

D&O OUTLOOK

What a difference a year - and a major world financial crisis - can make! At this time last year we were expecting a record low in Directors & Officers (D&O) securities class actions. The projected number of lawsuits for 2007 was well below the 1996-2006 average. Then the second half of 2007 delivered a real surprise, as the frequency of D&O securities class actions returned to pre-Enron levels. This year we are on a similar trajectory.



HOW EXTENSIVE IS THE PROBLEM?

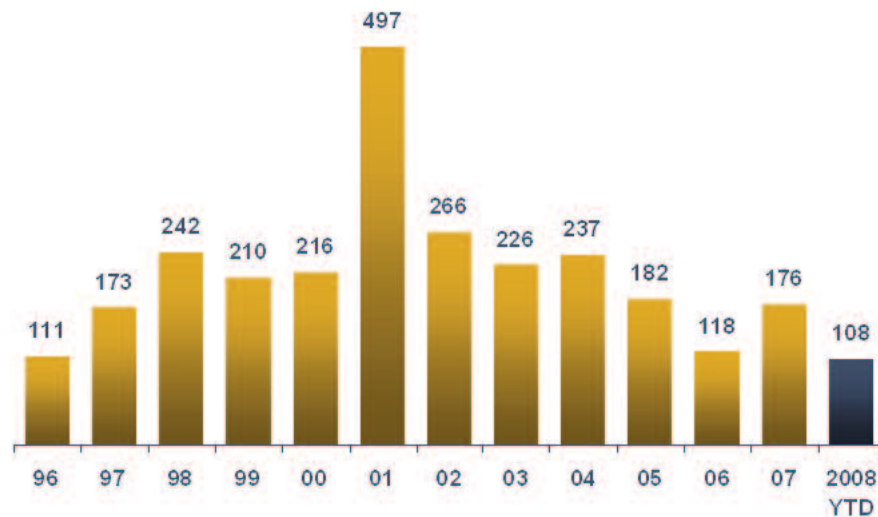
Of course, the number of cases is not the only determining factor in assessing legal trends. So far, 2008 has brought much noteworthy activity with the potential to alter the D&O landscape. In the first half we saw the legal downfall of the kingpins of D&O litigation - Bill Lerach and his former law partner Mel Weiss, both of whom have entered into plea bargains that include cash payments and prison terms. We also witnessed the collapse of the political career of Elliot Spitzer, the former governor of New York, who, in his previous role as State Attorney General, led a series of legal battles against Wall Street institutions and practices (including those in the insurance industry). This was followed by the recent demise of the suit he had brought against the ex-head of the New York Stock Exchange relating to compensation practices.

We also watched the U.S. Supreme Court return a win for the corporate defendants (see our [March 2008 Executive Risks Alert](#)) in *Stoneridge Investment Partners, LLC, Petitioner v. Scientific-Atlanta, Inc., et al.*, which we believe will have a strong impact on financial institutions (the usual targets for the type of D&O claim addressed in the case).

A Delaware Chancery Court decision continues to spark questions and concerns among corporate directors and officers. In *Richard B. Schoon and Linda J. Bohnen vs. Troy Corporation*, the court allowed a company to retroactively modify its bylaws to eliminate the advancement of defense expenses for former directors for subsequent D&O claims. D&O insurance buyers will want to review the indemnification provisions in their D&O policies, especially any language regarding "presumptive indemnification" (see our [June 2006 Alert](#)).

A recent Congressional ultimatum to the U.S. Department of Justice to change its policy of promoting waivers of attorney-client privilege in corporate investigations may well determine the outcome of pending legislation in Congress. The so-called McNulty memo states that waivers of attorney-client protection, while not required as evidence of corporate cooperation, are beneficial as they could help expedite an investigation. While requests by investigators for waivers may only be made when there is a "legitimate need," the

FEDERAL SECURITIES FRAUD CLASS ACTION FILINGS



“Securities Class Action Filings: 2008 Mid-Year Assessment,” Stanford Law School Securities Class Action Clearinghouse and Cornerstone Research.

U.S. House of Representatives approved a bill last year to end the waiver option altogether. The current bill would prohibit any agent or attorney of the federal government, in any criminal or civil case, from demanding or requesting the disclosure of any communication protected by the attorney-client privilege or attorney work product. Further, the bill would prohibit government lawyers and agents from basing any charge or adverse treatment on whether an organization pays attorney fees for its employees or signs a joint defense agreement. Some see this as a significant improvement on current operating procedures.

CRISES PAST, PRESENT AND FUTURE

Because court activity plays itself out over many years, the ultimate impact of a crisis that breaks today will not be fully understood until all the appeals and settlements grind their way through the system. For example: before subprime but after the IPO laddering classes of D&O claims, we saw a cluster of roughly 200 D&O suits – some securities class actions and some derivative – relating to corporate stock option dating practices. While the greater number have yet to settle (and a few are still being filed), it is worth noting two recent mega settlements (cash settlements greater than or equal to \$100 million): Brocade Communications for \$160 million¹ and United Healthcare for \$895 million. As a group, the stock option dating cases were unusual and unlikely to recur in the near future, and these two cases were anomalies among the anomalies. Still, they demonstrate that the irregular and unexpected can also be costly. These two settlements both broke the previous record for such settlements set back in October of 2007 with the \$117.5 million settlement involving Mercury Interactive Corp.

