



**INDEMNIFICATION AND INSURANCE FOR
DIRECTORS AND OFFICERS OF PUBLIC COMPANIES:**

***WHAT DIRECTORS AND OFFICERS NEED TO KNOW
IN THE POST-SARBANES-OXLEY WORLD***

STANFORD DIRECTORS COLLEGE

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I. Introduction

Along with the market turmoil of the last two years, public companies have experienced one of the toughest--if not *the* toughest—periods of retrenchment and contraction in the D&O insurance marketplace in recent memory. The financial scandals at Enron, Worldcom, Adelphia, Tyco and now HealthSouth have led to massive litigation and regulatory investigations, and an overhaul of the federal securities laws last year in the Sarbanes-Oxley Act. None of this has been good news for the major D&O insurers in the U.S., who have been forced to absorb the major share of over \$2.4 *billion* in settlement costs in 2002 alone--not including the defense costs that go along with the almost 400 new cases filed in 2001-02. The reaction from the insurance industry has been dramatic: significant changes to D&O insurance policy terms and conditions, the effect of which is to reduce coverage in a number of material ways; across-the board increases in premiums for policy renewals; and, in the case of a few carriers, the wholesale retreat from the D&O market, leaving a handful of established players to carry the load.

The accounting restatements announced by companies like Enron, Worldcom, Peregrine Systems, and Qwest also have led D&O carriers to seek to rescind their coverage altogether, on the theory that the policies were procured on the basis of false statements in those companies' applications for insurance. The insurers have filed legal actions alleging that the accounting restatements are admissions that those companies' financial statements were false, and therefore the carriers have no obligation to fund the defense of directors and officers. In a few of those situations, officers have been sued by the SEC or criminally indicted, adding fuel to the insurers' arguments that the policies were fraudulently induced.

All of these developments spell misery for the boards of directors of companies that are victimized by acts of accounting fraud. Yet there is little sympathy in the public sector for these scandal-plagued companies. Indeed, in the recent global settlements between the government and various investment banking firms over their IPO allocation practices, a key negotiating point was whether insurance would be permitted to fund any portion of the penalties paid by those firms – clearly, the regulators' political goal was to make the settlement painful.¹

Compounding the risk management challenges that the new D&O environment poses are new SEC guidelines on cooperation announced in 2001 in a report related to the SEC's investigation of Seaboard Corporation entitled, "Report of Investigation Pursuant to Section

¹ See Christopher Oster, "Firms May Try to Collect Insurance," THE WALL STREET JOURNAL, April 30, 2003 at C11 (of the \$1.4 billion, \$487.5 million constitute penalties for which the firms agreed not to seek insurance); see also Deborah Solomon and Randall Smith, "Lawmakers Say Settlement Has Failed to Change Culture and Prevent Future Abuses," THE WALL STREET JOURNAL, May 8, 2003 at C1 (noting the firms may seek insurance and tax relief for the non-penalty portion of the \$1.4 billion settlement).

21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Divisions.”² As has been widely mentioned in speeches by SEC Commissioners and Enforcement Staff, public companies wishing to resolve SEC enforcement investigations will be judged on the degree to which they react swiftly and definitively in response to the discovery of misconduct. A new "best practice" that has emerged in response to the SEC guidelines is for a target company to retain independent counsel to conduct an internal investigation into the suspected wrongdoing, and to produce an investigative report to SEC Enforcement. Once the report is turned over to the government, it also is shared with the D&O insurers, who use the report's findings to invoke policy exclusions for "deliberate fraud." Thus, the company's voluntary effort to "self police" becomes the basis for a rescission claim.

But that's not the end of it. Under the mandate of Sarbanes-Oxley, the SEC now is aggressively invoking its enforcement powers to seek to freeze director and officer personal assets in particularly egregious cases, on the ostensible grounds that these personal assets include the ill-gotten gains from the securities fraud, as well as bonuses and stock options that may be directly recoverable under Section 304 of the Sarbanes-Oxley Act. As well, some companies in the middle of a major securities or accounting fraud have chosen to "just say no" to advancement of defense costs, even where contractual indemnification agreements provide for mandatory advancement. The combination of rescission of the D&O insurance, asset freezes, and the refusal to advance defense costs may effectively deprive directors and officers of their ability to defend themselves.

It is timely, therefore, that public companies think about their risk management policies and practices, including the adequacy of their indemnification protections and D&O insurance. What contingency plan does the company have if the D&O insurance is not there to respond, either because the carrier has rescinded or because the carrier has itself disappeared? What indemnification exposure does the Company have to its directors and officers, and how will that obligation be secured? What can the company do to continue to attract and retain the best management and director team, given the new restrictive D&O coverage environment? This paper will provide an overview of current trends in indemnification and insurance, and a review of current litigation issues.

II. Current Trends

A. The D&O Insurance Market In Turmoil.

Any company that has recently renewed its D&O insurance would agree that current conditions reflect a decidedly “hardened” market for D&O coverage. A “hardened” D&O insurance market means that companies are paying substantially higher premiums and are seeing

² SEA Rel. No. 44969, October 23, 2001.

new coverage restrictions.³ Carriers also are increasingly attempting to contest coverage for claims, or to rescind issued policies entirely for the worst corporate meltdowns. Furthermore, some bankruptcy courts have demonstrated a willingness to seize control of the proceeds of the D&O policies when corporations file for bankruptcy protection.⁴ As if these problems were not enough, some D&O carriers are now having trouble remaining solvent, so that even if officers and directors are able to overcome attempts at policy rescission and strict claim language construction, coverage still may not be there to protect personal assets of officers and directors. As a result of these difficult market conditions, some leading carriers are dramatically increasing policy premiums, lowering limits, and increasing deductibles.⁵ Public companies are finding it more difficult to secure adequate levels of D&O insurance, and are having to resort to increasingly complex layers of insurance, which adds to the cost of coverage and to the complexity of claim settlement. Indeed, some public companies may find it impossible to secure D&O insurance at all, while still other companies are making the decision to essentially self-insure against securities litigation.

Finally, besides the tightening of the D&O market itself, coverage disputes between insureds and their carriers under existing policies are growing more frequent and more serious as carriers become increasingly aggressive with their insureds.⁶ Recent court cases underscore that just because your company has a D&O insurance policy in place, that does not necessarily mean the coverage will be there to provide protection for you. So while the level of litigation continues to escalate, the obstacles to obtaining adequate coverage are multiplying.

B. Litigation Trends.

The recent corporate disasters at Enron, WorldCom, Tyco, Adelphia, HealthSouth and others are among the most extreme examples of securities litigation claims now being played out in courtrooms throughout the country, but they are only part of the story. The continuing stream of earnings "surprises" in the high tech sector, the implosion of the internet and telecom sectors, and the enormous increase in financial restatements in all sectors, have contributed enormously

³ "Directors' Insurance Costs Soar for U.S. Firms", REUTERS (March 14, 2003).

⁴ "D&O Insurance Draws A Crowd," THE DAILY DEAL (March 11, 2002), noting that D&O insurance policies have "become fair game in bankruptcies".

⁵ "Study Says D&O Liability Premiums Skyrocket as Shareholder Claims Increase," INSURANCE JOURNAL (April 28, 2003)(identifying trends of higher premiums and tougher underwriting standards through 2003 and beyond);"Insurance: So Many Disaster Areas" BUSINESSWEEK ONLINE (Jan. 13, 2003)(forecasting possibility of up to 500% increase in premiums for D&O insurance).

