BAILEY | CAVALIERI

PARALLEL PROCEEDINGS: D&Os CAUGHT IN THE CROSS-FIRE

It is commonly recognized that the size of settlements in securities class actions against directors and officers has increased dramatically in the post-Enron environment. Equally troubling, but less publicized, is the similar increase in the frequency of proceedings against directors and officers which are separate from but related and parallel to the securities class action lawsuit. These parallel proceedings create difficult litigation dynamics and unique D&O insurance coverage issues which further complicate the management of the claims against and exposures of the defendant directors and officers.

The following summarizes the most common parallel D&O proceedings today (other than ERISA tagalong lawsuits, which have been extensively discussed in other articles) and many of the litigation and insurance coverage issues created by each type of parallel proceeding.

A. DERIVATIVE AND OPT-OUT CLAIMS

Securities class action lawsuits are now being prosecuted by an increasingly smaller group of sophisticated and highly experienced plaintiff law firms. Courts are typically appointing only one lead plaintiff and one lead plaintiff counsel in these cases. As a result, a growing number of plaintiff law firms are not selected to serve as counsel for the class and are unable to share in the huge plaintiff attorney fee award when the case settles. In order to create an alternative source for fees, many of those plaintiff law firms are bringing shareholder derivative lawsuits on behalf of the company and individual opt-out claims on behalf of a select number of institutional investors who would otherwise be passive members of the class in the securities class action lawsuit. Both of those types of parallel lawsuits are briefly discussed below.

Derivative Suits. Although the practice of filing a derivative lawsuit parallel with the federal securities class action lawsuit is not new, the frequency of that practice has increased somewhat recently. These derivative lawsuits are typically filed in state court and allege breaches of fiduciary duty rather than violations of the securities laws. Although the liability exposure in the derivative lawsuit is typically far less than the exposure in the securities class action, the presence of the derivative suit can complicate the defense of the securities class action.

For example, in the securities class action, discovery is stayed until the court rules on defendants' motion to dismiss. There is no comparable stay of discovery in the derivative lawsuit. As a result, plaintiffs frequently seek early discovery in the derivative lawsuit in order to help defeat defendants' motion to dismiss in the securities class action. Although such a

practice is not condoned by some courts, the risk of this "back door" discovery through the derivative lawsuit is a significant concern to defense counsel. In addition, the state court derivative lawsuit is at times scheduled for a very early trial date since state courts frequently process litigation much faster than large class actions in federal court. An early trial date in the derivative lawsuit typically benefits plaintiffs and creates unfavorable settlement leverage over the defendants in both cases.

Opt-Out Suits. Typically, opt-out lawsuits are brought by one or a small number of institutional investors who are not lead plaintiffs in the class action, but who lost considerable money as a result of the alleged securities law violations. By bringing a lawsuit separate from the larger class action lawsuit, these individual plaintiffs typically can negotiate a larger settlement recovery than if the plaintiffs were passive beneficiaries of the larger class action lawsuit. In addition, defendants may be required to respond to multiple motions and discovery requests in each of the separate lawsuits, which may be filed in different courts throughout the country. In other words, defense costs frequently increase considerably as a result of these parallel proceedings.

Partial Settlements. The most troubling aspect of these derivative and opt-out parallel proceedings is the risk that some but not all of the proceedings may be settled at one time. Because defendants must separately negotiate settlement terms with the plaintiffs in each separate case, there is considerable risk that acceptable settlements cannot be negotiated with all of the plaintiffs at one time. In that event, defendants and the D&O insurers must make some very difficult decisions.

Should defendants settle with some of the plaintiffs, thereby eroding or exhausting the insurance program and leaving the defendants underinsured or uninsured for the remaining claims? If different lawsuits name different D&O defendants, can the non-settling defendants prevent some or all of the D&O insurance proceeds from being paid in settlement of claims against other insureds? Who decides which defendant insured is entitled to the insurance proceeds when the insureds present conflicting demands to the insurer?

In many jurisdictions, courts have adopted a "first come, first serve" rule, pursuant to which an insurer should pay losses in the order in which the losses are incurred or presented to the insurer. In those states, these parallel proceedings can create a strong incentive by the insured D&Os in one case to settle that case as soon as possible in order to access the policy proceeds before those proceeds are eroded by one of the other cases. In addition, this situation may force a defendant D&O to agree to inflated or undesirable settlement terms (including uninsured personal contributions) in order to avoid being left behind in a settlement that will largely deplete or exhaust the policy limits.

