RT ProExec
Setting New Expectations

InSights

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What to Watch Now 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 myriad of things worth watching in the world of D&O.

D&O Insurance Implications of the SEC's New Policy Requiring Admissions of Wrongdoing

In "egregious cases", the SEC's new policy requiring admissions of wrongdoing in order to settle an enforcement action has important implications for the enforcement action itself, and has important implications for potentially related civil or criminal proceedings. Another issue that inevitably will arise is the impact of factual admissions on the continuing availability of D&O insurance.

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On August 19, 2013, in connection with its entry into a settlement with New York-based hedge fund adviser Phillip Falcone and his advisory firm Harbinger Capital Partners, the SEC implemented its new policy requiring defendants seeking to settle civil enforcement actions to admit wrongdoing, in contrast to the long-standing practice of allowing defendants to resolve the enforcement actions with a "neither-admit-nor-deny" settlement.

More recently, in its high-profile September 19, 2013 settlement with JP Morgan of an administrative proceeding related to the "London Whale" fiasco, the SEC also required JP Morgan to provide a formal admission of wrongdoing.

The SEC and the Harbinger defendants, including Falcone, had actually reached an earlier settlement in principle to resolve the case that reflected the traditional "neither admit nor deny" approach. However, in July 2013, the SEC Commissioners had voted to reject the deal. The vote apparently reflected the SEC's new policy, announced in June by new SEC Chair Mary Jo White, that going forward the SEC would require defendants settling enforcement actions to admit wrongdoing, at least in "egregious" cases.

In the revised settlement, Falcone and the Harbinger entities agreed to extensive admissions of wrongdoing. The factual admissions are set out in a detailed Annex to a Consent that Falcone signed on August 16 on his own behalf and on behalf of the Harbinger entities. The admissions are also set out verbatim in the proposed Final Consent Judgment filed with the Court. Pursuant to the settlement, the defendants agreed to pay a total of over $18 million in disgorgement, civil penalties and interest. As part of these

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payments, Falcone himself must pay over $11.5 million and has been banned from the securities industry for five years.

The SEC's admissions requirement has a number of significant implications. First, it means that in egregious cases, the SEC enforcement actions will be much harder to resolve as defendants, wary of the possible impact the admissions could have in other proceedings, will be reluctant to provide admissions. Another consequence could be that the SEC will be compelled to try more cases, which could strain the agency's resources.

The SEC's admissions requirement has a number of significant implications. First, it means that in egregious cases, the SEC enforcement actions will be much harder to resolve as defendants, wary of the possible impact the admissions could have in other proceedings, will be reluctant to provide admissions.

Additionally, a defendant's provision of admissions potentially could have enormous consequences for related proceedings. The recitation in the Consent that the Harbinger defendants have been provided no assurances about the possibility of criminal proceedings has to be particularly chilling, especially for Falcone. The admissions in the Consent may or may not draw criminal charges, but at least some commentators have suggested that criminal charges could follow.

Another question about the admissions is their collateral effect in related civil proceedings. As it happens, there is a pending civil action that Harbinger investors had filed against Falcone and the funds that could provide an early test of the civil litigation collateral estoppel consequences of admissions in an SEC enforcement action. Yet another issue that the admissions raise is the question of their impact on the availability of D&O insurance. The specific question is whether the admissions are sufficient to trigger the fraud and criminal misconduct exclusion in the D&O policy. The wording of these exclusions varies, but they typically preclude coverage for loss arising from fraudulent or criminal misconduct, but only after a final adjudication determines that the excluded conduct has taken place. If the admissions were found to be sufficient to trigger the exclusions, coverage would no longer be available for the wrongdoer, and the insurer could arguably try to recover amounts that had already been paid in defense of the wrongdoer.

Yet another issue that the admissions raise is the question of their impact on the availability of D&O insurance. The specific question is whether the admissions are sufficient to trigger the fraud and criminal misconduct exclusion in the D&O policy.

There is the potential that insurers could assert that a settlement of this type represents a "final adjudication" (A related question is whether this adjudication occurred in "the underlying proceeding" as many policy exclusions require). The specific factual admissions to which the defendants agreed were not only stated in the public court record, but they are incorporated verbatim into the Final Consent

Judgment filed with the court. On the other hand, there is a question whether the admissions satisfy the exclusion's misconduct requirement. While the admissions represent an extensive concession that the defendants engaged in wrongdoing – and while the admissions expressly recite that the defendants acted "improperly" and "recklessly" - at no point do the defendants admit to "fraud" or to any other level of conduct that would expressly trigger the typical D&O policy's conduct exclusion.

