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Setting New Expectations

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Top Ten D&O Stories of 2012

The past year included dramatic and important developments involving elections, the fiscal cliff and natural disasters. While there was nothing in the world of Directors and Officers Liability to match this drama, it was nevertheless an eventful year, with many significant developments. These are the Top Ten D&O stories of 2012.

1. Barclays and UBS Enter into Massive Libor Scandal-Related Regulatory Settlements: The Libor scandal first began to unfold more than four years ago, but with the dramatic announcements in late June 2012 of the imposition of fines and penalties of over $450 million against Barclays PLC, the scandal shifted into a higher gear. But as significant as the Barclays settlements were, the ensuing UBS regulatory settlements totaled over $1.5 billion.

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In both sets of settlements, the banks admitted that their representatives had attempted to manipulate the Libor benchmark interest rates. UBS also admitted that its representatives had attempted to collude with third parties – including both interbank dealers and other Libor panel banks – to try to affect the benchmarks, at first to try to extract profits from its derivatives trading activities and later to try to iinfluence public perception of the bank's financial health during the peak of the credit crisis.

Among the many implications of these developments is their possible impact on existing and future Libor scandal-related litigation. The revelations in the UBS regulatory settlements of collusive activity obviously will bolster the existing antitrust litigation that has been consolidated in Manhattan federal court. The sensational aspect of many of the factual revelations in connection with the UBS settlement may encourage other litigants to pursue claims, just as the revelations in the Barclays settlement encouraged other claimants to file suit, including a securities class action lawsuit.

Another consideration stemming from the above is the possibility of claims against the interbank dealers that allegedly participated in the Libor benchmark rate manipulation efforts.

It seems likely that there will be further regulatory settlements involving the panel banks in the months ahead. Among other features of the Barclays and UBS regulatory settlements that undoubtedly will capture the attention of the other banks is that both UBS and Barclays were the beneficiaries of credit for their cooperation with regulators. The unmistakable suggestion for the other banks is that they should step up their cooperative efforts with

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Contact:

Sigrid M. Hughes
Phone: 860-906-0107
Sigrid.Hughes@rtspecialty.com
www.rtspecialty.com

regulators as soon as possible or face the possibility of even more severe consequences. It does seem probable that by the time this scandal plays itself out, there will be many more regulatory settlements, some of which might make the Barclays and UBS settlements look modest.

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2. As Bank Failures Wane, the FDIC Ramps Up Failed Bank Litigation: The number of bank failures dropped significantly in 2012 compared with prior years. Only 51 financial institutions failed during 2012, the lowest annual number of bank closures since 2008, when there were 25 bank failures. By way of comparison, there were 92 bank failures in 2011 and 157 in 2010. Overall, there have been 468 bank failures since January 1, 2007.

Though the bank failure pace clearly is declining, the pace of the FDIC's filing of failed bank litigation is ramping up. The FDIC filed 25 failed bank D&O lawsuits during 2012 and a total of 43 altogether during the current wave of bank failures.

The signs are that the FDIC's active pace of litigation filing activity will continue as we head into 2013. A Cornerstone Research report noted that the FDIC tends to file its failed bank lawsuits as the third year anniversary of the bank closure approaches, owing to the applicable three-year statute of limitations. The peak period of bank closures came in early 2010, suggesting that we will continue to see further failed bank litigation in 2013.

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The Cornerstone Research report's analysis shows that the FDIC has initiated D&O lawsuits in connection with nine percent of the banks that have failed since 2007. During the S&L crisis, the FDIC (and other federal banking regulators) filed D&O lawsuits in connection with 24% of all failed institutions. The final number of FDIC lawsuits might well get into that range, as the FDIC's most recent update on the number of authorized lawsuits indicates that the agency has authorized suits in connection with 89 institutions (or about 19% of the banks that have failed so far).

The Jobs Act also introduces changes that could impact the potential liability exposures of directors and officers of both public and private companies. These changes could have important D&O insurance implications.

3. FDIC Wins $168.8 Million Jury Verdict Against Former IndyMac Officers: Even as the FDIC has continued to ramp up the number of lawsuits against former directors and officers of failed banks, the earliest suits the agency filed have been moving toward resolution. On December 7, 2012, in connection with the first D&O suit the agency filed as part of the current bank failure wave (and in what may prove to be one of the most dramatic resolutions of any failed bank suit), a jury in the Central District of California entered a $168.8 million verdict in the FDIC's lawsuit against three former officers of the failed IndyMac bank.

