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Will D&O Lawsuits Explode?

Corporate Governance Law Puts D&O Buyers, Sellers At Risk

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NATIONAL UNDERWRITER
PROPERTY & CASUALTY/RISK & BENEFITS MANAGEMENT EDITION

COVER STORY

Sarbanes-Oxley May Have Big Impact On D&O Litigation

By **Carol A.N. Zacharias**

On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002, an unprecedented corporate governance statute which redefines the conduct, liabilities and relationships of directors, officers, accountants, attorneys and analysts for publicly traded companies. It is a watershed in corporate law and relations, the most significant such legislation since passage of the first securities laws in the United States.

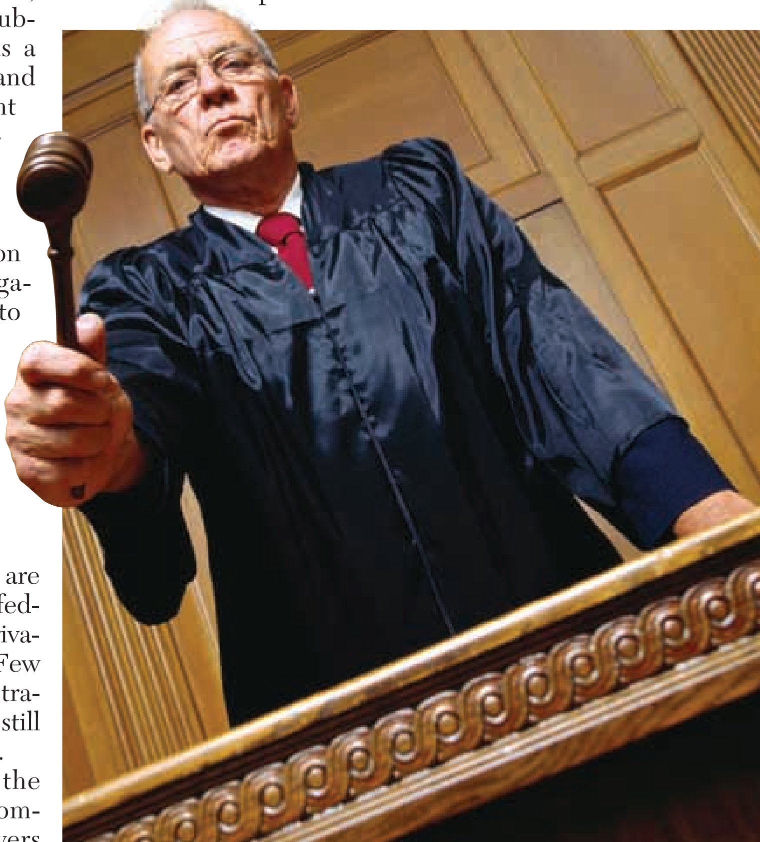
This article summarizes potential impact of the act on directors and officers litigation. While it is impossible to know at this early stage to what degree these issues will develop, the following issues are the key areas of concern for D&O insurers and brokers to watch in the months ahead.

• More forums.

Most securities fraud cases are filed as civil class actions in federal court. Some include derivative actions in state courts. Few include SEC civil or administrative cases, and even fewer still involve criminal prosecutions.

Under the new act, the Securities and Exchange Commission is given broad powers to bring various administrative proceedings, including cease and desist proceedings, actions seeking injunctive relief, actions seeking fines and penalties, actions to bar executives from further service, and criminal cases.

Former SEC Chairman Harvey Pitt promised more SEC civil, criminal and administrative actions at the American Bar Association Annual Convention earlier this year. According to an Aug. 12 Federal News Service report, Mr. Pitt said: "I think we have to see more prosecutions. I think that unless people believe that significant white-collar crime in which investors are bilked out of millions and even billions is subject to the same kind of punishment as so-called blue-collar or street crime, they will continue to lack faith in our system. And all I can say is that we are very, very determined to pursue this."



Hence there may be more litigation in a wider variety of forums.

The relevance for the D&O liability insurance industry is three-fold.

First, defendants may want to strategically and quickly settle lawsuits rather than allow them to go forward, for fear of producing evidence that could damage the defendants in a parallel administrative proceeding.

Second, defense costs may increase, because more forums mean more litigation, and because more forums may mean more lawyers, such as criminal lawyers in addition to a civil defense attorney.

Third, multiple lawyers may be requested where fellow executives cannot share counsel due to conflicts.

• More discourse, more evidence.

Audit committees and boards are now charged with more specific responsibilities than ever before under the Act. Consequently, power has shifted from the chief executive to the rest of the board.

A likely result will be a greater level of sensitivity and tougher questions in the boardroom. The increased scrutiny and discourse may be documented to show due diligence, which means more evidence than ever before regarding corporate decisions.

