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A Newsletter from Chicago Underwriting Group, Inc.
Underwriters of D & O and Professional Liability Insurance

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In this expanded issue....we discuss the recent Supreme Court decision in the *Dura Pharmaceuticals* case, which has a direct bearing on the liability of directors and officers. We then suggest an alternative approach to rating insurance companies by distilling several different rating agency evaluations into one simple number.

THE SUPREME COURT RULES ON DURA

It is rare that the U.S. Supreme Court decides to hear a case related to securities class action lawsuits. So when the Court agreed to hear the case of *Dura Pharmaceuticals, Inc. v. Broudo*, No. 03-932 (U.S. April 19, 2005) it attracted a great deal of attention.

In an unusual show of unanimity (9-0), the Court struck down a decision from the 9th Circuit Court of Appeals which had it stood, would have made it easier for plaintiffs to bring securities class action lawsuits, and correspondingly harder for defendants to fend them off.

At the core of the original 9th Circuit's decision was the formulation of a theory, known as the "price inflation approach," for evaluating the merits of a plaintiff's securities lawsuit. The theory held that a plaintiff needed only to show that the price of a security was inflated at the time of purchase because of a misrepresentation by defendants, and so the mere act of purchasing the inflated stock would be sufficient grounds for a plaintiff to pursue an action against the company. This theory was decisively rejected by the Supreme Court.

DECISION HIGHLIGHTS

There are three main parts to the opinion, which can be broadly summarized as follows: *(Quoted phrases are taken from the actual opinion as delivered by Justice Breyer; emphasis as original.)*

1. Simply buying a share of stock at an inflated price does not by itself constitute a loss. "As a matter of pure logic," wrote Justice Breyer, "at the moment the transaction takes place the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value." In other words, maybe the purchase price was high but the stock can be immediately sold for the same amount. The price of a stock, moreover, is affected by a "tangle of factors," with timing being especially critical: "Other things being equal, the longer the time between purchase and sale . . . the more likely that other factors caused the loss."

   And so the Court determined that while an inflated purchase price will "sometimes play a role in bringing about a future loss," that, said the Court, is not enough: "To 'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires."

2. The Court commented that the price inflation approach is not supported by precedent, citing several historical opinions which stated the need to prove proximate causation of actual

damages—in one instance reaching back to a case in 1789. . ."if no injury is occasioned by the lie, it is not actionable: but if it be attended with a damage, it then becomes the subject of an action." The Court therefore found it "not surprising" that the 2nd, 3rd and 11th Circuits had already rejected the inflated purchase price approach.

3. The 9th Circuit, according to Justice Breyer and the Court, had neglected to recognize an important securities law objective which was to protect investors "against those economic losses that misrepresentations actually cause," noting that the Public Securities Litigation Reform Act of 1995, "expressly imposed on plaintiffs the 'burden of proving' that misrepresentations by the defendants caused the loss for which plaintiffs seek to recover."

   Instead, the price inflation approach appeared to the Court to provide a kind of "broad insurance against market losses," adding that without the requirement that plaintiffs demonstrate the causal connections of a loss, private securities actions would be transformed into a "partial downside insurance policy."

Industry Reactions

Most commentators agree that the decision was not unexpected, and that the Supreme Court has effectively eliminated the price inflation approach as a plaintiffs' weapon.

There is also general agreement that the task facing plaintiffs and their attorneys has been, at least temporarily, made a little harder. The "tangle of factors" that the Court described as impacting a stock price might be seized upon by defendants to argue the difficult task of identifying causation. This in turn may result in the prevalent "plaintiff-style damages" (i.e., inflated) coming under attack as defendants cite the inherent complexity to chip away at plaintiffs' demands.

The Dog That Did Not Bark

The decision also sparked comment about what it omitted to do. Little guidance was handed down by the Court about how plaintiffs might demonstrate that defendants' misrepresentations proximately caused a loss. Commentators suggest that this lack of guidance will produce wrangling and litigation in the lower courts.

However, the Court's focused opinion was probably appropriate: it was not the job of the Supreme Court to provide a road-map for potential securities class actions, but to address the specific issue of price inflation that was before it.

The short term may see a few related dismissals of pending actions, perhaps signifying a slight shift of power towards defendants and their insurers, but it is certain the plaintiffs' bar will adjust its tactics accordingly. ❖

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Insurer Ratings: A Different Approach

It is no secret that we are proud of our insurer ratings, and sometimes frustrated by the industry's adherence to A.M. Best as the ratings standard. History has shown more than once how an insurer has gone from an 'acceptable' Best A- rating to being out of business within the span of a 12 month policy, giving little warning to brokers and buyers who rely solely upon Best's methodology.

To get a broader indication of an insurer's viability, we formulated a method of producing a rating that draws upon four separate agency assessments: A.M. Best, Standard & Poor's, Moody's and Weiss Ratings. By assigning a numerical value to these agencies' top five rating grades, an aggregate numerical result can be obtained that reflects the sum of their evaluations. Here is a table showing the agencies' top five grades and their assigned values:

	A.M. Best	S&P	Moody's	Weiss
5 Points	A++	AAA	Aaa	A+
4 Points	A+	AA+	Aa1	A
3 Points	A	AA	Aa2	A-
2 Points	A-	AA-	Aa3	B+
1 Point	B++	A+	A1	B

A "perfect" score would be 20 points.
As of May 2005 this is how the leading D&O carriers scored:

Gen Re (Genesis)	15 Points
Federal (Chubb)	13 Points
National Union (AIG)	13 Points
Old Republic (CUG)	**13 Points**
Executive Risk (Chubb)	11 Points
Swiss Re America	10 Points
Twin City (Hartford)	9 Points
XL Specialty	8 Points
RLI	5 Points
St. Paul F&M	5 Points
Ace American	4 Points
Liberty Mutual	4 Points
Westchester Fire	4 Points
Continental Casualty (CNA)	3 Points
Fireman's Fund	3 Points
Great American	3 Points
Odyssey Re (Hooghuis)	3 Points

(*Carriers must be rated by all four agencies to be included. Ratings are subject to constant change; we cannot be responsible for any inaccuracies. Interested readers should perform their own calculations.)*

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