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riskINSIGHTS

What to Watch Now in the World of D&O

Every fall, we assemble a list of the current hot topics in the world of Directors and Officers (D&O) liability insurance. As expected, there is much going on in the world of D&O, with further changes just over the horizon. The year ahead could be very interesting and eventful. Here is what to watch now in the world of D&O:

number*one*

How massive will the total cost of the Subprime and Credit Crisis litigation wave turn out to be?

Even though the subprime and credit crisis-related litigation wave is now well into its fifth year, only a small number of the cases have settled. But in recent weeks, a number of cases have settled in quick succession, and these settlements have been very substantial:

> $627 million Wachovia bondholders

> $208.5 million Washington Mutual

> $125 million Wells Fargo Mortgage Backed Securities

> $168 million National City

> $10.5 million Colonial Bank

> $90 million Lehman Brothers executives

With these latest settlements (many of which are subject to court approval), there have now been a total of 29 settlements collectively representing a total of almost $3.4 billion, for an average settlement of $116 million (although skewed upward by the $627 million Wachovia bondholders settlement and the $624 million Countrywide shareholders settlement).

As impressive as these cumulative numbers are, there are still many more cases pending. Of course, a certain number of the pending cases will ultimately be dismissed. But many will not, and eventually those remaining cases will be settled. Although it is impossible to conjecture how large the total

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tab for all these cases will ultimately be, the implication from the cases that have settled is that the total amount will be massive.

Naturally, the possibilities may have significant implications for D&O insurers. Of course, not all of these amounts will be covered by D&O insurance. But a significant amount will be. Indeed, a number of the recent settlements will be funded entirely by D&O insurance, including the WaMu settlement, the Colonial Bank settlement and the Lehman Brothers settlement. Interestingly, the Lehman settlement will come close to exhausting what is left of Lehman's $250 million insurance tower. In other words, the D&O insurers have had some very big bills to pay and could have some even bigger bills to pay in the months ahead.

number*two*

How extensive will the FDIC's Failed Bank Litigation efforts become?

Since January 1, 2008, 392 banks have failed, including 70 so far in 2011 (as of September 2, 2011). Fortunately, though the closures are continuing to mount, it appears that the failures may finally be starting to wind down. Since the current wave of bank closures began, there have been concerns that - just as it did during the S&L crisis in the late 80s and early 90s - the FDIC will again aggressively pursue claims against the directors and officers of the failed banks. At least so far, the FDIC's litigation activity has been relatively modest. However, the signs are that the FDIC has merely been gearing up, and that substantial numbers of failed bank lawsuits could be just ahead.

As of September 2, 2011, there have been a total of eleven FDIC lawsuits against the directors and officers of failed banks. A number of these were filed in quick succession in August, raising the possibility that the apparent backlog of FDIC lawsuit filings may finally be starting to work out. The FDIC's website states that the agency has authorized suits in connection with 30 failed institutions against 266 individuals for D&O liability with damage claims of at least $6.8 billion. The eleven cases the FDIC has filed so far involve only 77 individuals. Even just taking account of the lawsuits that have already been authorized, there are many more suits to come, and undoubtedly even more lawsuits will be authorized. Moreover, the litigation will not be limited just to cases brought by the FDIC. Many of the failed banks were publicly traded or otherwise have broad and diverse ownership, and in many instances, the bank failures have been followed by shareholder litigation. These shareholder suits represent competing claims for the D&O Liability insurance policy proceeds. The competing claimants will be vying to secure the dwindling limits, adding a layer of complexity both for the defendants and for FDIC.

number*three*

Will the Failed Bank Litigation be accompanied by a wave of Coverage Litigation?

During the S&L crisis, the FDIC was involved in extensive litigation to try to establish coverage under D&O Liability insurance policies. Many of the leading cases on the Insured vs. Insured exclusion arose out of this litigation and the Regulatory Exclusion was also extensively litigated.

The signs are that there could be a repeat of extensive coverage litigation. Indeed, when the FDIC recently filed a lawsuit against the former directors and officers of the failed Silverton Bank, it included the bank's D&O insurers as named defendants. The FDIC's claims against the D&O insurers in the lawsuit involved the insurers' attempt to deny coverage for the claim under the Regulatory Exclusion.

