RT ProExec INSIGHTS

VOL. VOLUME X ISSUE 3 FALL 2015

WHAT TO WATCH NOW IN THE WORLD OF D&O

Every year, we step back and survey the most important current trends and developments in the world of Directors' and Officers' liability and D&O insurance. Once again, there are a host of things worth watching in the world of D&O.

Recent Developments in Delaware

Because many U.S. corporations are organized under Delaware law, a number of important recent developments in Delaware could affect many companies, at least to the extent they are involved in corporate and securities litigation.

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 by-laws and confirms that Delaware corporations may adopt by-laws designating Delaware courts as the exclusive forum for shareholder litigation. Delaware's Governor signed the bill into law on June 24, 2015 and the bill's provisions became effective on August 1, 2015.

Though the legislation has been enacted, a number of questions remain. Among other things, the statute does not address other types of litigation reform by-laws, including, for example, by-laws requiring arbitration of shareholder suits and minimum stake to sue by-laws. In addition, the statute only relates to Delaware corporations. Other states may choose to take a different approach. For instance, the Oklahoma legislature has adopted a provision mandating the shifting of legal fees in derivative suits.

There have also been a number of significant recent developments in Delaware concerning M&A-related litigation. One of the hot button issues in the world of corporate and securities litigation has been the rise of merger objection lawsuits. All too often, these cases are resolved on the defendants' agreement to modify their disclosures about the transaction and payment of the plaintiffs' attorneys' fees. These kinds of settlements are often criticized as benefiting no one except the plaintiffs' lawyers.

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It appears that the members of the Delaware judiciary may have concerns about these kinds settlements as well. Two recent decisions (Acevedo v. Aeroflex Holding Corp. and in the merger objection litigation arising from Roche's $8.3 billion acquisition of InterMune) may suggest that Delaware courts, at least, are no longer willing to simply accept the standard "disclosure only" settlements that typically resolve these kinds of cases. Some commentators have said that these developments suggest that the kinds of settlements that were routinely approved in the past may now face greater scrutiny. If merger objection suits become harder to settle, they may become less attractive to the plaintiffs' lawyers, and fewer of them may be filed.

In another important decision, Vice Chancellor Sam Glasscock III's September 17, 2015 opinion in the Riverbed Technology merger objection lawsuit clearly suggested that approvals for disclosure-only settlements in which plaintiffs' counsel gets their fees paid and the defendants get an "intergalactic" claim release may be over. Although a settlement was approved, moving forward, expect three things from the Chancery Court judges: the value of the additional disclosures will be very closely examined; the amount of plaintiffs' attorneys' fees will be questioned; and the breadth of the releases will be actively scrutinized.

By the same token, the Chancellors' concerns about the release of unknown claims pose a significant problem for defense counsel. Settled practices and engrained expectations make it very difficult for defense counsel to agree to a settlement that does not include a comprehensive release including the release of unknown claims.

Another Delaware development suggests that while less meritorious cases may be more closely scrutinized, cases with greater merit could result in the award of significant damages. In an August 27, 2015 post-trial opinion, Vice Chancellor Travis Laster held that Dole's CEO David Murdock and its general counsel Michael Carter breached their fiduciary duties in connection with the November 2013 transaction in which an entity Murdock controlled acquired the 60% of Dole's shares that Murdock did not already own. Laster found that Murdock and Carter engaged in "fraud" that prevented Dole's shareholder from receiving a fair price in the transaction. Laster held Murdock and Carter jointly and severally liable for damages of $148.1 million, plus pre- and post-judgment interest.

There are those who contend that Delaware's courts are too hospitable to claimants. An August 3, 2015 Wall Street Journal carried a front-page article entitled "Firms Sour on Delaware as Corporate Haven", highlighting that some corporate officials and representatives are questioning Delaware's special status because, the naysayers assert, the state is not doing enough to protect against shareholder lawsuits. In a bid to challenge the often-cited superiority of Delaware's Chancery courts, Michigan and Texas have established dedicated business courts with judges well versed in corporate law. Also, Nevada is trying to hold itself out as a preferred forum, based on claims that its courts represent a streamlined and efficient alternative to those of Delaware.