⁶ See, e.g., "Conseco Sues Insurers That Refuse to Pay Settlement," BLOOMBERG NEWS (April 2, 2002), reporting that various insurers, led by Lloyds of London, had refused to consent to a \$120 million settlement of a securities class action.

to the surge in new securities cases against public companies and their officers and directors in the last several years. The PSLRA, passed in 1995 to reduce frivolous shareholder lawsuits, has been largely ineffective in stemming the tide of these cases. In part because of the overheated stock market of the last five years, the stock price declines for most public companies sued in shareholder litigation have produced market capitalization losses in the trillions--leaving massive uninsured exposures for the directors and officers sued in these cases.

The price for settling securities class actions has continued to remain at persistently high levels. According to a study recently published by Cornerstone Research, securities class action settlements in 2002 alone exceeded \$2.4 *billion*.⁷ The average cost to settle securities suits also has steadily increased. Since the passage of the Reform Act, average settlements have risen from \$14.7 million during the period 1996-2001, to \$24.3 million just for suits settled in 2002.⁸ Although the portion of these settlements that was funded by D&O insurance is not publicly available, it can reasonably be assumed that the majority of the settlement costs came from insurance.

These litigation trends were adversely affecting the D&O insurance market even before the collapse of Enron and the other recent large-scale corporate disasters, and all indications suggest that the negative trends are holding steady.

III. Officer and Director Indemnification

A. Indemnification Generally.

All fifty states provide for corporate indemnification, both permissive and mandatory. Generally speaking, mandatory indemnification is required when a director or officer succeeds on the merits of the case and defeats liability. Most states deny corporations the power to indemnify an officer or director unsuccessful in his defense.

Corporate officers and directors are subject to potential liability from a number of sources, including suits by shareholders on behalf of the corporation and suits by third parties due to allegations concerning the actions or inaction of company officers and directors.⁹ Many

⁷ "2002: A Year in Review", Cornerstone Research (hereafter the "Cornerstone Study"). The Cornerstone Study is posted at securities.cornerstone.com.

⁸ Cornerstone Study, p. 2.

⁹ Courts have drawn a distinction between derivative suits and third-party suits when considering whether indemnification of an officer or director is appropriate. Derivative suits are brought on behalf of the corporation, and the officer or director is accused of harming the corporation. The purpose of derivative suits would be nullified if the corporation were then permitted to indemnify the officer or director for the amount which the officer or director

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states, including Delaware, have enacted statutes generally (1) requiring the company to indemnify the officer or director; (2) giving the corporation power to indemnify; (3) providing for court approval of indemnification; or (4) providing a combination of the above elements. Moreover, Delaware law expressly permits the corporation to purchase insurance to cover the risks associated with claims against directors and officers. Delaware is most often thought of as the state with the most director-friendly corporate laws.

B. Limited Liability Provisions.

In the mid-1980's, the cost and potential unavailability of directors and officers liability insurance prompted the Delaware legislature to give incorporators and shareholders the power prospectively to limit the liability of directors. Section 102(b) of the Delaware General Corporation Law authorizes a corporation to include in its charter a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for money damages for breach of fiduciary duty as a director,¹⁰ with certain exceptions. In essence, the Delaware law allows directors to be shielded from monetary liability for negligence or gross negligence. Certain states followed Delaware's lead in enacting statutes that enabled a corporation to immunize directors from liability for state law claims through the inclusion of a charter provision.¹¹ Other states enacted legislation that directly immunized directors from liability without the requirement of a charter provision.¹² Most of the state exculpation statutes – both those that operate by charter and through legislation – apply only to suits by the corporation, by the shareholders on behalf of the corporation, or by the shareholders directly.¹³ Pennsylvania is the only state that currently permits stockholders to limit through a charter

[Footnote continued from previous page]

was held liable to the corporation. However, even with derivative actions, officers and directors should be entitled to indemnification for litigation expenses when successful in defense of the action.

¹⁰ Section 102(b)(7) contains exceptions, for which a director cannot be insulated from liability, most notable for a breach of the duty of loyalty, or for conduct not in good faith or involving knowing violations of the law.

¹¹ See e.g., MD. CODE ANN., CORPS. & ASS'NS §§ 2-104(b)(8), 2-405.2 (1999); N.J. Stat. Ann. § 14A:2-7(3) (West Supp. 2000). Both Maryland and New Jersey also include officers in their code provisions authorizing exculpating provisions in corporate charters.

¹² These states include Florida, FLA. STAT. ANN. § 607.0831 (West 2003); Indiana, IND. CODE ANN. § 23-1-35-1(e) (West 2003); Maine, ME. REV. STAT. ANN. tit. 13-A, § 716 (West 2003), Ohio, OHIO REV. CODE ANN. § 1701.59(D) (West 2003); and Wisconsin, WIS. STAT. ANN. § 180.0828 (West 2003).

¹³ See James J. Hanks, Jr., *Protecting Directors and Officers from Liability – The Influence of the Model Business Corporation Act*, 56 BUS. LAW 3, 25, November 2000.

provision the liability of directors to third parties.¹⁴

C. Advancement of Defense Costs.¹⁵

The ability of corporations to advance defense costs to their directors is viewed by most practitioners as critical to attracting talented independent directors. The rights of directors and officers to advancement are governed by a combination of state law and the bylaws of the corporation.¹⁶ Under state law, corporations typically have broad discretion to set terms and conditions in the company's bylaws on indemnification and advancement of fees, provided that the bylaws are not inconsistent with the statutory scope of the corporation's power to indemnify.¹⁷ For example, a company may provide through its bylaws for the mandatory advancement of expenses to its officers and directors, or for mandatory indemnification in circumstances where state law merely states that such advancement or indemnification is permitted.¹⁸

¹⁴ 15 PA. CONS. STAT. ANN. § 1713. The Pennsylvania statute provides, however, that a director may be liable if the breach or failure to perform constitutes "self-dealing, willful misconduct or recklessness."

¹⁵ Some commentators believe that Section 402(a) of the 2002 Sarbanes-Oxley Act, which prohibits companies from making "personal loans" to officers and directors, could be read to prohibit companies from advancing defense costs to their officers and directors. There is little legislative history on Section 402(a), and no reported cases on this point. A group of 25 prominent securities defense firms from around the country jointly authored a memorandum arguing that advancement of defense costs would *not* constitute a prohibited personal loan under Section 402(a). Still, until there is further guidance from the SEC or Congress, the issue of whether advancement of defense costs constitutes an improper loan will remain unsettled.

¹⁶ *See e.g.*, Section 145 of the Delaware General Corporation Law, 8 DEL. C. §145(a)-(b) (providing for and authorizing indemnification of expenses incurred by corporate officers and directors under certain circumstances even where they are not successful on the merits of a suit or investigation); 8 DEL. C. §145(c)(providing for mandatory indemnification of a corporate officer or director where he has been successful on the merits in defense of an action, suit, or proceeding).

¹⁷ *See* DEL. C. § 145(f).

¹⁸ A typical example would be a corporate bylaw, which states an indemnitee "shall be indemnified and held harmless by the Corporation to the fullest extent provided by the Delaware General Corporation Law." *See, e.g.*, DEL. C. § 145(e) ("Such expenses (including attorney fees) incurred by former directors and officers or other employees and agents may be so paid upon such terms and conditions, if any, as the corporation deems appropriate.").

