712 - D&O Insurance for Financial Services Lawyers

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Faculty Biographies

Chris Braithwaite

Christopher Braithwaite is a partner in the finance litigation and insurance group at Simmons & Simmons based in the London office. Mr. Braithwaite specializes in advising financial institutions on finance disputes, insurance and reinsurance coverage issues and disputes, and regulatory investigations and enforcement proceedings. In each of these areas he has advised U.S. and European investment banks, fund managers, hedge funds, insurers, insurance brokers, regulators and individuals. Together with other members of his firm, he regularly advises commercial policyholders on liability and insurance coverage issues including policy terms.

Mr. Braithwaite is a member of the ABA, the Federation of Defense and Corporate Counsel, the British Insurance Law Association, and the Association of Regulatory and Disciplinary Lawyers.

Heather Fox

Heather Fox is chief underwriting officer of National Union Fire Insurance Company of Pittsburgh, a member company of American International Group, Inc. Ms. Fox is the principal drafter of many of National Union's management liability products. Since she joined AIG, Ms. Fox has held a variety of underwriting and legal positions including, managing National Union's legal staff and compliance group.

Prior to her employment at AIG, Ms. Fox practiced law in Massachusetts, primarily focusing on civil litigation, including employment-related litigation.

She received a B.S. from St. John's University and a J.D. from New England School of Law.

John Tanner

John Tanner is senior vice president and claims counsel in the financial services division of insurance broker McGriff, Seibels & Williams, Inc. (a BB&T company).

Mr. Tanner joined McGriff from the Atlanta office of Alston & Bird, LLP where he gained extensive experience in securities litigation and professional liability matters including defense of public companies and directors and officers in shareholder class action litigation, defense of law firms sued by former clients or third parties (such as trustees in bankruptcy), and participation on the legal counsel investigation team representing the court appointed examiner in the Enron bankruptcy. He also has significant prior experience litigating claims of insurer bad faith and issuing formal insurance coverage opinions.

He has authored a number of articles pertaining to D&O liability and insurance and is a frequent speaker at legal and business conferences.

Mr. Tanner received his B.A., cum laude, from Maryville College where he was a presidential scholar and his J.D., magna cum laude, from Georgia State University College of Law.

ASSOCIATION OF CORPORATE COUNSEL

D&O INSURANCE FOR FINANCIAL SERVICES LAWYERS

Introduction

Most D&O liability policies written for North American companies (whether issued in North America or London) will be made subject to US or Canadian law Policy terms and coverage issues will therefore be negotiated or adjudicated by reference to those laws Many North American companies have subsidiaries or businesses operating in the U K , and the directors and executives of these companies will be exposed to personal liability should they fail to comply with local laws and regulations The purpose of this paper therefore is to report on developments, mainly in the U K , which may increase the exposure of directors and executives to claims, and to look briefly at the coverage issues which regularly arise when buying D&O insurance

Directors' general duties

There has been an important recent development in relation to directors' duties The general duties owed by directors under English law have recently been codified Sections 170 to 177 of the Companies Act 2006 (the Act) set out the duties

The seven codified general duties of directors introduced by the Act are

1 to act within their powers

2 to promote the success of the company

3 to exercise independent judgment

4 to exercise reasonable care, skill and diligence

5 to avoid conflicts of interest

6 not to accept benefits from third parties, and

7 to declare interests in a proposed transaction or arrangement with the company

The statutory duties will generally apply from 01 October 2007 On the face of it they seem harmless, and not radically different to the previous common law duties Beneath the surface, however, there are some significant changes, including the introduction of a new cause of action for shareholders against directors

There remain a broad range of other specific statutory duties applicable to directors contained in the Act as well as in other legislation A director may also owe a duty of care at common law to third parties where there is an assumption of personal responsibility towards them

The most relevant general statutory duties are summarised below

Duty to act within their powers

Section 171

"A director of a company must

(a) act in accordance with the company's constitution, and

(b) only exercise powers for the purposes for which they are conferred "

Directors must continue to comply with the company's constitution This is not new Directors need to be familiar with the constitution and aware of any restrictions, such as borrowing restrictions

Duty to promote the success of the company

Section 172

"A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to

(a) the likely consequences of any decision in the long term

(b) the interests of the company's employees

(c) the need to foster the company's business relationships with suppliers, customers and others

(d) the impact of the company's operations on the community and the environment

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company "

This new duty replaces the old common law and equitable duty of "acting in good faith in the interests of the company" It is deliberately designed to enshrine the new principle of "enlightened shareholder value"

Important features of this duty have been carried over from the old law

- the word "success" is a more modern, plainer term for "interests"
- the subjective test - "*he* considers" - has been retained
- in "*good faith*" has been retained, and
- "*for the benefit of its members as a whole*" has long been the old, but rather inelegant and imprecise, definition of "the company"

The new statutory factors are ones which large private companies and public companies would commonly take into account when reaching a decision, in addition to whatever else may be relevant in the circumstances What the new Act does is to make very much clearer the necessity of considering all relevant factors This may have been implied under the old law – depending on the circumstances – but the new law sets it out clearly

Directors of companies who cannot demonstrate awareness of even the need to consider these factors, and what they are, may find that any defence to a claim that they have breached their directors' duties is severely compromised For smaller, private, owner managed companies the new law will have an impact where Board procedures are, understandably, less formal, and there is a less obvious distinction between the views of directors and the shareholders, and less resource to address the issues that the government would expect to see considered as part of "enlightened shareholder value" For important Board decisions, briefing papers should, where relevant, address the statutory factors In practice, Board minutes will, as often before, simply record the decision

Duty to exercise independent judgement

Section 173

A director of a company must exercise independent judgement

This duty is not infringed by his acting

(a) in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors, or

(b) in a way authorised by the company's constitution

This codified duty now incorporates, in a single concept, the old law that a director should exercise his powers independently and not fetter his judgement by undue delegation or as a consequence of a conflict of interest While the codified wording attempts to unite these separate

duties together, section 170 of the Act requires the codified duties to be interpreted and applied in the same way as the old law Nonetheless, the codified wording is clearer and therefore brings into much sharper focus the need to act independently

The exercise of independent judgement refers to the way in which the director takes a decision For example, he should not simply do what he is told to do by a shareholder It may also be that a conflict of interest exists between the personal interest of a director and the interest of the company The director must not allow his personal interest to cloud his independent judgement This is in addition to compliance with the procedures concerning disclosures and approval of conflicts of interests

Duty to exercise reasonable care, skill and diligence

Section 174

"A director of a company must exercise reasonable care, skill and diligence

This means the care, skill and diligence that would be exercised by a reasonably diligent person with

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and

(b) the general knowledge, skill and experience that the director has "

This codifies the current law As now, there are two parts to the duty, an objective part and a subjective part

The section does not make any specific distinction between executive and non executive directors

It requires a minimum standard of conduct for all directors It does not, however, necessarily raise the standard to be followed by non executive directors to require them to use the same care, skill and diligence of executive directors, as section 174 makes it clear that the courts must also take into account the "functions carried out by the relevant director" This means that the courts should consider the different functions of executive and non executive directors when determining whether a particular director has exercised reasonable care, skill and diligence An executive director who is skilled in financial matters may be regarded differently to an executive director skilled in engineering The same might also be said of non executive directors

Liability for breach of duty

Generally speaking, under English law, a director acts as the agent of the company and owes duties only to the company This concept is maintained in the Act The company has the right to bring an action against a director for loss caused by a breach of duty Shareholders or third parties only have a right of action against the company

Section 178 expressly preserves the civil nature of a breach of directors' general duties in sections 171 to 177 and preserves the remedies for such breaches which are

- damages or compensation where the company has suffered a loss
- restoration of the company's property
- an account of profits made or received by the director, and/or
- rescission of an affected contract which has been entered into in circumstances where there is a conflict of interest

Derivative actions

The Act has significantly expanded the grounds on which a derivative action may be brought against a director A derivative claim may now be brought by members of the company in respect of any cause of action that might arise from an act or proposed act or omission involving negligence, a default, a breach of trust or a breach of any of the duties referred to above

It is immaterial whether the cause of action arose before or after the person seeking to bring or continue the derivative claim became a member of the company

No change has been made to the central concept that the duty of the offending director is owed to the company The shareholder is, therefore, stepping into the shoes of the company (the derivative element) to enforce the particular right Importantly, any damages recovered are payable to the company and not the claimants

It has been much commented that the new statutory shareholder derivative claim, when taken in conjunction with the codification of directors' general duties, will result in an increase in liability of directors This is possible There is, however, a much more likely outcome, namely an increased risk of claims, at least until the courts' approach to such claims becomes clear (see below)

In the same way as the codification of directors' general duties can be expected to increase the accountability of directors, so the new shareholder derivative claim can be expected to be used by a range of shareholders in a wider set of circumstances than was the case under the old law

The clarity with which the new right of action is written will mean that many shareholders will be aware, for the first time, of a remedy of which they may previously have had no knowledge

The Government, in the passage of the Act through Parliament, was lobbied to reduce the circumstances in which the shareholder derivative claim might be used – some of the lobbying was directly related to the additional exposure of directors expected to follow from the introduction of the new claim

The result was a late but important change to the legislation which sought to balance the enforcement of the statutory right of the shareholder (the new derivative claim) against abuse of the procedure The key protection introduced was the requirement for a preliminary determination by the court on whether the claim should be allowed to proceed If certain conditions are satisfied, the court must dismiss the claim There are a number of circumstances that the court must consider in deciding whether to allow a claim to proceed For example, where the acts have been authorised or ratified by the company, permission must be refused In this respect the votes of a director or anyone connected with the director will be disregarded

It remains to be seen whether these checks and balances will mean that the claim will be used successfully in only limited circumstances This will depend in large part on the attitude taken by the courts to the interplay between the new statutory duties and existing caselaw (based on the old common law duties) and the threshold for permitting a derivative claim to proceed

Our view is that, at least in the early days of the new law, in a business environment where directors' duties are in the spotlight and there are shareholders (from pressure groups to hedge funds) with an activist agenda, claims will be threatened and some will come to court Even if such claims are not permitted to proceed, it can be expected that the fact of the claim having been brought and the arguments made at a preliminary hearing will attract their own publicity in the court of public debate, particularly in high profile public situations We may yet see litigation being used to promote a particular social or business agenda in the U K , particularly as statements of case filed with the Court are now public documents unless ordered otherwise

Class Actions

Overview

Class actions are a device which can significantly increase the number and size of claims against businesses and directors Although, historically, the class action system has only been well developed in the US, the position is beginning to change in Europe This has implications for directors who may find themselves included among the defendants, justifiably or not

The US class action

As you will know, US class actions are those where a group of individuals (or entities), who are in a similar position, make their claims in a single action, on behalf of a larger class of unidentified but definable individuals The entire class is bound by any judgment (unless they opt out) Any damages are awarded to the members of the class as a whole, rather than to individuals Each member of the class is entitled to a proportion of such damages

True US class actions differ fundamentally from other types of multi-party litigation outside the U S , in particular collective actions and representative actions

Collective actions

A collective action is a single claim filed for and brought on behalf of a group of identified or identifiable individuals Any damages awarded are made to the group as a whole i e individual awards are not made to individual members of the group

Representative actions

A representative action is a single claim brought by, for example, an association on behalf of a group of identified individuals (commonly its members) Any award resulting from the action is made to the individual members

Why are class actions so well developed in the US?

