D&O 2013
CLAIMS TRENDS

D&O Claims Trends: Q3 2013

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Executive summary

Compared with the previous quarter, the number of new securities and business litigation filings and regulatory enforcement actions continued to decline in the third quarter, but at a much slower pace. The decline keeps 2013 in line to have the lowest annual total of new filings since prior to the credit crisis. Although the number of filings decreased for some categories such as derivative shareholder actions and merger objection suits, a couple of major categories increased, most notably securities class actions.

The financial sector remained the top sector for new securities litigation filings and enforcement actions in the third quarter. As the credit crisis recedes into the past, actions against financial firms and their directors and officers are approaching pre-credit crisis levels.

The number of settlements declined in the third quarter compared with the previous quarter but the average settlement values increased. Securities class actions represented the highest number of settlements and were also the most significant source of large losses.

Advisen is pleased to introduce a number of enhancements to the way in which it categorizes lawsuits and enforcement actions. While these changes do not affect the total number of cases they will affect the values in some categories. The changes include three new case types and the merger of case types to simplify the structure of certain categories. These changes will be highlighted and explained throughout the report.

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 and collective actions.

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.

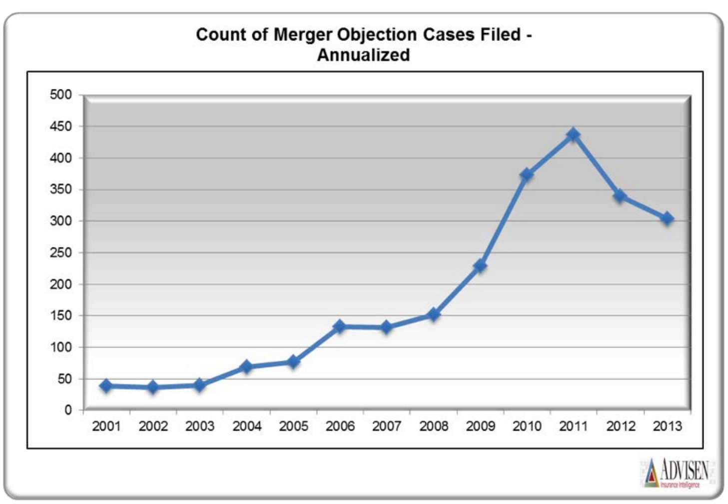
Findings

The downward trend in the various types of lawsuits and enforcement actions that could trigger coverage under a D&O policy continued in the third quarter with new events falling from 278 in Q2 to 268 in Q3, a 4 percent decline. This keeps 2013 on pace to have the lowest annual total of filings since prior to the financial crisis. When compared with the same quarter a year ago, new filings decreased by 21 percent. The 268 events represent the lowest quarterly total since prior to 2009.

The following case types experienced declines in new filings; merger objections (81 Q2 to 61 Q3), derivative shareholder actions (50 Q2 to 35 Q3), derivative actions (5 Q2 to 0 Q3), books & records violations (1 Q2 to 0 Q3), control pensions violations (1 Q2 to 0 Q3) and creditor derivative (1 Q2 to 0 Q3).

Quarterly increases were experienced by the following; capital regulatory actions (75 Q2 to 76 Q3), securities class actions (42 Q2 to 58 Q3), securities individual actions (11 Q2 to 26 Q3), breach of fiduciary duties (7 Q2 to 8 Q3) and proxies and solicitation violations (1 Q2 to 4 Q3).

Exhibit 1



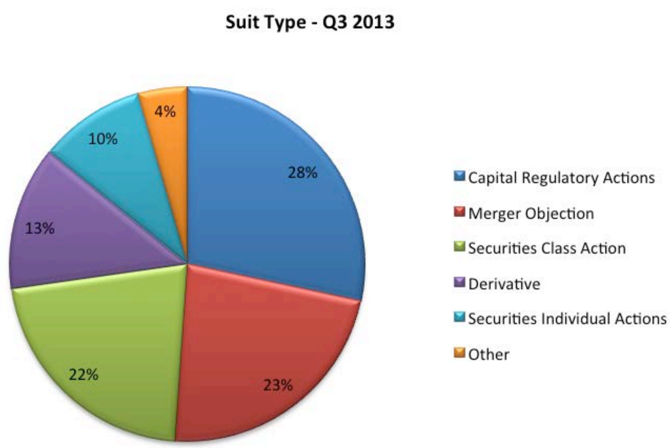
Note: Capital regulatory actions and securities individual actions are new case types introduced this quarter.