When a corporation has modified through bylaws its statutory obligations with respect to indemnification or advancement of expenses, courts typically will enforce the terms of the bylaws as if enforcing the terms of a contract.¹⁹ For example, where bylaws stated that an officer or director “shall be entitled to” indemnification and the advancement of expenses “as, and to the fullest extent, permitted by” applicable state law, one court has held that a corporation must advance expenses even to a corporate vice president accused of criminal actions solely for his personal benefit.²⁰ The court rejected the argument that the bylaw merely gave the board of directors discretion to advance expenses if they chose to do so, and declined to read into the bylaw additional terms and conditions.²¹

Courts also have denied advancement of fees where clear language in the bylaws controls the circumstances at issue. For example, a court denied the claim of a director who sought advancement of attorney fees and litigation expenses from the corporation for an action he brought as the plaintiff against the corporation.²² The court noted that under state law, the corporation was “free not to provide for advancement at all, or to provide it in limited situations,” and that through its bylaws, the corporation clearly limited advancement rights to officers and directors who were defendants or respondents in a proceeding.²³

If an officer or director is otherwise entitled to advancement of fees under the bylaws and relevant state law, a recent Delaware case holds that a corporation may not avoid the obligation by claiming the suit or action was not brought “by reason of the fact that the person is or was a director, officer, employee, or agent of the corporation” as required by relevant state law on indemnification. In *Reddy v. Electronic Data Systems Corporation*, the corporation argued that a former vice-president was not entitled to advancement of fees because his allegedly wrongful

¹⁹ See *Gentile v. SinglePoint Financial Inc. et al.*, 788 A.2d 111, 113 (Del. 2001)(“ . . . if the bylaw’s language is unambiguous, the Court need not interpret it or search for the parties’ intent. . . The bylaw is construed as it is written, and the language, if simple and unambiguous, is given the force and effect required.”)(internal citations omitted).

²⁰ See *Reddy v. Electronic Data Systems Corp.*, No. Civ. A. 19467, 2002 WL 1358761 at *3 (Del. Ch. June 18, 2002).

²¹ *Id.* at *4 (“Having been accorded the freedom to craft its bylaws as it wished, EDS cannot point to its own drafting failures as a defense to Reddy’s advancement claim, however. If it chose, EDS could have conditioned former employees’ advancement rights on an undertaking, proof of an ability to repay, or even the posting of a secured bond. But it did not do so.”).

²² See *Gentile*, 788 A.2d at 113.

²³ *Id.*

conduct was motivated by personal greed.²⁴ The Delaware Chancery Court acknowledged that a board may be reluctant to advance fees to an employee who they have already come to believe has engaged in wrongdoing, but contractual rights of advancement would be vitiated if they were dependant on the suing party's assessment of the motivation and underlying merits of the suit or investigation.²⁵ Similarly, the Chancery Court recently held that where an officer is successful on the merits of a covered proceeding, where the conduct at issue was "done in his capacity as a corporate officer," the corporation must indemnify him for his litigation expenses under relevant provisions of state law regarding mandatory indemnification of officers.²⁶ The officer's motivation was irrelevant to the analysis of whether his conduct was done in his capacity as an officer, and there was no requirement that he "acted in good faith or in what he perceived to be the best interests of the corporation" to obtain indemnification from the corporation.²⁷

The Delaware Supreme Court recently clarified an issue of importance to officers and directors who are forced to file an indemnification suit to obtain indemnification from a corporation.²⁸ In *Stifel Financial Corporation v. Cochran*, the court determined that an officer or director can seek the attorney fees and other expenses incurred in bringing the suit,²⁹ along with indemnification of the judgment, fines, or other costs at issue. In so ruling, the court noted that allowing such "fees on fees" awards would prevent a corporation from wearing down a former director or officer with a valid claim for indemnification through extensive litigation.³⁰

IV. Key Aspects of D&O Insurance Coverage

A. Covered Claims.

There are typically three types of coverage under D&O policies.

²⁴ *Reddy*, 2002 WL 1358761 at *5

²⁵ *Id.*

²⁶ *See Perconti v. Thornton Oil Corp.*, No. Civ. A. 18360-NC, 2002 WL 982419 at *4 (Del. Ch. May 3, 2002).

²⁷ *Id.* at 4-5.

²⁸ *See Stifel Financial Corp. v. Cochran*, 809 A.2d 555, 561 (Del. 2002)(allowing the award of "fees on fees" in a suit for indemnification under Del. C. § 145(a)).

²⁹ These are commonly known as "fees on fees."

³⁰ *Id.* at 561. Corporations remain free, however, to draft bylaws that exclude the award of "fees on fees."

- Coverage A: Natural persons (officers and directors) are covered against “Loss” arising from any “Claim” as those terms are defined in the Policy (so-called "Side A" coverage).
- Coverage B: The Company is covered for a Claim first made against an officer or director, if and to the extent that the Company is required or permitted by law to indemnify the officer or director for such alleged wrongdoing (so-called "Side B" coverage).
- Coverage C: The Company is directly insured for “Securities Claims” made directly against the Company (this is “entity coverage”).

The threshold question often is what is a covered “claim” under the Policy. D&O policies universally contain definitions of covered claims, and one must look first to the terms of the policy when deciding whether a particular claim is covered. The following is an example policy definition for “Claim”:

- (1) a written demand for monetary or non-monetary relief (including a request to toll or waive a statute of limitations;
- (2) a civil, criminal, administrative, regulatory or arbitration proceeding for monetary or non-monetary relief commenced by the service of a complaint, the return of an indictment or similar document, or the receipt or filing of a notice of charges; or
- (3) a civil, criminal, administrative or regulatory investigation of a natural person Insured or the Underwriters, but only after the Insureds are identified in writing by the investigating authority as persons against whom a proceeding [as detailed in (2) above] may be commenced, or in the case of a securities investigation, after the service of a subpoena on a natural person Insured.³¹

B. Other Key Policy Terms.

D&O policies are generally written on a “claims-made” basis. That is, claims are covered that are first made against the insured director or officer during term of the policy. The claim is “made” when the Insured officer or director receives it or learns of it. Most policies also require the Insured to report the claim to the Insurer within the policy period. Further, most policies require that claims be reported either during the same policy year or within a window of

³¹ “Loss” is typically defined in D&O policies as: damages, judgments (including interest), settlements, and defense costs. Loss does not include civil or criminal fines or penalties imposed by law, punitive or exemplary damages, multiplied damages, or any amount for which the Insureds are not financially liable. With respect to Securities Claims only, however, Loss includes punitive or exemplary damages imposed on any Insured. “Securities Claim” is often defined separately and more specifically.

sixty days or so following the expiration of the policy. Insureds, including the Company, must give detailed written notice of all Claims of Loss for which insurance coverage will be, or may be, sought.

Until the advent of entity coverage in recent years, D&O policies did not insure the liability of the company for securities and other claims brought directly against the company. In typical securities class action lawsuits, that fact led to "allocation" disputes between the insureds and the insurance companies. That is, insurance companies had the incentive to argue large portions of joint liability with insured officers and directors was attributable to the Company rather than to individual officers and directors, because Company liability was uninsured.

Entity coverage solves the allocation dispute problems by making entity liability a covered claim. However, many D&O carriers now believe that entity coverage creates a situation where companies no longer have an incentive to keep litigation and settlement costs down as long as a settlement can be achieved within policy limits. Furthermore, when insured companies file for bankruptcy protection, the presence of entity coverage has made it more likely for bankruptcy courts to find that the proceeds of the D&O policy should be swept into the debtor estate, because those proceeds make the debtor estate more valuable.

Finally, while there is no question that members of the board of directors are covered Insureds, there is occasional dispute regarding which company employees are covered as "officers." First, one must look to the language of the policy, and the definition within a policy of the term "officer" will govern. Some courts limit coverage to employees holding a formal company officer title. More recent cases reject this approach and treat the term as more inclusive and look to the managerial responsibility the employee holds.³²

C. Key Coverage Limitations.

Insured versus Insured Exclusion. Most D&O policies contain exclusions for any claim brought by or on behalf of any Insured of the company directly or derivatively, unless the Claim is instigated and continued totally independent of any director or officer of the company. This is the so-called "Insured vs. Insured" exclusion.

