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RT ProExec
Setting New Expectations

InSights

What to Watch in the World of D&O

Every fall, we take a step back and survey the most important current trends and developments in the world of Directors' and Officers' liability and D&O insurance. Once again, there are a host of things worth watching in the world of D&O.

Securities Cases on the U.S. Supreme Court's Docket Earlier this year, all eyes were on the U.S. Supreme Court as we awaited the outcome of the *Halliburton case*, which could have been a game changer in the world of securities class action litigation. In the end, because the Supreme Court did not reverse the "fraud on the market" theory, *Halliburton* will not have the disruptive effect that it might have. But even though the *Halliburton* case has been decided, there are still some good reasons to continue to keep an eye on the Supreme Court.

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First, the Supreme Court agreed to take up the Omnicare case to determine whether it is sufficient to survive a dismissal motion for a plaintiff in a Section 11 case to allege that a statement of opinion was *objectively* false, or whether the plaintiff must also allege that the statement was *subjectively* false – that is, that the defendant did not believe the opinion at the time the statement was made.

The Supreme Court's consideration of the *Omnicare* case will resolve a split in the circuits between those (such as the Second and Ninth Circuits) holding that in a Section 11 case allegations of knowledge of falsity is required; and those (such as the Sixth Circuit, in the *Omnicare* case) holding that allegations of knowledge of falsity are not required. The case is potentially important because the absence of allegations of knowledge of falsity is a frequent basis for dismissals of Section 11 suits in the Second and Ninth Circuits, where the vast preponderance of securities suits are filed. As it is, the current split would allow cases to go forward in the Sixth Circuit that would not survive in the Second and Ninth Circuits.

Second, in *Public Employees' Retirement System of Mississippi, v. IndyMac MBS,* the Supreme Court will consider whether the filing of a class action lawsuit tolls the statute of repose under the Securities Act (by operation of so-called "American Pipe" tolling) or whether the statute of repose operates as an absolute bar that cannot be tolled.

The statute of limitations for claims brought under the Securities Act of 1933 provides that all claims under the Act must be brought within one year of the discovery of the violation or within the three years after the

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security involved was first offered to the public. Under the tolling doctrine established in the Supreme Court's 1974 decision in *American Pipe & Construction Co. v. Utah*, the filing of a securities class action lawsuit tolls the running of the one-year statute of limitations. The question presented in the *IndyMac MBS* case is whether or not under *American Pipe*, the filing of a class action lawsuit tolls the three-year statute of repose.

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Even though this case raises technical issues involving seemingly arcane legal doctrines, the case has potentially significant practical implications. If the filing of a class action lawsuit does not toll the statute of repose, current practices regarding class action opt-outs could be significantly affected. Institutional investors contend that they rely on class action claims filed by other claimants to prevent their claims from being time barred. They argue that if the statute of repose is an absolute bar, they would have to incur significantly higher litigation expenses as they would have to intervene earlier or otherwise act to protect their interests. They argue that they would have to become actively involved more frequently than they do now.

Litigation Reform Bylaws For years, defense advocates have sought to try to curb abusive ligation through reform legislation and other means, yet corporate and securities litigation has continued to vex companies and their executives. However, an interesting new initiative has recently emerged – the attempt to achieve litigation reform through amendments to corporate bylaws.

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The first reform bylaw to have gained the most widespread acceptance is the forum selection bylaw. In June 2013, the Delaware Chancery Court upheld the validity of a bylaw adopted by Chevron's board that designated Delaware as the exclusive forum for adjudication of various shareholder disputes. An exclusive forum bylaw can discourage forum shopping by plaintiffs and the practice of litigating similar or identical claims in multiple jurisdictions. The bylaws remove the need to hire multiple counsel and to make filings in different jurisdictions. These provisions reduce the risk of inconsistent outcomes and they allow companies to designate a court with particular expertise in corporate matters – for example, the Delaware Court of Chancery. The use of exclusive forum provisions has now become mainstream. An increasingly large number of companies are adopting forum selection bylaws and courts outside of the selected forum are showing a consistent willingness to enforce the provisions.

