Tuesday, October 20
2:30 pm–4:00 pm

807 Care and Feeding of a Board: Liability Issues

Charles Blixt
Director
Krispy Kreme Doughnut Corporation

Jennifer J. O'Neill
In-house Counsel and Vice President
Zurich - Management Solutions Group

Thomas A. Schroeder
Senior Attorney
Georgia Lottery Corporation

Caroline Spangenberg
Partner
Kilpatrick Stockton LLP

Faculty Biographies

Charles Blixt

Chuck Blixt is the retired executive vice president and general counsel of Reynolds American Inc. and R.J. Reynolds Tobacco Company. He is currently a senior advisor to the law firm of Jones Day and serves on the board of directors of three publicly traded companies, Krispy Kreme Doughnut Corporation, Swedish Match AB and Targacept, Inc.

In addition, he is on the board of two legal technology firms, TCDI and H5. Prior to joining R.J. Reynolds, Mr. Blixt served as corporate counsel at Caterpillar Inc. and was a litigator in private practice. Mr. Blixt has been extensively involved in community service, including leadership positions on the board of trustees of Salem College & Academy and the board of directors of the Winston-Salem YMCA.

Mr. Blixt received his BA and JD degrees from the University of Illinois.

Jennifer J. O'Neill

Jennifer J. O'Neill is the international program business manager and legal counsel to Zurich's Specialties Management Solutions Group (MSG). Her responsibilities include managing MSG's international program business, creating, coordinating and providing formal product training programs, and providing legal support to the MSG underwriting team.

Prior to Zurich, Ms. O'Neill was the D&O product manager and passport manager for AIG Executive Liability. Prior to AIG, she was senior vice president and senior broker of Hilb Rogal and Hobbs (HRH) where she specialized in D&O, financial institutions, employment practices and fiduciary liability as well as bond, K&R and fidelity. Before HRH, Ms. O'Neill held various positions in AIG's legal department, supporting the executive liability divisions. Ms. O'Neill also worked for Lexis-Nexis as an educational specialist teaching legal research tactics to faculties and law students at laws schools throughout the metropolitan area.

Ms. O'Neill received her BA from CUNY of Staten Island and her JD from Brooklyn Law School.

Thomas A. Schroeder

Thomas A. Schroeder is the senior attorney for the Georgia Lottery Corporation (GLC). He is responsible for regulatory compliance, litigation management, vendor and supplier contracting, and risk management.

Before joining the Georgia Lottery, Mr. Schroeder represented commercial lenders, including CoBank, a cooperative bank with headquarters in Denver. Additionally, Mr. Schroeder was one of the founding members of the National Safety Alliance, which administered workplace drug testing programs, and which made the INC 500 list for four consecutive years, before being acquired by ChoicePoint.

In addition to ACC, he is a member of the American Bankruptcy Institute, the Atlanta Bar Association, The Bar Association of Metropolitan St. Louis, and the Lawyer's Club of Atlanta. Since 2001, Mr. Schroeder has been either president and/or program chair for the Atlanta Area Alumni Chapter of Beta Gamma Sigma, the international honor society serving business school programs accredited by The Association to Advance Collegiate Schools of Business. Mr. Schroeder is an active leader with Toastmasters International, the Japan-America Society of Georgia, and with the volunteer programs of Carleton College.

Mr. Schroeder received a BA from Carleton College in Minnesota, a JD from Washington University in St. Louis, and an MBA from Vanderbilt University.

Caroline Spangenberg

Caroline Spangenberg is a partner at Kilpatrick Stockton LLP and the leader of the firm's Insurance Coverage team. Ms. Spangenberg has thirty years experience representing policyholders in insurance coverage matters and related indemnity disputes, including numerous claims under directors' and officers' policies and bankruptcy disputes over D&O insurance proceeds. She has helped her clients recover insurance proceeds through negotiation, mediation, arbitration (including international arbitrations) and litigation throughout the United States and overseas.

Ms. Spangenberg is a member of the Risk and Insurance Management Society, Inc.; International Risk Management Institute; and the Atlanta, Georgia, Federal and American Bar Associations. Her charitable activities include Forward Arts Foundation, the American Cancer Society, the Atlanta Junior League, and the Westminster Schools, as well as pro bono work through her firm. She was recognized as a 2009 Best Lawyer in America® in the area of Insurance Law and is AV® rated by Martindale-Hubbell.

Ms. Spangenberg received her BA from Wellesley College (Phi Beta Kappa), and her JD, magna cum laude, from Harvard Law School.

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Summary of Litigation Arising Out of Subprime and Credit Crisis

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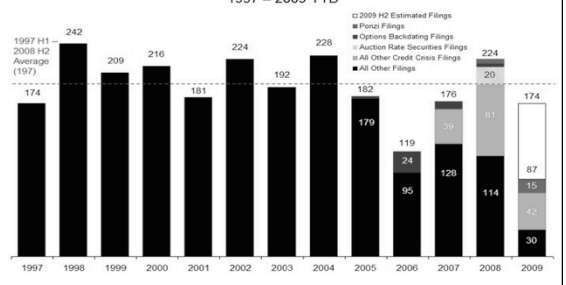
Cornerstone Research, Securities Class Action Filings, 2009 Mid-Year Assessment, Figure 2 (2009)

CAF Index™ – Number of Class Action Filings
1997 – 2009 YTD



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Cornerstone Research, Securities Class Action Filings, 2009 Mid-Year Assessment, Figure 7 (2009)

S&P 500 Securities Litigation Heat Maps™
Percent of Companies Subject to New Filings*
2000–2009 YTD

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Basic Materials	2.4%	0.0%	0.0%	0.0%	0.0%	3.4%	0.0%	0.0%	0.0%	0.0%
Communications	8.3%	17.4%	22.7%	4.8%	2.3%	4.8%	2.3%	6.5%	4.8%	2.4%
Consumer Cyclical	5.5%	4.1%	5.3%	5.5%	2.7%	9.5%	2.8%	5.9%	2.9%	1.6%
Consumer Non-Cyclical	4.5%	5.6%	9.7%	7.4%	8.4%	9.6%	7.1%	9.3%	7.4%	0.0%
Energy	0.0%	3.3%	19.2%	0.0%	4.0%	0.0%	0.0%	0.0%	0.0%	2.4%
Financial	4.2%	1.4%	18.3%	6.3%	13.6%	5.0%	0.0%	9.4%	32.8%	12.8%
Industrial	2.9%	0.0%	6.1%	4.5%	4.5%	4.6%	1.6%	1.6%	3.2%	1.5%
Technology	11.4%	14.8%	5.3%	3.6%	3.6%	5.4%	9.3%	0.0%	6.0%	0.0%
Utilities	5.9%	5.9%	34.3%	2.9%	6.1%	3.0%	0.0%	3.2%	3.3%	0.0%
All S&P 500 Companies	**5.0%**	**5.6%**	**12.0%**	**4.8%**	**6.0%**	**6.0%**	**3.2%**	**5.2%**	**9.2%**	**2.8%**

Legend 0% 0% – 5% 5% – 15% 15% – 25% 25%+

* The chart is based on the composition of the S&P 500 as of the first trading day of each year.
Industries are based on *Bloomberg* sector classifications.
Percent of Companies Subject to New Filings equals the number of companies subject to new securities class action filings in federal courts in each sector divided by the total number of companies in that sector.

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Cornerstone Research, Securities Class Action Filings, 2009 Mid-Year Assessment, Figure 8 (2009)

S&P 500 Securities Litigation Heat Maps™
Percent of Market Capitalizations Subject to New Filings*
2000–2009 YTD

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Basic Materials	8.9%	0.0%	0.0%	0.0%	0.0%	5.6%	0.0%	0.0%	0.0%	0.0%
Communications	23.6%	26.0%	34.5%	1.7%	4.2%	1.7%	0.4%	7.2%	4.7%	0.6%
Consumer Cyclical	10.1%	4.6%	5.2%	2.7%	4.3%	4.8%	8.9%	3.3%	4.0%	0.9%
Consumer Non-Cyclical	20.6%	4.7%	22.2%	11.0%	15.3%	11.5%	12.0%	13.9%	11.2%	0.0%
Energy	0.0%	6.8%	8.2%	0.0%	44.2%	0.0%	0.0%	0.0%	0.0%	0.9%
Financial	3.2%	0.8%	30.1%	6.5%	22.3%	7.0%	0.0%	18.7%	54.9%	41.2%
Industrial	4.3%	0.0%	12.1%	4.7%	5.7%	6.5%	0.6%	0.3%	24.9%	18.9%
Technology	3.3%	29.5%	2.9%	0.7%	1.6%	13.7%	12.6%	0.0%	13.7%	0.0%
Utilities	9.2%	4.0%	42.1%	4.3%	5.0%	5.6%	0.0%	5.8%	4.1%	0.0%
All S&P 500 Companies	**11.6%**	**10.6%**	**18.7%**	**5.2%**	**12.5%**	**7.3%**	**5.0%**	**8.3%**	**17.1%**	**7.5%**

Legend 0% 0% – 5% 5% – 15% 15% – 20% 20%+

* The chart is based on the market capitalizations of the S&P 500 companies as of the first trading day of each year.
Industries are based on *Bloomberg* sector classifications.
Percent of Market Capitalizations Subject to New Filings equals the total market capitalization of companies subject to new securities class action filings in federal courts in each sector divided by the total market capitalization of all companies in that sector.

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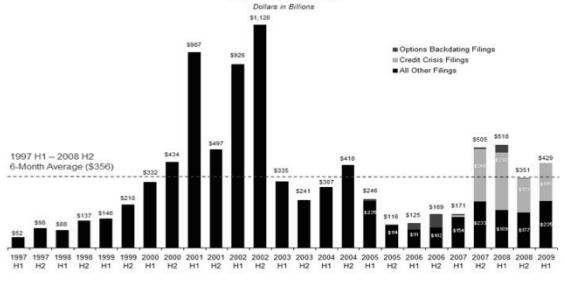
Cornerstone Research, Securities Class Action Filings, 2009 Mid-Year Assessment, Figure 10 (2009)

Maximum Dollar Loss: 6 Month Periods
1997 – 2009 YTD
Dollars in Billions



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Difficult Road to Recovery for Securities Plaintiffs

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I. Securities Fraud Claims

A. PLSRA Heightened Pleading Requirements

1. Must provide a detailed description of allegedly misleading statements.
2. Must explain why a statement is false.
3. Must provide particulars to support allegation made on information and belief.

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4. Must plead particularized facts supporting a strong inference of scienter that is "cogent and at least as compelling as any opposing inference that one could draw from the facts alleged." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308, 324 (2007).
5. Must show that the price decline is proximately caused by the disclosure. *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336, 342-43 (2005).

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B. General Pleading Requirements Post-*Twombly*

- Mere labels, conclusions, recitations of elements, and naked assertions are insufficient. *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555-57 (2007).
- Facts alleged must make claim "plausible on its face" and allow court to draw "reasonable inference" of defendant's liability. *Ashcroft v. Iqbal*, __ U.S. __, 129 S.Ct. 1937, 1950 (2009).

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Recent Case Developments

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***Hubbard v. BankAtlantic Bancorp*, 2008 WL 5250271 (S.D. Fla. Dec. 12, 2008)**

The court dismissed a complaint alleging false statements regarding a company's under-collateralized loan portfolio. The complaint did not allege that the defendants actually received specific information regarding the deficient portfolio, but instead made generalized allegations of common knowledge within the company and referenced the defendants' high-ranking positions.