The "Insured versus Insured" exclusion was developed in reaction to a case involving Bank of America, in which the bank brought a claim against its own board of directors, alleging that bank losses were caused by officer and director misconduct.³³ The D&O carrier took the

³² Finding that a particular company employee is an "officer" within the scope of coverage of the policy also has implications for a policy's insured versus insured exclusion. That is, if a court finds that a particular company manager qualifies as an Insured officer under the policy, then claims brought against company directors might be excluded from coverage under the policy.

³³ See Complaint in *Bank of Am. v. Powers*, No. C 536-776 (Cal. Super. Ct. filed Mar. 1, 1985).

position that the only purpose of the suit was to get to the D&O policy proceeds. Bank of America settled its \$95 million claim for an \$8.2 million payment from insurers. Related shareholder litigation was settled with payments from the D&O insurer totaling \$60.4 million.³⁴

Over the years, the exclusion has been broadened in some policies to preclude coverage for claims against directors and officers asserted either by a bankruptcy trustee or by the debtor-in-possession. However, some policy exclusion language specifically excepts from the exclusion claims brought by receivers, trustees, or the debtor-in-possession.

Interestingly, the Reform Act's heightened pleading standards for securities fraud claims has led plaintiffs' counsel to make increasing use of confidential witnesses in their complaints as a means of alleging fraud with the requisite particularity. The confidential witnesses who serve as the source of many of the substantive allegations in plaintiffs' complaint sometimes are current or former company officers. Some carriers argue that the participation of confidential witnesses who are or were company officers and insureds under the D&O policy triggers the insured versus insured exclusion. Though the carriers' position has not been litigated, it is one more piece of ammunition for insurers seeking to avoid or limit coverage for claims under D&O policies.

A notable exception of the insured versus insured exclusion pertains to shareholder derivative suits. In most derivative actions, the company is named as a nominal plaintiff. However, carriers will seek to exclude from coverage claims brought by derivative plaintiffs where insureds (officers or directors) cooperate with the plaintiffs.

Improper Personal Benefit. D&O policies typically exclude coverage for loss connected with claims made against an Insured arising out of an alleged improper personal profit or advantage for the Insured. It is uncommon that this exclusion takes on any force and effect because the exclusions usually require an adjudication of improper personal profit – a situation that rarely occurs in securities litigation. There is generally no coverage for claims against an Insured for improper payments made to an Insured without proper approval of stockholders of the Company.

Deliberate Fraud. There is no coverage for claims arising out of any deliberate criminal act or deliberate fraudulent act by the Insured. As discussed below, these policy exclusions are subject to a panoply of public policy and case law limitations and conditions, and many of the policy forms offer different "triggers" for the exclusion of deliberate acts, such as the requirement that the deliberate act must have been "finally adjudicated," not just alleged. Ambiguities abound as to who is entitled to make the determination that a particular act was "deliberately fraudulent," in the absence of a court adjudication.

³⁴ Peter Waldman, "BankAmerica Settles Suits Tied to Losses, Posts Gain on Sale of Bank-Firm Stake," WALL STREET JOURNAL, Jan. 5, 1998.

Regulatory Proceedings. Some D&O policies also contain exclusions for, or simply do not afford coverage for, claims related to state and federal regulatory investigations or enforcement proceedings, at least until someone is charged with misconduct. This can be a critical issue for a public company exposed to a major SEC or U.S. Attorney investigation, where the legal costs can run into the millions, with no D&O coverage for the vast majority of these legal expenses. Companies would be well advised to look carefully at the policy terms relating to investigation, to know exactly what kinds of non-court proceedings will or will not be covered.

Severability. A key D&O policy provision is the "severability" clause. The severability clause comes into play when a one or more individual insureds are accused of deliberate fraudulent conduct, but other officers or directors were unaware of such conduct. If all such wrongful conduct was imputed to all of the insureds, innocent directors might lose all coverage as a group due to the conduct of a few bad actors. A severability clause makes it possible to "sever" the wrongful conduct between and among individual insureds. What the clause means technically is that despite the fact that a policy is rescinded with respect to a particular individual or group — or coverage is denied for a particular individual or group — coverage remains in place for the innocent officer and director defendants. In the recent past, most policies had some version of a severability clause. In today's "hard" market, however, those provisions have either been eliminated entirely, or have been substantially weakened, such that a wrongdoing CEO or CFO will their wrongful conduct imputed to the Company as well as other insureds. The new policy provisions are in flux, however, and it is not clear whether a "standard" severability provision will emerge.

D. Claims Handling under the Policy.

D&O insurance does not provide for a duty to defend or right to defend. Therefore, the insured officers and directors are responsible for retaining defense counsel and for answering the litigation subject to the insurer's consent. Most D&O carriers assert the right to consent to the incurring of all defense costs as well as to the selection of defense counsel, and D&O policies typically provide that the policy will pay on behalf of or reimburse defense costs which are reasonable and necessary. However, unlike many other forms of insurance, D&O policies treat defense costs as a form of "Loss" that is directly subject to the policy's aggregate limits of liability. Thus, it is possible for the entire policy coverage to be expended on defense costs, leaving little or no funds remaining to satisfy a settlement or judgment. In some larger cases, therefore, there is a practical pressure on the primary carrier to provide policy limits for settlement purposes, since it can be reasonably anticipated that those limits would be exhausted in any event through the expenditure of defense costs.

D&O insurers and their insureds often enter into so-called "interim funding agreements." These agreements typically set out that the parties have reserved their rights regarding coverage under the policy and that the carrier will agree to reimburse or advance defense costs. The carrier will require that the individual officers and directors commit through an "undertaking" to reimburse the carrier when and in the event there is an adjudication that coverage is not available under the policy. Because the defense of directors and officers is left to the insured and their counsel, D&O policies typically provide for cooperation and settlement. While the carriers do not control the defense of the case, they typically require that cases cannot be settled without

their written consent.

The carrier generally has the right to tender the policy limits, that is, to pay the face amount of the coverage, either to a court for ultimate distribution to or among claimants, or directly to the insured to create a settlement fund or to pay judgments when rendered. The carrier might find this option desirable if the insured's liability appears certain, and in an amount at least equal to the face amount of the policy, or if the anticipated defense costs are considerable and might themselves exceed the policy amount. Case law differs whether the tender of policy proceeds relieves the carrier of its independent "duty to defend" the insured, the costs of which may increase the carrier's exposure significantly beyond the face amount of coverage.

V. Recent Efforts to Restrict Coverage in the D&O Insurance Market.

A. **How We Got Here.**

The crisis in the D&O insurance industry can be traced to the early 1990's, when carriers were able to settle claims against officers and directors for smaller amounts, and the claims were manageable in number. These facts helped make D&O insurance lines among the most profitable for a number of carriers. As a result, more players entered the market, forcing carriers to drive down premiums and increase the types and amounts of available coverage.³⁵ D&O carriers began developing policy products with more expansive coverage terms, in order to secure a larger piece of the market. Among other things, carriers added *entity coverage* to deal with claims made directly against the corporation. Entity coverage was initially designed to help eliminate disputes between companies and carriers over the allocation of damages between the company and covered directors when claims settled. The result, however, was something different. Carriers ended up merely providing additional coverage for the same or even lower premiums. *Id.*

The D&O insurance industry was heartened when The Private Securities Litigation Reform Act of 1995 ("Reform Act") was passed, as it intended to cut back further on the number of securities lawsuits filed against D&O insureds. Instead, however, the number of suits started increasing after the passage of the Reform Act.³⁶ Thus, the industry mis-judged the level of claims experience that would ensue following passage of the Reform Act. Of course, no one could have reasonably predicted the rash of financial scandals that ultimately surfaced beginning in 2000, and that led to the Sarbanes-Oxley Act.