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 type (which has now been merged with Breach of Fiduciary Duties: Securities). The absolute total of merger objection suits was climbing on an annual basis through 2011 but decreased in 2012 and is on pace to do so again in 2013. (Exhibit 1) The downward trend in merger objections suits is likely a result of a decline in overall M&A activity.[1]

As a percent of the total filings for the quarter, capital regulatory actions and merger objections were the most common types representing 28 and 23 percent of the total respectively. This is not surprising since Advisen formerly included merger objections in breach of fiduciary duties, the most common filing type in Q2. Additionally, capital regulatory actions includes a majority of cases that were classified as securities fraud, the second most common filing type in the second quarter.

The third most common type of filing, securities class action suits, represented 22 percent of the total, an increase of 7 percentage points from the second quarter. Derivative actions (including those brought by shareholders, creditors and boards of directors) comprised 13 percent of the total, down 5 points from Q2. Rounding out the top five was securities individual actions at 10 percent of the total. (Exhibit 2)

Exhibit 2



Consistent with previous quarters, at 24 percent of the total, the financial services sector and their directors and officers remained the leading target of new filings. However, the absolute number of new suits in the financial services sector continues to decline, a trend that dates back to the fourth quarter of 2011. While subprime and credit crisis litigation is far from dead, the declining number of new events in the financial services sector represents a winding down of subprime and credit crisis related activity. Other active sectors included health care at 15 percent and information technology and consumer discretionary both at 13 percent.

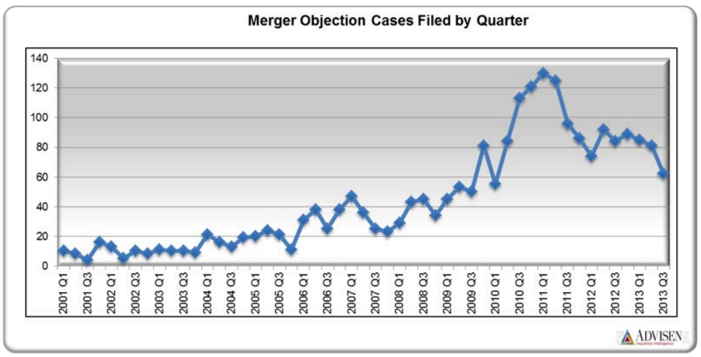
There were 94 settlements in Q3 down from 108 in Q2. The average settlement for all types of suits was $41.8 million, slightly up from the recently updated $38.6 million in the second quarter. "Settlement" includes, in addition to final approved settlements, proposed and tentative settlements, plus jury awards.

New events

By type of event

According to Advisen MSCAd data, the third quarter is highlighted by the continuation of a downward trend, the stabilization of a downward trend, the acceleration of an upward trend and what may be the an area of renewed focus in D&O litigation. Since its peak in Q1 2011, merger objection suits continued their decline in the third quarter. Although there have been quarterly fluctuations, this has been the longer-term trend over the previous two and half years.(Exhibit 3) Capital regulatory actions had experienced a similar trend since also peaking in Q1 2011, but stabilized, at least temporarily in the third quarter. Additionally, securities class actions ticked upward and securities individual actions spiked with the highest quarterly total since Q1 2012.