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***In re Williams Securities Litigation*, 558 F.3d 1130 (10th Cir. 2009)**

Even though the plaintiff alleged a steep drop in stock value following corrective disclosures regarding a telecommunication company's financial condition, the court affirmed summary judgment to the defendants because the plaintiff's causation expert failed to take into account that the industry as a whole was experiencing significant losses during the same period of time.

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II. Derivative Actions

A. Demand Futility

Plaintiff must make a formal demand upon the board to bring the action, unless such a demand would be futile. Del. Ch. Ct. R. 23.1

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B. Business Judgment

Courts presume that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

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C. Exculpation

Corporations may exculpate directors from personal liability for breaches of the fiduciary duty of care, but not for breaches of the duty of loyalty or good faith. *Malpiede v. Townson*, 780 A.2d 1075, 1093-94 (Del. 2000).

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D. Indemnification

In third-party actions, corporations may indemnify for settlements, judgments, and attorneys' fees so long as the directors acted in good faith and in the best interests of the corporation. Del. Code Ann. tit. 8, § 145(a).

In derivative actions, corporations may indemnify directors for attorneys' fees and expenses, but not settlements and judgments. § 145(b).

Corporations must indemnify directors for defense costs and attorneys' fees if the directors are successful on the merits in defending a third-party action and/or a derivative action. § 145(c).

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Recent Derivative Case Developments

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***DiLorenzo v. Norton*, Civil Action No. 07-144, slip op. at 12-18 RJL (D.D.C. July 31, 2009)**

The court dismissed a derivative action alleging the improper backdating of stock options, finding that allegations of director participation in granting the options were insufficient to show demand futility absent allegations of culpable knowledge or bad faith.

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***Swope v. Quadra Realty Trust, Inc.*, Index No. 600381/08, slip op. at 17-19 (N.Y. Sup. Ct. July 16, 2009)**

The court dismissed a derivative action challenging the sale of Quadra Realty Trust, Inc. because the complaint summarily alleged that the directors placed their interests ahead of Quadra and engaged in wrongdoing with no supporting facts and no attempt to distinguish among the directors and the roles that they allegedly played in the wrongdoing.

***Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009)**

The court dismissed a derivative action challenging alleged deficiencies in a board's consideration and approval of a merger offer. Because of director exculpation for duty-of-care breaches, the sole issue was whether the directors breached their duty of loyalty by acting in bad faith. While perhaps the directors could have exerted more effort, they did not "knowingly and completely" fail to attempt to obtain the best sale price, as required to constitute bad faith.

***In re Citigroup, Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009)**

The court dismissed a derivative action alleging that directors breached their fiduciary duties by failing to manage subprime lending risks and by failing to disclose a $5 billion exposure to subprime assets. Citing *Lyondell*, the court dismissed the complaint because it failed to allege particularized facts showing that the directors had actual knowledge of inadequate oversight mechanisms or wrongdoing.

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***Stockman v. Heartland Industrial Partners, L.P.*, 2009 WL 2096213 (Del. Ch. 2009)**

The court construed a corporate indemnification provision broadly in favor of the plaintiff officers so as to require proof of satisfactory conduct as a condition precedent to indemnification only in the event of an unfavorable outcome in the underlying proceeding.

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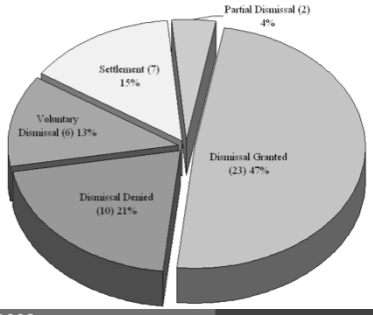
Dr. Faten Sabry, Anmol Sinha, and Sungi Lee, NERA Economic Consulting, An Update on the Credit Crisis Litigation: A Turn Towards Structured Products and Asset Management Firms, Exhibit 9 (Jun. 15, 2009)

Recent Credit Crisis-Related Decisions



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D&O Insurance Coverage

(*Unless otherwise noted, all policy provisions quoted in this presentation are from the St. Paul Travelers Companies, Inc. Directors & Officers and Company Liability Policy, Form FP096, Ed. 1/97.*)

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A. DIRECTORS AND OFFICERS INDIVIDUAL COVERAGE

"If Insuring Agreement A coverage is granted pursuant to Item 2 of the Declarations, the Insurer shall pay on behalf of the Insured Persons Loss for which the Insured Persons are not indemnified by the Company and which the Insured Persons become legally obligated to pay on account of any Claim first made against them, individually or otherwise, during the Policy Period or, if exercised, during the Discovery Period, for a Wrongful Act taking place before or during the Policy Period."

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B. COMPANY INDEMNIFICATION COVERAGE

"If Insuring Agreement B coverage is granted pursuant to Item 2 of the Declarations, the Insurer shall pay on behalf of the Company Loss for which the Company grants indemnification to the Insured Persons, as permitted or required by law, and which the Insured Persons have become legally obligated to pay on account of any Claim first made against them, individually or otherwise, during the Policy Period or, if exercised, during the Discovery Period, for a Wrongful Act taking place before or during the Policy Period."

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C. ENTITY LIABILITY

"If Insuring Agreement C coverage is granted pursuant to Item 2 of the Declarations, the Insurer shall pay on behalf of the Company Loss for which the Company becomes legally obligated to pay on account of any Securities Claim first made against the Company during the Policy Period or, if exercised, during the Discovery Period, for a Wrongful Act taking place before or during the Policy Period."

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Wrongful Act means:

"1. Any error, misstatement, misleading statement, act, omission, neglect, or breach of duty actually or allegedly committed or attempted by any of the Insured Persons in their capacity as such, or in an Outside Position or, with respect to Insuring Agreement C, by the Company, or

2. Any matter claimed against the Insured Persons solely by reason of their serving in such capacity or in an Outside Position."

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D&O Insurance Market

- Estimated $5.9 Billion in Insured Losses
- Losses Not Spread Evenly
  - –10 Insurers – 78%
  - – 3 Insurers – 50%

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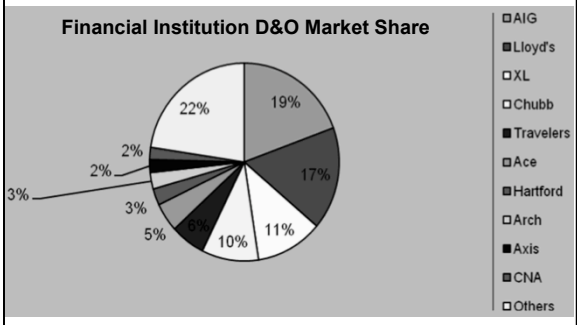
David K. Bradford, Advisen Ltd., The Subprime Mortgage Meltdown, the Global Credit Crisis and the D&O Market, Exhibit 6 (Nov. 4, 2008)

Financial Institution D&O Market Share



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Maximizing D&O Coverage

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- ***Indemnify Directors to the Fullest Extent Possible***

Indemnification

"If the Company is permitted or required by common or statutory law, but fails or refuses, other than for reasons of Financial Impairment, to advance Defense Costs or indemnify the Insured Persons for Loss, then, notwithstanding any other conditions, provisions or terms of this Policy to the contrary, any payment by the Insurer of such Defense Costs or other Loss shall be subject to (1) the Insuring Agreement B Retention Amount set forth in Item 5 of the Declarations, (2) the Coinsurance Percent set forth in Item 6 of the Declarations, and (3) all of the Exclusions set forth in Subsections IV.A. and B of this Policy.

For purposes of this Subsection, the shareholder and board of director resolutions of the Company shall be deemed to provide indemnification for such Defense Costs or other Loss to the fullest extent permitted by law."

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- ***Purchase Stand-Alone, Side A Only Coverage in Addition to the Standard ABC Policy***

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- ***Be Diligent in the Application Process***

Representations and Severability

"In granting coverage under this policy, the Insurer has relied upon the statements and representations in the Application. The Insureds represent that all such statements and representations are true and shall be deemed material to the acceptance of the risk or the hazard assumed by the Insurer under this Policy. This Policy is issued in reliance upon the truth thereof."

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Representations and Severability Cont'd

"The Insureds agree that in the event that any such statements and representations are untrue, this Policy shall not afford any coverage with respect to any of the following Insureds:

1. Any Insured Person who knew the facts that were not truthfully disclosed in the Application,
2. The Company, under Insuring Agreement B, to the extent it indemnifies any Insured Person referenced in (1), above, and
3. The Company, under Insuring Agreement C, if any Executive Officer knew the facts that were not truthfully disclosed in the Application,

whether or not such Insured Person or Executive Officer knew of such untruthful disclosure in the Application."

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- ***Mitigate Impact of Conduct-Based Exclusions***

For example, make exclusion for deliberately fraudulent acts and willful statutory violations applicable only:

"if a judgment or other final adjudication adverse to such Insured Person in the underlying claim establishes that such Insured Person committed such an act, omission or willful violation."

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- ***Negotiate Severability Clauses***

Severability of Exclusions

"No fact pertaining to or knowledge possessed by any Insured Person shall be imputed to any other Insured Person for purposes of applying the exclusions set forth in this Section IV. Only facts pertaining to or knowledge possessed by an Executive Officer shall be imputed to the Company for purposes of applying the exclusions set forth in this Section IV."

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- ***Pay Close Attention to the Retro Date And Any Prior Acts Exclusion***

Prior Acts Exclusion

"The Insurer shall not pay for any **Loss** for any **Claim** based on, arising from or in any way related to any **Wrongful Act** occurring prior to _____ or any **Interrelated Wrongful Acts** thereto."

Hartford Private Choice Encore Policy Form PE 00 H012 02 0904

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"Interrelated Wrongful Acts means all Wrongful Acts that have as a common nexus any fact, circumstance, situation, event, transaction, cause or series of related facts, circumstances, situations, events, transactions or causes."

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- ***Consider Impact of Insured v. Insured Exclusion***

"brought or maintained by or on behalf of the Company or any Insured Person in any capacity except:

a) a Claim that is a derivative action brought or maintained on behalf of the Company by one or more persons who are not Insured Persons and who bring and maintain the Claim without the solicitation, assistance or active participation of the Company or any Insured Person,
b) a Claim brought or maintained by any Insured Person for any actual or alleged employment-related Wrongful Act,
c) a Claim brought or maintained by any Insured Person for contribution or indemnity, if the Claim directly results from another Claim covered under this Policy, or
d) a Claim brought or maintained by any employee of the Company described in Subsection III.H(2)."

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- ***Punitive and Multiple Damages Coverage***

Base Definition of Loss

"Loss does not include … (3) the multiplied portion of any multiplied damage award or punitive or exemplary damages incurred by the Insured Persons …."

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- ***Punitive and Multiple Damages Coverage***

Punitive Damages Endorsement

"Loss shall include punitive and exemplary damages to the extent such damages are insurable under the internal laws of any jurisdiction which most favors coverage for such punitive or exemplary damages and which has a substantial relationship to the **Insureds**, **Insurer**, this **Policy** or such **Claim**."

ACE American Insurance Co., Endorsement PF-15001 (10/03) PNC.

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- ***Restitutionary Damages Coverage***
  - "Loss does not include … (4) matters uninsurable under the law pursuant to which this Policy is construed; provided this definition does not exclude punitive or exemplary damages incurred by the Insureds to the extent such damages are insurable under applicable law."

