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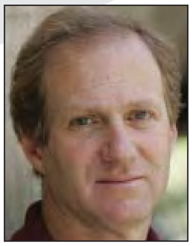

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How Protective Is D&O Insurance in Securities Class Actions? An Update

by Michael Klausner, Jason Hegland and Matthew Goforth

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How much protection does D&O insurance provide in securities class actions? When a securities class action settles, how much of the settlement is typically paid by the insurer, how much by the company, and how much out-of-pocket by officers and directors? What factors influence relative contributions? Is there any correspondence between sanctions imposed on officers and directors in SEC actions and out-of-pocket officer and director payments in settlements of parallel class actions?

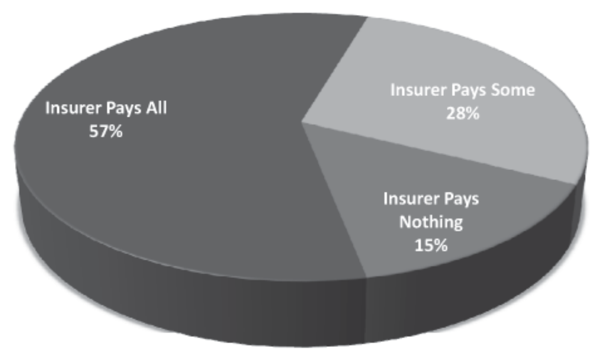
Two years ago, we published an article in the PLUS *Journal* that provided answers to these questions based on a dataset that we had begun collecting and which now covers the past 12 years of securities class actions and SEC enforcement actions. This article updates our earlier report. We find that on the whole, D&O insurance pays substantial portions of settlements in a large majority of cases, and that both corporate and individual defendants are highly protected.

The data presented here are taken from securities class actions filed between 2006 and 2010 and settled between 2006 and 2012. Additional data is taken from SEC enforcement actions that ran parallel to some of those class actions. In total, there were 652 non-merger cases filed during this period, 253 of which settled, 256 of which were dismissed with prejudice or voluntarily dropped by the plaintiffs, and 119 of which are still pending.[1] Twenty-four cases were dismissed without prejudice, providing plaintiffs with an opportunity to address deficiencies in their pleadings and file an amended complaint. We selected cases filed between 2006 and 2010 for this article so that a large majority of cases in our cohort would have been resolved.

What Proportion of Settlements Do Insurers Pay and What Factors Influence the Insurer's Contribution?

When a securities class action settles, how much of the settlement does the D&O insurer pay? Chart 1 provides some basic answers to that question. In 58% of cases, the insurer paid the full settlement, in 28% the insurer paid some of the settlement, and in 15% of cases the insurer paid nothing. Where the insurer paid nothing, the insured