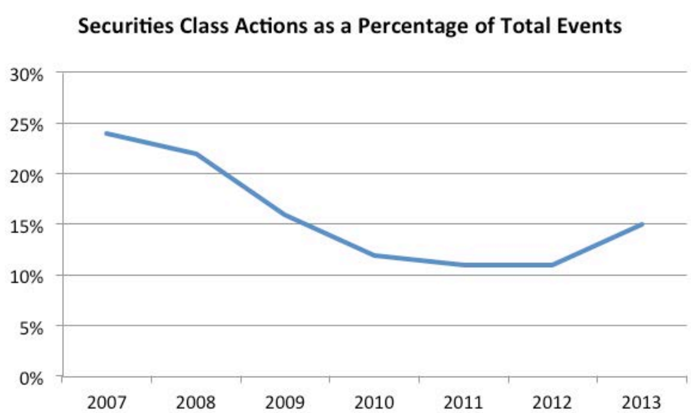
Exhibit 3



In previous reports it had been noted that the downward trend of what Advisen previously referred to as securities fraud suits (much of which is now categorized under capital regulatory actions) was at least in part due to a change of emphasis in SEC enforcement. Although the drastic decline noted in this area from Q1 to Q2 (52 percent) has tempered, it is still premature to say that the slowdown is a signal of a renewed SEC focus in this area. The new SEC Chairwoman, Mary Jo White, in fact has signaled a new emphasis on enforcement. In a recent speech she made it clear that she "believes it is important to pursue even the smallest infractions."[2]

In the third quarter the number of securities class action suits increased by 28 percent from the second quarter. They also increased as a percentage of the total events from 15 percent in Q2 to 22 percent in Q3. Most notably, however, is the increasingly apparent reversal of a six year trend. On an annual basis, securities class actions had been in steady decline as a percentage of total events from 2007 to 2012 (from 24 percent in 2007 to 11 percent in 2012). This year, with filings in other categories dropping sharply, securities class actions have thus far accounted for 15 percent of the total filings on pace to reverse the trend, at least temporarily. (Exhibit 4)

Exhibit 4

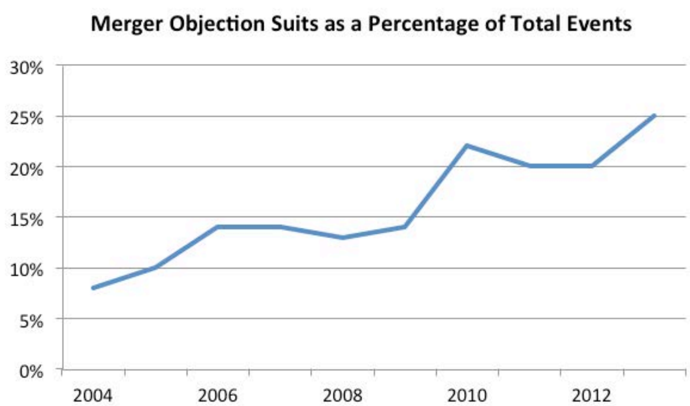


As noted in prior reports, the absolute annual total of securities class action filings had been trending downward over the past two years. Filings dropped from 212 in 2011 to 181 in 2012. The speculation as to the cause of this downward trend in filings had created much discussion among analysts and others. It is often attributed to fewer suits involving Chinese firms and the winding down of the credit crisis. Last quarter it was suggested that this trend would likely continue in 2013. However, the 28 percent increase in quarterly filings brings the annual total to 139 making the trend reversal much more likely.

A potential new trend within the securities class action arena that may be worth following is securities class action suits involving accounting allegations. After years of neglect in this area, there are indications that regulators will have a renewed focus on accounting fraud cases for the remainder of this year and beyond. This has the potential to contribute to a reversal in the downward trend in annual new filings.

Although the absolute annual total of merger objection suits is declining as was noted in exhibit 1, as a percentage of total events, merger objection suits have been trending in the opposite direction. They grew from 8 percent of the total in 2004 to 20 percent in 2012 to 25 percent through three quarters in 2013). (Exhibit 5) Merger objection suits are filed shortly following the announcement of a proposed merger or acquisition by shareholders of the company to be acquired. Typically they demand more favorable terms, such as more bidders or a more transparent auction process.

