



# Key D&O Policy Enhancements To Consider for 2009 – 2010

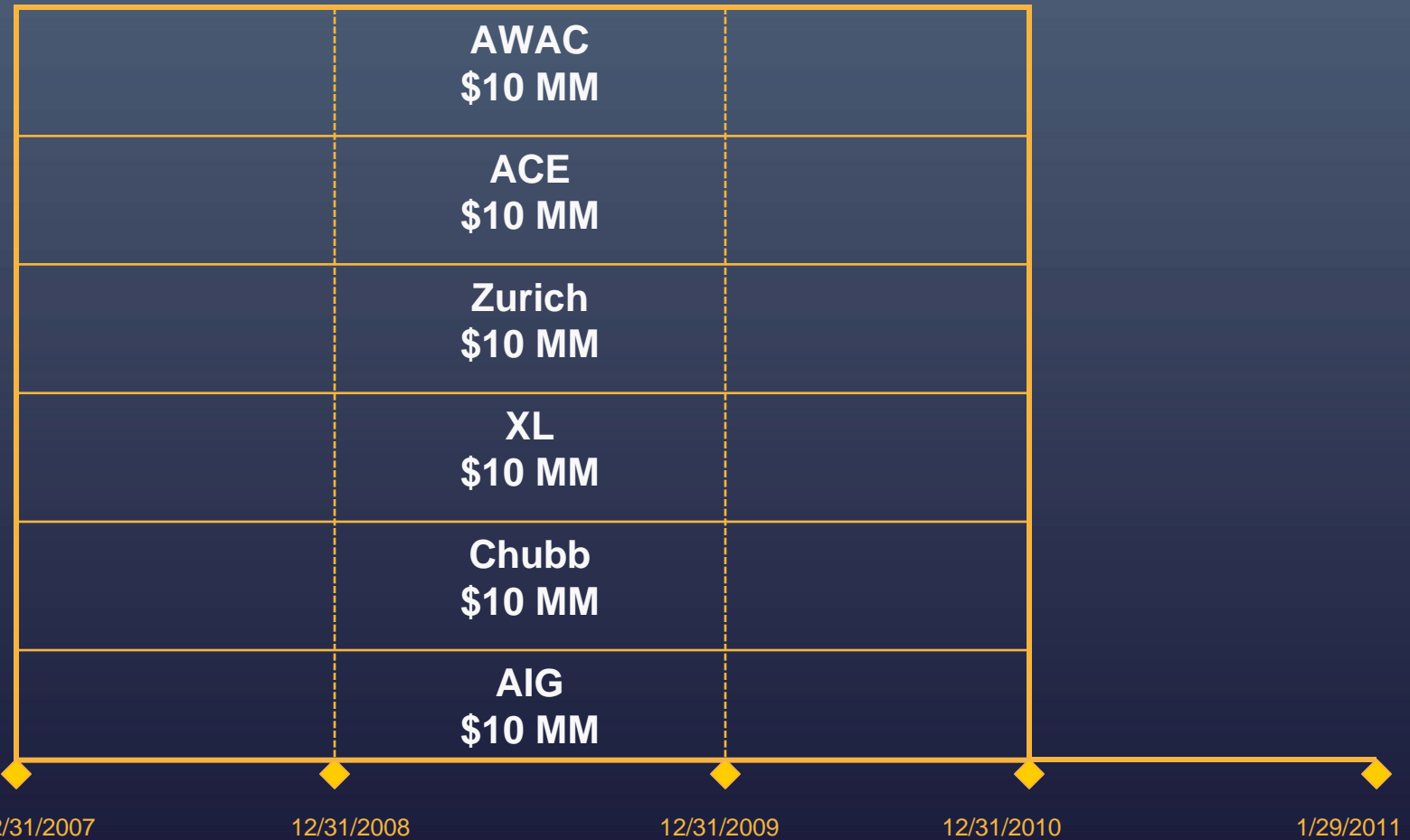
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# Overview of D&O Insurance

- Claims-Made Coverage
- Typically Combines three coverages in one package:
  - Side A - Individual directors and officers - non-indemnified loss
  - Side B - Reimburses company for claims against individual D's & O's
  - Side C - Corporate Entity Coverage - typically limited to securities claims
  - Other coverages available - employment practices, data privacy and security, cyberliability, etc.
- Application submitted by insured company is part of insurance contract.
- Policy forms non-standardized, highly negotiable and manuscripted, especially in today's market with new entrants, etc.
- D&O program typically includes multiple layers of coverage, in the form of a tower, often with inconsistent wording, creating tensions in the event of a claim.

