D&O Claims Trends:

2014 End of year wrap up

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ADVISEN
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Executive summary

New securities and business litigation filings and enforcement actions were down for a third consecutive year in 2014, although, in the aggregate, they were still elevated compared to the years prior to the financial crisis.

The decrease in new events was evident in most major categories of suits and enforcement actions including securities class actions, breach of fiduciary duty suits, securities individual actions, merger objection suits, and derivative shareholder actions. The always important category, securities class actions, saw the annual total of new filings drop slightly in 2014 and remain below its ten year historical average.

The number of settlements increased in 2014 but the average settlement value dropped. The average securities class action settlement, for example, fell 70 percent as compared to 2013.

In addition to a review of claims activity for 2014, this report also contains a special section on three areas – cyber, FCPA, and IPO related litigation – that generated interesting activity in 2014 and are likely to do the same in 2015.

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 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 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.

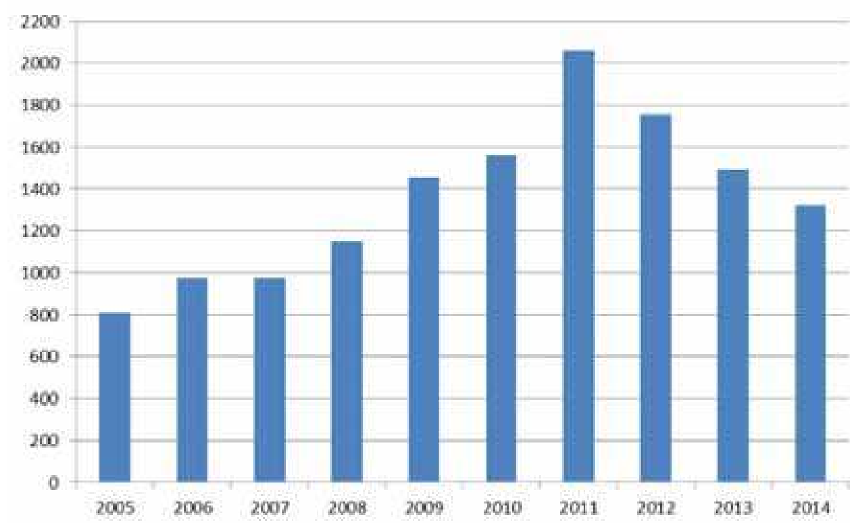
- **Merger Objection**: suits filed by disgruntled shareholders of a company that has been, or is about to be, acquired.

- **Derivative Action**: cases against directors and officers brought by shareholders, creditors and Boards of Directors on behalf of the company.

Summary of findings

Of the various types of lawsuits and enforcement actions tracked by Advisen that could trigger coverage under a D&O policy, most saw a decrease in new activity for a third consecutive year. In the aggregate, new events fell 10 percent, from 1,492 in 2013 to 1,342 in 2014. Although the total number of new events continued to decline from a peak of 2,059 in 2011, the aggregate still exceeds the totals from prior to 2009. (Exhibit 1)

Exhibit 1: Suits and Enforcement Actions



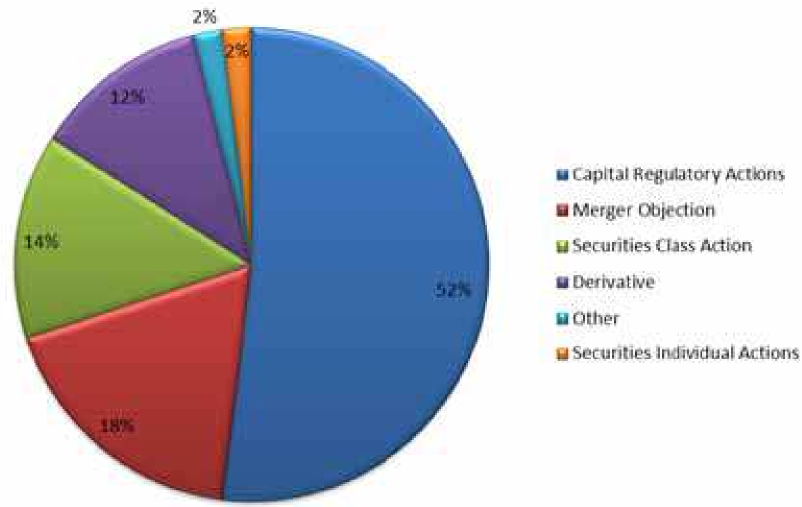
Securities-related breach of fiduciary duty suits saw the largest drop with the number of new filings falling 73 percent between 2013 and 2014. Other major case types that experienced year-over-year declines in new filings included a 51 percent drop in securities individual actions, a 25 percent drop in merger objection suits, a 17 percent drop in derivative shareholder actions, and a 3 percent drop in securities class actions.

