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The Gathering Storm of Director Liability

By Christopher Duca

The public is demanding that our elected officials hold responsible those at fault for their losses in real-estate value, 401(k) retirement funds, and jobs. The difficulty is in identifying who is at fault, since it is not clear who is to blame, primarily due to the interconnectivity of the world economies coupled with systemic market risk.

The U.S. government has provided financial assistance to private-sector corporations that it believes pose systemic risk to the financial system and, in return for the taxpayer-funded bailouts, the public has demanded more than equity stakes or a path to repayment of loans.

As we have seen, the public has expressed its outrage towards a few of these corporations through demonstrations, demanding that the U.S. government be intimately involved with the decision-making of specific executives' compensation, bonuses, and business-planning conferences. And while this level of anger is not directed at most companies, it is a new phenomenon that is different from prior years after the dot-com bubble burst and the corporate scandals behind Enron, WorldCom, Global Crossing, Tyco, and Adelphia.

Now the intensity of director scrutiny has heightened beyond investors, which may result in increased director liability that is unlikely to fade in the near future.

The global financial crisis has triggered volatility and a decline in the stock market of 40 percent over just the past year. Treasury Secretary Timothy Geithner told The Economic Club of Washington in April, "The world economy is going through the most severe crisis in generations. We each face somewhat different challenges and thus are not all in the same boat. But we are all in the same storm...Never before in

modern times has so much of the world been simultaneously hit by a confluence of economic and financial turmoil such as we are now living through."

Not surprisingly, securities class-action filings that name publicly traded corporations and their directors and officers increased 30 percent in 2008 to a six-year high, and filings are on track in 2009 to increase to even higher levels. During the first quarter of 2009, the Securities and Exchange Commission reached 16 percent more financial settlement cases than during the same period in 2008. SEC Commissioner Luis Aguilar, in a speech at the 2009 Independent Director Conference, said, "I've been very vocal about a number of changes the SEC should make and about the Congressional action needed to address gaps in the SEC authority, and the actions needed to provide the SEC with the teeth and resources it needs to aggressively fulfill its mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."

The article *SOX May Temper Call for New Legislation* (December/January 2009, *Directorship*) still applies on a macro basis, but we continue to see lawmakers anxiously reacting to recent public sentiment. In May, the Senate was expected to consider introducing a corporate governance bill dubbed "Say on Pay," a similar bill to one passed in the House of Representatives in 2007 that remains stalled in the Senate. If passed as proposed in its current draft form, this bill would provide shareholders with a non-binding vote on executive compensation, require annual election of directors, and provide greater proxy access to shareholders.

Despite expanded SEC disclosure with

respect to executive compensation and SOX regulations, lawmakers are considering still broader disclosure requirements which may spark historic levels of shareholder litigation, clogging the U.S. court system and burdening U.S. corporations with additional legal costs. As these costs would disproportionately affect U.S. corporations as compared to other corporations trading in world markets, the result may be that U.S. corporations become less competitive on a relative basis. Such litigation would therefore be detrimental to the intended beneficiaries, the corporation's shareholders.

The legal landscape for directors is concerning on multiple levels as they face higher levels of liability resulting from the global financial crisis, increased stock-market volatility, activist shareholders, an emboldened plaintiffs' bar, active regulatory oversight and strict securities laws enforcement. Additionally, if new legislation that broadens disclosure laws is implemented without thoughtful and robust analysis, it may create the appearance of legislative grand-standing and could result in unintended consequences. This kind of response to the gathering storm of public sentiment could result in higher compliance and litigation costs to corporations rather than meaningful corporate governance reform.

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