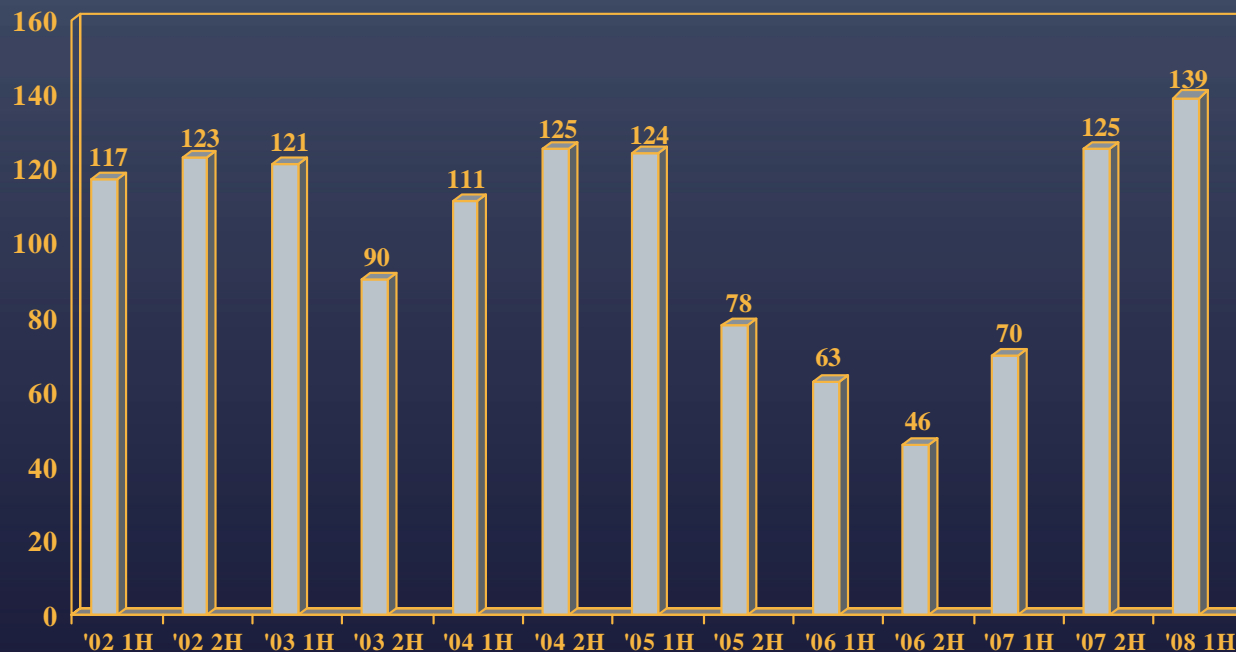
# SPECIMEN D&O INSURANCE TOWER



# Key Developments Affecting D&O Coverage

- Trends involving Securities Claims

## Federal Securities Class Action Filings Six Month Intervals



# Securities Litigation Trends

- Securities class action lawsuit filings returning to historical levels
- Securities class action lawsuit filings dropped during the second quarter of 2009, but filings rebounded in the third quarter
- Projected filings for 2009 = 191 (annualized based on first nine months of 2009 )
- That is close to average of 197.7 annualized filings during the thirteen year period from 1996 to 2008
- Concentration of filings in the financial sector is abating
- During first half of 2009, two-thirds of securities class action lawsuit filings involved financial companies, compared to one-third in third quarter
- Third quarter 2009 filings involve proposed class cutoff dates that are well in the past, suggesting that plaintiff lawyers are now working on the backlog developed when concentrating on subprime and credit-crisis -related lawsuits