There are several features of US litigation which encourage the popularity of class actions These include

- widespread use of contingency fees,
- trial by jury in most civil trials,
- availability of punitive damages,
- ability to advertise for prospective claimants,
- extensive disclosure,
- the losing party does not usually pay the winners' costs

and Europe?

Absence or limited availability of these factors, means that class actions have been slow to develop outside the US Generally, true US class actions are not available in European jurisdictions To date, one or more of the following factors has deterred actions of this type a

prohibition on contingency fee agreements and advertising for prospective claimants, lack of general disclosure obligations, requirement for the loser to pay the winner's costs, lack of punitive damages, and absence of jury decisions

However, in March 2007, the Commissioner for Consumer Protection announced the European Union's (EU) Consumer Strategy She stated "I do not have in mind the US type of class action This is not a John Grisham story We have another, European, narrative and this is much more related to collective redress" With the EU considering implementing an EU wide system of collective redress, it seems the class action, even if not in US form, could be a step closer In England, the mechanism for class actions is the group litigation order However, these are currently difficult to obtain European countries where there has been most development are Italy, the Netherlands and Spain but they fall short of the US style class action It remains to be seen whether the EU will impose by directive a requirement to implement mechanisms for consumer class action rights If, as expected, it does, and even though they may not amount to a US class action, the exposure of businesses and directors to claims will increase

Foreign criminal proceedings

Recent extradition proceedings in the UK have highlighted the inherent risk to directors and other senior executives of exposure to foreign criminal proceedings and the costs of defending them The most notorious of these is "the NatWest Three" in connection with Enron's bankruptcy but there have been other examples, for example the Tollman family who recently successfully resisted extradition from the U K Although these cases have attracted considerable publicity, there is also the risk of arrest within the relevant jurisdiction, for example the recent U S cases of Carruthers and Dicks in relation to on-line gambling The costs of involvement in foreign criminal proceedings, and extradition cases, can be considerable Senior executives exposed to such proceedings will want to ensure that there is sufficient D&O insurance cover to deal with the financial consequences of foreign criminal proceedings

On one view, such costs will come within the definition of "Claim" and "Defence Costs" in the D&O policy It would be advisable, however, to ensure that these are expressly covered by the wording There are now available some standard extensions covering amongst other things

- defence costs incurred in extradition proceedings, including judicial review
- cost of a bail bond
- public relations expenses

The limits applicable to such an extension however are often only a small percentage of the overall limits of the policy

Regulatory exposure

The likelihood of regulatory proceedings against senior employees of financial services companies has increased in Europe over the last few years This is particularly so in London where the FSA has published a stream of enforcement notices against companies and individuals The AMF in France, BaFin in Germany and CONSOB in Italy have also been more active

The largest fines issued against individuals in London by the FSA are

1 Philippe Jabre was fined £750,000 in a Final Notice dated 1 August 2006 due to market abuse and breaches of APER Principle 2 (Due Care, Skill and Diligence) and Principle 3 (Market Conduct), which occurred during his work for GLG Partners LP

2. David John Maslen was fined £350,000 in a Final Notice dated 10 April 2006 because, during his employment as Head of European Cash Trading with Deutsche Bank he was knowingly concerned and actively involved in the contravention by Deutsche Bank of FSA Principle 5 (Market Conduct)

3 Robert Johan Henri Bonnier was fined £290,000 in a Final Notice dated 21 December 2005 due to market abuse Mr Bonnier, during the course of his employment as Managing Director/Managing Partner of Indigo Capital LLC, purposefully gave misleading statements in relation to dealings related to shares by either himself or Indigo Capital LLC

These fines cannot be covered by insurance but undoubtedly they would have been imposed only after extensive investigation and negotiations in the course of which significant legal costs will have been incurred

The FSA has been keen recently to stress the importance it attaches to senior management responsibility – that is to say that senior management must take responsibility for ensuring that there are appropriate and adequate systems and controls operating in the business Failure to do so, or any serious transgression of the rules, may become the subject of an investigation and possibly enforcement proceedings against the individual (as well as the company)

That said, more recently the FSA has been quieter on the enforcement front, indeed it seems to have been downsizing in favour of higher quality staff There has also been a shift in focus to more serious offences and more often than not these relate to market abuse This is happening at the same time as the FSA is moving to a more principles based approach to regulation and enforcement (rather than detailed rules) so that firms will have to work out for themselves what the particular Principles mean for their own businesses The Principles are general rules such as a firm must conduct its business with integrity, conduct its business with due skill, care and diligence, take reasonable care to organise and control its affairs responsibly and effectively with

adequate risk management systems etc One of the concerns which firms and individuals face in relation to this type of regulation is that it does not describe in detail the standards which the firm must meet There will undoubtedly be uncertainty in many cases as to whether a standard has been met particularly when later events and hindsight suggest that this may not have been the case. This will be of particular concern to directors and managers who have management and compliance responsibilities who may be the target of regulatory investigations and proceedings if things go wrong (as they do from time to time)

The costs and expenses which an individual can incur responding to an investigation, making submissions to the FSA and if necessary seeking a review of the FSA's decision in the Financial Services and Markets Tribunal can be considerable and would be well beyond the means of most individuals in the financial services sector without the benefit of D&O insurance or an indemnity by the employer

Directors' indemnities: the new rules

From 06 April 2005, companies have been able to provide wider indemnities to their directors under English law to protect them from liability in carrying out their duties They can, as explained below, also pay their directors' defence costs as they are incurred These new provisions, now contained in sections 232-238 Companies Act 2006, form part of the Government's response to its consultation on the overhaul of directors' and auditors' liability The provisions are intended to address directors' concerns about the increasing risk of incurring personal liability which could not formerly be indemnified by the company

New indemnities

Before 06 April 2005, a company could only indemnify its directors for the costs of defending legal proceedings if the directors were successful – i e only after the event (former s 310 Companies Act 1985) Any other indemnity for liability to the company was void The new provisions still contain a general prohibition on indemnities being given by a company However an indemnity can now be given in the following circumstances

- actions brought by third parties (including for example regulators) - subject to the exceptions below, these indemnities can cover both legal costs and the financial costs of any judgment (including an adverse judgment),

- actions brought by the company - subject to the exceptions below, these indemnities can cover defence costs as they are incurred but the director would have to repay those costs if his defence was unsuccessful No indemnity can be given in respect of any damages awarded to the company

In both cases, no indemnity can be given in respect of

- legal costs of unsuccessful criminal proceedings,
- fines imposed in criminal proceedings,
- penalties imposed by regulatory bodies, such as the FSA

Companies may indemnify officers other than directors (for example company secretaries) as they see fit

Any indemnities which are given have to be disclosed in the annual accounts and shareholders will be able to inspect any indemnification agreements

D&O insurance

Company indemnities are only as good as the solvency of the company giving them S 233 Companies Act 2006 provides that the general prohibition on indemnities (subject to the exceptions referred to above) does not prevent a company from purchasing insurance for a director of the company or an associated company against liability for negligence, default, breach of duty or breach of trust

Many of the coverage issues that arise for financial services companies under US D&O policies also arise under English policies These will be discussed in more detail in other papers From an English point of view, the following issues often need to be addressed when reviewing and negotiating D&O policies for financial services companies

1. Express warranties or words which have this effect – insurers can avoid cover for breach whether or not the breach is material or causative of the loss These should be negotiated out or their application restricted

2. Misrepresentation or non-disclosure of material facts which would influence the judgment of a prudent insurer as to whether to accept the risk and if so on what terms, and which did induce the actual underwriter to accept the risk on the agreed terms – insurers can avoid cover for breach The scope of the duty to disclose information and steps necessary to satisfy it in terms of internal investigation and knowledge of specific individuals should be made clear Ideally the cover (or at least the part of it that directly indemnifies the director rather than the company) should be made non-rescindable other than for fraud by the director concerned

3. Severability will a breach of policy terms or fraud by one director entitle insurers to avoid cover for all directors? Under English law the policy is composite so each director is separately insured as if there was a contract of insurance with each An express term to this effect is wise – no statement, knowledge or conduct of one insured can be imputed to another insured In other European countries, for example Germany or Spain the position is not so clear and therefore an express severability clause is essential

4. Advance of Defence Costs The funding of defence costs is required by directors as the costs are incurred Wording is required to achieve this even if insurers are reserving rights Essentially, pay now, argue later In reality, up-front agreement on this is difficult and may only be for a proportion or percentage of the costs

5. Allocation Where one or more directors, and the company are jointly incurring defence costs, how much of these should be allocated to the D&O policy? This often develops later into an argument about who was the real defendant to the litigation or regulatory investigation/enforcement proceedings – the company or individual directors? Similarly how should costs be allocated where some claims are covered by the policy and others not? These are difficult issues to provide for in advance in policy wordings save in the former case where the company is an insured in its own right (for example for the purposes of securities claims)

6. Exclusions and proof Policies often exclude indemnity for certain types of conduct, for example fraud or secret profits Wording is required to ensure that insurers continue to pay defence costs until there is a *"final adjudication"* on the issue The insurer should not be able to rely on its own view of the matter to defer funding or avoid liability

7. Acquisitions Will newly acquired subsidiaries be covered? Which countries are excluded? Is there an asset value above which specific agreement of insurers will have to be obtained?

8. Retired or outside directors Does the policy cover past and present directors for at least six years after retirement, and non-executive directors?

9. Insured v insured exclusion This exclusion should not apply to shareholder derivative actions (see above) or to claims which are brought by or on behalf of the company (for example by the liquidator)

10. Protected limits It may be necessary to ensure that there are separate limits available for directors which are not diminished or exhausted by the company or for particular directors such as non-executive directors

11 Policy limits The Equitable Life case in the UK has illustrated how important it is that a realistic level of cover is obtained

12 Side B cover (reimbursement of the company when the company has indemnified the director) As the scope of the company's indemnification of its directors can now be significantly broader (see above) so larger claims are expected under Side B covers Limits of Side B covers should therefore be increased accordingly

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Your Company's D&O Policy

Will the Insured v. Insured Exclusion Surprise You?

By John C. Tanner, Rebecca M. Lamberth, and Scott N. Sherman

Surprises. Your CEO hates them. Your board members won't tolerate them. In the corporate world, a surprise means something was missed – and that's never good.

This is particularly true when the surprise has a price tag with lots of zeros after it. So a surprise that involves a problem with your company's Director & Officer (D&O) policy is precisely the type of surprise you want to avoid.

Consider each of the following scenarios and identify what they have in common:

- Litigation filed in the wake of Merger & Acquisition (M&A) transaction against your company or its directors and officers (Ds & Os) by one of the parties to the transaction or by a current or former D or O of one of the transaction parties.
- Shareholder or derivative litigation against your company or its Ds & Os filed by or with the active participation of one or more current or former Ds or Os of your company or an affiliated entity.
- Litigation filed against your company or its Ds & Os by a whistleblower or with a whistleblower's active participation.
- Litigation filed against your company or its Ds & Os in the wake of the company's bankruptcy or receivership.

