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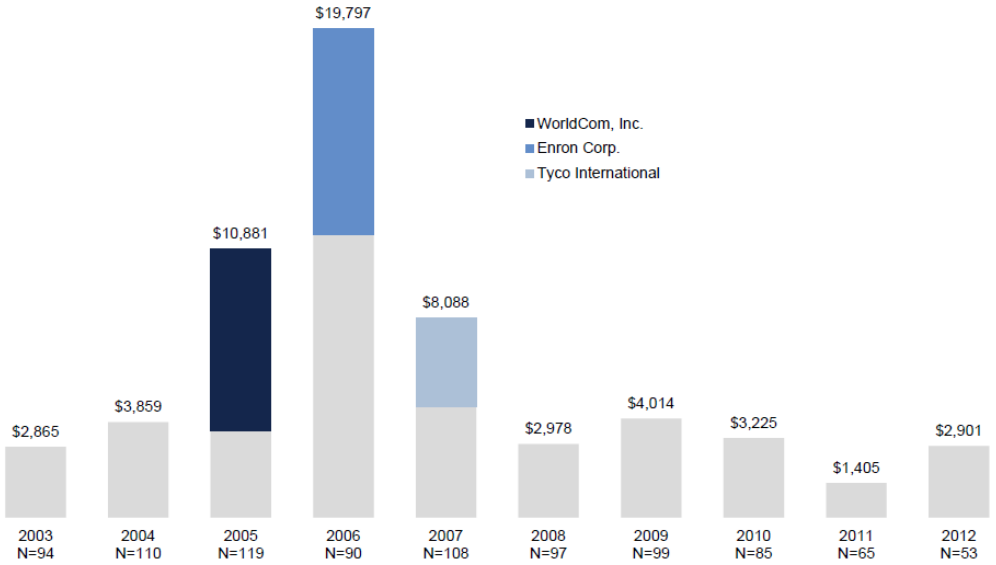
REDUCED SECURITIES LITIGATION LOSSES: CAUSES AND EFFECTS*

Many different statistics are used to describe the securities class action litigation environment. The number of securities class actions filed each year, the number of those cases dismissed by courts, and the average settlement amount are interesting points of information. However, the most telling statistic is the total settlement dollars paid each year to resolve securities class action litigation. The chart below reflects those aggregate settlement amounts for the last ten years, as compiled by Cornerstone Research in its recently released publication entitled *Securities Class Action Settlements—2012 Review and Analysis*.

FIGURE 1: TOTAL SETTLEMENT AMOUNTS
2003–2012
Dollars in Millions



Settlement dollars adjusted for inflation; 2012 dollar equivalent figures used.

The steady decline since 2009 in the number of securities class action settlements and the dramatic decline in the total amount of payments in those settlements from 2009 to 2011 raise important questions as to whether these developments are trends or aberrations. Year 2012 saw more than double the amount of total settlement dollars seen in 2011, suggesting that 2011 was the aberration and we are now returning to litigation activity in line with historical rates. But a deeper review suggests the 2012 results – rather than the prior years' results – are the aberration. For example, according to Cornerstone:

- The 53 court-approved settlements in 2012 represent a 14-year low.

* Prepared for The ACE Report, published by ACE Bermuda Insurance Ltd.

- Nearly 75% of all settlement dollars in 2012 were in mega-settlements (i.e., settlements in excess of $100 million), although mega-settlements represented only about 10% of the total number of settlements in 2012.

- Less than 60% of the settlements in 2012 were funded entirely by D&O insurance, compared with almost 80% in 2011.

- About one-third of the 2012 settlements were by companies in the financial sector.

These findings strongly suggest that the increased settlement numbers for 2012 are attributable in large part to several very large financial institution settlements in credit-crisis securities class actions. If non-recurring credit-crisis lawsuits are removed from the reported results, the significant downward trend in settlement numbers and total settlement amounts in 2009 through 2011 would continue, if not accelerate. This seems to suggest that securities class action litigation today is, generally speaking, much less threatening to corporations and D&O insurers than any time in recent history. Obviously, any one claim involving bad facts and large damages can still result in a very large settlement, but on an aggregate basis the total dollars expended to resolve this type of litigation is now at a surprisingly low level (excluding the credit-crisis claims).

