

What to Watch Now in the World of D&O

The Sights

The issues that are most critical in the world of directors' and officers' liability insurance vary significantly over time. There are of course the perennial topics that always remain important, but this overview is intended to address the most current significant concerns for D&O insurance professionals and their clients.

Will Rising Corporate Bankruptcies Produce Increased D&O Claims?

According to the Administrative Office of the U. S. Courts, the number of business-related bankruptcies increased 63% (to 55,021 from 33,822) during the year ended June 30, 2009. Although there are some encouraging signs of an economic recovery, a number of companies will continue to face the risk of bankruptcy for some time to come.

This overview is intended to address the most current significant concerns for D&O insurance professionals and their clients.

There is heightened risk of increased claims against officials at bankrupt firms. Advisen's 2008 year end report on securities litigation activity noted that since 1995, roughly 35 percent of large public companies (defined as having assets of over \$250 million) that filed for bankruptcy also sustained securities class action lawsuits against their directors and officers. During 2007 and 2008, the percentage increased to an alarming 77 percent. The directors and officers of private companies also face claims exposure when their companies file for bankruptcy.

Bankruptcy associated-claims present a host of complications, not least of which is the intricate (and sometimes problematic) way that D&O insurance policies respond in the bankruptcy context. One recent development illustrating the difficulties that can arise in the bankruptcy context was the July 2009 decision in the Visitalk case. In this case, as a result of the policies' insured vs. insured exclusion, the Ninth Circuit upheld the carriers' denial of coverage for a lawsuit brought by a company as a "debtor-in-possession" against former directors and officers of the company.

These kinds of complications underscore the need to scrutinize D&O insurance policies for their ability to respond to claims arising in the bankruptcy context.

One final concern is that the rising tide of corporate bankruptcies could trigger increased losses under excess A-Side insurance. This possibility is one of several factors, many of which that are discussed below, that could represent a changing environment for carriers offering this line of insurance. The increased number of bankruptcies in any event further reinforces the proposition that excess A-Side insurance is an indispensable part of a complete D&O insurance program for any corporate insured, whether public or private.

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Will the Growing Number of Bank Failures Produce a Wave of Failed Bank Litigation?

The number of 2009 year-to-date failed banks is now up to 120 (as of November 6, 2009), and the total number of bank failures since January 1, 2008 is up to 145. Alarmists have made predictions that as many as 1,000 banks could fail by the end of 2010. Whether or not the number of bank closures will come anywhere near that level, it is clear that we are in the midst of the most significant wave of bank failures since the S&L crisis.

The question remains whether this time around we will see the same level of litigation activity as witnessed during the last period of failed banks. Surprisingly, the FDIC has initiated relatively little litigation to try to recoup its losses from the directors and officers of the failed financial institutions. However, one must recognize that the FDIC is preoccupied, dealing with further bank closures. During the S&L crisis, the FDIC and other regulatory agencies did not usually act until statutes of limitations were just about to expire. As such, another round of failed bank litigation may occur.

Private litigants might also be expected to get in the act. For example, investors who lost their entire investment when a bank closed might well be expected to pursue claims. There has also been securities class action litigation activity involving failed banks whose shares were publicly traded. Of the 25 banks that failed in 2008, six of them are involved in securities class action litigation, even though only 11 of them were publicly traded.

To date, the securities class action litigation involving the failed banks has not fared particularly well. In the Downey Financial securities class action lawsuit, the district court recently granted the renewed motion to dismiss following the plaintiffs' attempt to remedy the pleading defects noted in the initial dismissal without prejudice with an amended complaint. In the Fremont General securities lawsuit, the court also granted the defendants' motion to dismiss, albeit with leave to amend.

These early decisions could discourage some potential litigants. Nevertheless, if for no other reason than the fact that there was so much failed bank litigation last time around, it seems likely that when all is said and done, the growing number of bank failures will at some point lead to an extended round of failed bank litigation.

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Whether or not the failed bank litigation ultimately emerges, the D&O insurers have responded defensively to the wave of bank failures by enacting a hard market. Many financial institutions, including even smaller community banks, are facing significantly more challenging circumstances when trying to renew their D&O insurance. Many banks find that they can obtain coverage at a significantly greater cost with restricted terms and conditions (specifically, in the form of a regulatory exclusion).