Besides the unanticipated level of claims, the advent of entity coverage also has been viewed by the insurance industry as having contributed to the current crisis in the D&O market. First, carriers perceive that corporations faced with claims covered by a policy with entity

³⁵ See Barbara Aarsteinsen, *Less for More*, 108 CANADIAN INSURANCE 3 (March 1, 2003).

³⁶ See AIG, 2002 D&O Insurance White Paper ("2002 White Paper") at 4.

coverage no longer have any incentive to keep litigation and settlement costs down as long as claims settle within the policy limits. Second, entity coverage was felt to have "diluted" the coverage for directors and officers, leaving less protection in place for those individuals, and causing the more rapid depletion of policy limits due to the broadened coverage afforded by entity coverage.

Finally, after September 11, 2001, the insurance industry as a whole, and D&O carriers in particular, suffered an avalanche of claims. The high technology market in the United States was already in deep decline at the time of the 9/11 attacks, and the continued downturn of the United States economy led to an increased number of securities fraud filings, with much larger damages estimates due to the significant market cap declines involved. Then came the mega-fraud corporate failures of Enron, Adelphia, Tyco, WorldCom, and most recently HealthSouth. Those disasters have resulted in enormous claims against D&O carriers.

B. Current Pricing and Underwriting Trends, and Loss Experience.

Carriers clearly have sought to reduce their financial exposure through a combination of drastically increased premiums and significantly reduced coverage. D&O insurance is now much more difficult and expensive to secure, even for blue chip companies with no record of securities or other claims.³⁷ Most industry experts do not expect that the D&O market will soften any time soon.

Industry consultant Tillinghast-Towers Perrin published its 2002 Directors and Officers Liability Survey that included a number of sobering developments.³⁸ The 2002 D&O Liability Survey included participation from nearly 2200 U.S. companies from across all major industrial groups. According to the survey, the premiums for "generally equivalent coverage" rose by more than 29% from those in 2001 across all industrial categories.³⁹ While premiums have

³⁷ See Bill Rigby, *Director's Insurance Costs Soar For U.S. Firms*, REUTERS, March 20, 2003 ("General Electric Co., for example, said this week it paid \$22.1 million for D&O insurance in 2002, almost 4 times the \$5.8 million it paid the year before, even though it has no problems with shareholder suits. It is set to renew the policy in June, and will likely face any further hike."). The same article reported that Nortel paid \$3.7 million for \$250 million of coverage in 2002, an almost 400% percent increase over the previous year. *Id.*

³⁸ Tillinghast-Towers Perrin 2002 Directors and Officers Liability Survey, Executive Summary of U.S. and Canadian Results ("2002 D&O Liability Survey").

³⁹ See 2002 D&O Liability Survey at 3. Average deductibles for American corporations are up from \$418,000 in 2001 to nearly \$500,000 in 2002. *Id.* The survey reported that 19% of its participants reported making D&O policy claims within the past ten years. *Id.* Companies with a history of merger and acquisition typically were more likely to face shareholder and other securities-related claims. *Id.* The 2002 D&O survey reported a dramatic increase in

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dramatically increased, the total amount of coverage offered by insurers retreated to its 1998 level. *Id.*

The D&O industry has seen losses increase from approximately \$760 million in 1996 to over \$5.6 billion in 2001. AIG, the carrier with the largest share of the U.S. D&O insurance market, issued the "2002 D&O Insurance White Paper", which discussed many of the issues affecting directors, officers, and the industry in general. The White Paper reported that the number of companies sued for securities fraud rose nearly 300% from 1996-2001 and that settlement values jumped 150% during that same period. *Id.* at 1. The balance sheets for a few D&O carriers were dangerously weak, and the 2002 White Paper gives the example of one large carrier that went from an A- credit rating to liquidation in a period of 18 months. *Id.* at 2.

The 2002 White Paper suggested that entity coverage needs to be reformed, and argues that the industry should adopt a pre-set allocation clause that details how much of a given claim will be covered by the policy versus the corporation for its own exposure to securities claims. D&O carriers must better understand the true nature of the risks they are choring. *Id.* at 3. The White Paper also argued that D&O premiums must be "aligned" with the current environment – *i.e.* premiums must rise dramatically. *Id.* at 4. Not surprisingly, premiums have increased substantially this year.⁴⁰

C. Key Areas of Dispute Over Coverage for Securities Claims.

1. Corporate insolvency.

The Bankruptcy Code defines "property of the estate" to include "all legal or equitable interests of the debtor in property as of the commencement of the case." There is a split of

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the average indemnity paid to shareholder claimants of 23.35 million dollars, as compared to 17.18 million dollars in 2001 and 9.62 million dollars in 2000. *Id.* at 8.

⁴⁰ The White Paper offered the view that the industry misjudged the impact the Reform Act would have on the D&O claims. *See* 2002 White Paper at 2. The White Paper also noted that one side effect of the stock market boom of the late 90's is that with large stock valuations comes a harder fall, with greater damages to shareholders, when things go wrong. *Id.* at 8. The White Paper stated that the industry is suffering from an essentially failed economic model, stemming from an oversupply of coverage, inappropriately low premiums, and extraordinarily high exposure. *Id.* at 9. Finally, the White Paper predicted that the Sarbanes-Oxley Act will lead to continued pressure on D&O insurance market. Specifically, it points to the fact that Sarbanes-Oxley extends the statute of limitations for bringing securities claims, it forbids the discharge in bankruptcy of liability for securities violations, the CEO/CFO certification requirement may lead to increased liability, increased frequency of SEC review will lead to increased investigation expenses and claims and audit committee requirements may lead to additional exposure for audit committee directors. *Id.* at 12.

authority concerning whether the proceeds of D&O policy for a bankrupt company are property of the debtor's estate. The majority of courts considering officer and director insurance policies, especially a policy that combines coverage for individual officers and directors with direct and indemnification entity coverage, find the policy is property of the debtor estate. This is so because of the contractual rights the debtor retains in the policy, and because of the control over the disposition of the policy this finding affords the bankruptcy court.⁴¹ A minority of courts has found that a D&O insurance policy is not property of the estate.⁴²

Many courts distinguish between an insurance policy and its proceeds when deciding whether the Policy is estate property. When considering other types of insurance policies, such as a general liability or fire protection policy, the general result is that if a policy is property of the estate, then its proceeds also belong to the estate.⁴³ Yet courts have recognized that this general rule is inappropriate for D&O insurance policies, because D&O policies differ fundamentally from other types of liability insurance. First, the Company is often not the direct beneficiary.⁴⁴ In most cases, the debtor purchased the policy for the benefit of its directors and officers, not for the benefit or protection of the Company itself.⁴⁵ Also, the proceeds from a direct liability or indemnification policy do not ultimately inure to the benefit of the Company, but to its officers and directors.⁴⁶ As a result of the structural differences between D&O and

⁴¹ See e.g., *Louisiana World Expo., Inc. v. Federal Ins. Co. (In re Louisiana World Expo., Inc.)*, 832 F.2d 1391, 1401 (5th Cir. 1987) ([T]he policies in this case belong to the bankrupt[']s . . . estate; this empowers the bankruptcy court to prevent their cancellation, for example.”); *Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Reinsurance Corp. (In re Minoco Group of Cos., Ltd.)*, 799 F.2d 517, 518 (9th Cir. 1986).

