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FUTURE D&O EXPOSURES:
STORM CLOUDS AHEAD?

Whenever the D&O claims environment is dominated by many large claims which are similar in nature, it is tempting to believe that once those similar claims run their course, the frequency of D&O claims will reduce significantly. That theory is particularly tempting today since a large majority of the claims now pending against directors and officers relate to the subprime and other credit crises, the Madoff fraud and the severe recession. All of those claim "drivers" are temporary and will eventually lessen or disappear. When that happens, will the D&O claims environment greatly improve or will plaintiffs simply turn to other events or circumstances as the foundation for their claims against directors and officers?

Based on history, it is very unlikely the frequency and severity of D&O claims will curtail after the current claims factors subside. Over the last 25 years, a new set of economic, business or governance developments have emerged every 3-4 years which successfully serve as the basis of a large number of D&O claims. The merger-mania of the mid-1980s, the S&L and bank crisis of the late 1980s, the financial downturn of the early 1990s, the .com bubble of the late 1990s, and Enron-era frauds of the early 2000s, the stock option backdating scandals of the mid-2000s and the current credit crisis/recession vividly demonstrate that although the nature of the D&O claims factors vary, there is always a constant supply of events which successfully gives rise to a significant line of claims.

Identifying what the next events will be, though, is quite difficult. By definition, to be a strong driver of D&O claims the event must be a surprise to shareholders, regulators and the public. Directors and officers are far less susceptible to claims which are or could be predicted long before the company or shareholders are injured. For example, unlike the factors summarized above over the last 25 years, other more predictable factors have had only a modest influence on D&O claims, such as the continuing effects of the internet revolution, executive compensation concerns and the enormous inflation in healthcare and energy costs.

Despite the inherently unpredictable nature of D&O claims, everyone concerned about claims against directors and officers (including D&O advisors, insurers and brokers) must continually seek to identify and mitigate future exposures. An important part of that process is an analysis of historic trends and current systemic developments which are likely to have some influence on future D&O claim activity. The following is a summary of many of those trends and developments, any one of which could lead to future severe D&O claims depending upon a company's unique situation.

A. Stock Market Rebound

Common wisdom indicates that a general stock market decline is good for plaintiffs since many companies are suffering large stock drops which plaintiffs can allege result from an artificial stock price inflation caused by misrepresentations. Conversely, common wisdom

suggests a general stock market increase is bad for plaintiffs since plaintiffs need a material stock price drop following a corrective disclosure to show the stock price was artificially inflated by misrepresentations.

Oddly, current stock market conditions may refute that common wisdom. With the stock price for many companies now at or near historic lows, it is difficult for plaintiffs to successfully allege that those low prices are artificially inflated due to misrepresentations by directors and officers. In addition, the stock price for most companies has or probably will soon "bottom out," which means the likelihood of a future severe stock drop following a corrective disclosure is not great for most companies. For these reasons, several securities plaintiff lawyers have expressed concern about their claims portfolio over the next couple years, as the credit crisis claims begin to be resolved without a new supply of claims yet emerging. In response to that concern, some securities plaintiffs are now filing relatively stale securities class actions, based on stock drops which occurred during the initial stages of the credit crisis, provided the stock drop occurred within the preceding 2-year statute of limitations.

As stock prices rebound, though, plaintiffs will have more opportunity to allege artificial price inflation through misrepresentations, particularly if the company's stock price later falls following a corrective disclosure. In other words, companies which will have a stock price rebound in the coming months become attractive targets for shareholder plaintiffs if those companies later announce surprising adverse information which causes a reactive stock drop. In this type of general stock market rebound, many more companies (and their directors and officers) will be susceptible to allegations of stock price manipulation than in the current bear market or even in a more normalized stock market cycle.

B. Misrepresenting Poor Financial Performance

In the current economic climate, many companies are encountering very difficult financial challenges. It is tempting for management or other employees of those companies to try to minimize those challenges by misrepresenting the company's true financial performance and condition. Historically, accounting fraud increases in poor economic times. This fraudulent activity is not limited to the most senior officers within a company. Depending on the company's culture, lower level employees may feel tremendous pressure to meet budget and to adequately contribute to the company's financial success.

