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D&O CLAIMS TRENDS: Q2 2014

July 2014

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Executive Summary

The second quarter of 2014 was an active period on several fronts in securities and business litigation. Among a handful of high profile settlements and a variety of important circuit court decisions, the quarter included the highly anticipated decision by the U.S. Supreme Court in Halliburton vs. Eric P. John Fund Inc. challenging the "fraud-on-the market" theory. On the regulatory front, the SEC continued to shift its priorities and reallocate its resources and companies for the first time were required to file their conflict minerals disclosures as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Even with all of this noise, the second quarter surpassed the first quarter as having the fewest securities and business litigation filings and enforcement actions in the post financial crisis era. Annualized, 2014 filing totals could approach pre-crisis levels.

Capital regulatory actions experienced the largest percentage drop of the major categories but remained the leading source of new filings. The always-important category, securities class actions, saw the number of filings bounce back to Q4 2013 levels after a downward fluctuation in the first quarter. As a percentage of total events, securities class actions reached a level not seen since the first quarter of 2009.

The Financial sector remained the top sector for new securities litigation and enforcement actions.

Both the number of settlements and average settlement values inched higher in the second quarter. And, same as the previous quarter, capital regulatory actions represented the highest number of settlements while FCPA (SEC) averaged the highest value.

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Several analytic firms publish tallies of securities class action suits filed, but rarely do these tallies agree.

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.

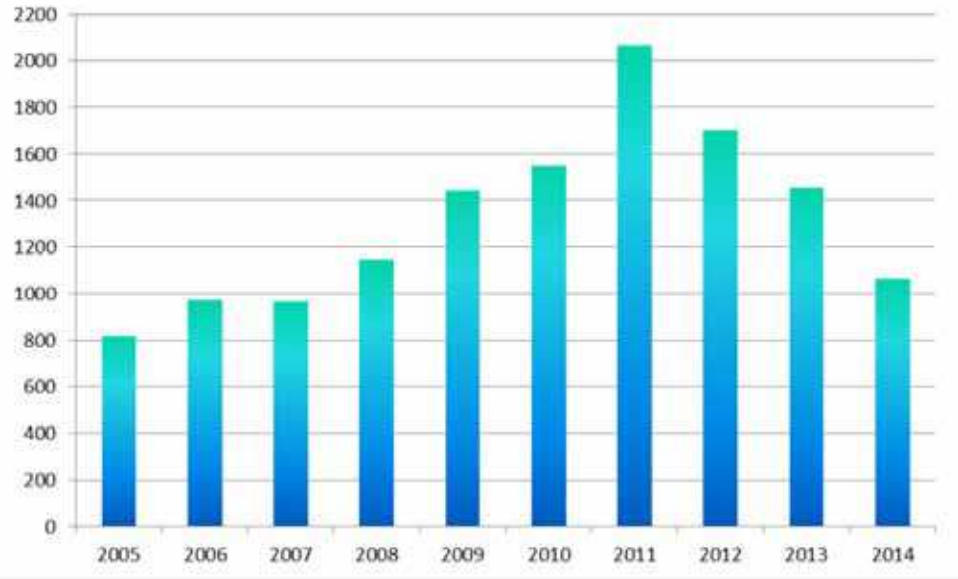
The downward trend in securities and business litigation filings continued in the second quarter of 2014 with a 26 percent quarterly drop in new activity.

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

Summary of findings

The downward trend in securities and business litigation filings continued in the second quarter of 2014 with a 26 percent quarterly drop in new activity. When compared with the same quarter a year ago (Q2 2013) the total number of events dropped 25 percent from 303 to 227. The quarterly decline keeps 2014 on pace for a third straight year of annual aggregate declines in securities suit filings. (Exhibit 1)

Exhibit 1: Securities Suits Filed (Annualized)