Looking at the current crisis – the subprime/housing/credit contagion – it is hard to predict what the litigatory future may hold, but so far the D&O news is not as bad as some have feared. The increased exposure, which we have detailed in a series of *Financial Institution Alerts*, has been largely isolated within the financial institution underwriting units at insurance carriers. (A review of D&O market conditions facing financial institutions appears below.) This is likely to

remain true for the foreseeable future, even though an oft-cited study from Navigant Consulting concluded that the number of subprime-related cases filed in federal courts is dramatically outpacing the savings-and-loan (S&L) litigation of the early 1990s,² a watershed event for D&O carriers.

THE OUTLOOK

In the second half of this year, we continue to see pricing decreases of 10%-20% on primary layers for commercial firms. As the chart shows, the market remains above the pricing levels of the late 90s. As usual, the traditionally more specialized industry sectors, such as healthcare, telecommunications and life sciences, are likely to see more resistance to such price reductions and, as the year progresses, may see reductions in the 7%-10% range. Pricing for excess or additional layers of coverage is subject to matching rating decreases, rather than the typical accelerated decreases seen until recently. Unfortunately for buyers, our expectations of continued reductions in excess pricing are due largely to an abundance of capacity following three to four years of pricing decreases rather than a reduction in severity of D&O claims. On certain large programs, where carriers are hitting minimum premiums, the rate of reduction is decreasing in the higher layers.

While there are no signs of reductions in potential capacity for commercial D&O risks (as opposed to financial institutions), capital is capital and subject to the vagaries of the economic weather. If we see more storms in the credit market comparable to those seen earlier this year, capacity in the insurance marketplace would be under pressure. Some commentators have compared the impact of the credit crisis on the insurance market to that of 9/11 and Hurricanes Katrina, Rita and Wilma. If credit conditions worsen, pricing might also change dramatically in a very short period of time, as we saw in 2002.

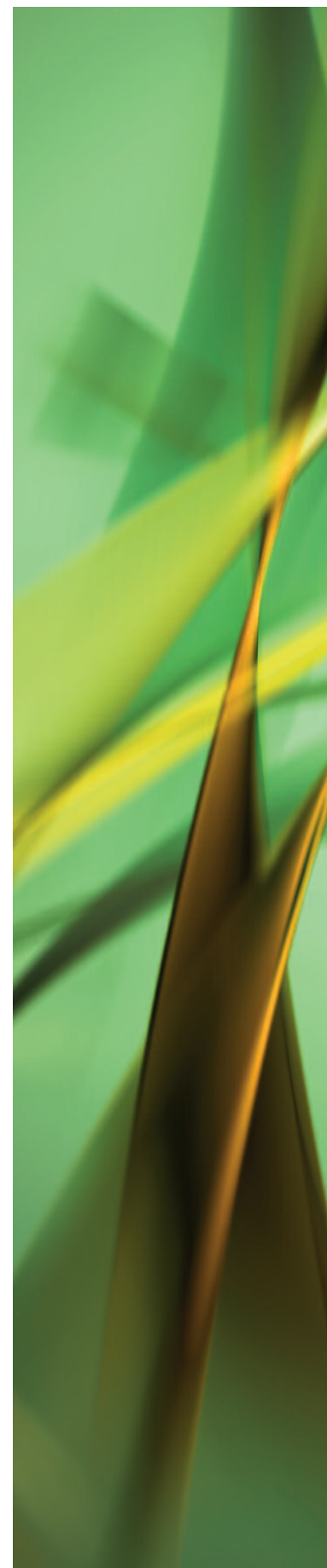
Meanwhile, continuing last year's trend, softness remains. For Side A-only D&O coverage, a number of domestic carriers (and Lloyd's) have introduced new forms and continued to commit additional capacity, resulting in even greater competition and flexibility, at least for those companies not seen as an insolvency risk. Contract wordings are also changing in other ways.

- Exhaustion of limits wording
- Clarification on Section 11 and 12 damages (for public companies or those considering going public)
- Multi-year policies for privately held companies – or another twist, guaranteed renewals

One final note. Seismic changes are on the horizon for the financial accounting rules followed by publicly traded companies in the U.S.: the coming adoption of International Financial Reporting Standards for international companies traded here, and XBRL (eXtensible Business Reporting Language), also referred to as “interactive data” by the SEC. Change can be difficult, if not terrifying. Superior companies will rise to the challenge and seize the opportunities.

¹ Note that a D&O derivative suit, rising out of the same alleged option dating practices, continues at this time.

² Navigant Subprime Mortgage and Related Litigation Study, “Subprime Mortgage Litigation Outpacing Savings-and-Loan Crisis of the Early 1990s,” Chicago, February 14, 2008.



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