

**D&O What's Next?**  
September 20, 2010  
Lake Buena Vista, FL

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**Antitrust Notice**

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Chubb, Box 1615, Warren, NJ 07061

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## Randy Hein

- Vice President and Quantitative Analytics Mgr
  - Predictive Modeling
  - Vendor Management
  - Referral Underwriting
  - Product Management Support
- MBA – Case Western Reserve University, OH
- BS – Miami University, OH

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## Industry D&O Results

- Schedule P – Other Liability includes many lines
- Securities Class Actions (SCAs) account for most D&O loss costs for Publicly-Traded companies
- Many commentators publish SCA statistics
- Understanding the commentators' audience is essential

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## Industry Commentators

- Advisen
- Cornerstone Research
- D&O Diary Blog
- NERA Economic Consulting

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## The Counting Game

- A publicly-traded company, its law firm and auditor are sued in 7 lawsuits alleging the same violations over a two-year period. What is the relevant “Count”?
- Correct Answers
- 21 “defendant lawsuits”
- 1 to 7 “lawsuits”
- 1 “public company”

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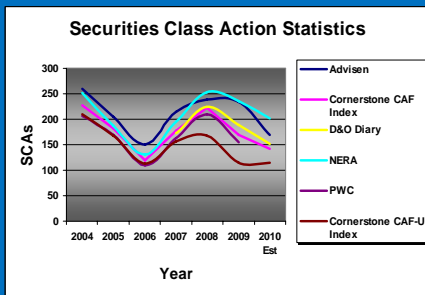
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## The Counting Game




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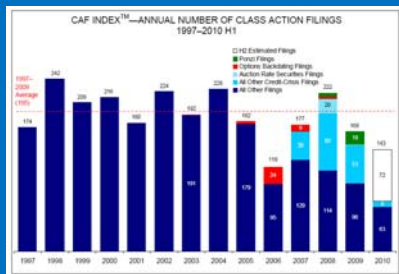
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## SCA Statistics



Source: Cornerstone Research

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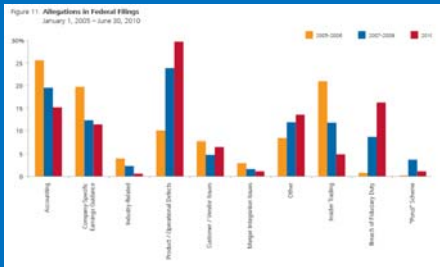
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# Allegations



Source: NERA Economic Consulting

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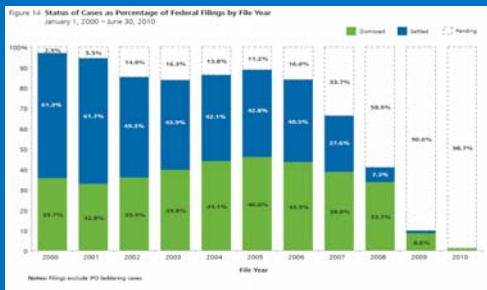
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# Case Status



Source: NERA Economic Consulting

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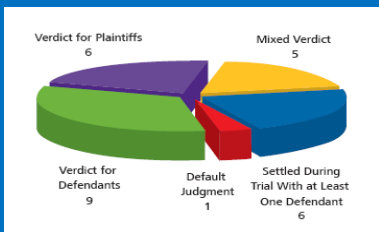
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# Trial Verdicts



Source: NERA Economic Consulting

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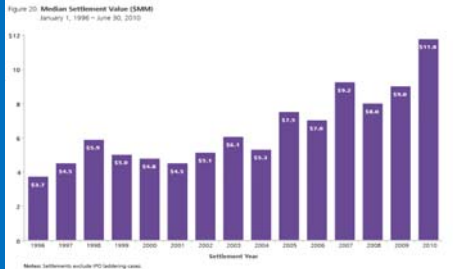
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## Median Settlement Values



Source: NERA Economic Consulting

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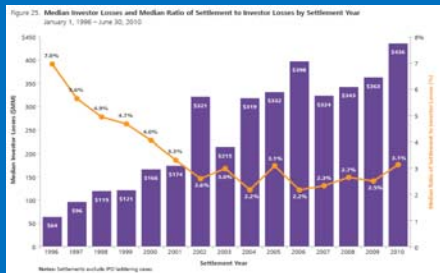
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## Median Investor Losses



Source: NERA Economic Consulting

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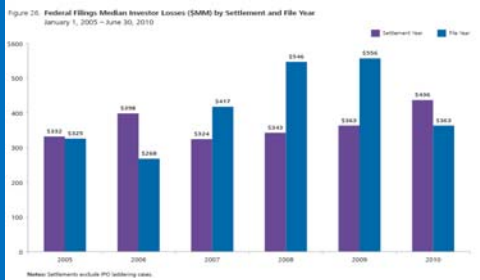
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## Filing Year v Settlement Year



Source: NERA Economic Consulting

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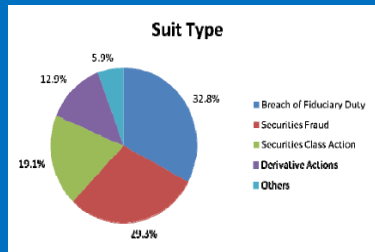
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## Suit Type



Source: Advisen

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## What's Next

- Macro-Economic Conditions
  - M&A Activity
  - Bankruptcies
- Dodd/Frank Financial Reform
  - Whistle-Blower Rewards
  - Salary Claw-backs
  - Study on Private Right of Action for Aiding and Abetting
  - Study on F-Cubed Case Resolution

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## D&O What's Next?

