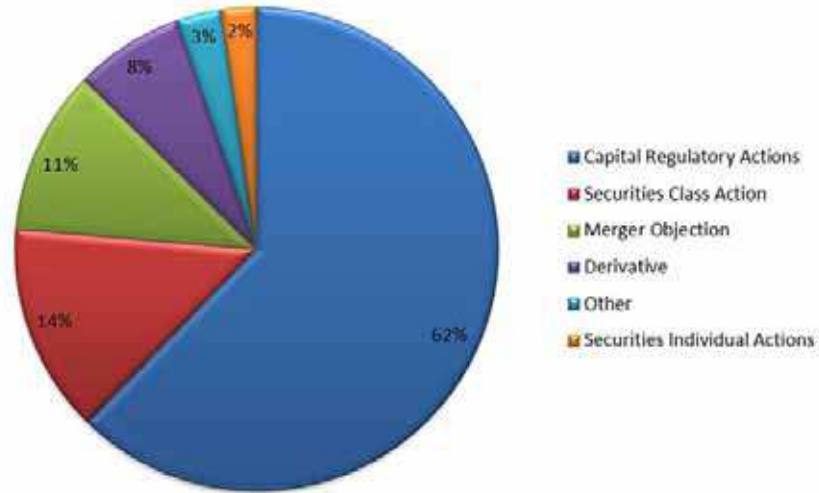


Decreases, however, were not across the board. Of the major case types, year-over-year (Q1 2014 vs. Q1 2015) declines were experienced by derivative shareholder actions (60 percent), merger objections (45 percent), and securities class action suits (2 percent). Conversely, capital regulatory actions (20 percent), securities individual actions (40 percent), foreign corrupt practices act (100 percent) and breach of fiduciary duties: securities (25 percent) saw year-over-year increases.

As noted in previous reports, declines in the aggregate total of new events 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 62 percent of the quarter's total filings, capital regulatory actions by far remained the leading source of new securities suit filings in the first quarter. In a distant second, securities class actions accounted for 14 percent, followed by merger objection suits at 11 percent.

Exhibit 2: Events by Type – Q1 2015



Financial services companies and their directors and officers remained the leading sector for new filings accounting for 30 percent of the quarterly total, which is 5 percentage points higher than 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 litigation. Other active sectors included industrials at 16 percent, consumer discretionary and information technology both at 14 percent, and health care at 10 percent.

The first quarter had 172 settlements, up slightly from 143 the same quarter a year ago and 155 the previous quarter. The average settlement for all types of suits was \$128 million. This is substantially higher than the 2014 average settlement of \$37 million and is in large part due to a massive \$16.7 billion settlement. "Settlement" includes, in addition to final approved settlements, proposed and tentative settlements, plus jury awards.

New events

The three year downward trend in the annual number of new events is likely a direct result of less litigation related to the financial crisis. Annual lawsuits and enforcement action totals, however, still remain substantially higher than the totals seen in the years prior to the financial crisis. With the first quarter recording one of the lowest totals in recent years, and barring another unforeseen crisis, it appears likely that this downward trend will continue in 2015.

By type of event

Capital regulatory actions

Capital regulatory actions remained the leading cause of D&O-related lawsuits in the first quarter of 2015 accounting for more than half (62 percent) of all recorded events. The capital regulatory actions event type was introduced by Advisen in the third quarter of 2013 and includes a majority of cases previously categorized as securities fraud.

In 2014 there was an uptick in the annual total of capital regulatory action events reversing a three year period of declines. The year-over-year increase could signal a continuation of this upward trend. This 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.

Thanks to the whistleblower statutes under Dodd-Frank and the use of analytical tools that look for numerical and textual indicators of fraud, the task force received an abundance of leads which likely contributed to the increase of actions in this area.

It has now been a few years since the Dodd-Frank whistleblower protections were put in place. Since these types of claims typically have up to a four year gestation period, there is a high probability that the number of actions in this category will continue to grow in coming years. 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 and 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 securities class actions have crept up slowly accounting for 13 percent of the 2014 annual total but they are still a long way from pre-financial crisis levels.

When compared with the first quarter of 2014 the absolute number of securities class actions was flat (43 in Q1 2014 vs. 42 in Q1 2015). As a percentage of the total events however, they were up from 13 percent in Q1 2014 to 14 percent in Q1 2015.

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.

Derivative shareholder actions

It was noted in the 2014 year-end report that the annual total of derivative shareholder 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. The first quarter of 2015 had 22 derivative shareholder action filings, down from 55 in Q1 2014 and from 31 the previous quarter.

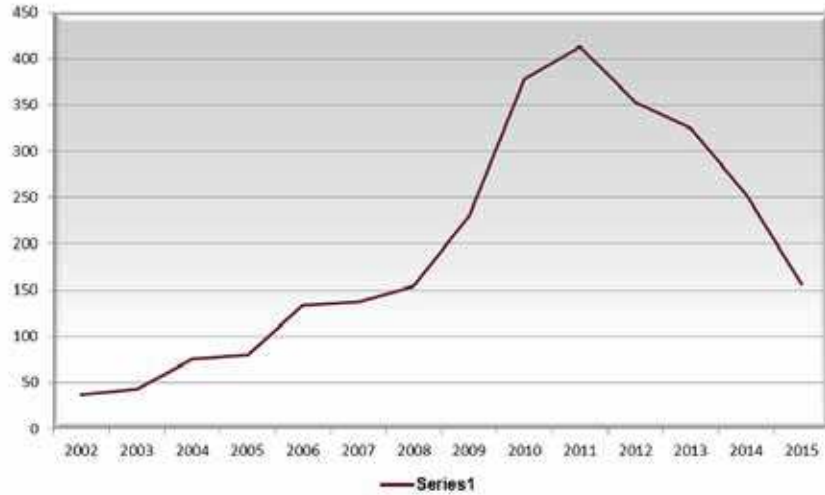
Merger objection suits

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. (Exhibit 3) 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, the first quarter saw only 33 filings, down from 60 in Q1 2014, increasing the likelihood for a continuation of the downward trend.