In effect, the Harbinger defendants seemed to have tried to preserve the right to argue that while they made certain admissions for purposes of the SEC enforcement action, they did not make those admissions for all purposes and for the benefit of all other parties who might seek to rely on them.

A related issue that could arise is the question of exactly how bound the admitting parties are by their admissions. The Harbinger defendants' Consent specifically recites that nothing in the agreement affects the defendants "right to take legal or factual positions in litigation or other proceedings or other legal proceedings in which the Commission is not a party." In effect, the Harbinger defendants seemed to have tried to preserve the right to argue that while they made certain admissions for purposes of the SEC enforcement action, they did not make those admissions for all purposes and for the benefit of all other parties who might seek to rely on them. The Harbinger defendants might well argue that notwithstanding their admissions in the Consent, they have the right to contest the factual matters in other proceedings, including for example, in the context of an insurance coverage dispute.

The Harbinger settlement represents a significant development with important potential implications for other defendants in SEC proceedings. The admissions these defendants may be required to provide in order to settle the enforcement action pending against them could have important collateral consequences, many of which at this point remain uncertain.

D&O Insurance Implications of the Massive Derivative Lawsuit Settlements

In April 2013, the parties to the News Corp. shareholder derivative litigation agreed to settle the consolidated cases for $139 million - funded entirely by D&O insurance.

There have been several shareholder derivative suit settlements that were nearly as large as News Corp.:

- In September 2012, the El Paso/Kinder Morgan merger-related derivative suit settled for $110 million.
- In 2005, the Oracle derivative suit settled based on Oracle CEO Larry Ellison's payment of $122 million.

- In September 2009, the parties to the Broadcom Corp. options backdating-related shareholders' derivative suit agreed to settle the case, as it relates to some of the defendants, for $118 million.
- In September 2008, the parties to the 2002 AIG shareholders' derivative lawsuit agreed to settle the case for a payment of $115 million.

One of the most vexing issues that can arise in the D&O claims context is the question of whether or not two claims are interrelated.

In addition, in December 2007, the UnitedHealth Group options backdating-related derivative lawsuit settled for a total nominal value of approximately $900 million. However, the value contributed to the settlement consisted of individual defendants' surrender of certain rights, interests and stock option awards, not cash.

These settlements are all dwarfed by the $2.876 billion judgment entered in 2009 against Richard Scrushy in the HealthSouth shareholders' derivative lawsuit and the $1.262 billion judgment in the Southern Peru Copper Corporation Shareholder Derivative Litigation. Both of these case outcomes involve judgments following trial, rather than settlements.

The fact that the News Corp. settlement was funded entirely by D&O insurance, represents an unwelcome event for the D&O insurance industry as it signals severity potential for shareholders' derivative litigation. Traditionally, insurers have viewed derivative cases as relatively low exposure events for the D&O policy

The increasing risk of this type of settlement represents a significant challenge for all D&O insurers, but particularly for those D&O insurers concentrating on providing Excess Side A insurance. Those insurers will have to ask how they are to underwrite the risks associated with these kinds of exposures, and how they are to make certain that their premiums adequately compensate them for the risk.

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Interrelatedness Issue Continues to Affect D&O Claims

One of the most vexing issues that can arise in the D&O claims context is the question of whether or not two claims are interrelated. The typical context in which the question arises is when two (or more) claims are filed in separate policy periods. If the claims are related, they trigger coverage under only a single year's policy, with the subsequent claims deemed to have been made at the time of the first related claim. If the claims are not related, but instead are separate, multiple policies are triggered.

> *Over the past several years, one of the more troublesome litigation trends has been the rise of multiple lawsuits involving the same circumstances, but filed in separate jurisdictions.*

There are few reliable guideposts on the interrelatedness issue and it is often litigated because it directly affects the amount of insurance available to resolve claims. The financial crisis of 2008 has led to a number of contentious situations revolving around the interrelatedness issue. Many of the companies involved in the crisis have been hit with multiple lawsuits, often filed over the course of several years. One noteworthy case that raises these issues involves the failed IndyMac bank now pending in the Ninth Circuit. In June 2012, Central District of California Judge R. Gary Klausner concluded, based on the relevant interrelatedness language, that a variety of lawsuits that first arose during the bank's 2008-2009 policy period were deemed first made during the policy period of the bank's prior insurance program, and by operation of two other policy provisions were excluded from coverage under the 2008-2009 program. The upshot of Judge Klausner's opinion is that only a single insurance tower of $80 million will apply to the various claims, rather than two $80 million insurance towers.