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Will the Rising Number of Derivative Lawsuit Mega Settlements Mean Significant Excess A-Side Losses?

Within the last several years, there have been a number of unprecedented mega settlements in shareholders derivative lawsuits, particularly during the last 12 to 24 months. These massive derivative lawsuit settlements include: the \$115 million AIG settlement; the \$900 million UnitedHealth Group settlement; and the \$118 million Broadcom options backdating settlement.

One consequence of this outbreak of massive derivative lawsuit settlements is that excess A-Side carriers are being called upon to significantly contribute toward settlements – outside of the insolvency context. The recent Broadcom settlement, in which the excess A-Side insurers collectively contributed \$40 million in limits, appears to represent a milestone development in that regard. While there may well have been prior occasions on which excess A-Side insurance contributed toward settlements outside of insolvency, the Broadcom settlement is by far the most public example. For D&O insurers, this represents a significant development. Until now they have enjoyed the opportunity to offer excess Side A insurance in a relatively low loss cost environment, particularly outside the insolvency context.

Another significant side effect of the Broadcom settlement is that the plaintiffs' lawyers may have developed an appreciation for the value of presenting claims that trigger the excess A-Side coverage. The question arises whether they might now attempt to craft claims for the express purposes of accessing the excess A-Side limits. That being said, the attempt to pursue this strategy would face considerable challenges – derivative lawsuits, for example, are subject to formidable defenses, including the demand requirement and the business judgment rule defense.

Will Securities Lawsuit Filings Return to Historical Levels?

As was widely noted earlier this year, securities class action lawsuit filings dropped during the second quarter of 2009. This decline was largely due to the low filing activity during May (when there were only 11 new securities class action lawsuits) and during June (when there were only six new securities lawsuits), compared to historical monthly filing levels in

the range of 15 to 20 new lawsuits a month. The third quarter has produced a rebound in filings. The annualized equivalent for the first nine months of 2009 projects out to a twelve-month filing rate of 191 which is slightly below, but still well within the range of, the average 197.7 annual filings during the 13 year period from 1996 to 2008.

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Another interesting attribute of the most recent lawsuit filings is that the third quarter filings are not as heavily concentrated in the financial sector. During the first half of 2009, about two-thirds of the securities class action lawsuit filings involved financial companies. However, of the 37 securities lawsuits filed in July and August, only about 13 (or roughly a third) involved financial institutions. In other words the proportion of lawsuits filed against financial companies to lawsuits filed against nonfinancial companies seems to be completely reversed from the first half of the year.

The other interesting fact about the third quarter filings is the extent to which the cases involve proposed class period cutoff dates that are well in the past, sometimes by as much as a year or more prior to the actual filing date. These belated filings suggest that while the plaintiffs' lawyers were scrambling to file subprime and credit crisis-related lawsuits against financial companies in the first part of the year, they were also developing a backlog of other cases that they are now working off.

All signs indicate that by the end of this year, securities class action filing levels will likely have returned to historical levels after the brief and apparently temporary decline in the second quarter. The concentration of filings in the financial sector also seems to be abating, with distribution of filings by industry starting to look more like historical norms.

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How are Plaintiffs Faring in the Subprime and Credit Crisis-Related Securities Lawsuits?

We are now more than two and a half years into the subprime and credit crisis-related litigation wave, yet in many respects the cases are still only in their earliest stages. That being said, there have been a number of recent significant developments that may allow us to make a number of generalizations.

First, it seems as though the defendants have the upper hand at the motion to dismiss stage. Among other things, the Eighth Circuit's recent decision affirming the district court's

dismissal in the NovaStar Financial case represents a significant victory for defendants. The Downey Financial dismissal, discussed above in connection with the failed banks is another example. The recent dismissals in the Citigroup subprime-related derivative lawsuit and Citigroup ERISA lawsuit also suggest that plaintiffs may be faring poorly in those cases as well.

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On the other hand, there have also been some significant recent settlements suggesting that if the plaintiffs can survive motions to dismiss in these cases, the cost of settlement can be significant. Along those lines, the recent \$32 million settlement in the RAIT Financial case and the \$22 million settlement in the Accredited Home Builders case illustrate how costly it can be to settle cases that survive motions to dismiss.