Give up? In each, the D&O insurance coverage you — and your company's Ds and Os — thought you had might disappear. Why? Well, if the plaintiff qualifies as an "insured" under that policy (or if someone who fits that definition is working closely with plaintiff's counsel), an exclusion typically contained in most D&O policies may negate the very coverage you, your company, and its Ds and Os relied upon to exist. That exclusion is the "insured versus insured" exclusion.

The Insured v. Insured Exclusion

Today, most D&O policies exclude coverage for claims filed by one insured against another insured under a so-called "insured v. insured" exclusion (I v. I). D&O insurers originally added the I v. I exclusion to their policies to prevent collusive or "friendly" lawsuits, where one insured would agree to have another insured assert a claim against him or her, with both looking to the insurer to fund the "loss." A corporation, for example, might decide to sue its Ds and Os under a pretext of alleged wrongdoing solely to recoup a business loss via insurance proceeds.

Unfortunately, most insurers now include broad I v. I wording that, when applied literally, extends the exclusion's reach far beyond its original purpose. A typical I v. I exclusion precludes coverage for claims filed "by or on behalf of the Company or any Director or Officer." While the precise language will vary both among different insurance carriers and from one policy to another based on a particular insured's success in negotiating the language, the import is the same.

At the same time, in what has generally been considered advantageous to insureds, D&O policies have been broadened over the years to expand the definition of "insured" to include more individuals and entities — including past, present, and future Ds and Os of both the parent company and its subsidiaries, as well as in some cases employees and even in-house counsel. With this expanded definition, however, the potential for unintended consequences (i.e., coverage surprises) regarding the I v. I exclusion has also increased. Such a result is almost certain to be viewed as a bad thing.

Indeed, numerous recent cases demonstrate that the language of fairly typical I v. I exclusions may remove coverage for claims that are brought by, on behalf of, or even with the assistance of anyone who qualifies as an insured, *regardless* of whether the claim or assistance is for an improper or collusive purpose. As a result, it is critical that your company's risk management professionals consider carefully the I v. I language in the company's D&O policy, and do so with an understanding of the types of circumstances under which the carrier may deny coverage.

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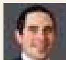

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Will You Have D&O Coverage During a Post-acquisition Divorce?

You are the GC of a company that is about to be acquired by a large competitor. In the midst of due diligence being conducted by both companies during the transaction, you are asked to confirm that after the transaction closes, all past and present Ds and Os of both transaction parties will still be covered by D&O insurance in any future litigation.

You confirm the existence of a current D&O policy for each corporate party in the transaction and confirm that the policy premiums have been paid. At that point, you wonder whether either you or your Director of Risk Management need to do more. The answer is "yes" quite a bit more. You need to incorporate the potential claims scenarios that could arise from the proposed transaction — and the potential insurance implications of such claims — into your M&A due diligence process. Otherwise you may find yourself reading through the insurance contracts only after the lawsuits have been filed — at which point you could find the needed coverage lacking! The I v. I exclusion typically present in most D&O policies offers many traps for the unwary.

When D & Os Sue or Get Sued

Although postacquisition litigation among transaction principals is never part of the rosy future toasted at a transaction closing dinner, it can, unfortunately, become a reality. Imagine what might happen if one party decides that the other party misrepresented its finances to induce the transaction and sues. The former Ds and Os of the purportedly fraudulent party — or the corporate transaction partner itself, if it has continued to exist posttransaction — may then find that the I v. I exclusion has been triggered and they must fund defense of the litigation on their own.

You can find one example of this kind of litigation in the *Stratton* case.[1] There, the court held that the former directors and officers of the acquired target company weren't covered by D&O insurance when the acquiring company sued them some years after the transaction. The reason? The acquiring company, after holding the target for some years as a subsidiary, had assumed all of the target's assets and liabilities following a Chapter 11 proceeding. Thus under the plain language of the policy, the acquiring company was an "insured," and the I v. I exclusion denied coverage to the directors and officers.

When an M&A transaction goes sour, a similar coverage issue can also arise if a plaintiff in the posttransaction litigation is a former officer or director. In that case, the plaintiff "insured" may likewise trigger the I v. I exclusion. (See "*Stratton*: I v. I in M&A," sidebar on p. 52.)

Lessons Learned

Directors and officers of a target company can face significant exposure to claims filed by or on behalf of the acquiring company and/or its directors, officers, and shareholders. As a result, companies facing acquisition should consider a prepaid, noncancelable runoff policy that cannot be modified by the acquiring company or its postacquisition management. The runoff policy should either state clearly that the acquiring or successor company is not an "insured" under the runoff policy, or expressly provide that claims brought by or on behalf of such entities are excepted from any I v. I exclusion. (See "Insurance Jargon," sidebar on this page.)

Where individual Ds and Os of the target company will be joining the board or management of the acquiring company or one of its subsidiaries, additional I v. I issues can arise. Some traditional D&O policies exclude only claims brought by or on behalf of the company, such that involvement by individual "insureds" will not invoke the exclusion. However, most D&O policies do exclude claims filed by or with the assistance of individual insureds, such that claims instituted by new Ds and Os joining the acquiring company postacquisition may be excluded from coverage in the absence of an express agreement to the contrary.

First You See Coverage, Then You Don't

You are the GC of a public company that has just disclosed having missed its projected earnings in one or more recent quarters or other bad news, and the company's stock price promptly drops. Predictably, the announcement is followed by the filing of class action litigation and derivative litigation on behalf of the company's shareholders. Upon receiving news of the lawsuit, you promptly notify the company's D&O carriers and seek confirmation of defense and indemnity coverage. The response is as expected: defense of the litigation proceeds with coverage in place.

At some point during the litigation, a new plaintiff is added. Unfortunately, this new plaintiff is a former director of the company who plaintiffs' counsel believes will be able to provide significantly helpful inside information. That should be the end of the bad news; after all, the I v. I exclusion is intended to prohibit coverage for claims brought in collusion with the insured company. You certainly aren't colluding with any of these plaintiffs! But the unpleasant reality is that the plain language of the I v. I exclusion — rather than the absence of any collusion in the litigation — may govern. So in our scenario, when you tell your D&O carriers that the former director has joined the litigation, they respond that your policies will no longer cover the lawsuit because the I v. I exclusion has just been triggered.

By way of example, one such case concerned Sphinx International, Inc.[2] In this securities class action litigation, the original plaintiff was a former Sphinx officer who had been fired several years earlier, based on certain misrepresentations he had made to the company. Although other shareholders subsequently joined the litigation as additional plaintiffs, the damage had been done for purposes of the policy's I v. I exclusion. The policy barred coverage for claims filed by any current or former director/officer, and that was enough for the court. Despite the fact that this plaintiff's claim was truly adversarial — there was no allegation of any collusion between Sphinx and this plaintiff (the former director) — the court ruled that given the clear and unambiguous language of the subject I v. I exclusion, the original plaintiff's lawsuit was not covered. Furthermore, although none of the other plaintiffs were "insureds," the court ruled that because the policy explicitly excluded claims with participation by insureds, the

Insurance Jargon

Side A–only Excess DIC policy. A "Side A" policy typically refers to an excess policy that provides coverage only for individual insureds, and only to the extent that the company cannot legally or financially fund its indemnity obligation. Many public companies today now purchase some form of Side A–only insurance devoted to individual insureds, on top of a tower of traditional coverage that is shared among individual and entity insureds. While traditional coverage also includes a Side A insuring agreement, some Side A excess policies, called Side A DIC ("difference-in-conditions") policies, contain broader coverage terms and conditions that can afford greater protection to individual directors and officers — filling in coverage gaps in the traditional coverage — in addition to providing individual insureds with dedicated limits.

Runoff Policy. A "runoff policy" provides coverage for claims made against insureds during the runoff policy period, but solely for actual or alleged wrongful acts that took place prior to the beginning of the runoff policy period. A target company, for example, might purchase a "runoff policy" to provide coverage for its directors and officers for claims brought postacquisition for preacquisition wrongdoing.

D&O policy excluded coverage for the entire litigation.

Some courts will take a more moderate approach.[3] Even if your policy contains language in the I v. I exclusion that applies to "solicitation, assistance, participation or intervention" by directors or officers, that policy may provide coverage even if an insured director or officer is participating in the lawsuit against your company.

- In one California case, an insurance carrier claimed the I v. I exclusion had been triggered because company officers had allegedly acted as "confidential informants" to the plaintiffs in a securities class action.[4] The insurer contended that this equated to "assistance" under the policy. The court disagreed, however, holding that such an interpretation would violate California public policy by encouraging companies to prevent officers and directors from providing information to plaintiff shareholders. Accordingly, unless the Ds and Os were to obtain some "economic benefit" for their participation, the court held the I v. I exclusion would not apply.
- In another securities fraud lawsuit, a court ruled that coverage was not excluded under the I v. I exclusion — albeit as governed by the policy's allocation provisions — where the insured joined the suit in a passive capacity six months after it was filed, and the relevant D&O policy did not address participation by an insured.[5]

Stratton: I v. I in M&A

One example of the issues the I v. I exclusion can pose can be seen in the history of one company's fairly typical M&A activity. In 1996, MHG acquired a privately owned company; the sellers received MHG stock in that transaction.[*] MHG then became an acquisition target two years later. Contemporaneously with its own acquisition, MHG placed its D&O coverage into runoff, providing coverage for claims made following the acquisition based on preacquisition wrongdoing. The acquirer (MPAN) separately purchased ongoing coverage for claims made in the future. Postacquisition, MHG continued its corporate existence as a wholly owned subsidiary of MPAN.

In January 2000, MPAN and MHG commenced Chapter 11 reorganization proceedings. Following the bankruptcy, MPAN assumed MHG's assets and its remaining liabilities and changed its name to MHC (as "successor-in-interest" to MPAN and MHG).

MHC sued four former MHG directors and officers, alleging that they had made misleading statements in order to induce MPAN to acquire MHG. In a separate suit, the sellers of the privately held company acquired by MHG in 1996 (some of whom had subsequently served as MHG directors) also sued the same former MHG Ds and Os, alleging that they had mismanaged MHG following the 1996 deal, thereby driving the company into bankruptcy and diminishing the value of their MHG stock ("the Kellett claims"). Insurers for the sued former MHG Ds and Os invoked the I v. I exclusion and denied coverage for both claims.

MHG's primary D&O runoff policy included as "insureds" all "past, present or future duly elected or appointed directors or officers of the Company . . .[as well as the Company itself and any] successor company." Because MHC was a successor of MHG — and thus "the Company" — under the plain meaning of the policy definition of "insured," the district court denied coverage for claims asserted in the MHC lawsuit under the I v. I exclusion as claims filed by or on behalf of another policy "insured."