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- ***Pay Attention to "Change in Control" Provisions and Purchase Tail Coverage When Necessary***

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Acquisition of Parent Company

"If during the Policy Period

a) The Parent Company merges into or consolidates with another organization, or

b) Another organization, or person or group of organizations and/or persons acting in concert acquires securities or voting rights which result in ownership or voting control by the other organization(s) or person(s) of more than 50% of the outstanding securities representing the present right to vote for the election of directors of the Parent Company,

coverage under this Policy shall continue until termination of this Policy but only with respect to Claims for Wrongful Acts taking place prior to such merger, consolidation or acquisition. As of the effective date of such merger, consolidation or acquisition, all premiums paid or due at any time under this Policy shall be deemed fully earned and non-refundable."

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- ***Post-Claim Diligence***
  - **Prompt Notice of Claim**
  - **Broad Notice Letter**
  - ***Cumis* Counsel**
  - **Consent for Settlement**

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THE IMPORTANCE OF AN INTERNATIONAL INSURANCE PROGRAM

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- Why is International Program Business Relevant to Financial and Professional Lines of Business?
- What is an International Program?
- How is an International Program Executed?

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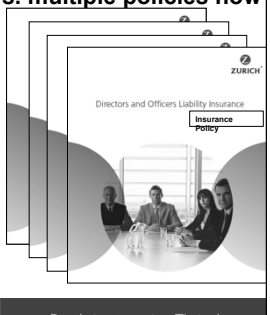
The benefits of an International Program – One policy in the past vs. multiple policies now

How do I ensure a **consistent insurance cover** for all my local operations?

How do I deal with all local **regulatory, legal and tax requirements**?



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Why is International Program Placement important?

Certainty of Coverage

- Some countries **DO NOT** legally permit out-of-territory insurance
  - Different licensing rules pertaining to admitted insurance requirements
  - Sanctions on non-admitted insurance policies including the power to declare a policy void if not compliant

Tax Compliance

- Some countries **DO** permit out-of-territory insurance, but levy foreign premium taxes (FPT) on non-life insurance premiums that must be paid in order for out-of-territory insurance to be considered valid *(Kvaerner Court Decision)*
  - FPT rules vary by territory and by LoB
  - Different parties responsible for payment of taxes
  - Necessity of a licensed tax paying entity

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Regulatory and governance developments

Tangible emerging exposures across the globe are driven by Regulatory & Governance precedents

- **Kvaerner Court Decision**
  - Uncertainty of out-of-territory coverage created by increasing complexity of foreign premium tax (FPT) regulations and licensing laws applicable to the conduct of multinational insurance business
- **Sarbanes – Oxley Act** & Enhanced Shareholder Rights
  - **Japan** is considering draft legislation entitled the "Financial Instruments and Exchange Law," dubbed J-SOX by observers because of its similarity to Sarbanes-Oxley. (*Risk Management Magazine* / January 2007)
  - **Germany** has notched back its securities class action shareholder requirement: formerly 10% stake was required, currently only 1%

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Litigation – Coming to a country near you

- **American-style litigation seeping into other lands**
  - "*There are significant signs that the number of lawsuits is rising,*" said Rick Murray, chief claims strategist at Swiss Re.
  - "*The growth dynamics of the U.S. tort system is driving this development, as U.S. lawyers are expanding their markets by opening offices in Europe*." (Dow Jones Newswire, 23.11.2006)
- **D&Os increasingly sued for**
  - Accounting irregularity
  - Employment-related claims
  - Issues resulting from bankruptcy, M&As
  - Illegal insider trading
- **Risks vary by country, with increasing trends in**
  - South America – Brazil, Argentina & Bolivia
  - U.K., Australia, Japan

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What do regulatory and governance changes mean for companies?

- Retrospective tax liabilities including fines and penalties
- Local authorities may declare sanctions against local operations
- Non-compliant policies may be declared null and void
- Very strict penalties in some overseas jurisdictions that may include imprisonment of offending insurers

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What is an International Program?

International Program is
- an insurance product
- a structure that consists of various policies in various countries (***Program***)
- applicable to policyholders with a need for insurance of its risks outside their home country

→ **International Insurance Program (=Program) is a planned interlocking of local policies, Master policy and reinsurance**

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ACC Association of Corporate Counsel

What are the customer benefits

From uncertainty to certainty	• Transparent underwriting processes and structures that address the increasing complexity of international tax and licensing rules
Certification of taxes paid in each country	• Customers expect global protection whilst addressing Foreign Premium Tax and regulatory obligation • Customers obtain detailed reports, stating when and where taxes have been paid
Improved structure	• The program makes transparent who is liable for taxes • Customers benefit from changes in the program structure, e.g. higher local limits, broader local coverage

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Basic Principles of an International Program

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Basic Principles of an International Program

The Master Policy sets the frame and scope of the program

However… 5 MUSTs to consider:

1. Cover must be provided where the risk is (mainly under the local policies)
2. (Local) mandatory coverage must be provided
3. The company issuing a policy must have a corresponding license
4. Adequate premium must be apportioned to the local policy and the Master Policy
5. Insurance tax must be paid where due: locally and/or under the Master Policy

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TABLE OF CONTENTS

I. INTRODUCTION

Shaken by seismic waves generated by the sub-prime mortgage debacle, the credit crisis, and billion-dollar Ponzi schemes, among others, financial institutions and their directors must now suffer the aftershocks of securities lawsuits seeking damages in the billions. Even if your company is relatively unscathed, the sights and sounds of this debacle have surely rankled your directors' nerves. No director likes to be reminded of the possibility, no matter how remote, of being sued and held personally liable for service on a board.

What do you say to soothe their nerves? You could mention that courts are seemingly leery of investor claims that mismanagement and fraud caused a company's losses when a large portion of the corporate world rode the same elevator to the bottom. Perhaps it would help to point out that the U.S. Supreme Court has ratcheted up civil pleading requirements, and trial courts have taken the decisions seriously by more frequently granting motions to dismiss. Some may find solace in recent decisions from Delaware. But surely your directors most want to hear that you have put in place the broadest indemnification permissible under the law and that the D&O insurance program you have constructed is world-class and will see them safely through even the worst-case scenario.

These materials will first give you an overview of securities class action and other litigation brought against officers and directors in the last couple of years. Then, we shall address significant developments that can be expected to influence new filings and the course of cases over the next several years. With this backdrop, we then turn to the heart of the matter: very practical tips to improve your directors' chances of weathering the storm.

II. THE FINANCIAL LITIGATION ONSLAUGHT[1]

When the housing bubble burst, homeowners with tarnished credit histories created a tsunami of mortgage defaults that swept through the global financial markets in 2007 and 2008, leaving in its wake a host of vulnerable mortgage lenders, hedge funds, investment

[1] We graciously acknowledge that the statistics discussed herein are derived from reports published prior to August, 2009 by NERA Economic Consulting, Advisen Ltd., and Cornerstone Research. For additional information, we highly recommend that you subscribe to these sources.

banks, insurers, and investors.[2] Financial institutions wrote down more than $750 billion in securities backed by subprime mortgages.[3] Faced with the prospect of writing down more, they restricted lending and, with other factors, ignited a credit crisis on a scale not seen since the Great Depression.[4] Adding to the stress was the demise of Bear-Stearns and Lehman Brothers, the AIG debacle involving systemic risk stemming from its financial products division, and high-visibility, high-volume Ponzi schemes, such as Madoff.

A. The First and Second Waves of Litigation, 2006-2008

Lawyers filed individual suits and class actions in 2006 and 2007 on behalf of shareholders, securities investors, plan participants, and a wide variety of other claimants.[5] First to be sued in 2006 and 2007 were the players most directly involved in subprime lending, such as lenders, originators, and home builders.[6] Next in line for 2008 were companies involved in the securitization process, including banks, insurance companies, rating agencies, bond insurers, and pension funds,[7] as well as entities that directed or advised investments in those securities. Investment banks have been hammered by lawsuits in both waves because they are involved in virtually every stage of the origination and securitization process.[8] Auction rate securities[9] have also been a litigation lightning rod in this latest round, with firms that structured or sold them being involved in 20 securities class action suits and 10 securities fraud suits through October 2008.[10]

During 2007 and 2008, the subprime and credit crisis spawned more than 650 major federal and state lawsuits.[11] Fully one-half of the 210 federal securities class actions filed in

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[2] David K. Bradford, Advisen Ltd., *The Subprime Mortgage Meltdown, the Global Credit Crisis and the D&O Market*, 4 (Nov. 4, 2008).
[3] *Id.*
[4] *Id.*
[5] Dr. Faten Sabry, Anmol Sinha, and Sungi Lee, NERA Economic Consulting, *An Update on the Credit Crisis Litigation: A Turn Towards Structured Products and Asset Management Firms*, 5 (Jun. 15, 2009).
[6] Bradford, *supra* note 2 at 8.
[7] *Id.*
[8] *Id.*
[9] Auction rate securities are investments whose interest rates are periodically reset through an auction process. *Id.* Advertised as highly liquid investments, the market for auction rate securities disappeared when the credit markets froze, leaving investors with securities that they could not sell. *Id.*
[10] *Id.*
[11] David K. Bradford, Advisen Ltd., *Securities Litigation in 2008: Implications for the D&O Market in 2009 and Beyond*, 4 (Feb. 25, 2009).

2008 are related to the subprime and credit crisis, and the estimated maximum dollar loss attributable to these 2008 filings is a staggering $856 billion, a 27% increase over 2007.[12] Although the number of shareholder derivative suits decreased from 2007 to 2008 by an estimated 22%, derivative plaintiffs now typically seek substantial monetary damages.[13] Monetary settlements are now becoming both more frequent and larger as exemplified by a September, 2008 derivative suit that AIG executives agreed to settle for $115 million.[14]

Financial firms bore the brunt of the 2008 filings, having been named as defendants in half of the securities class actions and half of all securities lawsuits.[15] To put this into perspective, nearly one-third of all large financial firms in the U.S., representing two-thirds of the industry by market capitalization, were sued in a securities class action in 2008.[16] In addition, financial firms hold 46% of the estimated $856 billion maximum loss for 2008 class action filings.[17] Plaintiffs' lawyers pulled directors and officers into the fray in 62% of "credit crisis" complaints filed in 2008.[18]

The subprime and credit crisis has also generated an impressive number of investigations by regulatory and law enforcement agencies around the world, including 48 investigations by the SEC, 21 investigations by the FBI's Subprime Mortgage Industry Fraud Initiative, and 40 investigations by the Financial Industry Regulatory Authority.[19]

Because the subprime and credit crisis had caused such a spike in securities lawsuits, it may be surprising to hear that the October, 2008 plunge in global stock markets did not trigger an avalanche of filings. Some believe this is because the downturn was so widespread that few companies escaped its impact.[20] As one commentator explained, "the market volatility has been so large that plaintiffs found it difficult to isolate company-specific stock movements that could be alleged to be the result of fraudulent activity from the

[12] Cornerstone Research, *Securities Class Action Filings, 2008: A Year in Review*, 4, 12 (2009).
[13] Bradford, *supra* note 11 at 14.
[14] *Id.*
[15] *Id.* at 6.
[16] Cornerstone Research, *supra* note 12 at 2.
[17] *Id.*
[18] Sabry, Sinha, and Lee, *supra* note 5 at 4.
[19] Bradford, *supra* note 2 at 10.
[20] Bradford, *supra* note 11 at 11.

noise generated by a market that could swing 5 percent in a single day."[21] Another theory is that the major financial players had already been sued during the 2007-2008 flurry of class action filings arising out of the subprime and credit crisis.[22]

