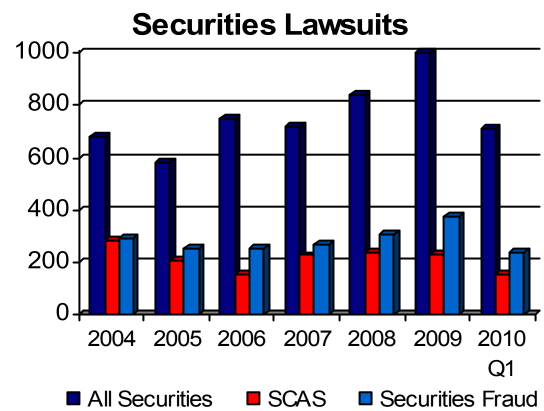
Securities Suits Ease Back to Normal Following a Frantic Two Years

An Advisen Quarterly Report – Q1 2010

Executive summary

The wrath of the credit crisis and the ensuing Great Recession took its toll on securities litigation in 2008 and 2009. Securities class action suits (SCAS) remained strong during this period, but it was regulator activities on many levels that erupted. The credit crisis and the collapse of Ponzi schemes, headlined by Bernard Madoff, also resulted in a rapid expansion of suits alleging breach of fiduciary duties. As the economy stabilized, albeit at a relatively depressed level, securities suits floated back to earth in the first quarter of 2010, to a pre-credit crisis plateau. In Q1 2010, securities suits totaled 178, at an annualized rate of 712 and down 29 percent from 2009 at 1,003, the lowest level since 2005. Given heightened regulatory enforcement activities and the fact that regulators have increased the coordination of their efforts since the credit crisis, forcing parallel proceedings, corporations and their directors and officers would be unwise to let their guards down during this relative calm in the litigation storm.



Note: Q1 2010 numbers are annualized.

The 178-suit first quarter was down 34 percent from the previous quarter, and down 39 percent year-over-year from Q1 2009, which was a record-breaking quarter at 294 suits filed. The first quarter of 2010 followed two years of rapid expansion of securities suit filings, with 2008 growing at 17 percent and 2009 at 19 percent. Although securities fraud cases, which according to Advisen's definitions (see page 2) are largely suits filed by regulators, dropped 42 percent from the previous quarter to 59 suits, they continue to be the leading type of case at 33 percent of all suits filed, reflecting continued heightened regulatory vigilance. SCAS fell off as well from 58 to 38 suits filed, and continued a long-term trend by dropping as a percentage of all suits to 21 percent in Q1 2010 from 23 percent in 2009 and over 40 percent in 2004. Breach of fiduciary duty claims came in at 55 suits filed, down from a quarterly high of 85 suits in Q4 2009, but represented 31 percent of all suits filed, up from 25 percent in 2009, also continuing a long-term trend.

Financial firms were named in 31 percent of all securities suits filed in Q1 2010, remaining the most targeted sector despite that credit crisis- and Madoff-related securities suits dwindled to one suit filed for each. The number dropped significantly from almost 40 percent in 2009 and 42 percent in 2008. More important for financial firms wrapped up with credit crisis securities suits is that dismissals for these suits have been rolling in, with 62 dismissals against 32 settlements thus far, and 13 of those dismissals coming in Q1 2010. New filings for the past two quarters have been more dispersed among other industries as bankruptcies across-the-board resulted in securities litigation.

Being global phenomena, the demise of credit crisis- and Madoff-related suits also led to a falloff in suits filed against non-US companies, falling from 12 percent in 2009 and 20 percent in Q1 2009, to 10 percent in Q1 2010. While the number of suits naming non-US companies was down, the percentage of total securities suits filed is up from 6.3 percent in the previous quarter which also saw little filing activity from these two related-suit types.

Securities suits defined. The purpose of this report is to examine all sources of securities-related suits that impact management liability insurance policies other than ERISA liability suits. In addition to SCAS, this report encompasses a much broader set of suits, such as securities fraud, breach of fiduciary duties, derivative actions, collective actions and Ponzi scheme cases, among others.

Several analytic firms publish tallies of SCAS filed, but rarely do these tallies agree. In addition to the broad array of securities suits other than SCAS that Advisen covers, another issue is the way events are counted. In some cases, multiple companies (and their respective directors and officers) are named in the same complaint. Advisen counts each company for which securities violations are alleged in a single complaint as a separate suit. Advisen also includes securities class action suits filed in state courts in its SCAS tally.

The specific definition of each type of suit can vary as well, resulting in different lawsuit tallies. Advisen defines the major types of suits in this report as follows:

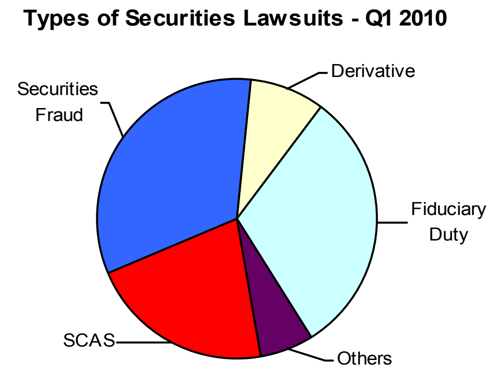
- **Securities Class Action:** suits alleging violations of federal securities laws, principally the Securities Act of 1933 and the Securities Exchange Act of 1934, filed by a private party on behalf of a class of persons injured by alleged violations.
- **Securities Fraud:** suits charging violations of securities fraud laws filed by regulators or law enforcement agencies. They also include cases brought by private parties alleging violations of securities laws that are not styled as class actions, and where more specific securities law violations are not made.
- **Collective Action:** similar to Securities Class Action; used in jurisdictions, outside of the US, where class action laws do not exist.
- **Breach of Fiduciary Duty:** suits alleging breach of fiduciary duty owed under the federal securities laws, primarily 15 USC Sec. 80a-35, or direct claims of breach related to securities and products whose sale or transfer is covered by securities laws. This includes merger, privatization or other transactions that involve public companies.

