

III D&O insurance in the US

BY CLAIRE SPENCER

In the US, a corporation cannot hope to attract competent directors and officers without comprehensive D&O coverage. It both provides protection for directors and officers against liability claims, and covers the expenses associated with defending the directors and officers in court. Without D&O protection, personal assets can be at risk. Few directors and officers will tolerate the risk of serving on the board of profit or not for profit organisations if they face potentially large personal loss. As such, the US D&O insurance market had enjoyed several years of profitability prior to the financial crisis. This was also due to a combination of fewer security class action suits, stronger pricing, and increased demand in the wake of the Enron and WorldCom class action suits. However, things have now changed amid the disruption and uncertainty of the current global market. Premiums are increasing, and companies are less able to negotiate favourable insurance terms and conditions, increasing their vulnerability.

Recent history

Directors and officers are now under intense scrutiny, with the number of such individuals facing claims and class action suits increasing by at least 10 percent when compared with 2007. However, the figures may not be telling the full story. “The increase in the sheer number of D&O claims that we have seen over the past 12 months has far outpaced the reported numbers that we are seeing in official releases,” says Ann Longmore, executive vice president and product leader at Willis HRH. A significant percentage of these were spawned by the financial crisis. “When it comes to size, or severity, we haven’t yet seen many settlements or court awards for the ‘Class of 2008’, but with the staggering size of the asset write downs and stock drops, the damages being sought dwarf previous experience,” she continues. It is also thought that the fallout from Bernard Madoff’s alleged Ponzi scheme will lead to litigation arising from against those investment managers who recommended his fund as a good investment to clients, as well as suits against their lawyers and accountants.

Furthermore, the number of these security class action suits is expected to increase, with financial institutions bearing the brunt of the action. Most suits will lead to claims on the D&O insurance policy. In addition, the number of regulatory investigations has also increased. However, insurance policies have clashed over whether these can be labelled ‘claims’. “Insurers will argue that governmental subpoenas and SEC investigations are not claims until a formal proceeding is instituted,” notes Jerold Oshinsky, a partner at Gilbert Oshinsky. “The resolution of this issue depends upon the policy language, which may vary from policy form to policy form. These policies also cover loss, which may exclude coverage for fines and penalties; however, fines and penalties may really constitute damages and, as such, should be covered by insurance,” he says. Nonetheless, it is thought that so-called claim denials, and the subsequent coverage litigation caused by those denials, are set to increase.

It is clear that D&O insurance is more important than ever, particularly for financial institutions. Unfortunately, it is also more expensive than ever, says Angela Elbert, a partner at Neal Gerber & Eisenberg. “The impact of the financial crisis on D&O insurance has been felt most heavily by financial institutions, which are experiencing rising prices, a tougher underwriting process, shrinking capacity and decreasing limits on B and C sides of coverage. Premium increases for financial institutions are all over the board, with reports ranging anywhere from 20 to 250 percent. One financial institution client, which did not file a claim in 2008, saw its D&O rates rise by nearly 70 percent for 2009 based solely on fears that claims would be forthcoming.” However, Ms Elbert adds that the institution’s coverage, limits and deductible remained consistent. It is unclear at this stage whether other types of companies will feel the same hardening effect on pricing and cover on their D&O insurance policies, although it is fair to suggest that most insurers will, at least, be reviewing the language used in those policies.

D&O insurers believe that these measures are necessary to maintain satisfactory capital reserves in the face of the ever-increasing number of claims. Nonetheless, many insurers have suffered multi-billion dollar losses and write downs, causing their financial ratings to suffer and forcing them to tap into government bailout funds for survival. Those companies which hold D&O insurance with such companies are currently questioning their stability, fearing that they will be unable to provide coverage when it is required. This is a particular worry for those who hold Side-A D&O insurance, which pays claims when the company cannot indemnify its executives – a very possible scenario in the current market.

The changing landscape and its effects on policies

Arguably, the most startling change to the D&O landscape in recent months came from the office of General Counsel of the New York State Department of Insurance, which has to approve all new D&O contracts issued within the state. In October last year, they held that a D&O insurer cannot place the duty to defend onto the policyholder, and has indicated that D&O insurance for public companies must be written on a duty-to-defend basis. The effects of this ruling could be significant. Most D&O policies are ‘duty to indemnify’ policies, which are only required to advance or reimburse the insured for reasonable defence costs.

Ms Longmore believes that this decision could have both positive and negative effects. “If public company D&O insurance were written in a duty-to-defend rather than reimbursement manner, the carriers could not allocate between defence costs for covered and uncovered allegations that may be included in a single claim or series of related claims. Instead, the carrier would have to pay the full tab. In most cases this would result in larger payouts by the insurance carriers for D&O claims. However, the dark side of this potential change is that the insurers would have more control over the defence and settlements of ▶▶

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D&O claims against public companies, including the selection of defence counsel, which most executives and their companies would view as a negative development," she says. How this will play out in the long term remains to be seen.