⁴² See, e.g., *Pintlar Corp. v. Fidelity and Casualty Co. of New York*, 124 F.3d 1310 (9th Cir. 1997).

⁴³ See e.g., *Louisiana World Expo.*, 832 F.2d at 1399-1400 (5th Cir 1987) (citing *In re Davis*, 730 F.2d 176, 184 (5th Cir. 1984).

⁴⁴ See, e.g., *Louisiana World Expo.* 832 F.2d at 1394; *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203, 216 (3d Cir. 2000).

⁴⁵ See, e.g., *Youngstown Osteopathic Hosp. Ass'n v. Ventresco, et. al. (In re Youngstown Osteopathic Hosp. Ass'n)*, 271 B.R. 544, 2002 Bankr. LEXIS 30, at *17 (Bankr. N.D. Ohio 2002) (“While [debtor] is the named insured on the policy, the policy is for the benefit of the directors and officers.”)

⁴⁶ See David H. Kistenbroker, et. al., *Securities Litigation and Insolvency: The Case for the Director and Officer Insurance Proceeds in Securities Litigation* 2001 661, 681, n. 69, (PRACTICING LAW INSTITUTE SECURITIES LITIGATION 2001 PROGRAM), September-October 2001 (in a typical indemnification provision, “[i]n essence, the proceeds merely ‘pass

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general liability policies, courts have created a distinction between ownership of the policy and ownership of its proceeds.

The United States Court of Appeals for the Fifth Circuit was the first to recognize this distinction in *Louisiana World Exposition, Inc. v. Federal Insurance Co.*⁴⁷ The court found the proceeds of a D&O insurance policy were not property of the estate in that case, but the holding was limited to the situation where only the direct liability portion of a combined D&O policy (meaning direct liability and indemnification coverage) was at issue. Other courts seem to follow a per se rule that proceeds are property of the estate if payments to the officers and directors for direct liability and indemnification claims could exhaust the policy. Still other courts have concluded D&O insurance policies and proceeds are property of a debtor estate without further analysis or explanation.

Several cases suggest that the presence of entity coverage in a combined policy could render the proceeds property of the estate. As noted above, entity coverage is written for the protection and benefit of a corporation, rather than its directors and officers.⁴⁸ In one of the first

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through' the estate on their way to the directors and officers; the corporation never profits or 'comes out ahead' as a result of the payments.'").

⁴⁷ See *In re Louisiana World Expo.*, 832 F.2d at 1393. Louisiana World Exposition, Inc. had an insurance policy with both directors and officers direct liability coverage and indemnification coverage for the Company, with a combined limit of \$20 million. See *id.* The Company filed for bankruptcy protection under Chapter 11, and the creditors' committee subsequently sued the Company's directors and officers for mismanagement. See *id.* at 1393-4. As litigation progressed, the committee became concerned that the policy proceeds would be depleted by payment of the directors' and officers' legal expenses, leaving little excess to pay any judgment in the suit against them. The committee filed an adversary proceeding in the bankruptcy court to prohibit payment of the directors and officers' legal expenses. See *id.* at 1394.

On appeal, the Fifth Circuit upheld the bankruptcy court and district court's dismissal of the case, and held that the policy proceeds were not part of the debtor's estate. See *id.* at 1393-94. The court distinguished the case from those holding that insurance proceeds belong to a debtor estate, reasoning that here the Company had purchased the policy to protect its directors and officers, not directly to insure its own corporate losses or liability. See *id.* at 1399-1400. The court recognized that the policy consisted of both direct liability coverage as well as indemnification coverage for the Company, see *id.* at 1394, yet without explanation stated that only the direct coverage for directors and officers was at issue in the case. See *id.* at 1399. In the end, the directors and officers were allowed to draw on the insurance proceeds to fund their defense. See *id.* at 1401.

⁴⁸ See Nan Roberts Eitel, *Now You Have It, Now You Don't: Directors' and Officers' Insurance After a Corporate Bankruptcy*, 46 LOY. L. REV. 585, 590 (Fall 2000).

cases to consider the effect of entity coverage on the proceeds analysis, the court in *First Central Financial Corp.* rejected a per se rule, instead noting that this determination must be made in light of the facts of each case.⁴⁹

At least one court has applied a completely different analysis to determine that the proceeds are not property of the estate.⁵⁰ The court reasoned that the policy proceeds are not property of the estate because “[n]o one has a property interest in the proceeds of the insurance policies unless and until there is a judgment requiring that the insurers issue payment. Any property interest in the proceeds has not yet matured and may never mature.”⁵¹ The Trustee merely had contractual rights governed by the terms of the insurance policy at the time of the bankruptcy filing. “Unless and until the terms are met, which they may never be, the proceeds are not property of the estate.”⁵² Even before the advent of entity coverage, courts disagreed about whether the proceeds of a combined policy – a policy with both direct liability and indemnification coverage – should be considered estate property. Though indemnification coverage does not insure a corporation for its own liability, courts have regarded such coverage, coupled with actual or even potential claims against that coverage, as a basis for treating D&O policy proceeds as estate property. If the D&O policy proceeds are made available to a bankruptcy debtor in use of a mechanism for extinguishing corporate liabilities to shareholder litigants, the officers and directors could be left bare – with no coverage.

Several recent cases have employed a fact-intensive analysis to balance the interests of the debtor estate and the directors and officers in the proceeds of a D&O insurance policy.⁵³ The cases suggest that courts are attempting to avoid the harsh impact on officers and directors of finding the policy proceeds to be entirely within the bankrupt entity’s estate, while preserving the proceeds for the debtor where possible. The cases also suggest that in some instances courts may balance the interest of officers and directors and the debtor on an ongoing basis – evaluating successive requests for defense costs against the current needs of the debtor.

In one case, the insurer moved for a determination that payment of directors’ and officers’ defense costs out of a D&O policy would not violate the bankruptcy reorganization plan. The Court found that the officers and directors would be irreparably harmed if proceeds

⁴⁹ See *In re First Central Fin. Corp.*, 238 B.R. at 17 (citing *In re Sfuzzi, Inc.*, 191 B.R. 664, 668 (Bankr. N.D. Tex. 1996) (general liability policy).

⁵⁰ See *In re Marchfirst, Inc.*, 288 B.R. 526 (Bankr. N.D. Ill. 2002).

⁵¹ *Id.* at 530.

⁵² *Id.*

⁵³ *In re Boston Regional Medical Center, Inc.*, 285 B.R. 87, 89 (Bankr. D. Mass 2002)

were not distributed to them in time to conduct their defense.⁵⁴ In contrast, though the debtor corporation could be harmed by payment of the officers' and directors' defense costs if claims for coverage ultimately exceeded the policy limit, such harm was mitigated by the small size of the proposed payment in proportion to the policy limit, and the court's ability to control the payment of later claims to assure a pro rata distribution of the proceeds amongst the insureds.⁵⁵

Another court came to a similar conclusion and noted that former directors of a company "may suffer substantial and irreparable harm if prevented from exercising their rights to defense payments."⁵⁶ In contrast, the harm to the debtor from such payments was speculative where there were presently no claims for indemnification or entity coverage, and no "immediate risk" of depletion of policy proceeds.⁵⁷ The court found that the debtor was not truly harmed by the payment of policy proceeds as defense costs, as these are claims for which the company ultimately was obligated to indemnify its officers and directors.⁵⁸

A variant of the balancing of harms test was adopted by the court administering Adelpia's bankruptcy case.⁵⁹ The Adelpia court noted that it was "loath" to allow the estate's potential claims for entity or indemnification to trump the contractual right of directors and officers to coverage under the policies.⁶⁰ Nevertheless, the presence of entity coverage prevented the court from awarding "unfettered access" to the D&O policies for the director and officer insureds.⁶¹ Ultimately, the court struck a balance between the competing claims to policy proceeds by adopting an incremental approach to such payments; directors and officers could request, and the court would authorize insurers to make, "meaningful payments" for defense costs, but the court would retain control over successive requests in order to preserve the bulk of the policy proceeds, and ensure that such payments did not impair the rights of other entities that had an interest in the policy proceeds. Carrier attempts at policy rescission.