For the reasons discussed in this article, more frequent and more severe securities class action claims appear inevitable in the future; the question is when, not whether, a more severe litigation environment will return. As a result, directors, officers and their insurers should resist the temptation to become complacent in their governance, risk management and underwriting practices.

A. CAUSE OF REDUCED LITIGATION

Several different factors have contributed to the recent reduction in the severity of securities class action litigation. None of those factors, standing alone, caused the current litigation decline. Instead, all of those factors, acting in combination, created the current environment. Some of the more important of those factors include the following:

1. Stock Market. Since 2008, the stock market has been at either historically very low levels or in a rebound. Because a predicate for a valid securities class action lawsuit is a sharp and immediate stock drop following a corrective disclosure, the recent stock market conditions have not served as an incubator for a large number of severe securities class action lawsuits. Obviously, even in recent years some companies have encountered steep market price declines following a corrective disclosure, in which event problematic securities litigation has been filed. However, plaintiffs frequently premise their securities class action on a large market-wide or sector-related stock drop which happens to occur on the same day as a purported corrective disclosure by the company. The risk of such stock drops has been much less in recent years than exists in a declining or more volatile stock market.

2. Better Governance. The legacy of poor governance practices and corporate fraud over the last 10 years appears to have improved at least to some extent the quality of governance practices at many corporations. Fewer corporate frauds are being uncovered and fewer financial restatements are occurring. The increased accountability and diligence contemplated by the Sarbanes-Oxley Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act, among other new regulations, now appear to have accomplished at least to some extent their goals of enhanced corporate governance practices and reduced financial manipulation.

3. Better External Oversight. Auditors and, to some extent, regulators are now more aggressively and more effectively performing their oversight function, thereby further contributing to fewer severe securities law violations. Internal and external auditors, assisted by more reliable internal controls and certifications, are much more likely to detect and prevent manipulative conduct today than ever before since those auditors now better realize their own personal reputational and liability exposures if they fail to properly perform their functions.

4. Fewer Public Companies. Over the past 15 years, the number of publicly-held companies has decreased by about one-half. As a result, there are far fewer companies for the plaintiffs' bar to target.

5. Plaintiff Bar Capacity. The mega-cases absorb a disproportionate percentage of the plaintiffs' bar capacity, particularly among the most effective and sophisticated plaintiff law firms. With the unusually large number of mega-cases in recent years against financial institutions, fewer "routine" securities class actions have been filed by these most-feared plaintiff lawyers.

Importantly, none of these factors suggest a permanent reduction in the frequency or severity of securities class action litigation. To the contrary, several developments that are now occurring or may occur in the future could cause a more problematic litigation environment to return. For example:

- The stock market is now at an elevated level with increased volatility, and investor expectations are returning. As a result, there is a greater risk of large stock drops which can fuel securities class action litigation.

- The commitment and capabilities of the SEC to aggressively enforce the securities laws have increased significantly since 2010, and the fruits of that increased enforcement activity will likely spawn additional and more severe securities class action litigation. The plaintiffs' bar typically benefits from the SEC's success in uncovering securities violations. For example, the new whistleblower rules under the Dodd-Frank law are inducing many more insiders to disclose to the SEC alleged securities law violations, which will eventually provide to the plaintiffs' bar unprecedented inside information of wrongdoing.

- As a result of the 2012 JOBS Act, it is much easier for private companies to conduct an initial public offering with somewhat reduced disclosures, thereby

likely resulting in increased securities litigation by investors who become surprised and disappointed with company performance after the IPO.

- Courts are more willing today to allow the prosecution of a securities class action lawsuit based upon a violation of Item 303 of Regulation S-K, which requires disclosure of a "known trend or uncertainty" that the company reasonably expects would have a material unfavorable impact on revenues or income. This is a potentially much broader and dangerous disclosure requirement than the typical Section 10(b) requirement of disclosing existing material facts. By requiring companies to predict the future effects of known trends, this provision (which has been referred to as the "sleeping tiger" of securities litigation) significantly improves the likelihood that plaintiffs will survive a motion to dismiss in a growing number of securities class action lawsuits

- Over time, executives will tend to forget or ignore the important lessons from the past. The Enron era, the stock option backdating uproar, the subprime mortgage debacle and the resulting credit crisis, among other recent events, vividly demonstrate the consequences to directors and officers when poor governance practices and misleading disclosures occur. As in the past, some executives will eventually succumb again to the strong temptation to use manipulative conduct in order to maintain an image of corporate success and to justify lucrative compensation packages.

