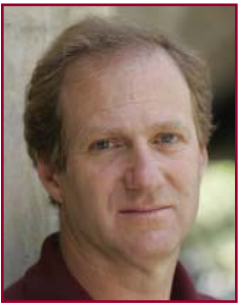


HOW PROTECTIVE IS D&O INSURANCE IN SECURITIES CLASS ACTIONS? – PART I

by Michael Klausner and Jason Hegland



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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 by officers and directors? What factors influence relative contributions? With respect to officers and directors, does evidence of culpability influence liability exposure? 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?

Until now, these questions could be answered anecdotally at best. On the basis of an extensive set of data that we have recently collected, we explore these questions

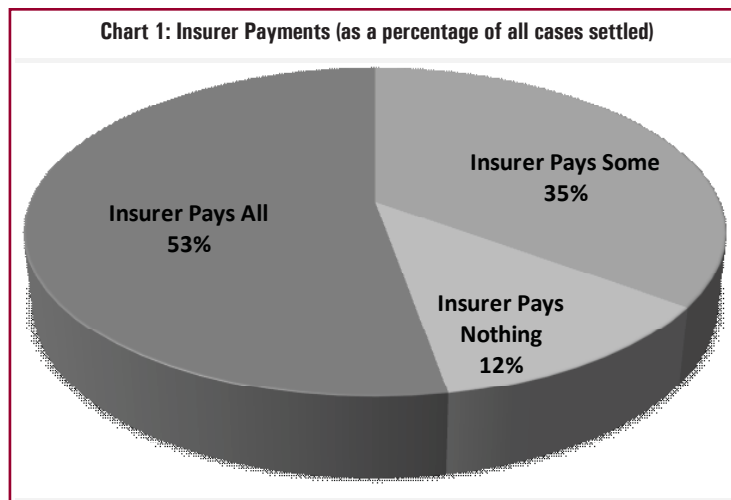
quantitatively below. We find that on the whole D&O insurance pays substantial portions of settlements in a large majority of cases, and that both corporate and individual defendants are highly protected. This is the first of two articles reporting findings from this new database. The second, which will be published in the next issue of the *PLUS Journal*, will analyze the timing of settlements and dismissals.

The data presented here are taken from securities class actions filed between 2000 and 2003 and settled between 2001 and 2009. Additional data is taken from SEC enforcement actions that ran parallel to some of those class actions. In total, there were 726 cases filed during this period, 443 of which settled, 249 of which were dismissed with prejudice or voluntarily dropped by the plaintiffs, and 34 of which are still pending.¹ These numbers include three cases that went to trial. One was tried to conclusion and decided in the defendants' favor. That case is included among dismissals. Two were settled during trial and are treated here as settlements. We selected cases filed

between 2000 and 2003 for this article so that we would have a cohort of cases that have nearly all been resolved.

WHAT PROPORTION OF SETTLEMENTS DO INSURERS PAY AND WHAT FACTORS INFLUENCE THE INSURER'S CONTRIBUTION?

