White and Williams LLP

Securities Class Action Filings Continue at Record Levels: How Should D&O Insurers Respond?

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On January 29, 2020, Cornerstone Research released its annual report on securities class action filings. As expected, the report demonstrates that securities class actions in both federal and state courts continue to be filed in record numbers. Among other things, here are some of the highlights of the report:

- There were 428 new securities class actions filed in 2019 — nearly double the annual average of filings between 1997 and 2018.
- Combined core federal filings in the Technology and Communication sectors grew by almost a third from 2018 and have more than doubled since 2017.
- Second Circuit core federal filings increased to 103, the highest number on record. The Ninth Circuit's core federal filings decreased by 25% to 52 filings.
- Core federal filings against companies headquartered outside the United States increased to 57, the highest total on record. The likelihood of a core federal filing against a non-U.S. company increased from 4.8% to 5.6% from 2018 to 2019.

Here are some takeaways from the Cornerstone report for D&O underwriters:

- One of the most concerning data points underlying the Cornerstone report is that the all-time high number of securities lawsuit filings in 2019 is tied to a public company marketplace that is about half the size it was back in 1997. In a shrinking marketplace, even a flat number of filings year-to-year results in a higher frequency rate. Rising frequency risk means that risk selection becomes more challenging, and portfolio management through retention amounts, limits management and minimum excess attachment levels takes on more importance.
- Our Group's experience is that the Cornerstone and NERA settlement predictors are more accurate for settlements over $100 million, and less accurate below that number. Although there's no available empirical data on this point, we believe that a stronger predictor of sub-$100 million SCA settlements is the size of the D&O insurance tower. Available D&O insurance tower information is obtained by the plaintiffs' counsel through the normal discovery process and takes on greater significance in mediations where the plaintiffs' lawyers and the company counsel are often aligned in maximizing use of available D&O insurance limits to affect a settlement. So, sitting excess of $20 million, $30 million or $40 million is often only helpful if there is not significant ABC insurance sitting above your layer. For underwriting purposes then, we believe that the most secure position on a sub-$100 million tower is the top excess ABC layer, which the plaintiffs' counsel and the company counsel appear reluctant to exhaust.
- A wild card not captured in the Cornerstone data is the D&O insurance implication of an U.S. Securities and Exchange Commission (SEC) investigation parallel to a securities class action. While the defense and strategic arrangements

(and their expected costs) for the early stages of a securities class action are relatively predictable, the legal expenses of a companion SEC investigation are not. We are increasingly seeing each of the numerous individuals subpoenaed in connection with a SEC investigation demand their own defense counsel who, in turn, insist that they need to review each and every document turned over to the SEC by the company in order to prepare their witness for a SEC interview. Such a process can accelerate the defense cost burn rate materially, even while the securities class action is relatively dormant awaiting decisions on initial motions to dismiss or for class certification.

- Shareholder derivative cases are not just a headache for Side A insurers; the indemnifiability of defense costs brings derivative cases within the scope of ABC coverage, at least for defense purposes, and because some states permit indemnification of derivative settlements too, a derivative case brought in such a state could bring the entire loss within an ABC insurance tower. Finally, soft market add-ons, such as coverage for special litigation committee legal fees and costs, can drive up overall derivative loss results significantly too.

On the claims side of the house, D&O insurers can take a closer look at ways to reduce exposure by securities class actions. Securities class actions frequently settle at mediation in or around the motion to dismiss stage. So what are some things that D&O claims professionals can do to attempt to mitigate the potential impact of settlements? Here are some suggestions:

- ***When assessing the defense counsel, inquire about flat fee arrangements*** for motions to dismiss. The securities class action defense bar is competitive, and many firms will offer flat fees (anywhere from $250,000–$400,000) to defend the case through one or potentially multiple rounds of motions to dismiss. These arrangements in many cases leave the tower with its full limits come mediation time to effectively deal with any settlement.
- ***Dive deep into plaintiff-style damages and loss causation***. In securities class actions, the plaintiffs will allege large market cap losses incurred by the company in connection with a stock drop, which in many cases can be in the hundreds of millions of dollars. Settlements of these cases tend to fall within 10%–12% of the market cap loss. Therefore the only way to bring those numbers down (and potentially avoid exposure to certain layers of any D&O tower) is to give serious thought to damages and loss causation. Does the market cap loss contemplate additional stock drops during the Class Period that may not have “revealed” anything new to the market after an initial corrective disclosure? Did something else significant happen in the market on the day of the corrective disclosure that could have contributed to the stock drop? Are there portions of the corrective disclosure that contributed to bringing the company’s stock price down that have nothing to do with the case? Each of these questions can elicit answers that are crucial leverage points, which can be used to push the settlement value of the case down.
  - As a corollary, it is important to engage the defense counsel on these questions early, especially if D&O insurers perceive unique arguments to be available with respect to damages. At the early stage, the defense counsel tend to focus (as they should) on the facts of the case and whether the plaintiff’s case can proceed based on their theory of liability. However, engaging the defense counsel on damages issues can produce better results for D&O insurers, especially come mediation time, because at that point D&O insurers can point to early damages analysis to argue, for example, that while plaintiffs may have a strong case on liability, the damages simply aren’t as large as the plaintiffs allege.
- ***When selecting a mediator, consider candidates who understand and respect D&O insurers’ perspective, but who can also “speak plaintiff” too.*** The plaintiff’s counsel in the securities class action field are often very

sophisticated and understand the nuances of getting these cases positioned to settle. At any given time, the plaintiff's counsel will have a portfolio of securities class actions at different stages of their respective life cycles, and they tend to place these claims on a certain value scale based on what they perceive to be the ultimate settlement value relative to the time, energy, and money invested in the case from their end. On the defense and D&O insurer side, having a mediator who can engage plaintiffs along these lines can be crucial. If a mediator is able to effectively convey to the sophisticated plaintiff's counsel that "this case simply isn't one in your book that should be valued where you value it," that is a much more effective and persuasive conversation than "the D&O insurers don't like your settlement demands." This type of constructive conversation in a mediation can produce favorable results, and get the case settled for a value that is more consistent with the facts and risks presented.

The 2019 Cornerstone report on securities class action filings presents many challenges, but also opportunities. What are some creative ways on the underwriting and claims side to tackle these challenges? We'd be interested to hear your views too.

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