# Key Developments Affecting D&O Coverage

- Recent Claims Activity
  - Securities Litigation and Investigations
  - Data Privacy and Security
  - Overseas Issues
  - Environmental/Climate Change
  - Foreign Corrupt Practices Act
  - Shareholder Activism
- Financial Crisis Hit General Insurers
  - Market Hardening – Some Markets
  - Security of Risk Transfer an Issue in 2009.
- Coverage Disputes
  - Rise in Rescission Threats
  - Rise in Issues Relaxed to Excess Insurers
  - Focus on Requirement of Insurer's Consent to Settle
  - Restitution/Disgorgement Issues
  - Relatedness Issues

# Problems and Solutions for Individual Directors & Officers

- Some Common Issues From Perspective of Individual D&O's:
  - Erosion of limits via defense of "black hats" or entity
  - Rescission risks
  - Loss of coverage due to crime/fraud by individual D or O
  - Exclusion of circumstances or claims pending prior to individual's board tenure
  - Bankruptcy risks
  - Loss of coverage due to company's failure to provide timely notice or meet other conditions
  - Indemnification issues regarding derivative shareholder claims under Delaware law.
- Potential Divergent Interests of Individual Directors, Corporate Officers and Corporate Entity

Key Issue: How To Balance Interests in D & O Policy

# Five Key Enhancements to Address Individuals' Concerns

- Side A only policies – Excess to corporate program -
  - Segregated limits for individual directors only – limits can't be tapped by company.
  - Addresses risk of corporate erosion, but not erosion by “black hat” individual D's or O's
  - Some insurers offering endorsement to deny coverage to individual D or O who pleads guilty, subject to super-majority vote of Board. (e.g., AWAC)
  - Segregating limits for outside directors is worth consideration
- Make policy non-rescindable for Side A and B -
  - Insurers face difficult burden to rescind coverage – proof of material misstatements, causation, etc.
  - But false statements by authorized officer may result in rescission of entire policy, even as to innocents, in some states (CA, PA, FL)
    - ▲ TIG of Michigan v. Homestore, 40 Cal. Rptr. 3d 528 (Cal. Ct. App. 2006).
  - Non-rescindable coverage is solution, but varies widely – beware:
    - ▲ Policy may still permit denial of coverage under sides B and C based on material misstatements or omissions in materials submitted with the application – better for insurers (no return of premium, lower burden)
    - ▲ May contain broader exclusions than standard forms
    - ▲ Negotiate the language and compare options



# Five Key Enhancements to Address Individuals' Concerns

- Side A Difference-in-Condition (DIC) Coverage:
  - Purpose: to fill gaps in standard D&O policy
  - True DIC coverage should contain virtually no exclusions
    - ▲ Should have no pollution exclusion, pending/prior claim exclusion
    - ▲ Personal conduct exclusion must be severable, apply to individuals only.
  - Coverage drops down to apply in the event that coverage under an underlying D&O policy is denied under an exclusion or failure to meet a condition, coverage is "wrongfully" denied, or an insurer is insolvent; may also apply if carrier seeks rescission.
  - Wording varies widely - may not drop down, and may contain too many exclusions.
  - Should afford coverage to individual directors if the company is legally permitted to indemnify the directors but fails to do so.

