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Four Things to Watch in the World of D&O

The world of directors' and officers' liability often seems as if it is in a state of constant change -- and it is no wonder, because so many factors affect it: legislation, litigation, volatile securities markets, and the ever-changing global economy. With so many shifting factors and varying dynamics, it can sometimes be difficult to isolate trends and identify their significance. This difficulty is exacerbated when there is a single issue that, like the current options backdating scandal, is dominating the headlines.

The purpose of this article is to identify four current trends in the world of D&O beyond the options issue, and to comment on their significance. While some of these trends may not yet be in the headlines, they represent important developments in the D&O arena.

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The Milberg Weiss Indictment and the Declining Number of Securities Fraud Lawsuit Filings

For many years, the Milberg Weiss law firm has been the market-share leader of the securities fraud plaintiffs' bar. Even after the firm's west coast lawyers split off and formed their own firm, the Milberg Weiss firm has been widely viewed as the leading securities class action plaintiffs' firm. In May 2006, a federal grand jury returned a criminal indictment against Milberg Weiss and two of its partners. The indictment alleges that the firm paid illegal kickbacks to a small stable of professional plaintiffs and their relatives to facilitate Milberg Weiss's ability to file lawsuits and pursue litigation.

The criminal proceedings are only in their earliest stages, but the indictment is already having two significant impacts in the securities litigation arena. The first is that the law firm itself may be slowly dissolving. Milberg Weiss has already closed two of its four offices, and it is down to under 75 lawyers from over 125 at the time of the indictment. Many of the departing attorneys are leaving to join other firms, but some are forming their own firms.

The second impact may be that as a result of the indictment, securities lawsuit filings are down significantly. The Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse have recently released their "2006 Mid-Year Assessment," which showed a 45% decline in the number of securities lawsuits filed in the first half of 2006 compared to the prior year period. According to the Report, the 61 securities class action lawsuits filed in the first half of 2006 represents the lowest level of securities lawsuit activity in any six month period since 1996.

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The decline actually began in September 2005 – shortly after the grand jury indicted Seymour Lazar, one of the paid plaintiffs later identified by name in the Milberg Weiss indictment. The decline raises the question as to whether the Lazar indictment and the publicity surrounding the grand jury investigation may have been a shot across the bow for the entire plaintiffs' bar. The question is whether the criminal investigation has disrupted their ability to rely on paid plaintiffs in order to press their lawsuits. Without paid plaintiffs, it may be difficult for plaintiffs' lawyers to find anyone on whose behalf to file a lawsuit.

Regardless of whether loss of the ability to rely on paid plaintiffs is the cause, it is clear that the criminal investigation is taking its toll on the Milberg Weiss law firm's ability to file lawsuits. According to news reports, the Milberg Weiss firm has filed just 17 securities lawsuits during 2006 (and none since the indictment), compared with 55 lawsuits in the first half of 2005 and 36 in the second half of 2005. Milberg Weiss's alienated sister firm, Lerach Coughlin, has also seen its filing rate decline significantly in 2006 as compared to prior periods. In recent years, one or the other of these two firms has filed a complaint against over 80% of the companies that have had securities fraud lawsuits filed against them. The diminution in these firms' activities has had a significant impact on overall securities litigation frequency. The long term consequences remain to be seen. The Milberg Weiss firm's dissolution could prove to be a temporary disruption, as the newly spawned firms may more than make up for the Milberg Weiss firm's loss of capacity. In addition, plaintiffs' firms that previously had been viewed as asbestos or tobacco litigation firms have been becoming more active in the securities arena, suggesting that additional capacity could come from outside the traditional plaintiffs' securities bar.

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The Impact of SOX on the Number of Public Companies

Much has been written about the impact of Sarbanes-Oxley on corporate governance, and about the burdens the law has imposed on U. S. businesses. More recently, it has become clear that Sarbanes-Oxley is undermining the ability of U.S. securities exchanges to compete in the global financial arena. For example, in 2000, nine of the ten largest non-U.S. initial public offerings (IPO) listed their shares on the New York exchanges; in 2005, 24 of the 25 largest non-U.S. IPOs chose other markets, with London leading the alternatives.