Conversely, in the case of *Schoon v. Troy Corp.* (2008), the Delaware Chancery Court's ruling was rather unfavourable for retired or soon-to-retire corporate executives. "In *Schoon*, the Court held that a corporate bylaw that granted advancement of expenses to former directors could be amended to take away that right after the executive resigned, if the amendment was made before a claim or threatened claim was asserted against the former director. Corporate executives need to be aware of this development so they can take measures to protect themselves against post-service bylaw amendments that can impair their indemnification rights," says Seth Schafler, a partner at Proskauer Rose. The case was raised when a D&O claim was brought forward, causing a director to seek indemnification from the company. This was ultimately denied.

The weight of these changes and the effects of the financial crisis have inspired directors, officers, and the companies they work for to be wiser when securing indemnification. Without it, their personal assets can be at risk. As such, indemnification for individuals can often be a huge issue in the event of a bankruptcy. In most security class action suits, the company would indemnify its directors and officers. "However, in cases where the company cannot indemnify due to insolvency or state law, they will need protection from the D&O policy. In the event that the company is also being sued, there is a possibility that the Side-C coverage may exhaust the policy limit, which would leave minimal coverage for Side-A, which is for individual directors and officers," warns Benny Yuen, Property Casualty Actuarial Professional at Ernst & Young. To mitigate this risk, he recommends a standalone Side-A policy, which will indemnify directors and officers in situations where a company would not or cannot indemnify them.

In a turbulent market, a Side-A only policy can be critical for directors and officers. If a traditional D&O policy is considered as part of the bankruptcy estate, directors may have to share it with the company, or worse, be unable to access it. Newer versions of Side-A only policies should ensure that they are still indemnified in such circumstances. This is because, under such policies, the company itself is neither covered nor a contingent beneficiary. Furthermore, a director's duties are ex-

tended to assist a company's creditors, as well as its shareholders in the event of a bankruptcy. Then, the creditors have the right to bring a derivative action on behalf of the corporation, which can adversely impact D&O insurance. This is due to the fact that additional claims may have to be asserted under the policies.

However, this is not a trend that D&O insurers had anticipated. As such, it has only exacerbated insurers' losses on D&O policies "The likelihood of large financial institutions being insolvent has historically been remote, so most D&O insurance writers thought the Side-A only policy would not attract that many clients. But that is no longer the case in the current financial crisis, and more Side-A only policies will be affected in the coming months," predicts Mr Yuen. On the other hand, it should be noted that, in the event of a government bailout, the government may often indemnify the directors and officers, thereby preventing the Side-A policy from being triggered.

Of course, regulatory updates and judicial precedent are not the only vehicles for change. For example, the Madoff fraud, uncovered in December 2008, has also had an impact. "In an attempt to limit this impact, policyholders can expect to see Madoff exclusions in their D&O (and E&O) renewal policies, providing significant urgency to investigate possible Madoff-related claims now and report any notice of circumstance to carriers before expiration of current policies," asserts Ms Elbert. However, these exclusions are unlikely to be applied retroactively.

In addition, there are long-term issues that providers are yet to fully address, which are changing outlooks in a more gradual capacity. "Ultimately, there are several over-arching issues we are now addressing," reveals Ms Longmore. "Primarily, there is the continued challenge of arranging D&O insurance globally and complying with local premium tax concerns in the jurisdictions where our clients do business. There is still a way to go in being able to deliver turn-key solutions, if we ever are able to do so," she says. However, it is likely that these long-term concerns may take a backseat during the next couple of years, as both insurance providers and their clients focus on making changes associated with negotiating market volatility.

Future developments

Ultimately, directors need to familiarise themselves with the full range of D&O insurance products in order to select the right one for them. The exclusions and limitations are particularly important, as inadequate protection can be just as risky as liability and insolvency issues. "Directors and officers can take steps to secure maximum protection at the outset," asserts Mr Oshinsky. "They should engage coverage counsel to review the proposed coverage - being proactive now could avoid unnecessary disputes later. For example, the definition of a claim should be carefully scrutinised, and all SEC investigative proceedings should be included within the definition of a claim. Insureds should seek a duty to defend provision to implement the New York Insurance Department ruling. Furthermore, there should not be any substantive discrepancies in coverage among the layers." The intricacies of D&O insurance are numerous, and it is easy to miss something which could compromise coverage.

The easiest of these to spot at this time are the liabilities associated with company insolvencies. These can normally be resolved with the use of a standalone Side-A policy. Nonetheless, it is important to ensure that the chosen Side-A policy is complementary to the underlying D&O policy. Other insolvency measures include an 'order of payments' provision, which prioritises payment to corporate executives, reducing the risk that insurance proceeds payable to the officers and directors will be regarded as property of the bankruptcy estate and be held up in during bankruptcy proceedings as a result. Also, a non-rescindable element is ►►

recommended, as it ensures that their coverage will continue, even if the organisation or other individuals are found to have committed fraud or misled the insurance company in procurement of the insurance.

