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ProExec INSIGHTS

TOP TEN STORIES OF 2016

While the world of directors' and officers' liability is always dynamic, the D&O liability arena was particularly eventful during 2016, with significant implications for what may lie ahead in 2017 – and possibly for years to come. With full awareness that a complete inventory of key 2016 events could actually be much longer, here is a list of the Top Ten D&O stories of 2016.

1. 2016 SECURITIES CLASS ACTION LAWSUIT FILINGS REACH RECORD LEVELS DUE TO A SURGE IN MERGER OBJECTION SUITS

Largely driven by a surge in the number of federal court merger objection class action lawsuits, the number of securities class action lawsuit filings reached record levels during 2016. There were a total of 271 federal court securities class action lawsuits filed in 2016, which represents a 43% increase over 2015. Excluding only 2001, when the filing figures were inflated by a one-time wave of IPO laddering lawsuits, the 2016 total number of securities class action lawsuit filings represents the highest number of securities suit filings in a single calendar year.

Even more significant than the number of lawsuits is the rate of litigation – that is, the ratio of the number of lawsuit filings to the number of U.S.-listed companies. The number of listed companies has declined over time, while the number of lawsuits has held steady or increased. Thus, although the annual average litigation rate during the 1997-2014 period was 2.9%, the litigation rate in 2015 was 4.0%. With the surge in lawsuit filings in 2016, the litigation rate exceeded 5%, a historically high level. As a result, in 2016, the likelihood that a U.S.-listed company would get served with a securities class action lawsuit was at its highest level since the U.S. securities laws were substantially revised in 1995.

CONTACT

RT ProExec
180 N Stetson Ave., Suite 4600
Chicago, IL 60601

Main: (312) 784- 6001

Other than merger objection lawsuits, there are a number of other factors behind the increase in the number of securities suit filings during 2016 - the most significant of which is the change in the securities suit filings arising from changes in the plaintiffs' securities bar. As a study by Michael Klausner and Jason Hegland of Stanford Law School detailed, since 2009, a significantly larger number of securities class action lawsuits (both in terms of absolute numbers of lawsuit filings and in terms of percentage of all lawsuits filed) are now being filed by a group of small plaintiffs' firms that were not previously active in filing securities lawsuits.

Among the important practical implications arising from the emerging firms' increasing activity is that lawsuits are increasingly likely to involve smaller companies, as measured by the defendant company's market cap. Doug Greene of the Lane Powell law firm wrote in a December 27, 2016 post on his D&O Discourse blog that one of the key securities litigation developments in 2016 was "the persistence of securities class actions brought against smaller public companies primarily by smaller plaintiffs firms on behalf of retail investors," a development that Greene said represents "a fundamental shift in the securities class action landscape."

2. THE ERA OF COLLECTIVE INVESTOR ACTIONS OUTSIDE THE U.S. ARRIVED WITH A VENGEANCE IN 2016

Until recently, discussion of securities class action litigation almost exclusively involved developments in the United States. In one of the most significant recent changes, the topic of securities class action litigation and collective investor actions now increasingly involves developments outside the United States. The actions outside the U.S. often are very different from U.S.-style class action litigation, but they represent a new and increasingly important phenomenon in the D&O claims environment.

The most vivid examples of how much has changed are the massive settlements reached during 2016 in two separate collective investor actions. First, in March 2016, shareholder associations acting on behalf of former shareholders of the failed financial firm Fortis entered a $1.3 billion settlement under the Dutch Collective Settlement procedures. Second, in December 2016, collective investor groups negotiated a $1 billion partial settlement in the U.K. of the credit crisis-era claims asserted against RBS. These two unprecedented settlements, both of which would have been among the largest ever settlements in the United States, are game changers.

In addition to these massive settlements, there has also been a surge of new collective investor actions filed in a variety of jurisdictions outside the U.S. against a number of companies, including Volkswagen, Tesco, Toshiba, Petrobras, and others.

A number of different forces are contributing to this recent surge of collective investor actions outside the U.S. First and foremost, the rise in collective investor actions reflects extensive legislative changes a number of countries have introduced in recent years to permit actions for collective redress. Another significant factor has been the growth of third-party litigation funding, which, as discussed further below, is increasing rapidly.