Master Significant Case and Action Database (MSCAd).[1] Advisen tracks significant lawsuits filed against companies and their directors and officers in MSCAd. MSCAd is the most complete and accurate database of such lawsuits, consisting of almost 40,000 events and over $900 billion in aggregate losses. Securities cases in MSCAd represent almost 6,000 events and over $80 billion in aggregate losses.

Advisen's MSCAd covers a full range of securities cases, categorized by type. Information about suits and filing details are available for purchase at Advisen's online store, Advisen Corner, at http://corner.advisen.com/reports_topical_sec_normal_home.html and available at no extra charge to Advisen members through their advisen.com logins. For more information please call +1.212.897.4800 or e-mail corner@advisen.com.

[1] On Advisen.com, MSCAd cases can be found under the "Losses & Exposures" tab, then click on "MSCAd".

Case breakdown



Of the 178 securities cases filed in Q1 2010, the 38 SCAS cases formed the third largest category. Securities fraud represented the largest category, accounting for 59 suits filed, down from 101 in Q4 2009, and represented a third of all securities suits filed. Securities fraud cases are largely the result of actions by regulatory and law enforcement agencies such as lawsuits or proceedings by the US Securities and Exchange Commission (SEC). State attorneys general and regulators are increasingly important actors in this arena. In Q1 2009, regulatory efforts consisted of 90 percent of these suits, or 53 of the 59 suits filed. The second most frequently filed type of case was breach of fiduciary duty suits at 55 suits filed in Q1 2010, rounding out the top three types of suits at 85 percent of all suits filed during the quarter. Other types of cases filed in Q1 2010 were derivative actions (15), and other cases (11).

SCAS cases comprised almost half of all securities lawsuits before 2006. They have been on a steady trend down in terms of percentage of suits, falling to 23 percent of all securities suits in 2009 and 21 percent in Q1 2010. However, securities fraud cases, reflecting regulatory efforts, remained steady as a percentage of all securities suits through recent explosive years as well as in the latest subdued quarter. As SCAS cases shrink as a percentage of suits, their mirror image seems to be breach of fiduciary duty cases, growing from 8 percent of all securities suits in 2004 to 25 percent in 2009 and 31 percent in Q1 2010.

The major jurisdictions of securities suit filings during Q1 2010 included:

- 46 suits in state courts;
- 24 suits in US District Court, Southern District of New York (mostly New York City);
- 14 suits in US District Court, Northern and Central Districts of California;
- 11 suits in US District Court, Massachusetts;
- 10 suits in US District Court, Northern, Southern and Eastern Districts of Texas;
- Seven suits in US District Court, Northern District of Illinois;
- Five suits in US District Court, District of Columbia;
- Five suits in US District Court, Western and Eastern Districts of Pennsylvania;
- Five suits in US District Court, Maryland;
- Four suits in US District Court, Southern District of Florida; and
- Four suits in US District Court, Western District of Washington.

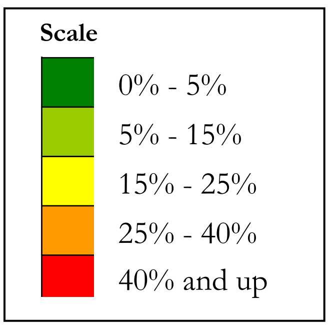
In Q1 2010, 17 suits (or 10 percent) of securities suits were filed against non-US companies, and one large suit was filed in a non-US court. In 2009, securities litigation against non-US companies reached 12 percent, with 5 percent of large cases filed in non-US courts. These numbers mostly accumulated early in the year, as Q4 2009 saw 6.3 percent of suits filed against non-US companies and under 2 percent in non-US courts.

Sector Impact Metric™ (SI Metric™)

Advisen Ltd. recently introduced two new Impact Metrics: Sector Impact Metric™ (SI Metric™) and Market Cap Impact Metric™ (MCI Metric™). This SI Metric™ measures the extent that securities lawsuits have played in each industry sector over the past decade. The Metric provides a visual compass tracking the changing seas of securities litigation throughout the past decade.

As demonstrated by the SI Metric™ charts, certain industries have been hit harder by securities litigation than others. Business news of the past couple of years has been dominated by the credit crisis and Ponzi schemes, resulting in financial services firms being principal targets of litigation. Scandals and alleged wrongdoings, however, have shifted throughout the economy over the past decade, providing ample fodder for law firms, shareholders, and regulators to initiate lawsuits against companies in other sectors.

The SI Metric™ gives two visual indicators of securities lawsuits in each sector per year, providing an effortless way to track trends by industry sector. The height of the bars indicates the percentage of securities suits that fell in each sector per year. The bars are color-coordinated to also reflect the frequency of suits per year for each sector: green (0%-5%); light green (5%-15%); yellow (15%-25%); orange (25%-40%); and red (40% and over).



SI Metric™

Sector	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 Q1
Energy	1%	3%	3%	3%	3%	3%	2%	4%	4%	9%
Materials	2%	3%	2%	1%	2%	1%	3%	2%	3%	3%
Industrials	8%	10%	11%	11%	8%	9%	9%	9%	8%	11%
Consumer Discretionary	13%	12%	16%	14%	19%	17%	12%	10%	12%	13%
Cons. Staples	2%	3%	4%	6%	6%	5%	5%	5%	3%	2%
Healthcare	6%	11%	13%	13%	15%	12%	11%	10%	12%	11%
Financials	8%	21%	26%	24%	18%	19%	28%	42%	39%	31%
Information Technology	48%	25%	19%	21%	21%	30%	24%	14%	15%	14%
Telecom.	7%	5%	3%	3%	5%	1%	2%	1%	1%	0%
Utilities	1%	5%	2%	2%	1%	2%	3%	2%	0%	2%
Other	2%	2%	2%	2%	2%	2%	1%	2%	3%	4%

Market Cap Impact Metric™ (MCI Metric™)

