

*Director and Officer Liability Trends
and D&O Insurance – Advanced Issues*



DIRECTOR & OFFICER LIABILITY TRENDS

At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, Gordon "Chip" Davenport III, partner Foley & Lardner, moderated a panel discussion on "Director and Officer Liability Trends." Panelists included Michael Rice, managing director, AON Financial Services Group, and Dan Fortin, senior vice president, CNA Financial Corporation. The topic was looked at in more detail during the afternoon session on "D&O Insurance – Advanced Issues" wherein the panelists were joined by Ethan Lenz, partner, Foley & Lardner LLP and Steve Shappell, managing director, Aon.

The panel presentation featured an overview of the latest trends in D&O litigation and the D&O insurance marketplace; how insurance companies scrutinize the companies they write D&O policies for and what a company and its directors and officers can do to get the best possible D&O insurance coverage; and how to avoid gaps in insurance coverage and how to negotiate the best possible policy terms.

Trends in D&O Litigation and the D&O Insurance Market

There are two things that drive the D&O insurance market: the frequency and severity of claims. According to Mike Rice, the year 2006 saw a 50% decrease in the number of federal securities class action lawsuits filed when compared with the average over the preceding ten years. While this decrease in the frequency of lawsuits is good news for those in the market for D&O insurance, it is tempered by a substantial increase in the severity of those lawsuits and resulting claims. The average settlement of a federal securities class action in 2006 was \$38.39 million, with 12 settlements in amounts greater than \$100 million.

Overall, however, the D&O insurance market is a good one for buyers. First, since frequency of claims tends to drive D&O insurance prices to a greater extent than severity of claims, the downward claim-frequency trend has driven prices down notwithstanding the increase in severity of claims. Second, in recent years, D&O carriers have made significant profits on their policies, which has attracted new insurers into the D&O market. This increase in supply also has put downward pressure on D&O insurance premiums.

The result has been a broad, substantial buyers market for D&O insurance. Over the past three years, the trend has been decreased premiums and increased coverage. In fact, on average, a renewing company's 2006 premiums were 15% lower than its premiums in 2005. While this sort of reduction is not sustainable over the long term, Mr. Rice does believe that the trend will continue in 2007.

Aside from pricing concerns, the strategic selection of a D&O carrier is important, because you are transferring both personal and balance-sheet risk to that carrier. In making that choice, several factors should be considered:

- While D&O insurance pricing acts in a commodity-like fashion, no two carriers write the same policy. Consequently, D&O insurance cannot be viewed as a commodity, and a careful analysis of the insurer's policy form is critical.
- Although there is no S&P AAA rated carrier that writes D&O policies, the financial strength of the carrier is important and needs to be considered.



- Alignment with a carrier that is a market “leader” is important. Mr. Rice explained that from his perspective, D&O carriers are either market “leaders” or “followers.” The leaders are those insurers that are willing to write primary policies and that have a sound understanding of risk. The followers are those insurers that are only willing to write excess policies, essentially following those carriers that write primary policies. It is important to be aligned with the leaders – those that understand risk.

D&O Risk Assessment and Implications for Directors

Dan Fortin focused on how D&O underwriters look at risk, how they price risk, and what companies in the market for D&O insurance can do to influence the price they pay. Briefly summarizing some key D&O claim statistics at the outset, he noted that public companies face a 35% chance in any given year of experiencing a D&O claim. Shareholder-claims are the largest source of this risk, accounting for 50% of all D&O claims. Significantly, he noted, 90% of all losses in CNA’s public company D&O portfolio consist of costs to defend and resolve securities class action claims brought by shareholders. Private companies face a significantly lower risk of D&O claims, at only 10% per year. The largest number of D&O claims against private companies (50%) are brought by employees.

It’s absolutely necessary for buyers to understand Insurer Strategies in order to achieve the best fit with a D&O insurer. Items that buyers ought to consider include:

- *Long-term v. Short-term* – Weigh the pros and cons of buying from insurers who try to time the market or behave erratically.
- *Risk Appetite* – If *your* risk profile changes, is your *insurer’s* risk profile broad enough to accommodate that change?
- *Capacity Management* – What’s the limit that the insurer will commit to any one risk, and how much of your risk will the carrier bear itself as opposed to passing it to a reinsurer?
- *Primary v. Excess* – Does the insurer have the actuarial and claims structure necessary to be a primary insurer (a “leader”), or are they a “follower”?
- *Claims* – Interview the insurer about its claims process: Is claims administration outsourced? Are claims handled by attorneys? What is the process when there is a dispute about a claim?

In reviewing how D&O carriers price their policies, Mr. Fortin noted that the criteria that underwriters use has become much more objective due to the large amount of information and other data that underwriters have available to them. Typically, the underwriter will plug into a model a set of objective risk factors to come up with base pricing for a D&O policy. Some of the objective risk factors that are usually included in that process are:

- Market Capitalization
- Industry
- Jurisdiction



- Ownership
- Assets
- Revenue
- Beta
- Credit Rating

Once these objective factors are analyzed, subjective factors and intangibles are considered. These are the factors that a company can emphasize to distinguish itself from others with similar objective factors and obtain better pricing and coverage. Subjective risk factors include:

- Financial performance
- Stock price performance, short sales, volume
- Corporate governance
- Investor profile
- Internal controls, compliance, code of conduct
- Secondary offerings
- Corporate transactions
- Restatements
- Change in auditor
- Claim activity, legal proceedings, investigations
- Accounting practices
- Insider trading

Along with these subjective factors, there are other “intangibles” that can help buyers get better pricing and coverage. For example, relationships play a huge role in pricing, terms, and claims. It therefore behooves companies to develop a good relationship with their insurer, and to consider developing relationships with multiple insurers. In addition, underwriters are keen to see that the company is serious about corporate governance and realistic about the risks that it faces. Thus, when meeting with a potential carrier, corporate officers should be ready to confront negative issues and be prepared with a risk self-assessment.