As to the Kellett claims filed contemporaneously, two of the plaintiffs were also "insureds" because they had served as MHG directors for several years — thereby triggering the I v. I exclusion for that suit as well. However, the four D&O defendants sought allocation of coverage, arguing that the I v. I exclusion in the policy should not reach the portion of the claims asserted by several uninsured Kellett entities. The district court rejected this argument, again relying on the plain language in the subject D&O policy I v. I exclusion, which stated as follows:

> *[t]he Insurer shall not be liable . . . for Loss in connection with a Claim made against an Insured . . . which is brought by any Insured or by the Company, . . . or which is brought by any security holder of the Company . . . , whether directly or derivatively, unless such security holder's Claim(s) is instigated and continued totally independent of, and totally without the solicitation of, or assistance of, or active participation of, or intervention of, any Insured or the Company . . . ."*[†]

Because the Kellet plaintiffs (as security holders of MHC) asserted claims with the assistance and active participation of certain former MHG director and officer "insureds," the court held that the I v. I exclusion applied to exclude all coverage under the D&O policy.

Notes

[*] *Stratton v. Nat'l Union Fire Ins. Co.*, No. Civ.A.03-CV-12018-RGS, 2004 WL 1950337 (D. Mass Sept. 3, 2004).

[†] *Id.* at *6.

Lessons Learned

Many D&O policies exclude coverage for shareholder lawsuits brought by current or former Ds and Os. Some policies go even further, to expressly exclude claims filed by noninsured shareholders where those shareholders are assisted in some way by other "insureds." At a minimum, make certain that your Ds & Os are covered for such claims where the company does not provide indemnification.

How Whistleblowers Affect Your D&O Coverage

The current regulatory environment (Sarbox, for example) encourages whistleblower assistance in ferreting out securities fraud and other violations of state or federal law. The SEC, the Department of Justice, and many states' attorneys general are actively demanding that companies under investigation cooperate with their investigators. Companies in turn are demanding that their employees likewise assist with the investigations — at times even requiring cooperation as a condition to corporate indemnification. The intent is clear: to project a public policy that protects and encourages individuals to both report violations of the securities laws and assist with investigations and legal proceedings.

Emboldened by the increasingly aggressive stance exhibited by state and federal enforcement personnel, some members of the plaintiffs' bar have likewise begun to use more aggressive tactics that go beyond merely seeking out disgruntled former employees. In one such example, class action plaintiffs' lawyers sought judicial limits on the enforceability of confidentiality agreements obtained upon the severance of corporate employees.[6]

The potential ramifications of such aggressive plaintiffs' tactics could extend significantly beyond concerns that a disgruntled former officer or employee will vent his or her ill will in a public forum. One such unintended cost is the risk of triggering the company's I v. I exclusion.

Consider the following scenario: You are the Deputy GC within the small legal department of a midsized manufacturing company. Your responsibilities include litigation oversight and risk management for the company, including retention and analysis of all corporate insurance coverage. You have just learned that your company has been sued in federal and state court, and the allegations laid out in the several (remarkably similar) complaints mirror the allegations made several months ago by the company's former controller. Although you resolved these allegations after a careful internal investigation, you had a hunch even then that you hadn't heard the last from him — and now it looks like you were right. When you share the remarkable similarities between the two sets of allegations with your insurer, you receive yet another surprise — a denial of coverage under the I v. I exclusion in your company's D&O policy.

As in the M&A and shareholder litigation contexts, this potential hole in your D&O insurance coverage may arise if this former whistleblower, who is almost surely assisting plaintiffs' counsel in their class action and/or derivative litigation, qualifies as an "insured" under the policy. If he does qualify as an insured, then:

- under policy wording that includes an embedded shareholder exclusion in the I v. I preamble, his assistance may result in a forfeiture of coverage for the class action or derivative claim.
- under policies that do not include an embedded shareholder exclusion, the shareholder class action claim should not lose coverage, as the mere assistance to the plaintiffs should not be interpreted as a claim brought "on behalf of" an insured. However, the issue is still clearly framed in the derivative claim exception to the exclusion.

Unfortunately, D&O coverage may be lost regardless of whether the whistleblower's allegations are ultimately determined to be without merit (as is often the case).

Lessons Learned

Even in cases where your I v. I exclusion would prevent coverage where a whistleblower insured directly sues your company or its directors and officers, you should still strive for a policy that does not exclude claims brought by *other* shareholders, directly or derivatively, simply because the whistleblower "insured" is willing to aid their lawsuit. Although your ability to succeed may vary, depending on your company's claims history and current circumstances and the carrier with whom you are dealing, you should consider at least two goals in attempting to negotiate D&O policy language that contains a whistleblower assistance carve-back:

- The mere filing of a whistleblower action, or assertion of whistleblower protection, should not be considered "assistance or active participation" within the meaning of the I v. I exclusion, merely because the shareholder or derivative plaintiffs are benefited by discovery or other information in the public record in the whistleblower action.
- The wording in your policy needs to clarify that any "solicitation, assistance or participation" of an individual insured, after asserting protection under the whistleblower provisions of SOX 806 (or similar

whistleblower provision), will not be deemed "solicitation, assistance or participation" for purposes of the I v. I exclusion.

Bankruptcy and Your D&O Policy

No one joins a company expecting corporate failure and bankruptcy. But it is only prudent to understand how a bankruptcy could affect your corporate D&O coverage. In particular, you need to understand how the identity of the persons or entities that may assert bankruptcy-related claims can affect the I v. I exclusion — and your ability to survive any resulting litigation. Thus, consider the following scenario:

You are senior corporate counsel at a company in the process of a Chapter 11 reorganization. During the proceedings, you were a member of the workout team, where you helped prepare the reorganization plan ultimately approved by the bankruptcy court. The plan created a litigation trust to which the debtor transferred all claims and rights of recovery held by the debtor, including any claims against the company's former Ds and Os for prepetition wrongdoing.

A week ago, the trustee commenced an adversary proceeding against the company's former president and CEO, as well as its CFO, alleging that these officers breached various fiduciary obligations resulting in the company's bankruptcy.

Your GC instructs you to notify the company's carriers of the litigation. "Oh, by the way," she says, "when your workout team agreed to the creation of the litigation trust, you confirmed that this sort of claim would be covered, right?"

You quickly review the policy and are relieved (to put it mildly) to see an exception to the policy's I v. I exclusion for claims brought in any bankruptcy proceeding by a trustee of the company. A couple of months later, however, a denial of coverage letter arrives, citing the I v. I exclusion. What gives?!

Application of the I v. I exclusion in the bankruptcy context has been widely litigated with the surge in bankruptcy-spawned D&O litigation in recent years. Historically, the primary coverage issue concerned whether claims asserted by a bankruptcy trustee, creditors committee, or other litigation entity were brought "on behalf of" the corporate insureds within the meaning of an I v. I exclusion. Over time, a split of authority developed as

to whether the I v. I exclusion barred such claims.[7] As a consequence, insureds began to push for bankruptcy carve-outs or exceptions to the litigated I v. I exclusion language, and most D&O insurers today provide an exception to the exclusion for certain claims brought in bankruptcy. A critical issue now, as you might therefore expect, is whether your policy contains any exceptions to the bankruptcy exception.

Claims Filed by a Debtor-in-possession

Unfortunately, even if your policy's I v. I exclusion has a bankruptcy exception, claims filed by a debtor in possession (or its assignee) may still be excluded from coverage. In one recent case, a court held that an I v. I exclusion precluded coverage for an assigned claim against the company's former CEO and CFO filed by a litigation trustee.[8]

The I v. I provision in the company's policy excluded claims "brought or maintained by or on behalf of any Insured," as well as derivative claims brought with the "solicitation, assistance or participation" of the debtor insured. The court determined that when the bankrupt company transferred the claims to the litigation trust pursuant to the Chapter 11 reorganization plan, it was "a voluntary assignment of claims by contract." Critical to this determination was the court's view that the assignment was "a voluntary affirmative act of the Debtor," rather than being the result of an "involuntary appointment of the chapter 11 trustee." The court reasoned that a claim brought by a debtor-in-possession, or its assignee, was fundamentally indistinguishable from a claim asserted by a prepetition debtor insured. The fact that the claims asserted by the litigation trustee could be construed as derivative claims belonging to the corporation did not alter the result. In the court's view, the company's drafting a plan providing for the creation of a litigation trust and appointment of the trustee constituted "solicitation" and "assistance" within the meaning of the I v. I exclusion.

In fact, in recent years, many D&O insurers have expressly included debtors-in-possession in their policy definition of corporate insureds. Where the D&O policy defines "insured" to include debtors-in-possession and exceptions to the I v I exclusion do not expressly identify claims filed by a debtor in possession, insurers may take the position that their I v. I language excludes such claims. (See "*Cirka*," sidebar on this page.)

Lessons Learned

- Review bankruptcy-related provisions in your D&O policy *before* your company files for bankruptcy. The D&O insurance may be the sole source of asset protection for individual Ds and Os.
- Negotiate bankruptcy-related coverage enhancements well in advance of a bankruptcy filing. Insurers are obviously less likely to provide coverage enhancements to a perceived bankruptcy risk. Most D&O insurers today will include an exception to the I v. I exclusion for certain claims brought in bankruptcy, but many of them still preclude claims brought by a debtor-in-possession. If your traditional D&O insurer refuses to except such claims from the I v. I exclu-

Cirka: A Problem in Bankruptcy

In *Cirka v. National Union Fire Ins. Co.*, No. Civ. A. 20250, 2004 WL 1813283 (Del. Ch. Aug. 6, 2004), the insurer argued that a claim brought by a creditors' committee was "on behalf of" the insured debtor-in-possession and therefore within the I v. I exclusion. There, a creditors' committee demanded that the debtor-in-possession permit them to prosecute an action against certain former directors of the debtor. When the debtor-in-possession refused to grant permission, the committee obtained permission from the bankruptcy court to commence the litigation on behalf of the estate. The directors sought coverage under the debtor's D&O policy, but the insurer denied coverage under the I v. I exclusion.

The D&O policy expressly excluded claims brought "by or on behalf of any insured or the Company," and expressly defined "Company" to include a debtor-in-possession. The insurer therefore argued that the claim by the creditors' committee was "on behalf of" the insured debtor-in-possession and therefore excluded from coverage.

The policy contained a bankruptcy trustee exception clarifying that the I v. I exclusion did not apply "in any bankruptcy proceeding by or against the Named Corporation or any Subsidiary thereof, any Claim brought by the Examiner or Trustee of the Company, if any, or any assignee of such Examiner or Trustee." The court interpreted that exception to exclude coverage for any action filed by a person or entity other than an Examiner or Trustee. Fortunately for the former directors named in the lawsuit, however, the court determined that the committee's claims were brought on behalf of the estate and not on behalf of the debtor-in-possession. (For cases on related topics, *see Rigby v. Underwriters at Lloyd's, London*, 907 So. 2d 1187 (Third Dist. Ct. Fl. 2005), and *In re Ha 2003 Inc.*, 310 B.R. 710 (Bank. N.D. Ill. 2004).)

sion, you may be able to purchase a Side A DIC ("difference-in-conditions") policy without the exclusion altogether.