Not surprisingly, some people respond to that pressure by submitting false information rather than acknowledging their performance failures. As has been repeatedly demonstrated in various large corporate scandals over the years, it only takes a few people to create a major disaster for the entire company (including the innocent directors and officers).

Companies can undertake various initiatives to minimize this risk, and insurers can evaluate a company's exposure to this risk by monitoring the company's commitment to fraud prevention and detection. For example:

- Companies can implement comprehensive fraud awareness training for its employees, which emphasizes the importance of truthful disclosures and educates

employees on ways to identify whether fellow employees are reporting information completely and accurately.

- Companies can adopt a robust fraud risk assessment, which reviews current policies and procedures to identify the adequacy of the company's initiatives to prevent and detect fraudulent practices.

- Companies can assess and strengthen their internal audit and compliance programs through further training, additional personnel and updated practices. The effectiveness of legal compliance practices should be periodically assessed not only by senior management, but also by the Board.

- Companies can update and re-publicize their whistleblower procedures (including accessible hotlines for employees and strong assurances of absolute confidentiality).

Although most large companies already have these types of programs in some form, the current increased potential for fraudulent activity suggests companies should reexamine and improve the effectiveness of those programs.

C. Financial Distress

In the current severe economic downturn, many companies are experiencing serious financial distress. Most companies have adopted dramatic initiatives to reduce costs, have closed unproductive facilities or have revised the company's strategic and operational plans. Whenever a company undergoes or arguably should undergo such fundamental and widespread changes, different constituents of the company will be affected differently, and the risk of criticism of management is elevated. Shareholders, and in some instances creditors, can allege management failed to act timely or with sufficient vigor, or misrepresented to investors the severity of the company's financial situation or future prospects. Employees and other third-party constituents such as franchisors, dealers and independent contractors may allege various types of statutory violations related to the company's response to its financial challenges.

For companies that file bankruptcy, these exposures become particularly acute. History has shown that D&O claims frequency rises when the company enters into an insolvency proceeding since the company's affairs are more visible and various constituents (particularly creditors) can more easily organize and prosecute claims.

The current recession also presents a host of new and unresolved issues relating to the federal government's unprecedented intervention in many financially distressed companies. As major stakeholders in these companies, will the government become a plaintiff in D&O claims against former or current D&Os? Will other shareholders have viable claims against D&Os for allowing the government to effectively control major business decisions for the company (despite the government's arguable conflict of interest on some issues), for authorizing a drastic dilution of the other shareholders' interest in the company for arguably inadequate consideration, or for continuing or terminating the government's support for too long or too short a time period? Will the mere existence of that government support encourage or aggravate the prosecution of D&O claims by others? It is far too early to determine the effect of government bail-outs on

D&O claims, but it is certainly reasonable to believe there will be an adverse impact on defendants.

D. Mergers & Acquisitions

Another likely consequence to the current economic climate is an increase in merger and acquisition activity. Although not noticeable yet, it seems very likely that as credit markets open, more companies will be engaged in strategic transactions. For example, opportunistic companies will seek to acquire other strategically desirable companies for a relatively inexpensive price, distressed companies will seek a "white knight" to save it from financial ruin, or complimentary companies will seek to combine in order to create a larger, more competitive and more efficient organization.

D&O claims frequently are filed in connection with these types of change-in-control transactions. Regardless of the transaction's circumstances, one or more company constituents will probably be disappointed with the transaction or its terms and will have an arguably viable claim against the company's directors. The different types of M&A-related D&O claims include:

- Disclosure. The greatest D&O liability exposure with respect to M&A transactions relates to alleged misrepresentations to investors regarding the negotiation, terms or effects of an M&A transaction. Class action securities lawsuits are frequently filed against the target D&Os alleging that the defendants did not accurately, completely and timely disclose the existence of the M&A negotiations or other material information about the transaction. Securities class action lawsuits can also be brought against the D&Os of the acquiring company, alleging the defendants failed to fully and timely disclose the M&A negotiations or misrepresented the future prospects or likely effect of the acquisition on the acquiring company. Like other types of securities class actions against D&Os, these suits can involve huge potential damages and result in increasingly large settlements.