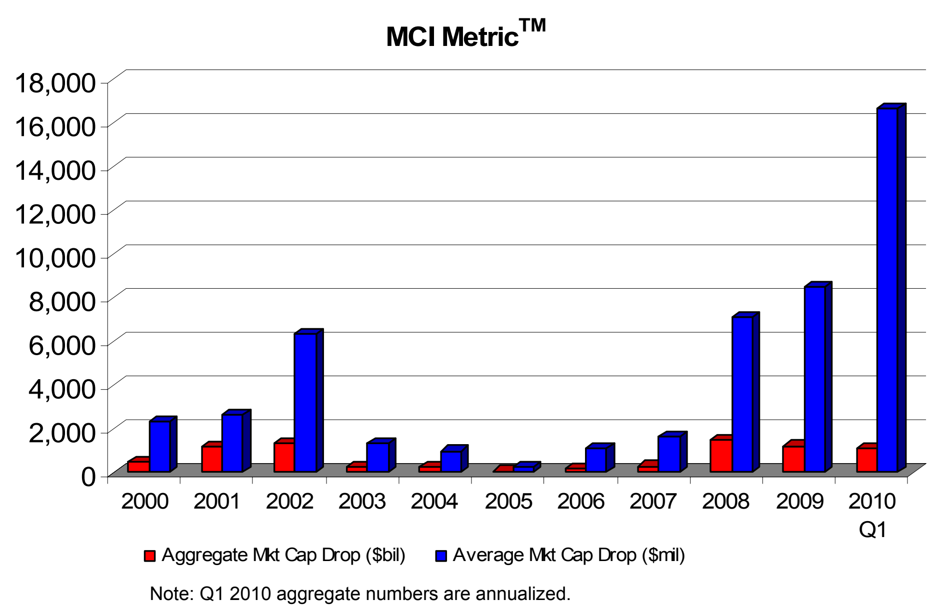
The second Impact Metric recently introduced by Advisen Ltd. is the MCI Metric™, a measure of potential damages due to SCAS lawsuits. This Metric measures the aggregate and average market capitalization drop around the "class period" of SCAS cases, which is the period of the alleged wrongdoing. For SCAS cases initiated by shareholders, courts will typically award shareholders who purchased shares in a company during the class period an amount based on their estimated losses due to the alleged wrongful act. A shareholder's initial purchase price during the class period is the court's typical starting point. Since the stock price will often rebound somewhat shortly after the class period, courts will usually consider the price approximately 30 days following the class period end date to consider an investor's losses.

The MCI Metric™ considers the market capitalization loss experienced by companies with SCAS suits, considering the typical starting and ending points for calculating damages to shareholders. Since claimants in any one case could have purchased shares on any date during the class period, Advisen considers the average market capitalization during the class period as the starting point. Advisen also uses the market capitalization 30 days after the class period end-date as the ending point for considering the company's market capitalization loss.

This market capitalization loss is calculated for most companies with a SCAS suit filed against them during each year of the past decade, with certain SCAS cases eliminated. SCAS cases eliminated from the calculations are those whose alleged losses are not tied to defendants' stock price losses, thus their potential damages are not tied to market capitalization losses. For example, Madoff-related SCAS cases with investors that experienced losses due to feeder funds investments in the Ponzi scheme claim losses that are not tied to the defendants' stock price. Other examples include losses experienced by auction rate securities investors, which are tied to the underlying security as opposed to the stock price of investment banks named in many of these SCAS cases.

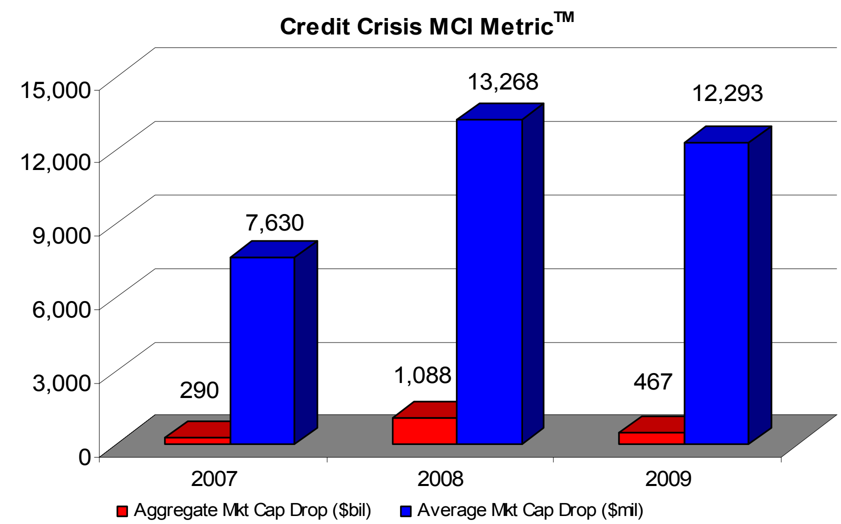
Aggregate losses and average losses are calculated by the MCI Metric™. The aggregate loss measures the total fall-off in market capitalization, using the method described, for companies with SCAS suits filed against them for each year. This number is a starting point for calculating damages, and is a useful benchmark for comparing the impact across years. The average loss measures the average fall-off in market capitalization per company and lawsuit. It provides an important new insight into the impact the average SCAS lawsuit could potentially have on the average company for each period.

The aggregate and average market capitalization losses have risen in recent years. Aggregate losses were $1.2 trillion in 2009 and 2008 saw $1.5 trillion in losses. In Q1 2010, the annualized



aggregate losses were $1.1 trillion. The losses in 2008 and many in 2009 reflect that most of the class periods occurred during the large stock market losses of the past couple of years. Since the beginning of Q2 2009, however, the stock market has been strongly rising, yet the aggregate losses remained high, indicating that this metric is measuring the falloff in stock prices of companies that have attracted SCAS, which is independent of the overall market.