The Best Surprise Is No Surprise

A careful and well-informed review of your company's D&O policy may help to avoid an I v. I exclusion "surprise." The need is heightened if your company is or might be headed into an M&A transaction or financial challenges. Likewise, if your company is in a highly regulated industry or is otherwise at foreseeable risk of whistleblower activity, a careful review of your policy now — rather than later — would be wise. None of us have a crystal ball, but some thoughtful questions to your insurance professionals may serve both you and your company well.

Have a comment on this article? Email editorinchief@acca.com.

Notes

1. *Stratton v. Nat'l Union Fire Ins. Co.*, No. Civ.A.03-CV-12018-RGS, 2004 WL 1950337 (D. Mass Sept. 3, 2004).
2. *Sphinx Int'l, Inc. v. Nat'l Union Fire Ins. Co.*, 412 F.3d 1226 (11th Cir. 2005).
3. *See Level 3 Commc'ns, Inc. v. Federal Ins. Co.*, 168 F.3d 956 (7th Cir. 1999) (I v. I exclusion inapplicable to claims by uninsured plaintiffs even when insured joined the lawsuit, based on plain reading of the D&O policy); *Bernstein v. Genesis Ins. Co.*, 90 F. Supp. 2d 932 (N.D. Ill. 2000) (plain meaning of D&O policy did not include past security holders as insureds under the policy; claims by plaintiffs — all past securities holders — were covered under the policy).
4. *Harris v. Genesis Ins. Co.*, 297 F. Supp. 2d 1220 (N.D. Cal. 2003).
5. *Level 3 Commc'ns*, 168 F.3d 956; *but see Level 3 Commc'ns, Inc. v. Federal Ins. Co*, 272 F.3d 908 (7th Cir. 2001) (settlement of the underlying securities fraud lawsuit was not a "loss" within the meaning of the D&O policy and therefore not covered under the policy).
6. *See, e.g., In re JDS Uniphase Corp. Sec. Litig.*, 238 F. Supp. 2d 1127 (N.D. Cal. 2002); *see also In re Tyco Int'l Sec. Litig.*, No. 00-MD-1335-B, 2001 WL 34075721 (D.N.H. 2001).
7. I v. I exclusion did not apply: *In re County Seat Stores, Inc.*, 280 B.R. 319 (Bankr. S.D.N.Y. 2002) (Chapter 11 trustee); *see also Nat'l Union Fire Ins. Co. v. Jewel Recovery, L.P. (In re Zale Corp.)*, No. 392-3001- SAF-11, Adversary Proceeding No. 393-3309 (Bankr. N.D. Tex. Apr. 11, 1995). I v. I exclusion did apply: *Reliance Ins. Co. v. Weis*, 148 B.R. 575 (E.D. Mo. 1992), aff'd in part, 5 F.3d 532 (8th Cir. 1993) ("Plan Committee," composed of unsecured creditors); *Hydra-Co Enters., Inc. v. Federal Ins. Co.*, 89-CV-468, 1990 WL 191803 (N.D.N.Y. Oct. 26, 1990) .
8. *Terry v. Federal Ins. Co. (In re R.J. Reynolds-Patrick County Mem'l Hosp.,)*, 315 B.R. 674 (Bankr. W.D. Va. 2003).

ACC and Other Extras on . . . Insurance

***Docket* Articles:**

- John C. Tanner & David E. Howard, "Blowing Whistles & Climbing Ladders: The Hidden Insurance Issues Behind Sarbanes-Oxley & Recent Corporate Governance Reform," *ACC Docket* 23, no. 4 (April 2005): 32–51. *www.acca.com/protected/pubs/docket/apr05/ladder.pdf.*

InfoPAKs:

- **A Policyholder's Primer on Insurance** (Sept. 2005). *www.acca.com/protected/infopaks/insurance/infopak.pdf.*

Annual Meeting Course Materials:

Program material is available from the following courses at ACC's 2005 Annual Meeting.

- 402: Ronald E. Baldwin, A. Peter Prinsen, Susan T. Travis, "Insurance Basics for the In-house Generalist." *www.acca.com/am/05/cm/402.pdf.*
- 604: Mollie Lambert, Richard S. Mannella, Steve Shappell, "Thirty Developments in Insurance Coverage." *www.acca.com/am/05/cm/604.pdf.*

Leading Practice Profiles:

- "Indemnification and Insurance Coverage for In-house Lawyers" (2004). *www.acca.com/resource/v6300.*

Non-ACC Resources:

- Barry R. Ostrager and Thomas R. Newman, *Handbook on Insurance Coverage Disputes.* (Aspen Publishers 2004).
- Websites on D & O liability and insurance:
  - *www.baileycavalieri.com*
  - *www.thecorporatecounsel.net*
- Websites on general insurance issues:
  - www.inslawgroup.com
  - www.insurancescrawl.com

Plan to attend ACC's 2006 Annual Meeting, October 23-25 in San Diego, and get the facts firsthand. Session 704: Indemnifying Your Officers, Directors, & Employees will cover these topics and more. For information on the panel or to register for the meeting, visit *www.acca.com/am/06.*

10 Issues to Consider WHEN NEGOTIATING Your Company's D&O Coverage

By John C. Tanner and Anthony P. Tatum

Today, directors and officers (Ds and Os) are very interested in the terms and conditions of their company's D&O liability insurance, and for good reason. In a relatively short span of five years, they saw the fall of Enron and WorldCom; comprehensive reform and legislation in the form of the Sarbanes-Oxley Act; heightened enforcement activity by the SEC and Department of Justice; the indictment and collapse of Arthur Andersen; intense scrutiny of executive compensation; and now, numerous lawsuits and investigations arising out of stock option backdating. Several high profile CEOs and CFOs have gone to jail, and in-house counsel have also been implicated.

In this environment, Ds and Os are frequently demanding outside legal review of their D&O coverage and are putting more pressure on in-house counsel and corporate risk managers to ensure the broadest possible coverage. The good news is that the number of shareholder class action filings is currently trending downward on an annualized basis and, as a result, the D&O insurance market is more competitive today than in years past. The following list is not exhaustive, but should assist you in reviewing and negotiating insurance protection for your company and its Ds and Os.

1. Understand the ABC's of the Insuring Clauses

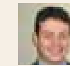
The first step in negotiating D&O coverage should be to understand how your company's indemnification obligations work in conjunction with the insuring clauses of your coverage. First, set your D&O policy aside and research the law of indemnification and advancement in the state where your company is incorporated. You will likely find that certain claims and expenses are not legally indemnifiable, and that with respect to other claims—though legally indemnifiable—your company may refuse indemnification. For example, under the law of many states, settlements and judgments in derivative cases may not be legally indemnifiable. Moreover, indemnification and advancement may be merely permitted under the applicable state law, giving your company the discretion under the specified circumstances to fund indemnification, but not requiring that it do so.

Next, dust off your corporate bylaws and indemnification agreements, and obtain a basic understanding of the scope and limits of your company's formal grant of advancement and indemnification to its Ds and Os. Most companies include within the bylaws, a specific grant of indemnification to the fullest extent authorized by law and an express agreement to advance defense costs until such time as there is a final adjudication that indemnification is improper. Nevertheless, even where costs are legally indemnifiable and the given bylaws mandate indemnification, a company could still withhold indemnification and advancement of legal fees where it lacks adequate funds, is otherwise bankrupt and formally prohibited from funding indemnification, or where the decision makers—at the time—incorrectly determine that indemnification should be withheld on the basis that the individual D or O did not satisfy the requisite legal standard of conduct for permissible indemnification.

After you have reviewed your company's indemnification and advancement obligations, review the insuring clauses in your D&O policy. Insurance professionals speak a unique language of "Side A, B, or C insurance." The ABCs are coined from the three standard insuring clauses in a typical D&O policy:

- **Side A coverage,** styled as Insuring Clause 1 in some policies, refers to coverage that protects the assets of individual Ds and Os for claims where the company is not legally or financially able to fund indemnification.
- **Side B coverage,** styled as Insuring Clause 2 in some policies, reimburses the company to the extent it grants indemnification and advances legal fees on behalf of its Ds and Os.
- **Side C coverage,** or Clause 3 coverage, provides separate entity coverage for "securities claims."

All three coverage parts are generally subject to a single shared limit of liability. The limits of Sides B and C coverage are typically in excess of a large retention (ranging anywhere from $500,000 to as much as $10 million or more) that must first be funded by the company.



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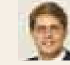

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Carefully review any "presumptive indemnification" and other provisions in your policy concerning how the retention will be applied to a given claim. For legally indemnifiable claims, many policies state that the company's bylaws and resolutions are presumed to indemnify insureds to the full extent permitted by law. This means that the Side B retention may apply regardless of whether the company actually grants indemnification to an individual insured. If your company is legally permitted to indemnify an individual D or O but chooses not to do so, the individual defendant may be forced to fund his or her own defense up to the Side B retention amount before the insurer will step in and fund the defense costs.

2. Personal Conduct/Fraud/Profit Exclusion

Next, review the policy exclusions governing fraud, dishonesty, and illegal profit or advantage. These so-called conduct exclusions are implicated in nearly every D&O claim. A typical class action claim of securities fraud, for example, alleges that individual Ds and Os knew, or should have known, of misrepresentations in financial documents or other public filings. Recent claims involving backdating of stock options allege that certain individuals received the benefit of in-the-money option grants to which they were not legally entitled. In responding to notice of such claims, D&O insurers invariably send the insureds a formal coverage position, reserving the right to deny coverage on the basis of the conduct exclusions. The extent to which the reservation to deny coverage is a mere formality or ultimate reality depends upon the specific wording in your policy.

All conduct exclusions contain a "trigger" by which the insurer may invoke the exclusion. Some policies, for example, require a judgment or "final adjudication" adverse to the insured in the underlying action before the exclusion is triggered. With such wording, insurers should not be able to deny coverage in the absence of a final adjudication of fraud or illegal profit in the underlying lawsuit. This should also at least afford the insured coverage for defense costs, assuming other exclusions do not bar coverage.

Other policies require only that the requisite conduct occurred "in fact." Under such policies, the insurer may be able to rely on evidence of misconduct to deny coverage outright or otherwise leverage a greater insured contribution to settlement. Certain newer policy forms further trigger the exclusion where the conduct occurs "in fact," as evidenced by an insured's written statements, documents, or admissions. Under some variations of this wording, insurers may point to testimony or admissions of *any* insured to deny coverage as to other insureds. The key issue here is whether the fraud or illegal profit attributable to one individual D or O can be imputed by the insurer to other individual Ds and Os or to the company. Fortunately, most policies contain a provision that states that the bad conduct of one individual insured will not be imputed to other individual insureds. Nevertheless, in many policies, excluded conduct of certain senior corporate executives may be imputed to the company for purposes of the Side B or Side C coverage. As a result, where the insurer can invoke the exclusion as to such individuals, it may deny coverage entirely or, for purposes of settlement, allocate and exclude a large portion of otherwise covered loss.