- Resist Hostile Takeover. In the somewhat unusual situation where a company is the target of a hostile takeover bid, directors of the target company who resist the hostile takeover attempt will likely be sued. Disgruntled shareholders typically allege that the directors breached their fiduciary duty by resisting the takeover proposal, thereby denying the shareholders the opportunity to sell their shares at the much higher offer price. The amount of recoverable damages in such a claim can be enormous, and therefore the settlement value of such a claim can be significant even if the liability exposure is relatively small in light of the broad discretion courts now give directors in such a situation.

- Approve Friendly Takeover. The directors of a target company who approve an acquisition of their company also are frequently sued by shareholders, who allege that the directors failed to make an informed decision regarding the adequacy of the purchase price, failed to negotiate the best available price, or failed to "shop" the company. These cases are typically less severe than the hostile takeover cases

since the potential recoverable damages are usually much less. Shareholders in this type of litigation frequently seek a bump up in the purchase price, as opposed to the entire acquisition premium which is at issue in D&O lawsuits involving hostile takeovers. These types of cases usually either settle for a relatively modest amount or eventually are dismissed for lack of merit.

- Pre-Acquisition Mismanagement. After a company is acquired, the new owners and their appointed managers may determine that the directors and officers of the acquired company mismanaged the company prior to the acquisition and therefore may sue the prior D&Os for the injury caused to the company. These claims are not common since the acquiring company typically conducts a thorough due diligence investigation before agreeing to purchase the company. However, this type of claim is brought occasionally and is particularly problematic for the defendant D&Os since they no longer control the company or its indemnification or insurance programs when the claim is made.

- Mismanagement of Acquisition. D&Os of the acquiring company can also incur liability exposure in connection with the management of the acquired company after the acquisition or the disclosure of the actual results of the transaction. This exposure has proven particularly problematic when the acquisition is part the acquiring company's diversification program since D&Os of the acquiring company frequently have little experience with respect to management of a company in a completely new industry or market.

E. Industry Changes

Some industries are facing large transformations or acute volatility, which increases the risk of D&O claims for companies in or affected by those industries. For example, it appears the healthcare industry may be undergoing fundamental changes in their competitive marketplace and to their historical revenue and expense structures. In that type of industry transformation, there will certainly be winners and losers. The directors and officers of the "losers" may be susceptible to a variety of claims, including disclosure claims alleging the D&Os failed to properly warn shareholders of the likely consequences of the industry changes, and mismanagement claims alleging the D&Os failed to properly anticipate, plan for and react to the industry changes. Because all similar companies within the healthcare industry will be facing the same general challenges, it may be difficult for management of the poorly performing companies to explain why the industry transformation is harming them more than their competitors or peers.

Another example is the energy industry and companies heavily reliant on the energy industry. The price of oil will probably continue to be highly volatile, thus subjecting many companies to large swings in financial performance as their revenues and expenses vary widely with the oil price fluctuations. Those peaks and valleys create an attractive environment for shareholder litigation which alleges the resulting stock price fluctuations are caused in part by misleading disclosures by D&Os who are manipulating the company's stock price.

In addition, the enormous emphasis now being placed on energy conservation and alternative sources of energy seems likely to create increased risks for D&O claims. Many companies are making unprecedented investments in largely untested and speculative businesses and technologies. Inevitably, some of those endeavors will fail or disappoint investors. The larger the failure or disappointment, the better the chance for shareholder litigation which criticizes various decisions and disclosures relating to the failed or disappointing venture.

Numerous other industries are susceptible to similar types of systemic D&O claims relating to industry-wide pressures. For example, the automotive industry faces highly publicized economic challenges and segments of the financial institutions industry face likely and severe new regulations defining what they can do and how they must operate. The risk of D&O mismanagement and disclosure claims as those companies navigate these unchartered waters seems significant.

F. Less Likely Exposures

Not all controversial issues affecting directors and officers are likely to result in frequent or severe claims. For example, executive compensation has become a huge source of criticism by investors, the public and the government. But it is unlikely that criticism will equate to significant D&O claims activity. In recent years, particularly the Delaware courts have given directors great deference regarding executive compensation decisions even when the facts are rather egregious. As demonstrated by the highly-publicized *Disney* decision, courts will generally not second-guess the amount of an executive's compensation as long as the process used by directors in approving the compensation was informed and disinterested.