Chart 1: Insurer Payments ***(as a percentage of all cases settled)***

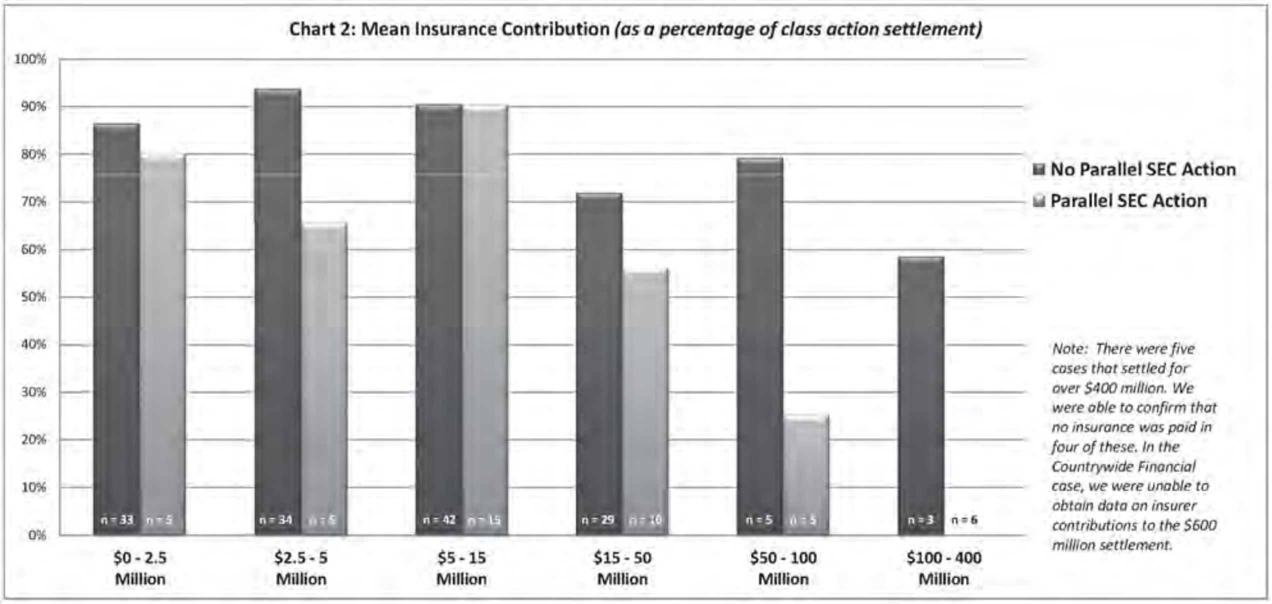


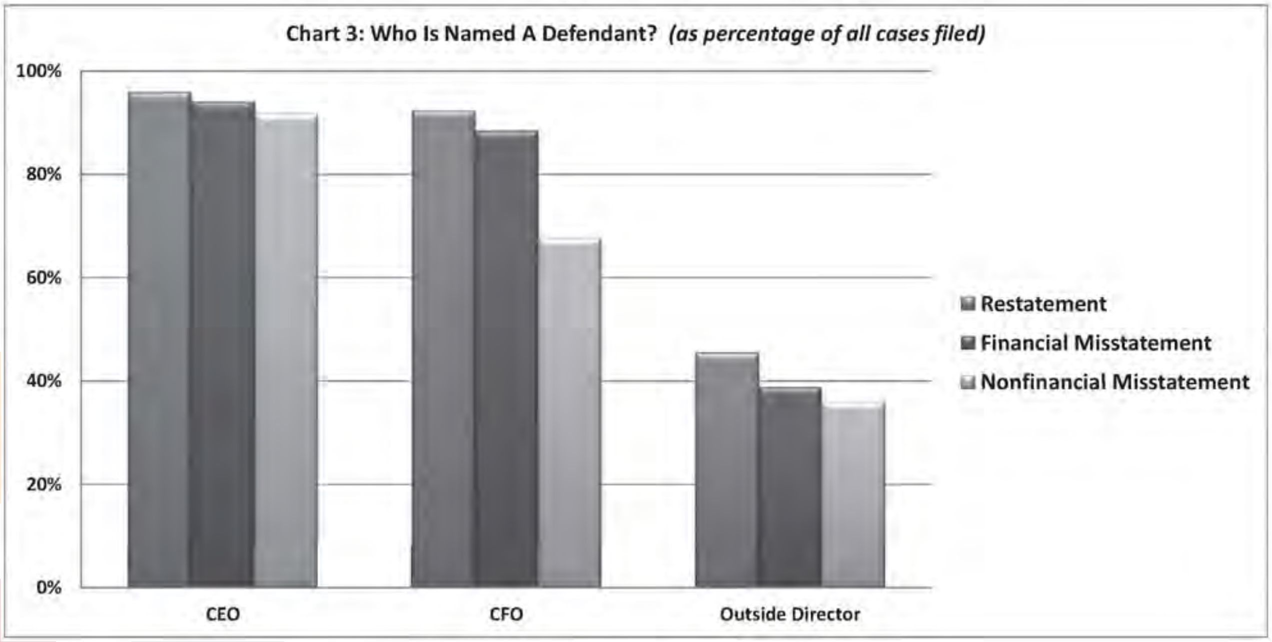
may have been uninsured, the case may have been excluded from coverage under the terms of the policy, or the policy limits may have been exhausted in defense costs or in other litigation.[2]

The size of the settlement is the primary factor influencing the portion of the settlement paid by insurance. Another factor appears to be the severity of the alleged misconduct.