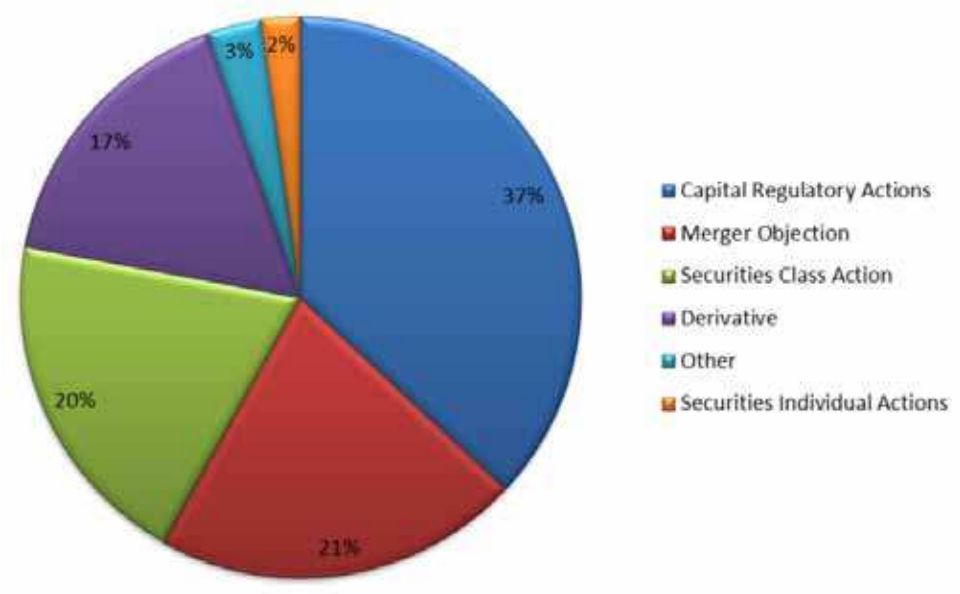
Of the major case types, capital regulatory actions experienced the largest drop falling 46 percent from the first quarter (151 filings to 82 filings). Other areas that saw quarterly declines included breach of fiduciary duties: securities (3 Q1 2014 vs. 1 Q2 2014), derivative shareholder actions (48 Q1 2014 vs. 37 Q2 2014), merger objections (55 Q1 2014 vs. 47 Q2 2014), control persons violations (2 Q1 2014 vs. 0 Q2 2014), and proxies and solicitation violations (2 Q1 2014 vs. 0 Q2 2014).

The following event types experienced quarterly increases in new filings in the second quarter; foreign corrupt practices act (FCPA) (SEC) (0 Q1 2014 to 3 Q2 2014), securities class actions (39 Q1 2014 to 44 Q2 2014), and securities individual actions (5 Q1 2014 to 13 Q2 2014).

As has been the case in every quarter since the financial crisis, at 27 percent of the total, financial services companies and their directors and officers remained the leading sector for new securities and business litigation filings, and enforcement actions in the second quarter.

Despite the significant drop in filings in the second quarter, capital regulatory actions remained the leading source of new securities and business litigation representing 37 percent of the total, followed by merger objections at 21 percent, and securities class actions at 20 percent. (Exhibit 2) Twenty percent was the highest quarterly percentage for securities class actions since the first quarter of 2009. Annualized, 2014 is on pace to be the third consecutive year securities class actions grew as a percentage of the total events.

Exhibit 2: Events by Type – Q2 2014



As has been the case in every quarter since the financial crisis, at 27 percent of the total, financial services companies and their directors and officers remained the leading sector for new securities and business litigation filings, and enforcement actions in the second quarter. This was a slight increase from Q1 at 26 percent. Although the spike in financial services-related suits experienced in the height of the financial crisis – from 2008 through 2011 – has subsided, the financial services sector remains a lightning rod for D&O related litigation. Other active sectors in the second quarter were information technology at 18 percent, industrials at 12 percent, and consumer discretionary at 12 percent.

There were 108 settlements in Q2 up from 105 in the first quarter. The average settlement for all types of suits was $16 million, an increase $2 million from the first quarter. "Settlement" includes, in addition to final approved settlements, proposed and tentative settlements, plus jury awards.

Although the second quarter saw total events fall overall, the mixture of declines and increases across event types was more in-line with historical trends.