However, having begun as a lion, the year 2008 did not go out like a lamb. Bernie Madoff was arrested on December 11, 2008, and lawyers managed to file 37 Madoff-related lawsuits before the end of the year, 29 of which are securities suits.[23] Through the second quarter of 2009, the total number has increased to 189.[24]

Outside of the financial sector, the year 2008 was largely uneventful with average filings against the usual defendants. IT companies were sued in approximately 12% of 2008 securities cases, and life sciences companies (including pharmaceutical and biotechnology companies) accounted for 5% of total filings.[25] The healthcare industry came in at 4%.[26]

B. Litigation in 2009

Cornerstone reports that the first half of 2009 saw 87 total securities class action filings in federal court, of which only 35 were filed in the second quarter. On an annualized basis, this is a 22% decrease from 2008.[27] NERA and Cornerstone agree that financial firms continued to shoulder the heaviest burden as defendants in more than 60% of 2009 federal securities class actions.[28] They also agree that more than 40% of 2009 federal securities class actions relate to the subprime and credit crisis.[29]

Seemingly at odds with the drop in filings reported by Cornerstone during the second quarter of 2009 is the precipitous increase in the estimated maximum dollar loss. According

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[21] Cornerstone Research, *supra* note 12 at 3.
[22] *Id.* at 9.
[23] Bradford, *supra* note 11 at 7.
[24] John W. Molka, III, CFA, Advisen Ltd., *Securities Litigation Drops in Q2 2009, An Advisen Quarterly Report - Q2 2009*, 10 (2009).
[25] Bradford, *supra* note 11 at 8.
[26] *Id.*
[27] Cornerstone Research, *Securities Class Action Filings*, 2009 Mid-Year Assessment, 2, 4 (2009). Most likely due to a difference in how filings are classified, NERA Economic Consulting ("NERA") reports 127 federal securities class action filings during the same period, on an annualized basis, on par with 2008. Stephanie Planchic, PhD, and Svetlana Starykh, NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2009 Mid-Year Update*, 1 (July 2009).
[28] Planchic & Starykh, *supra* note 27 at 6; Cornerstone, *supra* note 27 at 2.
[29] Planchic & Starykh, *supra* note 27 at 3; Cornerstone, *supra* note 27 at 4.

to Cornerstone, the estimated dollar loss for securities class actions filed in the first half of 2009 is $429 billion, 22.2% higher than the second half of 2008.[30] Seven "mega-filings" accounted for a whopping $367 billion, with five exceeding $25 billion each.[31] Three of the seven mega-filings are related to the credit crisis, according to Cornerstone.[32]

Including all state and federal securities-related lawsuits, rather than just federal securities class actions, Advisen reports 361 filings through the second quarter of 2009, which on an annualized basis marks a 28% increase from 2008.[33] Filings dropped significantly from the first to second quarter of 2009.[34] Advisen attributes the heavy volume in the first quarter to Madoff filings, and theorizes that the lull in second-quarter filings may be a result of law firms concentrating on the flood of suits filed in the first quarter.[35] Supporting this theory is an uptick in filings observed during the first few weeks of the third quarter.[36] Advisen believes that the wave of Madoff and sub-prime suits may have crested in the first quarter of 2009, but that businesses outside of the financial services sector will be impacted in the next wave of securities litigation that will surely flow from the increasing number of bankruptcies.[37]

Federal class action filings against companies outside the financial sector have continued to be essentially flat through the first half of 2009.[38]

C. Evolution of Securities Litigation

Another interesting development in 2008 and 2009 is the metamorphosis of securities class action complaints into pleadings exceeding 100 pages and asserting, in addition to traditional theories, novel, often common-law theories sounding in tort, contract and breach of fiduciary duty.[39] Defense lawyers theorize that the complaints are longer and more

[30] Cornerstone, *supra* note 27 at 11, 13.
[31] *Id.*
[32] *Id.*
[33] Molka, *supra* note 24 at 1.
[34] *Id.* at 1.
[35] *Id.* at 2.
[36] *Id.*
[37] *Id.* at 7.
[38] Planchic & Starykh, *supra* note 27 at 3.
[39] Bradford, *supra* note 11 at 4.

complex because the facts are more complicated; class action attorneys are attempting to distinguish their suits to avoid consolidation with similar suits; and detailed complaints may be more likely to survive a motion to dismiss, especially post-*Twombly* and *Iqbal*.[40] A significant increase in defense costs is an inevitable result of lengthier pleadings and novel, complex liability theories.[41]

Only time will tell whether the new liability theories will pass judicial muster under the heightened judicial scrutiny of pleadings described in Section III, *infra*. However, the statistics are promising from the first batch of 48 subprime and credit crisis cases resolved through March, 2009. Courts granted complete dismissals of 48% and partial dismissals of 4%, while plaintiffs voluntarily dismissed 13%, and parties settled 15%.[42]

There are two beacons of light for companies that find themselves as defendants in securities lawsuits. First, courts are scrutinizing filings more carefully from the outset. Second, outside of the financial sector, D&O insurers are still clamoring for your company's business and are more than willing to underwrite business risks in the toughest environment that the insurance industry has experienced in decades.

III. THE PLAINTIFFS' MORE DIFFICULT ROAD TO RECOVERY

A. Heightened Pleading Requirements Under PLSRA, *Twombley*, and *Iqbal*

Although experiencing a slight decline in 2008, claims under Section 10(b) of the Securities and Exchange Act of 1934 and SEC Rule 10b-5 remain the most common claims asserted in securities litigation, including litigation arising out of the subprime and credit crisis.[43] The primary obstacle to recovery for securities plaintiffs is the heightened pleading requirements of the Private Litigation Securities Reform Act ("PLSRA"),[44] an act passed in 1995 to curb perceived abuses in private securities litigation. The PLSRA requires that plaintiffs describe in detail the allegedly misleading statements, state the reasons why the

[40] *Id.* at 10; *see Ashcroft v. Iqbal*, __ U.S. __, 129 S.Ct. 1937 (2009), and *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007). A discussion of *Iqbal* and *Twombly* follows in § III, *infra*.
[41] Bradford, *supra* note 11 at 16.
[42] Sabry, Sinha & Lee, *supra* note 5 at 15.
[43] Cornerstone Research, *supra* note 12 at 21.
[44] 15 U.S.C. § 78u-4 *et seq.*

statement is false, and, if an allegation is made on the basis of information or belief, state with particularity all facts forming such a belief.[45] Plaintiffs must also "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," commonly referred to as the scienter requirement.[46] Finally, plaintiffs are required to show that the defendants' alleged false statements or wrongful conduct proximately caused the claimed economic loss, referred to as the "loss causation requirement."[47]

The federal courts take these pleading requirements seriously. They are significant new weapons in the fight against securities lawsuits arising out of the subprime and credit crisis.[48]

Plaintiffs also have to contend with the Supreme Court's recent tightening of the pleading requirements applicable to all civil actions in *Twombly*[49] and *Iqbal*.[50] Rule 8(a)(2) of the Federal Rules of Civil Procedure provides that a pleading must contain a "short and plain statement of the claim showing that the pleader is entitled to relief." For decades, federal courts followed the admonition in *Conley v. Gibson*[51] that a complaint should not be dismissed at the pleading stage unless the court finds "beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." In *Twombly*, the Court concluded that, "[w]hile a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations, … a plaintiff's obligation to provide the grounds of his entitlement to relief requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do."[52] Stated somewhat differently, a complaint that offers "naked assertions" without "further factual enhancement" is

[45] § 78u-4(b)(1); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).
[46] § 78u-4(b)(2).
[47] § 78u-4(b)(4); *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005).
[48] Plaintiffs claiming false or misleading statements in SEC registrations can avoid the heightened pleading requirements under the PSLRA by filing a claim in state court under Sections 11 and 12(a)(2) of the Securities and Exchange Act of 1933. *See* 15 U.S.C. § 77(a) *et seq*. Insurance coverage for Section 11 claims is discussed in Section VI, *infra*.
[49] 550 U.S. 544.
[50] 129 S.Ct. 1937.
[51] 355 U.S. 41, 45-46 (1957).
[52] *Twombly*, 550 U.S. at 555 (internal quotation marks and citations omitted).

insufficient.[53] The Court addressed the matter further in *Iqbal*, explaining that under *Twombly* a complaint must allege facts sufficient to state a claim that is "plausible on its face" and allow "the court to draw the reasonable inference that the defendant is liable for the misconduct alleged."[54] Rule 8 "does not require 'detailed factual allegations,' but it demands more than an unadorned, the defendant-unlawfully-harmed-me accusation," and the "mere possibility of misconduct" is insufficient to state a plausible claim for relief.[55]

B. The Scienter Requirement and Loss Causation

Even prior to the enactment of the PLSRA, a private cause of action under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 would not survive a motion to dismiss unless it alleged that the defendant acted with the intent to deceive, manipulate, or defraud.[56] Complaints are insufficient unless supported by particular facts giving rise to a "strong inference" of scienter on the part of each defendant with respect to each alleged violation.[57] In 2007, the Supreme Court held in *Tellabs*[58] that a "strong inference" of scienter means an inference that is "cogent and at least as compelling as any opposing inference that one could draw from the facts alleged."[59] Accordingly, *Tellabs* mandates that trial courts consider all of the facts and allegations as a whole and dismiss cases where the exculpatory inferences are stronger than inferences of scienter.[60]

The scienter requirement can prove to be formidable for plaintiffs in securities cases arising out of the subprime and credit crisis, as exemplified by *Hubbard v. BankAtlantic Bancorp, Inc*.[61] In *Hubbard*, a class of stock purchasers alleged that BankAtlantic, and certain officers and directors, made a series of false and misleading statements regarding the company's highly-concentrated portfolio of under-collateralized land development loans, which artificially affected the value of the company's stock. In support of these allegations, confidential witnesses (former employees) testified that (1) the company engaged in

[53] *Id.* at 557.
[54] *Iqbal*, 129 S.Ct. at 1950.
[55] *Id.* (quoting *Twombly*, 550 U.S. at 555).
[56] *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976).
[57] *See* 15 U.S.C. § 78u-4(b)(2)(2000); *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1238 (11th Cir. 2008).
[58] 551 U.S. at 324-25.
[59] *Id.* at 324.
[60] *Id.* at 325.
[61] 2008 WL 5250271 (S.D. Fla. Dec. 12, 2008).

inappropriate underwriting practices, documented in monthly reports that were circulated to the individual defendants; and (2) it was otherwise "common knowledge" that the company was heavily invested in loans subject to default with inadequately funded reserves. Plaintiffs contended that the individual defendants made a series of public statements describing the company's lending practices as "conservative" and "prudent," without revealing the risks associated with the real estate loans.[62]

Defendants moved to dismiss the complaint for, among other things, failure to properly plead scienter under the PLSRA. The district court found that the complaint alleged misrepresentations and omissions with sufficient detail, but failed to allege a "strong inference" of scienter.[63] Noting that, under *Tellabs*, a "strong inference" of scienter must be at least as compelling as any exculpatory inference to survive a motion to dismiss, the court examined the specific allegations and supporting evidence and ultimately concluded scienter was not established.[64] According to the court, the complaint did not contain particular facts showing that the individual defendants acted with knowledge of the allegedly deficient underwriting practices at the time the representations were made.[65] Specifically, there was no allegation that the individual defendants actually received the monthly reports or other specific information concerning the bad loans, and conclusory allegations of common knowledge within the company were insufficient.[66] Moreover, the court dismissed any notion that scienter can be shown simply by virtue of the fact that the individual defendants held high-ranking positions.[67]

