D&O 2013
CLAIMS TRENDS



# D&O Claims Trends: 2013 Wrap-Up & Possibilities For 2014

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ADVISEN
Insurance Intelligence

# D&O Claims Trends: 2013 Wrap-Up & Possibilities For 2014

## Executive summary

In the aggregate, new securities and business litigation filings and enforcement actions were down for the second straight year but remained elevated as compared to the years immediately prior to the financial crisis. The decline was largely a consequence of credit crisis litigation continuing to fade combined with few of the types of economic or sociopolitical events that drive new fillings.

The decrease in new events was evident in most major categories of suits and enforcement actions, including securities individual actions, capital regulatory actions, derivative shareholder actions, breach of fiduciary duties and merger objection suits. Although the always-important category, securities class actions, did not experience a decline in the annual total of new filings, it increased only nominally and remained well below its ten year historical average.

***Although the always-important category, securities class actions, did not experience a decline in the annual total of new filings, it increased only nominally and remained well below its ten year historical average.***

Not only was there a decline in the total number of new events, the number of settlements also fell for the second consecutive year. Fewer settlements, however, did not correlate to smaller settlements. In fact, the contrary was true, as the average settlement value in most categories tended to be significantly greater thanks to a higher than usual frequency of abnormally large settlements. The average settlement value for all types of suits was the most in five years and nearly four times higher than 2012.

But will this downward trend in new securities business litigation and enforcement actions continue for a third consecutive year? D&O litigation is currently experiencing a shift in priorities and a reallocation of resources as it moves past the financial crisis. It appears that there may be more drivers for filings in 2014, but plenty of doubt still exists.

One major question in the securities class action arena surrounds the Supreme Court case *Halliburton Co. v Erica P. John Fund, Inc.*, to be heard in March of this year. The case could potentially be the biggest securities case in decades as it reexamines the 1988 decision, *Basic Inc. v Levenson*. The "fraud on the market" doctrine for presumption of reliance allowed in the Basic case made class actions against businesses easier to pursue. If and how the fraud on the market doctrine will be changed as a result of the Halliburton decision is one of the biggest question marks hanging over the securities class action arena in 2014.

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## 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.

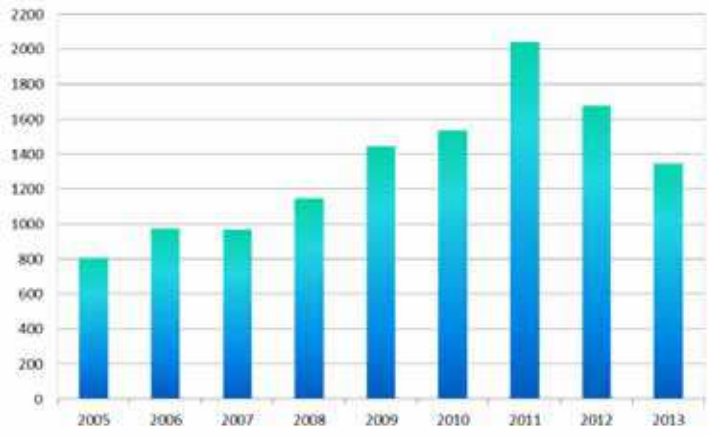
The specific definition of each type of suit can vary as well, resulting in different lawsuit tallies. Advisen defines the major types of suits in the report as follows:

- **Securities Class Actions:** suits alleging violations of federal securities laws, principally the Securities Act of 1933 and the Securities Exchange Act of 1934, filed by 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.
- **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.

## 2013 In Review - Summary of Findings

Of the various types of lawsuits and enforcement actions tracked by Advisen that could trigger coverage under a D&O policy, for second consecutive year almost all saw a decrease in new activity. In the aggregate, new events fell 20 percent, from 1,677 in 2012 to 1,344 in 2013. Although the number of new events has continued to decline from the peak of 2,041 in 2011, the aggregate still exceeds the totals from prior to 2009 as well as the ten year average of 1,285 events.