New events

The annual number of new events has been trending downwards since 2011 pointing to the end of an era of high frequency credit crisis litigation. With the first two quarters of 2014 recording two of the lowest quarterly totals in years, and barring another unforeseen crisis, it appears that this downward trend will continue in 2014.

Although the second quarter saw total events fall overall, the mixture of declines and increases across event types was more in-line with historical trends. The first quarter saw nearly across the board decreases in filings which is highly unusual. Typically, plaintiff firms allocate resources to different types of litigation to respond to changing conditions.

By type of event

Capital regulatory actions

Capital regulatory[1] actions remained the leading source of D&O-related lawsuits in the second quarter accounting for 37 percent of all recorded events. On an annual basis, however, the absolute total has steadily declined every year since 2011 (862 in 2011, 764 in 2012, and 634 in 2013). With the annual total of capital regulatory actions at 233 events halfway through 2014, it appears that this downward trend will continue. There has been a renewed regulatory focus in this area over the past year, however, which will make this a trend worth following in 2015 and beyond.

The regulatory focus stems back to last July when the SEC announced new enforcement initiatives to combat financial fraud. Continuous leads have been pouring into the agency as a result of the whistleblower statutes under Dodd-Frank and the use of new analytical tools that look for numerical and textual indicators of fraud. Consequently, it can be reasonably assumed that as these cases mature, the number of actions in this category will increase.

Securities class actions

The second quarter saw the highly anticipated decision in Halliburton Co. v Erica P. John Fund, Inc., in which the Supreme Court reconsidered the "fraud-on-the-market" theory. A reversal of the precedent set in the 1988 decision, Basic Inc. v Levinson, would have made it more difficult for plaintiffs to purse class actions against businesses and their directors and officers. Fortunately for the plaintiffs' bar, a reversal did not occur. The Supreme Court decision preserved the "fraud-on-the-market" concept but gave companies an out by allowing them to demonstrate that stock price movement was a result of other factors. The decision should have minimal impact on future securities class action trends.

The general decline in the number of securities class actions may be driven by factors such as a reduction in the number of companies traded on US Stock Exchanges or the winding down of credit crisis litigation.

After a dip in the first quarter, the number of securities class action suits rebounded in the second (from 39 in Q1 to 44 in Q2). Securities class actions also increased as a percentage of the total events from 14 percent in Q1 to 20 percent in Q2. Although there have been quarterly and even annual fluctuations, overall the past decade has seen securities class actions represent a decreasing portion of all D&O-related claims. The general decline in the number of securities class actions may be driven by factors such as a reduction in the number of companies traded on US Stock Exchanges or 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.

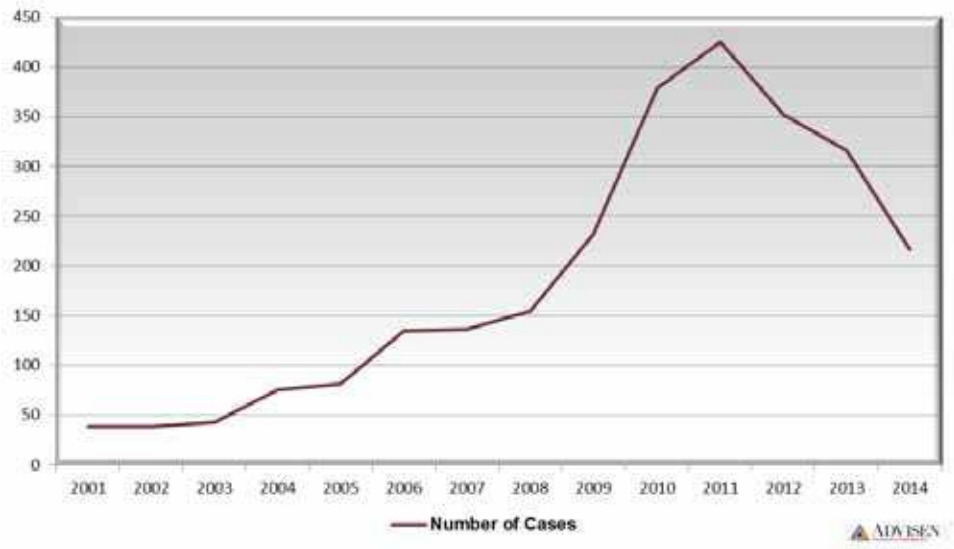
Merger objections suits

Merger objection suits are usually 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.