Two major case types that experienced a year-over-year increase in new filings were capital regulatory action which rose 6 percent from 656 in 2013 to 693 in 2014, and foreign corrupt practices act (SEC) which rose 57 percent from 7 filings in 2013 to 11 in 2014.

Similar to the previous two years, the decline in the total number of filings occurred despite some plaintiffs firms being highly capitalized from huge settlements related to the financial crisis and other areas such as the Foreign Corrupt Practices Act (FCPA) settlements. The decline can be attributed to a variety of factors including the continued wind down of financial crisis related litigation, fewer US public company targets, and a reduced ability to settle due to fewer mediators.

At 52 percent of the total filings for the year, capital regulatory actions by far represented the largest number of new events. Merger objections accounted for 18 percent of the year's total, securities class actions 14 percent, derivative shareholder actions 12 percent, and securities individual actions 2 percent. (Exhibit 2)

Exhibit 2: 2014 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. In-line with the previous two years and typical of the levels seen prior to the financial crisis, 25 percent of new events in 2014 involved companies and their directors and officers in the financial services sector. While subprime and credit crisis litigation is not yet dead, this suggests that the spike in suits experienced at the peak of the crisis, from 2008 through 2011, has subsided.

Industrials was the second most active sector accounting for 15 percent of the total events, followed by consumer discretionary and information technology both at 13 percent.

The average settlement for all types of suits was $28 million in 2014. This was down substantially from $45.2 million the prior year. This decrease was due in large measure to a sharp decline in the average securities class action settlement from $83.5 million in 2013 to $25.1 million in 2014. "Settlement" includes, in addition to final approved settlements, proposed and tentative settlements, plus jury awards.

Although settlement values were down in 2014, the total number of settlements rose from 458 in 2013 to 570 in 2014.

New events

The drop in new events in 2014 should be seen in the context of longer term trends. The three year decline is further evidence that the era of high frequency credit crisis related litigation has ended. Nonetheless, a nearly across-the-board decline in lawsuits is atypical when compared to historical trends. More typically, plaintiff firms reallocate resources to different types of litigation to respond to changing conditions. If this is in fact occurring, it appears that those resources are possibly being allocated outside the realm of D&O-related litigation.

By type of event

Capital regulatory actions

As previously observed, capital regulatory actions accounted for 52 percent of the total new D&O-related events during 2014. This was an increase of eight percentage points from 2013 when capital regulatory actions represented 44 percent of the total. The capital regulatory actions event type was introduced by Advisen in Q3 of 2013 and includes a majority of cases previously categorized as securities fraud.

Over the previous three years the absolute total number of capital regulatory actions declined from 874 in 2011 to 655 in 2013. It was noted last year that the decline in the number of capital regulatory actions over that period was due in part to a change of emphasis in SEC enforcement, but that a sea change could be on the horizon when SEC Chair Mary Jo White created a new financial fraud task force.

Thanks to the whistleblower statutes under Dodd-Frank and the use of new analytical tools that look for numerical and textual indicators of fraud, the taskforce received an abundance of leads which is likely a contributing factor to the increase of actions in this area. It has now been a few years since the Dodd-Frank whistleblower protections have been 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 increase in the coming years.

Priya Huskins, a partner with Woodruff Sawyer, a California based commercial insurance brokerage, also expects to see an increase of SEC regulatory activity coming out of the Office of the Whistleblower. “The office went from scary, to not doing very much, to really scary. I expect we will continue to see significant activity there in 2015” she explains.

Huskins believes insider trading will be a big deal in 2015 and points to comments made by Mary Jo White expressing her concern about the Second Circuit’s decision in the United States vs. Newman and Chiasson which overturned two insider trading convictions as one of the reasons. The crux of the case was that an insider trading conviction could not be sustained if the tippee did not know that the alleged tipper disclosed material nonpublic information in exchange for a meaningful personal benefit. “The Newman decision leaves us with a much more narrow view of insider trading than what the SEC and prosecutors have been pursuing in recent years. The SEC will want to find cases to clarify Newman so it doesn’t give the wrong impression to the world” Huskins explains.