Judge Klausner's coverage decision took on even greater significance in December 2012, when the FDIC obtained a $168.8 million jury verdict against three former IndyMac officers. The verdict may be of little value to the FDIC if only a single $80 million tower of insurance is available for the various claims arising out of IndyMac's collapse as prior settlements and defense fees have largely eroded the single $80 million tower. Judge Klausner's coverage decision is now on appeal to the Ninth Circuit. The bank's former directors and officers have argued to the appellate court that Judge Klausner erred in ruling that all of the various claims were interrelated and therefore triggered only a single insurance tower. A number of other parties are also challenging the ruling, including the FDIC and the trustee for the bankruptcy of the bank's holding company. The insurers have argued that all of the claims are interrelated and therefore that only a single tower of insurance was triggered.

The likelihood is that even after the Ninth Circuit issues its opinion, interrelatedness issues will continue to vex insurers and policyholders alike.

Multi-Jurisdiction Litigation and By-Law Forum Selection Clauses

Over the past several years, one of the more troublesome litigation trends has been the rise of multiple lawsuits involving the same circumstances, but filed in separate jurisdictions. As a way to try to avert the inefficiencies and added expense associated with multi-jurisdiction litigation, reformers suggested that a provision could be added to company by-laws requiring shareholders to litigate claims in a specified jurisdiction (usually Delaware). The boards of a number of companies adopted forum selection by-laws.

The first judicial challenge to a forum selection by-law resulted in a set back for the idea. In January 2011, a judge in the Northern District of California refused to enforce a forum selection by-law that had been adopted by Oracle, because it had not been approved by shareholders, but rather had been adopted only by the company's board of directors.

The question will still remain whether the courts of other jurisdictions will enforce the forum selection clause when faced with a motion to dismiss a case pending in their courts. The fact that the by-laws are valid under Delaware law will not necessarily be determinative of whether the by-laws are in fact enforceable elsewhere.

However, on June 25, 2013, in a judicial development that may help ease the burden of multi-jurisdiction litigation, Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery held that forum selection by-laws adopted by Chevron and Federal Express are statutorily and contractually valid. According to Chancellor Strine's opinion, in the last three years over 250 publicly traded companies adopted forum selection by-laws. Chancellor Strine recites in his opinion that Chevron's board adopted the by-law due to concerns about "the inefficient costs of defending the same claim in multiple jurisdictions" and in order to "minimize or eliminate the risk of what they view as wasteful duplicative litigation."

Chancellor Strine's determination that Chevron and Fed Ex's forum selection by-law are valid is of course far from the final word. The Delaware Supreme Court may yet take a different view. In addition, the question will still remain whether the courts of other jurisdictions will enforce the forum selection clause when faced with a motion to dismiss a case pending in their courts. The fact that the by-laws are valid under Delaware law will not necessarily be determinative of whether the by-laws are enforceable elsewhere.

Courts Extension of the Broad Judicial Support for the Enforceability of Arbitration Clauses

In the latest in a series of decisions in which it upheld the enforceability of arbitration agreements, the U.S. Supreme Court ruled on June 20, 2013 that an arbitration agreement with a class action waiver is enforceable even it means that an individual's cost of pursuing a claim exceeded the economic value of the individual's potential recovery (American Express Co. v. Italian Colors Restaurant).

Although the decision is consistent with other recent Supreme Court rulings, it has its own important implications – and it also raises a question of just how far the principle of broad enforceability of arbitration agreements can be taken. In particular, does the broad enforceability of arbitration agreements reach far enough to include the enforceability of arbitration agreements and class action waivers in corporate articles of incorporation or by-laws?

The question about the inclusion of arbitration provisions and class action waivers in corporate by-laws is not far-fetched. In fact, at least one court has already held these kinds of by-law provisions to be enforceable. In May 8, 2013, a Maryland

Circuit Court held that Commonwealth REIT could enforce a by-law requiring shareholders to arbitrate their claims.

