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Straight Talk About the Escalating Risks Facing Directors and Officers in 2010

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Directors and officers of American public companies face many substantial risks, not just the risk of their companies' success or failure in the marketplace. Every year, hundreds of directors and officers are sued, most notably in securities fraud class actions filed by professional plaintiff law firms. For decades, it has seemed every time a company's stock price drops by more than 10% in a two-day period, one or more plaintiff firms are likely to bring an action.

For a corporate director or officer, worrying about one's own prospective liability can create an unfortunate distraction from the primary goal of delivering shareholder value. Executives can be further confused and distracted if they pay too much attention each year, when noted consultants and commentators release statistical studies examining fluctuations in filing volume during the previous year, and offering sweeping opinions as to the causes, the historical and social significance, and the consequences of such statistical fluctuations, however great or small they may be.

COMFORT FROM THE COMMENTATORS?

For example, commentators famously opined in 2007, "increased enforcement activity" by the SEC and the DOJ had resulted not only in "less fraud," but that this downward movement was in fact a "permanent shift."[1] Not with standing these optimistic projections, in 2008 the number of securities fraud class action filings increased by almost 28% to 224, which tied 2002 for a 10-year high.[2] Last year (2009), the number of discrete filings went back down somewhat to 178,[3] which is still higher than the average volume for the previous five years (174),[4] and once again commentators seem to be rushing to say that the corporate waters are evidently safe again.

Experience, however, suggests otherwise. Indeed, the only consistent identifiable trend in filing volume over the last couple of decades appears to be that, in general, years in which securities class action filing volume went down have been followed by years in which the number of filings increased again. As Grace Lamont, the U.S. securities litigation and investigations practice leader for PriceWaterhouseCoopers, said in an April 1, 2010 press release: "Although 2009 saw a decline in the total number of federal securities class action lawsuits, neither financial services firms nor companies in other sectors should take this as license to drop their guard. Far from being a trend, the decline may simply be a lull as the plaintiffs' bar refocuses following two years of intense financial-crisis-related filings."[5]

More importantly for an individual director or officer, the number of securities fraud class action filings in a given year has no logical or identifiable link to the likelihood that a particular company will suffer a securities fraud class action. If the company experiences a sudden drop in stock price, then the company is likely to be sued.

And not even the most optimistic commentator predicts that plaintiff lawyers are ever simply going to stop filing cases. To the contrary, in recent years the statistical studies of securities class action filings, while still important, have become progressively less relevant as a measure of the broadening risks faced by corporate directors and officers today.

Risk: Competition Among Plaintiff Lawyers and Institutional Plaintiffs

The conviction and imprisonment of several of the key leaders of the securities plaintiffs' bar several years ago created a vacuum into which numerous enterprising attorneys have attempted to leap. Plaintiff firms and especially institutional plaintiffs have become more aggressive than ever, making cases harder to settle. Defendants paid $3.8B in settlements in 2009, which was up 35% from 2008.[6] Plaintiff firms out to make a reputation have proven to be more willing than ever before to call defendants' bluff and take cases to trial. Unfortunately, plaintiffs have been persistent and had considerable success tapping into current anti-corporate sentiment and winning verdicts in cases against Vivendi, Household Finance, Apollo Group (jury verdict, later reversed on appeal), Charles Conaway of Kmart (in a suit by the SEC, even though Mr. Conaway had previously won a bankruptcy-related arbitration), Gregory Reyes the CEO of Brocade (convicted for the second time, after his prior conviction was overturned) and Richard Scrushy of Healthsouth ($2.9B judgment in a corporate derivative suit, even though Mr. Scrushy had previously won a criminal trial in 2005). With stakes that can run into the billions, the company's only viable strategy may be to pursue settlement and hope its insurers will assist and not impede the process.

1 Cornerstone Research Report: Securities Class Action Filings – 2007 Mid-Year Assessment: http://securities.stanford.edu/clearinghouse_research/2007_YIR/20070710-01.pdf.

2 Cornerstone Securities Class Action Filings: 2008: A Year in Review: http://securities.cornerstone.com/pdfs/YIR2008.pdf; (the 2008 Report did not include filings from the second half of December 2008 in its stated total of 210).

