

What to Watch Now in the World of D&O

In the September 2006 issue of *InSights*, we took a look at “Four Things to Watch in the World of D&O.” Many of the trends we identified then remain relevant, even as circumstances have evolved. Now that a year has passed, it is time to take another look and survey the current hot topics in the world of D&O insurance. We have set forth below our current list of the things to watch in the world of D&O.

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Will Securities Class Action Filings Return to Historical Levels?

Recent statistical studies by Cornerstone Research and NERA Economic Consulting confirm that the level of securities class action filings has been well below historical averages since mid-2005. Stanford Law Professor Joseph Grundfest speculated in a July 2007 statement that there may have been a “permanent shift” to a lower level of securities class action filings.

But in its mid-year 2007 study of securities class action lawsuit filings, NERA Economic Research noted that while securities filings in the first half of 2007 remained well below historical levels, the number of filings for the first-half of 2007 filings was 47% greater than the number of filings in the last six months of 2006.

The difference between these two periods is even more pronounced when the options backdating wave is taken into account. Options backdating litigation filings were at their peak in 2006 but dropped off in 2007, yet the first-half 2007 filing level still exceeded the second half of 2006.

Moreover, the NERA study looked only at filings through June 30, 2007. If anything, the filing rate after that date accelerated. In particular, during the two-month period between August 1, 2007 and September 30, 2007, 37 companies were sued for the first time in securities class action lawsuits. If this filing rate were extrapolated over a 12-month period, the resulting annualized filing rate would be 222 lawsuits. By way of comparison, according to Cornerstone, the average number of securities class action lawsuit filings during the period 1996 to 2004 was 202, compared with only 116 filings for the full year 2006.

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Contact:

Lisa McNamara Hughes
Phone: 860-906-0103
lhughes@oakbridgeins.com
www.oakbridgeins.com

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The increased securities class action filing level so far in the second half of 2007 is due in part to the subprime lending mess (about which, see more below). But subprime litigation is only a part of the story. Second-half 2007 lawsuits have swept across many industries and have arisen from a variety of circumstances. While two months may be too short of a period from which to generalize, it is undeniable that the filing level so far in the second-half of 2007 is at as high a level as it has been for several years. It may be too early to conclude that the pattern of the last two years has been broken, but it does appear possible that filing levels have reverted back toward historical levels.

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How Big Will the Subprime Lending Litigation Wave Become?

The subprime meltdown has dominated the headlines, disrupted credit availability and riled the financial markets. It has also generated a wave of litigation, much of it directed against directors and officers of publicly traded companies. As of October 23, 2007, there have been 17 companies sued in subprime lending-related securities lawsuits. Four residential construction companies have also been sued in subprime securities lawsuits. In addition, two credit rating agencies have been sued by their shareholders in connection with subprime mortgage backed securities ratings, and two lawsuits alleging ERISA violations have been filed by employees against their subprime lending related employers.

The subprime lending litigation already filed represents a significant development for D&O insurers. But the insurers' real concern is how much worse the problem may become. Some D&O insurers have increased their underwriting related to subprime issues, not only to identify companies that were involved in subprime lending, but to also identify companies that may be carrying troubled mortgage-backed assets as investments on their balance sheets. These investment assets are only as valuable as the performance of the underlying mortgages. Because so many adjustable rate mortgages will reset in the months ahead, there may be further mortgage foreclosures, resulting in further deterioration in the valuations of mortgage-backed assets. Companies that carry significant mortgage-backed investments on their balance sheets could see the value of their investment assets decline, which in turn could lead to disappointed investors who may contend that the companies did not previously or adequately disclose the company's mortgage investment risk.

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The subprime mortgage mess is already a significant event for the D&O industry. Unfortunately, it appears likely that the subprime mortgage-related litigation wave will continue to grow, at least in the near term. Only time will tell how serious an event it will prove to be.

How Will the Securities Plaintiffs' Bar Respond to Changes at the Industry-Leading Firms?

The most prominent plaintiffs' securities lawyers have been ensnared in the criminal investigations of kickback payments to class representatives. Bill Lerach pled guilty, and Mel Weiss has taken a leave from his firm to contest the criminal charges that have been filed against him. Unquestionably, these two lawyers were the most prominent plaintiffs' securities class action attorneys, and their respective law firms were the most active plaintiffs' securities firms. These events have already gravely affected Milberg Weiss. The firm (which also faces a criminal indictment of its own) has essentially filed no new lawsuits since mid-2005.

As financial problems have spread beyond the subprime lending arena, companies not directly involved with subprime lending have also found themselves drawn into lawsuits as a result of turbulence in the credit marketplace.

There are numerous firms already jockeying to exploit the former industry leading firms' setbacks. Indeed, a number of plaintiffs' firms more commonly associated with asbestos and tobacco litigation have recently entered the securities class action arena, and new plaintiffs firms have been formed by former Milberg Weiss partners.