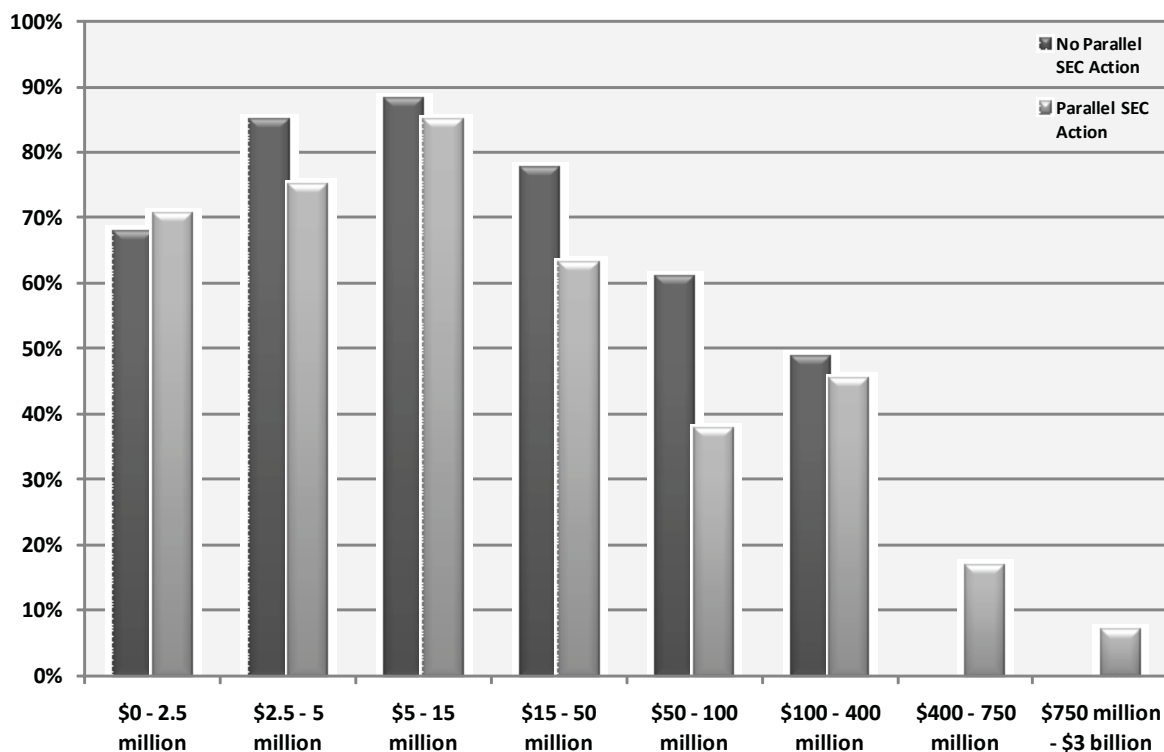
When a securities class action settles, how often does the D&O insurer pay the full settlement? When the insurer pays less, how much does it pay? We were able to obtain data on insurer payments in 90% of the cases included in this study. Chart 1 provides some basic answers to those questions based on those cases. In 53% of cases, the insurer paid the full settlement, in 35% the insurer paid some of the settlement, and in 12% of cases the insurer paid nothing. Where the insurer paid nothing, the insured may have been uninsured, or 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. It is also possible that companies incorrectly reported in SEC filings, which were the source of these data, and that they paid the full settlement.



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

Chart 2: Mean Insurance Contribution (as a percentage of class action settlement)



exclusion of a case from coverage under the terms of the policy. As shown in Chart 2, insurers' mean percentage of settlements paid in cases with parallel SEC actions is in fact lower than their mean percentage of settlements paid in cases without parallel SEC actions. This is true in each bracket of settlement size. (In the highest settlement ranges, all cases have parallel SEC actions.)

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,

of settlement size, Chart 2 shows the mean insurer contribution, in terms of a percentage of the settlement, for two sets of cases: those with parallel SEC actions and those without parallel SEC actions.²

Mean percentage insurer contributions are relatively low for both the smallest and the largest settlements. In settlements between \$2.5 million and \$15 million, insurers pay on average between 75% and 90% of a settlement. In cases that settle below \$2.5 million, insurers on average pay a smaller portion, and as settlements rise above \$15 million, the insurers' share declines. Although there are surely particularized facts underlying these averages, the pattern here suggests some general explanations. First, the relatively low percentage payments in smaller settlements may reflect the effect of retentions, especially for the smallest of these settlements. Second, the lower percentage paid by insurers in the largest settlements may reflect settlements that exceed policy limits. Third, the insurers' lower percentage contribution in large settlements may also reflect insurers' assertion of defenses to coverage where deliberate misconduct is involved. This assumes, all other factors equal, that settlements are larger when deliberate misconduct is involved.