When negotiating the "trigger" to conduct exclusions in your D&O policy, give careful consideration to your company's advancement and indemnification obligations to its Ds and Os as outlined in articles of incorporation, by-laws, and/or written indemnification agreements. As noted in section 1, many corporate bylaws mandate

Ask yourself **how many** individuals qualifying as **"insureds"** in your D&O policy may themselves **be future plaintiffs or** otherwise assist plaintiffs with **future claims.**

advancement of legal fees to allegedly culpable Ds and Os until the wrongdoing is finally adjudicated. Unless the conduct exclusions similarly require a final adjudication of wrongdoing, the D&O insurer may be permitted under the policy to stop payment for, or on behalf of, allegedly bad actors short of a final adjudication, notwithstanding the fact that your company must continue advancing legal fees as a matter of corporate law.

3. Insured vs. Insured (I v. I) Exclusion

The I v. I was originally intended to exclude collusive or "friendly" lawsuits whereby insureds improperly attempted to shift business losses to their insurers. A financially troubled company, for example, might sue its Ds or Os to recoup business losses via an insurance settlement under the guise of a D&O claim for mismanagement or corporate waste. Insurers understandably do not want to insure collusive claims, or disguised business losses, under a liability policy. Unfortunately however, the I v. I in many policies today extends beyond circumstances of collusion, to exclude any claims that are brought by, on behalf of, or even with the assistance of anyone qualifying as an insured, regardless of whether the claim or assistance is for an improper or collusive purpose.

Many policies today have expanded the definition of those included within the definition of "insured." In so doing, the number of claim scenarios implicating the I v. I has also increased.

Your policy likely includes past, present, and future Ds and Os of both the parent company and its subsidiaries as covered "insureds," and may also include all current and former employees and in-house counsel for "securities claims." Ask yourself how many individuals qualifying as "insureds" in your D&O policy may themselves be future plaintiffs or otherwise assist plaintiffs with future claims.

Depending on the language of the I v. I exclusion, shareholder claims brought with the assistance of a corporate whistleblower, could be excluded from coverage. A claim brought by or with the assistance of a former director or officer could also result in a denial of coverage. A September 2006, *ACC Docket* article covers this topic in greater detail: See the "ACC Extras on . . . D&O Coverage" on pg. 96 for details.

When negotiating your D&O coverage, try to limit application of the I v. I exclusion to claims brought directly by the company. At a minimum, make certain that your policy includes the available market exceptions to the I v. I exclusion, which carve back coverage for:

- derivative claims;
- claims brought with the assistance or participation of corporate whistleblowers;
- certain claims brought on behalf of a company while in bankruptcy;
- employment practices claims asserted against individual Ds and Os;
- claims for contribution or indemnity between defendants in otherwise covered claims;
- claims brought entirely in a foreign jurisdiction; and
- claims asserted by former Ds and Os of more than four years.

4. Severability/Rescission Protection

Application severability and rescission risk might have been number one on our list in prior years, but the market today fortunately offers many adequate solutions to protect your Ds and Os against rescission. In reviewing your coverage, make sure you understand the rescission issue and carefully consider the various available endorsements. Many insurers offer multiple severability and non-rescission endorsements providing varying levels of protection.

So, what is the issue? In underwriting a given D&O insurance risk, insurers frequently evaluate the company's financial statements and public filings. In the context of making investment decisions, security holders (i.e., potential plaintiffs) likewise evaluate a company's financial condition and public disclosures. Where those financial statements and disclosures are materially misstated, Ds and Os face a simultaneous securities claim and rescission risk. At the same time, shareholders claim that they relied—to their detriment—on misrepresentations by the Ds and Os in making their investment decisions; the D&O insurers argue that the same misrepresentations fraudulently induced the issuance of the D&O policy. In recent years, your Ds and Os have probably read about this nightmare scenario, as the potential for rescission was an issue in many of the widely publicized corporate debacles.

The scope of information the insurer is relying upon is outlined in the definition of "application" in your policy; you should carefully review that definition and, when possible, narrow the scope to written information submitted to the insurer with the application.

Fortunately, non-rescindable coverage for non-indemnifiable (Side A) loss is widely available today. At a minimum, you should negotiate expressly non-rescindable coverage for those claims where the company cannot financially or is legally prohibited from granting indemnification.

The issue today concerns the degree to which corporate reimbursement Side B coverage and Side C entity coverage remains subject to rescission. Many markets will provide full severability as to Side B coverage, such that corporate reimbursement of innocent parties is protected from rescission. In other words, even where the insurer can void coverage as to certain individual Ds and Os, coverage remains to the extent the company continues to advance defense costs or otherwise provide indemnification to other innocent Ds and Os.

While most insurers impute the knowledge of certain senior executives to the company for purposes of Side C coverage, a minority of insurers will occasionally agree to a form of pure severability that does not impute the knowledge of any individual or corporate insured to any other individual or corporate insured.

Against a backdrop of numerous pro-insured court rulings on severability and rescission, some insurers have recently offered fully non-rescindable ABC coverage purporting to eliminate the rescission risk entirely from your D&O coverage. Don't be fooled by broad terminology. All endorsements purporting to provide non-rescindable coverage should be closely scrutinized. Pay particular attention to any new endorsement wording permitting a denial of coverage for misrepresentations in the application process that would have otherwise given rise to potential rescission.

5. "Follow-form" Excess Coverage

Most underwriting negotiations focus on terms, conditions, and exclusions in the primary policy. Don't forget to

ACC Extras on... D&O Coverage

ACC's 2007 Annual Meeting

Here is your opportunity to issue spot challenges and identify new insurance product offerings and trends with your peers. Register for ACC's 2007 Annual Meeting, October 29-31 in Chicago, and attend session 712: *D&O Insurance for Financial Services Lawyers*. You will be able to benchmark the most important elements to look for and negotiate in D&O insurance for a financial services firm. Register today at *http://am.acc.com*.

ACC Docket

- *Your Company's D&O Policy: Will the Insured v. Insured Exclusion Surprise You?* (2006). Think you know your company's D&O insurance coverage? Think again. Exclusions regularly contained in D&O policies may negate coverage that you and your entire team depend on. Find out which parties qualify as "insured" before you get caught in a loophole that may cost big bucks. *www.acc.com/resource/v7525*
- *Blowing Whistles and Climbing Ladders: The Hidden Insurance Issues* (2005). It's a Sarbanes-Oxley nightmare. An unhappy employee claims that she knows about certain accounting irregularities and is being persecuted for her whistle-blowing, and then posts her allegations online. Your CFO phones asking about insurance coverage for being named personally in the suit—and you're going to be named, too. Does your coverage go far enough? *www.acc.com/resource/v5716*
- *State of the D&O Insurance Market* (2003). What you need to know to navigate the turbulent marketplace for director and officer protection. *www.acc.com/resource/v877*

Program Materials

- *Insurance 201: Specialized Policies for Specialized Problems* (2005). Lawsuits filed against corporations and their present and former directors and officers for purported misconduct have been on the rise in recent years. With claims alleging civil and criminal violations, breach of fiduciary duty, or internal business misconduct against the company or individual, how does an organization maximize insurance coverage for attorneys' fees and liabilities? *www.acc.com/resource/v6867*

ACC Alliance

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review coverage under your excess policies as well. It is a common misconception that excess policies follow-form to all of the terms negotiated in the primary policy.

While excess polices do typically follow many if not most terms and conditions contained in the primary policy form, they follow the terms of the primary policy "except as otherwise provided," and some excess forms today do contain significant limitations on key provisions. For example, some excess polices include reliance endorsements that substitute representations and severability wording from that of the primary insurer. In that case, the excess insurer may have a greater ability to rescind coverage than your primary insurer.

Other excess policies include a provision stating that the insurer will not recognize payment by the insured in negotiated settlements with underlying insurers. As can be the case in negotiating large class action settlements, if the insured negotiates a buy-out of the primary policy at less than full limits, in the absence of negotiated wording to the contrary, the excess insurer may argue that the underlying policy has not been exhausted for purposes of excess attachment.

Many excess polices also include different prior and pending litigation exclusions and different claim-reporting provisions. The key here is to include your excess policies in the renewal negotiation process and be sure they dovetail with your primary placement.

Lawyers think in **terms of lawsuits.** When you receive a copy of a **complaint,** you intuitively know that **it should be reported** to the company's **applicable insurers.**

6. Side A Difference-in-Conditions (DIC) Excess Insurance

Many companies today purchase Side A-only excess DIC coverage in addition to and on top of a tower of traditional insurance. Side A DIC coverage operates much like an umbrella policy, providing broader coverage terms and conditions than that afforded by the Side A insuring clause of traditional ABC coverage.

Specifically, Side A DIC policies may drop down and fill gaps in coverage for non-indemnifiable claims that are excluded by the traditional coverage. Side A DIC policies, for example, often do not include ERISA or pollution exclusions, and may have more favorably worded conduct and I v. I exclusions. Since the company is not insured under Side A coverage, such policies should not be considered an asset of the estate in the event of bankruptcy, and the limits of liability are not eroded by company claims.

Side A DIC policies may also be crafted to drop down and fund an individual's defense where the company wrongfully refuses to advance defense costs otherwise subject to the corporate retention. Because legally indemnifiable claims are often subject to a large corporate retention where a company wrongfully denies advancement and indemnification to an individual insured, the drop down feature of Side A DIC coverage can prove invaluable. Although not exhaustive and subject to the actual negotiated terms, below are examples of the broader features and benefits provided as part of many Side A DIC policies:

- No "presumptive indemnification;"
- Specifically nonrescindable;
- Full severability of the application and conduct exclusions;
- Policy drops down as primary in the event of insolvency of the underlying carrier;
- Less restrictive fraud exclusion;
- No pollution or ERISA exclusion;
- Less restrictive I v. I exclusion;
- Covers Ds and Os where company refuses to indemnify; and
- Covers where primary policy has been deemed an asset of the debtor's estate in bankruptcy.

Side A DIC policy forms vary greatly from one insurer to the next, and the market for Side A DIC coverage is extremely competitive. Some forms include dedicated limits for independent directors. Other forms eliminate most, if not all, of the exclusions. You should work closely with your risk management team and broker to evaluate all of the available options.

7. Claim Definition and Claim Reporting

Lawyers think in terms of lawsuits. When you receive a copy of a complaint, you intuitively know that it should be reported to the company's applicable insurers. But, what about a "frivolous" demand letter from plaintiff's counsel? Or a letter from shareholder activists demanding changes to your company's corporate governance? Do they too require prompt reporting to your D&O insurers?

Just think of the many ways a **claim reporting deadline** can be missed. An officer may **decide to ignore** a client's demand letter, or try to work it out **on his own.**

The "claim" definition in most D&O policies extends well beyond formal complaints. So what happens when "claims" are not brought to the attention of corporate risk management or to the legal department until service of a formal complaint? In many jurisdictions, the insurer need not prove prejudice to establish a valid late notice defense. Written demands from shareholders or other parties may constitute a claim triggering a claim-reporting obligation, and the failure to timely notify the insurers of an initial written demand may jeopardize coverage for subsequently notified lawsuits.

Some policies require notice as soon as practicable after the claim is made against any insured. Just think of the many ways a claim reporting deadline can be missed. An officer may decide to ignore a client's demand letter, or try to work it out on his own. Or, a demand letter from plaintiff's counsel may sit in the in-box of in-house counsel under a stack of other urgent legal matters.