The average market capitalization losses per lawsuit were $16.7 billion in Q1 2010, $8.5 billion in 2009 and $7.1 billion in 2008, possibly anticipating record payouts for securities lawsuits. Although the annualized aggregate losses in 2010 Q1 was down slightly, the average losses were sharply higher off of the already sharply-higher levels of 2008 and 2009. These losses compare to those of 2002, during the previous stock market downturn, which saw aggregate losses of $1.3 trillion and average losses of $6.3 billion.

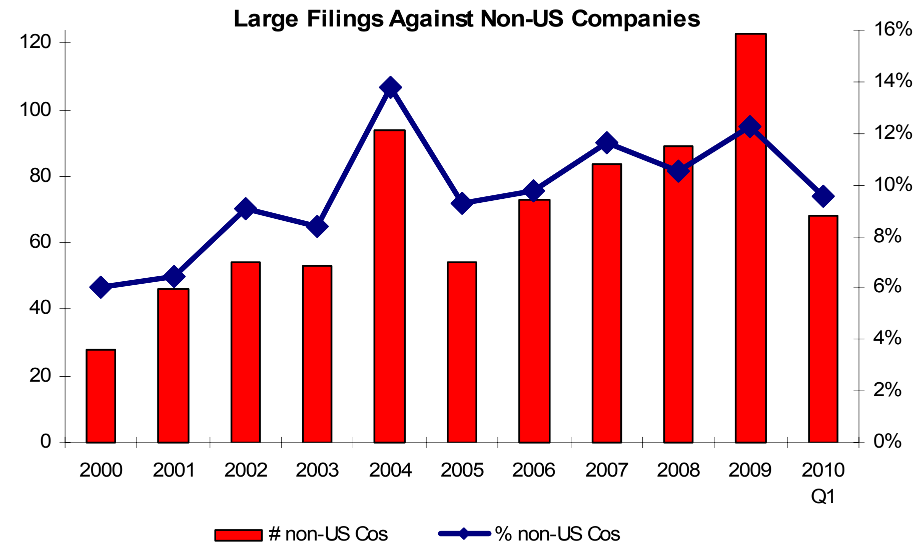


The credit crisis brought about its own set of related cases, which dominated securities litigation over the past few years. For credit crisis-related suits only, the hardest hit year was 2008, with $1.1 trillion in market losses. As the number of credit crisis-related securities lawsuits began to fall off from mid-2009, so have the aggregate market cap losses, while coming in still higher than 2007, at $467 billion. Interestingly, the average market capitalization losses for credit crisis-related cases far exceeded the overall average numbers, with 2008 at $13.3 billion per lawsuit, and 2009 at $12.3 billion. Of special note, this metric suggests that the average credit crisis-related securities lawsuit may settle for higher sums than other securities lawsuits.

Globalization of securities litigation

The globalization of securities litigation is seen in the long-term trend of a growing number of suits filed against non-US companies. Non-US companies once felt immune from US-style class action suits in courts in both the US and abroad. However, an increasing number of European companies agreeing to settlements in excess of $100 million makes one point crystal clear: securities litigation has become a reality of doing business for companies around the world. Any company with operations in the US, and particularly any company with shares trading on US exchanges, is subject to securities litigation (and other management liability-related litigation) in US courts. Furthermore, many countries around the world, especially in Europe, are "modernizing" their civil legal systems by providing greater access to court remedies through various collective action mechanisms. The end results are systems closer to the US class action system, and ultimately more suits with greater payouts from courts outside of the US. In addition, financial regulators around the world, such as the UK's Financial Services Authority, have stepped up enforcement efforts in the wake of the credit crisis, and increasingly work in consort with US authorities.

As the chart on the right shows, the number of large securities suit filings against non-US companies, filed in any court in the world and tracked by Advisen's MSCAd, is on a long-term growth path. In Q1 2010, the number of suits fell off as a result of the overall fall off in securities suits in the quarter. The percentage of suits is down a bit from 2009, but much higher than the 6.3 percent posted in the previous quarter. Given legal reforms around the world, this long-term growth path is expected to continue. The chart illustrates both the number of large securities suits filed against non-US companies over the past decade, and the percentage these suits represent of total securities suits filed.

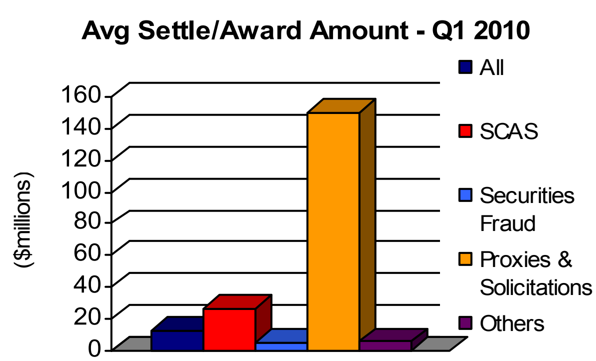


Note: Q1 2010 numbers are annualized.

Settlements and awards

In Q1 2010, 99 cases were settled/awarded, meaning that either a judgment came down awarding damages or a settlement was reached. Of the 99 suits, seven were cases with non-US companies as defendants and two were settled in courts outside of the US. The average settled/awarded amount for the quarter was approximately flat from the previous quarter at $12.9 million. The Q1 2010 results were significantly lower than full year 2009, which had an average settled/awarded amount of $18.2 million. The average for 2009 was disproportionately influenced by one derivative action suit in Q2 2009, which awarded almost $2.9 billion to shareholders derivatively on behalf of HealthSouth Corporation, against its former CEO Richard M. Scrushy. Without this one suit, the average settled/awarded amount for 2009 would have been $14.2 million. The average for Q1 2010 was low historically, with 2008 at $17.1 million, 2007 at $29.3 million, $35.0 million in 2006, $17.9 million in 2005, and $28.2 million in 2004.