To further investigate whether lower insurance contributions may be explained by insurers' assertion of misconduct-related defenses, Chart 2 compares class actions with and without parallel SEC enforcement actions. The SEC's filing of an enforcement action may suggest a level of culpability on the part of management that would support the

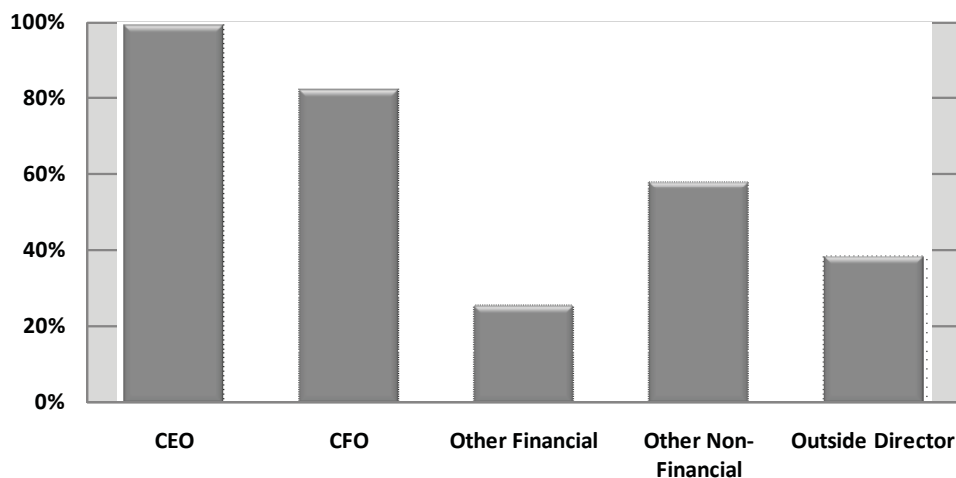
policy limits, and insurers' conduct-related defenses.

PROTECTION OF OFFICERS AND DIRECTORS

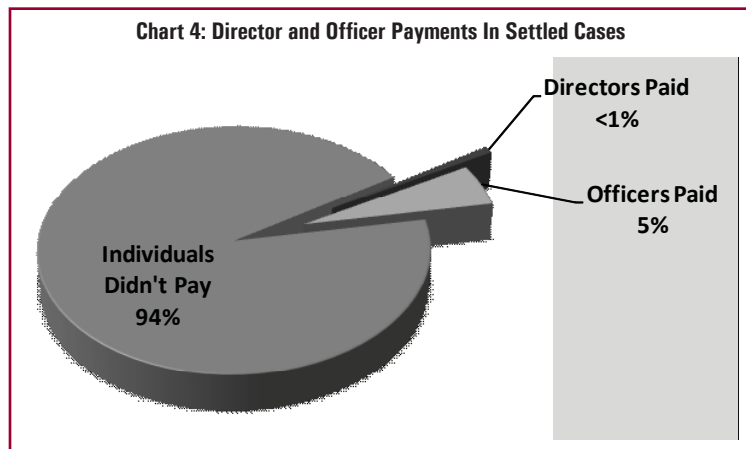
Chart 3 shows the frequency with which CEOs, CFOs, other officers, and outside directors are named in class actions. CEOs are named in 99% of cases, and CFOs are named in over 80%. Outside directors are named in just under 40% of cases. Some of the cases that name outside directors name only outside board chairs, and some name particularly relevant committee members, such as audit committee members in an accounting case, but many cases name the full board.

Once named, how often do officers or directors make out-of-pocket

Chart 3: Who Is Named A Defendant? (as percentage of all cases filed)