3. THIRD-PARTY LITIGATION FUNDING HITS THE BIG TIME

Any question that litigation funding has become a very big business was completely eliminated by the December 14, 2016 announcement of the merger between Burford Capital Ltd., the world's largest litigation funding firm, and GKC Holdings, LLC, the parent company of Gerchen Keller Capital, the second-largest litigation funding firm. The merged company will have $2 billion committed to litigation and a current portfolio of more than $1.2 billion in litigation investments, with hundreds of millions of dollars of capital available for further litigation investments.

The leading funding firms have moved away from single-lawsuit funding arrangements, toward investment in portfolios of lawsuits. For example, Burford, which at its founding invested 100% of its funds in individual cases, in 2015 invested just 13% in individual cases. These changes have allowed the firms "to deploy money faster and creased more consistent returns" for investors. According a recent Wall Street Journal article, Burford's internal rate of return is 28%. The ability of these firms to generate these kinds of returns has attracted competition. While the litigation funding industry may attract controversy, it is clearly growing and is having an increasingly important impact on the litigation environment.

4. THE LATEST PHASE IN THE MERGER OBJECTION LITIGATION PHENOMENON MEANS MORE FEDERAL COURT LAWSUITS

One of the distinctive recent litigation phenomena has been the rise of merger objection lawsuits. In recent years, nearly every merger attracted at least one lawsuit challenging the transaction. Many of these lawsuits settled quickly based on the defendants' agreement to make additional transaction-related disclosures and to pay the plaintiffs' attorneys' fees, in exchange for a comprehensive release. These so-called disclosure-only settlements proved to be controversial; in a series of rulings culminating in the January 2016 ruling in the Trulia case, the Delaware Court of Chancery has shown its disapproval of the disclosure-only settlement model.

One practical consequence of the Delaware Chancery Court's discouragement of disclosure-only settlements has been that fewer merger objection lawsuits are being filed in Delaware.

The plaintiffs' lawyers filing these kinds of merger objection lawsuit now seem to be increasingly inclined to file their claims in federal court. Plaintiffs' lawyers filed 73 merger objection lawsuits in federal court in 2016, representing over 27% of all federal securities class action lawsuits filed during the year, compared with only 14 federal court merger objection securities class action lawsuit filings during the full-year 2015, representing about 7% of all securities suit filings.

With cases being filed outside Delaware, the question of whether or not judges in other jurisdictions will follow the lead of Delaware's courts in rejecting disclosure-only settlements takes on greater significance.

On August 10, 2016, in a lawsuit involving Walgreen's acquisition of Alliance Boots, the Seventh Circuit, in a blistering opinion written by Judge Richard Posner, affirmatively adopted the Delaware Chancery Court's position on disclosure-only settlements. Saying that these kinds of lawsuits are "a racket" and characterizing the additional disclosure that

was the basis of the settlement as "worthless," the appellate court reversed the district court's approval of the settlement. The strongly-worded opinion by a respected jurist on a federal appellate court seemed as if it might represent the death-knell for these kinds of lawsuits. However, the plaintiffs' lawyers continued to file these kinds of cases in federal court in significant number even after Judge Posner's opinion in Walgreen.

5. THE LONG-AWAITED ONSET OF CLIMATE CHANGE-RELATED D&O CLAIMS ARRIVES

For many years, commentators have been raising the possibility of climate change-related corporate and securities litigation. However, the climate change-related D&O claims failed to materialize – that is, until now. On November 7, 2016, investors filed a purported securities class action lawsuit in the Northern District of Texas against Exxon Mobil Corporation and certain of its directors and officers. The lawsuit specifically references the company's climate change-related disclosures, as well as the company's valuation of its existing oil and gas reserves. One lawsuit doesn't make a trend, and many of the lawsuit's allegations relates specifically to Exxon Mobil and its particular disclosures, but nevertheless, the filing of the lawsuit raises the question whether there may be other climate change-related disclosure cases ahead.