By type of suit in Q1 2010, SCAS cases were the most substantive with an average of $26.3 million among 30 cases. Three of the top four settlements, with a total settlement amount of $424 million, were SCAS cases. The highest SCAS settlement, and highest of all settlements for the quarter, was a suit filed against Juniper Networks Inc., with a proposed settlement of $169 million. The network infrastructure company was accused of manipulating stock option grant dates. The second highest overall settlement for the quarter, also a SCAS, was for $165 million and involved Merck & Company. Merck



inherited this lawsuit via its acquisition of Schering-Plough Corporation. The suit alleged that the company failed to disclose material manufacturing operations deficiencies that would have a substantial impact on future revenue and earnings.

The second most substantive type of suit was securities fraud, with an average of $4.7 million settlement for 51 cases. After an elevated 2009 of $16.5 million average settlement, settlements for securities fraud cases fell off a bit in Q1 2010. Securities fraud cases are increasingly a threat to companies due to increased regulator activities. In addition to leading the number of cases filed in the quarter, securities fraud suits also led in the number of cases settled/awarded for the quarter at 48, more than half of all cases settled/awarded. The fifth highest settlement amount for the quarter was a securities fraud case filed against State Street Bank and Trust Company, at $58.4 million. In the suit, the SEC alleged that State Street misled investors about the extent of sub-prime mortgage-backed securities held in certain funds under management.

The largest type of suit in terms of average settlement for the quarter, and third most substantive type, was for proxy and solicitation violations, which consisted of one proposed settlement for $150 million. This one suit, an SEC action against Bank of America, had the third largest settlement amount for the quarter. The SEC alleged that in proxy materials, soliciting the votes of shareholders on its proposed acquisition of Merrill Lynch, Bank of America stated that Merrill Lynch agreed it would not pay year-end performance bonuses to its executives without Bank of America's consent. In fact, the suit alleged, Bank of America had already contractually authorized Merrill to pay up to $5.8 billion in discretionary bonuses to Merrill executives for 2008. All other types of suits averaged $5.5 million, consisting of 17 suits.

Trends

Dismissals roll in on credit crisis-related cases. It appears that the wave of credit crisis-related suits, and in particular suits filed against financial services companies, hit a crest in 2008 and Q1 2009. These lawsuits started growing in number beginning in February 2007. Through the end of Q1 2010, 1,039 total credit crisis suits have been filed. Of this total, 348 were securities suits. In Q1 2010, a mere one securities suit was filed related to the credit crisis issue, following Q4 2009 with three suits filed. This level is down substantially from the 49-suit Q1 2009 and 185 credit crisis-related securities suits in all of 2008. Credit crisis-related suits were more global than most types of suits. Of the 348 all-time securities suits related to this issue, 51 were filed against non-US companies, and 11 of the total suits were filed in courts outside of the US.

It remains to be seen if credit crisis suits will be dismissed at a higher rate than most types of suits, but dismissals appear to be piling up. Judges thus far have been reluctant to blame the results of an economic crisis on a company's management, as mistakes do not equate to fraud. If juries feel similar reluctance, defendants could win more cases, or at least plaintiffs could seek less ambitious settlements fearing a defendant-friendly jury. Many cases may be difficult to prove, and plaintiffs may be hard pressed to identify any specific actions by directors and officers that led to losses. Some suits that are not dismissed, however, may be subject to higher settlements and awards as suggested by Advisen's Market Cap Impact Metric™.

Recently, several high-profile cases have been dismissed due to similar logic by judges. For example, in a derivative action against officers and directors of AIG, alleging that the defendants failed to properly oversee the company's credit default contracts, the judge granted motion to dismiss on March 30, 2010. In granting the defendant's motion, the court stated that plaintiffs "may not support a claim based on the duty of oversight…merely by identifying signs of general difficulty in the market in which the company participates and asserting that the defendants should be held liable for exercising their business judgment in a manner that appears to have been inconsistent with those indications." The judge continued to claim that plaintiffs must support a claim that officers of the company "knew they were not discharging their fiduciary obligations" or "demonstrated a conscious disregard for their obligations."[2]

Of the 348 credit crisis-related securities cases filed, 32 have been settled as of the end of Q1 2010, and 62 dismissed. Just four cases have been settled for over $100 million, including: a $475 million proposed settlement against Merrill Lynch in a SCAS case in Q2 2009; a $406.5 million award against Credit Suisse in a securities fraud case in Q1 2009; and a pair of $150 million tentative settlements against Merrill Lynch in two SCAS cases in Q3 and Q4 2009.

The first quarter brought 13 dismissals of credit crisis-related securities suits, including 12 SCAS and one derivative action. All companies are in the financial services industry and three are non-US companies. Companies with dismissals of credit crisis-related suits in Q1 2010 included:

- ACA Capital;
- American International Group (derivative action);
- Canadian Imperial Bank of Commerce (Canada);
- Deutsche Bank (Germany);
- E*TRADE Financial;
- Fortis (Netherlands);
- Lehman Brothers;
- MBIA;
- Merrill Lynch;
- MGIC Investment;
- Residential Capital; and
- State Street (two SCAS cases dismissed).

Madoff-related cases also dwindle. Madoff-related cases filed since the fraud was disclosed on December 11, 2008 comprise 259 lawsuits in total through the end of Q1 2010, including 119 securities-only filings. One Madoff-related securities suit was filed in Q1 2010, following four in Q4 2009, down from 54 filed in Q1 2009. These cases represented a true global lawsuit phenomenon. Of the 119 all-time Madoff-related securities cases, 45 were filed against non-US companies, and 27 were filed outside of the US. This translates to 38 percent of Madoff-related securities suits filed against non-US companies, and nearly a quarter were filed in courts outside of the US with many involving non-US regulatory activity.

Non-SCAS gaining in importance. SCAS has fallen from almost half of suits filed in 2004 down to 28 percent in 2008, 23 percent in 2009, and 21 percent in Q1 2010. Securities fraud has been the leading case type, and in 2009 breach of fiduciary duty suits filed outpaced SCAS for the first time,

[2] Excerpts from Kevin LaCroix's *The D&O Diary* (www.dandodiary.com).

which continued into Q1 2010. The percentage has been on a long-term downward trend, as historically SCAS suits comprise the majority of securities suits.