D&O Insurance: Hot Coverage Issues and How to Address them at your next Renewal

There are several key issues to consider and address in making certain that your company obtains the best possible D&O policy. Echoing some of the themes throughout the presentation, Chip Davenport stressed that D&O policy forms and coverage vary widely, with many terms open to negotiation. To get the best policy, it is critical to leave enough time (60 days preferred, but 30 days minimum) to: 1) get the right people involved (a broker plus someone else knowledgeable about D&O insurance), 2) set up a competitive



bidding process among carriers, and 3) understand what you need to ask and negotiate for in the policy.

Some examples of important coverage terms that require attention and may be negotiated include:

- *Severability* – This provision determines who loses coverage if the carrier rescinds the policy. If the policy is rescinded for failure to disclose material facts in the application, the presence or absence of a severability provision will determine whether only those responsible for the nondisclosure lose coverage, or everyone – the company, and all officers and directors.
- *Crime/Fraud Exclusion* – There are important differences in the fine print of this exclusion (which appears in every D&O policy) that determine when the exclusion kicks in and what type of conduct it applies to. It comes into play frequently in securities cases, which frequently include allegations of fraud.
- *Nonrescindable A-Side* – This is the part of the policy that covers officers and directors in the event that the company does not indemnify them. It is increasingly possible to obtain policy language that makes this coverage nonrescindable.
- *Punitive Damage Coverage* – Some policies cover punitive damages and some don't. Additionally, some states do not allow this coverage, but there are terms that can be negotiated into a D&O policy to maximize the possibility that punitive damages will be covered.
- *Regulatory Investigation Coverage* – Many D&O policy forms either don't cover or provide only limited coverage for regulatory investigations, which can be quite expensive.
- *General Counsel Coverage* – Many D&O policies do not provide coverage for inside lawyers when acting as a lawyer. A separate policy may be needed for that.
- *Hammer Clause* – This clause gives the insurance company leverage to force a settlement by capping your coverage if you don't agree to settle.

Some of the hot D&O coverage issues include the ongoing options dating investigations and global warming coverage issues. There are currently about 120 options dating investigations being conducted. Coverage for these investigations and any resulting loss can be determined only by a close scrutiny of the D&O policy, and particularly how it defines a "claim" and a "loss." Second, while there currently is not a lot of global warming-related claims activity, it is on the horizon. Cases are split on whether there is D&O coverage for global warming-related claims. Coverage may depend on the language of the pollution exclusion in the D&O policy.

Several other issues should be considered when purchasing or renewing D&O insurance, including:

- *Fiduciary Claims* – These are claims relating to employee-benefits – for example, ERISA and 401(k) claims. They are *not covered* by D&O policies. A separate fiduciary liability policy is necessary. Such policies are no longer simply an



afterthought, and companies are buying increased amounts of coverage due to larger exposure for these claims.

- *Non-Rescindable Coverage* – A few carriers are now beginning to offer non-rescindable ABC coverage, though there are some detriments that come with these policies.
- *A-Side Only* – These policies provide an extra layer of protection exclusively for officers and directors. They are quite common.
- *Bankruptcy Issues* – Bankruptcy courts tend to take the view that any insurance coverage belongs to the estate of the bankrupt corporation, which limits the ability of officers and directors to take advantage of the policies. It is important to negotiate provisions into the D&O policy that can help (but not eliminate) this problem.

Private companies also often need D&O insurance, particularly where they are engaged in raising capital (either equity or debt), mergers, or acquisitions.

D&O INSURANCE – ADVANCED ISSUES

Addressing more detailed issues surrounding D&O liability trends, the panel fielded questions from the audience and provided the following feedback:

- *Individual Director Policies*
These tend to be expensive and there are more gaps in coverage than coverage. They typically are not a great product.
- *Understanding Your Coverage*
Some directors will have an attorney review a company's D&O policy before joining a new board, however, this isn't necessarily mandatory. It is simply a matter of whatever it takes for the officer or director to be comfortable with the coverage offered by the company. More and more frequently, companies are requesting presentations to their entire board to address coverage questions.
- *Fiduciary Claims Not Covered*
This is one of the few clear border lines between D&O policies and other insurance policies. Fiduciary claims (ranging from claims pertaining to the administration of employee benefit plans to breach of fiduciary duty in 401(k) administration) are virtually uniformly not covered by D&O policies. Though such claims are neither as frequent nor as feared as D&O claims, they have been increasing over the past few years.
- *Coverage for Non-Officers/Directors*
A D&O policy can be adjusted to cover individuals who, though not technically officers or directors, engage in the types of activities and decision-making in which officers and directors engage. This can be done by adding the individuals as named insureds to the D&O policy either by position or by name. When doing so, the insurer typically will want a statement from the company that the added



individual would be indemnified by the company as would be any other officer or director.

- *Protection of D&O Insurance in Bankruptcy*
There are several things that can be done in the D&O policy to protect directors and officers from having to expend personal assets in the event of bankruptcy. First, a priority of payments provision can be added to the policy, which states that if there is not enough insurance money to go around, individuals get it first. Second, a provision can be added to the policy to waive the automatic stay to the extent it would block individuals from getting the proceeds to the policy. Neither of these are perfect, however. One additional thing that can be done, though, is to purchase an A-side only policy.
- *A-Side Only Policies*
A-side only policies provide coverage to directors and officers to the extent the company cannot or is unable to indemnify them. They protect officer's and director's personal assets. About 70% of companies provide A-side only coverage, but there are many variations.

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

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