**Exhibit 1: Suits and Enforcement Actions**




Percentagewise, shareholder derivative suits experienced the largest drop in the number of new filings falling 30 percent between 2012 and 2013. Other major case types that experienced year-over-year declines in new filings included a 29 percent drop in breach of fiduciary duty cases, a 26 percent drop in securities individual actions, a 24 percent drop in capital regulatory actions and an 11 percent drop in merger objection suits.

Securities class actions were the only major case type to experience a year -over -year increase in new filings rising ever so slightly from 178 in 2012 to 180 in 2013.

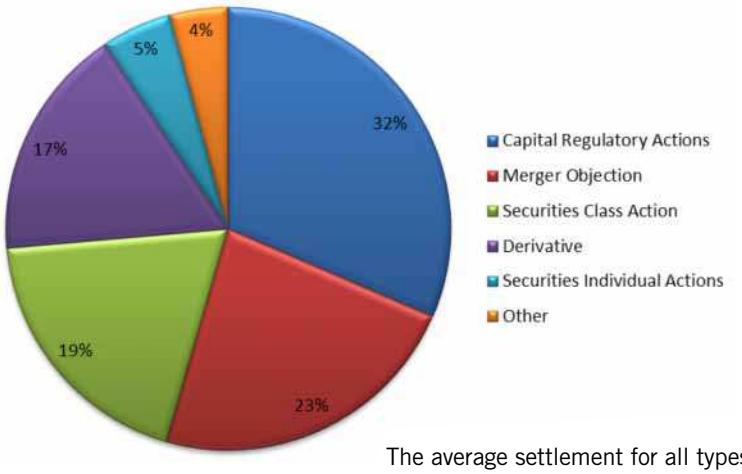
The decline in the total number of filings occurred despite the fact that some plaintiff's firms are sitting on huge war chests as a result of big credit crisis settlements. The decline is likely due to a combination of factors, including a winding down of financial crisis related litigation, fewer US public company targets and a limited ability to settle due to fewer mediators.

***At 42 percent of total filings, capital regulatory actions by far represented the largest number of new events.***

As mentioned in the 2013 Q3 D&O Claims Trends report, the growth in the importance of merger objection cases – suits filed in the wake of an announcement of a merger or acquisition – required Advisen to pull them out of the breach of fiduciary duties: class action case type (which is now merged with the breach of fiduciary duties: securities case type). Although lawyers report that the vast majority of large mergers continue to trigger lawsuits, the total number of merger objection suits has declined now for two consecutive years.

At 42 percent of total filings, capital regulatory actions by far represented the largest number of new events. Merger objections accounted for 22 percent of the year's total, and securities class actions represented 13 percent up 2 percent from 2012. As a percentage of the total D&O related events tracked by Advisen, securities class actions have decreased materially in recent years. However, the 2 percent increase in 2013 is the second consecutive year they have ticked higher and is a trend worth following.

**Exhibit 2: 2013 Events by Type**




As has been the case every year since 2006, the financial services sector again accounted for the highest percentage of new filings. Twenty-four percent of new events in 2013 involved companies and their directors and officers in the financial services sector. This was exactly the same percentage as in 2012 and is typical of the levels seen prior to the financial crisis. While subprime and credit crisis litigation is not yet dead, this suggests that the spike in suits experienced from 2008 through 2011 has subsided.

Information technology was the second most active sector, with 15 percent of the events, followed by consumer discretionary and industrials both at 13 percent.

The average settlement for all types of suits was $51.5 million in 2013, up from $13.2 million the prior year. This was the highest average settlement value since 2008 when it was $65.7 million. The increase was due in large measure to sharp increases in the average settlement values for the following; capital regulatory actions at $39.5 million in 2013 compared with $8.6 million in 2012, derivative shareholder actions at $13.5 million in 2013 compared with $4.8 million in 2012, foreign corrupt practices act (SEC) at $29 million in 2013 compared with $12 million in 2012, and securities class action at $82 million in 2013 compared to $32 million in 2012. "Settlement" includes, in addition to final approved settlements, proposed and tentative settlements, plus jury awards.

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Although settlements were bigger in 2013, there were significantly fewer of them. In fact, 2013 had the fewest number of settlements since 2005. This may be due to any of a number of factors including larger war chests enabling pursuit of bigger fish, stronger control of litigation from institutional investors driving higher expectations for bigger awards and fewer mediators causing litigation costs to increase and therefore settlement demands to increase as well.