The FDIC may not be the only litigant involved in D&O Liability insurance coverage litigation. As multiple defendants struggle with the problems associated with too many claims and too many insured persons, the various defendants will want to sort out their entitlement to the policy proceeds. For example, a subsidiary of the failed IndyMac Bank, which is a defendant in a number of lawsuits arising out of the bank's failure, recently attempted to obtain a judicial declaration of coverage in order to sort out who was entitled to what under the bank's D&O policies. Although the subsidiary's claims were dismissed for lack of standing, the case does show that a variety of parties may be interested in using litigation as a way to establish their rights to the proceeds of the D&O insurance.

number*four*

Will the Dodd-Frank Whistleblower provisions lead to more claims? And how will the D&O Insurers respond?

Among the parts of the Dodd-Frank Act that may have a significant impact on claims is the Act's whistleblower provisions. The whistleblower provisions include the creation of a new whistleblower bounty pursuant to which individuals who bring violations of securities and commodities laws to the attention of the Securities and Exchange Commission or the Commodities Futures Trading Commission will receive between 10 and 30 percent of any recovery in excess of $1 million.

While it is too early to tell what impact the bounty provisions will ultimately have, most observers expect that the substantial incentives provided by the whistleblower provisions will lead to an increased number of whistleblower reports and that these reports will lead to investigations and enforcement actions. In some instances, the revelations in the whistleblowers' reports will also lead to follow-on civil litigation, as aggrieved shareholders or others pursue claims for misrepresentation or mismanagement.

number*five*

What will be the next "Hot" litigation target?

From time to time, a sector or industry will find itself as the target by plaintiff securities class action attorneys. For a brief period last summer, the hot sector was the for-profit education section. Since then, the hot target has been U.S.-listed Chinese companies. This year alone, there have been 32 cases filed against U.S-listed Chinese companies (through September 2, 2011).

This surge of litigation involving Chinese companies arose out of accounting scandals, many of which were first revealed by online analysts, many of whom had short positions in the companies they were attacking. The Chinese companies attempted to deflect the assertions of accounting improprieties by charging that the online attacks were merely rumors started by those with a financial incentive to drive down the companies' share price. Fair or not, the online reports seemed to directly lead to shareholder litigation, as in many cases the shareholder plaintiffs were simply quoting the online analysts' reports in their complaints.

For now, the phenomenon shows no sign of letting up, as the lawsuits involving the U.S.-listed Chinese companies have continued to accumulate as the year's second half has progressed. Indeed, between July 1, 2011 and September 2, 2011, there were a total of 6 U.S.-listed Chinese companies sued in new securities class action lawsuits in the U.S.

The recent litigation outbreak involving the U.S.-listed Chinese companies is a reminder of circumstance-specific events that can drive securities class action lawsuit filings. Many things determine filing levels, many of which cannot be captured or predicted in historical filing data. As a result, it can be misleading to try to generalize from short term trends about future filing levels. Simply put, the numbers vary over time, because, for example, contagion events and industry epidemics happen.

number*six*

Will M&A Litigation continue to surge?

One of the more interesting phenomena in the world of corporate and securities litigation has been the changing mix of litigation. The insurance information firm Advisen has documented that in more recent years, class action securities litigation has represented an increasingly smaller percentage of all corporate and securities lawsuits. One area that has been growing as a percentage of all corporate and securities litigation has been M&A related litigation.

According to Advisen, in 2010, there were 353 lawsuits challenging corporate mergers filed in state and federal courts, which represents a 58% increase over 2009. As of

August 27, 2011, 352 M&A related lawsuits had already been filed, putting this year's filings to far exceed last year's.

As discussed in an August 27, 2011 *Wall Street Journal* article entitled "Why Merger Lawsuits Don't Pay", these lawsuits rarely produce substantial damage awards. Often, the most they succeed in accomplishing is a delay in the merger or slightly improved disclosures about the deal's terms. The reason these lawsuits continue to be filed, and indeed continue to be filed in increasing numbers, is that these cases are good business for the plaintiffs' firms. These firms can collect fees that range from $400,000 for typical cases to millions of dollars for larger cases.