These same partial settlement problems can also arise in any one proceeding if the "white hat" D&O defendants can settle at favorable terms, but the "black hat" defendants cannot settle without making large personal contributions. Those non-settling defendants may be forced to either lose their remaining insurance coverage or agree to a significant personal settlement contribution.

The D&O insurer in these situations is in a serious dilemma once it receives competing and conflicting demands from the D&O insureds. The insurer would prefer that the insureds resolve among themselves their competing claims against the policy proceeds. For example, the insureds could agree that each insured would have access to a defined amount of the remaining policy proceeds, thereby allowing some insureds to settle early while the remaining insureds retain a share of the policy proceeds for future losses. The insurer's ultimate recourse if the conflicting demands cannot be consensually resolved is the filing of an interpleader action, pursuant to which the insurer deposits the policy proceeds with the court and relinquishes to the court the right and duty to resolve those conflicting demands.

At least with respect to partial settlements involving shareholder derivative lawsuits, insureds can reduce the problems created by these partial settlements through the purchase of a Side-A Only excess policy. Since that policy would respond only to the non-indemnified derivative settlement, and not to settlements in the securities class action or opt-out claims, the D&O defendants could settle the securities claims (thereby eroding or exhausting the Side-B and Side-C coverages) and retain coverage under the Side-A Only policy for the non-settled derivative lawsuit.

B. REGULATORY CLAIMS

In the post-Enron era, claims by the SEC, and to a lesser extent other regulators, have increased significantly. Since 2001, the SEC budget has more than doubled and the size of its staff has increased by about 30%. Similarly, the number of enforcement proceedings brought by the SEC has increased dramatically in the last several years. Other regulators, most notably New York Attorney General Elliot Spitzer, have likewise become much more active in bringing proceedings against companies and their directors and officers. As a result, it is far more likely today that D&O defendants in a securities class action lawsuit must also defend a parallel regulatory proceeding.

These parallel regulatory proceedings create unique problems for the defendants. The regulators frequently have extremely broad discovery rights and conduct their investigations much faster than plaintiffs in the securities lawsuits. As a result, the regulators frequently develop a "road map" for the private plaintiffs to follow in prosecuting the securities class action litigation. In addition, the regulatory proceedings are frequently not consolidated or coordinated with the private litigation, thus forcing the defendants to engage in duplicate and overlapping discovery.

From a D&O insurance standpoint, the primary issue is whether these regulatory proceedings are covered claims under the policy. Typically, D&O policies do not insure regulatory proceedings against the company even if the policy includes securities entity coverage. Although many policies insure regulatory investigations or proceedings against directors and officers, a coverage issue frequently arises whether a particular regulatory investigation or proceeding is against an insured director or officer for wrongful acts by the director or officer.

In many regulatory investigations and proceedings, various individuals within a company may receive subpoenas or be deposed as a fact witness. Unless that person has been identified by the regulator as a target against whom a claim may be made in the future, the individual will likely not have coverage under most D&O policies for legal fees incurred in responding to the discovery request. However, under some circumstances, the D&O insurer may recognize coverage for those legal fees even if the D&O is not an identified target of the regulator, provided the insured D&O can demonstrate that the legal costs incurred in responding to the regulator also helped in the defense of the parallel securities class action lawsuit.

C. CRIMINAL PROCEEDINGS

The frequency of criminal proceedings against directors and officers will likely continue to increase as a result of the Sarbanes-Oxley Act and the unprecedented efforts by officials to identify and punish wrongdoing by directors and officers. Typically, the securities class action lawsuit against an indicted director or officer is stayed while the criminal proceeding against that director or officer is prosecuted. Thus, the plaintiffs in the securities class action can let the prosecutor in the criminal proceeding develop the facts proving wrongdoing, and then use those facts and any conviction or guilty plea to their advantage in the securities class action lawsuit. If the securities class action is not stayed while the criminal case is being prosecuted, the D&O defendant will likely refuse to respond to discovery requests in the securities class action in reliance upon the Fifth Amendment privilege against self-incrimination. By invoking that privilege, the court in the securities class action can infer that the answers to the questions for which the privilege was invoked would have evidenced wrongdoing by the defendant director or officer.

