Fewer Filings, Bigger Risks

Although claims have decreased, D&O insurers face a potentially volatile underwriting landscape.

by Angelo G. Savino

In the field of directors & officers liability insurance, 2013 may look a lot like 2012 in terms of D&O claims. Securities class-action filings are likely to continue at a flat or reduced pace, although the cost of settlements may remain on the upswing. Continued diversification of the types of securities-related lawsuits being brought is also likely.

A number of factors could trigger an increase in the number and types of regulatory investigations and actions. D&O insurers must be alert to these trends, which will impact the exposures presented by the coverage claims submitted to them.

The frequency of high-severity securities class actions, long the principal risk for which public companies purchase D&O insurance, decreased in 2012. NERA Economic Consulting, Cornerstone Research and Advisen, which track the numbers of such filings, all reported a decline in 2012 in the number of class actions from 2011. In part, this may be due to a lack of any theme-related body of cases, such as claims against China-based companies, credit crisis litigation or claims against for-profit education entities that prevailed in prior years.

In addition, the decline may be the compound effect of the Private Securities Litigation Reform Act and recent Supreme Court decisions such as *Twombley*, *Iqbal*, *Tellabs*, *Dura* and *Morrison*, which have raised the bar for such claims to survive a motion to dismiss.

These decisions and the PSLRA may have produced a lull in the filing of such class actions. They create greater incentive for more searching pre-filing investigations, and a larger investment of time and resources by plaintiffs' counsel needed to plead claims that are more likely to survive a motion to dismiss.

Indeed, this greater cost in time and resources may serve as a deterrent to keep small, less well-capitalized firms from engaging in securities class action litigation. Fragmentation of the plaintiffs' bar also may have exacerbated this factor.

The declining number of filings also could be the partial result of a gradual decline in the number of public companies as a result of mergers and "going private" transactions. The recent decline in the volatility of stock prices may also explain some of the decrease in filings by making it harder to allege the requisite stock drop to plead loss causation. Moreover, economic conditions may have resulted in fewer

Key Points

▶ **The Issue:** The number of filings of high-severity D&O claims seems to be falling.

▶ **The Cause:** Various developments have raised the standards under which D&O filings can be brought before the courts.

▶ **The Bottom Line:** D&O insurers need to remain alert to how these trends, which will affect exposures under their policies, develop throughout the year.

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initial public offerings, creating less opportunity for bringing cases under the 1933 Securities Act.

Absent a reversal of these factors, securities class-action filings are likely to continue at a reduced level. In contrast to the decline, however, the average and median costs of settling class claims have risen, possibly due to the reduced number of filings and the greater investment necessary to bring a viable claim.

According to NERA's 2012 *Trends in Securities Class Actions,* the average settlement value in 2012 was $36 million and the median was $11.1 million. These higher benchmarks, however, may be hard to reverse even if the rate of class action filings accelerates.

Greater Exposure

On the other hand, the decline in class action filings may not provide any respite to D&O insurers or their insureds. Although there have been fewer securities class actions, the difficulties presented by the PSLRA and Supreme Court decisions may actually provide greater incentive for plaintiffs' counsel to bring more cases on behalf of single or multiple institutional plaintiffs.

Having developed relationships with such investors and experienced success in achieving higher recovery rates in opt-out litigation, plaintiff firms may see greater opportunity for success in the non-class arena. In such circumstances, firms need not deal with certain impediments posed by PSLRA, like staying discovery pending resolution of a dismissal motion. An uptick in regulatory activity may also lead to increased parallel private litigation that may reverse the decline in filings.

In addition, recent years have seen an increase in various types of breach-of-fiduciary-duty lawsuits brought in state courts. Although 2012 saw a decrease in merger objection lawsuits, increased merger activity and management buyouts early in 2013 may portend an increase in litigation objecting to the price of, or the procedures employed in arriving at, such transactions. These actions are most frequently brought in state courts. Moreover, there has been a tendency in recent years for a given transaction to spawn multiple lawsuits in different jurisdictions.

Due to the lack of any facility for consolidating such state court litigation, and reluctance by some state court judges to defer to the courts of sister states, this type of litigation may proceed in multiple jurisdictions with a consequent increase in defense costs.

Because the initial stages of the investigation, when vast amounts of response costs may be incurred, do not typically involve allegations of specific wrongdoing or identify particular directors or officers as potential targets, insurers have argued that such costs are not covered.