The \$37.25 million settlement in the American Home case and the \$30.5 million settlement in the Beazer Homes case – suggests that in cases that are sufficiently serious the plaintiffs may be able to avoid the initial pleading hurdle altogether. The cases were both settled before the motion to dismiss had even been heard.

The American Home settlement may be particularly noteworthy as the company's public offering underwriter and outside auditor contributed substantially toward the cost of settlement. That, together with the Judge Scheindlin's September 2, 2009 partial denial of the motion to dismiss the claims against the rating agencies in the Cheyne Finance lawsuit, could suggest that in at least some of these cases the possibility of gatekeeper liability could be an important part of the overall claims resolution.

The final point is that these cases are proving to be extremely costly to litigate. The most dramatic illustration is State Street's August 10, 2009 announcement that the approximately \$625 million subprime-related litigation expense reserve established in January 2008 was, as of June 30, 2009, already down to \$193 million, and that there could be no assurances that the remaining amount would be adequate.

So while the defendants may have won some important victories in the courtroom, the aggregate overall cost of defending and settling these financial cases continues to look as if it will be enormous. By any measure, the subprime and credit crisis-related litigation wave continues to represent a tremendous loss exposure for D&O insurers.

Will the SEC's Renewed Aggressiveness Expand Into Individual Liability Exposures for Corporate Officials?

The SEC is under considerable pressure to reestablish its regulatory credentials and restore its tarnished reputation. As a result, it has recently shown a renewed aggressiveness and apparent willingness to expand its arsenal, in ways that may pose increased threats to individual corporate officials.

Two recent enforcement actions underscore this pronounced new aggressiveness. First, in July 2009, the SEC launched an enforcement action against the CEO of CSK Auto. The SEC is seeking to claw back the compensation the CEO earned during the period for which the company later restated its financial statements. It is important to note that the SEC is pursuing this claim even though the CEO is not alleged to have engaged in any wrongful misconduct or have had any role in – or knowledge of – the issues that triggered the company's restatement.

The second example of the SEC's recent aggressiveness is the July 2009 enforcement action filed against two corporate officials at Nature's Sunshine Products. The SEC sought to impose control person liability on the two officials for the company's activities that violated the Foreign Corrupt Practices Act, even though the two individuals were not themselves alleged to have been involved in or aware of the corrupt activities.

Fortunately, Judge Jed Rakoff has questioned the proposed settlement of the enforcement action involving the Merrill Lynch bonuses as the settlement does not involve any specific allegations against or claims against the individuals who caused the alleged wrongdoing. Regardless of the outcome of the Merrill Lynch settlement, the SEC will likely have to anticipate this objection and incorporate targeted allegations against individuals in an effort to forestall further objections of this kind.

The bottom line is that, as a result of these developments, corporate officials could find themselves increasingly on the firing line. Of particular concern is that the CSK Auto and Nature's Sunshine Products enforcement actions are evidence of a potentially disturbing willingness on the SEC's part to attempt to impose liability on corporate officials even in the absence of culpable involvement in or even awareness of the alleged wrongdoing.

Will Claimants Increasingly Target Outside Directors?

The \$61.55 million settlement earlier this year against the outside director defendants in the Peregrine Systems securities lawsuit is merely the latest example where outside directors have found themselves required to contribute toward a separate settlement of significant liability claims against them. Further, at least some of the outside director defendants appear to have been required to contribute toward the Peregrine Systems settlement out of their own personal assets.

As was also shown in the now infamous *Just for Feet* settlement, the threat that outside directors will be targeted and could be called upon to contribute toward settlement – out of their own assets – is a growing concern, and one that is significantly increased in the bankruptcy context. Given the growing number of corporate bankruptcies, outside directors may increasingly find themselves on the front lines of D&O claims.

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These cases highlight the extent to which the outside directors' liability exposures and interests should be separately considered as part of the construction of a company's D&O insurance program. Simply put, the outside directors' interests and the interests of the company's officers may or may not be completely aligned. These developments and considerations suggest that the non-officer directors could be well advised to have their insurance interests independently reviewed, in order to ensure that their interests are being appropriately addressed.

