Recent wave of securities class actions poses challenges for D&O insurers

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A significant factor contributing to the increase in SCA actions is the growth in federal merger-objection lawsuits, which challenge M&A deals on grounds that the company's board of directors breached their fiduciary duties by failing to maximize shareholder value or failed to make adequate disclosures. (Photo: Fotolia)

Securities class action (SCA) lawsuits are being filed at a heated pace that hasn't been seen in more than two decades.

According to Cornerstone Research, there were a record 325 SCAs filed in the first three quarters of 2017.

Filings in the first half of 2017 were up 49% over the second half of 2016, and represented the highest number of SCA filings over a six-month period since Cornerstone Research began tracking the data in 1996.

What makes these numbers remarkable is that the stock market has been strong with indices trading at record levels, having rebounded in the almost 10 years since the financial crisis in 2008. In addition, the Sarbanes-Oxley Act has had a positive impact on companies' internal controls over financial reporting, which according to research firm Audit Analytics has led to a drop in financial restatements.

PricewaterhouseCoopers noted in its 2016 study on securities litigation that there was no apparent relationship between the performance of the S&P 500 index in 2016 and the number of new SCAs filed, although in prior years there had been an inverse relationship.

Factors accounting for the rise

A variety of factors appear to be driving the rise in SCA filings, from changes in the law governing mergers and acquisitions to a disproportionate number of filings by smaller-tier plaintiff's firms. We could be witnessing the lawsuit equivalent of a stock-picker's market: second- or third-tier plaintiffs' firms that are identifying target companies for early settlements, as we often witnessed before the enactment of the Private Securities Litigation Reform Act.

As a natural result, this wave of SCA filings may have significant implications for Directors and Officers (D&O) liability insurers, who find themselves increasingly exposed to D&O claims involving SCA lawsuits. D&O insurers should therefore be aware of these trends, and should take certain steps to ensure they can effectively handle such claims and underwrite these risks.

A significant factor contributing to the increase in SCA actions is the growth in federal merger-objection lawsuits, which challenge M&A deals on grounds that the company's board of directors breached their fiduciary duties by failing to maximize shareholder value or failed to make adequate disclosures. The majority of these lawsuits are resolved through settlements in which the target company agrees to make additional disclosures in its proxy statement and improvements in corporate governance (corporate therapeutics).

Shift to federal court

There also has been a shift in the filing of SCAs from state court to federal court as a direct result of the Delaware Court of Chancery's decision in *In re Trulia, Inc.,* which noted disclosure-only settlements would be viewed with greater scrutiny. This heightened scrutiny is unappealing to plaintiffs' class action attorneys, which is the reason the plaintiffs' bar is filing an increasing number of Section 14(a) proxy lawsuits under the 1934 Exchange Act.

These federal securities-fraud lawsuits allege disclosure violations and pose potential liability and damages against the target company and its directors and officers, as well as the purchaser in certain cases.

In contrast to Section 14(a) proxy litigation, shareholder plaintiffs are filing Delaware Section 262 appraisal actions with increasing frequency. These actions differ from the Section 14(a) proxy suits because under Delaware Section 262, the target has no liability, as the purchaser pays the difference in value between the price offered in the M&A transaction and the court's appraisal.

Yet another factor contributing to the rise of SCA lawsuits is the number of cases brought against companies that are headquartered outside the United States but whose shares trade on U.S. exchanges.

According to Cornerstone Research's 2017 mid-year report, the number of SCA filings against non-U.S. companies is on pace to be at its highest level since 1997.

Certain industries being targeted

In addition, certain industries are being targeted at a higher rate. As reported by Cornerstone Research, a total of 69 securities class action lawsuits were filed in the first half of 2017 against life sciences companies (companies in the fields of biotechnology, pharmaceuticals, and healthcare), which exceeds the number of SCA filings against life sciences companies in all of 2016.

Another plausible explanation for the significant uptick in SCA lawsuits is the number of cases brought by second- and third-tier plaintiffs' firms. These law firms often target small-cap or mid-cap companies, and they became more active in the years since the global financial crisis in 2008.

Today, SCA lawsuits filed by these firms make up a sizeable portion of the total SCAs filed. These firms also often pursue a strategy of filing lawsuits in the wake of bad news about a company or a decline in the company's stock price. Second- and third-tier plaintiffs' firms are increasingly bringing SCAs on behalf of retail investors, while the first-tier firms appear to be focusing on bringing larger cases on behalf of institutional clients.

How SCA lawsuits are resolved

Of the 226 SCA lawsuits brought in the first half of 2017, 95 were merger objection lawsuits which represents more than one-third of the total number of cases. Moreover, there are an increasing number of SCA lawsuits arising out of regulatory violations (although this number fell slightly in 2015 and 2016 according to NERA Economic Consulting), with fewer suits alleging that a company issued misleading earnings figures or insider trading violations.

The outcomes of SCAs are of no small importance to D&O insurers, who may fund defense costs above the retention, as well as any covered settlement or judgment. According to NERA, motions to dismiss were filed in an overwhelming majority (94%) of SCAs between 2000 and 2016.

The court granted the motion with or without prejudice 44% of the time, granted in part and denied in part 30% of the time, and denied the motion 25% of the time. In addition, a substantial number of SCAs are settled. In 2016, approximately 113 SCAs were settled, which represents approximately 43% of all filings from that year.

What does this mean for D&O insurers?

The impact of the rise in SCAs on D&O Insurers is difficult to predict, but certain actions are worth taking given these trends.

1. Given the significant costs to defend SCAs, D&O underwriters should **evaluate pricing levels and ensure their policies contain sufficient self-insured retentions**. SCAs have become increasingly costly to defend, and these costs quickly erode retention levels, even through the motion-to-dismiss phase.

2. Insurance claim departments must **be pro-active in handling SCA claims** tendered under their policies, and ensure that they have sufficient resources to effectively monitor these actions.

3. It might be necessary for D&O Insurers to **re-evaluate claim strategies**, including closer coordination with defense counsel and pursuit of early resolution strategies to avoid unnecessary defense costs which can erode a significant portion of the retention and/or policy limits.

As SCA lawsuits continue at a record pace, companies that are the targets of these lawsuits will likely seek coverage under their D&O policies, making it important for insurers to be aware of these ongoing trends, carefully review their policies, and consult with counsel.

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