

D&O liability: Is this the calm before the storm?

Directors have enjoyed a good run on good news. But important cautions must be offered.

BY RANDY HEIN

AUGUST'S WHIPSAWING stock market should serve as an important reminder that, when it comes to financial markets, there is peril in letting your guard down.

Certainly the past five years have seen a relatively stable stock market. This "Great Moderation," as Federal Reserve Chairman Ben Bernanke has described this period, has been marked by steady stock market growth and reasonable, smooth corporate price/earnings ratios.

This time period has also been characterized by a marked decline in securities class-action lawsuits against companies and their directors and officers. Since the number of securities suits peaked at 497 in 2001, they have declined steadily, plunging in 2006 to 118 — their lowest level since 1996.

Speculation about the underlying causes of this welcome respite in litigation has centered around three main events:

1. Sarbanes-Oxley

Passage of this Act in 2002 has helped engender a U.S. corporate climate of improved disclosure. One of its hammers — required certification of financial statements by the CEO and CFO under threat of criminal penalties — has definitely had the desired effect. Boards are now taking corporate internal controls far more seriously: Corporate financial restatements had nearly tripled in 2006 from their 2003 level. Thomas Lehner,

director of the Business Roundtable, commented on the effects of Sarbanes-Oxley in the *Wall Street Journal* (July 30, 2007), saying, "There is without question greater accountability in the boardroom."

2. Indictment of Milberg Weiss law firm

Known for its aggressive behavior in bringing class-action securities suits, the nation's "most respected and effective plaintiff law firm" (according to its own Web site), which currently is under federal investigation over its litigation practices, was indicted in May 2006 for allegedly arranging kickbacks to its lead plaintiffs. This has clearly had a quieting effect on the plaintiff's bar.



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3. Dura Pharmaceuticals, Inc. v. Broudo

The U.S. Supreme Court's April 2005 decision in effect placed a higher burden of proof upon plaintiffs who allege investment losses, thus dampening the plaintiff's bar practice of routinely filing frivolous lawsuits. The decision was a solid win for class-action defendants.

More recently, in its June 2007 *Tel-labs, Inc. v. Makor Issues & Rights, Ltd.* decision, the U.S. Supreme Court formulated guidelines to help federal courts determine when securities class-action suits are not properly pled and should be dismissed. The High Court's action should reduce the advancement of less meritorious securities class-ac-

tion cases. However, it is unlikely to affect the more substantive cases.

All of the above notwithstanding, a less-discussed but more probable cause of the litigation quiescence of recent years has been a steady, predictable, even-paced stock market. Enabled in part by the availability of inexpensive capital, this may merely be a temporary condition.

August's wild market ride, the scariest in some time, may open the door to a resurgent environment of litigation should jitters spread into sectors outside mortgage lending.

Clearly, two important cautions must be offered with the mid-August plunge fresh in our minds:

First, volatility is a financial fact of life. Some argue that Sarbanes-Oxley, the *Dura Pharmaceuticals* and *Tel-labs* Supreme Court decisions and the Milberg Weiss indictment will have a permanently calming influence on the securities class-action landscape. However, as we all know, history shows that volatility is a fact of life, and volatility always attracts securities class-action activity.

Second, substantive securities suits will always be present. Although weak securities lawsuits against directors and officers may have a steeper hill to climb, substantive suits will continue to advance.

For the most part, directors have enjoyed a good run on good news. Thanks to regulatory and legislative reforms, companies are now equipped to be better defendants in what continues to be a litigious environment. Furthermore, recent case law decisions have been favorable for corporations. However, we shouldn't be lulled to sleep.

It's simply unrealistic to assume that the calm will continue indefinitely and that volatility has permanently disappeared from the marketplace. The only truly permanent condition is the potential to be sued. ■

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