Policies should also limit the application of conduct exclusions, where appropriate. "These are exclusions that take away coverage where an individual insured committed deliberate fraud or dishonesty or reaped personal profits to which they were not entitled," explains Mr Schafler. "It is important that such exclusions be triggered only by a final adjudication of such wrongdoing in the underlying case, so that insurance settlements will be covered." He also recommends the use of severability provisions, which treat individual insured entities separately for purposes of the application of policy exclusions, such as conduct exclusions. They protect innocent officers and directors from losing their insurance because of actions taken or knowledge possessed by others. However, Mr Schafler warns that severability provisions are not all alike and can lead to unfortunate outcomes for the unwary.

Mr Schafler suggests that directors and officers should also make themselves aware of two more potentially troublesome areas. Firstly, they need to ensure that they are covered in the event of a Section 11 claim. "Some courts have held that claims brought under Section 11 of the Securities Act of 1933, which applies to public offerings of securities, are not covered because they do not seek recovery of covered 'loss' but rather restitution of ill-gotten gains. Endorsements are available that specify that the insurer will not contend that settlements and judgments in Section 11 cases are not covered loss," he reveals. Lastly, he warns that a number of courts have interpreted so-called 'attachment' provisions in such a way that an excess carrier may not have to provide excess coverage if the insured parties settle for less than the full limits involved. As such, companies should seek a provision specifying that excess coverage will apply if underlying limits are paid by either the underlying insurer or the insured.

With so much to consider amid an uncertain landscape, a number of new D&O insurance products are likely to be released over the next couple of years. "These could be in the form of excess coverage or broad-based coverage to eliminate coverage gaps," predicts Mr Yuen. "However, I think the most likely outcome is that D&O insurance products will become more industry-specific. There will be products that address the specific needs that come out of the individual markets. For example, a policy designed for a technology firm may have slightly

different coverage conditions and limitations than one that has been designed for an advisory firm," he says.

It is also thought that new products will address the concerns that clients have about the stability of their insurance companies. "While the government bailout has momentarily calmed some fears, another product that might make its way into the market if more insurers get radically downgraded is an excess following form product that will simply drop down in the event of insurer impairment or insolvency, which surfaced recently in the wake of financial turbulence at key D&O insurers," explains Ms Elbert. These products are designed to complement existing policies, and should give clients some much-needed peace of mind.

Resolutions

It should be understood that D&O insurance is no replacement for the efficient resolution of a company's litigious woes. In reality, a number of companies will not have adequate coverage in place, and will find themselves in a tight spot when trouble hits. "Defence fees and the losses are subject to the same limits of liability under the policies," asserts Mr Oshinsky. "Either payment can exhaust the policies. An important strategy is for plaintiffs, defendants, and insurers to work together to resolve claims against directors and officers. If the policies are exhausted by defence fees, there may be nothing left to pay claims. If the claims can be settled quickly, then huge defence expenditures will not be required." As such, cooperation across the board makes good business sense, and is in everyone's moral, legal, and financial interests.

Ultimately though, D&O insurance is vitally important to both plaintiffs and defendants in the US. The former expect insurers to compensate for their losses, and the latter expect to have their defence fees paid by their insurer. As such, neither party can afford to close their eyes to their coverage, and particularly not in the current climate. Standalone Side-A policies will be particularly prevalent in the coming months, as they will ensure that the personal assets belonging to directors and officers will be safe, leaving enough coverage in the original policy for indemnification and entity coverage. However, new developments will rise to meet the needs of an unpredictable market, and companies should keep abreast of what is out there to ensure that their protection is not compromised. ■



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Jerold Oshinsky joined Gilbert Oshinsky as a name partner in 2008 to reunite with lawyers he has worked with in the past, some of whom he has known for nearly 30 years. Referred to by his peers as "the dean of the policyholder bar," Jerold Oshinsky is "energetic and creative" with the "uncanny ability to size up the strengths and weaknesses of a dispute." Mr. Oshinsky focuses his practice on insurance coverage litigation on behalf of policyholders in federal and state courts

throughout the country and on counseling clients nationwide on insurance coverage and related matters. In October 2007, Mr. Oshinsky was named as "The Leading Lawyer in Insurance" for Washington, DC by the Legal Times. He was chosen from among 10 finalists based on independent research and nominations from peers, clients, and other members of the legal industry.

Mr. Oshinsky has lectured since the early 1980s

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Mr. Oshinsky often has contributed his services on a pro bono basis, including providing advice to nonprofit organizations, with an emphasis on the theatrical community.

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