Exhibit 5

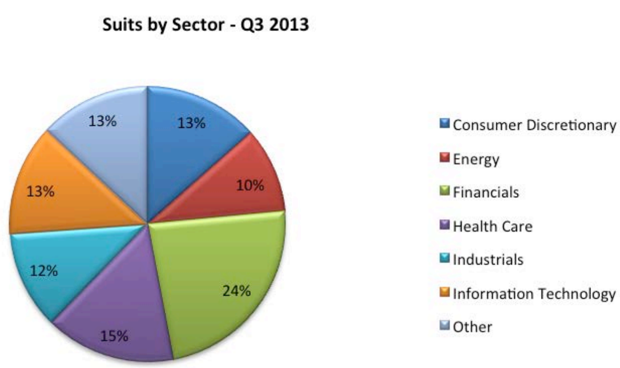


Securities individual actions – cases brought by purchasers of securities that are not styled as class actions – have been few and far between since Q1 2012 when they represented 8 percent of the total cases. This quarter they spiked to 10 percent of the total, a 6 percentage point increase from the previous quarter. It will be interesting to track whether this was a quarterly anomaly or the start of new trend.

By industry

Perhaps not surprisingly, financial firms continued to experience the largest number of new filings in the third quarter. Consistent with the previous two quarters, nearly a fourth of all new filings in Q3 named businesses and the directors and officers from the financial services sector. (Exhibit 6) While still undeniably the industry with the highest percentage of new filings – 9 percentage points higher than health care – on an annual basis it has been declining since its peak of 40 percent in 2009 (40 percent 2009, 32 percent 2010, 30 percent 2011, 24 percent 2012 and 23 percent thus far in 2013). This downward trend is in large part an outcome of the continuing wind down of subprime and credit crisis activity. New filings are now approaching pre-crisis levels.

Exhibit 6



Non-U.S. companies

Securities litigation in Europe, Asia and Latin America is less frequently a matter of public record as compared to the United States. This makes it more difficult to get as complete of a picture of litigation activity. Typically, only the largest cases attract media attention, and non-U.S. companies are far less likely to provide details of litigation in their public disclosures. In spite of these data collection limitations, it is increasingly clear that 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 the third quarter, events involving non-U.S. companies, filed both in the U.S. and elsewhere accounted for 12 percent of the total. This was 3 points lower than the second quarter and 4 points higher than the same quarter a year ago (Q3 2012) at 8 percent. Of the events involving non-U.S. companies, Chinese and Canadian companies accounted for the highest percentage at 24 percent each.

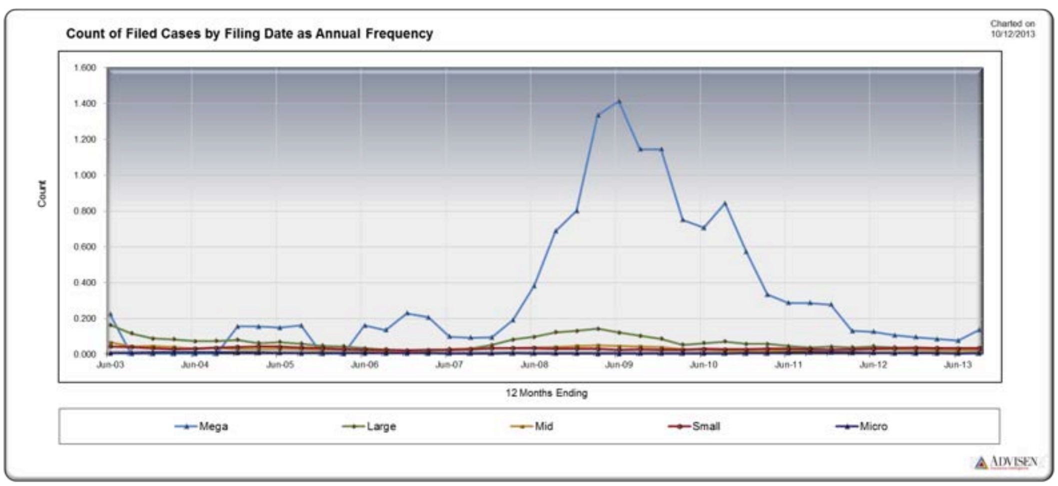
Longer Term View

There has been considerable discussion among observers as to whether the general decline in the number of Securities Class Action suits being filed represents a true reduction or whether it is driven by a reduction in the number of companies traded on US Stock Exchanges. Furthermore, it is considered axiomatic among underwriters and actuaries that companies with larger market capitalization are more likely to be sued. To that end, changes in the distribution of companies among different market cap groups may also influence the frequency with which claims are filed.