The jury found that the defendants had been negligent and had breached their fiduciary duties with respect to each of the 23 loans at issue in this phase of the FDIC's case. The just completed trial apparently represents only the first trial phase of this matter. There apparently will be a separate trial phase that will address the FDIC's allegations as to scores of other loans as well as allegations with respect to the bank's loan portfolio as a whole. The FDIC appears to be seeking total damages of more than $350 million.

In a related development a week after the jury entered the massive verdict against the three former IndyMac officers, Michael Perry, IndyMac's former CEO, reached an agreement to settle the separate lawsuit that the FDIC had brought against him. In his settlement, Perry agreed to pay $1 million, plus an additional $11 million to be funded entirely by insurance. The settlement agreement provides that Perry has no liability for the insurance portion of the settlement and also provides for an assignment to the FDIC of all his rights against IndyMac's D&O insurers.

4. Congress Enacts the Jumpstart Our Business Startups (JOBS) Act: On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (commonly referred to as the JOBS Act). This legislation is intended to ease the IPO process for Emerging Growth Companies (EGCs) and facilitate capital-raising by reducing regulatory burdens and disclosure obligations. The Act also introduces changes that could impact the potential liability exposures of directors and officers of both public and private companies. These changes could have important D&O insurance implications. For example, Section 302(c) of the Act expressly imposes liability on issuers and their directors and officers for material misrepresentations and omissions made to investors in connection with a crowdfunding offering. The crowdfunding provisions may blur the clarity between private and public companies.

The JOBS Act contains a number of IPO "on ramp" procedures designed to ease the process and burdens of the "going public" process for EGCs. For example, EGCs can elect to submit their IPO registration statement for SEC review on a confidential, non-public basis, although the registration statement must be publicly filed at least 21 days before the IPO roadshow.

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Among the other features of the JOBS Act that have attracted the most attention are its provisions allowing "crowdfunding." Under these provisions, a company is permitted to raise up to $1 million during any 12-month period through an SEC-registered crowdfunding portal. The crowdfunding provisions have yet to go into effect and the SEC's implementing regulations are due to be released in early 2013.

It remains to be seen how the JOBS Act's changes will ultimately play out. Many of the Act's provisions (such as, for example, the crowdfunding provisions) are subject to significant additional rulemaking. Even before the JOBS Act was enacted, the SEC was already straining under rulemaking obligations imposed by the Dodd-Frank Act.

As was the case with the Sarbanes-Oxley Act and the Dodd-Frank Act, the D&O insurance industry may face a long period where it must assess the impact of changes introduced by this broad, new legislation. It may be some time before all of the Act's implications and ramifications can be identified and understood.

5. Credit Crisis Suits Continue to Produce Massive Settlements: The subprime and credit crisis related litigation wave that began in 2007 continues to grind through the court system, and, during 2012, several of the remaining cases resulted in massive securities class action lawsuit settlements. The first was the $275 million Bear Stearns settlement in June 2012. That was followed within a few weeks by the $590 million Citigroup settlement in August 2012. Then in September 2012, the parties to the pending BofA/Merrill Lynch settlement announced a $2.43 billion settlement, the largest settlement so far of any of the subprime and credit crisis related lawsuits (which also represents the eighth largest securities class action lawsuit settlement).

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With the entry of these large settlements and several additional smaller settlements during the year, the subprime and credit crisis related litigation wave total has climbed to $8.092 billion. The average credit crisis securities suit settlement is

$139.5 million; however, if the three largest settlements are removed from the equation, the average drops to $80.87 million. Moreover, many of the subprime and credit crisis securities class action lawsuits continue to grind through the system, and defense costs continue to accumulate and the prospects for even further settlement costs loom.

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6. Securities Class Action Opt-Outs Return with a Vengeance: One of the more interesting story lines in the securities class action litigation arena in recent years has been the emergence of class action opt-out litigation, whereby various claimants representing significant shareholder ownership interests select out of the class suit and separately pursue their own claims and settlements. The class action opt-out litigation emerged as a significant phenomenon in the litigation arising out of the era of corporate scandals a decade ago. After attracting a great deal of attention and concern at the time, the phenomenon seemingly faded into the background - that is, until several large public pension funds and mutual fund families opted out of the $624 million Countrywide subprime-related securities lawsuit settlement.

