

# **Directors' & Officers' Challenges for 2007**

Alejandro Martinez del Castillo  
University of Wisconsin-Madison

Corporate scandals have put the actions of executives under greater scrutiny. The Sarbanes-Oxley (SOx), new corporate governance initiatives, changes in the regulation of the Securities and Exchange Commission (SEC) that presents new liability exposures, and shareholders involvement and demands, have resulted in increased costs, responsibilities and concerns for many companies and its directors and officers. In turn, executives are demanding substantially pay increases and thinking twice about the risk of being part of a board of directors, as their personal assets are highly at risk without mentioning the perception of an increase in the odds of spending time in prison.

Nowadays, it is critical that directors and officers understand their responsibilities, exposures and how their Directors and Officers (D&O) liability insurance protects—or fails to protect—them and their personal assets. No two D&O policies are exactly the same, so corporations need to be knowledgeable about the market for cover, the extent of litigation risk that the products offer protection against and the numerous permutations of the different types or coverage.

More securities lawsuits went to trial in 2005 than in the past 10 years combined. Several senior executives of former Fortune 100 companies have been tried or face trials in 2006. Regulators continue to aggressively pursue perceived stock manipulators and recently have started to target outside directors. Suits involving foreign corporations have been an increasing target of shareholder litigation.

There are some signs that this trend may be abating. Perhaps due to less volatility in the stock market, the impact of Sarbanes-Oxley, and the efforts of regulators, the frequency with which securities class action suits were commenced decreased in 2005. Moreover, the market capitalization and disclosure dollar losses associated with those suits was lower than at any point prior to 2000

Below we present an overview of some of the challenges directors and officers faced during 2006 and their impact for the upcoming years.

# Current Landscape

## Securities Fraud Class Actions

Securities class action suits remain the principal source of D&O losses to public companies. They reached unprecedented levels in 2005 when even excluding WorldCom's over \$6.1 billion payment to resolve shareholder and bond claims, and Enron's \$7.1 billion (and counting) settlement, the total value of cases settled during 2005 grew to an all time high of \$3.5 billion.

Nonetheless, the number of securities fraud class actions filed in 2006 was the lowest ever recorded in a calendar year since the adoption of the Private Securities Litigation Act (PSLRA) of 1995<sup>1</sup>. In total, securities fraud class actions decreased by 38 percent since 2005, that is, from 178 filing to just 110. This represents the lowest level of filing activity in a 10-year historical average.

The decline is even more striking when filings alleging options backdating are excluded. To date, there have been 22 securities class actions filed related to options backdating allegations, 20 of which were filed in 2006. Excluding the options backdating cases from the sample, as these reflect one-time events that will not recur in the future, suggests that "core" securities class action litigation in 2006 was only 90 cases, a decline of 53% from the historic norm.

Incidences of "mega" filings — cases with Disclosure Dollar Loss<sup>2</sup> (DDL) in excess of \$5 billion or Maximum Dollar Loss<sup>3</sup> (MDL) in excess of \$10 billion — also declined in 2006. There was only one "mega" DDL filing in 2006, whereas there were 5 such filings in 2005. There were 8 "mega" MDL filings in 2006, 4 of which were driven by option backdating claims. In contrast, there were 9 "mega" MDL filings in 2005.

This reduction in filings can be attributed to the enforced pressure that the SEC and Department of Justice bear on corporations to conduct internal investigations that implicate the individual executives responsible for the fraud, which may be reducing the amount of fraud in the market. Other factors are the lower stock price volatility, the stricter legislation and severe punishments demanded by investors.

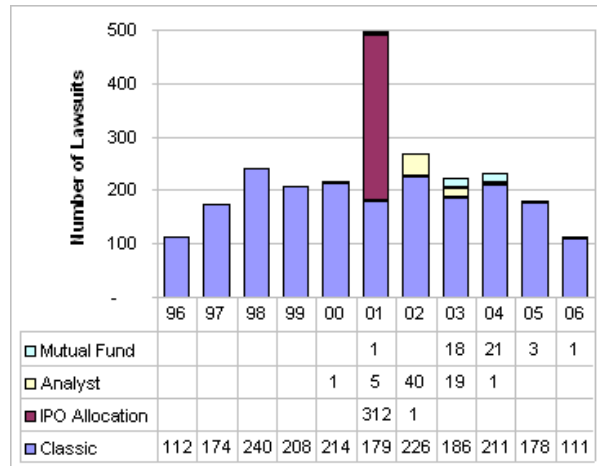
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<sup>1</sup> Securities Class Action Case Filings—2006: Year in Review report, Stanford Law School Securities Class Action Clearinghouse

<sup>2</sup> Market capitalization losses at the end of the class period

<sup>3</sup> Shareholder losses measured by the largest capitalization decline experienced during the class period

**Chart: Filings by Type of Lawsuit**



Source: Stanford Law School, Securities Class Action Clearinghouse

During 2006, the highest percent of the filings alleged misrepresentation in financial documents and false forward-looking statements, followed by allegations in accounting irregularities and accounting for options issuance.