Enterprising plaintiffs' lawyers seeking to diversify their product line will likely assess whether or not climate change disclosure violations represents a promising new liability area. The possibility of future climate change-related D&O litigation represents a potential concern for companies in a variety of industries; not just energy companies like Exxon, but also utilities, mining companies, automobile manufacturers, transportation companies, insurance companies, and many others

6. DESPITE CHALLENGES, PLAINTIFFS CONTINUE TO FILE CYBER SECURITY-RELATED D&O CLAIMS

For some time now, commentators have been predicting that a rising number of corporate data breaches would translate into a resulting wave of D&O lawsuits. There has been a small number of high profile data security-related D&O lawsuits filed. However, several of those cases – including, for example, the derivative lawsuits filed against Target and Wyndham Worldwide – were quickly dismissed. Following these earlier dismissals, the sole remaining high-profile data breach-related derivative lawsuit was the one filed against the directors and officers of Home Depot. However, in late November 2016, the Home Depot lawsuit was dismissed as well.

In December 2016, however, within days after the Home Depot suit dismissal and just at the point where it seemed as if these kinds of cases might dwindle altogether, a plaintiff shareholder filed a new shareholder derivative lawsuit against the board of Wendy's.

It is fair to say that so far plaintiffs' lawyers' efforts to pursue data breach-related derivative lawsuits have fared very poorly. The magnitude of the hurdles may well explain why so few data breach-related derivative lawsuit have been filed overall, despite the significant numbers of high-profile data breaches.

However, the arrival of the Wendy's lawsuit is a reminder that it is far too early to conclude that we don't need to be worried about the possibility of cybersecurity-related D&O litigation. The reality is that the plaintiffs' lawyers are still trying to find the right approach (or perhaps to find a case with just the right facts). The plaintiffs' bar is creative and entrepreneurial and they have significant incentives to try to find a way to capitalize on the chronic cybersecurity risks and exposures that companies face.

In the meantime, companies continue to face the risk of regulatory claims. A growing number of federal regulatory agencies are jockeying to join the regulatory cyber security bandwagon, and state authorities are not far behind.

7. FOLLOW-ON CIVIL SUITS FILED IN THE WAKE OF REGULATORY INVESTIGATIONS SURGED IN 2016

One of the characteristic securities litigation patterns has been that lawsuit filings tend to come in distinctive waves, in which specific sectors get served with a series of securities suits or companies engaging in certain types of conduct or business practices attract a spate of securities litigation. The lawsuits arising out of the dot-com crash and the options backdating scandal are examples of these kinds of litigation patterns. During 2016, a different pattern has emerged - that is, the emergence of a significant number of lawsuits filed in the wake of regulatory investigations.

A particularly distinct category of these kinds of claims emerged during the year when shareholder claimants filed a series of lawsuits against companies caught up in antitrust investigations. During 2016, claimants filed a number of securities lawsuits against companies in the generic drug industry that arose from investigations of allegations of price collusion. These cases followed an earlier surge of lawsuits filed against companies in the poultry production industry that are the subject of an investigation questioning whether they had manipulated the price of broiler chickens. In total, at least seven securities class action lawsuits were filed in 2016 against companies targeted in industry-focused antitrust investigations.

In addition to these antitrust investigation-related lawsuits, there were a number of follow-on securities class action lawsuits filed against companies being investigated for anticorruption or bribery. For example, on December 12, 2016, shareholder claimants filed a securities class action lawsuit in the Southern District of New York against the U.K.-based mining firm Rio Tinto plc and certain of its current and former officers, following the company's announcement of a corruption investigation involving its operations in the Simandou iron mine, located in southern Guinea.

There were a number of these kinds of corruption-related securities class action lawsuits filed during 2016, such as the lawsuits involving Freeport McMoRan, PTC, Inc., Platform Specialty Products Corp., Gerdau, Banco Bradesco and Embraer. Together with the lawsuit filed in late December 2016 against Andrade Gutierrez International, S.A., there were a total of at least nine securities class action lawsuits filed in 2016 as follow-ons to a bribery or corruption investigation.