Hubbard is not an anomaly. In fact, a plethora of courts from across the United States have not hesitated to dismiss securities claims based upon generalized, conclusory

[62] *Id.* at **2-7.
[63] *Id.* at **11-18; *see* 15 U.S.C. § 78u-4(b)(1)(2000)(requiring that complaint specify each misleading statement, explain why statement was false or misleading, and state with particularity facts forming the basis for any facts pled based upon information and belief).
[64] *Hubbard*, 2008 WL 5250271, at **12, 18.
[65] *Id*. at **11-18.
[66] *Id*. at **13-14.
[67] *Id.*

allegations rather than detailed facts showing the individual defendant knew or had access to information contradicting public statements regarding the company's financial status.[68]

In addition to this stringent pleading requirement, plaintiffs must also contend with the loss causation requirement that a defendant's alleged false statements or wrongful conduct must proximately cause the claimed economic loss.[69] In *Dura*,[70] the Supreme Court held that merely alleging or proving the purchase of stock at an artificially inflated price is insufficient to establish loss causation. Instead, plaintiffs must show that a decline in the price of the stock is tied to the disclosure of the truth to the public.[71] Importantly, the Court acknowledged that showing causation is especially problematic when the lower price is attributable, in whole or in part, to changed economic circumstances or other factors aside from the alleged misrepresentation.[72] *Dura* can present a steep, uphill battle for plaintiffs

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[68] *See, e.g., In Re Ceridian Corp. Sec. Litig.*, 542 F.3d 240, 246 (8th Cir. 2008) (rejecting contention that sheer number of GAAP violations and magnitude of restatements created inference of recklessness, and finding that the fact that officers sold shares during class period for first time in four years and earned bonuses based on revenue growth was not sufficient, by itself, to create a strong inference of scienter); *Metzler v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1068 (9th Cir. 2008) (finding management's general awareness of company's daily operations insufficient to establish scienter without evidence showing each defendant received specific information relating to inappropriate accounting practices); *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1247-54 (11th Cir. 2008) (finding evidence of widespread fraud insufficient to show scienter without proof that senior officers had actual knowledge of alleged inappropriate accounting practices); *In Re Verifone Holdings, Inc. Sec. Litig.*, No. C07-06140) (N.D. Cal. May 26, 2009) (dismissing complaint because plaintiffs failed to allege particular facts showing management had actual knowledge of inappropriate accounting practices, and mere fact that defendants sold majority of their shares at profit during class period was insufficient without evidence that transactions dramatically departed from prior trading history); *In Re Impac Mortgage Holdings, Inc. Sec. Litig.*, 554 F. Supp. 2d 1083, 1101 (C.D. Cal. 2008) (holding that "voluminous conclusory allegations" regarding defendants' knowledge of falsified statements was insufficient without detailed allegation that they had actual knowledge of fraud); *Tripp v. Indymac Financial, Inc.*, 2007 WL 4591930 at **3-5 (C.D. Cal. Nov. 29, 2007) (generalized allegations that underwriting and internal control problems were widely known throughout company insufficient to show scienter); *but see Atlas v. Accredited Home Lenders Holding Co.*, 556 F. Supp. 2d 1142, 1156 (S.D. Cal. 2008) (concluding that plaintiffs sufficiently alleged inference of scienter with detailed allegations that directors and officers knew of widespread deviations from company's standard underwriting and loan origination practices); *accord In Re Countrywide Financial Corp. Derivative Litig.,* 554 F. Supp. 2d 1044, 1057-66 (C.D. Cal. 2008) (strong inference of scienter existed where plaintiffs alleged detailed facts showing defendants' knowledge that company had abandoned company-wide underwriting practices while making representations regarding the strength of company's financial status, quality of loans, and loan origination process).

[69] § 78u-4(b)(4)(2000).

[70] 544 U.S. at 342-43.

[71] *Id.*

[72] *Id.* at 343. *Dura* was decided in an effort to resolve a conflict among jurisdictions regarding what exactly plaintiffs had to show in order to prove loss causation. Prior to *Dura*, the Ninth Circuit adopted the rule that a plaintiff only needed to show that the price on the date of purchase was artificially inflated. Other jurisdictions held that an inflated purchase price alone was not sufficient to show loss causation in the absence of evidence that the price declined due to a corrective disclosure. *See generally Dura,* 544 U.S. at 340.

filing suit in the aftermath of the subprime and credit crisis, as exemplified by the Tenth Circuit's recent ruling *In Re Williams Sec. Litig.*[73]

In *Williams*, the Williams Company, Inc. ("WMB") formed Williams Communications Group ("WCG") in an effort to re-enter the telecommunications market. After two years, WMB announced that it would spin-off WCG as a stand-alone company. Plaintiffs alleged that officers of WMB and WCG induced the purchase of securities by publicly touting WCG's ability to operate as a profitable, independent company, despite internal information indicating the spin-off was due to WCG's increasing capital needs and dwindling income.[74] Over the next year, the value of WCG's stock declined from $28.50 to $2.35 per share.[75] In January 2002, WMB issued a press release announcing the delay of its 2001 earnings pending assessment of WMB's contingent obligations with respect to WCG. One month later, two more press releases announced that WCG was possibly facing default and considering bankruptcy.[76] In April, 2002, WCG finally filed bankruptcy. During this four-month period, WCG's shares dropped from $2.35 to $0.06 per share.[77]

Plaintiffs' loss causation expert advanced two theories. The first was that, because corrective disclosure occurred gradually from the time of the spin-off until the bankruptcy filing, the entire loss in value was attributable to the misstatements. The expert's second theory was that the decline of the stock price after the four 2002 public press releases were "materializations of the concealed risks."[78]

The district court granted the defendants' motion for summary judgment, based in part on its conclusion that the plaintiffs failed to prove loss causation. The Court of Appeals affirmed, finding that the decline in stock price following the series of press releases was insufficient to prove causation absent proof of a specific public disclosure relating directly to the alleged misstatements.[79] In reaching its conclusion, the Court noted that the plaintiffs'

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[73] 558 F.3d 1130 (10th Cir. 2009).
[74] *Id.* at 1132-34.
[75] *Id*. at 1133-34.
[76] *Id*. at 1134.
[77] *Id*.
[78] *Id.* at 1135-36.
[79] *Id.* at 1137-43.

expert failed, under both theories of causation, to take into account factors which were not related to the fraud and which could have influenced the declining price of the stock, such as the fact that the telecommunications industry as a whole was experiencing significant losses. Citing *Dura*, the Court found that the expert's conclusion - that the decline in the stock price "must have" been caused by the revelation of fraud and not by the "tangle of factors" that otherwise could have affected the price - was insufficient to satisfy the loss causation requirement.[80]

The result reached in *Williams* is not atypical. Indeed, other courts, relying on *Dura*, have dismissed claims because plaintiffs could not prove loss causation in a market characterized by universal declines, especially where market movements could not be tied directly to corrective disclosures.[81] NERA reports an uptick of approximately 5% in the dismissal rate of securities cases decided since *Dura* and predicts that plaintiffs filing securities cases based upon the subprime and credit crisis "may face challenges demonstrating loss causation related to specific corrective disclosures, given the extreme volatility and large price declines in the markets generally and the major negative finance industry shocks."[82]

C. Derivative Actions: Futility, Business Judgment and Exculpation

The road to recovery in derivative actions has also become more difficult over the past few years. Plaintiffs in derivative actions face significant obstacles due to the triumvirate of the demand futility rule, the business judgment rule, and the statutory

[80] *Id.* at 1139-42.

[81] *See, e.g., In Re Omnicom Group, Inc. Sec. Litig.,* 541 F. Supp. 2d 546, 553-54 (S.D.N.Y. 2008) (granting summary judgment to defendants because plaintiffs failed to show stock decline was caused by corrective disclosures directly related to fraud rather than other negative information simultaneously released to market); *In Re Redback Networks, Inc. Sec. Litig.,* 2007 WL 4259464, **4-5 (N.D. Cal. 2007) (loss causation not shown where stock price actually closed higher on day of disclosure, only to decline eleven days later while entire telecommunications industry was experiencing a decline); *Joffee v. Lehman Brothers, Inc.,* 410 F. Supp. 2d 187, 192-93 (S.D.N.Y. 2006) (finding plaintiffs failed to prove misrepresentations caused loss where decline in stock price of medical company was attributable, at least in part, to decreased demand for laser surgery procedures); *In Re Acterna Corp. Sec. Litig.,* 378 F. Supp. 2d 561, 588 (D. Md. 2005) (loss causation not shown where decline in share price "was not a result of the alleged fraud being revealed, but rather a continuation of the rapid decline that began due to the economic slowdown commencing in 2001."); *In Re Cree, Inc. Sec. Litig.,* 2005 WL 1847004, at **11-12 (M.D.N.C. 2005) (loss causation not shown where decline in stock price was attributable to factors other than fraud and corrective disclosure).

[82] Planchic & Starykh, *supra* note 27 at 2, 18.

immunity provided to directors. In addition, corporate indemnification provisions, and the generosity with which courts interpret them, provide an extra layer of protection. No state offers a better illustration of these concepts, and their recent impact on derivative suits, than Delaware.

Delaware law requires, as a prerequisite to a derivative suit, that the plaintiff make a formal demand upon the board to bring the action, unless such a demand would be futile.[83] The demand futility rule is an important defense. For example, in *DiLorenzo v. Norton*,[84] the District of Columbia recently applied Delaware law to dismiss with prejudice a derivative suit filed over the alleged improper backdating of stock options by ePlus directors for failure to show demand futility, even though at least half of the directors had either received options or had been involved in granting them. The court readily acknowledged two Delaware Chancery Court opinions from 2007, *Ryan v. Gifford*[85] and *Conrad v. Blank*,[86] holding that a plaintiff satisfies the demand futility rule by alleging that a majority of the directors received backdated options or participated in granting them.[87] However, the court explained, the Delaware Supreme Court held more recently in 2008 that, where "a board of directors is protected from monetary damages by an exculpation clause, 'then a serious threat of liability may only be found to exist if the plaintiff pleads a non-exculpated claim against the directors based on particularized facts."[88] Because the ePlus directors were protected by such an exculpation clause, the plaintiff could not establish demand futility by a showing that the directors were not disinterested absent specific allegations "that a majority of the directors either received backdated options, or *knowingly* participated in the granting or concealment of backdated options, in violation of their duty of loyalty."[89] While the complaint alleged that a majority of the directors approved the stock option grants, the fatal flaw was its failure to allege culpable knowledge or bad faith.[90]

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[83] Del. Ch. Ct. R. 23.1.
[84] Civil Action No. 07-144 RJL (D.D.C. July 31, 2009).
[85] 918 A.2d 341 (Del. Ch. 2007).
[86] 940 A.2d 28 (Del. Ch. 2007).
[87] *DiLorenzo*, Civil Action No. 07-144 , slip op. at 12.
[88] *Id.* at 14 (quoting *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008)).
[89] *Id.*
[90] *Id.* at 18.