In an effort to differentiate themselves in the competitive securities litigation marketplace, plaintiffs' attorneys increasingly have filed securities lawsuits alleging common law torts, contract law violations, and breaches of fiduciary duties. This often results in two advantageous outcomes for plaintiffs and their attorneys: (1) it may avoid having the suit consolidated with others in a large class action suit by alleging unique claims; and (2) by filing in state court, as opposed to federal, plaintiffs' attorneys have more flexibility to seek out states with plaintiff-favorable laws and lower pleading standards.

Complaints that allege breach of fiduciary duty in Q1 2010 dropped off from its all-time high pace in 2009, as all suit types did in the quarter, but the number of suits continued to build in terms of percentage of suits. At 55 suits filed in the quarter, breach of fiduciary duty suits represented 31 percent of all securities suits, the second largest suit type and far surpassing SCAS at 21 percent. Despite that this was a slow quarter across-the-board, this suit type hit an annualized level of 220 suits, higher than 2008, an overall litigious year, at 166 suits filed. Breach of fiduciary duty suits as a percentage of all securities suits before 2008 was often in the low double digits and single digits, with 2007 at 14 percent, indicating a new trend that began in 2008 and expanding further in 2009 and Q1 2010.

These suits are often connected with M&A activities, alleging that the directors of the defendant company did not negotiate a high enough price. With the Great Recession exposing weaker companies, M&A activities are likely to pick up as stronger companies seek strategic acquisition opportunities. More suits that allege breach of fiduciary duties will certainly follow, and the cost of settling such suits is considered by most when acquiring targets. These suits are often tried in state courts, with 39 of the 55 cases filed in Q1 2010 filed in state courts.

Although derivative actions have not grown in numbers over the past few years, they have grown in importance due to the emergence of large cash awards and settlements from a number of these cases. Most notably, in Q2 2009, a derivative action awarded almost $2.9 billion to shareholders on behalf of HealthSouth Corporation, against its former CEO Richard M. Scrushy. Historically, derivative actions were used by shareholders to force corporate governance and executive changes on the company. Since shareholders are suing the directors and officers on behalf of the company, it is frequently a matter of state law that the company is unable to indemnify its directors and officers for any losses.

The inability of corporations to indemnify their directors and officers for derivative action losses in most cases brings Side-A directors and officers (D&O) insurance into play, which covers directors and officers when companies are unable to do so. Side-A also comes into play when companies cannot indemnify their directors and officers because of limitations under federal securities laws or on account of insolvency. Side-A insurers recently were called upon to contribute $45 million to the $118 million settlement of a derivative action against Broadcom, triggered by allegations of stock option backdating. Even with the recent rise in bankruptcies and large derivative action settlements, rates for Side-A only D&O policies remain soft, underscoring the need for underwriting discipline for this coverage.

The number of securities fraud cases has been growing since 2007. In 2009, 377 securities fraud suits were filed, 23 percent higher than in 2008, which grew 13 percent over 2007. Securities fraud cases have been the leading type of case filed since 2004, and rose in terms of percentage of all securities suits from 36 percent in 2008 to 38 percent in 2009. In Q1 2010, they remained the leading suit type at 33 percent of all securities suits filed. The total settled/awarded amount for this suit type was the second highest for the quarter, totaling $240 million, about a fifth of all settlements/awards for the quarter.

More importantly, concerning securities fraud cases, the SEC plans to become more proactive in light of recent not-so-stellar events that exposed an image of the SEC as sleeping at the wheel. According to Reuters, SEC Chairperson Mary Shapiro told reporters "I like to tell the staff we are going to act like our hair is on fire." The fiscal 2011 budget (beginning October 2010) calls for 400 additional full-time equivalent employees, and the Obama Administration's proposed regulatory overhaul plan envisions much enhanced SEC authority. Securities fraud settlements often contain fines and penalties not typically covered under D&O policies, or other management liability policies, although defense costs may be covered. Furthermore, SEC actions often have a carryover effect on other types of securities suits, such as SCAS and derivative actions.

Changing risk landscape for SCAS. SCAS cases remain a vital watermark for securities litigation trends. In addition to remaining one of the most frequent types filed, SCAS suits often lead in average settled/awarded amounts, with Q1 2010 at an average of $26.3 million. Most of the top settlements/awards for the quarter were SCAS.

A type of SCAS that proliferated in 2009 and continued into Q1 2010 is a suit filed by plaintiffs who are not shareholders of the defendant company. For example, investors in a mutual fund as plaintiffs in a SCAS filed against the managers of the fund alleging the failure to disclose risky strategies. These types of suits are especially common during falling markets. The unusually large number of this type of SCAS does not necessarily announce a new trend, as these suits might be considered a byproduct of the credit crisis.

Though alleging violations of securities laws, many of these suits are likely to trigger coverage under E&O policies rather than D&O policies, and it is important to note that most E&O policies provide direct coverage for the entity whereas not all D&O policies do so. The wider array of events triggering SCAS underscore the range of exposures that need to be assessed in the underwriting process beyond those associated specifically with market capitalization drops. Market capitalization losses often are associated with stock market volatility. Stock markets substantially stabilized since the second half of 2009, but experts warn that D&O underwriters cannot afford to let down their guard.

More suits in state courts? A tactic explored by plaintiffs' attorneys in 2008 was filing SCAS suits in state courts, which also perked up in Q4 2009, but seems to have subsided again in Q1 2010. Breach of fiduciary duty suit types filed in state courts might have become the alternative. For this suit type, 35 of the 55 breach of fiduciary duty suits in the first quarter were class action suits and 26 of those 35 class action suits were filed in state courts.

The advantages of state class action claims over federal include forum-shopping for a more sympathetic state court, as well as avoiding the higher pleading standards for class-action status in federal courts. SCAS filed in state courts take advantage of a non-removal provision in Section 22 of the Securities Act of 1933 that permits cases alleging violations of the '33 Act to be tried in state courts. However, the Class Action Fairness Act of 2005 (CAFA), requiring larger multi-state class actions, which are minimally diversified, to be removed to federal courts, is considered a potential impediment to this tactic.