- With the settlement of the remaining mega-credit-crisis claims, the plaintiffs bar will be forced to refocus their efforts on more routine securities class actions.

These factors, when combined with the inevitable arrogance and greed of some executives, will very likely cause the return of a more severe securities litigation environment eventually.

B. EFFECTS OF REDUCED LITIGATION

A continued reduction in securities class action settlement payments is both good news and bad news for public companies, their executives and D&O insurers. Obviously, the good news is that companies and D&O insurers are paying significantly less money to resolve securities litigation. The bad news is that the plaintiffs' bar is now pursuing other types of litigation against companies and their directors and officers in an attempt to replace the lucrative fees which they would otherwise earn in large securities class action settlements. Although the settlement amounts in those other proceedings are usually quite modest, those proceedings can present significant defense cost exposure and can complicate the defense of a parallel securities class action. Examples of some of those other types of lawsuits which the plaintiffs' bar is now pursuing with greater frequency and vigor include the following:

1. Shareholder Derivative Lawsuits. According to the Cornerstone *Analysis*, more than 50% of securities class actions settled in 2012 were accompanied by one or more shareholder derivative lawsuits. That percentage is a significant increase

over the 30% average for prior years and confirms the general belief that many more shareholder derivative lawsuits are being filed today.

Historically, settlements in derivative lawsuits usually consist of the defendants agreeing to certain corporate governance reforms, perhaps a small monetary payment and a modest plaintiff attorney fee award. Although not highly lucrative litigation for plaintiff lawyers, derivative litigation nonetheless allows plaintiff lawyers to realize a generous fee for relatively little work and therefore is an attractive alternative to the more preferred securities class action litigation.

Because derivative lawsuits assert breaches of state law fiduciary duties, those lawsuits are almost always filed in state courts. Unlike the federal court system where securities class actions are litigated, there is no defined procedure for consolidating or coordinating multiple derivative lawsuits in multiple states. Therefore, as more derivative lawsuits are now being prosecuted in multiple states, defendants are being forced to defend identical derivative lawsuits around the country, thereby significantly increasing the defense costs in those cases, creating the potential for inconsistent rulings in those lawsuits, and making it much harder for defendants to reach a global settlement in all of those multiple lawsuits.

A recent ruling by the Delaware Supreme Court involving parallel derivative lawsuits in Delaware and California highlights the challenges and opportunities in defending these multi-jurisdictional derivative claims. In that case, nearly identical shareholder derivative lawsuits were filed in both California and Delaware. The California cases were dismissed by the court because the plaintiffs failed to first make a demand on the company's board of directors to pursue the claims. Defendants then sought to dismiss the nearly identical Delaware derivative lawsuit based upon the California court ruling. However, the Delaware Chancery Court ruled that it was not compelled to follow the California ruling and refused to dismiss the Delaware case. On April 4, 2013, the Delaware Supreme Court reversed that ruling and held that Delaware courts should follow the prior ruling in California if the two cases are essentially the same, even if the cases largely involve issues under Delaware law. *Pyott v. La Municipal Police Employees' Retirement System*, 2013 Del. LEXIS 179 (April 4, 2013). As a result, plaintiffs do not get two-bites-at-the-apple if one case is dismissed or settled before the other case.