Chart 2 shows mean insurer contributions, separating settlements into several ranges of size. For each range of settlement size, Chart 2 shows the mean insurer contribution, in terms of a percentage of the settlement paid, for two sets of cases: those with parallel SEC actions and those without parallel SEC actions.[3]

Mean insurer contributions, in percentage terms, are relatively low for the smallest settlements, then rise for middle-range settlements, and then decline as settlement size rises. In addition, insurance pays relatively less in cases with parallel SEC enforcement actions. The somewhat lower percentage paid by insurers in the lowest bracket of settlements probably reflects the impact of retentions. For settlements in higher ranges, there are surely particularized facts underlying these averages, but the pattern here suggests some general explanations. First, the lower percentage paid by insurers in the largest settlements may reflect settlements that exceed policy limits. Second, the insurers' lower percentage contribution in larger settlements may also reflect insurers' assertion of defenses to coverage where deliberate misconduct may have been involved. This assumes, all other factors equal, that settlements are larger when evidence of deliberate misconduct





is strong. Third, to the extent that larger settlements are associated with the presence of parallel SEC cases, lower insurance contributions may reflect a dissipation of policy limits defending those cases.

These data thus show that D&O insurance provides substantial protection to corporate insureds. Corporations' payments into settlements, on average, constitute relatively small portions of total settlements, and to a large extent appear to be explained by retentions, policy limits, and insurers' conduct-related defenses.

Protection of Officers and Directors

Chart 3 shows the frequency with which CEOs, CFOs, and outside directors are named in class actions. CEOs are named in 93% of all cases, CFOs are named in over 80% of cases, and outside directors are named in just under 39% of cases. For CEOs, the frequency of being named is not very different across our three categories of cases—those involving a restatement, an alleged financial misstatement without a restatement and a nonfinancial misstatement. For CFOs, not surprisingly, the frequency of being named is lower in cases alleging nonfinancial misstatements. For outside directors, the frequency of being named is significantly higher in cases involving a restatement than in other cases, but in those cases it is frequently the audit committee members being named. In other cases with an outside director named, it is often the chairman alone who is named.

Once named, how often do officers or directors make out-of-pocket contributions to a settlement? Infrequently, as shown in Chart 4. Among cases filed during the 2006 to 2010 period, no case has resulted in an out-of-pocket payment by an outside director (though 18% of these cases are ongoing, so a director may yet pay). Among cases filed from 2000 through 2005, outside directors paid into 13 out of 660 settlements (2%).

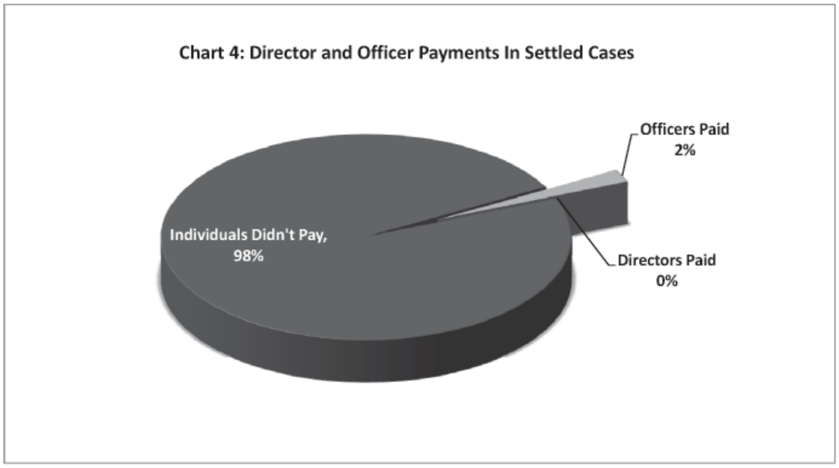


Chart 5: SEC Penalties for Officers and Officer Payments in Parallel Class Actions

