D&O 2012
CLAIMS TRENDS

D&O Claims Trends: 2012 Wrap Up

January 2013

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D&O Claims Trends: 2012 Wrap Up

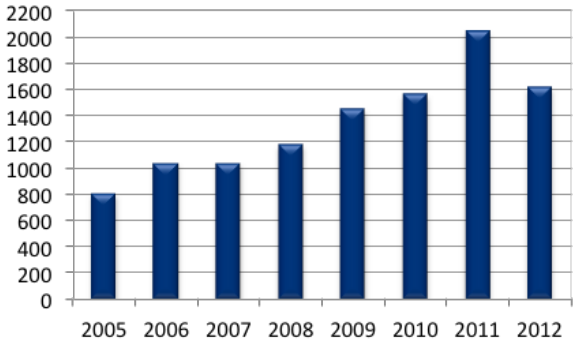
Executive summary

New securities and business litigation filings and enforcement actions were down in 2012 as compared to 2011, although, in the aggregate, they were still elevated compared to prior years. The decrease in new events was evident in all major categories of suits and enforcement actions, including securities class action suits, securities fraud suits filed by regulators and state breach of fiduciary duty suits. In two important categories, securities class action suits and breach of fiduciary duty suits, new filings not only were below 2011 counts, but also were lower than 2010.

Not only was the number of new events lower, the number of settlements also fell. For securities class action suits and breach of fiduciary duty suits, the decreasing number of settlements was a continuation of a longer-term trend. Settlement values, however, tended to be higher. The average securities class action settlement, for example, jumped nearly 50 percent as compared to 2011.

This report also contains a special section on Foreign Corrupt Practice Act (FCPA) enforcement. The surge in enforcement activity of the prior several years let up in 2012, though the decrease in new enforcement actions is likely a short term phenomenon. While D&O policies typically provide only limited coverage for FCPA claims, insurers should be concerned about follow-on litigation that would likely trigger coverage under a D&O policy. Presently, between 20 percent and 30 percent of formal FCPA investigations spark a related shareholder derivative suit.

Exhibit 1: Suits and Enforcement Actions



Source: Advisen MSCAd™

Summary of findings

Of the various types of lawsuits and enforcement actions tracked by Advisen that could trigger coverage under a D&O policy, almost all saw a decrease in new activity in 2012. In the aggregate, new events fell 21 percent, from 2,043 events in 2011 to 1,616 in 2012. Nonetheless, the number of new events exceeded every other year prior to 2011. (Exhibit 1)

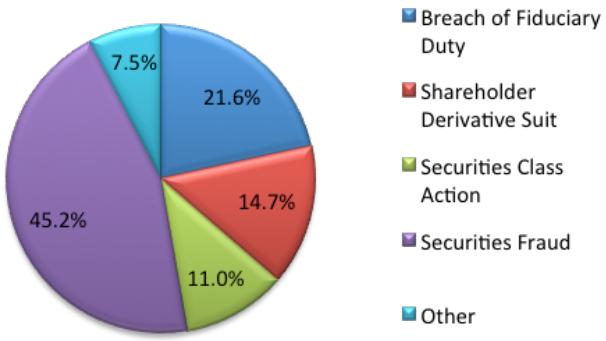
The largest drop occurred in breach of fiduciary duty suits, which saw the number of new filings fall 31 percent between 2011 and 2012. As defined by Advisen, this type of suit is usually filed in state courts, and typically alleges a breach of fiduciary duties by a company's directors. Many of these suits are so-called merger objection suits, which are filed in the wake of an announcement of a merger or acquisition.

As a percentage of total of D&O-related events tracked by Advisen, securities class action suits have decreased materially in recent years.

Foreign Corrupt Practice Act (FCPA) actions fell by 30 percent. As will be discussed in a later section, this decrease is most likely due to a temporary realignment of Department of Justice (DOJ) resources, and not an indication that enforcement of the law is waning. New securities class action filings dropped 21 percent. Securities fraud suits, which as defined by Advisen principally are securities-related actions brought by regulators and law enforcement agencies, fell nearly 17 percent. Shareholder derivative suits fell by about 10 percent.

Although the number of events was materially below elevated 2011 levels, the total nonetheless was above 2010 and prior levels. This was due largely to increases in securities fraud and shareholder derivative suit filings as compared to 2010 and prior. Breach of fiduciary duty suits and securities class action suits were below 2010 counts, with both down about 5 percent as compared to 2010.