The *Pyott* decision does not eliminate or discourage plaintiff lawyers from filing overlapping derivative cases in multiple states. In fact, the Delaware Supreme Court in *Pyott* also rejected the Chancery Court's related ruling that the California shareholder plaintiffs were inadequate representatives of the company to prosecute the derivative suit due to their rush to file their complaint without conducting a reasonable investigation. But, the *Pyott* decision can help defendants to resolve those multiple-cases at one time whether or not all of the plaintiffs participate in the resolution. The Decision can also help defendants and their D&O insurers when negotiating a settlement in the multi-state lawsuits by

creating a reverse auction negotiation environment. Consistent with this *Pyott*, one plaintiff in one of the cases can settle the derivative suit with defendants, and once the settlement is approved by the court, the remaining derivative suits in other states will likely be dismissed. As a result, any one plaintiff is incentivized to settle for an amount less than the settlement demands of the competing plaintiffs, thereby potentially precluding the competing plaintiffs from sharing in the fee award.

Despite the efforts of the plaintiffs' bar to use derivative litigation as an alternative forum for generating fees, there is some evidence that at least in certain circumstances courts recognize that derivative litigation should be carefully controlled by the courts in order to avoid abusive litigation on behalf of an unwilling company. For example, the Seventh Circuit Federal Court of Appeals ruled in 2012 that a derivative lawsuit should be dismissed because it "serves no goal other than to move money from the corporate treasury to the attorneys' coffers." The derivative lawsuit alleged that two directors of the company also served on the boards of other companies that allegedly competed with the company, in violation of antitrust laws. The Court of Appeals noted that neither the Department of Justice, the Federal Trade Commission nor any consumer had complained about the interlocking directorships. Instead, the Court concluded the lawsuit was a meaningless effort by the plaintiff lawyers to generate a fee and therefore should be rejected:

> The only goal of this suit appears to be fees for the plaintiffs' lawyers. It is impossible to see how the investors could gain from it – and therefore impossible to see how Sears' directors could be said to violate their fiduciary duty by declining to pursue it….It is an abuse of the legal system to cram unnecessary litigation down the throats of firms whose directors serve on multiple boards, and then use the high cost of anti-trust suits to extort settlements (including undeserved attorneys' fees) from the targets.

Booth v. Crowley, et al., 2012 U.S. App. LEXIS 11927 (June 13, 2012).

To counter this judicial criticism, plaintiff lawyers are unlikely to abandon the pursuit of derivative litigation. Instead, it is more likely that plaintiffs will more aggressively pursue derivative litigation through discovery (where permitted) in order to develop better facts suggesting wrongdoing by the defendant directors and officers. In other words, this heightened judicial scrutiny of derivative litigation practices ironically will likely result in higher defense costs and perhaps larger settlement amounts in shareholder derivative litigation.

2. Merger Litigation. Another type of litigation more frequently being pursued by plaintiff lawyers today relates to alleged wrongdoing by directors of companies being acquired. Shareholder class action litigation against those directors alleging

breaches of fiduciary duty in connection with their investigation, negotiation, approval and disclosure of the acquisition transaction has been common particularly in large acquisitions for many years. However, fee-hungry plaintiff lawyers today are routinely filing those so-called "bump-up" lawsuits against directors of the target company in virtually every acquisition transaction, regardless of its size or circumstances. The vast majority of these cases are settled relatively quickly (and without a large amount of defense costs) by the company agreeing to make additional disclosures to shareholders regarding the proposed transaction. Of course, the plaintiff lawyers insist upon a fee as part of such a settlement. Even though those plaintiff fees in this type of litigation are usually a relatively modest six-figure amount, those fees are nonetheless profitable for the plaintiff lawyers who perform very little work for the fee. Those fees are problematic for primary D&O insurers who are paying these modest fee awards in a large number of bump-up claims, thereby jeopardizing the profitability of their books of business.

Occasionally, plaintiff lawyers will actually investigate the facts underlying their claim and identify problematic circumstances relating to the proposed acquisition. Especially when plaintiffs can show that either the directors or the involved officers of the target company had material conflicts of interest with respect to the acquisition, these modest bump-up settlements can become large eight-figure settlements. In other words, the high frequency and the occasional high severity of these bump-up claims have proven to be an attractive alternative source of fee income for the plaintiffs' bar and a meaningful financial challenge to primary D&O insurers. Although these bump-up cases have diminished in recent months as the number of M&A deals have diminished, they will certainly return when M&A deals return.

