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riskINSIGHTS

Top Ten D&O Stories of 2015

2015 was an eventful year in the world of directors' and officers' liability. Many of the year's key events significantly changed the D&O liability environment, while other developments during the year have the potential to alter the D&O insurance marketplace. The list of the Top Ten D&O Stories of 2015 is discussed below.

number*one* 1

New Department of Justice Policy Means Corporate Officials Could be Targeted

In the U.S. Department of Justice (DOJ) September 9, 2015 directive (universally referred to as the Yates Memo), the DOJ restated and reinforced its commitment to targeting individual executives. The cornerstone of the agency's new policies is the specification that in order for a company to receive any cooperation credit in a DOJ investigation, the company must provide the agency with all relevant facts about the individuals involved in the misconduct. The new policy directives increase the likelihood that individuals will be targeted and that individuals could remain as targets of criminal or civil actions even after companies have been able to negotiate the resolution of the actions against the companies themselves.

In light of the agency's increased emphasis on actions targeting individuals, corporate officials' rights (either in their companies' corporate charters or standalone indemnification agreements) to advancement and indemnification will be even more important. In addition, for the individuals involved, their companies' D&O insurance will become more important than ever. If an individual has been targeted as result of the agency's new directive, or an individual finds himself or herself unable to extricate themselves from a prosecution or civil action even after the company has managed to resolve the case against the corporate entity, the D&O insurance may represent the individuals' last line of defense.

There are a number of insurance implications from all of this. First, the DOJ's new guidelines suggest that

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prosecutions and civil cases could become more protracted, as companies become unable to negotiate resolutions that conclude cases for both the company and for the individuals involved. Since defense expenses erode the available limits of liability, limit adequacy issues may arise.

Second, it is going to be more important than ever that the policies' conduct exclusions are structured to ensure that the coverage will not be withheld at the very moment the corporate executives need it most. That means, among other things, ensuring that the coverage preclusive effect of the conduct exclusions will be triggered only when and if there has been a final, non-appealable adjudication adverse to the insured person in the underlying proceeding. These restrictions ensure that the coverage will remain available, for example, to allow individuals to pursue appeals even if they have been convicted criminally.

Third, the agency's new policies should spur companies to obtain an excess Side A/DIC policy. These policies, which provide a measure of catastrophe protection for corporate executives, would be triggered if the company wrongfully withheld advancement or indemnification from its executives, or if the company is financially or legally unable to indemnify its executives or to advance defense expenses. Companies that already have Side A/DIC insurance as a part of their D&O insurance program may consider increasing their Side A/DIC limits.

numbertwo 2

Courts Slam Disclosure-Only Settlements in Merger Objection Cases

One of the trends of the corporate litigation environment in recent years has been the proliferation of merger objection suits. These cases frequently are resolved through a disclosure-only settlement in which plaintiffs' counsel gets their fees paid and the defendants get an "intergalactic" claim release. In a series of decisions during the year, the judges of the Delaware Chancery Court made it clear that they have serious concerns both about these kinds of cases and about the disclosure-only settlements. It now appears that the days when these kinds of settlements routinely pass judicial scrutiny are over, which in turn could mean that we could start to see fewer merger objection lawsuits being filed.

In an October 9, 2015 settlement hearing in the litigation that had been filed objecting to Hewlett-Packard's $2.7 billion acquisition of Aruba Networks, Delaware Chancery Court Vice Chancellor Travis Laster rejected the parties' proposed disclosure-only settlement of the case, stating his belief that the merger objection litigation dynamic represents a "systemic" problem that has resulted in a "misshapen legal system." Laster cited the "inadequacy of the representation" of plaintiffs' counsel for the shareholder class as the basis for his rejection of the settlement, as well as for the outright dismissal of the case. Laster's comments made it clear that his concerns were not only specific to the settlement in the Aruba Networks case, but were directed at these kinds of disclosure-only settlements in general and even at the kinds of cases in which these settlements arise.

Delaware courts are not the only ones taking a dim view of disclosure-only settlements in merger objection lawsuits. In an October 23, 2015 opinion, New York (New York County) Supreme Court Judge Charles E. Ramos refused to approve the disclosure-only settlement proposed in the Allied Healthcare merger objection lawsuit, saying that the proliferation of these kinds of settlements "reflects poorly on the profession and on those courts that, from time to time, have approved these settlements."