Huskins also points to charges brought by the SEC against 28 officers, directors and major shareholders and six publicly-traded companies for violations of Section 16 filing requirements as a sign increased enforcement activity. The SEC made it quite clear that not following insider holding disclosure form requirements is a violation of federal securities laws. What they also made clear is that they are looking for violations both large and small. “We are seeing an agency that takes enforcement seriously,” Huskins explains. “We are going to see a lot of activity from the SEC in 2015.”

Securities class actions

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 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 as a percentage of total events, but they are still a long way from pre-credit crisis levels.

The absolute number of securities class action filings has held steady over the past three years. They were down just slightly from 188 in 2013 to 183 in 2014, and remained well below the 10 year average of 199. Fewer securities class action filings continue to be a topic of much discussion and speculation among analysts. Over a short time horizon, the general decline may be driven by factors such as a reduction in the number of companies traded on the US Stock Exchange and the winding down of credit crisis 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 decisions favoring defendants.

Derivative shareholder actions

The annual total of derivative shareholder action filings has declined every year since 2011, a year that saw the second highest annual total in the past ten years. In fact, the 2014 annual total of 164 filings is significantly below the 10 year average of 233. The number of shareholder derivative settlements has also been trending downward over that same period, from 64 in 2011 to 38 in 2014.

Joe Monteleone, a partner with Rivkin Radler LLP, noted that although the overall severity of settlements is declining there appears to be a trend of increasing frequency of severe shareholder derivative settlements. He points to both the Activision and Freeport McMoRan settlements of $275 million and $137.5 million respectively as evidence as well as the fact that there have been more than a handful of nine figure settlements over the past five to six years. We will continue to follow this trend in 2015.

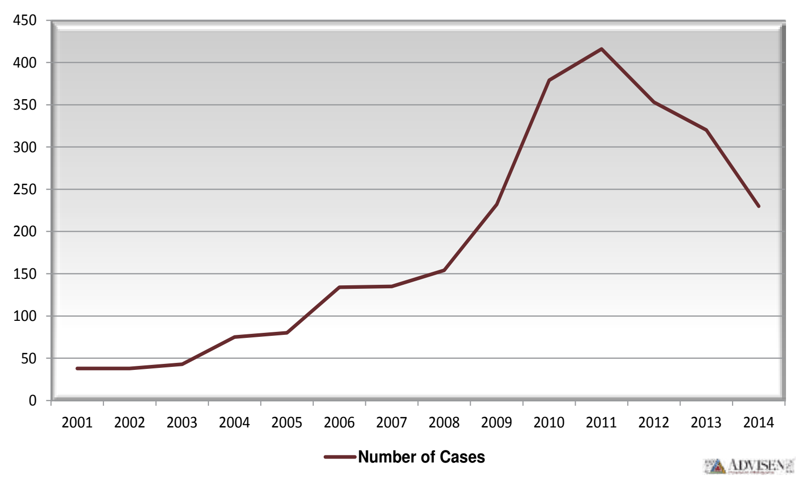
Merger objection suits

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

It has been noted in previous reports that a majority of large M&A's are involved in shareholder lawsuits. It was also noted that most of the settled cases 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 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 42 percent. (Exhibit 3) Strong stock markets as have been experienced the past two years, however, often drive M&A activity which in turn will drive more merger objections suits.