Now, more than a year after the high-profile Countrywide opt-out suits, significant class action opt-outs appear to be becoming a regular part of the larger securities class action litigation. Even the $590 million settlement in the Citigroup subprime-related securities class action lawsuit, as massive as it is, has been accompanied by a significant number of class action opt-outs. Similarly, a significant number of institutional investors opted out of the Pfizer securities class action litigation pertaining to the company's disclosures about the safety of its Celebrex and Bextra pain medication. In their November 15, 2012 complaint, seven public pension funds (including CalPERS and CalSTRS) and dozens of mutual funds from four separate mutual fund families filed a separate lawsuit against the company and five of its individual directors and officers.

The comments in the *Am Law Litigation Daily* article suggest that institutional investors' interest in opt-out litigation is growing, largely due to the growing perception that their recoveries will be increased by proceeding outside of the class. The opt-out claimants also avoid the cumbersome process and delays involved in the class settlement process. Mutual funds, which traditionally have not been involved in opt-out litigation, have become more interested and involved in opting out. The article quotes Columbia Law Professor John Coffee as saying that "the trend is toward opting out."

Given the apparently increasing institutional investor interest in pursuing claims separate from the larger investor class, we could very quickly be getting to the point where resolution of class litigation is only one part of a multistep process.

7. Securities Suit Filings, Settlements and Dismissals Decline During 2012: Largely as a result of a slowdown in new filings during the fourth quarter, 2012 securities class action lawsuit filings were below the levels of recent years and well below historical averages. There were 156 new securities class action lawsuit filings during 2012, down from 188 in 2011 and well below the 1996-2011 annual average of 193.

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According to the NERA study, the 92 settlements projected to be approved in 2012 is the lowest number of annual approved settlements since 1996 and 25% lower than 2011. The 60 dismissals NERA projected for 2012 represent the lowest dismissal level since 1998. The 2012 dismissal total is 50% lower than 2011. The NERA report notes that part of the reason for the decline in case resolutions may simply be that there were fewer cases pending and therefore available to be resolved as 2012 began, when there were the lowest level of pending securities cases since 2000. The report also speculates that the slowdown in the number of settlements and dismissals may also be due to "other changes in the legal environment."

While the number of settlements may have declined, adjusted average and median settlements are up. The average securities class action settlement in 2012 was $36 million, compared to a 2005-2011 average of $42.1 million. But if the calculation excludes settlements over $1 billion, the IPO laddering cases and the merger objection cases, the 2012 average of $36 million compares to an adjusted average for the 2005-2011 period of $32 million. The median settlement in 2012 was $11.1 million, which is the largest ever annual median since 1996, making 2012 only the second year since 1996 that the median has exceeded $10 million.

8. The Mix of Corporate and Securities Litigation Continues to Change: For many years, the default topic when the question of corporate and securities litigation came up was securities class action litigation. However, in more recent years, a broader range of lawsuits have become relevant. This diversification phenomenon started in the middle part of the last decade with the wave of options backdating lawsuits, many of which were filed as shareholders' derivative suits rather than as securities class action lawsuits. Another more recent manifestation of this development has been the onslaught of merger objection litigation, as a result of which nearly every merger transaction these days now involves litigation.

It seems clear that as the opportunities for plaintiffs' attorneys to participate in traditional securities class action litigation have diminished, the plaintiffs' attorneys are casting about, seeking ways to diversify their product line. The opt-out litigation noted above seems to be one manifestation of this effort, along with the merger objection litigation.

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During the past year, yet another result of the plaintiffs' lawyers' efforts to diversity was the result of a new form of litigation involving executive compensation. This new wave of executive comp suits, in which the plaintiff's seek to enjoin upcoming shareholder votes on compensation or employee share plans on the grounds of inadequate or insufficient disclosure, have resulted in some success – at least for the plaintiffs' lawyers involved. According to a recent law firm study, these new kinds of executive compensation–related lawsuits may be "gaining steam".

These new suits share certain characteristics with the M&A-related lawsuits. That is, they are filed at a time when the defendant company is under time pressure that motivates the company to settle quickly rather than deal with the lawsuit. Just as in the merger context, where the company wants to move the transaction forward, they are pressured to reach a quick settlement rather than risking a delay in the shareholder vote.