Data Breaches and D&O Lawsuits

There is speculation whether the rising wave of data breaches and cyber security attacks will result in litigation against the directors and officers of the affected companies. In 2014, there were two sets of lawsuits filed against the boards of companies that had experienced high-profile data breaches, Target Corp. and Wyndham Worldwide. The Wyndham lawsuit was dismissed in late 2014, and until recently there had been no additional significant cyber security-related D&O lawsuits filed.

However, on September 2, 2015, a plaintiff shareholder filed a redacted complaint in a lawsuit against Home Depot, as 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.”

So, while there definitely was a lag between the Target and Wyndham D&O lawsuit filings and the more recent filing of the Home Depot lawsuit, given that the data breaches themselves are almost certain to continue, it is probable that data breach-related D&O litigation will become an increasingly important part of the corporate and securities litigation landscape.

Companies Suffering Data Breaches Face Regulatory Claims

While it remains to be seen whether data breach-related shareholder lawsuits will become a substantial phenomenon, it is, as a result of a recent federal appellate court decision, now clear that companies experiencing data breaches could face a possible Federal Trade Commission (FTC) enforcement action.

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 hit with data breaches, the Third Circuit affirmed the authority of the 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, companies may also face a regulatory action from the FTC as well.

It is important to note that the question the court was asking was whether or not the FTC had the authority to proceed against Wyndham. While confirming that the FTC had that authority, the court did not rule that the FTC was entitled to prevail on its claims. The case will now go back to the district court for further proceedings on the basis of this ruling. The proceedings in the lower court will determine whether or not the agency’s claims are meritorious. We will continue to watch carefully for D&O litigation that often follows regulatory actions.

Consumer Data Breach-Related Class Action Lawsuits

One of the more distinctive features of the U.S. litigation system is the possibility of pursuing in a single lawsuit all of the similar claims of a similarly aggrieved group of persons, in the form of a class action suit. In recent months, there have been important class action litigation developments. For instance, the Seventh Circuit’s recent decision in the Neiman Marcus consumer data breach class action could provide an important boost for future consumer data breach class action litigation.

Neiman Marcus had sustained a data breach that resulted in the exposure of customer credit card information, and a consumer class action lawsuit followed, filed on behalf of the customers whose information had been exposed. The company moved to dismiss, arguing that because the plaintiffs could not allege any actual, present injuries, they lacked standing to pursue their claims under Article III of the U.S. Constitution. (In order to establish Article III standing, the party seeking to sue must personally have suffered some actual or threatened injury that can fairly be traced to the challenged action of the defendant and that is likely to be redressed by a favorable decision.) The plaintiffs in the case had alleged that they have standing based on two “imminent injuries”: an increased risk of future fraudulent charges and greater susceptibility to identity theft.

In reliance on the U.S. Supreme Court's 2013 decision in Clapper v. Amnesty International U.S.A., which held that "allegations of future injury are not sufficient" to establish Article III standing, the district court granted the company's motion to dismiss. The plaintiffs appealed the dismissal to the Seventh Circuit.

In a July 20, 2015 decision, the Seventh Circuit reinstated the Neiman Marcus consumer data breach class action lawsuit, ruling that the district court erred in concluding that the plaintiffs' fear of future harm from the breach was insufficient to establish standing to pursue their claims. The appellate court's ruling is of course only binding within the Seventh Circuit itself, but it is likely to be influential on district courts in other circuits.

Supreme Court to Rule on the Question of "No Injury" Class Actions

On April 27, 2015, in a development that could have significant implications for a wide variety of class action lawsuits, the United States Supreme Court granted the petition of for a writ of certiorari of online search firm Spokeo. The cert grant sets the stage for the Court to consider whether Congress may confer Article III standing on a plaintiff who had suffered no specific or concrete harm but who alleges a violation of a federal statute. Depending on which way the Court rules, it could have very significant impact on class action lawsuits under a wide range of consumer protection statutes.

In the Spokeo case, an individual sued the company under the Fair Credit Reporting Act, claiming that information Spokeo had gathered about him and published on its website was incorrect. Spokeo argued that the plaintiff lacked standing to assert his claim because he did not allege any concrete harm. The district court agreed and granted Spokeo's motion to dismiss, holding that the plaintiff had failed to allege an "injury-in-fact" and therefore lacked Article III standing. However, in a February 4, 2014 opinion, the Ninth Circuit reversed the district court, holding that the plaintiff's allegations that his statutory rights had been violated alone were sufficient to satisfy Article III's standing requirement.