Further, other types of follow-on civil action that have emerged stem from claims filed in the wake of environmental investigations. There have been number of lawsuits filed in the U.S. following the collapse in Brazil of the Fundão tailings dam, in what has been called Brazil's worst-ever environmental disaster. There were a number of other civil actions filed in the U.S. in 2016 against companies caught up in environmental investigations.
Altogether, the follow-on antitrust investigation lawsuits, the follow-on bribery investigation lawsuits, and the environmental investigation claims represented a total of at least 19 follow-on securities class action lawsuits in 2016, representing more than six percent of all of the securities class action lawsuits filed in 2016.

Not only will we likely see greater regulatory enforcement, but the increased regulatory activity will likely result in a wave of follow-on civil lawsuits as well. In light of the increasing levels of collective investor actions outside the U.S. noted above, the likelihood is not only that there will be increased claims activity in the U.S. following regulatory investigations, but these kinds of claims will likely become increasingly more frequent outside the U.S. as well.

8. PRIVATELY-HELD SILICON VALLEY "UNICORN" SERVED WITH SECURITIES CLASS ACTION LAWSUIT

In April 2016, the SEC announced a "Silicon Valley Initiative" reflecting the agency's concerns about private companies receiving sky-high valuations in private offerings. The agency said it is particularly focused on so-called "unicorns" – that is, private companies with valuations greater than $1 billion. Although the agency did not name the specific companies, it soon became clear that one of the companies the agency was investigating was Theranos, the blood-testing technology company that had attracted media and regulatory scrutiny.

The accumulating bad news surrounding Theranos has not only drawn the attention of the SEC; it has also attracted private civil litigation as well. In October 2016, after a series of alarming developments involving the company, one of the company's investors filed a lawsuit in Delaware state court against the company and its senior officials alleging that the company had engaged in misrepresentation and disclosure omissions in its fundraising. In November 2016, another investor filed a securities class action lawsuit in the Northern District of California against the company and certain of its directors and officers.

There is, of course, nothing new about private company investors filing lawsuits alleging that they were misled into making an investment, as securities laws apply to private companies as well as to public companies. What is noteworthy is not that investors filed a securities fraud lawsuit, but rather the scale of the claims, as well as the fact that at least one of the claims was filed in the form a class action lawsuit.

The D&O industry in the U.S. has tended to view the world as neatly divided between public and private companies, with distinct attributes distinguishing the two categories. The rise of start-up private companies with valuations over $1 billion blurs the distinctions between the categories. When a company is raising hundreds of millions of dollars of investments with valuations ranging into the billions of dollars, it is hard to say that a company – even if entirely privately-held – has only the characteristics traditionally associated with the private company category.

The events surrounding Theranos and other “unicorn” companies are only the latest in a series of developments contributing to the breakdown of the insurance industry’s traditional sharp distinction between public and private companies. It may well be that the division was never as sharp or distinct as was usually perceived, but old habits die hard.

9. THE DODD-FRANK WHISTLEBLOWER PROGRAM HITS NEW HEIGHTS FOR REPORTS AND AWARDS

Though the whistleblower program that the Dodd-Frank Act created has only been in place since 2011, it has become a substantial part of the SEC’s enforcement program. According to the agency’s report for fiscal year 2016, during the program’s history the agency has awarded a cumulative total of more than $111 million to 34 whistleblowers. With the agency’s November 14, 2016 award of $20 million to a whistleblower (which came after the 2016 fiscal year end), the agency has now made whistleblower awards totaling over $130 million. In FY 2016 alone, the agency issued awards totaling $57 million to 13 whistleblowers, the total amount representing more than all of the award amounts made in preceding years combined. Of the ten largest awards in the history of the program, six were made during FY 2016. Just as the number of awards are increasing, the number of tips the agency has received has increased as well. Among many questions arising from the upcoming change of administration in Washington is the question of the extent to which the new administration will continue to pursue the Dodd-Frank whistleblower program. One of the new President’s frequent statements while he was on the campaign trail was that he would “repeal” the Dodd-Frank Act. However, the general consensus is that the President will not in fact seek the wholesale elimination of the Dodd-Frank Act. The greater likelihood is that he will remove components of the Act while leaving other measures in place. Among the likeliest provisions of the Act to be left in place is the whistleblower program; it is working and it is effective. The likelihood is that the whistleblower program is likely to be an increasingly important part of the corporate liability landscape.