3. Say-On-Pay Litigation. As another example of plaintiff lawyers seeking alternative ways to generate fees, some members of the plaintiffs' bar have filed numerous derivative or class action lawsuits against directors in connection with a shareholder vote regarding the company's compensation arrangements for its senior executives. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires public companies to submit its executive compensation arrangements to shareholders for a periodic advisory vote. To date, the vast majority of those votes have supported the company's actual or proposed executive compensation programs, although occasionally shareholders reject the company's compensation arrangements. Initially, some shareholder plaintiffs sued the directors if the shareholders rejected the compensation arrangements and the board thereafter ignored that "advisory" vote by shareholders. Courts almost unanimously dismissed those suits as infringing on the business judgment of the directors. In response to those rulings, some shareholder plaintiffs changed their strategy and sued the directors before the advisory vote for failing to disclose truthful and complete information to shareholders about the compensation arrangements. These "second generation" say-on-pay lawsuits are generally also being rejected by courts, but they demonstrate the effort and creativity of the plaintiffs' bar in

their attempts to generate fees outside of securities class actions. Even in those cases where the defendants prevail, though, the expense of defending those lawsuits and the distraction and adverse publicity generated by those lawsuits create a toll on the defendants and their D&O insurers.

C. D&O INSURANCE IMPLICATIONS

Although the ripple effect from the reduced settlement payments in securities class action litigation involving non-financial institutions ("FI") creates added and new challenges for D&O insurers in other types of shareholder litigation, the D&O insurance industry has certainly benefitted from the significantly reduced non-FI settlement payments. Those savings, when combined with an unprecedented number of D&O insurers in the market, have helped sustain a more competitive market for D&O insurance when compared with most other lines of insurance today. But, the changing complexion of shareholder litigation has several implications which should be considered by both D&O insurers and their insureds, including the following:

1. Side A Policies. The types of alternative shareholder litigation now being pursued by plaintiff lawyers present an increased risk of defendant directors and officers incurring non-indemnifiable losses. Settlements and judgments in derivative lawsuits are not indemnifiable under the laws of most states. Similarly, bump-up claims against directors of a target company can present indemnification risks to the defendant directors if that litigation survives the acquisition date and those target directors lose control of the company and its indemnification decisions. As the risk of non-indemnifiable loss increases, the importance of high quality Side A D&O insurance likewise increases. Now more than ever, companies should be sure that they are purchasing an adequate amount of Side A insurance with as broad of coverage as possible from insurers with a proven record of high quality Side A claims experience. For this important non-indemnifiable exposure, directors and officers should not accept anything less than the best insurance protection available in the market from the most reliable Side A insurers.

2. Primary v. Excess Insurance. These alternative litigation strategies by the plaintiffs' bar are resulting in higher frequency but much lower severity claim payments. In other words, higher level excess D&O insurers are benefitted from the current D&O claims environment much more than primary D&O insurers. As a result, at least some primary D&O insurers are seeking larger premiums and are adjusting retentions and other terms of coverage in response to this increased exposure. But excess insurers who are benefitted by the current litigation environment continue to operate in a more competitive market. As a result, the size of the discounting of premium levels between the primary policy and the excess policies is likely to grow.

3. Disciplined Underwriting. As explained above, the near record low level of losses paid in non-FI securities class action litigation is not likely to continue indefinitely into the future. Probably without warning, one or more events will likely change that loss experience rather quickly and perhaps dramatically. To avoid a chaotic insurance market when that occurs and to promote long-term

stability and predictability for both insureds and insurers, the D&O insurance market should resist the temptation to accept unsustainable coverage terms and pricing. Extreme swings in the D&O insurance market during different claims cycles benefit no one.

D. SUMMARY

People can reasonably debate whether the total amount of securities class action settlements will ever return to the record levels which occurred in the aftermath of the Enron era. But, the current near-record low level of total securities settlement payments at least for certain sectors is unlikely to be sustainable in the long-run. The factors that seem to be contributing toward a smaller pool of settlements are probably temporary and have the potential to actually incubate more litigation activity in the coming years. Both insureds and D&O insurers need to anticipate and prepare for an increase in those total settlement amounts by having a continuing commitment to superior governance and compliance practices, and by having a renewed emphasis on long-term insurance purchasing strategies.