While there are many opportunistic plaintiffs' lawyers hoping to capitalize on the changes at the leading firms, it remains to be seen whether any of these firms can duplicate the role the erstwhile leading firms previously played. The Milberg Weiss firm, for example, was willing to make big investments to support cases and fronted costs that might not be recouped for years – if at all. The would-be successors to Weiss and Lerach may or may not be willing to make this kind of investment.

Will Securities Class Action Settlement Opt-Outs be a Significant Part of Future Claims Resolutions?

There have always been class action settlement opt-outs – that is, shareholders who choose not to participate in the settlement of a securities class action lawsuit. What has changed is that more investors, representing significant investment interests, are concluding that it is in their best financial interest to opt-out. Over the last several months, public pension funds have announced the settlement of their individual opt-out claims, often claiming that their individual recoveries exceeded what they would have recovered in the class settlement. The sheer scale of these opt-out settlements

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is enormous. In the Time Warner securities lawsuit alone, the aggregate \$795 million that the nine publicly announced opt-out claimants have garnered represents a significant amount over and above the \$2.65 billion class settlement. And there are many more opt-out claims in that case yet to be resolved.

If investors believe they can substantially improve their recoveries by proceeding individually rather than as part of a class, the utility of class action lawsuits could be substantially undermined. At some point, if enough investors opt-out, the defendants may invoke the 'blow' provisions to have the class settlement set aside. If opting-out becomes a routine part of the class action settlement process, total litigation cost could increase. If a defendant must defend itself against both a class action and multiple opt-out lawsuits, the costs of defense - and ultimately claims resolution - could escalate enormously.

These developments could pose a significant problem for D&O insurers and policyholders. Insurers base their pricing and claims reserves on data derived from past settlements. But with the emergence of significant opt-out claims, past claims data may no longer be indicative of future claims severity. And for policyholders, the emergence of opt-out claims significantly complicates the question of limits adequacy.

It is unclear whether the recent wave of opt-outs will become a permanent part of the class action settlement process. All of the recent opt-outs have come in 'mega-cases' associated with the corporate scandals from earlier in the decade. But while it remains to be seen whether opt-out settlements will or will not be a significant part of class action settlements going forward, it is hard to disagree with Columbia Law School's John Coffee, who called the emergence of class action opt-outs "possibly the most significant new trend in class action litigation."

Will Claims Disputes with Excess Carriers become a Standard Part of the D&O Claims Process?

The statistical studies cited above detailing the recent reduction in securities class action filings also noted a rise in both average and median securities class action settlements. As settlement amounts have escalated, and as defense expense has also continued to increase, excess D&O carriers, particularly upper level excess D&O carriers, have become an increasingly important part of D&O claims resolution.

Perhaps because of their increasing contributions in D&O claims, excess carriers have been involved in disputed D&O claims and claims litigation more frequently. Many of the recent significant D&O claims litigation developments have involved litigated claims

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disputes between policyholders and their excess D&O carriers. Strikingly, many of the disputes with excess carriers have arisen after the primary carrier and even the lower level excess carriers have paid all - or substantially all - of their respective policy limits.

Some disputes with excess D&O carriers have arisen when the excess carrier has taken the position that an underlying carrier's payment of less than its full policy limit relieves the excess carrier of its payment obligation, even if the policyholder funds the 'gap' resulting from the underlying carrier's partial payment. One particularly important area of concern is the excess policy's exhaustion language. Policyholders' interests are best served by flexible language that reduces restrictions on payments of loss that could trigger the excess carrier's payment obligations.

Other disputes have involved follow-form excess insurers who have taken the position that they are not bound by the primary carrier's actual or implied coverage decisions. When it threatens to become routine for follow form excess D&O carriers to take positions that the underlying carriers are not taking, the industry has a problem that it needs to address. Given the increasing importance of excess insurance in D&O claims resolution, these issues will remain critical in the months ahead.

Conclusion

A wide variety of different trends and forces continue to shape the ever evolving D&O marketplace. The changes pose challenges for insurers and policyholders alike. The rapidly changing nature of the world of D&O liability underscores the importance of having a skilled insurance professional involved in every D&O insurance transaction.

About the Author

This article was prepared by Kevin M. LaCroix, Esq. of OakBridge Insurance Services. Kevin has been advising clients concerning directors' and officers' liability issues for nearly 25 years. Prior to joining OakBridge, Kevin was President of Genesis Professional Liability Managers, a D&O liability insurance underwriter. Kevin previously was a partner in the Washington, D.C. law firm of Ross Dixon & Bell. Kevin is based in OakBridge's Beachwood, Ohio office. Kevin was the co-Chair of the 2007 PLUS D&O Symposium. Kevin's direct dial phone number is (216) 378-7817, and his email address is klacroix@oakbridgeins.com.

A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You can access the blog 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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