The next type of litigation reform bylaw that some companies have started to take up is the fee-shifting bylaw. This type of bylaw provides that an unsuccessful shareholder claimant in intra-corporate litigation would have to pay his or her adversaries' cost of litigation. The Delaware Supreme Court stirred controversy earlier this year in the *ATP Tours, Inc. v. Deutscher Tennis Bund* case when it upheld the facial validity of a fee-shifting bylaw. The controversy seemed headed for a swift resolution when the Delaware General Assembly quickly moved to act on a measure that would have limited the Supreme Court's ruling to non-stock corporations (meaning that it wouldn't apply to Delaware stock corporations). However, the legislature tabled the measure and now it will not be acted upon until at least January 2015.

While the continued validity of fee-shifting bylaws for Delaware stock corporations would seem to be in significant doubt, at least some companies are going ahead and incorporating these kinds of provisions in their bylaws.

Finally, the most interesting and arguably most controversial proposal is the adoption of bylaws requiring shareholder disputes and claims to be resolved through binding arbitration. Several courts have now upheld the validity of these types of bylaws, which may encourage other companies to consider adopting bylaws requiring shareholder disputes to be arbitrated. If mandatory arbitration bylaws barring class actions were enforceable, the likely outcome would be a decline in class actions, since the alleged existence of a class is a principal driver of attorneys' fees.

However, there are a number of potential barriers to the widespread adoption of mandatory arbitration bylaws, including the policy of the Securities and Exchange Commission staff against allowing companies with arbitration provisions in their organizing documents to go public. Mandatory arbitration bylaws are also likely to attract significant negative stockholder sentiment, particularly, if they include a class action waiver.

Cybersecurity and D&O Liability The news at the end of August that J.P. Morgan and four other major U.S. banks had been hacked by overseas operatives was merely the latest incident highlighting how critical cybersecurity issues have become for all companies and their boards. These risks present significant privacy and network security concerns for just about every enterprise. Along with the reputational risks and operational integrity issues, cybersecurity also increasingly represents a potential liability exposure for corporate directors and officers, as highlighted by two sets of lawsuits filed this year.

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First, in January 2014, shareholders filed two derivative lawsuits in the United States District Court for the District of Minnesota against certain officers and directors of Target Corp. The two complaints alleged that the defendants were aware of how important the security of private customer information is to customers and to the company, as well the risks to the company that a data breach could present. The complaints allege that the company "failed to take reasonable steps to maintain its customers' personal and financial information," and that the defendants failed "to implement any internal controls at Target designed to detect and prevent such a data breach."

Second, a shareholder for Wyndham Worldwide Corporation initiated a derivative lawsuit against certain directors and officers of the company, as well as against the company itself as a nominal defendant, related to the three data breaches the company and its operating units sustained during the period April 2008 to January 2010. The company is already the target of a Federal Trade Commission enforcement action in connection with the breaches. The plaintiff alleges that "in violation of their express promise to do so, and contrary to reasonable expectations," the company and its subsidiaries "failed to take reasonable steps to maintain their customers' personal and financial information in a secure manner."

These two lawsuits highlight the fact that the risks and exposures companies face in connection with cybersecurity issues include potential liability exposures for companies' corporate boards. SEC Commissioner Luis Aguilar underscored these potential liability exposures in a June 2014 speech which he stressed that "ensuring the adequacy of a company's cybersecurity measures needs to be a part of a board of director's risk oversight responsibilities." He added the warning that "boards that choose to ignore, or minimize the importance of cybersecurity oversight responsibility, do so at their own peril."

Regulators Outside the U.S. Regulators outside the Unites States have recently become more active. These regulators' enforcement activities have significant implications within their respective home jurisdictions, but they may have important implications for all companies doing business in those countries, regardless of where the companies are domiciled. The developments may also have important D&O insurance implications as well.

One of the highest profile regulatory enforcement developments outside the U.S. in recent months was the July 2014 action by India's securities regulator, the Securities and Exchange Board of India (SEBI). SEBI entered an order against the founder and former executives of Satyam Computer Services to disgorge over $306 million in allegedly ill-gotten gains from their role in the scheme to falsify the company's financial statements, as well as at least $201 million in interest.

These developments in India are merely one part of the significant efforts by regulators around the world to ramp up their enforcement efforts. Authorities in a number of countries, including, among others, China and Brazil, have ramped up their anticorruption enforcement. China and the EU, among others, have also recently stepped up their antitrust enforcement.