In its cert petition, Spokeo framed the question it sought to have the Supreme Court address as follows: "Whether Congress may confer Article III standing upon a plaintiff who suffers no concrete harm, and who therefore could not otherwise invoke the jurisdiction of a federal court, by authorizing a private right of action based on a bare violation of a federal statute." The question the company has posed will affect class action lawsuits not only under the Fair Credit Reporting Act, but also the Telephone Consumer Protection Act, the Americans with Disabilities Act, the Truth-in-Lending Act and numerous other federal statutes authorizing consumers to file damages actions. In any event, this case, which will be argued and decided during the Court's term beginning in October 2015, will be one to watch.

Prevalence of Litigation Financing Affect Corporate and Securities Litigation

A recent Wall Street Journal article noted that the "next act" for a hedge fund that previously had been involved purchasing troubled mortgage securities during the financial crisis will be to deploy a new litigation finance arm that has, according to the Journal, already "raised hundreds of millions of dollars" to "lend to law firms pursuing class-action injury lawsuits."

Why would a hedge fund previously focused on financial securities get involved in litigation financing? For a very simple reason – litigation financing is profitable. How profitable? Because several litigation financing firms are publicly traded, we don't 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% to $82 million, with a 43% 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.

Litigation funding has attracted criticism and controversy. Just the same, litigation funding also continues to attract new entrants and investors and is already well-established in several other countries, such as Australia and Canada. It is important to note that there are important differences between the legal system in the U.S. and the legal systems in the other countries where litigation funding is now well-established. Canada, Australia and the U.K. all have a "loser pays" litigation model, where unsuccessful claimants must pay their adversary's legal fees. In the U.S., by contrast, we follow the so-called American Rule, under which each party bears its own cost. In addition, most states in the U.S. allow contingency fees, in contrast to many other countries where contingency fees are not permitted. Because of the loser pays model and the prohibition of contingency fees, there may be reasons why litigation funding is better established in other countries. Just the same, litigation funding recently has been quickly developing in the U.S., perhaps because there is so much litigation and because litigation in the U.S. can be so expensive – which raises the question of what the rise of litigation funding may mean for civil litigation in the U.S. There are many unanswered questions about the growing presence of litigation financing on the U.S. litigation scene. We will stay close to this issue as it evolves and try to anticipate what it means.

The Current "Short-Termism" Debate Could Lead to Corporate Reporting Changes

In recent months, commentators from across the political spectrum, largely in response to perceived excesses of activist investors, have called for changes to discourage "short-termism" – that is, the perceived excessive focus of businesses on short-term results rather long-term value creation.

During a recent campaign speech, Democratic Presidential Candidate Hillary Clinton argued that "short termism" is harming the economy and called for a variety of reforms, saying that "today's marketplace focuses too much on the short term, like second to second financial trading, and quarterly earnings reports, and too little on long-term investments." And, while he differs about the steps to be taken in response to the phenomenon, outgoing Republican SEC Commissioner Daniel M. Gallagher also noted concerns about the effects of short-term thinking. Though concerns about short-termism are bipartisan, there are still those who take a different view. In an August 9, 2015 Financial Times article, former U.S. Treasury Secretary Lawrence Summers, while calling generally for "long-termism," sounded a note of caution, observing that "skepticism about whether all horizons should be lengthened is appropriate." In the U.S., companies that are dissipating the most value, such as General Motors before its 2009 government bailout, "have often been the most enthusiastic champions of long-termism." Investors who are pouring money into Silicon Valley startups with bold plans but little revenue "may be putting too much, not too little, weight on the distant future."

In an August 19, 2015 post on the Harvard Law School Forum on Corporate Governance and Financial Regulation, prominent New York lawyer Martin Lipton of the Wachtell, Lipton, Rosen & Katz law firm recently caused something of a stir by calling for the end of quarterly reporting requirements.

Whether or not a proposal such as the suggestion to eliminate quarterly reporting present any realistic possibility of success is questionable at best. However, when a concept like "short-termism" becomes an issue in the presidential election, the possibilities for practical action take on a greater significance – particularly when the issue attracts bipartisan consensus.