Another recent example of the demand futility rule's potency is the July 16, 2009 decision by the Supreme Court of the State of New York dismissing a derivative suit that challenged the sale of Quadra Realty Trust, Inc. ("Quadra").[91] The plaintiff failed to allege that a demand, or a delay in awaiting a response to a demand, would have caused irreparable harm.[92] In addition, the plaintiff did not "plead the personal and direct conflict required for application of the demand-futility exception."[93] The complaint merely contained summary allegations that the directors placed their interests ahead of Quadra and engaged in wrongdoing, with no supporting facts and no attempt to distinguish among the directors and the roles that they allegedly played in the wrongdoing.[94]

Even assuming that a plaintiff satisfies the demand futility pleading requirement, he must also plead facts sufficient to overcome the business judgment rule and its presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[95] Finally, the Delaware Code[96] permits corporations to exculpate directors from personal liability for breaches of the fiduciary duty of care, but not for breaches of the duty of loyalty or good faith and certain other conduct.[97] If a defendant corporation has a Section 102(b)(7) provision in its charter, as many do,[98] plaintiffs cannot hold the directors personally liable absent detailed facts showing that the directors violated their duty of loyalty or good faith in the decision-making process.[99]

A good explication of the deference given to boards, as well as the importance of exculpatory provisions in charters, is found in the Delaware Supreme Court's recent decision

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[91] *Swope v. Quadra Realty Trust, Inc.*, Index No. 600381/08, slip op. at 17-19 (N.Y. Sup. Ct. July 16, 2009).
[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
[96] Del. Code Ann. tit. 8, § 102(b)(7)(2002).
[97] *Malpiede v. Townson*, 780 A.2d 1075, 1093-94 (Del. 2001). It is important to note that § 102(b)(7) does not apply to officers, employees, or agents. An individual who is both an officer and a director may be liable as an officer for implementing a decision for which he is not liable as a director for approving. Karl E. Stauss, *Indemnification in Delaware: Balancing Policy Goals And Liabilities*, 29 Del. J. Corp. L. 143, 149 (2004).
[98] E. Norman Veasey, *An Economic Rationale For Judicial Decisionmaking In Corporate Law*, 53 Bus. Law 681, 691 (1998).
[99] *Malpiede*, 780 A.2d at 1094-96.

in *Lyondell Chemical Co. v. Ryan*.[100] The *Lyondell* shareholders filed a derivative action alleging that its directors breached the duties of care, loyalty, and candor by approving an all-cash merger offer from Basell AF ("Basell"). The trial court rejected all claims except those alleging that the directors breached their duties of care and loyalty because of alleged flaws in the negotiation process and deficiencies in the merger agreement's deal protection provisions.[101] Summary judgment was not proper on those claims, according to the trial court, because the evidence suggested that the board (1) took no action to prepare for possible acquisition proposals after an SEC filing by Basell that publicly announced its interest in acquiring Lyondell; (2) negotiated and finalized the merger in one week, after meeting for a total of only seven hours; and (3) failed to press for a better price or conduct even a limited market check.[102] The Delaware Supreme Court reversed, finding that the directors were entitled to summary judgment on all counts.

The Supreme Court quickly narrowed the legal issues to one, starting with the well-known premise that, pursuant to *Revlon v. MacAndrews & Forbes Holdings, Inc.*,[103] a board "'must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise.'"[104] The Supreme Court held that the claim for breach of the duty of care had to fail because Lyondell's charter included an exculpatory provision protecting the directors from personal liability for duty of care breaches, as authorized by Section 102(b)(7).[105] And since the trial court determined that the board was independent and not motivated by self-interest or ill will, "the sole issue" became "whether the directors are entitled to summary judgment on the claim that they breached their duty of loyalty by failing to act in good faith."[106] Bad faith, the Supreme Court explained, is a narrow concept that encompasses only actual intent to harm, gross negligence, and the intentional dereliction of one's responsibilities.[107]

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[100] 970 A.2d 235 (Del. 2009).
[101] *Id.* at 239-40.
[102] *Id.* at 241.
[103] 506 A.2d 173 (Del. 1986).
[104] *Lyondell*, 970 A.2d at 239 (quoting *Revlon*, 506 A.2d at 182).
[105] *Id.* at 239-40.
[106] *Id.* at 240.
[107] *Id.*

Before turning to the issue of whether the board acted in bad faith, the Supreme Court first found two mistakes in the trial court's interpretation of *Revlon* and its progeny. First, the trial court erred in finding that *Revlon* permitted a critique of conduct that occurred before receipt of the merger offer from Basell, such as the board's alleged failure to prepare for possible proposals in light of Basell's profession of interest in Lyondell in an SEC filing.[108] This is because the *Revlon* duty to seek the best available price "applies only when a company embarks on a transaction -- on its own initiative or in response to an unsolicited offer -- that will result in a change of control."[109] The trial court also erred because "there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties."[110]

More importantly, the fundamental mistake of the trial court was that it simply "approached the record from the wrong perspective" when determining the sufficiency of the board's conduct.[111] Instead of asking whether the directors "knowingly and completely" failed to attempt to obtain the best sale price, as required for bad faith, the trial court asked whether the directors "did everything that they (arguably) should have done to obtain the best sale price," as required for duty of care violations.[112] Even if the trial court was correct that the directors could have done more, they "clearly" satisfied their duty of loyalty by (1) meeting several times to consider Basell's offer; (2) being "generally aware" of the value of their company and the relevant market; (3) soliciting and following the advice of their financial and legal advisors; (4) attempting to negotiate a higher offer even though Basell had offered a "blowout" price; and (5) approving the merger because "it was simply too good not to pass along to the stockholders for their consideration."[113] For these reasons, the Supreme Court found that the directors were entitled to a complete dismissal of all claims.[114]

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[108] *Id.* at 242.
[109] *Id.*
[110] *Id.*
[111] *Id.* at 244.
[112] *Id.*
[113] *Id.* at 244.
[114] *See also Wayne County Employees' Retirement System v. Corti*, Civil Action No. 3534-CC (Del. Ch. July 24, 2009) (citing *Lyondell*, dismissing *Revlon* claims against directors for alleged inadequacies in negotiating and agreeing to sale of control of Activision, Inc.).

In Re Citigroup, Inc. Shareholder Derivative Litigation[115] applied the *Lyondell* teachings in the subprime context. The *Citigroup* plaintiffs alleged that the directors breached their fiduciary duties by failing to properly monitor and manage risks associated with the subprime lending market and failing to properly disclose Citigroup's alleged $55 billion exposure to subprime assets.[116] Plaintiffs also alleged that the directors ignored red flags signaling the worsening condition of the subprime and credit markets, as well as the negative effects such conditions had on Citigroup's peers.[117]

In its order dismissing the complaint, the court first explained that the protection afforded to the directors by Citigroup's Section 102(b)(7) exculpatory provision, together with the business judgment rule, placed an extremely high burden upon plaintiffs to state a claim for personal director liability.[118] The complaint was insufficient because it contained only generalized, conclusory accusations rather than particularized facts showing the directors had actual knowledge that corporate oversight mechanisms were inadequate or that the company was otherwise engaged in wrongdoing.[119] The court reasoned that generalized knowledge of a deteriorating subprime mortgage market does not amount to knowledge or awareness of actual wrongdoing.[120] A contrary ruling, the court explained, would undermine the business judgment rule because a director should not be held personally liable for making decisions that, in hindsight, turned out poorly for the company.[121]

If *Lyondell*, *Williams*, and *Citigroup* are emblematic of the courts' approach to the onslaught of cases from the subprime mortgage and credit crisis, perhaps the eventual result of this litigation will be considerably less than currently forecast. It remains to be seen how influential these decisions will be in the various state supreme courts as they address analogous issues under their respective state codes.

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[115] 964 A.2d 106 (Del. Ch. 2009).
[116] *Id.* at 112-13.
[117] *Id.* at 113-14.
[118] *Id.* at 124-25.
[119] *Id.* at 128-35.
[120] *Id.* at 127-29.
[121] *Id.* at 129-30.

D. The Broad Scope of Corporate Indemnification

An added layer of protection for directors is the broad scope of corporate indemnification. Sections 145(a) and (b) of the Delaware Code permit a corporation to indemnify its officers and directors for (1) settlements, judgments and attorneys' fees incurred as a result of third-party actions, so long as the officer or director acted in good faith and in a manner reasonably believed to be in the best interests of the corporation; and (2) attorneys' fees and expenses, but not settlements and judgments, incurred as a result of derivative actions. In addition, Section 145(c) requires indemnification for defense costs and attorneys' fees if the director is successful on the merits in defending a third-party action and/or a derivative action.[122]

Delaware courts construe indemnification provisions broadly in favor of the officer or director, as illustrated by *Stockman v. Heartland Industrial Partners, L.P.*[123] In *Stockman*, two officers filed suit after Heartland, a limited liability partnership, refused to indemnify them for defense costs incurred in a criminal proceeding, even though the court dismissed the proceeding without prejudice at the request of the U.S. Attorney. The indemnification provision in the organizational documents stated that indemnity was available

> only to the extent that such Indemnitee's conduct (A) was in or was not opposed to the best interests of the Partnership, (B) in the case of a criminal action or proceeding, the Indemnitee had no reasonable cause to believe his conduct was unlawful, or (C) did not constitute fraud, bad faith, willful misconduct, gross negligence, a violation of applicable securities laws or any material breach of the Agreement or the Advisory Agreement ....[124]

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[122] Del. Code Ann. tit. 8, § 145(c) (1983). Notably, Section 145 does not authorize indemnification of settlements or judgments in suits brought by or on behalf of the corporation (including derivative suits). Whereas Section 145(a) expressly refers to "expenses (including attorneys' fees), judgment, fines and amounts paid in settlement," Section 145(b), which encompasses derivative actions, only refers to "expenses (including attorneys' fees)." This limitation is intended to avoid the circularity which would result if funds received by the corporation were simply returned to the person who paid them. *Arnold v. Society for Savs. Bancorp, Inc.*, 672 A.2d 533, 540 (Del. 1996); Dennis J. Block & Stephen A. Radin, *Indemnification and Insurance of Corporate Officials-The Corporate Counselor's Deskbook*, § 2.02[D] at pp. 32-33 (5th ed. 2004).

[123] 2009 WL 2096213 (Del. Ch. 2009).

[124] *Id.* at *3.

Heartland argued that, even though the criminal charges were dismissed without prejudice, the officers must still prove their conduct was commensurate with the standard of conduct described in the provision.[125]

Although limited partnerships are given greater freedom to craft their indemnification provisions than corporations under Section 145, the court interpreted the provision in light of Section 145's statutory framework because the court found that the provision incorporated language very similar to that found in Section 145.[126] The court construed the provision as requiring proof of satisfactory conduct only in the event of an unfavorable outcome or a settlement without Heartland's consent.[127] The court explained that this interpretation is entirely consistent with the primary intent of Section 145 to police the availability of indemnification only where the indemnitee has suffered an adverse judgment, admitted to a breach of duty, or settled a case for money.[128]

Stringent pleading and evidentiary requirements will undoubtedly result in the dismissal of some securities fraud and derivative actions arising out of the subprime and credit crisis. For others, directors should benefit from indemnification and exculpatory provisions found in their partnership agreements or corporate charters. The final question thus becomes whether the D&O insurer will ultimately pick up the tab for everyone's losses.

IV. THE BROAD SCOPE OF D&O INSURANCE COVERAGE

Standard D&O insurance policies typically provide three forms of claims-made coverage often referred to as Sides A, B, and C. Side A protects directors and officers for loss resulting from "claims" alleging "wrongful acts," but only if the insured entity cannot provide indemnification. Side B covers losses incurred by the insured company when it indemnifies directors and officers for "claims" alleging "wrongful acts." Side C indemnifies the company for claims made directly against it. The scope of Side C coverage, otherwise known as "entity coverage," varies significantly from policies that restrict coverage to

[125] *Id.* at *12.
[126] *Id.* at **8-9. Indemnification provisions in partnership agreements are governed by Del. Code Ann. tit. 6, § 17-108 (2009), which provides that "a limited partnership may, and shall have the power to, indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever."
[127] *Id.* at **16-17.
[128] *Id.* at *17.

securities-related claims to others that broadly cover claims alleging "wrongful acts" by the company. Some policies provide only Sides A and B coverage. More recently, excess Side A/DIC [Difference in Conditions] policies have also garnered a significant percentage of the marketplace. They are discussed below. Finally, D&O coverage is sometimes bundled with fiduciary liability [ERISA], commercial crime, or EPLI [Employment Practice Liability] coverages.