3 Cornerstone Securities Class Action Filings: 2009: A Year in Review: http://securities.stanford.edu/clearinghouse_research/2009_YIR/Cornerstone_Research_Filings_2009_YIR.pdf (the 2009 Report did not include filings from the second half of December 2009 in its stated total of 169); other commentators showed an increase in numbers. See Advisen Research Report: Securities Suits Abound in a Harsh 2009:https://www.advisen.com/downloads/sec_lit_Q42009.pdf.

4 Extrapolated from http://securities.stanford.edu

5 Pricewaterhouse Coopers (April 1, 2010) "2009's Class Action Lull May Signal Shift in Focus from Financial Services to Other Industries, and Abroad.": http://10b5.pwc.com/PDF/2009%20SECURITIES%20LITIGATION%20STUDY%20-%20PRESS%20RELEASE.PDF

6 Cornerstone Research Report: Securities Class Action Settlements: 2009 Review and Analysis: http://securities.cornerstone.com/pdfs/Cornerstone_Research_Settlements_2009_Analysis.pdf.

Risk: The Credit Crisis Is Still Generating Litigation, with Few Resolutions to Date

Although many optimists now speak of the "Credit Crisis" as if it was a thing of the past, it is important to bear in mind about 80% of the subprime and Credit Crisis cases are still pending.[7] About 15% of the cases have been dismissed, many without prejudice to re-filing by plaintiffs, and only about 5% of the cases have been settled (11 Credit Crisis securities class actions have settled, for a total of $858.5M).[8]

Throughout 2009 and into 2010, the effects of the "Credit Crisis" spread far beyond the financial sector, and cash flow problems have led to increased bankruptcy filings and related securities fraud suits.[9] Business bankruptcy filings were up 52% for 2009 over 2008.[10] One example of this type of seeming knee-jerk response from the plaintiff bar involves a company called Idearc. When, arguably as a result of the economic downturn, the company had to write off $47 million in receivables, it filed for bankruptcy protection and experienced a 10b-5 suit for allegedly misrepresenting its credit policies. Other non-financial companies which have recently entered Chapter 11 bankruptcies and seen their directors and officers sued under Rule 10b-5 include MRU, Charter Communications and Nortel Networks. Of course, bankruptcy situations can lead to many other types of claims, including claims by bankruptcy trustees and creditors, as well as suits by laid-off employees.

Risk: The New Lawsuits Alleging Older Stock Price Drops

Another significant development has been the growing number of recently-filed suits against non-financial companies where the proposed class period ended in 2007 and 2008 (e.g., Nokia, CRM Holdings, Stryker Corporation, Bidz.com, Liz Claiborne, Coach, Inc., Rackable Systems and Sprint Nextel). These cases, which take advantage of the lengthened limitations periods granted by the Sarbanes-Oxley statute (SOX), should remind companies which experienced bad news within the last two years that they can't afford to ignore the ongoing potential exposure.[11]

Risk: Continuing Diversification of Securities Litigation

Apart from securities class actions themselves, directors and officers may be faced with other increasingly expensive (and increasingly common) securities-related litigations, such as corporate derivative suits, merger and acquisition challenges and securities fraud suits brought individually by large institutional plaintiffs. These actions do not fit directly within the rubric of "securities fraud class actions," and are thus frequently omitted from the annual reviews and commentary,[12] but they may present significant problems for directors and officers nonetheless.

Risk: Legislative Efforts to Make the Plaintiff's Job Easier

Following the 2008 elections, Congress has been considering legislation that could greatly expand potential liability for companies doing business in the U.S., including measures which would override recent specific U.S. Supreme Court decisions. One such bill would lower pleading standards for all civil litigation, so plaintiffs could more easily survive motions to dismiss and then bludgeon corporate defendants with onerous discovery demands. Another proposed bill would create a civil cause of action for aiding and abetting securities fraud, thus undoing the Supreme Court's Stoneridge decision.[13] Each of these measures could drastically increase exposure to directors and officers.

Risk: More Vigorous Regulatory Enforcement Activity

The risks are not limited to private litigation. Directors and officers also must not ignore the recent increases in government enforcement activity at the state and federal levels. This is particularly true as costs involved in responding to government inquiries and proceedings are skyrocketing, partly because the government's efforts can be more unpredictable than private plaintiffs and are not motivated purely by economic incentives.