While securities class actions dropped 38 percent in 2006, derivatives lawsuits rose. Derivative class actions related to stock option backdating rose to 140 threatening further losses in the D&O insurance market. While settlements and judgments in these derivative cases are often less severe than other forms of securities litigation, the resurgence of A-side policies in the D&O market can exacerbate losses for insurance carriers.<sup>4</sup>

### **SEC's Involvement**

The Securities and Exchange Commission has continued to step up its prosecution of securities violations and accounting frauds. In 2002 announced its intention to pursue director and officer based on individual misconducts, thanks to the SOx permitting the SEC to pursue directors and officers in an administrative proceeding (no longer exclusively within the federal courts). Furthermore, a company that cooperates may avoid millions of dollars in civil penalties and save its executives from a lengthy bar.

### **Insurance Market**

Insurance to manage the costs of litigating and settling lawsuits has long been a prerequisite to conduct business in the United States. Although it is not a legal requirement, executive and

<sup>4</sup> Chubb Vice Chairman, John Degnan

independent directors normally will not even think about taking on a new board post without being personally indemnified and insured against such losses, as the risks for significant financial loss are just too high.

The wave of scandals involving stock-option backdating pushed Directors' and Officers' insurance premiums higher in anticipation of a surge in class-action suits.

So far, restatements related to backdating have led to 19 shareholder suits, with many more expected over this year. More than 100 companies have disclosed that they are the subject of regulatory, criminal or internal probes into whether or not they improperly inflated executives' pay when dating their stock options.

The backdating scandal is expected to widen in the coming months as Sen. Charles Grassley (R-Iowa), chairman of the Senate Banking Committee, has vowed to pursue advisers, including lawyers, accountants, and consultants, who promoted backdating as a strategy.<sup>5</sup> Should the number of backdating cases continue to grow, pressure to raise D&O premiums for all executives will increase

Changing corporate governance practices and excess capital in the insurance market have made directors and officers (D&O) liability premiums drop in recent years, according to Advisen Ltd., a provider of analytics, benchmarking and market information to the global commercial insurance industry.

According to Advisen, the falling rates are the result of increasing aggregate capacity and decreasing frequency and severity of losses. Capacity withdrawn from hurricane exposed business and redeployed to other lines and regions, plus new capacity generated by 2006 profits and more than \$30 billion in new investments in the industry, increased downward pressure on rates in 2006 for business other than hurricane exposed property, including D&O. As a result, global D&O capacity is greater than ever – well in excess of \$1.8 billion before considering the additional limits that may be available on an A-side basis (for non-indemnifiable claims).

Based on Advisen's data, rate level erosion in almost every line of business will cut into insurer profits in 2007, but as long as it is not an unusually severe year for natural catastrophes, aggregate policyholders' surplus nonetheless should continue to accumulate. This will further increase downward pressure on pricing in most lines of business including D&O. In addition, the trend towards fewer securities class action suits should continue through 2007, which will increase pricing pressure.

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<sup>5</sup> Alerts, Issue 21—Executive Risks, Willis North America

# What to look for

## Negotiating the D&O coverage

Negotiating directors and officers insurance can be a complex and time-consuming event – but one that is vital to get right, due to the risks and costs involved. The key is for corporations to work together with their broker and underwriter to understand each other's needs.

What boards need to consider when choosing a policy for directors is the type of D&O cover. One significant decision is whether to take out entity coverage insuring the company against securities class action lawsuits or whether to concentrate coverage on individual directors and officers. The key is for corporations to understand whom and what they are trying to protect.

Increasingly, after Enron and WorldCom, directors have been negotiating for their own individual D&O insurance when they join a company. Some corporations now favor a mixture of both entity and individual cover. However, in a market where capacity is tight and premiums are still significantly higher than they were four years ago, companies need to think carefully about which costs they want to insure against and which costs the company will retain as a cost of business in the event of a lawsuit. Regulatory exposure is one example. Often, the SEC will initiate an informal inquiry into a corporation – usually as part of a wider industry investigation. Formal proceedings may or may not be brought. Companies can negotiate for these costs to be picked up earlier under their D&O policies, but the extra coverage will increase the overall price of the policy and may, in defending against what might be a relatively routine inquiry, diminish the limits available to the company and its individual insureds for more serious claims. Other potential corporate situations such as the need to restate financial results, hostile takeover bids and proxy battles may change the nature of the risks.

Policies providing entity and individual coverage may not be sufficient in the event that a company is unable to indemnify its directors and is in bankruptcy. If shareholders bring a lawsuit against a company and it goes into Chapter 11 bankruptcy protection, for example, its creditors can apply to have all its assets – which some courts have held to include its D&O insurance entity/individual coverage policies – frozen. If that happens, directors and officers may find themselves at least for some period of time with no company indemnity and without insurance, leaving them to front their own defense costs and any successful settlements.

## **Outside Directors**

In the wake of the massive accounting scandals at Enron and WorldCom, the SEC announced that it would pursue enforcement actions against outside directors who ignore corporate wrongdoing. The SEC's proclamation represents a fundamental shift in the SEC's enforcement policies with respect to outside directors. An SEC enforcement action against a former outside board member at Chancellor Corporation exemplifies the SEC's new stance.

