

Federal Securities Class Action filings: The "1,000 claim backlog"

Authors and conference speakers addressing the current D&O liability landscape often raise the specter of the "1,000 claims" inventory. This emotive concept refers to the fact that every year since at least 1991 Securities Class Action filings have outpaced settlements, so that with each passing year the number of unresolved cases grows, casting a progressively larger shadow on D&O insurance carriers who must eventually pick up most of the tab. This issue of CUG.COMments examines this concept in light of historic facts and offers some thoughts for the future.

Security Class Action Filings

1991-2003

From 1991 through 2003 there were a total of 2,650 federal Securities Class Action filings. This excludes two anomalous batches of claims due to first, the IPO "laddering" cases that occurred mostly in 2001 (303 cases), and second, the "analyst" cases that alleged analyst stock purchase recommendations were compromised by their company's desire for lucrative investment banking business (54 cases).

During the same period there were a total of 1,637 settlements, and 341 cases were dismissed. The 2,650 filings minus settlements (1,637) and dismissals (341) leaves a total of 672 open cases.

However, there is a potential flaw in this calculation; some settlements and dismissals occurring after 1991 would have been for cases filed before 1991. This has the effect of artificially reducing the number of open claims. Conversely, there are almost certainly cases still pending from before 1991 that would increase the open total. Precise data on this is hard to find; perhaps the best that can be said is that the true number of open Securities Class Action lawsuits is more than 672 but probably less than 1,000.

Average Settlement Values

The "laddering" and "analyst" cases have not yet settled and so have no impact on the average

settlement amount. Also excluded is the extraordinary 2000 Cendant settlement of around \$3.2 billion. Without Cendant the average settlement from 1991 through 2003 is \$15.45 million (with Cendant the number jumps to \$ 17.15 million).

It may, however, be more relevant to take an average of the past six years, in which case the average settlement value (without Cendant) increases to \$17.9 million. (It should be noted that not every "settlement dollar" is paid for by insurers. Large retentions can reduce carriers' ultimate exposure, and some settlements included within the average exceeded the insurance limits of liability or were not insured at all.) Most alarming, this increased average does not reflect the inevitably huge settlements yet to occur in the still pending litigation arising out of the many recent debacles such as Enron, WorldCom, Adelphia, HealthSouth and Tyco.

Average Rate of Settlement

If there were 1,637 settlements from 1991 through 2003, that is an average of about 125 settlements a year. If this average is maintained it means there is a reasonable expectation that the "backlog" will continue to produce a pure-loss impact of around \$2.238 billion annually (125 times \$17.9 million) to the D&O market.

Other Factors

This estimate of \$2.238 billion is based on historic data with some cautious assumptions. But although the past might be a helpful guide to the future, for a more complete assessment we should consider other factors, whose impact in some instances is yet to be determined.

Defense costs

Defense costs are not included in the above numbers, but historically they have been significant and they are almost certainly increasing. A case that takes around two years to settle (a very typical time frame) can expect to produce considerable expenses. Among the more notorious cases, costs have exploded: D&O defense costs in the Enron litigation already exceed \$100 million. It is therefore not unreasonable to assign an extra 15% to address defense expenses. This would increase the notional annual cost to around \$2.57 billion. It should also be remembered that even cases which are ultimately dismissed can inflict substantial costs on the carriers.

Interest rates

Interest rate and investment return levels continue to be low, especially from the government and investment grade bonds that form a large part of insurance company portfolios. This means underwriting results will not be bolstered by investment income.

Plaintiffs opting out of class actions

Unhappy with corporate behavior and unsatisfied by the typical class action rewards, large institutional shareholders are bringing with increased frequency legal action independent from any class action. They feel this increases their chance of a more substantial recovery. As this trend develops, the D&O market will be faced with an unwelcome aggregation of loss from the same event; and of course legal fees will rise significantly.

Derivative Actions

Formerly a negligible source of losses, derivative actions are now being taken up by plaintiff lawyers who miss out on the spoils of the primary class action. While it is

expected that derivative settlements and judgments will remain small in comparison, defense costs and settlements will impact policy limits.

Conclusion

The D&O claims backlog, whatever the precise number, is substantial and will continue to provide a "reverse-annuity" drain on the D&O market for the foreseeable future. Constant replenishment seems assured: 63 filings in 2004 so far.

The burden imposed on D&O insurers reinforces some established truths:

1. The backlog provides data which insurers must use to realistically address the adequacy of their loss reserves. Correct reserving for this business will be critical and failure to do so could be terminal, as demonstrated by the demise of Kemper last year.
2. As a result, insurer financial strength becomes even more important. The \$2.5 billion annual obligation is a realistic baseline estimate, but what if a succession of "anomalous" losses occurs and significantly increases that number? The IPO "laddering" claims and the "analyst" claims tend to be viewed as unusual -as we do here- but they are about to be joined by the Mutual Fund scandal as yet another possible \$1 billion event. The March 2004 edition of the *PLUS Journal* (page 13) contained an article that estimated the backlog could eventually cost as much as \$75 billion: maybe that is closer to reality.
3. Current D&O premiums must take into account the impact of the claims backlog as a predictor of future experience, and be set accordingly. Although it is tempting for insureds, brokers and even insurers to ignore the sobering reality of this huge backlog in order to request and offer lower premiums today, that type of short-sighted "cash flow" underwriting seriously jeopardizes both the stability and viability of this important insurance product in the long run.

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