The aversion to the U.S. markets is not limited to non-U.S. companies, nor is it limited to IPO companies. Recent academic studies indicate that an increasing number of U. S. public companies are "going dark" – that is, delisting with the SEC and listing their shares on the "Pink Sheets." (This contrasts with "going private," whereby management or investors buy out public shares, after which the shares are not publicly traded in any way.) According to these studies, in 2002, when Sarbanes Oxley was enacted, 65 publicly traded companies went dark; in 2003, 183 companies went dark, and in 2004, the most recent year studied, 122 companies went dark. While Sarbanes-Oxley may have been an unavoidable political reaction to enormous corporate frauds, it is clearly having the effect of reducing the number of companies that seek to trade their shares on U.S. exchanges. This unintended consequence is not only affecting the way business is conducted in this country but it is also affecting this country's ability to compete in a global economy.

In any event, the reduction in the population of companies whose shares are publicly traded on U.S. exchanges is clearly an important development in the world of D&O. Carriers face the prospect of competing for a shrinking pool of public company D&O insurance buyers, which could further exacerbate competitive marketplace conditions.

The Foreign Corrupt Practices Act: A '70s Revival that Could Affect 21st Century D&O Risk

Another consequence of the globalization of the economy has been an increase in U.S. businesses' activities in foreign countries. Unfortunately, U.S. businesses' efforts to compete in foreign business cultures are increasingly bringing these businesses into contact with a 1970s vintage statute, the Foreign Corrupt Practices Act (FCPA). The FCPA emerged in the mid-70s from SEC investigations that led to over 400 U.S. companies admitting to having made questionable illegal payments to foreign governments or officials. The FCPA contains antibribery and accounting requirements. The antibribery provisions make it unlawful for any U.S. person (and certain foreign issuers) to make payments to a foreign official for the purpose of obtaining or retaining business. The accounting provisions specify certain books and records requirements.

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There has been a recent upsurge in FCPA enforcement actions. One reason for the increase is the challenge U.S. companies face in doing business in China. *The Washington Post* reports that "the lure of China profits combined with local corruption is tempting foreign companies and managers and bringing them into conflict with U.S. antibribery laws." U.S. companies find themselves "adopting Chinese-style tactics to secure sales, as they compete in a market in which Communist Party officials routinely control businesses, and purchasing agents consider kickbacks part of their salary."

Another important reason for the increase in FCPA enforcement actions is the Sarbanes-Oxley Act. Sarbanes-Oxley's requirements that senior management assess their internal controls and verify their financial statements are increasing management scrutiny of all operations (including offshore transactions), in turn leading to discovery of more FCPA concerns. Under Sarbanes-Oxley, management is required to report potential violations to the company's chief legal officer or the company's board. This self-examination requirement coincides with the self-reporting requirements under the so-called "Thompson Memo," which identifies the factors that federal prosecutors will consider in determining whether to prosecute a corporation. A corporation may avoid prosecution if, among other things, it has self-reported and cooperated fully with authorities. Companies are now choosing to voluntarily disclose FCPA violations in an attempt to receive favorable treatment. The increased Sarbanes-Oxley scrutiny combined with the incentive to self-report has resulted in a substantial increase in FCPA enforcement proceedings.

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From the perspective of D&O risk, one of the dangers from an FCPA enforcement proceeding is the possibility of follow-on litigation. For example, Willbros Group was named in a securities class action lawsuit alleging that the company had been the subject of numerous investigations "because the Company engaged in a campaign of illegal and illicit bribery of foreign government officials in Bolivia, Nigeria, and Ecuador to successfully obtain construction projects." The complaint alleged that the company was forced to restate several years of financial statements and to accrue a reserve for possible FCPA fines and penalties.