⁵⁴ *Id.* at 97

⁵⁵ *Id.*

⁵⁶ *In re Cybermedica, Inc.*, 280 B.R. 12, 18 (Bankr. D. Mass 2002),

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *In re Adelpia Communications Corp*, 285 B.R. 580, 600 (Bankr. S.D.N.Y. 2002)

⁶⁰ *Id.*

⁶¹ *Id.*

Some D&O carriers have attempted to address problems caused by the presence of entity coverage through the inclusion of priority of payment clauses, which provide that the policy proceeds should be made first available to individual directors and officers in connection with non-indemnifiable liabilities. The intention of these priority of payment provisions is to insure that the proceeds are paid to officers and directors first, even in the event of insolvency. In March, 2002, for example, attorneys for the bankrupt Enron Corporation moved for an order lifting the automatic stay in that bankruptcy proceeding to allow the primary D&O insurer to begin advancing defense costs to officers and directors. The attorneys argued that even though the corporate entity is jointly covered by several of the D&O policies, the individual defendants should be able to access the proceeds under the "priority of payments" provision in the Enron policy. The court allowed the stay to be lifted to permit the parties to the policy "to exercise whatever contractual rights they may have under the D&O policy" with respect to advancing defense costs. In this later proceeding, attorneys for the outside directors and the insurer argued that entity coverage and indemnification coverage for Enron were both expressly subordinated in the policy to the rights of the directors and officers.⁶² Thus at least one court has found a clause regarding priority of coverage in the event of bankruptcy to be persuasive in allowing officers and directors to access policy proceeds for defense costs. The same court later allowed an excess insurer to advance defense costs to the former officers and directors of Enron after the first layer of insurance was exhausted.⁶³

2. Carriers' attempts to rescind policies based upon fraud in the application, or under the "deliberate fraud" exclusion.

Many policy forms contain a clause whereby the insurance carrier incorporates all of a company's public statements into the policy application, including statements the Company makes in its periodic reports filed with the SEC such as 10-K's and 10-Q's. In securities cases, the truth of the company's public statements are always at issue. Especially in restatement cases, plaintiffs' counsel allege falsity based on the fact that a restatement by definition rendered the company's prior SEC filings false. In those cases, carriers might use the "incorporation by reference" clause in their policies to argue that coverage should be rescinded because the policy was induced by a misstatement of a material fact in the insurance application. Carriers are becoming increasingly aggressive in the use of, or threats of, rescission.

The recent WorldCom, Inc. securities litigation involved one of the more high profile rescission efforts by D&O carriers. In November, 2002, the court approved a settlement between WorldCom and National Union Fire Insurance Company, the provider of the primary D&O insurance policy. The settlement stipulated to the rescission of the policy as to the company, but

⁶² *In re Enron Corp., et al.*, 2002 WL 1008240 (Bankr. S.D.N.Y. 2002)

⁶³ *In re Enron Corp., et al.*, No. 01-16034, order entered (Bankr. S.D.N.Y., Dec. 20, 2002).

maintained coverage for individual officers and directors.⁶⁴ Subsequently, two of the excess D&O insurers have filed suit seeking to have \$30 million of coverage declared void on the theory that company officials intentionally failed to disclose ongoing wrongs when the policies were renewed. The company sought to have this coverage litigation stayed by the bankruptcy court, arguing that because the policies contain coverage for the entity as well as officers and directors, both the policy and proceeds are property of the estate, and subject to the bankruptcy stay.⁶⁵ That motion has not yet been decided.

Another high profile D&O policy rescission case involved Sunbeam Corporation (“Sunbeam”). Shortly after Sunbeam restated its financial results for the six quarters ending March 1998, AIG rescinded the D&O policy AIG and Sunbeam it had in place for Sunbeam’s officers and directors.⁶⁶ Sunbeam brought suit in federal court in Florida in an attempt to restore the policy.⁶⁷ While Sunbeam and AIG ultimately settled the federal court action, and AIG agreed to pay \$10 million, AIG did not reinstate the rescinded D&O policy.⁶⁸

As another example, the Wall Street Journal reported recently that Tyco International Ltd. was sued by its carrier for rescission of its D&O policy based on a theory that the policy was acquired fraudulently. Tyco was forced to settle in order to retain coverage for its outside directors. Under the terms of Tyco’s settlement with its carrier, the four individuals charged with criminal conduct, including L. Denis Kozlowski, will have no coverage under the company’s policy. Tyco also will pay \$92 million dollars to avoid losing the balance of its D&O insurance coverage. *See* Mark Maremont & Christopher Oster, “Tyco pays \$92 million dollars to keep insurance for officers, directors”, THE WALL STREET JOURNAL, May 14, 2003, at A3. The carrier is continuing to seek rescission of the policy with respect to those directors accused of criminal conduct.

The D&O carriers for Enron, Adelphia, and HealthSouth have all threatened to rescind the policies for those companies. In fact, Chubb Corp., the D&O carrier for HealthSouth Corp.

⁶⁴ *See In re WorldCom, Inc., et al.* No. 02-13533, order entered (Bankr. S.D.N.Y., Nov. 26, 2002). Pursuant to the settlement, the insurer reserved its rights with respect to the policies, including its right to rescind the policy for any insured director or officer who is later convicted of a crime, found in any proceeding to have committed fraud or dishonesty or to have received unjust enrichment, or who is sued by the debtor on such grounds.

⁶⁵ *See In re WorldCom Inc., et al.*, No. 02-13533, (Bankr. S.D.N.Y., Feb. 25, 2003).

⁶⁶ *See* JOANN S. LUBIN AND JOHN R. EMSHWILLER, *Enron Board’s Actions Raise Liability Questions*, THE WALL STREET JOURNAL, January 17, 2002.

⁶⁷ *Id.*

⁶⁸ *Id.*

sued HealthSouth and its directors in Delaware seeking rescission of the D&O policies.⁶⁹ Other carriers in other cases have attempted to carve out coverage for individual directors accused or convicted of criminal conduct. In general, the threat of rescission is high in these and similar high-profile cases.

Not all the news is bad for directors and officers who find themselves in coverage disputes with carriers over alleged "deliberate acts." In a decision from the United States District Court in Delaware last year – *Alstrin v. St. Paul Mercury Insurance Company, et al*, 179 F. Supp.2d 376 (D. Del. 2002) – the court refused to permit a D&O carrier to deny coverage for the defense and settlement of a securities class action, based on the carrier's argument that the policy, *inter alia*, excluded coverage for claims arising out of "criminal or deliberate fraud." The court held that since "Securities Claims" were explicitly covered under the policy, it would not be equitable and fair to interpret an insurance contract in a way that gives force to an exclusion for fraudulent conduct in the face of an explicit grant of coverage elsewhere in the policy – effective making the coverage illusory if the exclusion was enforced. It is unclear at this point the extent to which the *Alstrin* opinion will apply to future coverage disputes, but it augers well for D&O insureds, at least in the Third Circuit.

