You Sold it for What?

New Trend in Suits by Shareholders Who Claim Company Was Sold For Too Little

Everyone remembers the famous movie teaser for *Jaws 2*: "Just when you thought it was safe to go back in the water . . ." It applies to trends emerging in lawsuits by shareholders and regulators, trends that have significant implications for directors and officers liability coverage.

According to studies by both Advisen and Stanford University, securities lawsuits relating to the credit crisis may have peaked, but are being overtaken by a new trend. Advisen notes a substantial increase in the number of suits filed by shareholders claiming breach of fiduciary duty in the sale of the company. These suits are usually filed by shareholders of an acquired company who claim the sellers sold out for a low-ball offer, cheating them of the gains they deserved. Perhaps this is no surprise. Company values are low in this business environment. Buyers with capital to purchase companies are demanding bargain basement prices. And shareholders are looking for an edge to increase their share value. Shareholder plaintiff attorneys are plentiful and all too eager to represent them in breach of fiduciary responsibility suits. More and more of these cases, according to Advisen, are being filed in friendly state courts, rather than in courts traditionally thought favorable to shareholder litigation, such as federal courts and more conservative state courts. Coupled with the BP oil spill suits and the winding down of credit crisis-related suits, these new actions seem likely to combine to form another new record for securities lawsuits in 2011.

The Worst Might be Yet to Come And the Worst Might Not be Over

Companies are just beginning to feel the effects of the Dodd-Frank Act passed in 2010, which expanded the Securities and Exchange Commission's and Department of Justice's ability to enforce federal securities legislation with respect to fraudulent activities of U.S. companies doing business out of the country. The SEC has begun collecting public comment and conducting a study on whether to extend the federal anti-fraud laws to cover a company's behavior outside the U.S. In addition, states are beginning to react to this trend by filing suits in state court against companies on fraud charges. While some local officials are filing such suits to stop potential criminal activity, some believe another motivation for such suits is to fill depleted state bank accounts with the enforcement settlements that can result from such suits.

Fortunately, insurance markets appear to have reacted well to these trends, as D&O insurers eager for new business compete for the best risks. This is leading to favorable pricing in markets, making the expansion in D&O liability exposure a little easier to swallow.

The new regulatory environment is a game-changer for companies and their D&O insurers. For instance, the SEC recently issued rules about compensation for company executives and when a

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company must disclose business climate changes. Dodd-Frank might also encourage more of these investigations because the financial incentives for so-called whistleblowers have grown. A person who provides the SEC with substantial leads can recover a large amount of money if the SEC investigation results in recovery of more than $1 million.

Another effect that robust regulatory activity has on the D&O insurance market lies in the relative formality of an SEC or DOJ investigation. When an investigation is informal (meaning that no subpoena has been served or formal court document has been filed), the target rarely perceives the informality. A company or individual director or officer can be called upon to produce millions of documents, at substantial cost, when cooperating with an "informal" SEC investigation. Not cooperating is not much of an option, because regulators often decide whether or not to prosecute based on a respondent's relative helpfulness. Yet most traditional D&O policies cover only the costs of responding to a formal investigation, leaving a key component of loss – the cost of responding to an informal investigation, which can run into the millions — an uncovered by insurance and expensive albatross around a company's neck.

Very recently, several insurance carriers began to offer coverage for informal investigations. The coverage is expensive and as yet untested in the marketplace. Many companies will watch from the sidelines for awhile before buying this coverage, letting others be the guinea pigs.

As for the future of such suits: representatives on an Advisen webinar said to watch out for the regulators' favorite whipping boy of the year. In 2010 it appeared to be for-profit colleges and universities. Once federal regulators start going after a targeted sector, state prosecutors often follow. And plaintiffs' attorneys will not be far behind. ▲