Another hotly debated topic is global warming. Although some companies are being severely criticized by regulators and conservationists for their greenhouse gas emissions and their failure to fully disclose various information about the level and effects of their emissions, that criticism has not, and likely will not, equate to significant D&O claims activity. The only realistically viable plaintiff in such a D&O claim would be shareholders who allege misrepresentations or mismanagement. But, a viable misrepresentation claim would require a corrective disclosure followed by an immediate stock drop, which seems unlikely given the amount of publicity which already exists relating to climate change issues. In addition, a mismanagement claim would face difficult causation issues as well as the business judgment rule defense (i.e., would the alleged losses have been incurred but for the mismanagement?).

G. Loss Prevention

Much has been written in recent years about director and officer best practices and ways in which a company can reduce its exposure to various types of D&O claims. Ultimately, an effective D&O loss prevention program simply requires directors and officers to be sensitive to the fact that virtually everything they do can give rise to a claim and to apply common sense to minimize that potential. The exposures summarized above do not require new or unique loss prevention practices, but recent claims highlight a few best practices which are especially important today.

1. Be Proactive. One of the biggest mistakes directors and officers can make is to become reactive and not sufficiently proactive. D&Os must continually seek to identify internal and external challenges to the company's financial success and quickly address those challenges before they materialize or become a problem. As the saying goes: the time to repair the roof is when the sun is shining.

   Directors need to be sufficiently informed so that they can have a "situational awareness" of prospective issues and can ask hard questions and demand thoughtful answers. A constant commitment of time and resources to educate the Board about the company, its industry and competitors and its legal and regulatory constraints is essential. This process is never-ending since circumstances constantly change. New challenges—and new opportunities—constantly emerge and evolve.

   This proactive attitude is particularly important when a company is in crisis. Boards should take control of governance issues and provide informed, decisive and firm leadership. For example, the Board should quickly decide if the current CEO is part of the solution or part of the problem, and should be measured in its reaction to the crisis (i.e., aggressively respond, but don't overreact or over delegate responsibilities to outside advisors).

2. Behavioral Leadership. Boards should assure that the correct "tone at the top" is created, maintained and communicated throughout the company. Actions speak far louder than words, and a company's true culture is created by the Board's and senior management's conduct. Is there a visible, credible and unquestionable commitment at the highest levels of the company to high ethical standards, principles of fair dealing, full compliance with legal requirements and resistance to external pressures, regardless of the consequences? At times, this commitment requires courage to do the right thing even in the face of tempting alternatives or potentially harmful consequences.

3. Enterprise Risk Management. Many companies, including many companies outside the financial institution industry, have or are now adopting robust enterprise risk management ("ERM") programs. At its core, such a program is intended to identify and reasonably manage the most important risks which a company faces from time to time. That goal is precisely the same as a good D&O loss prevention program. In other words, senior management and the Board should use the ERM program as a way to manage D&O exposures by considering how best to respond to the identified company risks.

   An ERM program also allows D&O insurance underwriters an unprecedented view of a company's most troubling risk exposures. Both companies and insurance underwriters should consider including within the D&O insurance underwriting process the company's Chief Risk Officer or the results of the ERM program. If a company is doing a good job of identifying and responding to its most important risks, this transparency with the insurance underwriters should

provide valuable comfort to the insurer and may result in improved coverage terms and pricing.

H. Conclusions

Each company faces its own unique challenges and exposures, so it is impossible to accurately predict the same D&O risks for all companies. In addition, by definition the most troubling future exposures cannot be anticipated. Not surprisingly, there will always be opportunities for plaintiffs to sue directors and officers in a variety of contexts.

The good news for careful directors and officers is that many of those troubling exposures can be mitigated if not eliminated through prudent and common sense governance practices. But when a D&O claim eventually is filed, it is critical that the defendants have maximum indemnification and insurance protection. Like other aspects of D&O best practices, that maximum protection will exist when needed only if the company proactively and periodically evaluates and where appropriate enhances its protections, using independent and highly qualified outside advisors. With increasing frequency, that evaluation is being separately conducted on behalf of management and on behalf of outside directors, which is a wise practice since to some extent management and outside directors have disparate and conflicting interests.