The claims against Willbros Group illustrate a growing D&O risk that increased FCPA enforcement activity could represent. The threat is not so much from the underlying FCPA enforcement action itself; any FCPA fines or penalties would likely not be covered under most D&O policies. Rather the threat is from the potential liability that could arise in any follow-on civil action (such as the follow-on securities fraud lawsuit filed against Willbros Group). Any settlement or judgment in a follow-on action, as well as defense expenses, would usually be covered under the typical D&O policy.

As FCPA enforcement actions grow in number and magnitude, this exposure could pose an increasingly greater D&O risk.

Private Money, D&O Risk

The Wall Street Journal's recent series on "Private Money" describes "the new financial order" arising from the "new rules of the private equity game." The new power players are private financiers – hedge funds, buyout firms and venture capital firms, who are highly skilled at quickly extracting cash from the firms they acquire. The private financiers collect dividends, fees for advising, and fees for stock

underwriting and management. The magnitude of cash hauled out can be stunning; the *Journal* describes the $22 million in professional fees and $448 million in dividends that the private investors pulled out of Burger King prior to its May 2006 IPO.

These claimants may assert that the private investors' extraction of dividends, management fees, or equity buy-outs represent a form of "looting" or "waste" or a violation of other legal duties, and that the other directors violated their duty of care for permitting these actions.

One example described in the *Journal* series involved Dade Behring, Inc., a medical diagnosis company that found itself saddled with enormous debt that was incurred in the attempt to buy out private investors' equity stake. Eventually the debt burden drove the company to the brink of bankruptcy. Creditors formed a committee to examine the conduct of Dade Behring's "owners, directors and advisors." The creditors considered bringing claims relating to "illegal dividends, illegal stock redemptions and impairment of capital." (The company later recovered and subsequently went public.)

Although the Dade Behring creditors ultimately did not bring a claim, the example provides a cautionary tale for those who must assess the potential risk of D&O claims arising under the new rules of the private equity game. The presence on company boards of representatives of the new power players whose interests may conflict with the interests of the company, other investors, or creditors, creates an environment where accusations of wrongdoing may more easily arise. These same risks are present even if the private equity investors do not have company representations; the board's actions for the benefit of private equity investors could draw criticism even if the investors do not have board representation. The risk could be particularly applicable where a debt-saddled company is driven into bankruptcy. Creditors may claim they are owed special duties while the company was in the "zone of insolvency." These claimants may assert that the private investors' extractions of dividends, management fees, or equity buy-outs represent a form of "looting" or "waste" or a violation of other legal duties, and that the other directors violated their duty of care for permitting these actions.

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A vivid example of the problems that can arise when private investors have interests that conflict with management can be seen from a tactic that hedge funds are increasingly adopting when the companies in which they have invested fail to file their financial reports on time (a current problem for many companies as they struggle with the accounting issues arising from past options timing practices). Bondholder hedge funds are claiming that the late financial reporting represents a technical default under the bonds, and are attempting to force the company to redeem the bonds (which the hedge funds purchased at a discount) at face value. In the last 18 months, at least 25 companies have had their bonds accelerated this way or they

were forced to pay multimillion dollar fees to bondholders. The threat of litigation surrounding these issues, as well as the larger threat of bankruptcy looming in the background, underscores the potential D&O risk these circumstances present. The conflicting interests between a company and its investors create an environment where accusations of wrongdoing can more easily arise.

The significance of private funding in the world of corporate finance has long been recognized, but there is a growing realization that the increasing influence of private funding has its consequences. Among those consequences is a growing possibility of conflicting interests that could trigger a D&O claim.

Conclusion

The four trends mentioned in this article are still emerging and will continue to develop in the weeks and months ahead. In order to provide continuing updates on these stories as they unfold, periodic reports will be posted on the author's Internet weblog, the *D&O Diary,* which can be accessed via the OakBridge website: www.oakbridgeins.com or directly at http://dandodiary.blogspot.com.

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