Now that the pathway to a quick case resolution of these kinds of cases is in doubt, the question becomes whether or not we will see a decline in the number of merger objection lawsuits filed. The early signs are that there will be fewer of these cases. According to a recent analysis, the number of new merger objection lawsuit filings in the Delaware Chancery Court has already begun to drop in response to the Chancery Court's rulings.

numberthree 3

Delaware Legislature Prohibits Fee-Shifting Bylaws

In a move to address a development that could have changed the face of corporate litigation in the U.S., on June 11, 2015, the Delaware House of Representatives overwhelmingly passed S.B. 75, which prohibits Delaware stock corporations from adopting "loser pays" fee-shifting bylaws and which confirms that Delaware corporations may adopt bylaws designating Delaware courts as the exclusive forum for shareholder litigation. Delaware's Governor signed the bill into law on June 24, 2015.

The dust-up in Delaware over fee-shifting bylaws got started in May 2014, when the Delaware Supreme Court in the *ATP Tours, Inc. v. Deutscher Tennis Bund* case upheld the facial

validity of a bylaw provision shifting attorneys' fees and costs to unsuccessful plaintiffs in intra-corporate litigation. This development quickly caught the eye of litigation reform advocates, as the adoption of fee-shifting bylaws seemed to offer a way for companies to reduce the costs of and possibly curb burdensome litigation. At the same time, shareholder advocates became concerned that these types of bylaws could deter even meritorious litigation. Because of the debate, the proposed legislation stalled for a legislative term, but eventually the legislature passed the bill.

The Delaware legislature's action does not necessarily mean the end of the discussion. Obviously, the statute only relates to Delaware corporations. Other states may choose to take a different approach. (Indeed, the Oklahoma legislature has adopted a provision mandating the shifting of fees in derivative suits.)

number*four* 4

Increased Numbers of IPOs Means More IPO-Related Securities Lawsuits

The number of securities suit filings increased in 2015 compared to recent years, largely as a result of an increase in the number of IPO-related securities suit filings. The increased number of IPO-related securities suit filings is a direct reflection of the higher number of IPOs completed during the 2013-15 period. IPO-related suits were an important part of the 2014 securities class action lawsuit filings, and they represented an even more significant part of securities suit filings in 2015.

According to Renaissance Capital, 170 companies completed IPOs on U.S. exchanges in 2015. These numbers are down approximately 38% from the 275 companies that completed offerings in 2014. Although the 2015 IPO filing activity was below the prior year's elevated levels, it still was above the levels that prevailed during the 2008-2012 period, when IPO activity was quiet.

The IPO-related securities lawsuit filings increased in 2015 compared to 2014. During 2015, there were 29 IPO-related securities class action lawsuit filings (including state court filings), representing about 15% of the year's securities suit filings. Of the 29 IPO-related securities suits filed in 2015, one involved a 2012 IPO, four involved 2013 IPOs, fifteen involved 2014 IPOs, and nine involved 2015 IPOs.

Of the 275 companies that completed IPOs during 2014, 22 have been involved in securities class action lawsuits so far. Because of the three-year statute of limitations under the '33 Act for actions against IPO companies, we won't know until the end of 2017 how many of the IPO class of 2014 will ultimately be served with securities suits.

Given the increase in the number of IPOs during the 2013-2015 period, and in light of the usual lag time between the IPO date and the date of lawsuit filings, it seems probable that there will continue to be significant number of filings in the months ahead involving IPO companies.

number*five* 5

Securities Suits Against Foreign Defendants Continue to Accrue

In addition to the upsurge in securities suits involving IPO companies, another current securities class action filing trend is the heightened level of securities suit filing activity involving non-U.S. companies. The number of securities suit filings against non-U.S. companies during 2015 was both above historical levels and disproportionately greater than the representation of foreign companies on the U.S. exchanges.

In 2015, there were 34 securities class action lawsuits filed against non-U.S. companies (that is, companies that have either organized under the laws of a foreign jurisdiction or that have their principal place of business in a foreign jurisdiction). The 34 filings in 2015 were well above the historical average of 22 annual filings against non-U.S. companies during the 1997 to 2013 period. The 34 filings represented about 18 percent of all 2015 securities class action lawsuit filings, which is well above the 1997-2013 historical average of 11 percent.