Although these cases typically attempted to enjoin the transaction from being consummated—then usually settled for additional disclosures and an award of plaintiffs' attorneys fees for which insurance coverage is sought—an increasing number of these actions have persisted after the transaction closed. In that event, the object has been to recover damages, which presents issues as to whether the relief sought is D&O-insured.

The debate centers on whether the indemnification or settlement amount constitutes an increase in the stock price, which may be excluded from covered loss, or simply damages for the alleged breach of fiduciary duty by the target's directors. Insureds argue that such relief is covered.

In either event, these trends in merger objection litigation may result in higher frequency and greater severity of claims.

A similar trend is starting to play out in litigation involving shareholder votes over executive compensation. Complainants allege that corporate disclosures regarding executive compensation are inadequate and they seek to enjoin annual meetings at which the votes are taken. Although the voting on this issue is merely advisory, the threat of halting the annual meeting creates incentive for the board to seek a quick settlement, once again entailing an award of plaintiffs' attorneys fees for which coverage may be sought.

Here too, because of the fragmentation of the plaintiffs' bar and the expense of securities class-action litigation, these types of state law claims may continue to provide a growing exposure to D&O insurers and their insureds.

Regulatory and Coverage Issue

At least partly resulting from the recent financial crisis, along with the Dodd-Frank reform act and greater devotion of agency resources, there has been a dramatic increase in regulatory enforcement activity by the Securities and Exchange Commission, the Department of Justice and other federal agencies. The SEC in particular has ramped up its efforts to investigate and litigate with respect to claims against financial institutions; insider securities trading including through allegedly improper trading in 10b-5-1-regulated plans; and violations of the Foreign Corrupt Practices Act.

As a result of Dodd-Frank, the SEC has promulgated policies to encourage reports by whistle-blowers, allowing bounties of 10% to 30% of monies collected. The resulting volume of tips may lead to increased litigation by the Commission. Such regulatory activity may also trigger criminal investigations and even charges by the DOJ, as well as parallel private litigation in the form of securities fraud actions and derivative litigation.

The high cost of responding to regulatory investigations has led to disputes with D&O insurers over coverage. Because the initial stages of the investigation, when vast amounts of response costs may be incurred, do not typically involve allegations of specific wrongdoing or identify particular directors or officers as potential targets, insurers have argued that such costs are not covered.

Many policies only cover costs of responding to informal regulatory investigations incurred by the executives when they are subpoenaed. Depending on the specific policy terms, the corporation's costs may only be covered at the formal investigation stage; even then, in some instances, only if executives are also the focus of the investigation.

Typically, regulatory actions result in monetary awards of fines or penalties. This type of relief is usually not within the scope of loss covered by D&O or E&O policies even if, as in the case of the SEC, the proceeds are placed in a Fair Funds account for distribution to shareholders.

However, agency settlements, which often require court approval, have come under heightened scrutiny by federal judges during the approval process.

Federal Judge Jed S. Rakoff of the Southern District of New York declined to approve a settlement by the SEC and Citigroup in which the defendant neither admitted nor denied any wrongdoing—a long-standing, traditional aspect of SEC settlements.

Judge Rakoff's decision was appealed to the U.S. Court of Appeals for the Second Circuit in Manhattan by both the SEC and Citigroup, placing the judge in the unusual procedural posture of having counsel appear before the Court of Appeals to defend his decision.

Recently, Judge Richard Leon of the U.S. District Court for the District of Columbia also declined to approve SEC settlements with two corporations involving alleged FCPA violations. Other federal judges have similarly questioned or declined to approve such SEC settlements.

The DOJ, too, has begun insisting on guilty pleas by corporate subsidiaries as part of settlements with banks involved in the LIBOR rate-rigging scandal.

The fallout from such decisions by federal judges, and the new DOJ policy, may be to deter corporations from settling with the SEC or other federal agencies due to the adverse effects that any admission of liability would have on parallel private litigation and on availability of insurance. It may also promote more parallel private litigation in the hope that a finding of liability in the SEC action would inure to the benefit of the private class while reducing the cost of achieving a recovery in the private case.

This would result in increased exposure to D&O insurers.

The effect of any apparent lull in class action filings may be offset by an increase in settlement values for such cases.

Moreover, individual securities fraud actions, state court breach-of-fiduciary-duty actions and regulatory enforcement matters may more than make up for any decline in class action filings, both in frequency and severity.

D&O insurers need to remain alert to how these trends, which will affect exposures under their policies, develop throughout the year. Moreover, in underwriting policies, insurers should be mindful of the scope of coverage they are offering for regulatory investigations and breach-of-fiduciary-duty claims, which are likely to grow both in number and the exposure presented. BR