DELIVERING STRATEGIC SOLUTIONS ACCA'S 2000 ANNUAL MEETING

COVERAGE AND INDEMNIFICATION FOR LIABILITY OF DIRECTORS AND OFFICERS

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I. INTRODUCTION

A. TRENDS

1. D&O litigation is an area in-house counsel to watch.

(a) Forty-one percent of claims against corporations and their officers and directors are brought by disgruntled shareholders. Such claims often involve allegations of misrepresentations or omissions, manipulation of stock prices, or problems arising from mergers and acquisitions.

(b) The average judgment in cases brought by shareholder claimants in 1997 was in excess of $7.5 million. By one estimate, this number rose to almost $11 million for 1998.

2. Developments in the broader economy are influencing the types of cases being brought against directors and officers.

(a) The recent record volume of securities litigation is fueled by the surge in public offerings – and, in some cases, subsequent failures – of high-risk Internet start-up companies.

(b) The primary targets of stock fraud suits are officers and directors of computer, biotechnology, pharmaceutical and other high-tech firms.

3. In this litigious climate, companies and their officers and directors should review their D&O insurance coverage.

4. D&O insurance has taken on increasingly greater significance with the advent of class action litigation involving securities fraud and consumer claims, raising the stakes significantly for corporate directors and officers and the corporations that may be obligated to indemnify them.

5. Disputes with D&O insurers also have increased in both frequency and intensity.

6. The following summary will focus on D&O insurance coverage and some legal issues surrounding protection of officers and directors from claims.

B. ALLOCATION

1. Generally

(a) The issue of allocation is often a source of contention between policyholders and insurance companies selling D&O policies.

(b) Insurance companies routinely argue that they are entitled to apportion their costs of defense and indemnification between insured and uninsured parties named in the underlying lawsuit.

(c) Under traditional D&O policy forms, there is no coverage for claims against the company – only for claims against the officers and directors or to reimburse amounts companies pay to indemnify or defend their officers and directors.

a. To reduce their costs, insurers allocate costs between claims against those defendants covered under the D&O policy (*e.g.,* directors) and claims against defendants not are not (*e.g.*, the corporation).

(e) Some newer D&O policy forms and endorsements provide so-called entity coverage for claims against the corporation. Nevertheless, the entity coverage is often limited to certain kinds of claims (such as securities claims), giving rise to new disputes about whether some claims against corporate defendants are covered.

2. Circumstances Giving Rise to Allocation

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(a) Allocation of defense costs and expenses during the time the underlying claims against the officers and directors are pending.

(b) Allocation of indemnity payments at the time of any settlement or judgment.

(i) Insurance companies selling D&O insurance regularly seek to allocate costs of defense and indemnity on an arbitrary 50-50 basis.

(ii) Many insurers attempt 50-50 allocation even with little or no investigation of the surrounding facts.

(iii) The recent trend in the law disfavors this tactic.

II. Indemnifying the Corporate Entity:

The "Larger Settlement Rule"

A. TRADITIONAL RULE

Under the traditional rule, a D&O insurer is responsible only for those losses resulting from the liability of the named insureds (officers and directions) and has no responsibility for liability imposed on the corporation for its wrongful acts.

B. THE LARGER SETTLEMENT RULE

1. "Under the larger settlement rule, a corporation is entitled to reimbursement of all settlement costs where the corporation's liability is purely derivative of the liability of the insured directors and officers."

Richardson Electronics v. Federal Insurance Co., 2000 WL 804673 (N.D. Ill. June 21, 2000).

2. Rationale

a. Allowing the insurer to allocate "between the directors' liability and the corporation's derivative liability . . . would rob the [policyholder] of the insurance protection" it reasonably expected to receive.

Harbor Ins. Co. v. Continental Bank Corp., 922 F.2d 357, 368 (7th Cir.1990)(Posner, J.).

(b) A D&O policyholder is entitled to expect that the insurance company will be responsible for the cost of liability attributable in any way to the wrongful acts or omissions of the directors and officers, regardless of whether the corporation could be found concurrently liable on any given claim under an independent theory.

3. The only two U.S. Courts of Appeal to have addressed this issue, the 9th and the 7th Circuits, have adopted the larger settlement rule.

4. Seminal Case: *Nordstrom, Inc. v. Chubb & Son*, 54 F.3d 1424 (9th Cir. 1995).

(a) Facts

(i) In 1990, various groups of Nordstrom shareholders brought class action suits alleging securities fraud against Nordstrom and its directors and officers.

(ii) The parties eventually reached a global $7.5 million settlement, with the corporate entity and individual directors and officers jointly and severally liable for the sum.

(iii) Federal Insurance, which had insured Nordstrom under a policy covering "all loss" stemming from the wrongful acts of corporate directors and officers, consented to the settlement.

(iv) Federal, however, agreed only to fund half of the settlement and half of the defense costs because both (a) individual directors and officers of Nordstrom (insured entities) and (b) the corporation (an uninsured entity) were named as defendants in the underlying suit.

(b) Procedural History

(i) Nordstrom initiated a coverage action in federal district court, claiming that the policy covered the entire settlement.