In the past, these types of cases have not represented a significant claims exposure for D&O insurers. However, now that so many more of them are being filed, and now that individual merger deals are now attracting multiple claims, these cases are becoming a much bigger problem for the D&O insurers, particularly those that are the most active as primary insurers. A basic assumption of the D&O insurance industry is that D&O claims represent a low frequency, high severity threat. But these M&A claims are exactly the opposite – they represent a high frequency, low severity exposure, for which the D&O insurers likely did not price and almost certainly cannot underwrite. And even if the typical case settles for relatively modest amounts, the claims costs including defense fees are now in the aggregate becoming an issue for the D&O insurers. If the D&O market were to turn, the D&O insurers might require higher self-insured retentions for these types of claims, on the theory that they really represent a cost of doing business, rather than a true third-party liability exposure.

number*seven*

Will the U.S. Supreme Court continue its inexplicable willingness to take up securities cases?

Years from now, when the history of the Roberts Court is finally written, perhaps the historians will be able to explain why during the second half of the first dozen years of the 21st Century, the Court was so eager to take up securities cases. The Supreme Court is just coming off a term in which the Court heard three different securities cases, and it has already agreed to take up one more case in the term that is about to begin.

The case that the Court has already agreed to hear next year is the Credit Suisse Securities case, and it involves statute of limitations issues arising in connection with Section 16(b) claims for short-swing profits. This narrow, technical issue is unlikely to have widespread significance - but what is significant is that yet again this Court has taken up a securities case. There does not seem to be any particular member of the Court that is driving the Court's interest in securities cases, but for whatever the reason, the Court's docket increasingly includes these types of cases.

The current Court does not always rule in the favor of the defendants. For example, this last term, in the *Matrixx Initiatives* case, the court rejected the defense argument that plaintiffs must show "statistical significance" in order to establish materiality in a securities lawsuit. In an earlier term, in the *Merck* case, the court rejected the defendants' statute of limitations arguments. But many of the Supreme Court's recent securities law decisions have been in the defendants' favor, and the Court's rulings in recent terms in such cases as *Janus Capital*, *Morrison*, and *Tellabs* represent significant defense victories that have or will have a significant impact in many cases on the plaintiffs' ability to pursue securities claims.

The overall cumulative impact of the Court's interest in taking up securities cases has been favorable to companies and unfavorable to plaintiffs. There is some speculation that the increased difficulty of successfully maintaining a securities class action lawsuit through the motion to dismiss may be one reason for the shift in the mix of corporate and securities litigation away from securities class action lawsuits and toward other types of litigation (like the M&A litigation, discussed above).

number*eight*

Will the implementation of the U.K Bribery Act mean increased Anti-Bribery Enforcement Activity?

On July 1, 2011, the U.K Bribery Act became effective. The Act has a broad reach, regulating prohibited conduct that takes place within the U.K. or that involves a company or person that carries on business in the U.K., regardless of where the prohibited activity takes place. The Bribery Act is broader than the U.S.'s Foreign Corrupt Practices Act, reaching a broader range of prohibited activities and providing for greater possible liabilities for those at companies involved in these activities - even if not directly involved in the prohibited conduct.

From the time the Act received Royal Assent, one of its features that has been the focus of particular concern has been Section 7 of the Act. Section 7 creates a new offense which can be committed by commercial organizations that fail to prevent persons associated with them from committing bribery on their behalf. Commentators have been concerned that this provision would seemingly subject any firm—even non-U.K. companies that have operations in the U.K.—to liability under the Act for violative conduct taking place any where in the world.

Because the Act has only just become effective, it is not yet known how aggressively it will be implemented or what its overall impact will be. At a minimum, it seems likely that the Act will lead to an increase in enforcement activity.

As companies confront these developments, among the issues that are likely to arise are questions concerning coverage for these proceedings under their D&O insurance policies. The Act's fines and penalties are not likely to be covered under typical policies. Whether investigative costs and defense fees will be covered will depend on a large variety of circumstances, including who is the target of the investigation. How serious these problems will turn out to be will depend a lot on the Act's implementation, a development that will be worth watching.

number*nine*

What impact will the changing Corporate Governance Requirements have?

