

 **FOLEY**

FOLEY & LARDNER LLP

# *Director and Officer Liability Trends*

2008 NATIONAL DIRECTORS INSTITUTE



## DIRECTOR AND OFFICER LIABILITY TRENDS

### INTRODUCTION

“Director and Officer Liability Trends” was a featured breakout session at the seventh annual National Directors Institute, hosted by Foley & Lardner LLP on March 6, 2008, in Chicago. The panel discussion was led by Foley Partner Gordon (Chip) Davenport III along with Michael Rice, Chief Executive Officer of Aon Financial Services Group, and Dan Fortin, Senior Vice President of CNA Financial Corporation.

The panel presentation featured an overview of the latest trends in director and officer (D&O) litigation and the D&O insurance marketplace. Panelists discussed how insurance companies evaluate the companies for which they write D&O policies as well as steps a company and its directors and officers can take to secure the best possible D&O insurance coverage.

### TRENDS IN LITIGATION AND THE D&O INSURANCE MARKET

The important factors in determining the price and scope of D&O coverage are frequency of claims and severity of claims. The year 2007 saw a decrease in the number of federal securities class action claims. The average settlement size of federal securities class action claims also decreased from \$38 million in 2006 to \$25.8 million in 2007. The result is a strong buyers’ market for D&O insurance — coverage is broader and premiums are down. D&O renewal rates have decreased each quarter for the past 17 quarters. In the fourth quarter of 2007, the renewal premiums for all industries were down 18.9 percent. Similarly, renewal premiums for Fortune 500 companies were down 22.9 percent.

However, the early numbers for 2008 may have an impact on this buyers’ market. Based upon the last five months of 2007 and the first two months of 2008, the annualized rate of federal securities class action claims is 240. Although this increase in frequency may lead to increased premiums, such changes are not likely to occur in the current year. Generally, it takes about a year for external events such as frequency of claims to impact pricing. This is due in large part to the fact that most D&O insurers insure their books of business with reinsurers. These policies typically have a term of one year. When they expire, D&O insurers may need to respond to an increase in the frequency of claims by increasing premiums for the next year’s terms.

When selecting a D&O insurer, a company and its directors and officers should have a good understanding of the D&O insurance marketplace and its players. Several factors should be considered during the selection process:

- There are approximately 40 insurers with an appetite for public and private company D&O insurance.



- While D&O pricing acts in a commodity-like fashion, no two carriers write the same policy. As a result, 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 Standard and Poor's (S&P) AAA-rated carrier that writes D&O policies, the financial strength of the carrier is important and needs to be considered.
- Due in part to the decrease in frequency of claims, D&O insurers are bypassing reinsurers and keeping more of the risk. As the frequency of claims increases, carriers without reinsurance policies will change pricing quickly as losses increase.

Similarly, a company and its directors and officers should have a good understanding of the hot topics that D&O insurers are facing. When dealing with public companies, D&O insurers are concerned with:

- Exposure to subprime-mortgage-related liability
- Stock option grant practice
- Mergers and acquisitions (M&A) plans and procedures
- Sarbanes-Oxley Act compliance and enterprise risk management
- Board/senior management turnover
- Existing litigation and U.S. Securities and Exchange Commission (SEC) investigations
- Stock price volatility and industry volatility
- Increasing shareholder activism
- Foreign Corrupt Practices Act (FCPA) adherence
- Global warming

When dealing with private companies, D&O insurers are concerned with:

- Audited financials
- Employee count/growth
- "Securities" exposure for exempt offerings
- Initial public offerings (IPO) plans
- Quality and independence of board and senior management



## D&O INSURANCE FROM THE INSURER'S PERSPECTIVE AND IMPLICATIONS FOR DIRECTORS

When purchasing a D&O policy or renewing an existing policy, companies and their directors and officers can increase their understanding by viewing the process from the perspective of the D&O insurer. First, it is important for companies to understand how D&O carriers price premiums: by using a combination of objective and subjective criteria to price premiums. The objective criteria include:

- Whether a company is owned publicly or privately or is a nonprofit
- Market capitalization
- Assets
- Revenue
- Industry
- Location
- Beta
- Credit rating