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In a July 8, 2013 Law 360 article commenting on the Commonwealth REIT decision, Andrew Stern, Alex J. Kaplan and Jon W. Muenz of the Sidley Austin law firm note that though it remains to be seen how other courts will address the question of the enforceability of arbitration clauses in corporate bylaws, the Maryland decision "should be seen as, at the very least, a significant incremental victory for boards and trustees who view arbitration as an effective means to manage the typically highly public nature of corporate activism." At a minimum, the authors note, the decision could be seen – at least for Maryland companies - as "a green light for boards … to include broad arbitration clauses in their by-laws without seeking shareholder approval."

The Maryland trial court decision has no precedential value and may or may not be followed by other courts. But with the U.S. Supreme Court's willingness to enforce arbitration agreements including class action waivers in commercial and consumer contracts, and with case law developments like the one in Maryland, more companies may be encouraged to attempt to use their by-laws as a way to control shareholder litigation. We undoubtedly will see more – both from companies and from the courts – on the topic of arbitration clauses in corporate by-laws.

Impact of the Conflict Minerals Disclosure Rules

Among the many hundreds of pages of the Dodd-Frank Act was a provision unrelated to the financial crisis. Congress included in the Act a provision directing the SEC to promulgate rules requiring companies to disclose their use of conflict minerals originating in the Democratic Republic of Congo (DRC) or an adjoining country. It has taken some time for the regulatory process to unfold, but the conflict mineral disclosure requirements are now in effect. The consequences for companies could be significant.

There is risk for the companies involved. First and foremost, companies found to be out of position on conflict minerals could face a publicity firestorm from humanitarian groups and activist investors.

On August 22, 2012, the SEC adopted the conflict mineral disclosure rules. The specific minerals at issue are tantalum, tin, tungsten and gold. The countries covered by the disclosure rules are, in addition to the DRC, Angola, Burundi, Central African Republic, the Republic of Congo, Rwanda, South Sudan, Tanzania, Uganda and Zambia (the "Covered Countries").

The rule applies not just to companies with SEC reporting obligations (including both domestic and foreign issuers) but it also applies to any company that uses the

specified minerals if the minerals are "necessary to the functionality or production" of a product manufactured by or "contracted to be manufactured" by the company. Companies are required to comply with the new disclosure rules for the calendar year beginning January 1, 2013, with the first disclosures due May 31, 2014 and subsequent disclosures due annually each year after that.

The peak of the recent financial crisis is five years in the past. Although banks are still continuing to fail, it appears that the worst of the bank failure wave is now behind us.

There is risk for the companies involved. First and foremost, companies found to be out of position on conflict minerals could face a publicity firestorm from humanitarian groups and activist investors. As with any disclosure requirement, there is also a significant litigation risk as well. Companies compelled to reveal their use of conflict minerals could well be the target of shareholder suits. A particularly difficult problem would involve companies that had declared themselves to be conflict free and are later shown have been using conflict minerals after all. The negative publicity and likely share price decline could be followed by a securities class action lawsuit. Activist shareholders could also launch derivative suits based on allegations such as the failure to implement adequate procedures to ensure that the company's products were conflict mineral free.

Of course, whether any of these kinds of suits actually emerge remains to be seen. However, the disclosure deadline that had seemed so far in the future is now rapidly approaching.

Failed Bank Litigation

The peak of the recent financial crisis is five years in the past. Although banks are still continuing to fail, it appears that the worst of the bank failure wave is now behind us. Along those lines, in its most recent Quarterly Banking Profile, the FDIC reported that the number of "problem institutions" continues to decline - although still troublingly high.

Although we can hope that the number of bank closures will continue to decline, the litigation that the FDIC is filing against the banks' former directors and officers continues to mount. As of the agency's latest report on August 8, 2013, the agency has filed 76 lawsuits against the directors and officers, including 32 so far this year. By way of comparison, the agency filed 25 lawsuits during all of 2012.

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The number of failed bank lawsuits is likely to grow. As of August 8, 2013, the FDIC has also authorized suits in connection with 122 failed institutions against

987 individuals for D&O liability. The number of suits authorized is inclusive of 76 lawsuits that the agency has already filed naming 574 former directors and officers. In other words, there is a backlog of as many as 46 additional lawsuits yet to be filed. In addition, for some time now, the FDIC has increased the number of lawsuits authorized each month. The FDIC has already authorized lawsuits to be filed in connection with about 25% of the 485 banks that have failed since January 1, 2008. (By comparison, during the S&L crisis, the agency filed D&O lawsuits in connection with about 24% of bank failures). With a total of 76 lawsuits actually filed, the agency has now filed suit in connection with about 15% of bank failures.