## New Events

The drop in new events in 2013 should be seen in the context of longer term trends. The two year decline points to the ending of an era of high frequency credit crisis litigation. The 2013 counts were more in line with prevailing trends since 2007. Nonetheless, this was the second straight year where there was a nearly across-the-board decrease in lawsuits, which is atypical when compared to historical trends. More typically, plaintiff firms reallocate resources to different types of litigation to respond to changing conditions. If that indeed is happening, those resources are being allocated outside the realm of D&O-related litigation.

***By Type of Event***

As previously observed, capital regulatory actions accounted for 42 percent of the total new D&O related events during 2013. This was slightly below 2012, when capital regulatory actions represented 45 percent of the total. The capital regulatory action event type was introduced in Q3 2013 and includes a majority of the cases Advisen previously categorized under securities fraud.

It was noted last year that the decline in the number of securities fraud suits was due in part to a change of emphasis in SEC enforcement in 2012, but that a sea change could be on the horizon with the appointment of Mary Jo White as the new head of the SEC. In fact, she made it quite clear with the creation of the new financial fraud task force that her goal was to pursue even small infractions.

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The SEC appears poised to ramp up investigations thanks to the new whistleblower statutes under Dodd-Frank and through the implementation of their new Robocop profiles which are designed to look for numerical anomalies and textual indicators of fraud. As a result, all indications point to the SEC being inundated with leads and financial fraud being the dominant topic. However, the 24 percent year over year decline in capital regulatory actions, a year into the Mary Jo White era, would make it appear that, at least so far, the contrary is in fact true.

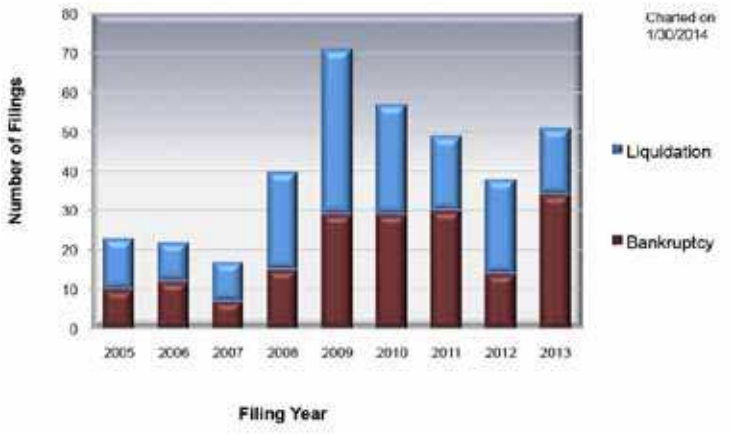
It is important to note, however, that it has only been a couple of years since the Dodd-Frank whistleblower protections have been put in place. According to Michael Young, Partner, Willkie Farr & Gallagher LLP, "there's a two to four year gestation period on these types of claims and we're only half way through that. There may be a lot in the pipeline and we just haven't seen it yet." With this in mind it seems that there is a high probability that the number of actions in this category will increase in the coming years.

Prior to the credit 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 had 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. Although in the past two years securities class actions have been creeping up slowly as a percentage of total events, they are still a long way away from pre-credit crisis levels.

The absolute number of securities class action filings ticked up slightly in 2013 but remained well below the historical average. Fewer securities class action filings has been the topic of much discussion and speculation among analysts. Over a short time horizon, the decrease is attributable to fewer suits involving Chinese firms and the winding down of credit crisis suits.

The longer term trend towards fewer securities class action suits likely reflects a change in emphasis by plaintiffs' firms, due in part to a string of Supreme Court decision favoring defendants. Another such Supreme Court decision with huge securities class actions implications is expected in March of 2014 in Halliburton Co. v Erica P. John Fund, Inc., which debates the "fraud-on-the-market" doctrine for presumption of reliance. A reversal of the precedent set in the 1988 decision Basic Inc. v Levinson, could make it more difficult for plaintiffs firms to pursue class actions against businesses. Regardless, another event such as the meltdown of the subprime market undoubtedly would open a floodgate of new filings.