3. State insurance codes can cause coverage problems.

State insurance codes and regulators can also complicate insurability questions for securities claims brought against officers and directors. For example, many state laws, including those of California, prohibit insurance companies from providing coverage for liability due to willful conduct. A recent California court of appeal decision – *California Amplifier, Inc. v. RLI Insurance Company*, 94 Cal. App. 4th 102 (Cal. App. 2001) – held that a carrier was not responsible for providing coverage to insureds to cover liability for securities fraud, because the court found securities fraud liability required a finding of willful conduct. Though the claims in *California Amplifier* were brought under the California securities laws, liability under the federal securities laws requires a similar finding of willful conduct. This case suggests, at a minimum, that state insurance codes can be a source for additional ammunition for carriers seeking to avoid payments for covered claims.⁷⁰

⁶⁹ See Johanna Bennett, "Court Asked to Cancel HealthSouth Exec-indemnity Policies", DOW JONES NEWS SERVICE, April 1, 2003.

⁷⁰ Legislative efforts are underway in California to mitigate the effect of the *California Amplifier* decision. Plaintiffs' lawyers recognize the ruling in *California Amplifier* would often result in an inability to access the proceeds of D&O policies, which would make the settlement of claims both more difficult and less lucrative, so they are supporting legislation that abrogates *California Amplifier* to the extent it holds liability for fraud requires a finding of intentional or knowing conduct. See SB No. 766 (S. Florez).

4. Public policy concerns can bar coverage.

Other courts have sided with carriers and have refused to order coverage for claims appearing to meet the definition of covered claims. For instance, the United States Court of Appeals for the Seventh Circuit, in two recent opinions, held that a claim for securities fraud did not properly constitute a “Loss” under the terms of the policy because the court found that the plaintiffs were essentially seeking restitution from an ill-gotten gain. The court distinguished a claim for restitution from a “garden variety” securities fraud claim where plaintiffs are harmed indirectly by the action of defendants. The Seventh Circuit reasoned that it was against public policy for an officer or director to lose an action requiring restitution to plaintiffs of ill-gotten gains, then expect an insurance company to cover the costs.⁷¹ In another case, the Seventh Circuit held that an assessment against a company officer or director for failing to pay employee income tax was a penalty which was not covered under the terms of the policy. Again, the court reasoned that it was against public policy for an employer to make a business decision to pay obligations other than employee income tax liabilities, then expect its insurance company to cover the cost of any penalty associated with that decision.⁷²

VI. How Your Company Should Evaluate the Adequacy of Its D&O Coverage

Providing sufficient coverage for the company’s directors and officers must be weighed against the heavily-reinforced perception that settlements in securities class action cases are resource driven. That is, the higher the limits of a company’s policy, the higher the settlement expectations for the plaintiff lawyers.

Some commentators suggest that D&O coverage should be in inverse proportion to the scope of reimbursement provided or permitted in the bylaws of the corporation. That view, however, does not account for circumstances where the company becomes insolvent, or is otherwise not permitted or is unable to indemnify the officer or director (such as claims alleging improper personal benefit, which are not indemnifiable under Delaware law). Some D&O

⁷¹ *Level 3 Communications, Inc. v. Federal Ins. Co.*, 272 F.3d 908 (7th Cir. 2001). *See also Citibank N.A. v. Hochu International*, 2003 WL 1797847 (S.D.N.Y. Apr. 4, 2003) (holding a contract term purporting to limit liability for securities fraud was void as against public policy). Furthermore, at least one recent case has held that defendants found liable for securities fraud may not seek indemnification. *See In re Livent Sec. Litig.*, 2002 U.S. Dist. LEXIS 3854 (S.D.N.Y. Mar. 5, 2002) (“permitting claims of indemnification by alleged perpetrators of fraud would run counter to the paramount policy objectives of the securities laws to punish violators and to deter fraudulent conduct. Thus, the Second Circuit has held that ‘it is well established that one cannot insure himself against his own reckless, willful or criminal misconduct.’” (citation omitted)).

⁷² *Mortenson v. National Union Fire Insurance Company*, 249 F.3d 667, 672 (7th Cir 2001).

insurance brokers suggest that a company should purchase sufficient liability limits to settle a securities class action arising from a 50% stock price drop. Some brokers key on a matrix of financial factors, including revenues, stock price volatility, and the like. Opinions abound, and there is no "one size fits all" answer to this question.

Given the tougher conditions under which public companies now will be renewing their D&O policies, it will be important to have a methodical and creative risk management team explore all available options, and review terms and conditions carefully. Not all D&O policies are created equal, and there are a number of key factors to consider when both examining the sufficiency of existing coverage, and when seeking new or renewal coverage.

First, it is critical to examine the financial resources of the policy underwriters. It does a company and its directors no good to secure an excellent level of coverage, only to discover when that protection is needed that the carrier cannot stand behind its policy.

Second, not all policies cover the same claims. For instance, it is critical to examine a policy's definition of a covered claim to determine whether securities-related claims are expressly covered. With a greater enforcement budget going to the SEC under Sarbanes-Oxley, it may be desirable to have coverage for the costs associated with regulatory investigations, but few policies now cover that exposure except in the case of subpoenas issued to individual directors and officers. Understanding what is *not* covered is important to the overall risk management process.

As noted earlier, carriers are trending away from including entity coverage in their D&O policies. In its place, pre-set allocations are being offered, including allocations of up to 100% if the Company is sued along with directors and officers. Companies should explore ways to maximize such pre-set allocations, to avoid fights down the road over how much of a case is "uninsured" because the Company is also named as a defendant.

The AIG White Paper argues that companies may wish to maximize "side A" coverage, including a dedicated Side A excess program that is exclusively for officers and directors in situations where the corporation is not permitted to indemnify (and therefore Side B coverage is unavailable). *Id.* at 15.

Finally, besides the obvious points of comparison (premium amount, aggregate limits, term, etc), there are qualitative and policy issues that companies may wish to review, including:

- What is the carrier's claims-handling reputation? Will your insurance be illusory because you will have to fight with your carrier on every claim in order to obtain coverage? When deciding on a D&O carrier, companies should look not only to the financial resources and solvency of the carrier, but also to its reputation for paying valid claims, and its track record for challenging coverage and seeking rescission of policies.
- How onerous are the policy exclusions, and how do they compare to other insurers' forms? Are some of the policy exclusions, such as for "deliberate acts,"

negotiable?

- How does the coverage apply (or not) to investigative proceedings with the SEC, or other government agencies? Is there going to be coverage for those kinds of matters?
- How does the policy deal with "entity coverage"? If the Company gets sued, is that covered? What about non-securities claims against the company?
- Is there any provision that might require an "allocation" of a claim, such that the Company will be asked to contribute some portion of a settlement amount, along side the carrier?
- Are "layers" of D&O insurance going to create unforeseen problems if you have a weak carrier for one of the layers, and that carrier becomes insolvent during the policy period? What happens if there is a "gap" in coverage as a result of that?
- Is there any material difference between the primary and excess policy terms? Are you potentially going to face a coverage "gap" because the excess policy does not completely follow form to the primary policy?
- What does the application for insurance say, and how will it be second-guessed in the event of litigation? What is the carrier going to say they are relying on in deciding to issue or renew the policy?
- Is the D&O insurance "severable," so that the actions of one officer or director will not prejudice the insurance of others? What conduct will be imputed to the company, for purposes of determining whether the company has insurance?
- Are there policy provisions dealing with how the policy will pay out in the event that the company becomes insolvent and is in bankruptcy? Are there "priority of payment" provisions that will protect the directors and officers in the event of a bankruptcy?

These are just a few of the many questions that might be raised at the time of renewal, and may dramatically affect the analysis of which policy – and which carrier – is the better bet.