While increased discourse is intended to create better management and financial reporting, it will also provide a paper trail for plaintiffs in litigation.

• More disclosures, more evidence.

The act requires more and faster financial disclosures. For example, accountants are required to submit audit reports that include an assessment of internal controls, off-balance-sheet companies and relationships, and the adequacy of the financial reporting. Accountants are also required to keep audit records and work papers for seven years.

Executives must certify that they have revealed to the auditors all fraud and all financial information. In addition, executives must disclose trades in company stock within two days thereof.

These and the other new disclosure requirements under the Act force production of more evidence around which

plaintiffs may frame a new case, and which plaintiffs may use to withstand motions to dismiss for failure to plead fraud with specificity.

• Fewer dismissals.

Until now, the higher pleading standard under the Private Securities Litigation and Reform Act of 1995 meant that more cases were being dismissed, albeit many with leave to file again, for failure to plead fraud with adequate specificity. With the increase in the amount of available evidence and the increase in discovery due to the fact that the same event may give rise to litigation in more than one forum, it may be easier than ever before for plaintiffs to collect enough facts to survive motions to dismiss.

• Larger classes, more damages.

The act provides a longer statute of limitation for filing securities fraud suits, which means longer class periods.

Until now, shareholders could wait until the sooner of one year from discovery of the acts or three years from the act itself. Under the new Act, they can wait until the sooner of two years from discovery, or five years from the actual event.

This means potentially longer class periods, larger classes, and larger class damages.

• Larger penalties, more settlement pressure.

Hefty increases in jail time and financial penalties for executives under the Act may mean that executives are not willing to have the cases go forward. They may seek to settle, and settle quickly. This may include attempts to settle collateral cases that are otherwise not yet suitable for settlement, for fear of production of adverse evidence that could be used against them in the original case.

• More regulatory actions.

The SEC is required under the act to review the periodic reports of publicly traded companies at least once every three years. This kind of scrutiny may lead to more regulatory actions. In fact, former SEC Chairman Harvey Pitt expressly promised more prosecutions.

In addition, more regulatory actions may lead to additional, concurrent civil actions by private litigants.

• More directors and officers as defendants.

In most securities class actions in recent years, companies and key executives were sued, rather than the entire board, in part as a result of the enhanced pleading requirements of the Private Securities Litigation Reform Act of 1995. Under the new Act, however, audit committee members and independent directors have increased and specific responsibilities, which provides a concomitant chance of increased litigation against them.

• More to come.

It is important to note that the act's provisions become effective at staggered points in time over the next year, and that the SEC has been asked to promulgate rules and regulations to implement the Act's mandates. In addition, the SEC has been asked to conduct several studies, undoubtedly to measure the need for further corporate governance reform.

As such, the Act is only the beginning of an era of corporate governance reform. More duties and responsibilities will be added in the months to come, which may create a greater potential for liability. Accordingly, the continuing changes must be carefully monitored.

In addition, the exchanges are increasing the strictures on listed companies and their executives. The NASDAQ and the New York Stock Exchange have proposed listing requirements that support and supplement the corporate governance requirements of the Act.

The New York Stock Exchange's proposed rules can be found at *http://nyse.com/pdfs/corp_gov_pro_b.pdf*

In sum, they require:

• Shareholder approval of most equity- based compensation plans.

• Stronger and more active audit committees.

• Compensation, corporate governance and audit committees must be staffed entirely by independent directors.

• A majority of every board to be independent.

• Independent directors must meet regularly outside the presence of the management directors.

These requirements must also be monitored carefully as they, too, could create increased liabilities if abrogated by executives. NU

Carol A.N. Zacharias is underwriting counsel for CNA Global Specialty Lines in New York. The opinions set forth in her article are her own. They do not reflect analysis or opinions of any third party, and the article should not be construed as legal advice.

Insurance Carriers Respond To Changing D&O Liability Environment

By **Carol A.N. Zacharias**

Critical events coalesced in the past year to make it one of the most dynamic years in the history of directors and officers liability insurance.

The events included:

• The downturn in U.S. economic conditions.

• Strikingly adverse financial developments at various companies such as Enron, WorldCom, Adelphia, Tyco, Homestore.com, Qwest, and Xerox.

• Unprecedented legislation in the form of the Sarbanes-Oxley Act in an attempt to legislate good corporate governance (see related story on page 2).

• An exponential rise in claims severity.

Any one of these events would have contributed to an already hardening D&O insurance market. Together, they created an inexorable pull towards the first hard market in a decade.

Accompanying the predictably hardening premiums, deductibles and limits has been the hardening of policy terms and conditions. This article outlines some of the more critical changes under discussion in the D&O insurance community.

• Applications.

Applications are being revisited to incorporate certifications filed with the Securities and Exchange Commission by chief executive and financial officers, in which each warrant that the company's

filings accurately represent the state of the organization.