Whether the non-removal provisions of the '33 Act or CAFA govern these cases is being debated in the courts. In July 2008, the US Ninth Circuit Court ruled that no securities claims alleging violation of the '33 Act could be removed to federal courts in what was seen as a precedent-setting case, *Luther v. Countrywide*, a sub-prime mortgage-related suit originally filed in California Superior Court for Los Angeles County. In claiming that the provisions in the '33 Act trump CAFA, the court relied on a canon of statutory construction stating that the specific should control the general. This case potentially opened the floodgates to securities-related cases filed in state courts.

However, in January 2009, the Seventh Circuit Court in *Katz v. Gerardi* reached exactly the opposite conclusion: the provisions of CAFA trump Section 22 of the '33 Act. The court noted that the '33 Act's non-removal provision is incompatible with CAFA's jurisdiction and removal provisions. But the court claimed that it was unnecessary to consult canons of statutory construction, dismissing such canons as mere "doubt resolvers." The court points out that CAFA specifically addresses its applicability to securities cases, as it specifically lists exceptions to removal of securities cases.

How this issue plays out in other federal circuit and appeals courts is yet to be seen. It appeared through the first three quarters of 2009 that plaintiffs' attorneys mostly avoided this issue by filing other types of suits, such as breach of fiduciary duty rather than SCAS, in state courts. The fourth quarter of 2009 saw an increase in state SCAS activity, but this has dwindled again in Q1 2010. Many non-SCAS suits filed in state courts were brought by shareholders, suggesting that a number could have conceivably been filed in federal courts as SCAS cases, steering clear of the non-removal issue in these cases.

CAFA might begin to encourage more class action suits, perhaps having the opposite effect as originally intended by its defendant-friendly drafters, given a March 2010 Supreme Court decision in *Shady Grove Orthopedic Associates v. Allstate Insurance*. In this case, the Court ruled that certain class actions barred by state law may nevertheless proceed in federal courts. Under CAFA, when state class actions are required to be removed to federal court, federal courts must apply state "substantive" law and federal "procedural" rules. The recent Supreme Court decision allows certain state provisions that limit class actions to survive in federal court, but these provisions must be judged on a case-by-case basis as part of a state's "framework of substantive rights or remedies." In other words, if a court rules that the state's "substantive" law prohibits a class action, then the prohibition stands in federal courts. The case may proceed in federal courts, however, if the state's prohibition is ruled as merely "procedural." The case is by no means a wholesale opening of class action suits barred by state law into federal courts. The end effect, however, will allow certain class action suits to proceed in federal courts that might have otherwise been prohibited by state laws.

Regardless of suit type, the number of suits filed in state courts is on the rise, reaching over a quarter of all securities suits in Q1 2010. State courts viewed as one jurisdiction remained the No. 1 jurisdiction for new filings for the fourth quarter in a row. Of the 46 suits filed in state courts in the first quarter, the breakdown by suit type was: 39 breach of fiduciary duty; six derivative actions; and one SCAS.

Defense costs spiraling up. Although difficult to track, most insurance industry observers agree that defense costs have been mushrooming over the past years, particularly in 2009 and Q1 2010. Typical SCAS cases for large companies are often quoted at costing a minimum of $10 million to defend, and in certain cases costing in excess of $100 million.

No simple solutions to reigning in these costs exist for insurers. One factor in rising defense cost is the shear complexity of these lawsuits, often involving multiple allegations and defendants. Adding to complexity are often-present tagalong derivative claims and ERISA claims, and possibly even SEC or Department of Justice (DOJ) investigations. This complexity increases defense costs and ultimately drives up the cost of claims for insurers. Another factor contributing to escalating defense cost is the need for multiple defendants to secure their own defense counsel, and the perception that the best counsel is the most expensive. This perception is not necessarily based in reality, but insurers must deal with it in any case.

Skyrocketing defense costs raise the prospects of the need for higher D&O coverage limits, as defense costs can eat away at policy limits with little-to-no coverage left for indemnity. The underlying facts of cases have become increasingly complex, elevating attorney fees, leading to defendants exhausting their policy limits more quickly. Customers may assume that brokers just want them to buy more insurance, so they have their guard up. A frank discussion about defense and settlement costs may enable customers to come to the conclusion that higher limits are a sound decision.

In this world of super-sized defense costs, increased importance is placed on carefully selecting excess carriers. If the defense can prevail on a Motion to Dismiss, defense costs often can be kept under control, but can rapidly escalate during discovery if the Motion to Dismiss fails. In some cases, the primary limit can be exhausted by defense costs, leaving the first and possibly second excess carriers to take the lead role from a coverage and settlement standpoint. In those scenarios, selecting excess carriers could become more important than selecting primary carriers – and it is essential to carefully review policy provisions dealing with the claims process.

The heightened financial institution regulatory structure expected to pass through Congress, in conjunction with an already planned beefed up SEC, is cause for concern among insurers. Many are concerned that defense costs and settlements could rise with increased regulatory oversight. If more regulators look for problems, more problems will likely rise up. Companies that take due care in following new requirements, however, could be exposed to less risk, and risk levels of individual companies could become easier for underwriters to assess.

Another issue that could impact defense costs is budget cuts to court systems. With tax revenue shortfalls, many state and federal courts have experienced cutbacks in funding, which will certainly delay cases through the legal system. As cases spend more time in the court system, defense costs could increase. It is yet to be seen whether defendants are more likely to pursue a settlement early in order to avoid mounting defense costs.

