Publicly traded companies have never faced such a broad array of challenges to their integrity and threats to their existence. Ironically, the pressure on the securities plaintiff’s bar may be even higher. The past year revealed that familiar lawsuit trends such as Chinese reverse mergers and merger objection suits are often offset by countervailing market trends. In fact, market dynamics, competition among plaintiff’s firms, and a potential landmark decision by the United States Supreme Court have plaintiff’s firms desperately searching for the next big securities law trend. This paper examines the current state, identifies potential sources of the next wave of significant litigation, and suggests steps insureds can take to prepare for it.

Shareholder Class Actions—More Mouths, Less Pie?

In the last seven years, the securities plaintiff’s bar has feasted on a smorgasbord of new litigation trends that have sustained higher volumes of securities class actions even while the pool of public
companies to target has steadily contracted. For example, in 1997, there were nearly 8,900 public companies in the United States, but by 2007, that number had fallen to approximately 6,000, and continued to drop to around 5,000 by the end of 2013. Yet, the number of securities class action filings remained robust due to the emergence of certain novel litigation trends created by the credit crisis, Chinese reverse mergers, and merger objection lawsuits. Today, however, credit crisis-related lawsuits are precluded by statute of limitations periods, Chinese reverse merger suits have largely run their course, and merger objection suits, while ubiquitous, are dependent on M&A activity, which was down in 2013. In short, securities plaintiff’s firms that relied on litigation trends to supplement their case load over the last seven years will be facing unprecedented competition for cases at a time when there are fewer public companies to target.¹

The increased pressure on the securities plaintiff’s bar is illustrated by examining the types of class actions filed in recent years. From 2007 to 2011, a public company had approximately a 2.1 percent to 2.3 percent chance of facing a “traditional” securities class action (i.e., excluding class actions based on the credit crisis, Chinese reverse mergers, and merger objections, collectively “trend actions”). During that period, trend actions accounted for 35 percent of total class action filings each year, on average. For example, in 2008, 223 securities class actions were filed, but 45 percent were trend actions, which supplemented the number of filings even as the pool of public companies shrunk. In the past two years, however, the number of trend actions has sharply decreased, accounting for 15 percent and 11 percent of all securities class action filings, respectively. Not surprisingly, and largely due to this decrease in trend actions, a public company now faces a greater chance of facing a traditional securities class action than it has in the past—a 2.62 percent chance in 2012 and a 2.96 percent chance in 2013—even though the total number of securities class action filings was lower in the last two years than the previous five.² Today, the securities plaintiff’s bar has fewer targets and fewer legal theories to assert against those targets. In an effort to sustain this volume of cases, plaintiff’s firms brought more traditional securities class actions in 2013 (148) than were brought, on average, in the previous seven years (120). To continue to fill this void, plaintiff’s firms will be forced to ruthlessly search existing targets for potential claims and, most likely, bring more “borderline” cases. Making this situation even more difficult for plaintiff’s firms, a tried and true legal theory for bringing securities class actions now faces an historic challenge.
The End of the Fraud on the Market Presumption?

The U.S. Supreme Court is expected to issue a ruling this summer in Halliburton Co. v. Erica P. John Fund, Inc., that could alter the course of future securities class actions. In Halliburton, the Court will revisit a ruling from 1988, Basic, Inc. v. Levinson, where the Court established the “fraud on the market” presumption—that markets are efficient and investors presumptively rely on material information disclosed by the company. Because of the fraud on the market presumption, reliance on alleged misleading disclosures is presumed, and a class may be certified without having to prove that each and every stockholder relied on a specific disclosure. If Halliburton overturns Basic, however, each individual plaintiff must show he or she relied on the allegedly misleading disclosure, a nearly impossible task for classes that can include thousands of members.

Whether the Court will reverse Basic, uphold it, or find some complex middle ground is unknown, but this adds to the current pressure on the securities plaintiff’s bar to find a new litigation trend, and that pressure will skyrocket if the fraud on the market presumption is altered. One likely source of inspiration for plaintiff’s firms is the regulatory arena, where a seemingly reenergized SEC is poised to move on a number of fronts against corporate misdeeds and perceived abuses of power.