9. Whistleblower Reports Surge, Threatening Further Enforcement Action and Bounty Payments Ahead: When the whistleblower bounty provisions in the Dodd-Frank Act were enacted, there were concerns that the provisions – allowing whistleblowers an award between 10% and 30% of the money collected when the information provided by the whistleblower leads to an SEC enforcement action in which more than $1 million in sanctions is ordered – would encourage a flood of reports from would-be whistleblowers who hoped to cash in on the potentially rich rewards.

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As it has turned out, the whistleblower bounty program has been slow to get started. The SEC finally awarded its first whistleblower bounty in 2012. As reflected in the SEC's August 21, 2012 press release, the agency's first whistleblower award for the relatively modest amount of $50,000. However, the small amount of this award should not be interpreted to suggest that the whistleblower program will not amount to much. To the contrary, the signs are that the whistleblower program seems likely to turn out to be very significant.

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The report notes that during the past year there were 143 enforcement actions resulting in the imposition of sanctions in excess of the $1 million threshold, and that the Office of Whistleblower is continuing to review the award applications the Office received during the 2012 fiscal year. In other words, the likelihood is that there will be further awards in the year ahead – and the report notes that the value of the fund out of which any future awards are to be made now exceeds $453 million.

It seems probable that as more awards are announced, interest in the whistleblower program will increase as well. Opportunistic plaintiffs' lawyers casting about for alternatives to traditional securities litigation are already attempting to position themselves to take advantage of these anticipated developments. Many plaintiffs' firms are advertising on the Internet and elsewhere seeking to assist whistleblowers to submit their tips to the agency and also to try to get the inside track on any civil litigation opportunities that might follow in the event that the SEC were to pursue an enforcement action based on the whistleblower's tip. Further, expect the possibility of increased private civil litigation following in the wake of the enforcement actions.

10. Rule 10b5-1 Trading Plans Under Scrutiny Once Again: When the SEC brought civil enforcement charges against former Countrywide Financial CEO Angelo Mozilo in June 2009, a critical part of the agency's allegations was that Mozilo had manipulated his Rule 10b5-1 trading plans to permit him to reap vast profits in trading his shares in company stock while he was aware of increasingly serious problems in the company's mortgage portfolio.

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Among other things, the SEC alleged that pursuant to these plans and during the period November 2006 through August 2007, and shortly after he had circulated internal emails sharply critical of the company's mortgage loan underwriting and the "toxic" mortgages in the company's portfolio, Mozilo exercised over 51 million stock options and sold the underlying shares for total proceeds of over $139 million.

In October 2010, Mozilo agreed to settle the SEC's enforcement action for a payment of $67.5 million dollars, including a $22.5 million penalty and a disgorgement of $45 million. The financial penalty was the largest ever paid by a public company's senior executive in an SEC settlement.

There is no doubt that these various allegations involving insider trading plans have put the plans in a negative light. However, a well-designed and well-executed plan can still provide substantial liability protection by allowing insiders to trade in their holdings of company stock without incurring securities liability exposure.

As if all of this were not enough to cast a cloud over Rule 10b5-1 trading plans, the trading plans are once again back in the news, and once again the news about the plans is negative. A front page November 28, 2012 *Wall Street Journal* article entitled "Executives' Good Luck in Trading Own Stock", reports on the newspaper's analysis of thousands of trades by corporate executives in their company's stock. Among other things, the newspaper reports on numerous instances where executives, trading in company shares pursuant to Rule 10b5-1 plans, managed to extract trading profits just before bad news sent share prices down or to capture gains with purchases executed just before unexpected good news.

The SEC has launched investigations in connection with trading activities at several of the companies mentioned in the *Journal* article. While not all of the trades under scrutiny involved Rule 10b5-1 trading plans, possible plan misuse seems to be at least one aspect of the investigation. The allegations and ensuing investigations seem likely to produce significant enforcement activity in the months ahead, as well as possible follow on private civil litigation.

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About the Author

This article was prepared by Kevin M. LaCroix, Esq. of RT ProExec. Kevin has been advising clients concerning directors' and officers' liability issues for nearly 30 years. Prior to joining RT ProExec, Kevin was President of Genesis Professional Liability Managers, a D&O liability insurance underwriter. Kevin previously was a partner in the Washington, D.C. law firm of Ross Dixon & Bell.

Kevin is based in RT ProExec's Beachwood, Ohio office. Kevin's direct dial phone number is (216) 378-7817, and his email address is kevin.lacroix@rtspecialty.com.

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