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(ii) The district court granted Nordstrom's motion for summary judgment.

(iii) On appeal, the 9th Circuit rejected the argument that the joint and several liability applied by the settlement agreement required Federal to pay the entire amount. Instead, the court held that it must determine which claims would have exposed Nordstrom to liability independent of, rather than derivative from, its directors' and officers' liability.

(c) Conclusions of Law

(i) The 9th Circuit concluded that Federal would be responsible for any liability that was attributable in any way to the directors and officers, regardless of whether the corporation could be found concurrently liable.

(ii) The court would only allocate some of the settlement away from Federal to the extent that corporate liability was both independent of and not duplicated by liability against the directors.

(iii) After reviewing the settled claims, the court concluded that Nordstrom's liability, even where based on an independent theory, was wholly concurrent with D&O liability and therefore Federal was responsible for the entire amount.

5. *Nordstrom* Revisited

(a) PSLRA

(i) The Private Securities Litigation Reform Act of 1995 ("PSLRA") eliminates joint and several liability for those who violate the securities laws, absent a knowing violation.

(ii) This act, in part, aimed to stop the "race to the courthouse" by plaintiffs' firms every time a stock drop presented an opportunity to file a misrepresentation suit.

(iii) According to the Act, a person generally may be held liable only for that portion of a judgment that corresponds to his or her percentage of responsibility for the plaintiffs' losses.

(b) This change in the securities laws invites a re-examination of the allocation decisions in *Nordstrom* and the larger settlement rule.

(i) In the *Nordstrom* decision, the Ninth Circuit held that, because each defendant was liable for the entirety of the settlement, there should be no allocation among the various defendants. Now, with the general elimination of joint and several liability under the PSLRA, D&O insurers once again argue that there should be allocation of settlement payments and defense costs between covered and uncovered parties.

(ii) Following enactment of the PSLRA, the larger settlement rule came under renewed attack by insurers. In *Stauth v. National Union Fire Insurance Co. of Pittsburgh*, 185 F.3d 875 (10th Cir. 1999) (unpublished op.), the insurers argued that an uncovered corporation should bear its own share of expenses. The insurance companies contended that case law adopting the larger settlement rule pre-dates PSLRA and should, therefore, no longer be followed, since securities liability is now several and not joint. The insurers claimed that each defendant, including the company, must independently share in the cost of settling and defending securities claims.

III. One Response to the Larger Settlement Rule:

Entity coverage

A. "Entity coverage" Defined

1. Today, most D&O insurers offer policy forms expressly providing for coverage of the corporate entity, at least with regard to certain types of claims.

2. Some such policies also protect insured directors and officers against covered losses for which the corporation may not indemnify them.

B. The Advent of the Entity Approach

1. As allocation issues involving D&O insurance have been litigated and resolved by the courts, and as corporate

1. As allocation issues involving D&O insurance have been litigated and resolved by the courts, and as corporate policyholders and their brokers have called for coverage that avoids allocation disputes, D&O underwriters have responded by offering entity coverage.

2. One approach is to stipulate a preset allocation percentage that will be applied to all D&O suits naming both (a) directors and officers and (b) the company.

IV. When are Directors and Officers Entitled to Coverage?

A. BACKGROUND OF THE LAW

1. Directors and officers have become increasingly concerned with the potential for personal liability arising from their service in such capacities.

2. Consequently, the availability of indemnification and other ways to protect directors and officers from liability has become an important topic.

3. States have responded to this concern by enacting indemnification statutes intended to limit the exposure of directors and officers to personal liability.

B. Delaware LAW

1. Delaware General Corporation Law § 145 and many other statutes following the same model distinguish between:

a. indemnification that the corporation is required by law to provide under certain circumstances, called *mandatory indemnification*, and
b. indemnification that the corporation is authorized but not required to provide, called *permissive indemnification*.

2. Delaware enacted § 145 to provide Delaware corporations with generous indemnification powers. Courts have liberally construed this section, giving it an expansive application.

3. Section 145 is intended to promote two significant policy objectives:

(a) First, it is intended to encourage capable individuals to serve as corporate directors and officers by allaying their concerns over potential personal liability.

(b) Second, it is intended to encourage directors and officers to resist unjustified suits, with the assurance that the corporation will pay for the expenses associated with their defense.

C. Permissive Indemnification:

1. Permissive indemnification under § 145 is further divided into two categories: suits brought by third parties and suits brought by or in the right of the corporation.

2. Indemnification for Third-Party Actions

a. Section 145(a) conveys broad indemnification powers for actions brought against corporate directors or officers by third parties.
b. Generally, this section applies to any action against a director or officer not brought by or in the right of the corporation.
c. The scope of indemnifiable expenses under § 145(a) is extremely generous, authorizing corporations to indemnify directors and officers against expenses incurred, including attorneys' fees, judgments, fines and amounts paid in settlement. The right to indemnify is limited by a general reasonableness standard.
d. There are also two public policy limitations on permissive indemnification for third-party actions. To be entitled to indemnification, the officer or director must have acted:

(i) in good faith; and

(ii) in a manner reasonably believed to be consistent with the best interests of the corporation.