Largely due to the 2010 enactment of the Dodd-Frank Act, we have entered a watershed period of corporate governance reform. Processes now afoot have wrought a transformation in the relations between corporate boards and shareholders. These changes have not only created additional burdens on affected companies, but they have also resulted at times in a change in the corporate litigation environment as well.

Among the changes the Dodd-Frank Act implemented is the requirement for an advisory shareholder vote on executive compensation. As a result of Section 951 of the Dodd Frank Act and the requirements of SEC rules that went into effect January 25, 2011, all but the smallest public companies had to put their executive compensation practices to an advisory shareholder vote this past proxy season. As it turns out, about 40 companies experienced a negative shareholder vote. In some cases the negative "say on pay" vote has been followed by shareholder litigation - by activist investors seeking to reform executive compensation practices.

The requirement for a shareholder "say on pay" is only one of many current corporate governance reform under discussion. Other areas include the question of proxy access – that is, the question whether shareholders can have their board candidates listed on the annual proxy form. The D.C. Circuit recently struck down the SEC's rules requiring proxy access, but the issue is not likely to go away.

Other current corporate governance issues include reforms such as board declassification and majority voting. Other issues that loom ahead as other provisions of Dodd-Frank go into effect include requirements that companies disclose the ratio between total annual compensation of their CEO and the median annual compensation of their employees (rules implanting these provisions are required to be adopted before the end of 2011).

Another provision of the Dodd Frank Act requires the SEC to direct the national exchanges to impose new listing standards directing public companies to implement compensation clawback provisions. Under Section 954 of the Dodd Frank Act, companies making accounting restatements of prior financials must recover from any current or former officer all incentive-based compensation paid during the preceding three-year period above what would have been paid without the misstated financials. These provisions are to be implemented by this year-end.

These various provisions will affect companies in different ways. But it is clear that these changes are here to stay. As such, companies and their management are operating in a challenging environment. Companies that resist these governance developments may face heightened levels of scrutiny, both from shareholders and from the media. Moreover, as corporate governance standards change, boards will be held to standards of conduct reflecting the changed governance norms and expectations. Further, in an era of growing shareholder empowerment, that reality may translate into increased judicial expectation for boards to address shareholder initiatives.

Taken together, these changes in the corporate governance environment mean heightened scrutiny, changing shareholder expectations, and even an increased litigation risk. How extensive these changes will ultimately remain to be seen as the additional provisions of Dodd Frank are put into effect in the months ahead.

number*ten*

What does all of this mean for the D&O Insurance marketplace?

Given all of these trends and developments, an outside observer might reasonably expect that the marketplace for D&O insurance would be becoming more restrictive. And certainly with respect to certain categories, such as U.S.-listed Chinese companies and commercial banks, the marketplace for D&O insurance is challenging. However, outside of those particularized categories, the marketplace for D&O insurance remains generally competitive.

There is nothing specific to suggest that the generally competitive environment is about to change - at least immediately. But there are a number of considerations that could lead to change. The first is the cumulative impact of the year's catastrophic losses. The various natural disasters this year, from the earthquakes in New Zealand and Japan to Hurricane (and tropical storm) Irene, have had an impact on the insurance industry's collective balance sheet. If there were to be significant events in the four remaining months of the year, the accumulated losses could be enough to force a pricing increase or to cause carriers (or at least some of them) to pull back.

Given the catastrophe events that have already occurred this year, carriers are likely to be scrutinizing their books. Many of the developments discussed above will undoubtedly lead the various carriers to take a close look at their D&O portfolios. The mounting losses from the subprime meltdown and the credit crisis; the looming impact of the wave of failed banks; and the difficulties and uncertainties associated with a changing litigation and legal environment are all likely to raise concerns. These concerns inevitably lead to questions about pricing adequacy, risk selection, and scope of coverage.

In light of all of these considerations, it would be very rational for the D&O insurance marketplace to enter a more restrictive phase. But as long as capacity remains ample and competition active, most companies outside of the most troubled sectors will apparently continue to enjoy the benefits of a competitive marketplace for D&O insurance. The question is how long these conditions will continue. Time will tell of course, but if the wind blows or the earth shakes again, among the consequences could be a harder market for insurance generally and for D&O insurance in particular.

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