Areas in which the government has become demonstrably more active over the last year or two include the pursuit of SOX 304 compensation "clawback" claims by the SEC and Foreign Corrupt Practices Act-related enforcements being pushed by the SEC and the Department of Justice. The SEC's use of SOX 304 (separate and apart from its increased insider trading enforcement efforts) in 2009 included two highly publicized instances in which they sought the return of compensation from executives against whom they had not alleged any personal wrongdoing. Having stepped up their enforcement of SOX 304 in recent years against individuals who were alleged to have been at the heart of stock options backdating schemes (in suits relating to United Health, Mercury Interactive, Broadcom, Maxim and others), in 2009 the SEC surprised many observers by suing the CEOs of CSK Auto and Beazer Homes USA, respectively, without even alleging these individuals were aware the financials they certified had been incorrect.[14]

On the FCPA front, enforcement has reached record levels against both individuals and corporations (40 in 2009, 26 DOJ actions and 14 brought by the SEC; these numbers are up from 2 and 3 respectively in 2004). The SEC is in the process of forming a separate unit dedicated solely to FCPA enforcement. 2009 saw three criminal trials against four individuals, all of whom were convicted.[15] This increased governmental enforcement has also resulted in a growing number of related securities fraud class actions and corporate derivative suits against large multinational companies including Siemens and Baker Hughes.

7 Top Ten D&O Stories of 2009, Story #3: The Stockpile of Subprime and Credit Crisis Cases Slowly Makes Its Way through the System, www.dandodiary.com (January 5, 2010).
8 Current lists of Credit Crisis settlements (and decisions) can be found at http://www.oakbridgeins.com/clients/blog/subprimeresolution.doc (updated often).
9 www.dandodiary.com (June 3, 2009).
10 http://www.uscourts.gov/Press_Releases/2010/JudicialBusiness2009.cfm
11 www.dandodiary.com (May 11, 2009, November 24, 2009 & February 9, 2010).
12 The Advisen report includes other securities-related litigations, bringing the total number of relevant suits filed in 2009 to 910 suits, up from their count of 804 for 2008.
13 www.dandodiary.com (September 21, 2009).
14 http://www.securitiesdocket.com/2009/11/16/beazer-homes-discloses-well-notice-to-ceo/.
15 http://www.gibsondunn.com/publications/pages/2009Year-EndFCPAUpdate.aspx.

Risk: Increased Litigation Risk Abroad

U.S. companies and their foreign divisions and subsidiaries are more exposed than ever abroad, as more and more countries beef up regulation and add class and collective action litigation statutes. In addition to increased securities regulation exposure, companies and their directors and officers are increasingly exposed to liability and criminal charges from a variety of other types of statutes. This point was recently driven home when the Criminal Court of Milan on February 24, 2010 sentenced three officers of Google to six months in prison for violating Italy's privacy laws. Google's Chief Legal Officer, Chief Privacy Counsel and former Chief Financial Officer were each found guilty of violating Italy's Personal Data Protection Code by allowing the posting of a video showing high school students bullying another student with Down Syndrome.[16] In today's "small" world of global commerce and communication, executives in particular need to be sure that their policies are sufficient to fully protect them from the laws of all potentially relevant jurisdictions. In some countries, effective protection can only be accomplished by locally admitted policies, but fortunately some carriers have practical solutions available.

Managing Risk: Know Your Policies and Your Insurers

So what should our clients, and the management liability insurance buyers' market in general, take from all of this? First, our clients should not allow themselves to be complacent where their D&O insurance coverage is concerned. Any D&O policyholder needs to understand the ins-and-outs of their coverage, both the primary policy and any and all excess policies, and especially the potential differences among the terms of these policies. Additionally, and at least as importantly, insureds need to reassure themselves (gathering information from reliable sources with actual relevant experience) they will be fairly treated by the claims departments of the insurers into whose hands they are entrusting themselves.

Why is it important for clients to know their policies? Different carriers' policies have significant differences in terms. For example, some carriers' excess policies include terms that can make complex settlements far more difficult. Carriers may use different terms to limit coverage, block settlements, or unreasonably avoid paying claims. The ever-increasing costs of settlements, combined with the insurance markets' trend towards many lower limit layers and with spiraling litigation costs, make it more likely than ever that a given claim may present exposure to more than one layer of an insurance tower, potentially exposing insureds to some of these troublesome terms and to unreasonable claim handling-carriers with one small excess layer may be particularly difficult to engage, even if relatively low in the tower. One of the most troublesome of these terms is referred to as the "exhaustion provision," which provides for what conditions must be met before the excess policy will pay for loss. Some excess carriers' exhaustion provisions require that the entire amount of the primary limit must be paid by the primary carrier before the excess policy is implicated, thus potentially negating any chance for the primary carrier to resolve coverage issues via negotiation rather than litigation.[17]

Ideally, excess policies should be short and simple, allowing insureds to carry forward up the tower the benefits of hard-negotiated endorsements to primary policies, and should be triggered whenever ANY party (insurer, insured or third party) has paid the amount of the underlying limits towards covered loss. A streamlined excess policy, like the two-page Excess Edge℠ form from Chartis, gives insureds the best chance of getting consistent responses to claims from carriers throughout the tower.