Many insurers will modify the notice condition to require notice only after the parent company's GC or risk manager first learns of the claim, thereby mitigating the concern that a claim, non-lawsuit or otherwise, may sit in some remote part of the company unbeknownst to your risk management team. Other insurers will narrow the notice condition, but include an absolute cut-off of 60-90 days after the policy period in which to report claims. In such cases, it is imperative that the insureds establish a claim reporting procedure so that all "claims" under the policy are brought to the attention of risk management sufficiently in advance of the reporting deadline.

The scope of your "claim" definition can also be outcome determinative in terms of your ability to recoup costs incurred in investigating or defending against the claim. Most insurers will not cover costs incurred prior to the time an action, suit, or demand constitutes an actual "claim" as defined by the policy even if it ultimately benefits the defense of a covered claim.

Some policies, but not all, provide coverage for investigative costs incurred by a special committee in investigating shareholder derivative demands. Some policies may also extend defense cost coverage to certain regulatory and criminal investigations; however, many policies do not cover informal SEC investigations or costs incurred solely as a non-party witness. It is crucial to understand the scope of your "claim" definition and limitations of any claim-reporting condition.

8. Coverage for "Securities Claims"

Most public companies today purchase separate Side C entity coverage for securities claims or AB coverage only with predetermined allocation wording. The latter form of coverage does not afford any coverage for securities claims made solely against the company, but treats defense costs and other loss jointly incurred by the company and Ds and Os as covered loss.

Predetermined allocation

Even if your company is in the minority that does not purchase entity coverage, you will want to carefully consider how any predetermined allocation wording may be affected by the securities claim definition. Does coverage for "securities claims," and any predetermined allocation of the defense costs, disappear when individual insureds are dropped from the claim?

Individual insureds may have broader legal defenses than the company in many securities claims. In Section 11 claims under the Securities Act, for example, the company is strictly liable for misrepresentations in its offering documents, while individual Ds and Os who signed the documents are only liable if they failed to perform adequate due diligence. Make certain that the dismissal of individual Ds and Os will not result in the forfeiture of defense costs under your insurance.

Coverage for Section 11/12 Damages

You will also want to carefully consider the extent to which your coverage may or may not apply to securities claims arising out of public offerings of debt or equity securities. There is a growing debate concerning the extent to which a D&O policy extends coverage for damages arising out of initial public offerings of securities, particularly where such damages may be characterized as disgorgement or restitution of ill-gotten gain.

Your policy's definition of "securities claim" likely in-

cludes any alleged violation of the federal securities laws and may even specifically reference the Securities Act of 1933. However, a number of recent cases suggest that Section 11 and 12 damages—at least when paid by the issuer—constitute restitution or disgorgement and are uninsurable as a matter of public policy. Thus, even where your policy defines "securities claims" to expressly include alleged violations of securities laws governing initial offerings of securities, your carrier may take the position that damages paid in a settlement do not qualify as covered "loss" under the D&O policy.

Though your policy definition of "securities claim" may extend to all alleged violations of the securities laws, the "loss" definition in many policies expressly excludes from otherwise covered "loss" any amount deemed "uninsurable" under applicable law. Therefore, to the extent your jurisdiction considers issuer repayment of Section 11 and 12 damages to be restitution or disgorgement, there may be no coverage.

> Though your policy definition of **"securities claim"** may extend to all alleged violations of the securities laws, the **"loss"** definition in many policies **expressly excludes** from otherwise covered "loss" any amount deemed **"uninsurable"** under applicable law.

Individual Ds and Os of course do not directly receive the proceeds of initial offerings. To the extent such individuals are making a settlement payment in the Section 11 or 12 context, there is a strong argument that such payment is not disgorgement or restitution and is therefore covered "loss" under your D&O policy.

In response to the recent court rulings, a number of insurers now offer contract wording affirmatively stating that the insurer will not assert that the portion of any settlement arising out of initial offerings of securities constitutes uninsurable loss, and expressly voiding certain exclusions in the context of IPOs or other initial offerings of corporate securities. If your company recently conducted a public offering of debt or equity securities, or plans to do so, you should include this issue in your coverage review and obtain clarification from your insurers where possible.

Secondary Liability Coverage

Whether your company purchases entity coverage or maintains predetermined allocation wording for "securities claims," you should also confirm that the securities claim definition in your policy extends to secondary theories of liability such as 10b-5(a) or (c) theories of scheme liability, or SEC and state law exposure to claims of aiding and abetting. In many D&O policies, the company and non-officer employees are only afforded coverage for "securities claims" arising out of the purchase or sale of the insured company's securities.

Consider scenarios where your company may be sued by shareholders of another company for allegedly participating in a scheme to defraud or otherwise aiding and abetting a fraud on *that* company's shareholders. Enron and WorldCom shareholders, for example, also sued numerous investment banks as alleged scheme participants in the securities fraud. But, the issue of secondary securities liability may also be implicated in the context of ordinary vendor and sales agreements where your sales personnel enter into side agreements allowing business partners to improperly recognize revenue and cook *their* books.

The viability of 10b-5(a) or (c) theories of scheme liability is currently under review before the United States Supreme Court in *Stoneridge Investment Partners, LLS v. Scientific-Atlanta, Inc.* Whether your company will ultimately be held liable to the shareholders of another company for such a claim, or under SEC or state law theories of aiding and abetting, to the extent your company purchases entity coverage for "securities claims," you may wish to negotiate modifications to the definition to include all alleged violations of the federal or state securities laws including secondary theories of liability.

9. Employed Lawyers Insurance Coverage

Do you, as in-house counsel, need insurance coverage? Insurance professionals are asked this question several times in any given year. In-house attorneys were closely scrutinized in the Enron bankruptcy examination, and a few were also named defendants in the civil securities litigation. Numerous GCs have been implicated in the ongoing options backdating saga, with several under criminal investigation or indictment. The publicity afforded the in-house counsel's role as a gatekeeper, positioned to detect and possibly prevent corporate fraud, has certainly heightened the general awareness of in-house counsel liability exposures. Fortunately, corporate employers have rarely brought direct malpractice claims against their in-house counsel. Nevertheless, in-house counsel liability exposure (particularly as to third

parties or government regulators) may be on the rise.

A typical D&O policy affords coverage only to duly elected or appointed Ds and Os. Even if the in-house counsel satisfies the policy's definition of director or officer—many GCs serve as corporate secretary for example—insurers frequently raise an issue of whether coverage extends to the attorney's rendering of professional services to the company in the capacity as a non-officer attorney. And, of course, many other in-house attorneys are frequently not duly appointed officers pursuant to articles of incorporation and governing bylaws.

For companies that purchase Side C coverage or predetermined allocation for securities claims, all employees, including in-house counsel, should have coverage. Nevertheless, D&O policies are not typically crafted to address all in-house counsel liability exposures.

Some additional coverage may be extended by endorsement to the D&O policy, but you should make certain that any such employed lawyers extension to the D&O policy is in addition to, and does not take away, coverage that otherwise exists for all employees. Separate employed lawyers coverage may be purchased, with additional terms and conditions subject to negotiation. An April 2005 *ACC Docket* article covers this topic in greater detail. See the "ACC Extras on . . . D&O Coverage" on pg. 96 for details.

10. Global D&O Requirements

Our final issue concerns the fairly recent discussion in the D&O underwriting community of global D&O indemnification and insurance and the need for locally admitted policies in certain foreign jurisdictions. Your company's D&O policy likely applies to claims asserted worldwide. However, certain countries maintain compulsory insurance requirements that could theoretically preclude your insurer from making payment to insureds located in foreign jurisdictions.

If your company has Ds and Os with significant liability exposure overseas, consider whether any D&O coverage must be procured locally. While the authors are unaware of any major D&O claims to date where the lack of a local policy precluded coverage under a traditional, US-purchased program, the issue has recently received greater attention as a matter of general corporate compliance.

Have a comment on this article? Email editorinchief@acc.com.

Negotiating Policies Benefits Your Company

Keep in mind that D&O policies, both primary and excess, are not off-the-shelf, and many terms can and should be negotiated.

- **Start the renewal process early, leaving time for your broker to negotiate with several carriers.** Last minute requests for coverage enhancements are more likely to be denied.
- **Consider the benefit of in-house counsel and/or outside legal review**. To the extent your Ds and Os require outside legal review, allow sufficient time in advance of the renewal for outside counsel to thoroughly review the policies, prioritize areas of potential improvement to coverage, and review the findings with your risk management team.
- **Assess your specific risk exposures**. Don't fall into the trap of making assumptions about your company and its industry in light of historical exposures. Rather, each year include a review of your company's current and potential risks in your D&O renewal strategy discussions. For starters, review the risk disclosures and the management discussion and analysis portion of recent public filings. Outside analyst reports and/or rating agency evaluations can also help you frame your D&O renewal strategy.
- **Make sure your D&O broker is providing top-notch services.** The best brokers sell your risk aggressively into the market, proactively dictating coverage terms, conditions, and pricing to the market, rather than allowing such terms to be dictated by your insurers and then reacting to their terms.
- **Include all key parties throughout the renewal process.** In many companies, the risk management department has primary responsibility for D&O coverage negotiation and placement, but a number of other constituents play a significant role in the process. Some companies include board review of the D&O coverage, by committee or in a formal presentation to the board. The CFO or procurement department may have ultimate responsibility for the insurance purchase. The GC or in-house legal department may or may not play a role in upfront negotiation of coverage terms and conditions, but will invariably be required to understand them in the context of future claims. All of these parties have an inherent interest in understanding the scope of the D&O protection but are frequently engaged very late in the renewal process. Engaging key parties early in the process helps manage expectations both for policy renewal and when the claim arrives.

Program Description

Session 712: D&O Insurance for Financial Services Lawyers

The highly regulated nature of financial services firms poses unique legal issues for the in-house lawyer charged with ensuring the adequacy of directors and officers insurance. Here is your opportunity to issue spot challenges and identify new insurance product offerings and trends with your peers. Benchmark the most important elements to look for and negotiate in D&O insurance for a financial services firm.

Program Outline

I. Current D&O Liability Landscape
   a. U.S.
   b. International
II. Negotiating D&O Coverage – Ten Issues to Consider

Ten Issues to Consider When Negotiating D&O Coverage

- The ABC's of Insuring Clauses
- Personal Conduct/Fraud/Profit Exclusion
- Insured vs. Insured ("I v. I") Exclusion
- Severability/Rescission Protection
- "Follow-form" Excess Coverage
- Side A Difference-in-Conditions ("DIC") Excess Coverage
- Claim Definition & Claim Reporting
- Coverage for "Securities Claims"
- Employed Lawyers Insurance Coverage
- Global D&O Requirements

1. The ABC's of Insuring Clauses

- Understand advancement and indemnification obligations to Ds and Os
  - D&O insuring agreements vary depending upon whether the company is permitted or required to provide indemnification
- Side A, B, and C Insurance
  - Side A/Clause 1 coverage for non-indemnifiable claims
  - Side B/Clause 2 corporate reimbursement coverage
  - Side C/Clause 3 entity coverage for securities claims
- "Presumptive Indemnification" and other provisions
  - Side B retention may apply regardless of whether the company actually grants indemnification to the individual insured

Sample Policy Wording:

- Coverage A: This Policy shall pay the Loss of any Insured Person arising from a Claim made against such Insured Person for any Wrongful Act of such Insured Person, except when and to the extent that an Organization has indemnified such Insured Person.
- Coverage B: This policy shall pay the Loss of an Organization arising from a Claim made against an Insured Person, but only to the extent that such Organization has indemnified such insured person.
- Coverage C: This policy shall pay the Loss of any Organization arising from a Securities Claim made against such Organization for any Wrongful Act of such Organization.