It has been well-established that regulatory investigations in the U.S. can lead to follow on civil litigation. Recently, we have seen a rise of follow-on civil litigation in the U.S. following regulatory activity outside the country. For example, in January 2014, Nu Skin Enterprises was hit with a securities class action lawsuit following news of an alleged investigation of the company's allegedly fraudulent sales practices in China. Similarly, in June 2014, China Mobile Games and Entertainment Group was hit with a securities class action lawsuit following the news of an anti-bribery investigation in China involving company officials.

These developments raise important issues about the liability exposures of the potentially affected companies and their directors and officers. The liability exposures include not only the potential regulatory and enforcement risk but also the possibility of follow-on civil actions, brought by shareholders or others. The "others" that might bring claims include supervisory board members in those jurisdictions with a dual-board structure.

IPO Activity and Increased IPO-Related Litigation The number of companies completing initial public offerings is currently at the highest level in years. According to a recent study from Cornerstone Research, with the 112 IPOs in the first half of 2014, IPO activity is on pace to increase for the third consecutive year.

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While the listing activity seems to bode well for the general economy as well as for the financial markets, the increased number of IPOs has also led to an uptick in IPO-related securities litigation. According to our unofficial and unaudited year-to-date securities class action litigation filing tally, through the end of August 2014, there were a total of 106 new securities class action lawsuits filed this year. Of the 106 securities suits so far this year, seven (or roughly five percent) were filed based on alleged misrepresentations in the company's IPO documents. However, all but one of these suits involved companies that completed their IPOs in 2013. Given the uptick in IPOs, we expect additional lawsuits to be filed against 2014 IPO companies.

Along with the likely increase in the number of IPO-related securities suits, an increase in the number of lawsuits involving pre-IPO companies – asserting, for example, failure to launch claims – also seems likely. When a company is on a trajectory toward an IPO, there is a natural tendency to focus on the liability exposures the company will face after it goes public. But the process leading up to the IPO often involves circumstances that can create their own set of risks and exposures. As a company readies itself to go public, it often restructures its operations, its accounting, its debt, or other corporate features.

The company also makes pre-offering disclosures, for example, in road show statements. The process creates expectations that can result in their own set of problems. All of these changes, disclosures and circumstances potentially can lead to claims, particularly if the offering does not go forward.

JOBS Act Crowdfunding Provisions The JOBS Act contained statutory provisions providing exemptions under the securities laws allowing certain kinds of start up ventures to raise equity financing from non-accredited investors using Internet fundraising platforms. The statutory provisions specified that the SEC was to provide implementing regulations. The SEC finally published proposed crowdfunding rules in October 2013; however, the agency has yet to publish the final rules, and so the JOBS Act crowdfunding initiative is still yet to take effect, a development for which the SEC is now facing considerable criticism from members of Congress.

Eventually, the SEC will release the final crowdfunding rules and companies will be able to raise equity financing from non-accredited investors through online platforms. It is hard to know how significant a development this will turn out to be, since the JOBS Act imposes restrictive limitations on the amounts companies can raise through crowdfunding offerings.

Another issue that will be important to watch is the extent to which disappointed crowdfunding investors try to invoke the liability provisions Congress included in crowdfunding provisions. The Act expressly imposes liability on issuers and their directors and officers for material misrepresentations and omissions made to investors in connection with a crowdfunding offering.

This combination of small private companies and potential federal securities law exposure represents a conundrum for the D&O insurance marketplace, which generally views the world as neatly divided between private and public companies. These crowdfunding provisions may blur the clarity of this division. Once the implementing regulations finally take effect, the D&O industry will be monitoring this situation carefully to determine how significant the threat of crowdfunding liability will turn out to be.

Failed Bank Litigation The FDIC has filed a total of 97 lawsuits against directors and officers of failed banks as part of the current bank failure wave. In addition, through July 24, 2014, the FDIC has authorized suits in connection with 145 failed institutions. While the extent to which the number of authorized lawsuits exceeds the number of lawsuits filed would seem to imply a backlog of as yet unfilled litigation, the fact is that the pace of the agency's lawsuit filing activity has slowed. It may be that as the bank failures wind down, the level of lawsuit activity will wind down as well. One likely contributing factor is the lapse of the three-year statute of limitations with respect to the bank closures during the second half of 2009 and the first six months of 2010, when the number of bank failures peaked.