The scope of "wrongful acts" coverage provided by these insuring clauses, when viewed separately from the exclusions, is seemingly all-encompassing. Indeed, the term "wrongful act" is typically defined broadly to include, for example, "any actual or alleged breach of duty, neglect, error, misstatement, misleading statement, omission or act." The categories of claims that may trigger coverage include securities lawsuits, derivative actions, antitrust or environmental lawsuits naming individuals,[129] as well as simple business torts such as false advertising, commercial fraud and negligence, and intentional interference with prospective business advantage. Because of the broad scope of coverage available under Side C in some policies, all business tort complaints, whether or not naming individuals, should be analyzed for coverage under a D&O policy.

Oft-repeated is the unfortunate remark that private companies do not need D&O insurance. This is not true. Directors and officers of private companies owe similar duties to their shareholders as their counterparts in publicly-held corporations. While the risk of being sued may be smaller in a private company, the risk is still not worth taking when the personal assets of the directors and officers are the potential sacrifice. Consider also that D&O policies cover claims asserted by a host of claimants other than shareholders, such as employees, competitors, regulators, creditors, suppliers, and customers. Chubb conducted a random survey of 451 privately-held companies in 2005 and determined that 26% of the companies or their directors or officers had been sued in the past few years by a customer, government agency, vendor, or partner/shareholder.[130] Finally, corporate indemnification is

[129] Many policies extend coverage to "employees" as well as officers and directors. Sometimes, "employees" are insured persons only if at least one officer or director is also named as a defendant.
[130] Chubb Group of Insurance Companies, *What is D&O Insurance and Why Private Companies May Need It*, 1 (2006).

not available for all types of claims, and quality directors often will not serve unless the company provides D&O coverage.

Given the scope of D&O coverage, it is easy to understand why D&O insurers are at the epicenter of the subprime and credit crisis.

V. THE CURRENT D&O INSURANCE MARKET

The most recent estimate places total D&O insured losses from the subprime and credit crisis at $5.9 billion, up from a $3.6 billion estimate in February, 2008.[131] The estimate of $5.9 billion is within a range of $4.4 billion to $7.4 billion.[132] The revised estimate principally reflects the following considerations: (1) an increase in securities class action filings, which is the primary driver of D&O losses; (2) a consideration of derivative suits and securities fraud actions not included in the original forecast; and (3) the increasing number of bankruptcies, which increases the exposure of "Side A only" D&O policies providing coverage directly to directors and officers when the company cannot indemnify.[133] Compounding the problem is that the losses will not be distributed evenly because the top ten D&O insurers of financial institutions account for 78% of the total market, and the top three write close to 50% of the total premium volume.[134]

It should come as no surprise, then, that the average D&O premium for financial institutions increased by triple digits from 2007 through early 2009.[135] However, D&O premiums for non-financial risks have continued to decrease, in keeping with a soft market that began five years ago and was fueled by record profits and overcapacity.[136] Excess insurance capacity within the entire insurance industry has decreased dramatically from a high of $100 billion in 2005 to $20 billion by the end of 2008. In part because of this,

[131] Bradford, *supra* note 2 at 11.
[132] *Id.*
[133] *Id.*
[134] *Id.* at 12.
[135] Bradford, *supra* note 11 at 16.
[136] Bradford, *supra* note 11 at 16; Marsh, *U.S. Insurance Market Report 2009 Summary*, 3 (2009).

experts have been predicting for some time a hardening of the market in all sectors, but to date, it does not seem to have materialized.[137]

The current underwriting capacity for D&O insurance is $1.3 billion, with a number of insurers recently increasing their capacity in the hopes of writing additional business.[138] There are also new entrants in the D&O insurance market that hope to take advantage of higher pricing, including Freedom Specialty, Valiant, Catlin, Ironshore, and Berkley Professional Liability.[139] Advisen predicts that D&O premiums for non-financial risks will begin increasing in late 2009, as years of decreasing premiums combine with enormous underwriting and investment losses to decrease capacity.[140] Marsh believes that the overall market is hardening, but it is reticent to predict when rates will increase, citing a decrease in demand for insurance as a significant headwind.[141] Aon agrees that premiums will continue to rise for financial institutions and that premiums for everyone else will begin rising as insurers begin to absorb losses from securities cases filed in 2008.[142]

In addition to skyrocketing premiums, financial institutions may also find that the D&O policies they purchase provide less coverage. For example, when the S&L debacle sparked a wave of regulatory actions in the banking sector in the 1990s, D&O insurers began excluding regulatory claims from coverage.[143] In 1995, more than half of D&O policies sold to banks contained this exclusion.[144] As the S&L scandal faded into the background and the D&O market softened, the regulatory exclusion disappeared.[145] Some industry experts are predicting the exclusion's re-emergence in light of the current rash of bank failures (nearly 50 so far) and the accompanying surge in regulatory actions.[146]

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[137] Bradford, *supra* note 11 at 16.
[138] Marsh, *supra* note 136 at 35.
[139] *Id.*
[140] Bradford, *supra* note 11 at 17.
[141] Marsh, *supra* note 136 at 1, 11-12, 36.
[142] Michael D. Rice and Peter M. Trunfio, Aon Risk Services, *Quarterly D&O Pricing Index, First Quarter 2009*, 4 (2009).
[143] Christie Smythe, Law360, *Regulatory Exclusions May Reappear After Meltdown*, 2 (Apr. 24, 2009).
[144] *Id.*
[145] *Id.*
[146] *Id.*

Already pressed with tight budgets in this recession, companies will look for ways to save premium dollars by raising retentions, using captives and other alternative risk financing mechanisms, and purchasing insurance from low-cost providers.[147] The key will be to not be penny-wise and pound-foolish and to maximize protection for directors and officers in an era when D&O insurance will be more important than ever before.

VI. TIPS FOR MAXIMIZING D&O COVERAGE

There are several, important steps you can take to maximize the coverage afforded to your directors and officers.

A. Be Diligent in the Application Process and Negotiate the Language

Providing complete and accurate disclosures in the policy application is critical because, by statute in many states, material misrepresentations void coverage even without having proof of an intent to deceive on the part of the insured (or even that the individual making the misrepresentation knew the "true facts") and without having to show that the misrepresentation was related to the loss that eventually materialized. All that is generally required is that the misrepresentation be "material" to the risk assumed under the policy. In many states, the insurer need not prove that it would not have issued the policy at all -- merely that it would not have issued it on the same terms and conditions or for the same premium. If the insurer succeeds in rescinding the policy on the basis of misrepresentation, it is void -- there is no coverage even for innocent insureds. (In some states, the "innocent insured" issue has been addressed by statute.)

This draconian result is compounded by the fact that most applications require submission not only of a signed application, but also copies of the company's financial statements and public filings, which are then incorporated by reference. Some insurers incorporate all applications since the carrier first started underwriting the risk, such that erroneous financial statements from prior years can void coverage just when one needs it the most.

[147] Marsh, *supra* note 136 at 1, 11-12, 36.

What to do?

1) Conduct and document a due diligence process. This will not prevent the misrepresentation risk but should minimize it. Furthermore, although one's *bona fides* may not legally protect one from a misrepresentation rescission claim, proof of such *bona fides* nevertheless can undoubtedly influence the fact-finder.

2) Negotiate the language of the application so that only knowledge of particular insureds (CEO, CFO, Risk Manager) is imputed to the company. Be very careful if you include the General Counsel as one of these individuals: at least one case has held that by referencing the General Counsel's knowledge, one waives the attorney-client privilege.[148]

3) Negotiate the severability of the application so that coverage is preserved for "innocent insureds."

4) Negotiate the language of the application to "soften" the representations being made.

CAUTION: It may well be unrealistic to attempt to renegotiate the language of the application as suggested. This is one of the reasons for "non-rescindable" Side A Only policies.

B. Mitigate the Potential Impact of Conduct-Based Exclusions

The vast majority of D&O policies exclude claims arising out of an insured's criminal, dishonest, or deliberately fraudulent acts. Two aspects of these exclusions should be considered and negotiated.

First, what proof of wrongdoing is required for the exclusions to apply? The base policy form typically bars coverage for wrongdoing "in fact." Often, insurers offer an endorsement that prohibits application of these exclusions unless and until there is a "final

[148] *See Sharp v. Trans Union LLC*, 845 N.E.2d 719 (Ill. App. 2006) (holding that manuscripted exclusion for losses known to general counsel at policy inception waives privilege because "[t]he only way to determine whether … general counsel knew that a particular act might be the basis of a claim would be to look at the general counsel's legal reasoning and analysis of that act.").

adjudication" of intentional wrongdoing on the part of the insured. Some policies incorporate the "final adjudication" requirement in the body of the policy form. Even with the more favorable "final adjudication" requirement, insurers have attempted to obtain such a "final adjudication" in the coverage case, not the underlying litigation.[149] For this reason, try to negotiate a "final adjudication in the underlying claim" requirement.

Second, do the exclusions apply to only the insured who committed the act in question, or to all insureds? Most D&O policies contain a severability clause that prohibits imputing the knowledge and misconduct of one individual insured to any other individual insureds.[150] The wording of severability clauses varies from policy to policy, especially with respect to the exclusions to which the severability clause applies. Insureds should pay careful attention to the scope of the severability clause when comparing policies and negotiate the most favorable severability clause possible.

C. Negotiate Broad Severability Clauses

For the reasons described above, one should try to negotiate a more general severability clause, not one limited to specific exclusions. Moreover, the severability clause needs to reiterate the severability applicable to misrepresentations in the application.

D. Negotiate to Remove ADR Clauses

Although alternative dispute resolution ("ADR") is admirable, most insureds normally want the freedom to pursue litigation in the forum of their choice. Indeed, many states have by statute invalidated mandatory arbitration provisions in insurance policies. As to policies issued domestically, the McCarran-Ferguson Act of 1945[151] saves such state statutes from reverse pre-emption under the Federal Arbitration Act.[152] Mandatory arbitration is generally enforceable on policies issued in non-U.S. markets (Bermuda,

[149] The scope of issue or claim preclusion arising from factual determinations in the underlying action is beyond the scope of this article.
[150] Note that this form of severability does not protect the company from having knowledge of the wrongdoing imputed to it.
[151] 15 U.S.C. § 1011 *et seq*.
[152] 9 U.S.C. § 1 *et seq.*

London, etc.) because McCarran-Ferguson does not save them from enforcement under the New York Convention.[153]

Remember: one can always later agree to arbitrate. So, generally speaking, it is best to refuse to agree to mandatory arbitration, especially before a panel of insurance industry experts.

In addition, some D&O carriers have begun inserting form provisions within ADR clauses that purport to render inapplicable the maxim of contract construction that insurance contracts should be construed against the insurer as the drafter (*contra proferendum*). This maxim is one of a policyholder's most powerful weapons in a coverage dispute. If the arbitration clause is deleted, this harmful negation of the presumption will also be removed from the policy.