The 34 securities class action lawsuits filed in 2015 against non-U.S. companies involved companies from 18 different countries. As has been the case for the past several years, the country with the highest number of companies sued is China, with 15 (if the lawsuit filed against Alibaba, which is based in Hong Kong, is included). The lawsuits against Chinese companies represented about 44 percent of all suits filed in 2015 against non-U.S. companies, and about eight percent of all 2015 securities suit filings.

number*six* 6

As Securities Litigation Increasingly Involves Smaller Companies, Average and Median Securities Lawsuit Settlements Are Shrinking

For many years, the likelihood that a company would get served with a securities class action lawsuit was directly proportionate to its size – the bigger the company (as measured by its market capitalization), the likelier that it would face a securities lawsuit. In more recent months, this trend has changed. Increasingly, smaller companies are the ones getting served with securities suits.

As PwC noted, the size of the companies involved in securities class action lawsuits is shrinking. The accounting firm found that 66% of all companies named as defendants in securities suits in 2014 were "small-cap" companies (market caps of $2 billion or less). About one quarter of all 2014 securities suit filings involved "micro-cap" companies (market caps under $300 million). This trend continued in 2015. While the formal 2015 reports are not yet available, sources advise us that about 48% of the companies sued during the year had market capitalizations under $750 million.

The reason the size of the settlements is shrinking is simply that the fewer dollars are at stake in many of the cases that are filed. As the mix of securities cases has shifted toward smaller companies, the cases themselves are just smaller. Given the size of the companies named as defendants in the securities lawsuits filed in recent years, this trend toward lower average and median settlements seems likely to continue.

number*seven* 7

Supreme Court Issues Its Opinion in the Omnicare Case

In 2015, the Court issued its opinion in the *Omnicare* case, addressing the question of liability under the federal securities laws for statements of opinion in a company's offering documents. The Supreme Court took up the case to determine whether or not it is sufficient to survive a dismissal motion for a plaintiff in a Section 11 case to allege that a statement of opinion was *objectively* false, or whether the plaintiff must also allege that the statement was *subjectively* false – that is, that the defendant did not believe the opinion at the time the statement was made. The Supreme Court's granted the writ of certiorari in the *Omnicare* case because of a split in the circuits between those (such as the Second and Ninth Circuits) holding that, in a Section 11 case, allegations of knowledge of falsity are required; and those (such as the Sixth Circuit, in the *Omnicare* case) holding that allegations of knowledge of falsity are not required.

In a March 24, 2015 opinion in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, the U.S. Supreme Court set aside the Sixth Circuit's ruling that allegations of "objective falsity" were sufficient to make a statement of opinion in securities offering documents actionable. The Court held that an issuer may be liable for opinion in a registration statement if it does not genuinely hold the opinion or if a fact offered in support of the opinion is itself materially false or misleading. The Court further held that an issuer may be liable for omitting material facts about an opinion if those facts "conflict" with what a reasonable investor "would understand an opinion statement to convey" with respect to "how the speaker has formed the opinion" or "the speaker's basis for holding that view."

Statements of opinion often are involved in the allegations in Section 11 claims because financial statements contain many different types of opinions. Courts have held that financial statement items such as reserves, goodwill and so on constitute opinions, and, in general, courts have been comfortable saying that opinions are not actionable under Section 11 unless the speaker didn't believe the opinion. Now, courts will have to consider whether the opinion included misleading "supporting facts," and whether or not there were "omitted facts" sufficient to make the opinion misleading, taken in context of the entire registration statement.

These issues may be particularly important because of the increase in IPO-related litigation noted above. As plaintiffs in IPO cases prepare their complaints, they will now be sure to allege that an opinion omitted facts, and therefore, that the opinion was both misleading and actionable. The *Omnicare* standards of liability for statements of opinion in registration statements are likely to get a workout in the district courts where the IPO-related lawsuits are filed.

number*eight* 8

Cyber Breach-Related D&O Litigation Continues to Emerge

In early 2014, when plaintiffs initiated data breach-related derivative lawsuits against the boards of Target Corp. and Wyndham Worldwide, there was some speculation that these cases might be the first of what could become a wave of data-breach related D&O lawsuits. But then the Wyndham Worldwide case was dismissed and no new data breach-related D&O lawsuits followed, even though there were several high profile data breaches after that time (including Sony Entertainment, Anthem and Home Depot). Although many had predicted that more D&O lawsuits were to come, the suits themselves did not materialize.

However, the dearth of cyber breach-related D&O litigation ended in September 2015, when a Home Depot data breach-related shareholder's derivative lawsuit was filed in the Northern District of Georgia. On September 2, 2015, a plaintiff shareholder filed a redacted complaint in a lawsuit against Home Depot, as a nominal defendant, and twelve Home Depot directors and officers, alleging that the defendants breached "their fiduciary duties of loyalty, good faith, and due care by knowingly and in conscious disregard of their duties failing to ensure that Home Depot took reasonable measures to protect its customers' personal and financial information."

