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Global Trends coming to the U.S. Insurance Market

D&O: A Bear of a Claim

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QUICK LOOK

- The demise of company value has investors and regulators looking for scapegoats.
- Directors and officers are turning to insurers to pay costs associated with legal defense and cooperation with investigations.
- Determining what gets covered is the $64,000 question.

D&O claims go up as the market goes down.

by Maureen Latimer

Balance sheets across the globe are as red as the alleyways of Pamplona, but it's not bulls doing the running—it's bears. The plethora of red ink is making shareholders and regulators see in Technicolor, and they're setting their sites on directors and officers, who are increasingly being held liable for massive corporate losses and fiduciary malfeasance.

As accusations of fraud, carelessness and recklessness morph into shareholder lawsuits, regulatory scrutiny and criminal investigations, directors and officers are turning to their D&O insurance for coverage. They might be more exposed than they think, though. On average, only 37% of private companies report insuring their directors and officers, and some companies—public and private—that have purchased coverage are unable to keep it because of liquidity problems, according to Chubb. Beyond that, many insurers have implemented language that limits coverage to reduce the bleeding that occurs as a result of criminal investigations.

"The extent of coverage for criminal proceedings remains one of the perennially disputed claims issues," says Kevin LaCroix of Ohio-based OakBridge Insurance Services and the *D&O Diary*. With costs escalating for pre-indictment investigations and defense actions, many insurers now limit D&O coverage for criminal proceedings to post-indictment matters. Moreover, overhead costs of an insured defendant company are often excluded from the definition of covered defense costs.

Further complicating matters are the multiple venues under which a corporation's directors and officers can be investigated (and can run up costs). Not only might there be a criminal investigation to defend against and comply with, there can also be civil lawsuits and regulatory scrutiny that demand pricey legal counsel and responses. Determining which expenses go with which action (and which are therefore covered or excluded) can embroil a claims officer in a nasty battle.

"The critical question," says LaCroix, "will be whether or not the particular circumstances presented

constitute a 'claim.'" And that might be difficult when multiple insurers are involved, which happens frequently. "Many, if not most, of the auction rate securities lawsuits…involve multiple corporate subsidiaries as defendants," says LaCroix. Moreover, D&O insurance "isn't written on a common policy form," says Dan Bailey of Bailey Cavalieri, a top law firm based in Ohio. "Each D&O insurer has developed its own form."

To wit, most D&O policies do define what qualifies as a claim, and that's usually pretty broad. It typically includes written demands, civil and criminal proceedings, and administrative, regulatory or investigative undertakings.

"A civil proceeding is typically defined to commence upon service of a complaint or similar pleading on the insured, and a criminal proceeding is typically defined to commence upon the return of an indictment against an insured," notes Bailey. The definition is similar for administrative, regulatory and investigative proceedings. The problem arises when costly legal consultation and other work is needed before service of a complaint or the return of an indictment. Insureds want coverage, but does their policy apply? That's the $64,000 (or more) question.

And what about claims from subsidiaries and units abroad or from shareholders at home or overseas who want directors and officers to reimburse them for investment losses they have suffered as a result of malfeasance or ineptitude? The claims from outside the U.S. can get very sticky, since laws in the applicable country sometimes prohibit insurer payments for damages, even though the policy lists them as covered losses.

"In order to maximize the likelihood that a covered punitive damage award will be insurable by law, some D&O policies contain a broad 'choice of law' provision, which states that—if any jurisdiction which has a substantial relationship to the insureds, the insurer, the claim or the policy allows the insurability of punitive damages—then that jurisdiction's law will apply to determine insurability," says Bailey.

Regarding shareholder claims, insurers and courts are all over the map. Coverage depends on what the basis of the shareholder suit is. Securities lawsuits are increasingly being tossed out by courts, which deem the overall downturn in the economy as an inapplicable cause for director and officer culpability. OakBridge's LaCroix cites recent cases against Luminent Mortgage Corp. and Merrill Lynch in which the Second Circuit Court quoted a prior case, saying, "When the plaintiff's loss coincides with a market-wide phenomenon causing comparable losses to other investors, the prospect that plaintiffs' loss was caused by fraud decreases." LaCroix thinks this finding could apply broadly to many, "if not most," of the subprime and financial crisis-related lawsuits against directors and officers.

When investors sue for losses to company stock value incurred as a result of actual director and officer negligence or wrongdoing, courts are listening, and D&O policies are responding, although variously.

Some D&O policies now apply the retention that is applicable in securities claims to defense costs but not to settlements or judgments. They will often also excuse the retention for defense costs if all insured defendants win without having to pay any settlement or judgment. In cases where multiple claims arise from one or several interrelated wrongful acts, they can be treated as a single claim and require only one retention, but policies vary on the definitions of the relationships between wrongful acts.

Adding to the hodgepodge, some policies contain a "presumptive indemnification" provision that says a retention applies when a company is legally permitted and financially able to indemnify an insured director or officer—even if the company fails to provide such indemnification. Because this unduly exposes insured directors and officers whose companies refuse to indemnify them, some insurers now delete this provision, permitting the insurer to subrogate to the insured company for the retention.

Contentions Over Allocation

D&O claims often mix insured losses with uninsured. Sorting it out is only half the fun. Fighting with the insureds is the other 90%. Some policies predetermine the allocation for any claim that needs one, regardless of what the numbers actually say. There are differences in these predeterminations, so it's not as easy as establishing a number and calling it quits. How the allocation is split and what is covered varies depending on the policy. Key is that most of these provisions for public companies apply to securities claims only, while they usually apply to any claim for private companies.