Similarly, applications are being amended to confirm that financials filed with the SEC are made part of the application, even if not attached thereto because they are available on the Internet today.

Corporate governance questions are included in some applications, with questions such as whether a company has an audit committee, whether a company uses its public auditor to perform additional non-audit services, and the like.

Finally, severability of the application is under review with a variety of approaches under discussion, running the gamut from no severability, partial severability, to full severability. In addition, severability otherwise granted may be eliminated in some forms if certain senior executives had knowledge of any misrepresentations or omissions prior to policy inception.

• Claims.

Insurers are revisiting the kinds of proceedings that are covered under a D&O policy. Civil litigation is typically included. However, insurers are questioning the extent of coverage warranted for increasingly frequent and severe administrative, regulatory, criminal and investigatory proceedings.

In some policies, coverage remains, while in other policies it is expressly limited to defense costs coverage only.

• Insureds.

One of the most critical policy questions is whether and to what extent the entity should be insured.

Entity coverage was popularized in the last decade, and a majority of directors and officers liability insurance purchasers bought the coverage according to the 2002 Tillinghast Directors' and Officers' Liability Insurance Survey.

However, some executives, brokers and insurers have become concerned about the depletion of the limits by the entity.

Consequently, some newer D&O policies eliminate entity coverage entirely, and instead provide it for securities claims only, by endorsement.

The downturn in U.S. economic conditions, corporate scandals at companies such as Enron, good corporate governance legislation, and an exponential rise in claims severity combined to create the first hard D&O market in a decade

A corollary question regarding who is insured is whether and to what extent non-director and non-officer employees are covered.

Some D&O policies provide no employee coverage, while other policies cover employees in two instances. First, they may be covered where they are sued as a co-defendant along with otherwise covered directors and officers, in any type of claim. Second, they may be covered if sued in a securities claim, even if sued alone in such a claim.

• Subsidiary executives.

Insurers are examining the breadth of coverage for executives in subsidiaries.

Some newer policies do not include partnerships or joint ventures as subsidiaries, even if completely owned and managed by the insured entity. Instead, there are partnership policies that more appropriately address the exposure.

Further, with respect to for-profit companies that become subsidiaries after the policy incepts but during the policy period, some insurers give temporary coverage for a short time frame, subject to subsequent underwriting review and consent. Others require an endorsement before coverage for the new subsidiary will apply.

• Outside directorships.

Insurers are closely examining coverage for insured executives serving as directors on boards other than the board of the insured organization. These are called outside directorships.

Some policies require an endorsement for each for-profit outside organization board membership, and insure not-for-profit board memberships only if the insured company exercises management control over the not-for-profit company.

In addition, coverage for outside directorship positions is being sold in newer policies on a triple, not double, excess basis. This means that the coverage is excess over any indemnification and insurance provided by the outside organization, and any indemnification provided by the insured organization.

• Exclusions.

Some insurers are adding specific exclusions, either in the policy or by endorsement, such as restatement, remuneration and disgorgement, personal injury, defamation, and broader pollution (including mold, germs and chemicals) exclusions.

Insurers are also amending the profit and dishonesty exclusions so that they apply in the event of specific, objective events, such as an adverse admission by an executive, adjudication, final adjudication, or a plea of no contest by the executive.

• Defense.

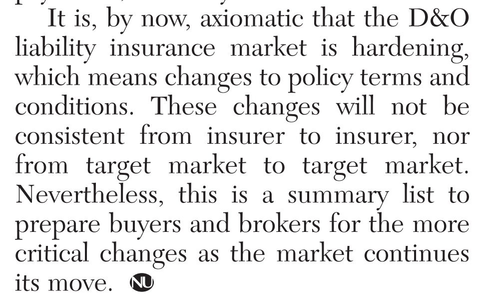
Policies are being amended to include an express obligation on the part of the insureds to contest claims where appropriate, not merely defend them.

Some forms also permit the insurer to associate in the negotiation of any settlement and the prosecution of any claim. Thus, the insureds should involve the insurer as a partner in the settlement negotiation process.

In addition, the insureds should align themselves with the insurer in prosecuting any appropriate claim. Moreover, some forms require some type of alternative dispute resolution mechanism to resolve any coverage disputes through arbitration, mediation or some other form of dispute resolution.

• Exposure.

Some insurers are capping limits for a single, common event that triggers coverage under the same insurer's D&O, employment practices liability and fiduciary liability policies. Moreover, forms may provide that the insurer will pay excess over any other limits, not merely payments, from any other insurance.



It is, by now, axiomatic that the D&O liability insurance market is hardening, which means changes to policy terms and conditions. These changes will not be consistent from insurer to insurer, nor from target market to target market. Nevertheless, this is a summary list to prepare buyers and brokers for the more critical changes as the market continues its move.

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