Exhibit 2: 2012 Events by Type



Source: Advisen MSCAd™

For the fourth quarter alone, the number of new breach of fiduciary duty filings just barely trailed security fraud filings, representing 31 percent and 32 percent of total events respectively. However, for the entire year, at 45 percent of the total, securities fraud suits by far represented the largest number of new events. Breach of fiduciary duty suits accounted for nearly 22 percent of the year's total, and shareholder derivate suits were about 19 percent of the total. Securities class action suits represented about 11 percent of total new events, which was unchanged from 2012. (Exhibit 2) As a percentage of total of D&O-related events tracked by Advisen, securities class action suits have decreased materially in recent years.

About a quarter of new events in 2012 involved companies in the financial services sector and their directors and officers. This was down from 33 percent in 2011. While subprime and credit crisis litigation is not yet dead, the declining number of new events in the financial services sector represents a winding down of subprime and credit crisis-related activity. Technology was the second most active sector, with 14 percent of events, followed by healthcare with 13 percent.

The average settlement for all types of suits was $21.2 million in 2012, up from $16.4 million the prior year. The increase was due in large measure to a sharp increase in the average securities class action suit settlement: $51.8 million in 2012 as compared to $34.9 million in 2011. "Settlement" includes, in addition to final approved settlements, proposed and tentative settlements, plus jury awards.

The significant drop in new events in 2012 should be seen in the context of longer term trends.

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 suits other than 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. Advisen also includes in its tally securities suits that are filed in state courts. If suits are filed in multiple jurisdictions, Advisen treats each 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 this report as follows:

- **Securities Class Action:** suits alleging violations of federal securities laws, principally the Securities Act of 1933 and the Securities Exchange Act of 1934, filed by a private party on behalf of a class of persons injured by alleged violations.
- **Securities Fraud:** suits filed by regulators or law enforcement agencies charging violations of securities fraud laws. Also included are cases brought by private parties alleging violations of securities laws that are not styled as class actions, and where more specific securities law violations are not made.
- **Breach of Fiduciary Duties:** 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. This includes merger, privatization or other transactions that involve public companies.
- **Derivative Action:** cases against directors and officers brought by shareholders on behalf of the company.

New events

The significant drop in new events in 2012 should be seen in the context of longer term trends. While the number of events was lower in 2012 than in 2011, 2011 was an unusually active year, especially for securities fraud suits and shareholder derivative suits. The 2012 counts were more in line with prevailing trends since 2007. Nonetheless, it is unusual to see an across-the-board decrease in lawsuits. More typically, plaintiff firms reallocate resources to different types of litigation to respond to changing conditions. If that indeed is what is happening, those resources are being allocated outside the realm of D&O-related litigation.

By type of event

The increase in breach of fiduciary duty filings over the past several years has been driven significantly by a surge in merger objection suits.

As previously observed, securities fraud suits accounted for 45 percent of the total new D&O-related events during 2012. This was slightly above 2011, when securities fraud suits represented 43 percent of the total. During the course of 2012, however, both the absolute number of securities fraud suits, and the percentage of total they represented, fell quarter-by-quarter. The first quarter saw 258 new securities fraud suits, which was more than half of the total of all events, but the fourth quarter saw only 79 new suits, representing 32 percent of the total.

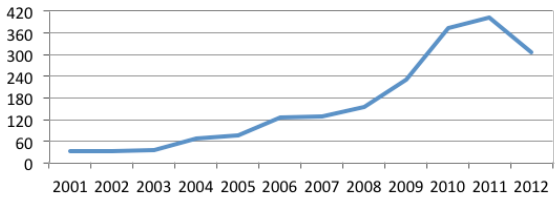
The decline in the number of securities fraud suits is due in part to a change of emphasis in SEC enforcement in 2012. While the total number of enforcement actions was virtually unchanged between 2011 and 2012, Financial Fraud/ Issuer Disclosure actions fell 11 percent. With the probable confirmation of Mary Jo White as the new head of the SEC, it seems likely that the number of actions in this category will increase in 2013 and beyond.

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 22 percent in 2007 to about 11 percent in both 2011 and 2012. In comparison, breach of fiduciary duty suits grew from 11 percent to 22 percent of total events over the same period.

The number of securities class action filings in 2012 was sharply lower than in 2011 (though dead even in terms of percentage of total events). It was also about 5 percent lower than the number of filings in 2010, and significantly below the historical average. The downward trend in securities class action filings has been the topic of much and discussion and speculation among analysts. Over a short time horizon, the decrease is attributable to fewer suits involving Chinese firms and the winding down of credit crisis suits. The longer term trend towards fewer securities class action suits likely reflects a change in emphasis by plaintiffs' firms, due in part to a string of Supreme Court decisions favoring defendants, but also perhaps attributable to a shift in focus towards other types of suits can be resolved quickly in more favorable state jurisdictions at a far lower cost to the law firm. However, another event such as the meltdown of the subprime market undoubtedly would open a floodgate of new filings.