# Five Key Enhancements to Address Individuals' Concerns

- Severability of application, cooperation clause, and exclusions -
  - Non-Imputation of knowledge between individuals
  - Corporate knowledge only if known to CEO, GC, CFO
  - Some insurers even threatening rescission despite "full severability" provision.
- Amend Personal Conduct Exclusions -
  - Crime/Fraud Exclusion should be triggered by *deliberate* fraud, determined after a final, non-appealable adjudication in the underlying action.
    - ▲ Settlement short of guilty plea not enough.
    - ▲ Finding in coverage action should not be relevant - don't want to try fraud case in coverage action.
    - ▲ Should be severable, i.e., applies to the wrongdoer only.
  - Illegal "Profit or Advantage"
  - Unlawful Remuneration

# Ten Problems and Solutions for Corporate Coverage

## ■ Insurability of restitution or disgorgement damages -

- Most insurers argue that damages under Sec. 11 and 12 of the '33 Act (barring misstatements in public offerings of Securities) are really disgorgement of amounts improperly gained, so no "loss" incurred, and in any event, public policy prohibits coverage for moral hazards.
- See *CNL Hotels v. Houston Casualty Company*, 505 F. Supp. 2d 1317 (M.D. Fla. Mar. 14, 2007), *aff'd* 291 Fed. Appx. 220, 2008 WL 3823898 (11<sup>th</sup> Cir. 2008).
- Trend for insurers to argue no "loss" for broad range of claims when damages arguably constitute return of "ill-gotten gains."
- Enhancement:
  - Insurer agrees not to assert that a Securities Claim alleging Sec. 11 or 12 violations is uninsurable as a matter of public policy or that damages incurred fall outside of the scope of Loss.
  - Address issue in same manner as punitive damages: presumptively covered unless prohibited by law.
  - At minimum, should expressly protect individuals who did not receive "ill-gotten gains," and defense costs should apply.

# Ten Problems and Solutions for Corporate Coverage

- **Pollution exclusion:**
  - Standard exclusion for any claims relating to pollutants
  - May exclude claims relating to global climate change
  - Should modify to cover any securities claims - or any other claims brought by or on behalf of shareholders
  - Except defense and Side A only claims
- **Excess policies:**
  - Excess insurers preventing settlements with primary by saying primary not exhausted unless insurer pays 100% of limits
  - Should be follow-form, triggered by exhaustion through payment by insurer or insured to 3rd party
  - Reduction of underlying limits endorsement solves some problems, may create more.
  - Need common dispute resolution clause
- **Allocation of covered and non-covered loss:**
  - Some policies allocate equitably
  - Better wording says if any claim covered, entire suit covered, or default to set percentage, or ADR
- **Bankruptcy Issues:**
  - Coverage must survive ch. 11 and include trustee claims
  - Add predetermined allocation, order of payment clauses
- **Pending and prior claims, prior acts, prior notice exclusions:**
  - Tailor to narrowest possible wording for claims related to prior claims previously noticed
  - Limit "previously noticed" to notice under D & O policies reported and accepted by carrier
  - Should account for newly elected directors
  - Interrelated Acts and Relation-back issues (N.B. Andy Warhol case.)

# Ten Problems and Solutions for Corporate Coverage

- Territorial scope:
  - Expected increase in class-action suits in Europe suggests need for non-domestic cover
  - Endorsement to address regulatory, compliance, and coverage issues associated with global D&O exposures
- Broaden Scope of Defense Coverage:
  - List company's preferred counsel as pre-approved defense counsel
  - Allocation for non-covered Loss should include 100% defense
  - Add defense of criminal proceedings, including FCPA
- Add Plaintiff's Fees to Covered Loss:
  - Carriers may assert class action plaintiffs' attorneys' fees often excluded because overall settlement does not meet definition of covered Loss
  - Specifying cover for fees awarded to counsel
- Insured v. Insured Exclusion:
  - Broaden exceptions
  - Former D&O assistance should be narrowly defined
- Scope of Exclusions Generally:
  - Introductory language applies each exclusion “alleging, based upon, arising out of, or attributable to”...
  - Replace with:
    - ▲ “for”
    - ▲ or “alleging, based upon, arising out of, or attributable to that portion of loss...”

# Market Trends:

- Long-term impact of AIG turmoil
- Security of insurance programs must be assessed, monitored
- Solutions for international risks and coverage evolving
- Customization of excess programs (Side A only, Outside Director coverage)
- Need to address coverage for investigations
- As always, consult coverage counsel on wording and terms



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