Advisen's Loss Insight Foundation (LIF) provides graphical insight into these matters. LIF is a new analytic solution that blends company counts and case filings to support exploration of issues affecting D&O insurers. The tool includes counts of the number of companies traded on US exchanges or Over the Counter including ADR's by quarter and segments them into groups based on their industry and quarter-end market capitalization. Cases filed against a company in a quarter are segmented into market cap groups based on the exposure of the company in the quarter. Dividing the number of cases by the number of listed companies produces a rate which can then be reviewed.

The graph below presents a ten year view of the quarterly filing rate per company of Securities Class Action Suits expressed on a rolling four quarter basis.(Exhibit 7) Clearly the rate of filings against "Mega" companies (those with a market cap above $200 billion at quarter end) dominates the graph with the rate peaking during the credit crisis. It is also apparent that companies with smaller market capitalization are generally less likely to have a Securities Class Action suit filed against them. Finally, the most recent uptick in cases being filed this quarter does not appear to be significant relative to longer term filing rates.

Exhibit 7



Settlements and awards

Securities class actions and capital regulatory actions represented the largest number of settlements in the third quarter with 47 and 31 respectively. Including proposed and tentative settlements, the average settlement cost for all case types was $41.8 million up from the $38.6 million reported in the second quarter. A securities class action settlement for $730 million was the largest settlement reported in the third quarter.

Securities class action suits remained the most significant source of large losses with an average settlement of $66.2 million for the quarter. Breach of fiduciary duties came in second with two settlements averaging $49.4 million, followed by derivative shareholder actions at $24.6 million and capital regulatory actions at $15.2 million.

On August 20, 2013, a federal judge issued an Order granting the plaintiffs' motion for final approval of the largest settlement of the quarter, a $730 million securities class action against Citigroup Inc. The settlement concerns claims that Citigroup failed to; disclose the true extent of its exposure to losses from it mortgage-related assets; accurately set forth its' mortgage-related assets to reflect their true value; properly account of balance sheet vehicles in which mortgage-related assets were being held; disclose its obligation to provide liquidity and other support to its off balance sheet entities; and disclose that the company had deficient internal accounting controls. All of which caused the price of the defendant's Common and Preferred Stock to decline.

A second suit that received final approval of settlement for a large sum in the third quarter was a $725 million securities class action against American International Group (AIG). The settlement resolved allegations of fraud from October 1999 to April 2005 involving anti-competitive market division, accounting violations and stock price manipulation.

Securities class action suits are typically heavily represented among the largest settlements. This again was the case in the third quarter where they represented three of the top five cases. The largest non-securities class action settlement was a capital regulatory action against J P Morgan Chase bank National Association for $220 million. Under United Kingdom jurisdiction, on September 29, 2013, the Financial Conduct Authority (FCA) fined J P Morgan $220 million (GBP 137,610,000) for serious failings related to its Chief Investment Office (CIO). The violations were in connection with the $6.2 billion trading losses sustained by the CIO in 2012.

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 recovered.

NOTES:

[1] FactSet Research Systems Inc., Factset Flashwire US Monthly, "US M&A News and Trends," (September 2013), http://www.factset.com/mergerstat_em/monthly/US_Flashwire_Monthly.pdf

[2] "Remarks by SEC Chairwoman Mary Jo White at the Securities Enforcement Forum," Just Anti-Corruption http://www.mainjustice.com/justanticorruption/2013/10/09/remarks-by-sec-chairwoman-mary-jo-white-at-the-securities-enforcement-forum/