The increase in breach of fiduciary duty filings over the past several years has been driven significantly by a surge in merger objection suits. These suits usually 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. Merger objection filings maintained a strong growth trend despite fluctuations in M&A activities through 2011. It has been suggested, including by some judges presiding over these cases, that the increase in filings has been driven more by plaintiff's attorneys seeking new sources of fee revenue than by the economics of mergers and acquisitions. After experiencing strong and steady growth in new filings between 2006 and 2011, the number of new merger objection filings decreased materially in 2012, falling 24 percent as compared to the all-time high in 2011. (Exhibit 3) The decline in merger objection suits may be in part a function of a decrease in M&A activity – global mergers and acquisitions fell about 10 percent in 2012, according to Bloomberg.[1] However, lower deal volume does not fully explain the large decrease in suits.

Exhibit 3: Merger Objection Suits



Source: Advisen MSCAd™

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By industry group

Financial firms continued to dominate new filings, as they have since the beginning of the credit crisis. About 28 percent of new filings in 2012 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 was down from 33 percent in 2011. In large measure, this is an outcome of the continuing wind down of subprime and credit crisis activity.

Historically, filings involving financial firms and those involving technology firms are negatively correlated: as the number of suits naming financial firms increase, the number naming technology firms decrease, and vice versa. That trend appears to be holding. Over the three-year period 2010-2012, suits involving financial firms have fallen from 36 percent of the total to 28 percent, while suits involving IT firms have grown from 9 percent to 14 percent of the total.

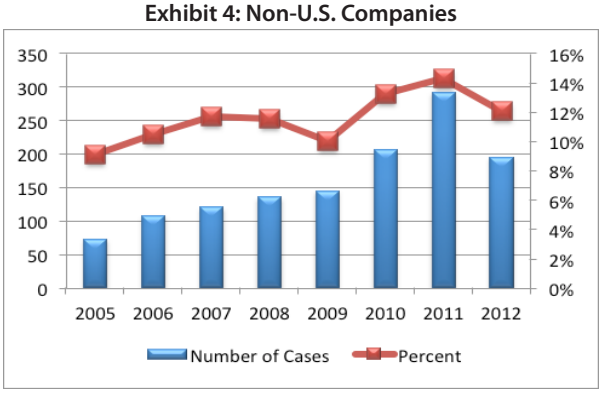
Suits related to companies in the healthcare sector represented 13 percent of total new events in 2012, up from 9 percent in 2011. The consumer discretionary and the industrials industries both represented about 12 percent of new events in 2012 – largely unchanged from 2011. (Exhibit 4)

Non-U.S. companies

As compared to the United States, securities litigation in Europe, Asia and Latin America is less frequently a matter of public record, making it 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 these limitations on data collection, it is nonetheless clear that litigation activity has become increasingly common in recent years in courts outside the Unites States. Among the common triggers for D&O claims in non-U.S. courts are bankruptcy and regulatory enforcement actions.

Between 2005 and 2009, events involving non-US companies, filed both in the U.S. and elsewhere, accounted for about 11 percent of total events on average. In 2010 the number increases to 13 percent, growing again to 14 percent in 2011. The number dropped to 12 percent in 2012. (Exhibit 4)

Exhibit 4: Non-U.S. Companies



Source: Advisen MSCAd™

Settlements and awards

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Securities class action suits continue to represent an increasingly smaller percentage of D&O-related suits filed, but they remain the most significant source of large losses. Including proposed and tentative settlements, the average securities class action settlement was $51.8 million for the year, up from $34.9 million the prior year. This compares to $19.4 million for breach of fiduciary duty suits and $8.4 million for securities fraud suits. Shareholder derivative suits often make no demands for monetary damages, and the average for the 41 suits settled during the year was $4.9 million.

While the average securities class action settlement was up, the number of settlements has been trending downward. There were 84 securities class action settlements in 2012 as compared to 94 in 2011 and 114 in 2010. Breach of fiduciary duty suits shows a similar trend. The number of securities fraud settlements also was down in 2012 as compared to 2011, but the longer term trend is less clear.

The largest settlement of the year was a $2.4 billion tentative settlement by Bank of America concerning its acquisition of Merrill Lynch, which Advisen classifies as a proxies and solicitations violations case. Shareholders accused the bank of providing false and misleading statements about the financial health of Merrill Lynch. Bank of America denied the allegations, but said it agreed to settle in order to put the case behind it. This also was the largest settlement yet of a subprime/credit crisis case.