It may seem reasonable for an insurance buyer not to worry about claim handling among the excess carriers as long as the primary carrier has excellent claim handling expertise. While we at Chartis take a great deal of pride in the excellent quality of our claim handling at primary and excess levels alike, it's short-sighted to look only at the primary carrier's claim handling. Indeed, companies are being attacked on many fronts: state and federal government actions, securities class actions, state and federal derivative suits, etc. Some of the issues are resolved relatively quickly, perhaps at the cost of the primary insurance policy, while others are left behind to be defended further. This may leave a higher excess carrier's claim handlers in "primary" positions in relation to the remaining litigation, a position with which they have little experience and no expertise.

Experienced claims analysts can add tremendous value in an insured's defensive strategizing and settlement efforts. As any insured unfortunate enough to have experienced one or more securities class actions can attest, the experience levels of D&O claims analysts can vary to an extreme degree from carrier to carrier, ranging from useless skills such as knowing how to say "no" and block or delay settlements to the value-added of having extensive personal experience with the specific plaintiff attorneys and mediators (in some instances taking the lead in settlement negotiations at the insured's request). It makes a lot of sense for directors and officers and risk managers alike to survey knowledgeable parties such as brokers, defense lawyers and even policyholder attorneys to get an up-to-date and accurate sense of which claims departments meaningfully assist in the defense of claims (in many ways besides the to-be-expected yet essential basic of paying claims which are covered by their policies).

16 Willkie Farr & Gallagher LLP Memo to Clients, "Top Google Executives Found Criminally Liable for Privacy Violations," March 2, 2010.

17 In Comerica Inc. v. Zurich American Insurance Co. and Houston Casualty Co. 498 F.Supp.2d 1019 (S.D. Mich. 2007), the excess carrier was successful in relying on its exhaustion provision after the primary carrier reached a compromise with the insured to pay less than its limits in reimbursement. Both carriers denied coverage for Section 11 securities claims, despite not having specific exclusions in their policies.

Another area of insurance in which buyers must be on their guard is with Side A coverage, an area where carriers have historically collected premiums while making few substantial payments, shielding both their policies and their lack of claim handling expertise from exposure. The landscape has been changing in the past year or two and seems likely to continue to evolve with the increasing frequency of bankruptcies and derivative suits. For example, the derivative settlement in the case involving Broadcom was for $118M, $40M of which came from Side A carriers.

Fortunately for insurance buyers, recent enhancements in Side A coverage (spearheaded by the Chartis Executive Shield policy form), besides including Difference In Conditions (D.I.C.) coverage, also provide for defense cost advancement even when D&O carriers lower down in the tower wrongfully refuse to indemnify. (Note that advancement is one of the most important features to look for in any D&O policy; directors and officers should be on the lookout as comprehensive advancement features are now being added for the first time to a main form primary policy, the Chartis Executive Edge form.) Side A carriers who have enjoyed profitability over the years may be pressed for the first time to make substantial payments as necessary in this new world of increased exposures.

Some carriers are just not used to making substantial D&O claim payments of any type, and will use any excuse not to pay, whether it's an onerous or obscure policy provision, or an uninformed or disingenuous refusal to admit the seriousness of an exposure. With increasing defense costs and settlements, and the huge market capitalization losses alleged far more often in recent years, carriers used to hiding safely in the excess layers will be called upon and tested like never before. Odds are some insureds will encounter difficulties in dealing with those carriers. To minimize risk at the claim stage, insureds must make informed choices at the purchasing stage.

CONCLUSION

As exposures proliferate and potential liabilities continue to grow, it will be more important than ever to have state-of-the-art policies and claims handling. Pursuing commercially sensible resolutions to potential disputes whenever possible is a must—until the rest of the D&O market is up to speed, it's up to the client and the brokers to understand the terms of their policies and to know what to expect from their coverage and their claims service in the event a significant claim occurs.

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