The Growing Global Corruption Crackdown Continue to Drive Corporate and Securities Litigation

A significant factor driving securities litigation filings so far this year has been the rising number of U.S. securities lawsuits involving non-U.S. companies. A number of different factors are contributing to the filing of these suits, but among the factors is the increasing number of U.S.-listed non-U.S. companies that have been caught up in corruption investigations in their home countries.

The highest profile company among the firms involved in corruption probes is the Brazilian petroleum company, Petrobras, which has been the target of the growing Operação Lava Jato (Operation Car Wash) corruption investigation in Brazil. Petrobras, whose ADSs trade on the NYSE, was hit with a class action securities lawsuit in the U.S. in December 2014.

The continuing Petrobras investigation has spread to a number of other Brazilian companies, and has also led to other U.S. securities class action lawsuits against some of the companies caught up in the investigation.
The phenomenon of civil litigation following in the wake of a corruption investigation is nothing new, at least in the U.S. What is different about the lawsuit discussed above is that it involves a non-U.S. company sued in a U.S. securities class action lawsuit in connection with bribery or corruption activities and investigations in their home country, brought by their home country's regulators or prosecutors.

As regulators in Latin America and around the world become increasingly more active, it not only becomes increasingly more likely that companies elsewhere could become involved in regulatory or even criminal investigations, but also, at least where the companies have securities trading on U.S. exchanges, increasingly more likely to become involved in a U.S. securities class action lawsuit.

Brazil is of course not the only country cracking down on corruption. China, Australia, Chile, Canada, Italy, South Korea and numerous other countries have stepped up their corruption enforcement. Increasingly, enforcement authorities are cooperating and collaborating cross-border as well. These activities create operational uncertainty for companies in these jurisdictions. They also create challenges for the local D&O insurance professionals.

Impact of the SEC's New Executive Compensation Rules

As required by the Dodd-Frank Act, the SEC has released the final rules relating to pay ratio disclosure and also separately proposed rules regarding executive compensation clawbacks. When these two sets of controversial rules eventually take effect, they could have a significant impact on executive compensation disclosures, and could possibly even lead to executive compensation-related claims and enforcement actions.

The more procedurally advanced of these two sets of rules are the rules the SEC recently released relating to pay ratio disclosure. As discussed in the agency's August 5, 2015 press release, the rules "require a public company to disclose the ratio of the compensation of its chief executive officer (CEO) to the median compensation of its employees." The rules are not effective until each reporting company's first fiscal year after January 1, 2017. The

requirements will not apply to emerging growth companies, smaller reporting companies, foreign private issuers, filers under the U.S.-Canadian Multijurisdictional Disclosure System and registered investment companies.
The second set of executive compensation-related rules the SEC released this summer, were the agency's proposed rules relating to executive compensation clawbacks. On July 1, 2015, a divided SEC voted 3-2 to propose rules directing the securities exchanges to create standards that in turn call for listed companies to adopt policies requiring the companies' executive officers to pay back incentive-based compensation in the event the company restates its financials for the year in which the compensation was awarded. The proposed rules are subject to a 60-day comment period.

It will be some time before these two sets of rules begin to have an impact on corporate disclosure and compensation practices, but we will continue to monitor them closely.

The Impact of Consolidation in the P&C Insurance Industry

As a practice, we generally avoid talking about specific companies in the insurance marketplace. But change has come to the Property and Casualty (P&C) insurance world in ways that could affect the D&O insurance marketplace.

The P&C insurance industry watchword for 2015 is "consolidation." XL acquired Catlin. Tokyo Marine Holdings will acquire HCC Insurance Holdings. Fosun has acquired Meadowbrook and will acquire 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 will acquire The Chubb Corporation, in a deal worth $28.3 billion.

Taken collectively, the level of consolidation in the P&C insurance industry over the last several months has been nothing short of remarkable. Moreover, the process may not yet be complete; there certainly is speculation about which company or companies might be next. Based on what we know to this point, it is fair to say that not every one of these deals will affect the marketplace in the same way. Some of the buyers 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 this wave of consolidation is going to have an effect.

The issues discussed above present the possibility that we could be entering a period of rapid and perhaps significant changes. 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 may have been 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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ABOUT RT PROEXEC

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