Securities class action suits typically have been heavily represented among the largest settlements in any given year. In 2012, they represented two of the top five settlements: ongoing AIG litigation was finally resolved when a $725 million payment to shareholders was approved, and Citigroup agreed to pay shareholders $590 million in a subprime mortgage-related case. Shareholders accused Citigroup of failing to take timely writedowns on collateralized debt obligations, many of which were backed by subprime mortgages. The third largest settlement of the year, classified by Advisen as a Ponzi scheme case, concerned Private Equity Management Group, LLC and Private Equity Management Group, Inc. The $704 million judgment was comprised of $631 million in disgorgement and $73 million in prejudgment interest. The SEC had accused Danny Pang, who controlled the two entities, of defrauding investors out of hundreds of millions of dollars. The fifth largest settlement of the year was a proposed settlement of a suit brought by the SEC against BP p.l.c. The SEC charged BP with misleading investors by significantly understating the flow rate of oil while its Deepwater Horizon oil rig was gushing into the Gulf of Mexico.

The largest breach of fiduciary duty settlement involved RBS Holdings N.V. (formerly ABN AMRO N.V.) concerning the takeover of the Dutch activities of the former Fortis Group by the Dutch state. The settlement calls for a one-time payment by ABN Ambro of €400 million ($503 million). The largest breach of fiduciary duty settlement involving a private sector defendant was a class action suit concerning The Bank of New York Mellon Corporation, which tentatively settled for $280 million. The settlement resolves litigation concerning the investment of securities lending collateral in Sigma Finance Inc., the operator of a structured investment vehicle that collapsed in September 2008.

It should be noted that D&O 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: FCPA and related violations

According to Advisen's MSCAd™ large loss database, the number of prosecutions jumped sharply in 2007 and peaked in 2010.

Companies conducting business in foreign countries increasingly are targeted for violations of the Foreign Corrupt Practices Act (FCPA), which prohibits payments to foreign officials to obtain or retain business. Prosecutions have skyrocketed since 2007. In a PwC survey of private company executives, 76 percent said that corruption is a key risk of venturing into emerging and fast-growing markets.[2]

The FCPA is enforced jointly by the SEC and the DOJ. The number of DOJ prosecutors devoted to working on FCPA cases has approximately doubled since 2009. In 2010, the SEC's Enforcement Division created a specialized unit to further enhance its enforcement of the FCPA. Since 2009, the DOJ's FCPA Unit has entered into nine of the top ten resolutions in the history of the act. These and other resolutions since 2009 have resulted in over $2 billion in fines.

The FCPA 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 can 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.

According to Advisen's MSCAd™ large loss database, the number of prosecutions jumped sharply in 2007 and peaked in 2010. Activity fell off a bit in 2012, but many observers believe that is only a short-term lull. Law firm Gibson Dunn attributes the downtick in new prosecutions, among other reasons, to the vast quantity of government resources that were devoted to the comprehensive FCPA Resource Guide released in November, 2012.[3]

D&O coverage

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, however, may be covered. Coverage usually is limited to individuals. 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 an FCPA violation.[4]

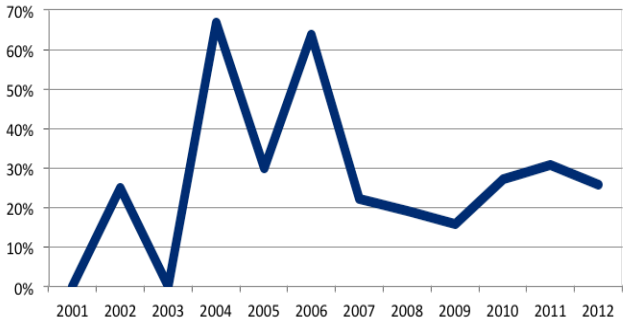
Historically, most D&O policies did not cover internal company investigations and informal investigations by regulators and law enforcement agencies. Courts, however, were divided as to whether formal SEC and DOJ investigations were covered.[5] Some policies now specifically afford coverage for regulatory investigations, though coverage may be limited to formal investigations triggered by a subpoena or a Wells notice issued by the SEC. A few carriers now offer policies specifically intended to cover FCPA investigations.