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D&O Liability: Post Crisis

Athula Alwis

CLRS 2010

September 20, 2010

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Agenda

- Introduction
- Post Crisis Environment
- Trends
- Data
- Modeling
- Q & A

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## Introduction

- *Excellent opportunity to enter a large market at a point of significant change*
- *A very strong parent with a solid capital base*
- *A+/\$15M paper*
- *A very experienced team*

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## Introduction

- *Philosophy of writing high excess and A – side business*
- *Management of limits*
- *High quality accounts*
- *Industry diversification*
- *Good opportunities in a stressed market*

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## Post Crisis Environment

- *Number of credit crisis related SCA law suits has decreased*
- *Recent subprime related settlements, on average, have been encouraging in terms of loss dollars*
- *Madoff, other Ponzi Schemes, auction rate securities*
- *Banks and Financial Regulation*
- *“Mega claims” in the horizon?*

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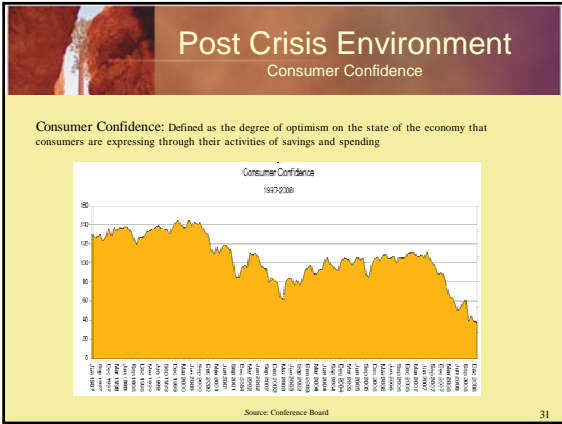
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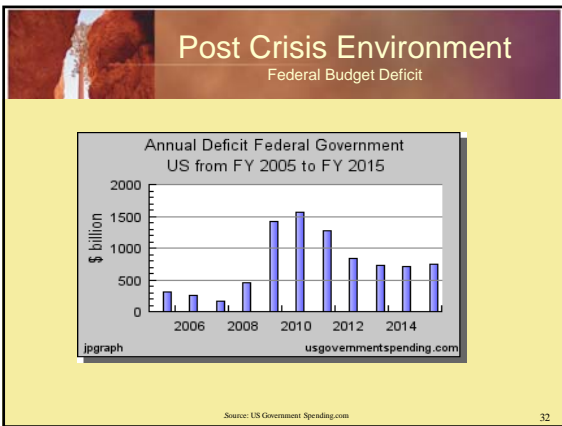
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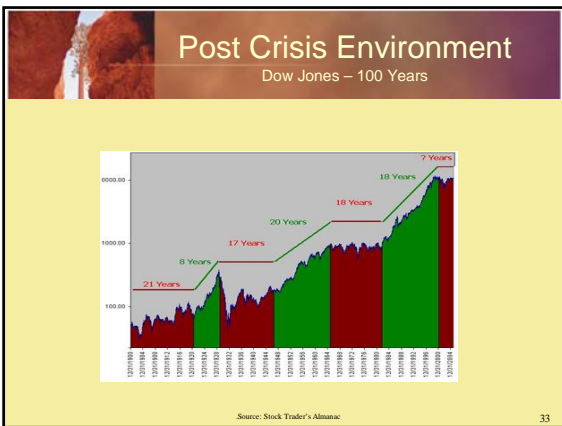
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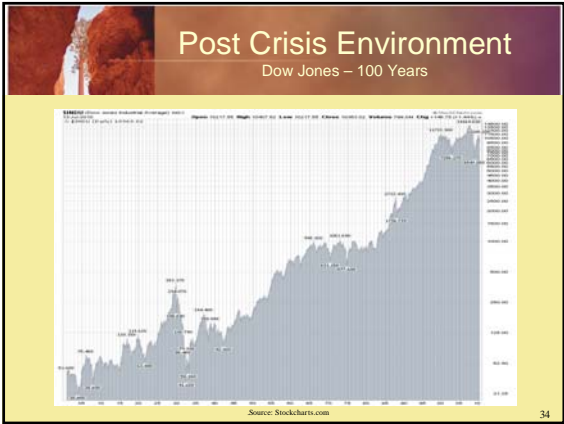
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### Post Crisis Environment