As noted last quarter, it was reported that nearly all M&A's valued at over $100 million were involved in a shareholder lawsuit in 2013. It was also noted that the vast majority of settled cases were '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.

Merger objection filings generally maintained a strong growth trend through 2011 but have decreased materially over the previous two years. Now half way through 2014, it appears that this trend will continue for another year. (Exhibit 3)

Exhibit 3: Merger Objection Cases (2014 Annualized)

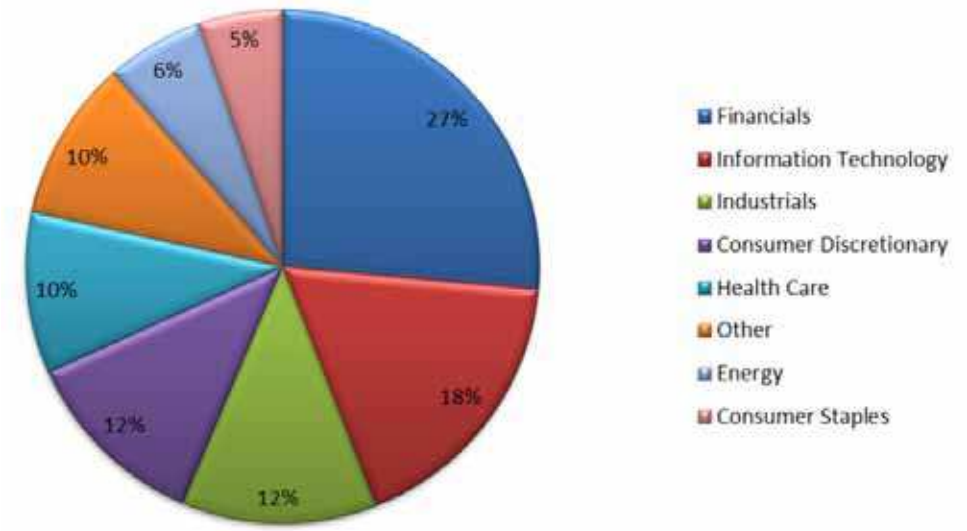


Securities litigation in Asia, Europe, and Latin America is less frequently a matter of public record as compared to the United States, making it more difficult to get as complete a picture of litigation activity.

By industry

Financial firms remained the leading sector for new filings in the second quarter, representing 27 percent of the total. (Exhibit 4) While still undeniably the industry with highest percentage of filings – 9 percentage points higher than information technology 18 percent –the annual trend has been downward since its peak of 40 percent in 2008. This downward trend is in large part an outcome of the continuing wind down of subprime and credit crisis activity as new filings now approach pre-crisis levels.