According to the FDIC, of the 97 lawsuits it has filed, 26 have fully settled and one resulted in a favorable jury verdict. These numbers imply a significant number of pending and as yet unresolved lawsuits that will continue to work their way through the system. There are a number of important implications from this continuing litigation.

First, it seems likely that we will continue to see significant judicial decision-making on issues relating to the liabilities of directors and officers. The failed bank litigation has already led to a number of significant decisions on issues relating to D&O liability. For example, in July 2014, in connection with one of the failed bank cases pending in Georgia, the Georgia Supreme Court issued a landmark decision discussing the protections available under Georgia law to corporate directors and officers under the Business Judgment Rule.

Second, in connection with insurance coverage litigation that has arisen in conjunction with the FDIC failed bank litigation, we will see further judicial decisions interpreting key D&O insurance policy provisions. For example, there have been a number of interesting decisions addressing the question of whether or not the insured vs. insured exclusion found in most D&O insurance policies precludes coverage for claims brought by the FDIC in its capacity as receiver of a failed bank. So far, the cases have reached differing conclusion on this question.

Third, the pending litigation will continue to weigh on the D&O insurance carriers that are active in providing insurance to commercial banks. Even though the peak of the financial crisis is now well in the past, the ongoing litigation continues to produce adverse development in these carriers' prior underwriting year results and serve to undermine their current calendar year results.

Environmental Liability / Climate Change and D&O Liability In recent months, there have been a number of securities class action lawsuits filed based on alleged misrepresentations of the defendant company's environmental compliance. On August 7, 2014, the securities suit filed against Exide Technologies and certain of its directors and officers based on the defendants' allegedly misleading statements about the company's compliance with environmental regulations became the latest environmental disclosure securities suit to overcome the initial pleading hurdles.

The survival of the environmental disclosure securities suit against Exide comes closely after the Second Circuit's recent ruling in the JinkoSolar securities suit, in which the appellate court reversed the lower court dismissal of the suit and concluded that the plaintiffs' allegations concerning the alleged deficiencies of the defendant company's environmental compliance disclosures were sufficient. While these are just two cases, it does seem as if the plaintiffs are getting some traction in securities suits based on environmental compliance disclosures. These cases underscore the fact that reporting companies' environmental compliance disclosures are facing increasing scrutiny, making the quality of the environmental disclosures increasingly important.

In addition to these issues arising from traditional environmental liability concerns, there may be reason to be concerned that D&O liability issues could arise from alarms over global climate change. In a series of letters sent to board members of various major energy companies and to a number of participants in the directors and officers liability insurance industry, three environmental groups (Greenpeace International, the World Wildlife Fund International and the Center for International Environmental Law) contend that climate change denial by energy industry representatives presents a risk of personal liability to the individual energy company board members. The letters also contend that "the threat of future civil or criminal litigation could have major implications for D&O liability insurance coverage."

What Does All of This Mean for the D&O Insurance Marketplace?: Because of the developments discussed above and numerous other issues and concerns, D&O insurers must operate in a dynamic and rapidly changing environment. In addition, insurers face pressure to produce profits with little assistance from investment income given the continued low interest rate environment.

Based on these concerns as well as ongoing claims results, primary public company D&O insurers and private company D&O insurers continue to push for rate increases. For some public company D&O buyers, increases in the premium for the primary D&O insurance continue to be offset, in part, by premium savings on their excess insurance.

The marketplace remains challenging for financially distressed risks or companies with adverse claims histories. In addition, certain risk classes – for example, developmental stage biotech companies, some commercial banks, and public non-traded REITS — continue to be viewed as higher risk and do pay higher premiums for their D&O insurance.

Despite all of the challenging circumstances, the D&O insurance marketplace continues to attract new insurers. The continued competition means that all of the trends toward a hardening market are blunted. For D&O insurance buyers outside the higher risk categories and with healthier financials, the marketplace remains generally favorable. By and large, policyholders continue to be able to obtain broad coverage.

We will continue to watch all of these issues in the world of D&O and will keep you apprised as new developments unfold.

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