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Insurance reserves, shareholder litigation and SEC enforcement

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Publicly held insurance companies are increasingly the target of shareholder actions and SEC scrutiny.

Public insurance company executives and directors are acutely aware that announcements of material reserve deficiencies or strengthening can lead to collateral consequences including regulatory scrutiny, rating agency implications, goodwill impairment charges and potential breach of credit agreement covenants. Recent trends from the plaintiffs' securities bar and the SEC suggest an additional concern: private securities litigation, SEC investigations, and shareholder demands and derivative actions.

For instance, 150 companies were the subject of private securities class actions in the past year alone, including a number of insurance holding companies. More generally, the SEC has stepped up enforcement activities across the board, recently announcing that it filed a record 755 enforcement actions in the fiscal year that ended in September 2014.

In anticipation of such proceedings, it is advisable for insurance companies to take proactive defensive measures, such as by maintaining thorough, timely records regarding internal reserve analyses by actuarial staff, review of reserves by management, outside auditors and/or actuaries, and board attention to and consideration of reserves and related controls. Documentation should similarly be maintained with respect to annual and any interim goodwill impairment analyses and controls related to goodwill. Finally, insurers should give careful consideration to any public disclosures regarding reserve adjustments and related matters, even during periods of reserve stability or decreases. Such disclosures may later be challenged if reserve estimates are materially revised at a later point.

Private securities litigation

Plaintiffs often file class actions asserting federal securities fraud claims upon the announcement of an adverse corporate event, such as an accounting restatement or regulatory action, that is accompanied by a significant stock price decline. In a typical securities suit, one or more stockholders will allege, on behalf of themselves and similarly situated stockholders, that they purchased the defendant company's stock at a time when its price was artificially inflated. Plaintiffs typically allege that they lost money in connection with the declining stock price because the higher price at which they purchased the stock was premised upon false or misleading statements (or upon the omission of information necessary to make information already disclosed not misleading or fraudulent) made by the company and/or its officers or directors.

In the insurance company context, an announcement of a material adjustment to reserves, followed by a stock drop, can precipitate a securities fraud claim. Plaintiffs may point to statements regarding the adequacy of the insurer's reserves and claim these statements were fraudulent based on subsequent developments. The argument is that the corporation's officers or directors either knew of (or recklessly disregarded) information suggesting that reserves were inadequate, and the reason that reserves were purportedly "understated" was to boost reported income and maintain the company's stock price. The lawsuits also often attack other related statements, such as statements regarding the adequacy of internal controls and reserving processes, or other statements regarding the company's financial statements such as reported goodwill.

Given their potential for abuse, Congress has enacted legislation — the Private Securities Litigation Reform Act of 1995 — to regulate securities class actions. The PSLRA provides a number of important benefits for defendants in securities fraud suits, including by mandating a stay of discovery until after the plaintiffs have demonstrated that their claims can survive a motion to dismiss.

The PSLRA heightens requirements that plaintiffs must meet in pleading their claims in two relevant ways. First, plaintiffs are not permitted generally to allege that defendants made fraudulent statements — rather, they must specify each statement alleged to have been false or misleading, and identify the reasons why the statement was false or misleading. Second, they must "state with particularity facts giving rise to a strong inference that the defen-

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dant acted with the required state of mind." Plaintiffs must demonstrate that their alleged inference regarding defendants' state of mind is cogent, and that it is at least as compelling as the inference that the statements were made with innocent intent.

Of course, reserves are, by definition, merely estimates of ultimate costs. For property and casualty insurers, with respect to which the majority of reserve-related actions have occurred, reserves reflect case-based estimates of reported unpaid losses and loss adjustment expenses, as well as actuarial judgments of incurred but not reported losses and related loss adjustment expenses. Life insurers calculate reserves in a different manner, but their calculations are similarly based on estimates of future experience. Regardless of the type of insurer, these estimates will necessarily change over time based on subsequent developments.

The securities laws do not allow for so-called "fraud-by-hindsight," i.e., the practice of claiming that a statement is false merely because it later is proven inaccurate. In this regard, a relatively well-established body of case law has developed in both the insurance reserves context and the loan loss reserve context. These cases recognize that reserves represent forward-looking estimates and matters of accounting and actuarial judgments, not matters of objective fact. Consequently, in order to allege that statements regarding the adequacy of reserves were fraudulent, courts have required plaintiffs to demonstrate that the statements were both false and not honestly believed when they were made, notwithstanding whether adjustments to reserve estimates were later determined to be necessary. Applying this standard, numerous courts have dismissed actions premised on the claim that statements regarding reserves must have been false or misleading simply because an insurance company recognized reserve decreases but later underwent a period of reserve strengthening, on the basis that such a hindsight critique is insufficient to provide the required "strong inference" that company officers and actuaries did not believe or were reckless with respect to the originally reported reserves.

Companies seeking to protect themselves against securities fraud claims should ensure that their public disclosures sufficiently inform investors that reserves are simply estimates, that they provide sufficient information about the process by which those estimates are derived (as well as the inherent limitations in such processes) and that they adequately state that while reserves are believed to be adequate based on all currently available information, ultimate costs may be higher or lower.

SEC investigations

SEC Chair Mary Jo White in October 2013 announced the SEC's intent not merely to pursue "the biggest frauds," but instead to enhance its focus on "even the smallest infractions." The SEC has also announced a Financial Reporting and Audit Task Force dedicated to identifying and monitoring accounting issues, including "securities-law violations relating to the preparation of financial statements, issuer reporting and disclosure, and audit failures."

This shift in focus may affect insurers taking reserves increases, particularly if the increases result in or are otherwise associated with potential accounting issues, such as a goodwill impairment charge. Given increased regulatory scrutiny, insurers are well-advised to thoroughly document their analysis of and basis for making determinations regarding reserves and goodwill, both during periods of reserve decreases or stability and during periods of reserve strengthening. Such documentation, along with accompanying reports to the board of directors and/or senior management regarding internal analyses and the outcome of any external reviews by outside auditors or actuaries, may later prove helpful in the defense of any regulatory investigation or proceeding.

Shareholder derivative actions and demands

Reserves adjustments can result in shareholder derivative lawsuits or shareholder demands for board action. Derivative lawsuits are actions brought by stockholders seeking to assert claims on a corporation's behalf against management and/or the board of directors. Such lawsuits are governed by the law of the state of incorporation and are typically based on claims for breach of fiduciary duties. Unlike securities fraud lawsuits, however, these lawsuits do not require a stock drop. A variation on these lawsuits is a "books and records" demand, which is where a stockholder requests documents (usually minutes and other board materials) in anticipation of filing a derivative lawsuit.

Most commonly in the context of reserves, these lawsuits are premised on the theory that directors breached their duty of oversight — i.e., that they failed to ensure that processes were in place to set adequate reserves. In such cases, stockholders must plead that a majority of the board either utterly failed to implement a system of internal controls, or that, having implemented such a system of internal controls, a majority of board members consciously failed to monitor them in order to disable themselves from being informed of risks or problems requiring their attention. Thus, stockholders face an uphill battle in maintaining derivative actions premised on alleged breaches of fiduciary duties in connection with reserves adjustments. In the absence of specific allegations regarding actual red flags presented to the board regarding reserve inadequacies, such as prior notifications provided to the board by state regulators, such actions are likely to be dismissed. *i*

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