Another example of a harmful ADR-related provision is one that precludes the award of attorneys' fees or "bad faith" or multiple damages. In many states, such as Florida, an insured may recover attorneys' fees as a matter of statutory right if it is able to prove coverage under the policy.

E. Pay Attention to "Change in Control" Provisions and Purchase Tail Coverage When Necessary

Most D&O policies provide that, in the event of a change in control, the policy will remain in force for the remainder of the policy period but will provide coverage only for claims involving wrongful acts occurring *prior to* the change in control. Some policies terminate coverage altogether at the time of, or even a specified number of days before, the change in control. Depending upon the policy definitions, a "change in control" is either a change in voting control or the sale of all or substantially all company assets. It can also be a major acquisition. Filing for bankruptcy typically does not trigger the change-in-control clause, nor does a substantial change in the composition of the board.

[153] The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the New York Convention, is a multi-lateral treaty that requires courts of a nation state to enforce private agreements to arbitrate and arbitration awards made in other contracting states. The United States is a signatory and enforces the treaty through Chapter 2 of the U.S. Federal Arbitration Act (FAA), which incorporates the terms of the Convention. *Thomas v. Carnival Corp.*, 2009 WL 1874098, at * 2 (11th Cir. 2009).

If your company is sold, "tail" insurance (more formally, "extended reporting coverage") should be purchased to provide coverage for claims filed after the date of closing that relate to wrongful acts occurring at or prior to closing. In addition, the coverage provided by the acquiring entity should be seamless, so that there is no gap for "wrongful acts" or "interrelated wrongful acts" that "straddle" the closing date.

The problem arises when the new policy covers "wrongful acts" occurring at inception or later and is compounded when the new policy also excludes claims for such acts if they are "related to" wrongful acts that occurred prior to that date. The new carrier can be expected to contend that it has no insurance for continuing wrongful acts that "straddle" the closing date, or indeed, even for "wrongful acts" that occur entirely after that date if they "relate to" wrongful acts occurring before them.

At the same time, if the earlier policy's change-in-control provision only provides an extended reporting period for "wrongful acts" occurring "prior to" the closing date, there is the potential for a gap into which many of the risks associated with the transaction itself can fall. This problem is exacerbated if there are different insurers before and after.[154]

One also needs to be cognizant of the problems that can arise if the existing policy converts to run-off at 12:01 a.m. on the closing date, whereas the new policy does not incept until 12:01 a.m. of the day after the closing. Again, this leaves the closing itself uninsured.

In short, the change-in-control provision should be carefully reviewed when the policy is first obtained to ensure that it will cover "wrongful acts" up to and including the closing. Then, insurance counsel or experts should be consulted whenever a major transaction is at hand to ensure that the run-off coverages and the new policies provide the most seamless coverage possible.

[154] Even insurers issuing policies that have been renewed will argue coverage is not available under either the earlier policy or the renewal policy. S*ee Cast Steel Products, Inc. v. Admiral Ins. Co.,* 348 F.3d 1298 (11th Cir. 2003) (ruling in favor of insured who reported claim to carrier two hours after renewal policy incepted, rejecting carrier's argument that original policy's extended reporting period applied only to cancellations and non-renewals, not renewals).

F. Purchase Stand-Alone, Side A Only Coverage in Addition to the Standard ABC Policy

Most companies today purchase a D&O program that includes the standard ABC policy and a tower of Side A only coverage. Side A only policies provide direct coverage to directors and officers when the company is unable to provide indemnification because of dissolution, financial difficulty, or legal prohibition. There are a number of reasons why standard "ABC" policies may fail to provide directors and officers with adequate protection. First, some bankruptcy courts consider standard D&O policies to be assets of the bankrupt company because of the Sides B and C protection afforded to the company.[155] The insurers have responded by including Priority of Payments clauses that essentially purport to give "first dibs" to the individual insureds, often reciting that the principal purpose of the policy is to protect the individuals. There are, however, arguments available in the bankruptcy context why such provisions should be disregarded.

This is especially important in today's environment because of the close link between corporate bankruptcies and securities class actions. Indeed, in 2007 and 2008, 77% of companies filing bankruptcy were defendants in a securities class action in the year preceding or succeeding the bankruptcy filing date, compared to 35% from 1995 to 2006.[156] Second, since a standard D&O policy combines coverage for both indemnified and non-indemnified losses, the policy limits may be exhausted or depleted by indemnified losses, leaving directors and officers uninsured or with little Side A coverage.

Two types of Side A excess coverage exist: standard follow-form excess Side A coverage, and excess umbrella Side A coverage, sometimes called Difference in Condition ("DIC") coverage. Under the former type of Side A coverage, if the primary policy contains problematic language, the excess follow-form Side A only policy may not drop down and pick up coverage when the primary policy has failed. Excess umbrella Side A only DIC coverage, in contrast, is designed to be broader than primary coverage, and should "drop down" and function as primary insurance when the primary carrier has canceled or rescinded

[155] Side A only policies should not be considered an asset of the estate.
[156] Bradford, *supra* note 11 at 5, 12.

coverage, or when the corporation has refused to indemnify the director or officer in question.

G. Indemnify Directors to the Fullest Extent Possible

Make sure that your company agrees to indemnify its officers and directors to the fullest extent permissible under the law of the state of incorporation. D&O policies contain a provision that presumes the company will have indemnified the individual defendants to the maximum extent permitted by law and that the company's bylaws have been amended to require such indemnification. Thus, if the insured company is permitted to indemnify the individual but fails to do so (other than for reasons of financial insolvency), many D&O policies will not pay the individuals under Side A, or will only pay after exhaustion of the [usually very substantial] self-insured retention or deductible applicable to Side B coverage. Narrowing indemnification decreases the scope of the company's Side B coverage for indemnified losses, and needlessly erodes coverage available to the directors and officers under Side A for non-indemnified losses.

H. Pay Close Attention to the Retro Date

D&O policies typically contain a "prior acts exclusion" that bars coverage for claims "based upon, arising from, or in any way related to" any "wrongful act" occurring prior to a specified date. This "retro date," or "continuity date," may coincide with a change in insurers or a change in control of the company. Careful attention should be paid to the date specified during negotiations with the insurer, and consideration should be given to whether tail coverage should be purchased for "wrongful acts" occurring, in part or in whole, prior to that date or occurring later but "relating to" such wrongful acts.

I. Post-Claim Diligence

Prompt notice to the carrier of a claim is always essential. Although some (but not all) states or policies require a showing of prejudice for an insurer to succeed on a late notice defense involving an "occurrence" policy, late notice is almost universally fatal in a "claims-made" or "claims made and reported" policy, including almost all D&O policies. A "claim" typically includes not only the formal service of a complaint, but also any "written demand

for damages or non-monetary relief," and the commencement of criminal, administrative or regulatory proceedings.

If a dispute is simmering, and the policy renews without notice of a claim or circumstances (a/k/a a "potential claim") having been given to the insurer, the insurer may later contend that the "claim" was "first made" under the expired policy. If so, that "claim," and also all other "related" claims (even if they arise years later) are excluded.

The best practice is to coordinate closely with the risk management and law departments whenever a litigation hold notice is issued on the one hand, and notice of a claim or circumstances is sent to any carrier on the other.

Make sure that the notice letter does not unduly restrict notice to some policies while failing to mention others that may provide coverage. The carrier will respond to the notice letter by requesting more information, denying coverage, or accepting coverage, perhaps under a reservation of rights. You should hire coverage counsel to advise of your rights and obligations in each scenario, including the right in some states to independent counsel, retained by you at the carrier's expense,[157] when the insurer accepts a duty to defend under a reservation of rights. In addition, do not settle the underlying action without first obtaining the carrier's consent unless the carrier has denied coverage and thereby breached its duty to defend or reimburse defense costs. Settlement without consent voids coverage in most jurisdictions in the absence of the carrier breaching its duty to defend or reimburse defense costs.

J. Take Steps to Ensure Punitive and Multiple Damages Cover

Most carriers exclude punitive and multiple damages from the definition of covered losses but offer a "buyback" endorsement that brings these damages within coverage. Some carriers even include punitive and multiple damages coverage within the base policy form. However, even when coverage is provided, it is usually limited to the extent permissible under the law of the relevant jurisdiction, and some states such as California prohibit

[157] Such independent counsel are sometimes known as *Cumis* counsel, referring to a decision from the California Supreme Court that first recognized this right.

coverage for punitive and multiple damages as a matter of public policy. To avoid this common pitfall, one can purchase a punitive damages wrap issued outside the United States, or negotiate the inclusion of a "most favored nation" clause that guarantees application of the law of the jurisdiction that is most favorable to the insured.

K. Be Mindful of the Restitution/Disgorgement Problem

Several United States courts have held that policies insuring against "loss" or "damages" do not provide coverage for restitution or disgorgement because an insured suffers no loss or damage by restoring a gain to which it was not entitled in the first place.[158] There is no solution to this problem, other than being cognizant of how the relief is characterized when discussed with the carrier.

The issue arises in many settings, including investor claims alleging fraudulent registration statements under Section 11 of the Securities Act of 1933.[159] For example, in August, 2008, the Eleventh Circuit held in *CNL Hotels & Resorts, Inc. v. Twin City Fire Insurance Company*[160] that a D&O policy does not cover Section 11 claims. The court began with the premise that an insured "loss" does not include the restoration of ill-gotten gains.[161] Even though the measure of damages under Section 11 is the difference between the actual value of the stock and the inflated price paid by the plaintiff, the court characterized the relief as restitutionary in nature because, in the underlying action, the loss to the plaintiff was equal to the gain of the defendant.[162] D&O carriers responded to *CNL Hotels* with policy language prohibiting insurers from arguing that Section 11 claims are against public policy or otherwise not covered. Care should be taken to ensure that your company's policy contains such a prohibition.

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[158] *See, e.g. Level 3 Communications, Inc. v. Federal Ins. Co.*, 272 F.3d 908, 911 (7th Cir. 2001) ("An insured incurs no loss within the meaning of an insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return."); *Bank of the West v. Superior Court of Contra County*, 833 P.2d 545, 553 (Cal. 1992) ("It is well established that one may not insure against the risk of being ordered to return money or property that has been wrongfully acquired. Such orders do not award 'damages' as that term is used in insurance policies.").
[159] 15 U.S.C. § 77k (2009)
[160] 2008 WL 3823898 (11th Cir. Aug. 18, 2008)
[161] *Id.* at **2-3.
[162] *Id.*

VII. CONCLUSION

Litigation arising out of the subprime and credit crisis has reached a fever pitch, and total claimed damages are measured in the hundreds of billions. Courts seem more willing to dismiss securities lawsuits than in the past, but defense costs alone can be staggering. D&O insurers are bracing for total payouts in the range of $4 billion to $7 billion, and they will have to raise premiums to cover the loss. In this volatile environment, great care should be taken to negotiate the best D&O coverage terms possible and to build a comprehensive D&O insurance program that will provide maximum protection.

ACC Extras

Supplemental resources available on www.acc.com

Director and Officer Liability Trends.
Quick Reference. December 2008
http://www.acc.com/legalresources/resource.cfm?show=275239

The Dangers of Arbitration Clauses in D&O and Other Liability Insurance Policies.
Article. April 2009
http://www.acc.com/legalresources/resource.cfm?show=198397

D&O Insurance Checklist.
Quick Reference. December 2008
http://www.acc.com/legalresources/resource.cfm?show=259377

Please note, these additional resources are provided by the Association of Corporate Counsel and not by the faculty of this session.