Exhibit 4: Suites by Sector – Q2 2014



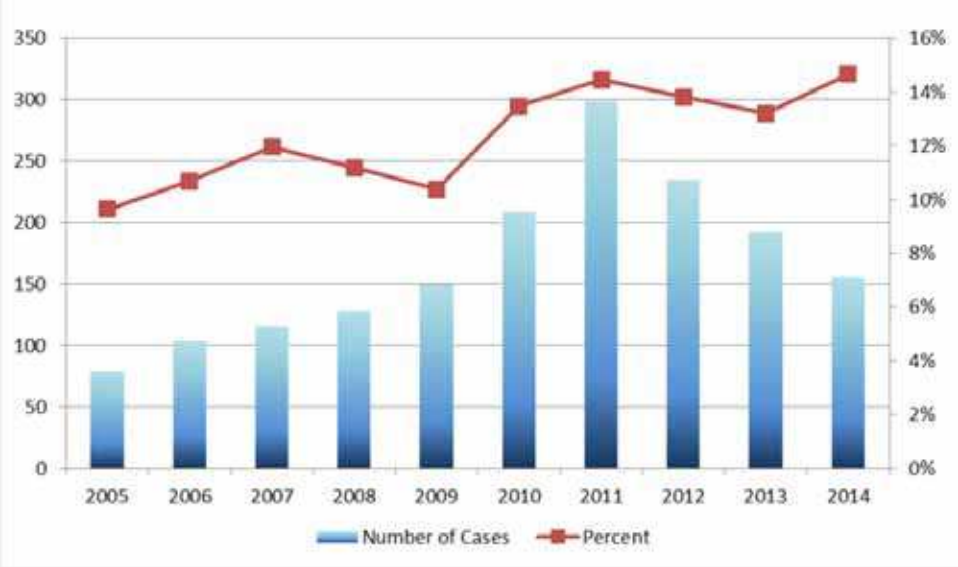
Non-U.S. companies

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 of 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 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 the second quarter of 2014, events involving non-U.S. companies, filed both in the United States and elsewhere accounted for 15 percent of the total. This was exactly the same as both the first quarter and the same quarter a year ago (Q2 2013) but 2 points above the 2013 average. (Exhibit 5) Of the events involving non-U.S. companies, Chinese and UK companies accounted for the highest percentage at 24 percent each.

Companies conducting business in foreign countries have increasingly become a target for violations of the Foreign Corrupt Practices Act (FCPA).

Exhibit 5: Non-U.S. Companies



Settlements and Awards

Including proposed and tentative settlements, the average settlement cost for all case types was $16 million, up from the $14 million reported in the first quarter but substantially lower than the $41 million reported in the second quarter of 2013. Capital regulatory actions had the most settlements in the second quarter with 71, and although there were only three, on average, FCPA (SEC) actions had the highest average settlement value at $43 million. Merger objections settlements came in second averaging $22 million, followed by securities class actions at $19 million, and capital regulatory actions at $15 million.

Companies conducting business in foreign countries have increasingly become a target for violations of the Foreign Corrupt Practices Act (FCPA). The FCPA prohibits payments to foreign officials to obtain or retain business. FCPA is jointly enforced by the SEC and the DOJ. In the first quarter FCPA had the highest average settlement value largely because of a $97.3 million dollar settlement against oilfield services company Weatherford International Ltd. In the second quarter it was mostly due to a $67 million proposed settlement against cosmetics company Avon Products, Inc.

An internal audit by the Avon Products, Inc. concluded that Avon employees in China may have been bribing officials. In October of 2008, the Company voluntarily contacted the SEC and the DOJ to advise both agencies of its internal investigation. On May 1, 2014, Avon agreed to pay $68 million to the DOJ and $67 million to the SEC ($135 million in total) to resolve the dispute.

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 single settlement of the quarter was a $900 million capital regulatory action by S.A.C Capital Advisors, LP for failing to prevent insider trading. S.A.C Capital was indicted on four counts of securities fraud and one count of wire fraud alleging that the fund made hundreds of millions of dollars illegally. The indictment also claimed that several employees committed insider trading offenses from 1999 to 2010, which were made possible by institutional practices that encourage widespread solicitation and use of illegal inside information.

A $265 million tentative settlement against Massey Energy Inc. was largest securities class action settlement of the second quarter. Massey produces processes, and sells bituminous coal extracted from mines in West Virginia, Kentucky and Virginia. During and prior to the class period, Massey claimed to be one of the safest mine operators in the industry, regularly touting its safety achievements and telling investors that safety was its number one priority. The parent company of Massey Energy Co., Alpha Natural Resources Inc., agreed to pay $265 million to settle a class action alleging Massey misrepresented it's safety record to inflate stock prices, which plummeted following the worst U.S. mining disaster in over 40 years.

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 fine, 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, Associate Editor, Advisen Ltd.

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[1] The capital regulatory action event type was introduced in Q3 of 2013 and includes a majority of the cases Advisen previously categorized under securities fraud.