1. Indemnification for Actions "In the Right of the Corporation"

Section 145(b) addresses the power of a corporation to indemnify its directors and officers for expenses incurred in connection with an action brought "by or in the right of the corporation."

a. Actions brought by or in the right of the corporation are either maintained directly by the corporation itself or, alternatively, in a shareholders' derivative suit.
b. In either case, such actions are premised on alleged breaches of the duties an officer or director owes to the corporation. The action is in the name of the corporation and any recovery is in favor of the corporation.

b. In either case, such actions are premised on alleged breaches of the duties an officer or director owes to the corporation. The action is in the name of the corporation and any recovery is in favor of the corporation.

4. The most significant difference between subsections (a) and (b) of § 145 is that the scope of expenses that a corporation is authorized to indemnify is narrower under subsection (b) (for actions in the right of the corporation).

(a) While subsection (a) (on third-party actions) allows for indemnification of amounts paid in settlement or under judgments, subsection (b) does not permit indemnification of such amounts in actions brought by or in the right of the corporation.

(b) Section (b) restricts indemnification exclusively to attorneys' fees and other expenses and does not permit indemnification for judgments or amounts paid in settlement of an action.

5. A Delaware corporation may include a provision in its certificate of incorporation limiting – or even eliminating altogether – the liability of a director or officer to the corporation for breaches of fiduciary duty.

(a) Section 145(b) restricts the circumstances in which such indemnification is available. As in § 145(a), indemnification under § 145(b) requires that the director or officer must have acted in good faith and in a manner reasonably believed to be consistent with the best interests of the corporation.

(b) Section 145(b) imposes a further constraint in the event that a director or officer is found liable to the corporation in a derivative suit. In that case, § 145(b) prohibits indemnification of any expenses unless, upon application, the appropriate court determines that the defendant is fairly and reasonably entitled to indemnity.

6. Further Public Policy Limitations

(a) A corporation may not indemnify its directors and officers who have been found liable for violations of federal securities laws.

(b) Public policy prohibits a corporation from indemnifying its directors and officers for intentional illegal conduct.

D. Mandatory Indemnification

1. Delaware General Corporation Law §145(c) *requires* a corporation to indemnify present or former directors and officers for expenses (including attorneys' fees) to the extent that they have succeeded "on the merits or otherwise" in defending against an action.

a. This section applies in the event of a successful defense to both actions brought by third parties and those brought by or in the right of the corporation.
b. Courts have liberally construed this section to provide corporate directors and officers with the broadest protection possible when they have successfully defended against a claim.
c. In contrast to subsections (a) and (b), this subsection requires no action on the part of the corporation for the director or officer to be entitled to indemnification. Similarly, under § 145(c), a director or officer is entitled to indemnification if he or she has successfully defended against a claim, irrespective of the corporation's by-laws or certificate of incorporation.
d. Mandatory indemnification is limited to expenses of a successful defense and, thus, will never include amounts paid in satisfaction of a judgment or settlement.

2. The successful conclusion of the underlying suit for which indemnification is sought must have been achieved without any payment or assumption of liability by the defendant director or officer seeking indemnification.

3. In Delaware, a director or officer is entitled to indemnification for the expenses associated with those claims against which he or she successfully defended, notwithstanding the fact that he or she did not succeed in defending other claims or issues.

4. Standard: a director or officer need only demonstrate that he or she successfully defended against the claim that gave rise to the expenses for which that he or she seeks indemnification

V. D&O INSURANCE FOR PRIVATE VERSUS PUBLIC Companies

A. D&O liability underwriters generally believe small startups can be well-underwritten. The fact that D&O insurance is largely a new purchase for privately held companies makes it an attractive product to be able to offer in a soft insurance cycle.
B. In the current robust economy, startups are fueling the D&O market for insurers. The ratio of private to public opportunities is about 7-to-1.
C. The number of carriers offering Employment Practices Liability (EPL) insurance over the last decade has grown by a factor of four or five.

C. The number of carriers offering Employment Practices Liability (EPL) insurance over the last decade has grown by a factor of four or five. While many insurers now offer blended packages of D&O and EPL coverage for privately held firms, it is the EPL coverage that often attracts private firms to purchase D&O policies.
D. On the public side, in the 1990s D&O policyholders had several years of rate reductions and coverage expansions. At the same time, they had also seen significant jumps in claim severity – with names like Philip Morris, Waste Management and Cendant facing exposures of $100 million to $2 billion. The D&O market – like other primary casualty markets – is now firming.
E. Privately held companies ordinarily do not have nearly the frequency or severity of covered D&O claims that public companies do. In addition to EPL exposures, antitrust litigation, breach of contract actions and patent infringement cases can give rise to covered D&O claims for private firms.
F. A company whose shares are not publicly traded may nevertheless have publicly traded debt or widely distributed stock. Even without publicly traded equity, such firms nevertheless are potentially exposed to liability to shareholders and lenders.
G. Directors and officers of private companies may also be exposed to liability for alleged breaches of duties owed to minority shareholders.

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