Exhibit 3: Merger Objection Cases Filed (2015 Annualized)

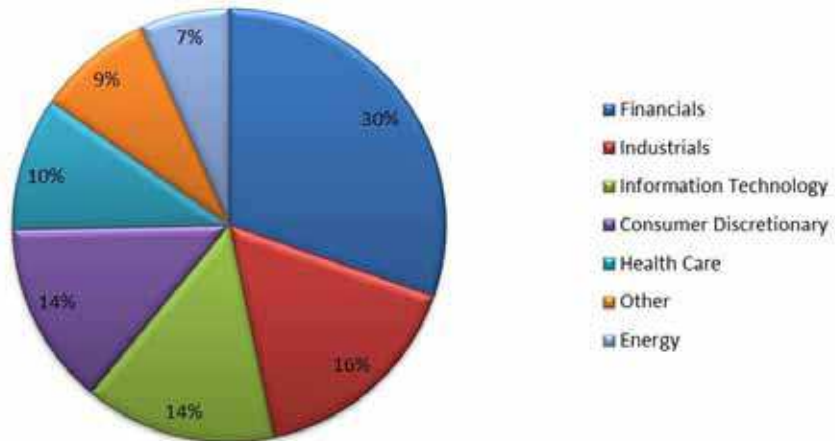


By industry

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 first 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.

For a fourth consecutive quarter industrials was the second most active sector for new filings.

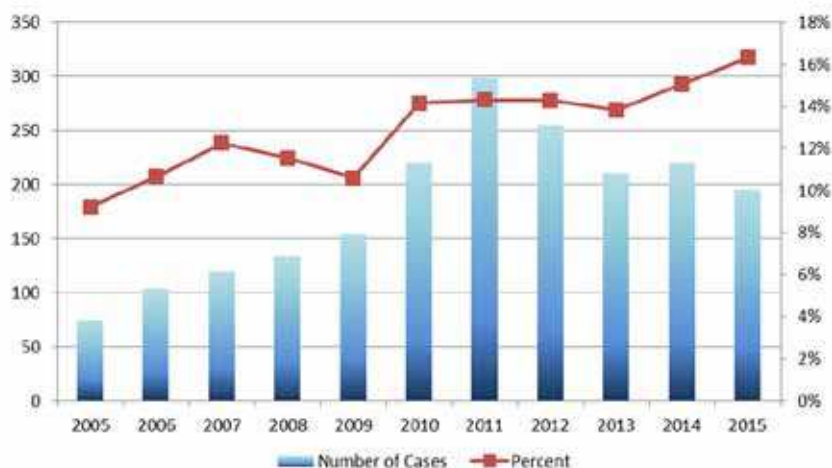
Exhibit 4: Suits by Sector



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 one of 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 first quarter, events involving non-U.S. companies, filed both in the U.S. and elsewhere accounted for 16 percent of the total. This was 2 percentage points higher than the first quarter in 2014 and 2 points higher than the 2014 average. (Exhibit 5)

Exhibit 5: Non-U.S. Companies



Settlements and awards

Capital regulatory actions, by a wide margin, had the most settlements in the first quarter accounting for 76 percent of the 172 total. Including proposed and tentative settlements, the average settlement cost for all case types was \$128 million, up substantially from \$62 million reported in Q1 of 2014, and the \$37 million 2014 average. The average settlement of \$128 million for the quarter was the highest average settlement since the fourth quarter of 2008 which had an average of \$244 million.

On average, capital regulatory actions were the most significant source of large losses at \$155 million. Although only having one settlement, securities individual actions came in second at \$115 million, followed by securities class actions at \$53 million, derivative shareholder actions at \$28 million, FCPA at \$10 million, and merger objections with a \$4 million average. In addition to the higher average settlement value, the number of settlements was also higher year-over-year, as well as quarter-over-quarter. The major case types that saw year-over-year increases included capital regulatory actions (104 in Q1 2014 to 130 in Q1 2015), derivative shareholder actions (5 to 10), and securities class actions (16 to 26). The spike in capital regulatory action settlements was likely a result of increased focus from the SEC's financial fraud task ordered to pursue even small infractions.

On February 1, 2015 the court made its final determination on Bank of America's (BOA) \$16.65 billion settlement to resolve allegations that it sold toxic mortgage-backed securities and other financial products in the lead-up to the financial crisis. The deal requires the nation's second largest bank to pay \$9.65 billion in cash and provide \$7 billion for consumer relief, such as reducing mortgage payments for struggling homeowners and funding neighborhood stabilization efforts.

Securities class action suits are typically heavily represented among the largest settlements. The largest during the first quarter was a \$960 million settlement involving American International Group, Inc. (AIG) to settle shareholder claims stemming from several class action lawsuits. On March 20, 2015 the court gave the final approval of the settlement.

Also notable in the first quarter was a final capital regulatory action settlement of \$666 million against Sentinel Management Inc. The CEO, Eric Bloom, and head trader, Charles Mosley, of the bankrupt company were indicted for defrauding clients of more than \$500 million before the firm collapsed in 2007. On January 30, 2015, the Court ordered Bloom to pay \$666 million in restitution.

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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