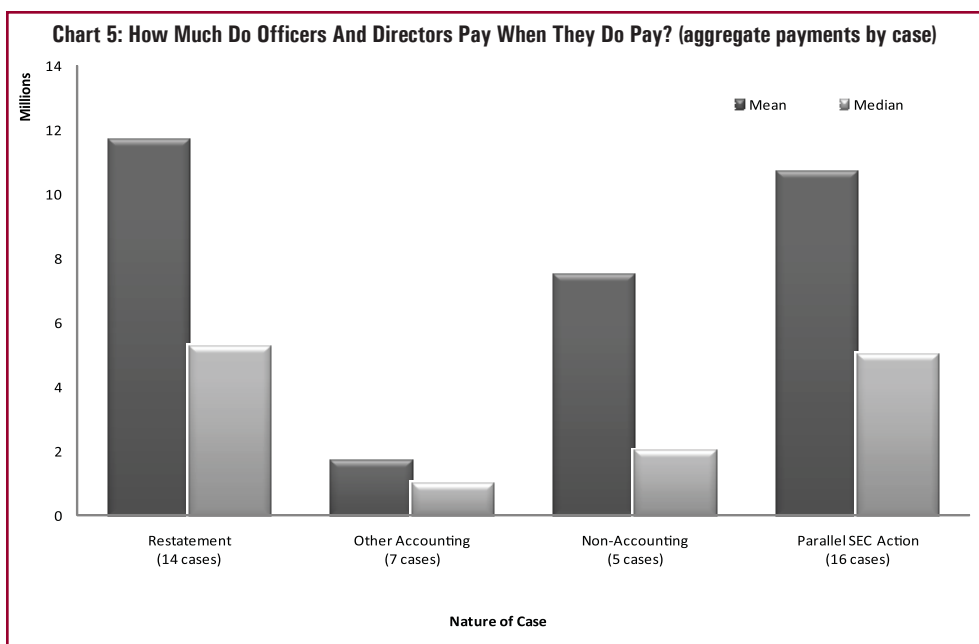
contributions to a settlement? Infrequently, as shown in Chart 4. Officers pay in 5% of settlements, and outside directors pay in fewer than 1% of settlements. Thus the combination of D&O insurance, indemnification, and the ability of the corporation to pay whatever portion of the settlement the insurer does not pay, provides substantial protection for officers and directors.



SIZE OF OFFICER AND DIRECTOR PAYMENTS

In the few cases in which officers and directors pay, how much do they pay? Chart 5 breaks this down by the nature of the allegations in a case and by the presence or absence of a parallel SEC action. The chart shows mean and median payments by officers and directors, aggregated by case. (Thus, if a CEO and CFO each contribute \$1 million to a settlement, officer payments for that case would be recorded as \$2 million.)

Officer and director payments are largest in cases involving restatements and cases with parallel SEC actions (the two not being mutually exclusive). For example, mean payments by officers and directors in cases involving restatements (of which there were a total of 14) are approximately \$12 million. Mean payments by officers and directors where there is a parallel SEC action are approximately \$11 million.



FACTORS LEADING TO OFFICER AND DIRECTOR PAYMENTS

What factors lead to officer and director payments? In an article published in the June 2006 issue of the *PLUS Journal*, one of us reported that out-of-pocket payments by outside directors are exceedingly rare—having occurred in a fraction of one percent of securities class actions. That article also identified the factors associated with such payments.³ Two of those factors were bankruptcy of the company involved and the presence of a claim under Section 11 of the Securities Act for misstatements associated with a public offering. Bankruptcy affects the likelihood of outside directors' payments simply because it removes the company as a source of payment, leaving only the D&O policy standing between the directors' personal assets and the plaintiff's demands. The presence of a Section 11 claim is an important determinant of outside director liability because Section 11's standard of liability is mere negligence, as opposed to the higher standard of intentionality or recklessness under Section 10 of the Securities Exchange Act, which applies outside the context of a public offering. Consequently, if as is sometimes reported, a lead plaintiff insists on payments from outside directors, it has greater leverage in threatening to go to trial with a Section 11 claim. In addition, some insurers reportedly take the position that Section 11 damages are not covered by the D&O policy. In our current study, the correlation between bankruptcy and Section 11, on the one hand, and settlement payments by outside directors is evident as well.

What about out-of-pocket payments by officers? The factors associated with payments by outside directors are associated with payments by officers as well. Bankruptcy and Section 11 claims are disproportionately present among the few cases with officer payments. On the other hand, there are far more cases involving bankrupt companies and Section 11 claims where no officer pays into a settlement. Thus while these factors increase the likelihood that an officer will pay, that likelihood remains very low even when these factors are present.

An important difference between officers and outside directors with respect to liability is that officers are in a better position to engage in deliberate fraud, if they are so inclined. Officers run day-to-day operations, and they make at least initial decisions regarding what information to disclose. One might therefore expect out-of-pocket payments by officers to occur when officers have engaged in deliberate misconduct.

