



D&O MAPS

IF IT HAPPENED ONCE, IT CAN HAPPEN AGAIN: WHY THERE WILL BE MORE DIRECTOR-FINANCED SECURITIES SETTLEMENTS

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The February 2005 D&O Commentary article titled "The Enron 'Director-Funded' Settlement: Why It Won't Start a Trend" makes many quality points, but a number of important facts were not addressed in that article. Indeed, there is much more to the story. These facts could substantially heighten the exposure of individual corporate directors to personal payment of securities settlements. This article examines a number of developments that are likely to make personal contributions by directors in securities class action lawsuits a common occurrence.

Currently, there are more than a dozen megasecurities class actions pending. (Megalitigation certification requires damages of \$1 billion or more.) Enron's total estimated global settlement is expected to exceed \$40 billion. Recently, both Citicorp and JPMorgan each contributed more than \$2 billion toward this estimated \$40 billion. In addition, there are a number of other pending cases in which we could see a repeat of Enron's director-funded settlement, such as the Tyco and Adelphia litigation. Given the number and high-profile nature of such cases, it would be surprising if at least one did not result in a director-financed settlement.

The Changing Dynamics of Securities Litigation Strategy

One trend that has gained momentum since the WorldCom and Enron directors' personal settlement contributions is the use of an even more aggressive litigation strategy by the plaintiffs' bar. This hard-line approach can in part be explained by changes in the dynamics of megasecurities class actions within the last few years.

Prior to passage of the Private Securities Litigation Reform Act (PSLRA) of 1995, the first plaintiff to file a claim was automatically appointed lead plaintiff. Many insurance industry and legal observers thought that the prime motivation behind PSLRA was to end this "first come, first collect" approach, a factor they believed was fueling expensive and frequently meritless litigation. Accordingly, PSLRA was supported largely by Northern California's tech industry, which at the time had become a prime victim of such litigation. The most important provision of the law was that it changed the designation of lead plaintiff status from "first to court" to "most harmed" (i.e., the party that suffered the largest dollar amount of damages).

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Despite the significant change in this key provision, for 5 to 6 years after passage of PSLRA, not a great deal changed in the way that securities class action claims were filed. This can be attributed to two main factors, in my opinion. First, like all major legislation, there is a learning curve (watch out, folks, re: Sarbanes-Oxley) during which both the plaintiff and defense bar need to study, test, and understand the legislation. In addition, there is a window of time during which the legislation must be analyzed and interpreted by the courts, yet another factor that lengthens this so-called hatching period.

Second, the constituency often harmed the most by securities fraud was the institutional investor; more specifically, large pension plans. Historically, however, the securities plaintiffs' bar was perceived by many as "opportunistic" and/or "extortionist" and, as a result, the large state employee pension plans felt uncomfortable associating with the plaintiffs' bar and litigating against corporate America. But this boundary has gradually eroded during the 10 years since the passage of PSLRA so that, currently, megasecurities litigation is routinely being brought by the big pension plans.

As noted above, large pension plans like CALPERS were granted the right to take a lead plaintiff position, given the change from "first to file" to "most harmed" with the passage of PSLRA in 1995. Although, at that time, the large pension plans felt uncomfortable and ill-equipped to take an aggressive lead position, a combination of factors has changed that mindset, including, but not limited to: (1) the magnitude of gross corporate fraud, (2) the realization that being the lead plaintiff affords the greatest degree of control over the litigation process (and consequent potential reward), and (3) the newly developing "courtship" between institutional stockholders and professional plaintiff attorneys.

Directors Are Personally "at Risk"

Many believe that this new constituency now taking part in class action securities litigation significantly increases the probability that individual directors will be required to personally contribute to future settlements. Keep in mind that the premise for bringing the litigation is

different in "first to court" versus "most harmed." In addition, the constituency of the lead plaintiff changes the dynamics of any settlement.

The management of the large pension plans needs to demonstrate to its members and the public, in general, that securities litigation has merit and is being brought in the best interest of those harmed (pension plan participants). The best way to drive this point home is by means of individual director participation in settlements. Any amount directors personally pay justifies the time, energy, and expense of the litigation. Also, it substantially enhances the leverage the plaintiff can exert against all other defendants (witness the large payments made by Citicorp and JPMorgan, as well as several other banks, in the Enron case).