A mass of D&O litigation was also one of the side-effects of the S&L Crisis. Insurance coverage disputes from those cases contributed to many of the important judicial decisions applicable to the interpretation of D&O insurance policies.

Given the litigation already filed and the lawsuits yet to come, there is and will continue to be a mountain of failed bank litigation working its way through the courts. These cases are a burden for the courts and for the litigants. They also represent a challenge for the D&O insurers involved as these claims move toward resolution. The losses associated with these cases will continue to weigh on the insurers' financial results, which in turn will affect their premiums and their risk appetites.

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Cyber Security Threats Affect on the Liabilities of Corporate Directors and Officers

It is not news that cybersecurity risks represent a significant concern for just about every company and their respective directors and officers. But while these issues are not new, it now seems clear that cybersecurity is going to be one of the hot button issues for the foreseeable future, both in the media and for the affected companies.

The heightened scrutiny of cybersecurity issues has a number of important implications for potentially affected companies, and not just from an operational standpoint. These developments also have important implications for public company's public disclosure statements, and, as a consequence, for the company's potential regulatory and litigation exposures.

Indeed, according to a February 21, 2013 memo from the King & Spalding law firm entitled "Cybersecurity: The New Big Wave in Securities Litigation?","it is likely that this issue will continue to gain momentum among government regulators and opportunistic plaintiff lawyers seeking to catch the next wave of shareholder litigation." In particular, the failure to promptly disclose a cyber breach "may put a company at risk of facing formal SEC investigations, shareholder class actions, or derivative lawsuits."

As the memo notes, the SEC "has already taken a firm stand on cybersecurity disclosures, and clearly views this issue as ripe for enforcement actions." In October 2011, the SEC's Division of Corporate Finance issued "Disclosure Guidance" on cybersecurity related issues. Among other things, the Guidance clarified that the agency expects companies to disclose the risk of cyber incidents among their "risk factors" in their periodic filings and expects companies to disclose material cybersecurity breaches in their Management Discussion and Analysis.

The law firm memo notes that so far, the SEC's Guidance "seems to have had little impact on corporate disclosure," and that in many instances, companies experiencing cyber breaches are "choosing to keep those events confidential." However, "given the increasing awareness of this hot issue," it seems "likely" that the SEC "will increase pressure on companies to disclose such events." The memo adds that "companies that have experienced significant cybersecurity breaches should prepare themselves for potential SEC investigations and lawsuits."

In addition to the risk of SEC enforcement action, companies experiencing cyber breaches also face the possibility of a securities class action lawsuit. However, the memo notes, a company experiencing a cyber breach "will likely not be a target of securities class action unless the disclosure of the breach can be linked to a statistically significant drop in the company's share price." Companies that do not experience a share price decline following a cybersecurity incident may not experience securities class action litigation, but they are still susceptible to derivative lawsuits alleging, for example, that company directors breached their fiduciary duties by failing to ensure adequate security measures. As the law firm memo notes, shareholders may claim that senior management and directors "were either aware of or should have been aware of the breach and the company's susceptibility to hacking incidents." Of course, any lawsuit of this type would face significant hurdles, including the requirement to make a formal demand on the board as well as the business judgment rule.

In any event, it is clear that cybersecurity issues are going to be an increasing source of scrutiny for companies and their senior officials.

How Will These Trends and Developments Affect the Market for D&O Insurance?

As should be apparent from this discussion, there is a great deal happening in the World of D&O. The surge in M&A litigation, in which virtually every merger or acquisition attracts at least one lawsuit, continues unabated. The SEC whistleblower program, which recently announced that it had made its second whistleblower bounty award, threatens an upsurge in whistleblower-driven enforcement actions and related securities claims. Anti-bribery enforcement actions are but one of the many regulatory risks in an increasingly global economy. And all of these developments are in addition to the wave of litigation relating to the subprime meltdown and the credit crisis that continues to work its way through the courts.

Given everything that is going on, it is hardly surprising that the D&O insurance carriers are taking a more defensive position. Indeed, many companies – including

both public and private companies – have seen the cost of their D&O insurance increase at their most recent renewal. The pricing increases are more concentrated in the primary D&O insurance policies and lower attachment points. In addition, in at least some cases and for some kinds of risks, carriers have started to try to restrict terms and conditions as well.

Generally speaking, D&O coverage remains very favorable to most Insureds. And pricing, while increasing, is still well below the highs witnessed during the last hard market ten years ago. How all of this ultimately will play out remains to be seen. The one certainty is that the World of D&O will continue to be interesting to watch.

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