Regulation/Supreme Court Cases

- *Effect of Sarbanes – Oxley (2002): Regulation of corporate governance and financial practice*
  - *Set a number of non-negotiable deadlines for compliance*
  - *Cannot be used to plead an inference of scienter*

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**Post Crisis Environment**  
Regulation/Supreme Court Cases

- *Effect of Dura Pharmaceuticals Inc vs. Broudo (2005):*
  - *A casual connection between the misrepresentation and the economic loss – Causation*
  - *Rejected plaintiffs “price inflation” theory*

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**Post Crisis Environment**  
Regulation/Supreme Court Cases

- *Effect of Tellabs Inc vs. Makor Issues & Rights, Ltd (2007):*
  - *An inference of scienter must be more than merely plausible or reasonable*
  - *A reasonable person could infer that the defendant acted with require intent*
  - *A strong inference that the defendant acted with the required state of mind*

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**Post Crisis Environment**  
Regulation/Supreme Court Cases

- *Stoneridge Investment Partners, LLC vs. Scientific Atlanta Inc (2008):*
  - *Parties with some role in fraudulent conduct but do not themselves make a misrepresentation or engage in deceptive conduct cannot be sued under implied private litigation rights of 1934 Act*

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## Post Crisis Environment

Regulation/Supreme Court Cases

- *Morrison vs. National Australia Bank (2010):*
  - Application of the federal securities laws to lawsuits brought
    1. By *foreign* investors
    2. Against *foreign* issuers of securities
    3. Based on transactions on *foreign* securities exchanges
  - A “*foreign-cubed*” or “*F<sup>3</sup>*” transaction

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## SCA Statistics

(from Randy Hein’s Presentation)

Figure 1: Federal Filings  
January 1, 1996 – June 30, 2010

Year	Total Filings
1996	171
1997	202
1998	276
1999	241
2000	238
2001	196
2002	241
2003	212
2004	242
2005	187
2006	131
2007	196
2008	248
2009	221
2010	202

Source: NERA Economic Consulting

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## Trends

- Overall frequency is up again to historical stable averages
- 2006 seems like an anomaly in terms of counts (however loss amounts are increasing for 2006 settlements)
- Emergence of new classes (For-profit educational entities)
- Increased M&A activity

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## Trends

- *Rate changes (so far limited to give backs?)*
- *Capacity*
- *Insurance Carriers that were under pressure due to Credit Crisis*
- *Reinsurance*

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## Trends

- *Next bubble in a low interest rate environment?*
- *Instability in oil prices*
- *Role of Private Equity*

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## Data

Three key elements to consider when reserving D&O losses

- *Data*
- *Contagion Risk*
- *Systemic Risk*

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## Data

- Historical data for traditional SCAs (Securities Class Actions) available through commercial vendors
- Requires scrubbing and cleansing
- Manual work

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## Data

- Use more than one vendor
- Regular updates
- *Differentiate data based on appetite (ex. ADRs )*

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## Modeling

Contagion Risk

- Institutions connected through one or more parameters deteriorating at the same time
- Mutual fund cases
- Analysts cases
- Subprime lending cases  
(as of June 2010, 183 open, 10 settled and 33 dismissed)



Source: Reuters

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**Modeling**

Systemic Risk

- The movement of the entire market in a downward cycle
- Financial Crisis
- Climate change
  - Carbon Disclosure
  - Mandatory climate risk disclosure



Source: Wikimedia Commons

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**Modeling**

Systemic Risk

- Pollution (Interpretation of the pollution exclusion)
- Energy crisis
- Water



Source: Wikimedia Commons

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**Modeling**

Systemic Risk

- Double Dip recession
- Unemployment over 10% again
- National home prices dropping further
- Another cycle of law suits? (anyone left to sue?)

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**Modeling**

Exposure Based Modeling

- Market Cap
- Change in market Cap



Source: GETTY

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**Modeling**

Parameters for reserving

- Market Cap loss during class period
  - Plaintiff friendly
  - Carrier friendly
- Maximum dollar loss
- Bounce back effect
- Stock price movement compared to sector movement

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**Modeling**

Predictive Modeling

- Stock price movement
- Option pricing
  - *D&O contract as a put option protecting shareholder value*
- Debt markets (CDS Pricing)
- GLM

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**Modeling**  
Expected Loss Ratio Pick

- Pick a loss ratio based on UW experience, judgment and intuition
- Historical loss ratios of similar companies
- Adjustments for market trends, contagion risk and systemic risk

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**Modeling**  
Expected Loss Ratio Pick

- Risk appetite (primary vs. excess, ABC vs. A-side,...)
- Expected loss ratio based on market cycle (as opposed to 3 to 5 previous years)
- Loss ratio indication based on a holistic view

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**Questions**



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D&O Liability: Post Crisis

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