	SEC Imposed Penalty	SEC Did Not Impose Penalty	SEC Actions Concluded
Officer Payment in Class Action	5 (100%)	0 (0%)	5
No Officer Payment in Class Action	55 (92%)	5 (8%)	60

Officers contributed to 2% of settlements (0.77% of cases filed). Most of these cases involved financial misstatements and had parallel SEC actions. The amounts paid ranged from $25,000 to $30 million, with the mean and median payments being $11.7 million and $600,000, respectively. From 2000 through 2005, officers made out-of-pocket payments in 5.45% of settlements (3.48% of cases filed). Ongoing cases in our sample period may result in additional payments by officers, but it is unlikely that the frequency of payments by officers will reach the level of this earlier period.

In sum, the combination of D&O insurance, indemnification, and the ability of the corporation to pay whatever portion of the settlement the insurer does not pay, provides substantial protection for officers and directors.

Officer Payments in Class Actions Compared to SEC Enforcement Actions

The dynamics of settlement negotiations clearly work in favor of officers and directors with respect to out-of-pocket payments. This is evident when we compare out-of-pocket payments by officers in class actions with penalties that the SEC imposes on the same individuals in parallel cases. Chart 5 contains outcomes of 65 pairs of parallel class actions and SEC enforcement actions. Each pair of cases involved the same conduct by the same defendants. In 60 of the 65 cases, the SEC imposed serious penalties—either monetary penalties or bars from serving as an officer or director of a public company. Among those 60 cases, there were only five that resulted in an officer making an out-of-pocket payment in the parallel class action.

Conclusion

The data analyzed here show that D&O insurance effectively transfers liability risk from officers, directors and companies to the insurer. Except in the very largest cases, D&O insurance provides substantial protection to both corporate and individual insureds. Insurers on average pay a smaller percentage of settlements in cases where there is a parallel SEC action. This may reflect insurers' assertion of misconduct-related defenses to coverage, or it may reflect the dissipation of limits in defending the SEC action.

Out-of-pocket payments by officers or directors are rare. Among cases filed from 2006 through 2010, 2% of settlements have included an out-of-pocket payment by an officer and none has involved a payment by an outside director. From 2000 through 2005, 5.45% of settlements included payments by officers and 2% included payments by outside directors. Until the remaining 18% of cases filed between 2006 and 2010 are resolved, we cannot be certain, but there appears to have been a decline in out-of-pocket payments by officers and directors over the past decade. The fact that individual defendants rarely bear personal liability in securities class actions is inherent in the nature of these cases. This is confirmed by comparing parallel pairs of cases involving SEC actions and class actions for the same misconduct—cases where there is reason to believe that the evidence of individual misconduct is relatively strong. In the vast majority of cases, individual defendants are penalized severely in the SEC action but bear no liability in the class action.

For more information regarding the Stanford Securities Litigation Analytics project, and to support the SLA's effort of building an interactive analytic tool for practitioners, please visit SecuritiesAnalytics.stanford.edu.

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Endnotes

1 We omit cases from the recent surge of merger litigation that solely challenge mergers.

2 We were able to obtain data on insurer payments in 81% of the settlements covered in this study. There is often a lag following a settlement in the availability of data on insurance contributions. Consequently, this number in part reflects the absence of data for recent settlements.

3 Mean insurer contributions are calculated as the fraction the insurer pays in each settlement and taking the mean of those fractions. Contributions to settlements by third party defendants such as underwriters and accounting firms are excluded.

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