Follow the Leader? A More Aggressive SEC

Since SEC Commissioner Mary Jo White has taken the helm, she has promised focused and rigorous enforcement. The SEC is coming off a record year—issuing $3.4 billion in penalties and disgorgements in 2013—and appears to be in a more aggressive mode as formal investigations are up 20 percent year over year. The public statements made by White and her fellow Commissioners illustrate the direction of SEC enforcement for the future:

- The SEC wants issuers of securities to be more accountable, and one way to achieve that is to require admissions of wrongdoing as a condition of a settlement. Commissioner White recently stated that “admissions can achieve a greater measure of public accountability—which can be important to the public’s confidence in the strength and credibility of law enforcement and the safety of our markets,” and she promised to “demand admissions in an expanded category of settlements.” This should have a major impact on civil litigation, as any admission is seen as a red flag and an opportunity for the plaintiff’s bar.

- The SEC is already sitting on a large volume of whistle-blower tips and previously awarded $14 million to a tipster for leading investigators to the source of the wrongdoing and assisting in the investigation. This award will likely encourage more would-be whistle-blowers to come forward, increasing the number of inquiries, investigations, and enforcement actions by the SEC. Plaintiff’s firms have already inserted themselves into the whistle-blower process and, to the extent they are
able, will file related civil suits based on successful tips and alleged wrongdoing.

- The SEC does not want to harm shareholders further, so enforcement will be less about punitive action (e.g., imposing large fines) and more about deterrence and preventing further abuses. To paraphrase Commissioner Gallagher—the SEC’s job is to foster efficient and fair capital markets; leave punishment to the Justice Department. To employ more creative enforcement measures, the SEC announced the formation of two units: the Financial Audit and Reporting Task Force and the Center for Risk and Quantitative Analytics. According to Commissioner White, the Financial Audit and Reporting Task Force “has very talented accountants and attorneys who will broaden and thereby improve the way we look at financial reporting misconduct.”

In the Center for Risk and Quantitative Analytics, the SEC has launched a systematic analysis of data to detect risks and threats that could harm investors, focusing on irregularities and abnormalities that could signal misreporting of financial statements and other forms of accounting fraud. While these new regulatory weapons may not be considered punitive by the SEC, they will alert plaintiff’s firms to potential wrongdoing and could serve as a basis for allegations for new civil suits.

According to Commissioner White, “The coming year promises to be an incredibly active year in enforcement, as we continue to vigorously pursue wrongdoers and bring enforcement actions across the entire industry spectrum.” Expect the securities plaintiff’s bar to capitalize on this increased activity and bring more follow-on civil suits stemming from regulatory actions.
The Growing Risk Landscape of Cyber

The specter of cyber risk is relatively new, but it is nevertheless casting a growing shadow over board rooms and could be the mother lode for future securities litigation. The infamous Target data breach is a perfect illustration; shareholders have filed two derivative suits against the company’s directors and officers asserting several causes of action, including breach of fiduciary duty and waste of corporate assets. The plaintiffs allege that company leaders knew the cyber risks but failed to protect customer data, and seek to hold the board accountable for cyber breach costs and any damages awarded in the related consumer class action lawsuits that have been filed. The lawsuit dynamics surrounding the Target cyber breach can easily develop into a new litigation trend as the foregoing pattern can be replicated whenever a company suffers a significant cyber event.

Moreover, data is rapidly becoming a company’s most valuable asset and, with the increase of mobile apps, digital processes are replacing more and more manual transactions. In this environment, companies must revisit their processes, procedures, and protocols for safeguarding data and abide by the SEC’s guidelines for cyber-related disclosures that have been in place since 2011, and any failure to abide by these guidelines is another potential source for new securities litigation.

A common criticism has been that companies do not adequately disclose cyber risks and are withholding material information from investors. Notably, omissions of this nature would not be impacted if Halliburton overturns the fraud on the market presumption. Accordingly, lawsuits concerning nondisclosures of cyber risks could gain steam with plaintiff’s firms looking to elude an unfavorable Halliburton ruling.