**Exhibit 3: Bankruptcy and Liquidation Trend from 2005 to 2013**




Although the total number of breach of fiduciary duties filings dropped 29 percent from 2012 to 2013, there are indications of an uptick in these cases as they pertain to bankruptcy filings. According to John McCarrick, a partner with White and Williams LLP, it is not unusual to see this when there are not huge returns in other areas. "Activist investors and particularly hedge funds have become opportunistic looking for returns wherever they can get it." He explains that, "in the bankruptcy context, hedge funds often look for companies with a D&O insurance program intact and buy up creditor claims for pennies on the dollar. They then position themselves to lead creditors' committees and sue the former directors and officers for breach of fiduciary duty for the things that led up to the bankruptcy filing seeking to monetize the D&O insurance program."

**Exhibit 4: Merger Objection Cases Filed**

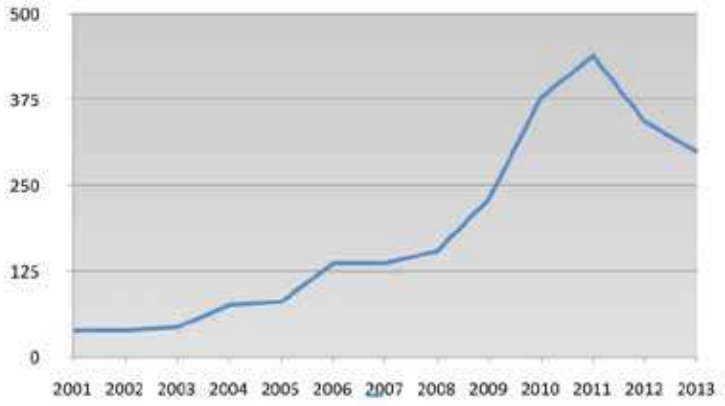



**Exhibit 5: M&A Transaction Trend from 2015 to 2013**


Merger objection suits usually 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. Merger objection filings maintained a strong growth trend despite fluctuations in M&A activities through 2011. (Exhibit 4 & 5) It was recently reported that nearly all M&A's in 2013 valued at over $100 million were involved in a shareholder lawsuit. It was also noted that the vast majority that are settled are "disclosure only" settlements. 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 mergers and acquisitions. Some of the judges presiding over these cases seem to agree. For example, Chancellor Strine of the Delaware Chancery Court recently commented that "The social utility of cases like this continuing to be resolved in this way is dubious."

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 two years, falling 27 percent. As a percentage of total events, however, merger objection suits have been trending in the opposite direction. Strong stock markets like we experienced in 2013, however, often drive M&A activity which in turn will drive more merger objection suits.

***Financial firms continued to dominate new filings, as they have since before the credit crisis.***

***By Industry***

Financial firms continued to dominate new filings, as they have since before the credit crisis. About 24 percent of new filings in 2013 named companies in the financial services sector and their directors and officers. While still by far the largest industry group for new filings, as percentage of the total it remained flat from 2012. This suggests that while the industry remains a magnet for litigation it may have leveled out from the high's experienced as a result of credit crisis activity. According to Young, "for the past five years it has been all financial crises all the time because that is where the resources for the SEC and the plaintiff's bar were placed. We are now moving past that and watching a reallocation of resources take place."

It was noted in last year's report that, historically, filings involving financial firms and those involving technology firms are negatively correlated: as the number of suits naming financial firms increase, the number naming information technology firms decrease, and vice versa. That trend appears to be holding true. Over a 5 year period 2009 – 2013, suits involving financial firms have fallen from 40 percent to 24 percent, while suits involving IT firms have risen from 12 percent to 15 percent.