One particularly noteworthy aspect of the Home Depot complaint is that the plaintiff's allegations built upon prior data breaches at Target and Neiman Marcus. The plaintiff contended that those prior breaches provided fair warning that Home Depot could expect much of the same. The suggestion is that as more organizations are served with data breaches, the expectation that boards and company management should act will rise, and the alleged failure to act in response to the drumbeat of revelations about data breaches itself could be the basis of claims against company officials.

Given that data breaches are almost certain to continue, the probabilities are that data breach-related D&O litigation will continue and could become an increasingly important part of the corporate and securities litigation landscape.

On a related note, on August 24, 2015, in a ruling that was much-anticipated because of its potential implications for the regulatory liability exposures of companies that have been served with data breaches, the Third Circuit affirmed the authority of the Federal Trade Commission (FTC) to pursue an enforcement action against Wyndham Worldwide Corp. and related entities alleging that the company and its affiliates had failed to make reasonable efforts to protect consumers' private information. This ruling confirms that, in addition to the disruption and reputational harm that may follow in the wake of a data breach, and in addition to the possibility of the kind of D&O litigation described above, companies could also face regulatory action from the FTC as well.

number*nine* 9

Litigation Financing Continues to Grow and Develop

Litigation financing has long been an important part of the corporate and commercial litigation scene in Australia, Canada, and the United Kingdom. More recently, it has become increasingly important in the U.S. as well. There is a very simple reason why litigation financing is continuing to grow and to attract more investors – litigation financing is very profitable for many of the firms involved.

How profitable is litigation financing? Because several litigation financing firms are publicly traded, we do not have to guess. For example, on March 18, 2015, Burford Capital Limited, the largest player in the growing U.S. litigation funding business and a publicly traded firm whose shares trade on the London Stock Exchange AIM Market, released its results for 2014, showing that the company's revenue during the year rose by 35 percent to $82 million, with a 43 percent rise in operating profit, to $61 million. The company, which has assets of over $500 million under management, reports that since its inception it has produced "a 60% return on invested capital."

Similarly, Bentham IMF, the U.S. arm of IMF Bentham Limited, whose shares trade on the Australian Stock Exchange, reported in December 2014 that it had funded ten deals during the year, with client recoveries of nearly $100 million resulting from jury verdicts and settlements. The firm itself had gross returns of more than $31 million for the year, with a net profit of $17 million.

Though litigation funding can be profitable, some firms have found success elusive. For example, in a November 18, 2015 statement, Juridica Investments Limited announced that it was not making any further litigation investments and would be returning its capital to investors. Juridica is a publicly traded company; its shares trade on the London stock exchange, so its closure is something of a public event.

numberten 10

Consolidation Comes to the P&C Insurance Industry

During 2015, change came to the Property and Casualty (P&C) insurance world in ways that may significantly affect the D&O insurance marketplace for years to come. The watchword for P&C insurance industry in 2015 was "consolidation." XL acquired Catlin. Tokyo Marine Holdings acquired HCC Insurance Holdings. Fosun acquired Meadowbrook and the portion of Ironshore that it didn't already own. Endurance Specialty Holdings acquired Montpelier Re. Exor will acquire Partner Re. And, in the biggest deal of all, ACE Limited acquired The Chubb Corporation, in a deal worth almost $30 billion.

It is too early to know what the consolidation will mean for the industry. Perhaps, further deals will be announced. We do know that not every one of these deals will affect the marketplace in the same way. Some of the acquirers have made it clear that they intend to function purely as a holding company and allow the acquired company to continue to operate effectively as an independent company. Other buyers are clearly intending to merge operations.

The one thing we can say for sure now is that the consolidation is going to have an effect. One of the deals that closed earlier in 2015, the XL acquisition of Catlin, is already having an impact as the two formerly separate companies go forward on a combined basis.

These circumstances present the possibility that we could be entering a period of rapid and potentially significant change. All marketplace participants will have to adjust. For insurance buyers, these changes may mean that settled assumptions will have to be revisited. It may also mean that transactions that were routine in the past may require more time, attention, and effort in the future. There could be complications. All of these developments underscore the importance for insurance buyers of working with a knowledgeable and experienced insurance advisor to help navigate these developments as they arise.

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