SEC unveils its cooperation initiative. Since the credit crisis, and the ensuing political storm, regulatory authorities have stepped up enforcement efforts, beefed up enforcement teams, and began coordinating efforts. The SEC, DOJ and state enforcement officers like attorneys general are more likely than ever to coordinate prosecutions, sharing evidence and information, making successful prosecution at all levels more likely. US regulators and enforcement agencies have also coordinated their efforts with regulatory entities in the EU and elsewhere, and most notably with the UK's Financial Services Authority. These parallel proceedings have contributed to spiraling defense costs, even in cases with no wrongdoing. Additionally, in January 2010, the SEC threw a curveball at corporate executives and their insurers.

In January, the SEC announced a set of tools as part of its new cooperation initiative. These tools, used by the DOJ in criminal proceeding for years, authorize the SEC Enforcement Division to provide limited immunity to many cooperating parties. The three tools include: cooperation agreements; deferred prosecution agreements; and non-prosecution agreements. Cooperation agreements are written agreements that the Enforcement Division could offer to cooperators who provide substantial assistance and agree to cooperate fully. The cooperator must waive statutes of limitation, but does not need to admit or deny any violations. The Division would then recommend to the SEC that the cooperator receive credit for assisting in the investigation, but it is not binding on the SEC.

Deferred prosecution agreements are also written agreements to cooperate fully. The cooperator would agree to either admit or not contest relevant facts underlying the alleged offenses, and to pay disgorgement and penalties. The SEC would agree to forego prosecution during a period of time, not to exceed five years. After the deferred period, the SEC could authorize enforcement, and any admission of facts could be used against the cooperator. Non-prosecution agreements are written agreements with those cooperating fully, where the SEC agrees not to pursue enforcement action against the cooperator. This agreement will be used under "limited and appropriate circumstances," and the cooperator would agree to pay disgorgements and penalties.

Most assume that more cooperation will result from this initiative, but the degree of cooperation will depend on the details of the agreements. In March, the SEC announced a possible policy change that would work against the tide of cooperation. The SEC might end its long-standing practice not disclosing many details of evidence from cases where companies and individuals cooperated. These details could reveal facts that would prevent indemnification from insurance policies, and possibly open the floodgates to SCAS and other lawsuits using these facts as a basis for their cases.

Cooperation initiatives could help to lower defense costs and lower insurance policy payments if most officers agree to cooperate. It also could increase overall defense costs depending on the dynamics of the case for a given company. A change in disclosure policies would make it less likely for officers to cooperate for fear that embarrassing and incriminating evidence would be released. It would at least delay cooperation to ensure that the increased number of facts is reasonably stated, prolonging negotiations with the SEC.

Any agreement that admits to liability would likely void coverage of defense costs for most D&O insurance policies. Furthermore, depending on the terms of the policy, if one director does something to void coverage, it may void coverage for all directors and officers, placing the company and all officers at risk. Looking at the specific restrictive provisions in policies becomes vital when agreeing to cooperation.

E&O and fiduciary liability policies could take a hit. Although securities cases have traditionally triggered coverage under D&O policies, many securities cases over the past two years may also trigger coverage under errors & omissions (E&O) and fiduciary liability policies. In a trend that started in 2008 and continued into 2009, many cases have dealt with credit crisis issues, and with Madoff and other Ponzi scheme issues. These suits, dealing with professional judgment and fiduciary duties may be excluded under D&O policies and covered under E&O policies. Fiduciary liability suits alleging violations of the Employee Retirement Income Security Act of 1974 (ERISA), the claim in many Ponzi scheme cases, may trigger fiduciary liability policy coverage.

In some cases, the same underlying cause of loss will trigger losses under D&O, E&O and fiduciary liability policies, resulting in aggregations across lines of business. Some allegations found in a securities suit that triggers E&O coverage may resurface in shareholder derivative suits, which can trigger coverage under Side A of a D&O policy. A recent trend for some Side-A DIC D&O policies is wording that clearly covers ERISA liability, sparking D&O policy liability for ERISA suits.

Financial services still lead, but filing becoming more dispersed. Financial services firms have been much more likely to have a securities lawsuit filed against them since 2008 than firms from any other sector. Out of the 178 securities suits filed in Q1 2010, 55 of them named financial services firms, or 31 percent. This is down from 2009 when 39 percent of all securities suits filed named financial services firms, and 2008 was at 42 percent. The height for financial service firms was in Q1 2009 when 54 percent of all securities suits were against financial service firms, which was a credit crisis- and Madoff-laden quarter.

The number of suits against financial services companies over the past couple of years, even the lower level in Q1 2010, is significantly higher than the approximate 20 percent-level of past years. Many of these suits were filed against a small group of large companies. More suits may yet surface against smaller banks and other financial institutions. Continued bankruptcies, high unemployment and deteriorating credit quality of bank customers may ensure this outcome.

In 2008 and the first half of 2009, most of the activity against financial services firms dealt with segments outside of insurance. As litigation evolves beyond the credit crisis- and Madoff-related cases, more attention has been focused on insurance firms. Insurance firms attracted 11 and 12 suits respectively in each of the last two quarters of 2009, or about 4.5 percent, and 12 suits in Q1 2010, or almost 7 percent of all securities suits.

As bankruptcies rise through the economy, hitting all industry sectors, and securities suits are filed as a consequence, suits filed have become more dispersed and broadly affect almost all sectors. A wider spread of suits by industry sector was observed in the first quarter, as financial services firms dropped in percentage of total suits to 31 percent, and other sectors picked up, such as information technology (14 percent), consumer discretionary (13 percent), healthcare (11 percent) and industrials (11 percent).

Critical cases

Ten events made up almost 70 percent of the settled/awarded amounts for Q1 2010, totaling $871 million among the 10. The breakdown of the top 10 suits by type includes: five SCAS cases, three securities fraud case, one proxy and solicitation violation and one breach of fiduciary duties case. All but one were in US federal courts, with one in a state court, and nine of the 10 cases involved US companies as defendants.

More information about suits and filing details is available for purchase at Advisen's online store, Advisen Corner, at http://corner.advisen.com/reports_topical_sec_normal_home.html and available at no extra charge to Advisen subscription members through their advisen.com logins. For more information please call +1.212.897.4800 or e-mail corner@advisen.com.

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