From a D&O insurance coverage standpoint, the primary question in criminal proceedings is whether such proceedings are covered claims under the policy. Although many D&O policies expressly include within the definition of "Claim" criminal proceedings, other D&O policies do not afford such coverage. Companies should evaluate whether such coverage is desirable when purchasing their D&O insurance. On the one hand, directors and officers may want the assurance that they will have defense costs coverage in the event they are indicted for criminal wrongdoing. However, such coverage can significantly erode the available insurance proceeds for the outside directors and other "white hat" D&O defendants in the securities class action or other civil claims. Since most indicted D&Os are viewed as "black hat" insureds, one could reasonably conclude that the D&O insurance policy should not cover those criminal defense costs and the policy proceeds should be preserved for the "white hat" D&O defendants.

If the policy does not cover criminal proceedings, a difficult allocation issue may arise. Usually, the same facts underlie both the criminal proceeding and the civil lawsuits against a defendant director and officer. The investigation, evaluation and development of those facts equally benefit the defense of the criminal proceeding and the civil lawsuits. It is frequently quite difficult to determine how those defense costs are allocated between the uninsured criminal proceeding and the insured civil lawsuits.

D. BANKRUPTCY PROCEEDINGS

If the company files bankruptcy, claims against the company are automatically stayed, but claims against the directors and officers generally continue. At times, the bankruptcy trustee or creditors committee may assert claims against the directors and officers in the bankruptcy proceeding at the same time as the securities class action lawsuit is being litigated. Again, this parallel bankruptcy proceeding presents challenging issues for the defendant directors and officers with respect to coordinating discovery, avoiding rulings in one proceeding that adversely affect the other proceeding, and controlling the increased defense costs.

From a D&O insurance perspective, these bankruptcy proceedings against directors and officers raise several issues. For example, courts have reached conflicting conclusions as to whether such proceedings are covered in light of the insured v. insured exclusion. The answer to that question is quite fact specific, depending upon who is bringing the claim in what capacity, who benefits from any recovery and how the plaintiff obtained authorization to bring the claim, among other variables. Although many D&O policies expressly state that this exclusion does not apply to claims by bankruptcy trustees or their assignees, that policy language frequently does not expressly address claims by the creditors committee, a litigation trust or other similar plaintiffs. In addition, if the relief being sought from the defendant director or officer is the disgorgement of a preferential payment or fraudulent conveyance (such as a retention bonus or other compensation payment received by the director or officer prior to the bankruptcy filing), such a claim may not be covered either because it seeks the disgorgement of ill-gotten gain or because the claim is not for wrongful acts by the defendant director or officer since it focuses exclusively on the transfer made by the debtor.

If coverage disputes arise in connection with these proceedings, another difficult issue is what court should resolve that dispute. The debtor company and the creditors typically want the bankruptcy court to resolve that dispute since the bankruptcy court is frequently viewed as being sympathetic to their interests. The defendant directors and officers, as well as the D&O insurer, frequently resist the jurisdiction of the bankruptcy court and prefer the coverage dispute be resolved in accordance with any alternative dispute resolution provision in the policy or in state or federal court, not the bankruptcy court.

In summary, both the insureds and the insurer under a D&O insurance policy are now faced with new and difficult issues regarding the management of and exposures created by parallel proceedings, as well as coverage implications from those proceedings. Frequently, little if any precedent exists for resolving many of these new issues, which too often are not anticipated by the insureds until the situation arises. Like many other aspects of the D&O insurance relationship, both the insureds and the insurer are best served by maintaining good communications between each other and fostering a cooperative environment in which each party appreciates the other's perspectives and is willing to compromise within reason.

About the Author:

Dan A. Bailey is the Chair of the Firm's Directors & Officers Liability Practice Group and represents and consults with directors and officers, corporations, insurance companies, and law firms across the country. In addition to advising Boards and drafting most of the D&O insurance policies in the market, he has represented clients or served as an expert witness in many of the largest D&O claims for more than 30 years. He is co-author of Liability of Corporate Officers and Directors, a leading treatise on the topic, has published dozens of articles and speaks at more than 20 seminars a year on the subject.

He can be reached at (614) 229-3213, or dbailey@baileycav.com*.*