Although fines, penalties and disgorgement typically are not covered, insurance protection nonetheless can be a material issue for many companies. FCPA investigation costs can exceed $100 million for a large company. Weatherford International, in its most recent 10-K, reported that it had "incurred $123 million for legal and professional fees in connection with complying with and conducting these on-going investigations" concerning alleged FCPA violations and allegations that the company did business with terrorist-friendly countries that are under U.S. trade sanctions. The expenses associated with alleged FCPA violations also can include costly internal investigations. Wal Mart reportedly spent nearly $100 million on an internal FCPA review over a 9 month period.[6]

Follow-on litigation

While D&O coverage for FCPA-related costs may be limited, coverage is broadly available for suits that frequently are filed in the wake of the announcement of an FCPA investigation.

Exhibit 5: %FCPA Actions with Follow-On Suits



Source: Advisen MSCAd™

Once it is known that a company is being investigated for possible FCPA violations, shareholders may bring a derivative action alleging that the directors and officers breached their duties by failing to implement effective internal controls to prevent and detect FCPA violations, or for turning a blind eye toward illegal payments. There were 13 derivative actions related to FCPA investigations filed in 2010, 9 in 2011 and 10 in 2012. Thus far, there is no clear trend as to what percentage of FCPA investigations will result in follow-on shareholder derivative suits, though the most recent years suggest that derivative actions are likely in 20 to 30 percent of investigations. (Exhibit 5)

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Often, FCPA investigations do not result in a parallel securities class action since FCPA disclosures do not necessarily cause a decline in a company's stock price. Nonetheless, these suits do occur on occasion and the exposure should not be ignored. Avon, for example, was sued by shareholders claiming to have been misled about the size and scope of potential FCPA violations.[7]

New SEC and DOJ Guidance highlights potential FCPA successor liability for companies that merge with or acquire another company. This could lead to an increase in M&A shareholder suits focused on FCPA violations. The DOJ and SEC Guidance urges companies to conduct pre-acquisition due diligence to uncover possible violations. Directors and officers may be held liable for breaching their fiduciary duties if they fail to conduct adequate pre-acquisition due diligence and thereby fail to uncover, remediate or disclose FCPA violations by the acquisition target.

The future of anti-bribery law enforcement

According to Lanny A. Breuer, Assistant Attorney General for DOJ's Criminal Division, in a recently speech:

"[R]obust FCPA enforcement has become part of the fabric of the Justice Department: Our global anti-corruption mission has seeped into the Criminal Division's core. And there is no turning back. The FCPA is now a reality that companies know they must live with and adjust to." [8]

Not only must companies be concerned about FCPA compliance, many are likely to be subject to the similar laws in other countries. The FCPA is a part of a growing global anti-bribery initiative that includes the 2011 UK Bribery Act as well initiatives by the Organisation for Economic Co-operation and Development, World Economic Forum, World Bank, and the United Nations Convention Against Corruption. These other laws will likely further increase liabilities and expenses for U.S. companies doing business around the globe.

This report was written by David Bradford, Editor-in-Chief with input from Jim Blinn, Executive Vice President, Advisen Ltd.

About AIG

NOTES:

[1] "Fourth-Quarter M&A Surge Spurs Optimism After 2012 Deals Decline," Bloomberg http://www.bloomberg.com/news/2012-12-27/fourth-quarter-m-a-surge-spurs-optimism-after-2012-deals-decline.html

[2] Cited in Foreign Corrupt Practices Act: What you don't know could cost you, PwC http://www.pwc.com/us/en/private-company-services/publications/assets/gyb-63-foreign-corrupt-practices-act.pdf

[3] 012 Year-end FCPA Update, Gibson Dunn http://www.gibsondunn.com/publications/Documents/2012YearEndFCPAUpdate.pdf

[4] "Insurance for FCPA Investigations," Pepper Hamilton http://www.pepperlaw.com/publications_article.aspx?ArticleKey=2315

[5] "Foreign Corrupt Practices Act Gives Rise to D&O Claims," Wilson Elser http://www.wilsonelser.com/news_and_insights/client_alerts/771-foreign_corrupt_practices_act_gives_rise_to_d_o

[6] "Wal-Mart Inquiry Reflects Alarm on Corruption," New York Times http://www.nytimes.com/2012/11/16/business/wal-mart-expands-foreign-bribery-investigation.html?pagewanted=all&_r=0

[7] "Avon Products, Inc. Hit With Investor Lawsuit Over Alleged Securities Laws Violations," Shareholders Foundation http://shareholdersfoundation.com/case/avon-products-inc-hit-investor-lawsuit-over-alleged-securities-laws-violations

[8] Assistant Attorney General Lanny A. Breuer Speaks at the American Conference Institute's 28th National Conference on the Foreign Corrupt Practices Act,USDOJ http://www.justice.gov/criminal/pr/speeches/2012/crm-speech-1211161.html