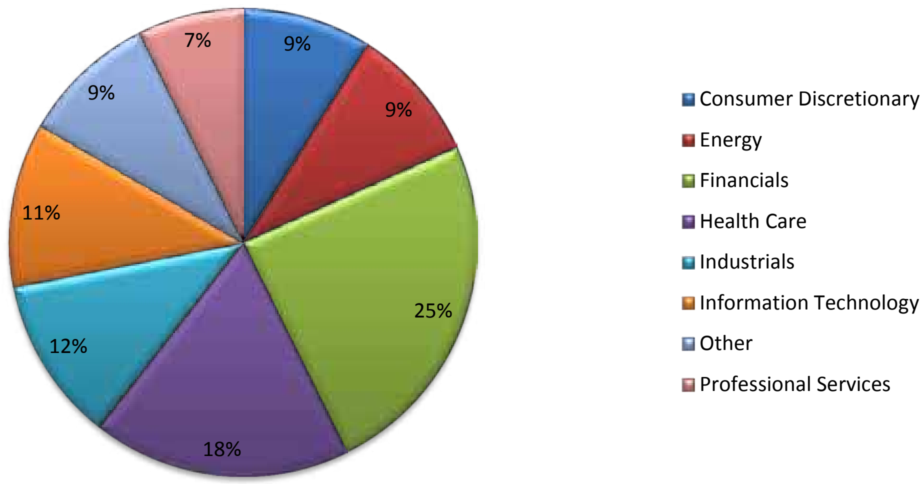
Exhibit 3: Merger Objection Cases Filed



By industry

Financial firms continued to dominate new filings in 2014, as they have since before the credit crisis. About 25 percent of new filings in 2014 named companies in the financial services sector and their directors and officers. While far-and-away the largest industry group for new filings, this number is down substantially from its peak of 40 percent in 2008 and 2009. While undeniable the riskiest industry in terms of D&O-related lawsuits – 10 percentage points higher than industrials at 15 percent – new filings in this sector have hovered around 25 percent for three straight years signaling an end to high frequency credit crisis litigation. (Exhibit 4)

Exhibit 4: Suits by Sector

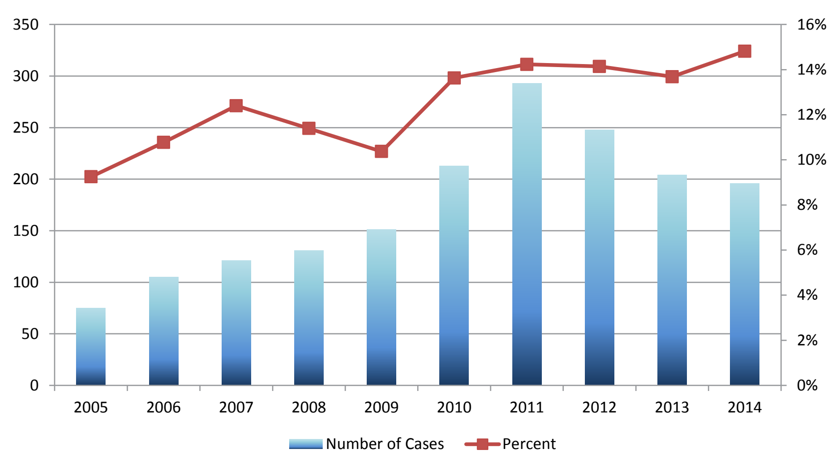


Non-U.S. companies

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 the common triggers for D&O claims in non-U.S. courts are bankruptcy and regulatory enforcement actions.

In 2014, events involving non-U.S. companies, filed both in the U.S. and elsewhere, accounted for 15 percent of the total. This was just slightly above 2013 at 14 percent. (Exhibit 5)

Exhibit 5: Non-U.S. Companies



Settlements and awards

Capital regulatory actions and securities class actions again represented the largest number of settlements in 2014 with 404 and 76 respectively. Including proposed and tentative settlements, the average settlement cost for all case types was $28 million which was down substantially from $45.2 million in in 2013.

On the average, capital regulatory actions were the most significant source of large losses. Including proposed and tentative settlements, the average capital regulatory action settlement was $31.8 million for the year, down slightly from $34 million in 2013. At $26.6 million, Foreign Corrupt Practices Act (SEC) had the second highest average settlement value, followed by securities class actions at $24.9 million, derivative shareholder actions at $14 million, merger objection suits at $10.5 million, proxies and solicitation violations at $3.4 million, and securities individual actions at $2.4 million.

While the average settlement value was down in 2014, the number of settlements ticked up. The major case types that saw increases included FCPA settlements (11 in 2013 to 16 in 2014), merger objection settlements (22 in 2013 to 27 in 2014), and most significantly, capital regulatory action settlements (264 in 2013 to 404 in 2014). The spike in capital regulatory action settlements was likely a result of increased regulatory focus from the financial fraud taskforce ordered by the head of the SEC, Mary Jo White, to pursue even small infractions.

The largest settlement of the year was in fact the largest civil settlement with a single entity in American history. On August 21st, 2014 Bank of America (BOA) agreed to pay nearly $17 billion to resolve allegations that it sold toxic mortgage-backed securities and other financial products in the lead-up to the financial crisis. As part of the settlement, BOA agreed to pay a $5 billion penalty under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) – the largest FIRREA penalty ever – and provide billions of dollars of relief to struggling homeowners, including funds that will help defray tax liability as a result of mortgage modification, forbearance or forgiveness.