At minimum, these developments underscore yet again the need for alternative insurance structures such as excess A-Side insurance to be included as an important part of the corporate D&O insurance program.

Will Congress Legislatively Overturn the U.S. Supreme Court's Decision in the *Stoneridge* Case?

In January 2008, the U.S. Supreme Court in the *Stoneridge* case followed its prior decision in *Central Bank of Denver* and held that there is no private right of action for scheme liability (aiding and abetting under the federal securities laws), ruling that Congress had reserved to the SEC the right to enforce aiding and abetting liability.

But what Congress has decreed, Congress can also change. And change is just what Senator Arlen Specter (D-Pa.) proposed on July 30, 2009 when he introduced Senate Bill 1551, "The Liability for Aiding and Abetting Securities Violations Act of 2009." If enacted, the bill would, in effect, legislatively overturn *Stoneridge* by amending the securities laws to allow private litigation against a person that provides substantial assistance in a violation of the securities laws.

Recent events may substantially increase the likelihood of the bill's passage. The sweeping Democratic victory in the 2008 elections and current popular need to assign blame for the global economic crisis will likely increase the collective willingness of Congress to remove barriers to the imposition of liability.

In addition, the courts have urged Congress to implement these changes. The most prominent example of this is the March 17, 2009 opinion by then-Southern District of New York Judge Gerald Lynch in the *Refco* case. (On September 17, 2009, the Senate confirmed Judge Lynch's nomination to the Second Circuit.) In the opinion, Judge Lynch dismissed the securities claims suit filed against a lawyer that had advised the client (who was later criminally convicted of securities fraud).

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Judge Lynch commented that "it is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable to the victims of the fraud." Judge Lynch stated that the Congressional decision to leave the enforcement of aiding and abetting liability solely to the SEC "may be ripe for re-examination." The sentiment expressed in the opinion of a judge as respected as Judge Lynch could provide intellectual cover, and perhaps even policy justification, for Congress to take steps that it is already inclined to take.

If the bill passes, the potential defendants who could find themselves drawn into securities class action lawsuits on "aiding and abetting" claims will include not just gatekeepers but also other companies whose business transactions with the alleged primary violator are alleged to have facilitated or contributed to the securities fraud.

At a minimum, this possibility has significant implications for D&O insurance coverage. In particular, the way in which the term "securities claim" is defined in the D&O insurance policy could become even more important than it is now. Currently, there are two variations in the way the term is defined. In one formulation, the term is defined solely with reference to violations alleged in connection with the purchase or sale of the insured company's own securities. In the other formulation, the term is defined with respect to any alleged violation of the securities laws. (To be sure, there are some definitions that incorporate both formulations.) In anticipation of the possibility that the Specter bill might pass, it is critically important to carefully review the D&O policy's definition of securities claim to ensure that it is sufficiently broad to encompass aiding and abetting claims.

The current legislative calendar is remarkably full, and therefore the bill may not be considered before the end of 2009, but the 111th Congress does not end until 2010. The bill could also be "incorporated into a larger finance, banking or securities-related bill."

Is the D&O Insurance Marketplace Headed for a “Hard Market”?

Earlier this year, Advisen took the bold and provocative step of predicting that the D&O insurance marketplace was headed toward a hard market in late 2009 or early 2010.

Whether or not we are actually headed to an overall harder insurance market remains to be seen, though as 2009 progresses, the possibility seems less and less likely.

To be sure, the D&O insurance marketplace for companies in the financial sector is definitely harder than for the rest of the marketplace, and some financial institutions are now hard to place. The speed with which the D&O marketplace for community banks firmed up shows how quickly conditions can change.

Nevertheless, for most companies, particularly those that are financially stable, the D&O marketplace remains competitive, with ample capacity and coverage available on favorable terms and conditions.

That is not to say that the possibility of a more wide-spread hard market is completely out of the question. The losses and defense expense associated with the subprime and credit crisis related litigation wave, in combination with several years' of pricing declines and coverage expansions, could start to affect carriers' overall results and trigger price increases and marketplace restrictions. Whether and when these circumstances might arise remains to be seen.

About the Author

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A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You can access the weblog via our website at www.oakbridgeins.com. To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to refer to The D&O Diary regularly.

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