Because securities class actions are settled with defendants denying all wrongdoing, there is no way to know whether actual misconduct occurred. It is therefore impossible to know whether officers who have engaged in deliberate misconduct pay into settlements. One potential (but far from perfect) indication of deliberate wrongdoing is insider stock sales during the class period. Where plaintiffs believe these sales help their case, they are alleged in the complaint. So the question is whether officers tend to pay in cases in which insider sales are alleged to have occurred. We find that indeed

insider sale allegations are disproportionately present in cases in which officers pay into settlements. But again, there are many more cases with insider sale allegations and no officer payment. Thus while insider sales increase the likelihood that an officer will pay, that likelihood remains very low even when insider sales are alleged.

Arguably, a better indicator of the presence of misconduct is a parallel SEC enforcement action for fraud based on the same allegations, where the SEC imposes a penalty on one or more officers. Chart 6 shows the relationship between SEC sanctions and officers' contributions to settlements in parallel class actions. During the period covered in this study, there were 124 class actions with parallel SEC actions for fraud—that is, SEC actions based on the same allegations and with claims for fraud. (There were another 15 parallel SEC actions for lesser violations.) Of the 124 parallel SEC fraud actions, 97 cases have been concluded against all defendants at the time this article is going to press; the rest are still pending against at least one defendant. The top row of Chart 6 shows class actions in which officers made out-of-pocket payments. There were 11 such cases with fully resolved parallel SEC fraud actions. In each of those parallel SEC actions, the SEC imposed penalties on officers involved. Those penalties include monetary fines, disgorgement of ill-gotten gains, and bars against serving as an officer or director of a public company. The bottom row of Chart 6 shows cases in which officers did not make payments in the class action. There were 86 of those cases with fully resolved parallel SEC actions for fraud. In 72 of those parallel SEC actions, the SEC imposed penalties on officers.

Chart 6: SEC Penalties for Officers and Officer Payments in Parallel Class Actions

	SEC Imposed Penalty	SEC Did Not Impose	SEC Actions Concluded
Officer Payment in Class Action	11 (100%)	0 (0%)	11
No Officer Payment in Class Action	72 (84%)	14 (16%)	86

Thus, among class actions with parallel SEC actions for fraud, officer payments in the class action settlement are associated with SEC sanctions against officers in parallel actions. On the other hand, there are far more cases in which the SEC imposes a penalty on an officer in a parallel action and yet the class action is settled without any officer contributing personally to the settlement. These data thus suggest that officers are commonly protected from out-of-pocket payment in securities class actions even if they engaged in misconduct.

CONCLUSION

The data analyzed here show that D&O insurance does indeed transfer 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, which may reflect their assertion of misconduct-related defenses to coverage.

Out-of-pocket payments by officers or directors are rare. Officers pay in 5% of settlements, and outside directors pay in fewer than 1% of settlements. Thus taking into account the roughly 35 percent of cases that are dismissed, personal liability risk even for officers is not very high. Officer and director payments occur disproportionately in cases where the company is bankrupt and in cases involving misstatements related to public offerings, where the standard of liability is negligence, as opposed to the higher standard of intentionality or recklessness. Nonetheless, the vast majority of cases involving bankrupt companies or public offerings do not result in out-of-pocket payments by officers.

There is some indication that officers are more likely to make out-of-pocket payments where evidence of misconduct is strong, but the overriding conclusion seems to be that, even when evidence against officers is strong, they are protected. Allegations of insider sales are disproportionately present in cases with officer payments. But there are far more cases with insider sale allegations and no officer payments. Similarly, payments by officers in class actions occur disproportionately where the SEC imposes sanctions against officers in a parallel enforcement action for fraud. But the opposite is not true; there are many cases in which the SEC brings an enforcement action for fraud and imposes sanctions on officers involved but where no officer pays into the settlement of the parallel class action. Thus, to a large extent, even culpable officers appear to be shielded from liability in securities class actions.

Part II of this article can be seen in the March 2010 *PLUS Journal*. *The authors thank the PLUS Foundation and the Rock Center for Corporate Governance for the funding of this research.*

FOOTNOTES

- 1 Our database includes class actions filed through 2008 at this point.
- 2 Mean insurer contributions are calculated by calculating 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.
- 3 To be clear, although bankruptcy and Section 11 claims are disproportionately present in cases with out-of-pocket payments by outside directors, there are a great many cases in which these factors are present and yet outside directors pay nothing.

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