10. THE BREXIT VOTE AND IN THE U.S. PRESIDENTIAL ELECTION RAISE QUESTIONS AND POSE CHALLENGES FOR THE D&O INDUSTRY

It can often seem that the world of D&O liability and insurance is its own universe, with its own unique issues and challenges and operating according to its own rules. Of course, this has never been true, as the D&O insurance marketplace has always been subject to larger factors, such as the relative supply of insurance capital.

Two particular events during the last year represent particularly significant developments, for the world as a whole as well as for the D&O industry. The outcome of the June 2016 U.K. vote in favor of Brexit could have a significant impact on the insurance marketplace, and the change in administration following the November 2016 U.S. Presidential election could have even greater significance.

Brexit

Even though the Brexit vote took place over six months ago, the fact is that no one still really yet knows what it means. Not only has the U.K. government not yet formally exercised its rights under applicable treaties to withdraw

from the E.U., but the U.K. government has not yet even stated in detail what its position with respect to withdrawal will be. A vast number of issues will have to be sorted out as the U.K. withdraws, the most important of which is the extent to which whether or not U.K. businesses and financial firms will continue to have access to the so-called "single market" within the E.U. An equally important issue is whether or not there will continue to be free movement of persons to and from the E.U.

Both the access to the single market and the free movement of people have been important to the growth of the financial services industry in London, including the insurance industry. Access to the single market has allowed London to establish itself as a sort of a global headquarters for doing business throughout Europe. The free movement of persons has allowed the London financial businesses to attract the top talent from around the continent. While it remains to be seen how the whole process plays out, if the consequences of Brexit include the loss of access to the single market or restriction of the free flow of people, the financial services industry could be affected. During what is likely to be a long period of negotiations, there likely will be fewer new business initiatives in the London insurance marketplace and hiring will likely be stayed. Europeans working in London may well start to leave, in anticipation of what is yet to come.

London will always be an important part of the global insurance marketplace. The London insurance marketplace will remain the only place where certain kinds of business can get done. But the business dynamic in London seems likely to change. What it will all mean is at best uncertain.

The U.S. Presidential Election

On January 20, 2017, Donald J. Trump was sworn in as the 45th President of the United States. Even among his supporters, there is uncertainty about what a Trump presidency will actually mean. There are, however, a number of specific issues that unquestionably will have to be addressed.

Among other things, the new President will have an enormous opportunity to shape the federal judiciary in the U.S. First and foremost, Donald Trump will nominate an individual to fill the current U.S. Supreme Court vacancy. The arrival of President Trump's appointee will shift the Court's balance toward its conservative wing, with important implications for future case outcomes. The addition of President Trump's nominee will also likely affect the mix of cases that the Court agrees to take up.

The Supreme Court vacancy is the headline issue, but there is more to the story than just the Supreme Court. There are a large number of vacancies in the other federal courts as well. As of January 3, 2017, there were a total of 112 federal court vacancies (including the Supreme Court vacancy), including 86 in the federal district courts and 17 on the U.S. Courts of Appeals. There will be as many as 15 additional future vacancies in the next few months as, for example, judges who have previously announced their retirements step down. There is a very real prospect that the new President will have the opportunity to remake the face of the federal judiciary.

Further, many of the President's cabinet appointments and other nominations have a significant potential to alter government policy. While some prognostication about the Trump administration's future direction is possible, the reality is that in many ways the practical consequences from the change in administration remains to be seen, just

as is the case with respect to the outcome of the Brexit vote. Adding to this uncertainty is the fact that there will be leadership elections next year in France, Germany and Netherlands, and possibly in Italy as well. The bottom line is that we are now in the midst of a period of significant political uncertainty.

CONCLUSION

The insurance industry is generally uncomfortable with uncertainty. For policyholders trying to navigate a secure course through the likely hazards, this is a particularly challenging time. The winds are variable and potentially capricious, and the greatest hazards are over the horizon. In the months ahead, it will be particularly important for insurance buyers to ensure they have enlisted the assistance of knowledgeable and experienced advisors. Only with a forward-looking approach, can you avoid the rocks and shoals ahead.

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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 under writer. Kevin previously was a partner in the Washington, D.C. law firm of Ross Dixon & Bell.

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