Once these objective factors are analyzed, subjective factors are considered. These are factors that a company can emphasize to distinguish it from others with similar objective factors and to obtain better pricing and coverage. In addition, a company has a greater ability to influence how a D&O carrier views these subjective factors, which include:

- Financial performance
- Stock price performance, short sales, and volume
- Corporate governance
- Investor profile
- Internal controls, compliance, and code of conduct
- Claim activity, legal proceedings, and investigations
- Accounting practices
- Insider trading practices

Along with these subjective factors, there are other “intangibles” that can help buyers secure better pricing and coverage. For example, relationships play a significant role in pricing, terms, and claims. It is therefore in a company’s best interests to develop a good relationship with its insurer. As part of this relationship, a company should conduct objective risk assessment and should address negative risk factors proactively. By doing so, the company will find that a D&O carrier may be more willing to reduce pricing and give broader coverage.



## ENSURING THE BEST COVERAGE FOR D&O LIABILITIES

There are several key issues that a company and its directors and officers should consider and address to obtain the best possible D&O policy:

- D&O coverage is just one type of coverage that a company and its directors and officers should consider when evaluating “executive risk” coverage. Other types include coverage for errors and omissions (E&O), employment practice, fiduciary liability, A-side coverage, and intellectual property (IP).
- The insurance market changes constantly. Insurance companies issue policies that vary from year to year on price and on terms and conditions. Therefore, it is important for a company to continually compare its coverage to the current best available coverage on the market. A company should strive to review and compare its policy to others in the market every year.
- Some brokers are better than others. A company’s broker should have expertise in executive risk coverage and experience with executive risk placements, and should be knowledgeable about the executive risk markets.
- Although it is important to utilize a good broker, a company should not completely rely on that broker. A company and its directors and officers should be active buyers. They should thoroughly analyze renewal proposals for price and, more important, the terms and conditions of the policy. They should create a list of targeted improvements to their policy and should negotiate actively for improvements to weak spots.
- Price is not the only factor to consider when purchasing a D&O policy. A company and its directors should review the details of coverage terms and conditions, the strength of the carrier, and the reputations of carriers for handling claims.
- A company and its directors and officers should build relationships with their carrier. Such relationships may result in better coverage terms.
- If a company is switching carriers, it should pay attention to continuity of coverage issues such as prior acts coverage, tail coverage, and notice of circumstances under the company’s old policy.
- A company and its directors and officers should evaluate and address their particular risk exposures. These may include international exposures, IP exposures, or risks related to private placements or professional services.
- A company and its directors and officers should know the details of the coverage they purchase. Such details include the types of coverage, the amounts of coverage, the premiums, and the different carriers in the market. The most important details, however, are the coverage terms and conditions.

As mentioned above, a company and its directors should pay attention to key coverage terms. Some examples of important coverage terms that may be negotiated include:



### **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 the type of conduct to which it applies. It comes into play frequently in securities cases, which frequently include allegations of fraud.

### **PUNITIVE DAMAGE COVERAGE**

Some policies cover punitive damages and some do not. Also, 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 do not cover, or provide only limited coverage for, regulatory investigations, which can be quite expensive.

### **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 coverage will be lost by only those responsible for the nondisclosure lose coverage or by everyone — the company and all officers and directors.

### **HAMMER CLAUSE**

This clause gives the insurance company leverage to force a settlement by capping coverage if the insured does not agree to settle.

### **FOR MORE INFORMATION**

For more information on this session or the seventh annual National Directors Institute, visit [Foley.com/ndi2008](http://Foley.com/ndi2008) or contact the panelists directly.

Gordon (Chip) Davenport  
Foley & Lardner LLP  
[gdavenport@foley.com](mailto:gdavenport@foley.com)

Dan Fortin  
CNA Financial Corporation  
[daniel.fortin@cna.com](mailto:daniel.fortin@cna.com)

Michael Rice  
Aon Financial Services  
[Mike.Rice@ars.aon.com](mailto:Mike.Rice@ars.aon.com)