Policy Wording Hypo One:

- Coverage B: This policy shall pay the Loss of an Organization arising from a Claim made against an Insured Person, but only to the extent that such Organization has indemnified such insured person.

- The failure to formally authorize indemnification and advancement may preclude corporate reimbursement under the policy. *See generally Westcott Holdings, Inc. v. Monitor Liability Managers, Inc.*, 2005 WL 2206196 (S.D. Tex. Sept. 12, 2005)(dismissing corporate reimbursement claim against an insurer in part for failure to plead indemnification as required by the policy); *accord Macmillan, Inc. v. Federal Ins. Co.*, 741 F. Supp. 1079 (S.D. N.Y. 1990).

Policy Wording Hypo Two:

- Coverage B: The Insurer shall pay on behalf of the Company Loss which the Company is required or permitted to pay as indemnification to any of the Insured Persons resulting from a Claim first made against the Insured Persons during the Policy Period for a Wrongful Act.

- This policy wording does not require an actual grant of indemnification, though the company may have to establish individual entitlement to indemnity under the applicable bylaws or indemnification agreements. *See generally Ameriwood Industries Int'l Corp. v. American Casualty Co.*, 840 F. Supp. 1143 (W.D. Mich. 1993)(noting [under similar wording] that the failure to formally indemnify the directors and officers involved in the underlying suits did not prevent a recovery under the policy where the company could otherwise establish that it was required by law to provide the indemnification).

2. Personal Conduct/Fraud/Profit Exclusion

- Implicated in nearly every D&O claim
- All conduct exclusions contain a "trigger" by which the insurer may successfully deny coverage:
  - Final Adjudication
  - "In Fact"
  - "In Fact as Evidenced by…"
- Relevant Cases:
  - *Great American Ins. Co. v. Gross*, 2005 WL 1048752 (E.D. Va. May 3, 2005) (granting a preliminary injunction requiring the insurer to advance defense costs notwithstanding criminal guilty plea by the individual insured)
  - *Bergonzi v. Rite Aid Corp.*, 2003 WL 22407303 (Del. Ch. Oct. 20, 2003) (requiring corporate advancement of legal fees per the bylaws notwithstanding CFO's guilty plea under oath to deliberate falsification of company financial statements)

3. Insured vs. Insured ("I v. I") Exclusion

- Original intent – to exclude collusive or "friendly" lawsuits
- Reality – can exclude any claim brought by, on behalf of, or with the assistance of any insured
  - Shareholder claims brought with assistance of corporate whistleblower "insured"
  - Claims brought with assistance of a former director or officer (parent or subsidiary)
  - Mergers & Acquisitions
  - Bankruptcy/Claims by or on behalf of the Debtor

Insured vs. Insured ("I v. I") Exclusion

- The Insured vs. Insured Exclusion in its basic form under most policies already has a number of exceptions as follows:
  - Derivative Claims;
  - An employment Claim by an Insured Person;
  - A Claim brought for contribution or indemnity by an Insured Person;
  - A Claim brought by an Insured Person who has not served the Company for at least four years.
- Additional coverage carve-backs/exceptions:
  - Claims brought against Insured Persons by a bankruptcy trustee, receiver, liquidator, conservator, rehabilitator or similar official;
  - Claims brought outside of the U.S.;
  - Claims brought by or with the assistance of whistleblowers (as defined by the Sarbanes-Oxley Act).
- A few carriers will further narrow the exclusion to apply only to claims brought by or on behalf of the insured organization

4. Severability/Rescission Protection

- D&O insurance contracts have always been subject to rescission (policy voided - as if it were never put in place) in the event insurers could successfully argue that they were misled in the process of applying for coverage
- The risk of rescission can be mitigated in the following ways:
  - Inclusion of broad severability language in policies – full severability, full severability for non-indemnifiable claims only, limited severability, no severability
  - Narrow the definition of "Application"
  - Inclusion of "non-rescindable" language in policies making the contracts specifically non-rescindable in all or certain circumstances

5. “Follow-form” Excess Coverage

- Excess policies typically follow-form to the primary policy “except as otherwise provided”
  - Reliance endorsements –excess insurer may have greater ability to rescind than primary
  - Payment by the insured in negotiated settlements with underlying insurers not recognized
  - Prior and pending litigation exclusions and/or claim reporting provisions differ
- Include excess policies in renewal negotiations

“Follow-form” Excess Coverage

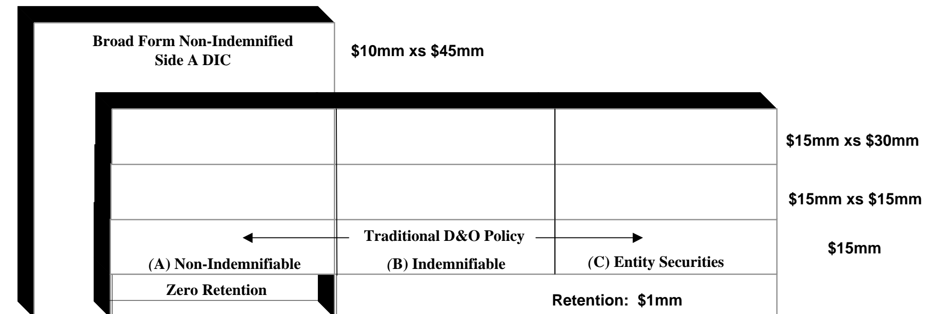
- Relevant Cases:
  - *In re Healthsouth Corp. Ins. Litig*., 308 F. Supp. 2d 1253 (N.D. Ala. 2004) (denying excess carriers’ argument that they did not follow full severability wording in primary policy because of silence and incorporation of different application information into the “follow-form” excess policies)
  - *In re Worldcom Inc. Sec. Litig*., 2004 WL 2955237 (S.D. N.Y. Dec. 22, 2004) (despite payment by primary insurer, excess insurers sought complete rescission)
  - *Allmerica Financial Corp. v. Certain Underwriters at Lloyd’s, London*, 2007 WL 2215589 (Mass. Aug. 6, 2007) (noting that an excess carrier is not bound by the coverage interpretation of the primary carrier it follows)

6. Side A Difference-in-Conditions ("DIC") Excess Coverage

- Broader terms and conditions than traditional Side A insuring clause
  - No "presumptive indemnification"
  - Specifically "non-rescindable"
  - Full severability of application and conduct exclusion(s)
  - Policy drops down as primary in the event of insolvency of the underlying carrier
  - Less restrictive fraud exclusion
  - No pollution or ERISA exclusion
  - Less restrictive I v. I exclusion
  - Covers Ds and Os where company refuses to indemnify
  - Covers where primary policy has been deemed an asset of the debtor's estate in bankruptcy
- Policies vary greatly. Some include separate limit for Individual Directors. Others eliminate <u>all</u> exclusions.

Side A Excess Difference-in-Conditions (DIC) Coverage (aka "Broad Form" Coverage)

Coverage can be purchased for all directors and officers, independent directors only, or for specific individuals only.



7. Claim Definition & Claim Reporting

Claim Definition:

- "Claim" definition often extends beyond formal Complaints:
  - A written demand for monetary, non-monetary, injunctive or other relief;
  - A civil or arbitration proceeding;
  - A criminal proceeding commenced by the return of an indictment; or
  - A formal administrative or regulatory proceeding
  - Investigative Costs? Formal vs. Informal Investigations?
- Relevant Cases:
  - *National Stock Exchange v. Federal Insurance Company*, 2007 WL 1030293 (N.D. Ill. Mar. 30, 2007) (granting coverage for formal SEC order of investigation)

Claim Definition & Claim Reporting

Claim Reporting:

- Failure to timely notify insurers of written demand may jeopardize coverage in subsequent lawsuits
- Modify notice condition to require notice after GC or Risk Manager first learns of "claim"
- Most insurers will not cover costs incurred prior to the "claim"
- Relevant Case:
  - *Federal Ins. Co. v. CompUSA*, Inc., 319 F.3d 746 (5th Cir. 2003) (finding an 11 month delay in providing formal notification – after jury verdict – was not "as soon as practicable" as a matter of law)

    Note:

    - Underwriting notice is insufficient
    - Carrier is not required to prove prejudice in many jurisdictions

8. Coverage for "Securities Claims"

- Section 11 & 12 damages under the Securities Act of 1933
  - §11 - issuer company strictly liable for misrepresentations in the offering documents and purchasers may recover the difference between the amount paid for the security and the "true" value of the security
  - §12 - imposes strict liability on the seller and entitles purchasers to a refund of the purchase price
  - Relevant Cases:
    - *CNL Hotels & Resorts v. Houston Casualty Insurance Co.*, 2007 WL 788361 (M.D. Fla., Mar. 14, 2007)
    - *Level 3 Communication, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001)
    - *Conseco, Inc. v. National Union Fire Insurance Company of Pittsburgh, PA, et al.*, 2002 WL 31961447 (Ind. Cir. Ct. Dec. 31, 2002)

Coverage for "Securities Claims"

- Secondary Theories of Liability
  - Viability of §10(b)-5(a) or (c) theories of scheme liability
    - *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. and Motorola, Inc.*, 443 F.3d 987 (8th Cir. 2006), *cert. granted*, 2007 WL 879583 (U.S. Mar. 26, 2007)
  - SEC and state law exposure to claims of aiding and abetting
    - *Sterling Trust Co. v. Adderley,* 168 S.W.3d 835 (Tex. 2005) (holding that an alleged aider is liable under the Texas Securities Act if it rendered assistance "'in the face of a perceived risk' that the assistance would facilitate untruthful or illegal activity by the primary violatior")

9. Employed Lawyers Insurance Coverage

- In-house counsel liability exposure may be on the rise
  - Corporate fraud "gatekeeper"
  - Options backdating scandal
  - Rendering of professional services to the company
- Side C coverage or pre-determined allocation for securities claims may provide applicable coverage to employees
- Some policies expressly include the General Counsel in the definitions
- Additional coverage may be extended by endorsement to D&O policy or in separate Employed Lawyers coverage

10. Global D&O Indemnification and Insurance

- D&O policy likely applies to claims asserted worldwide, however:
  - Some countries maintain compulsory insurance requirements, which could preclude insurer from making payments to insureds located in foreign jurisdictions
  - Need for locally admitted policies in certain foreign jurisdictions
    - Brazil
    - Japan
    - India
    - Romania
- Consider whether D&O coverage must be procured locally for Ds and Os with significant liability exposure overseas