Securities class action suits are typically heavily represented among the largest settlements. One of the largest in 2014 was a $264 million tentative settlement against Massey Energy Inc. Massey produces, processes, and sells bituminous coal extracted from mines in Wes Virginia, Kentucky and Virginia. Massey claimed to be one of the safest mine operators in the industry and regularly touted its safety achievements to investors. After Massey experienced the worst U.S. mining disaster in 40 years it stock price plummeted. As a result it agreed to pay $265 million to settle a class action that accused Massey of misrepresenting its safety record to inflate stock prices.

Also notable in 2014 were a handful of large FCPA settlements including a massive $772 million settlement with Alstom SA, which was the biggest criminal fine ever levied for FCPA offenses.   Also noteworthy were settlements with cosmetic company Avon Products Inc. for $135 million for bribing officials in China, and with oilfield services company Weatherford International for $97.3 million for authorizing bribes and improper travel and entertainment for foreign officials in the Middle East and Africa to win business.

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: Trends for 2015

Cyber

"Given the significant cyber-attacks that are occurring with disturbing frequency, and the mounting evidence that companies of all shapes and sizes are increasingly under a constant threat of potentially disastrous cyber-attacks, ensuring the adequacy of a company's cybersecurity measures needs to be a critical part of a board of director's oversight."[1] *Commissioner Luis A. Aguilar, U.S. Securities and Exchange Commission*

Although cybersecurity has been a hot topic for some time, especially among corporate risk managers and CIOs, more corporate boards are questioning the adequacy of their cyber risk oversight, and for good reason. Data breaches are now being followed by lawsuits where the board's oversight of cyber risk is coming into question.

Monteleone explains that while the frequency of cyber related D&O litigation has not been high to date, he does not rule out the possibility of an increase in cyber related D&O litigation in the coming year. He explains that outstanding cases against companies such as Target could act as template for this type of litigation in future.

Rick Bortnick of Traub Lieberman Straus & Shrewsberry LLP agrees. "Of all the areas of concern for corporate boards, cyber should be at the top of the agenda." It is his view that in the future just about any breach of significance will turn into a D&O lawsuit and boards need to have cybersecurity policies and internal controls in place to secure their defense.

Bortnick used the dismissal of a shareholder derivative suit that sought damages from the directors and officers of Wyndham Worldwide Corp. (WWC) for several data breaches as an example. In this case a derivative action against Wyndham was dismissed with prejudice based on the findings that they had done a reasonable job both putting in place cybersecurity policies and controls pre breach, and conducting formal reviews that resulted in enhancements to the policies and controls post breach.

Boards can take many steps to proactively manage cybersecurity risks such as increasing transparency, requiring cyber education, and reviewing insurance protection. It is also suggested that at a minimum they be aware of industry standards and best practices for managing cybersecurity risks. The National Institute of Standards & Technology (NIST) Framework is a benchmark that corporate boards can refer to when assessing their cybersecurity policies and procedures. "NIST is an outline of minimum standards. It's not everything, but at the very least it can act as a best practices playbook" Bortnick explains.

Massive data breaches such as Target, Home Depot, and Sony sustained in 2013 and 2014, all of which have resulted in extensive litigation, will likely become even more commonplace in 2015 and beyond. As a result, experts agree that ignorance is an unacceptable defense and cybersecurity must be at the top of a board's agenda in order to better protect their shareholder's assets.

Foreign Corrupt Practices Act (FCPA)

Companies paid more in 2014 than ever before to settle FCPA investigations. This included a $772 million settlement with Alstom SA and other large settlements with Avon Products and Weatherford International among others. Both Monteleone and Huskins agree that there will not be a let up in FCPA litigation in 2015. In fact, the Department of Justice (DOJ) already announced the first Foreign Corrupt Practices Act enforcement actions of the new year.

Huskins identifies a couple of reasons why this may be the case. The first is the office of the whistleblower and the opportunities for someone to earn big money for going to the SEC. The second is the Supreme Court's decision to deny the FCPA 'instrumentality' challenge by two jailed company executives, Joel Esquenazi and Carlos Rodriguez, who sought to challenge their FCPA convictions over the question of who counts as a foreign official. Huskins believes this case supports the SEC and DOJ's broad view of instrumentality and provides incentive to go after corruption.

The FCPA is enforced jointly by the SEC and the DOJ and has two primary focuses: the anti-bribery provisions and the books and records requirements. Most major enforcement actions involve allegations of unlawful payments to public officials, but violations of books and records requirements also are prosecuted under the FCPA, and carry significant fines and penalties.