SEC GUIDELINES

- Describe aspects of operations that might give rise to material cybersecurity risks.
- Detail cyber functions that are outsourced.
- Disclose past cyber incidents.
- Discuss cyber risks that may remain undetected.
- Describe relevant insurance coverage.
Implications for D&O Insurance

Anticipating the next trend in securities litigation is more speculation than science; the same is true for anticipating how to address these new trends in a D&O insurance policy. Fortunately, the best course of action is to wait for now. Existing policies often cover the latest claim developments, and carriers require time to react to new trends. The burden to adjust policy wording—by increasing retentions and strengthening exclusions—will be on the carriers, and they will rarely act prospectively, but instead will wait until a trend develops. Nevertheless, certain measures can be taken now to anticipate the “next big thing” in securities litigation.

While public company D&O insurance will cover individuals for most claims, the entity itself is only covered for “Securities Claims,” which are typically limited to claims arising out of a purchase and sale, or offer to purchase and sell, securities. The phrasing of that definition, however, can sometimes leave doubt as to coverage for claims and SEC enforcement actions concerning accounting violations. In light of the SEC’s new tools to investigate accounting fraud, these types of enforcement actions and follow-on civil suits are more likely to emerge. Accordingly, insureds should seek a definition of Securities Claim that will capture such matters. Likewise, insureds should avoid language that prospectively limits coverage for follow-on civil litigation that arises from ongoing SEC investigations.

Additionally, “written admissions” can trigger improper conduct exclusions that will preclude coverage for both enforcement actions and follow-on civil litigation relying on these admissions of wrongdoing. Most carriers, however, remain flexible with “admission” language and some insureds even prefer such language as it often matches bylaw provisions that preclude indemnity and defense for a bad actor who has admitted to wrongdoing. The SEC’s stockpile of whistle-blower tips and deep pool of potential claims also should be addressed now. Insureds should insist that whistle-blowers are carved out of any “insured v. insured” exclusion, so that claims arising from whistle-blower tips are not denied.

Finally, potential cyber-related D&O claims can be mitigated by rigorous cybersecurity policies and cyber insurance that protects a public company’s balance sheet and makes it more difficult for plaintiffs to allege corporate waste. As technology grows ever more present in daily living, the public will expect corporations to act responsibly, and any failure to mitigate cyber risk or to obtain cyber insurance may be grounds in and of itself for a breach of fiduciary duty action.

As technology grows ever more present in daily living, the public will expect corporations to act responsibly, and any failure to mitigate cyber risk or to obtain cyber insurance may be grounds in and of itself for a breach of fiduciary duty action.
Summary

While market and legal dynamics have made things more challenging for the securities plaintiff’s bar, it will inevitably respond and uncover a new litigation trend. Whether that new trend arises from regulatory actions, cyber risk, or something else, the challenge for public companies is to anticipate that trend and prepare themselves and their D&O insurance policies as best they can.

1Securities Class Action Filings, 2013 Year in Review, Stanford Law School Securities Class Action Clearinghouse and Cornerstone Research

2Ibid.

3The SEC in 2014, Chair Mary Jo White, 41st Annual Securities Regulation Institute, Coronado, Calif., January 27, 2014

4Recent Changes in SEC Enforcement Policy Require Renewed Attention to Directors’ and Officers’ Insurance Terms, Perkins Coie law firm, October 17, 2013

5SEC Awards More Than $14 Million to Whistle-blower, press release, October 1, 2013

6SEC Announces Enforcement Results for FY 2013, press release, December 17, 2013

7The SEC: the future path of enforcement (part III), Thomas O. Gorman, Dorsey & Whitney LLP, January 7, 2014

8The SEC in 2014, Chair Mary Jo White, 41st Annual Securities Regulation Institute, Coronado, Calif., January 27, 2014

9Ibid.
Our Mission

To be the worldwide value and service leader in insurance brokerage, employee benefits, and risk management

Our Goal

To be the best place to do business and to work

www.lockton.com