We will be seeing more and more individual contributions in securities class actions when these actions are brought by pension plans or state attorneys general (a development discussed below). Clearly, the die has been cast and the plaintiffs' bar now has the upper hand. This is because the threat of personal liability will have the directors at the table faster than a "New York minute."

The Insurance Industry's Perception

At first blush, having the directors personally contribute to a settlement might have directors and officers (D&O) underwriters thinking that such an event is a great victory for responsible corporate governance. Although this may be true in some cases, there are those in the underwriting community that see this development as a potential disaster. Once a director has personally contributed to a settlement, this could have the effect of making all of the so-called dominoes start to fall, raising the potential dollar value of the ultimate settlement amount on an across-the-board basis.

As a result of director-financed settlements, D&O and errors and omissions (E&O) underwriters now have collateral damage concerns that were not previously a part of their decision-making processes. Case in point: Citicorp underwriters did not factor the Enron settlement payment into

their thinking when they arrived at Citicorp's annual D&O policy premium. But in assuming such a risk, the underwriting community has been thrown a curveball as D&O/E&O insurers are now well aware of this additional exposure. Unfortunately for the underwriters and for investors in the insurance companies, no one has yet been able to develop a "collateral damage" program for D&O/E&O similar to those used by earthquake underwriters. Until such a model can be developed and as long as the plaintiffs' bar continues its vigorous pursuit of corporate America, underwriters, insureds, and brokers should be prepared for fluctuating (mostly upward) rates, followed by upward spiraling losses. It was only after Enron's \$350 million D&O policy limit loss that the reinsurers took notice and began to monitor their aggregate vertical exposure when designing D&O treaties. One unfortunate reinsurer was part of the treaty on every layer of the Enron D&O program.

Director-financed settlements have helped to create a new "ceiling" in D&O securities settlement levels and are likely to become a highly effective "hatchet" for the plaintiffs' bar. Prior to WorldCom and Enron, the worst-case scenario was that the corporation would contribute beyond its D&O insurance policy limits. Now it's the directors' personal funds that are at risk!

Plaintiffs' Attorneys as "Bounty Hunters"

Although yet to be confirmed, there are a number of people in the insurance industry who suggest that, increasingly, the retainers that institutional plaintiffs are signing with plaintiffs' attorneys include a "special reward" or "bounty" on individual directors. This is yet another factor that heightens their exposure to personal contributions and sends a disturbingly clear message to the next corporate defendant. *National Underwriter* recently reported that some of the clients of Lerach Coughlin Stoia Geller Rudman & Robbins, a leading securities litigation firm, have offered a fee equal to a full 50 percent of any settlement proceeds that the firm is able to obtain from individual directors and officers involved with insider trading.

Attorneys General Flex Their Muscles

Another troublesome trend for directors and officers is that state attorneys general have also emerged as aggressive lead plaintiffs. During just the last few months, attorneys general from New York, New Jersey, and California have brought litigation against Marsh, Inc.

Getting Personal

Such lawsuits have often gotten "personal," as in the cases of Jeff Greenberg at Marsh and his father Maurice Greenberg at American International Group. Moreover, the fact that state attorneys general have begun to take such aggressive approaches in these investigations (i.e., refusing to deal with corporations until their senior leadership resigns) portends a new chapter in corporate governance. A number of these state attorneys general have begun to use the threat of criminal charges to "jump-start" boards of directors into implementing immediate and drastic changes, including but not limited to demanding the resignation of long-term chief executive officers and board members.

Many D&O underwriters and reinsurers see such actions, which are often combined with the use of strong-arm discovery tactics by the state attorneys general, as an "A-list" for the plaintiffs' bar—especially when the extensive discovery has been conducted at the taxpayers' expense.

Concluding Thoughts

Despite the unusual circumstances surrounding the Enron and WorldCom director-financed settlements that were discussed in the February 2005 D&O Commentary article, it seems naïve to assume that such settlements are an aberration. More realistically, the effects of evolving litigation strategies, large pension funds joining forces with hard-line securities class action lawyers, and aggressive state attorneys general embarking on personal vendettas are more likely to produce additional settlements requiring individual directors and officers to pay claims out of personal assets.

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