Criminal violations of the anti-bribery provision of the FCPA can result in a corporate fine of up to $2 million per violation. Individuals may be fined up to $100,000 per violation in addition to imprisonment for up to 5 years. Willful violations of the books and records provision can result in a criminal fine of up to $25 million for a company and up to $5 million for an individual, plus imprisonment for up to 20 years. The SEC also can seek disgorgement of profits obtained as a result of improper payments under the Act.

The FCPA is a part of a growing global anti-bribery initiative which includes the U.K., China, Brazil and Canada, who have all enacted their own anti-bribery laws. The U.K.'s Serious Fraud Office (SFO) recently secured its first conviction under the UK Bribery Act in December against Sustainable AgroEnergy plc (SAE). The conviction followed an investigation into the sale and promotion of their investment products.

Insurance may be available for some FCPA claims, but it is often limited, and almost never covers fines and penalties. Some investigation and defense costs may be covered, but this coverage is also usually limited to individuals. According to Huskins, “A well brokered D&O policy will absolutely provide individuals with legal defense protection for formal and informal investigations.”

Entity coverage for public companies typically is available only with respect to a “securities claim,” which is most often defined in D&O policies to exclude payment for any FCPA violation. Individual directors and officers may have some coverage, but Monteleone explains that in the future “If the case is severe enough the DOJ and SEC may make it part of the settlement that the accused individuals can’t receive indemnification from insurance.”

IPOs

A trend that has emerged over the previous two years and is worth keeping an eye on in 2015 is the filing of securities related litigation following a company’s initial public offering (IPO). This is usually a result of a perceived failure to disclose information prior to the IPO that results in a significant drop in stock price. The increase in the number of IPO-related suits is directly correlated with an increase in IPO activity, and in the U.S. 2014 saw the most IPOs since 2000.[2] According to Monteleone, plaintiffs firms often get past the motion to dismiss on many of these cases.

The healthcare sector has been a leading sector for U.S. IPOs over the previous two years. A significant IPO suit involving a healthcare company in 2014 was a securities fraud case against HCA Holding Inc. which was granted class action status in a suit stemming from the company’s 2011 $4.3 billion IPO. The company’s stock sold for $30 a share during the March 2011 IPO and dropped to around $18 by October of that same year.

The suit alleged that HCA failed to disclose that growth from Medicaid revenue was in decline and was expected to continue to drop due to Medicaid cuts in certain states. It alleged that instead HCA focused on the substantial increase of Medicaid revenue it received from 2008 to 2011.[3]

In this case, the list of defendants includes HCA executives, investment banks, and private equity firms. Although he is not involved in HCA, according to Monteleone that is not atypical, “plaintiffs are not only suing the IPO Company, but they are also frequently trying to get at the private equity firms behind the IPO. In a lot of these cases they try to establish that the private equity company is actively involved in the misrepresentation.” He explains “private equity firms usually have their own insurance, but it sits in excess of the D&O insurance of the portfolio company.”

With regards to D&O insurance, the good news, Monteleone explains, is “There’s been more of a focus on the real value of these cases and less pressure on the entire tower of insurance. Let’s say there’s a market cap loss of say $100 million, that case is probably going to settle for somewhere in the vicinity of $5 million or less. Those typically will not impact the entire tower of insurance. It’s been refreshing, particularly where there’s a well-qualified mediator.”

It has been predicted that 2015 will be another strong year from IPOs in the United States. If this prediction holds true it is fair to say that IPO related litigation will remain active and be a trend worth following. ■

This report was written by Josh Bradford, Assistant Editor at Advisen Ltd.

[1] U.S. Securities and Exchange Commission, "Cyber Risks and the Boardroom Conference," June 10, 2014, http://www.sec.gov/News/Speech/Detail/Speech/1370542057946#.VL_0OS4_x2C

[2] Ernst and Young, Press Release, "2014 realizes strongest US IPO numbers in over a decade," (December 10, 2014), http://www.ey.com/US/en/Newsroom/News-releases/news-2014-realizes-strongest-us-ipo-numbers-in-over-a-decade

[3] Jamie McGee, The Tennessean, "Group granted class-action status in HCA lawsuit," (September 23, 2014), http://www.tennessean.com/story/money/industries/health-care/2014/09/24/group-granted-class-action-status-hca-lawsuit/16128357/