***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 a picture of litigation activity.***

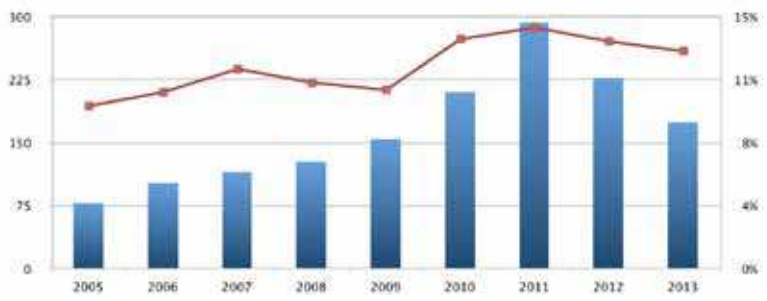
Across the board, the percentage of filings per industry remained almost identical to the prior year. For example, suits related to IT increased from 14 percent in 2012 to 15 percent in 2013, Industrials and consumer discretionary both remained flat at 13 percent, healthcare dropped from 13 percent to 12 percent, energy increased from 6 percent to 7 percent and both materials and consumer staples stayed flat at 4 percent.

***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 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 data limitations, it is increasingly clear that litigation activity outside the United States has become more common in recent years. Among the common triggers for D&O claims in non-U.S courts are bankruptcy and regulatory enforcement actions.

In 2013, events involving non-U.S. companies, filed both in the U.S. and elsewhere accounted for 13 percent of the total. This was just slightly below 2012 at 14 percent. (Exhibit 6) Of the events involving non-U.S. companies, Chinese and Canadian companies accounted for highest percentage at 25 percent and 27 percent respectively.

**Exhibit 6: Non-U.S. Companies**




## Settlements and Awards

Capital regulatory actions and securities class actions represented the largest number of settlements for the year with 253 and 106 respectively. Including proposed and tentative settlements, the average settlement cost for all case types was $51.5 million up from $13.2 million in 2012. A securities class action for $2.5 billion was the largest settlement reported in 2013.

On the average, securities class actions remained the most significant source of large losses. Including proposed and tentative settlements, the average securities class action settlement was $82 million for the year, up from $33 million in 2012. The $82 million securities class action average was more than double that of second highest average, capital regulatory actions, at $39.5 million. These compare to a $28.9 million average for foreign corrupt practices act suits, $17.9 million for breach of fiduciary duties suits, $13.5 million for shareholder derivative suits and $5.9 million for merger objection suits.

While the average settlement was up, the number of settlements continued to trend downward. In fact, securities class action was the only major case type to have an increase in the number of settlements. There were 106 securities class action settlements in 2013 compared with 66 settlements in 2012. The other major case types all experienced declines in the number of settlements; capital regulatory actions went from 328 in 2012 to 253 in 2013, derivative shareholder actions went from 42 to 31, merger objection from 44 to 15, breach of fiduciary duties from 11 to 8 and FCPA from 13 to 10.

*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*

The largest settlement of 2013 was a $2.5 billion securities class action against HSBC with a filing date of August 19, 2002. The complaint alleged that HSBC (formerly Household International Securities) violated federal securities laws by issuing a series of materially false and misleading statements regarding the company's business, operations and future prospects.

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 2013. The settlement concerned 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.

Other notable settlements included a capital regulatory actions settlement against S.A.C. Capital Advisors, LP for $1.2 billion to resolve insider trading charges and a $725 million securities class action against American International Group (AIG). S.A.C. Capital was charged with securities fraud and wire fraud in connection with a large-scale insider trading scheme and was imposed the largest insider trading penalty in history. AIG resolved allegations of fraud from October 1999 to April 2005 involving anti-competitive market division, accounting violations and stock price manipulation.

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.

## Other Potential Filing Drivers in 2014

The Halliburton decision, increased SEC investigations and enforcement actions, and a strong stock market driving more M&A's and therefore more merger objection suits, are only a few of the factors potentially influencing D&O claims in 2014.

A lot depends on whether the apparent return to good economic times continues. For example, good times equal heightened expectation for earnings, but great expectations may increase the motivation for fraud. Additionally, a good economy and a strong stock market will likely drive more IPO's which in turn may result in more disclosure suits. Conversely, an improving economy means fewer bankruptcies and fewer related suits.

2014 could be the year that cyber events drive more securities class action suits and even shareholder derivative suits. A shareholder derivative suit was filed on January 29 naming Target's directors as regards the massive data breach in late 2013. SEC guidance concerning disclosure of data security issues, issued in October 2011, is widely anticipated to spark litigation, and activists and public officials are putting pressure on the SEC to further elevate its guidance as concerns data breaches. ■