SEC actions against outside directors for so-called oversight failures are civil in nature. Criminal liability against an outside director generally requires that the director willfully or knowingly violated the securities statutes at issue. Accordingly, it is not surprising that in oversight cases there have been no criminal prosecutions against an outside director to date.

Conversely, criminal sanctions have been imposed against outside directors for insider trading and self-dealing. When an outside director is found to have engaged in insider trading, out-of-pocket payments are not uncommon. In such cases, the SEC may seek disgorgement of trading profits, civil penalties, and an officer and director bar. Similarly, in cases involving self-dealing, the SEC may seek disgorgement of the gains and possibly a civil penalty as well.

## **Foreign Corporations**

Companies that are listed on the US and other exchanges need to be aware of the risk associated with violations of the US Foreign Corrupt Practices Act (FCPA) and the Organization for Economic Co-operation and Development (OECD). Between 2000 and 2006 several companies were cited for alleged violations of the FCPA relating to: lack of sufficient diligence in knowing the counter-party (e.g., agent) and whether any part of the payments made would be passed on to foreign government officials; unsuccessful claims on reliance of an opinion by counsel or claims that the payments were facilitated; books and records alleged to have been violated; among others.

The last several years have seen a substantial increase in the number of SEC enforcement actions and securities class action lawsuits against foreign filers as securities regulators in the US, European Union countries, and other nations, have improved coordination of their regulatory and enforcement policies and activities.

Grace Lamont, partner, PricewaterhouseCoopers, notes: "The increased cooperation among global regulators and the increased focus by the SEC on foreign issuer related matters should serve to confirm that US domestic companies and foreign issuers are equally accountable. There

is no indication that foreign issuers should expect to be any less subject to securities litigation than their US counterparts”

“Most major financial frauds are committed by senior management. Their motives are greed, power and position (and fear of losing their power or position), and a headlong pursuit of business success – at any price.”

Since the enactment of SOx, the number of SEC enforcement actions against foreign registrants and entities has increased. In 2002 there were three enforcement actions against foreign registrants or entities as reported in the SEC Litigation Series Releases. In 2003 and 2004, the number of enforcement actions increased to seven. In 2005 there were a record 15 SEC enforcement actions against foreign registrants or entities. There was a modest decrease in the number of securities class action lawsuits filed against foreign issuers in 2005, from 29 suits in 2004 to 25 suits in 2005.

While several foreign jurisdictions have enacted legislation allowing litigation styled on U.S. securities class actions in recent years (e.g. Canada, Germany, Sweden, South Korea, and Australia) the United States remains at the center of securities class action litigation. For the most part, it appears that the English Rule in many countries that shifts the winner's fees to the loser, together with limitations on contingent fee arrangements, has so far limited the interest of the plaintiffs in such countries to pursue securities class action litigation. In addition, several U.S. court decisions in recent years have opened the doors to U.S. courts (and class recoveries) for foreign investors. U.S. courts have provided jurisdiction for the claims of purchasers of American Depository Receipts (ADRs) of foreign companies.

More recently, U.S. courts are permitting class actions against foreign companies to include—within the class—the claims of foreign purchasers of the shares of the foreign company purchased on foreign exchanges.<sup>6</sup> A clear consequence of such decisions is to broadly expand the size of the class, and therefore expand the exposure of the issuer and its officer and directors to U.S. litigation costs.

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<sup>6</sup> *In re Royal Ahold N.V. Sec. and ERISA Litig.*, 351 F. Supp. 2d 334 (D. Md. 2004) and *In re Vivendi Universal SA Sec. Litig.*, 2004 WL 2375830 (S.D.N.Y. Oct. 22, 2004)

## Conclusions

The data suggests that corporate officers and directors continue to experience significant exposure to liability in both private litigation and government enforcement actions. While there was a decrease in the number of private securities class action suits, it is too soon to conclude whether the data reflects a downward trend or is merely an aberration. The corporate scandals of the last several years have resulted in increased liability for outside directors and officers, from both government regulators and private plaintiffs. Finally, although there was a decrease in the number of securities class actions, SEC's investigations and proceedings against corporations and its executives have increased significantly, exposing their vulnerability.

The slight decline in the number of private securities litigation cases filed against U.S. registrants during the last couple of years most likely will not continue into the future. As the existing inventory of previously filed cases begins to deplete, plaintiffs are likely to start to file cases they currently have at the ready, to the degree the case filings will trend around the traditional 180+ yearly average. Even recent events, namely the backdating allegations related to stock option grants, is not likely to cause any significant divergence from the yearly average. So far in 2007, new issues are already emerging as causes for private securities litigations including pension fraud claims associated with securities fraud cases; and hedge fund frauds. Other factors impacting the number of case filings coming forward are the roles of "whistle-blowers" and compliance "hot-lines" and the overall antifraud efforts being undertaken by companies' offices of compliance and internal audit functions, and by companies' independent auditors, all of which will likely produce more reporting of frauds.