Instead of predetermining the allocation itself, some policies define the method that will be used to allocate payments. One method could be called the "Rodney King version": Can't we all just get along? Under this approach, parties agree to try their hardest to agree on an allocation that best fits the particular claim. This style of allocating

Cases in Point

Last year, as markets collapsed, investors went to the mat with companies over massive losses and shady stock deals. Cablevision Systems directors and officers took it on the chin in June 2008, settling a lawsuit over improper stock options backdating practices. At that time, the company confirmed that a group of individuals, including Cablevision board members and executives, agreed to contribute $24.4 million to the total settlement. D&O insurance picked up the remaining $10 million of the tab.

This past summer, the Delaware Superior Court rejected Royal & SunAlliance Insurance Co. of Canada's claims that it could refuse to advance defense costs to it's D&O insured, Sun-Times Media Group. The court found that "the policy required the insurers to advance defense costs prior to final disposition of the claim," so exclusions based on fraud and illegitimate personal profit couldn't yet be applied.

This September, Broadcom Corp. settled with plaintiffs in an options backdating suit for $118 million, funded wholly by its D&O insurers. This case is particularly telling about the complexities of such claims. Broadcom had numerous D&O policies with different carriers. It held $100 million in traditional D&O coverage and another $100 million in excess Side A coverage. In the recent settlement, lawyers and insurers worked together to craft an agreement that assessed costs across the exposed insurers.

leaves a lot of uncertainty and can lead to serious disputes between insurer and insured.

Another method bases allocation on costs and benefits to both insurer and insured. It requires the assessment of the strengths and weaknesses of the case against the insured and the financial impact and/or benefits of settling or going to court. It is appearing more in newer D&O policies.

Complications Abroad

Lawsuits and governmental actions against subsidiaries of U.S.-based multinationals are on the rise, says Carol Zacharias, senior vice president of ACE USA. Aon Risk Services reported 307 D&O liability claims outside the U.S. in 2007–2008, and there were already 100 regulatory or criminal actions at the halfway point of 2009.

Fewer than 2% of global organizations surveyed by Towers Perrin say they have separate D&O policies for the foreign countries in which they operate. Moreover, U.S. policies providing worldwide coverage might not provide coverage for claims from abroad, according to Towers Perrin, which says that foreign insurance regulations and changing corporate laws abroad are increasing D&O liability exposures.

Laws in foreign countries mandating locally admitted insurance could invalidate global D&O coverage carried by an overseas parent company, exposing directors and officers to uninsured risk. Worse yet, in many countries, insurance laws are unclear, leading to protracted disputes.

Some of the big insurers offer locally admitted policies that are tied to the parent company's global D&O liability program, but that is available only in countries where the insurer has offices. These are increasingly popular, though, with insurers like Zurich and AIU reporting exponential growth. So-called "friendly fronting" policies are an alternative. Under such an arrangement, a local insurer provides primary coverage but reinsures through the client's global D&O provider.

Generally, D&O policies in Europe resemble those in the U.S. at their basic level, but issues regarding claims are cropping up there as they do in the States. Many European D&O policies restrict the type of investigations that are covered. It is important not to make assumptions about the way investigations overseas are conducted because small differences in policy wording can make a great deal of difference in what is and isn't covered. Notably, in criminal proceedings, the question of coverage for the costs of fighting extradition as part of an insured's defense has arisen as have demands for the cost of bail and security bonds. Treaties of cooperation on extraditions have to be part of the equation.

Whichever way they are insured, claims are still complicated, and adjusters must be familiar with laws at home and abroad, as well as the policy form obligations, in order to fulfill the insurer's duties toward clients.

The Worldwide Response

Germany instituted a new law in August 2009 requiring publicly traded companies in that country to impose a per-loss deductible of 10% on directors and officers for their liability coverage, capped at 1.5 times the person's annual fixed compensation. All new D&O insurance must apply the deductible, and in-force coverage must comply by July 2010. Not to be outdone by regulators, insurers are already developing new programs to insure the deductible—separately, though, and at the individual's expense.

Not all changes to the European D&O scene are that new. In May 2006, Spain instituted a voluntary corporate code of governance that recommends stricter definitions for directors' duties of loyalty to their companies. Since 2007, companies have had to explain failures to comply with the provisions. In Italy, an overall reform of corporate law in 2003 included intensified requirements for directors to become more professionalized in their duties.

In the U.K., regulators are focusing more on the conduct of company management. Shareholder derivative actions can now be brought against both present and

former directors with some restrictions. Directors have recently been mandated by law to promote the success of the company, which could conflict with other required duties, such as considering the impact on the community and the environment. British law also has criminalized pollution by companies, cartel activity, and corporate manslaughter, which increases the duty of directors to ensure safety and health practices.

What's Around the Corner

Business bankruptcy filings are up 63% this year, according to the Administrative Office of the U.S. Courts. This may bode an increase in Side A coverage claims. Seventy-seven percent of large public companies that filed for bankruptcy in the past two years also faced D&O lawsuits. Complicating matters for claims adjusters is the insured versus insured exclusion, which may eliminate coverage for former directors and officers of a bankrupt company in actions brought by the post-bankruptcy "debtor in possession." This is highlighted in the recent Visitalk case, in which the company—while in Chapter 11 bankruptcy—sued former board members and executives for fiduciary malfeasance. The company's insurers declined to pay costs for the suit, citing the insured versus insured exclusion. Even though Visitalk, in its reorganization, assigned the suit to a creditor entity, the court found that the exclusion applied.

On the legislative front, Arlen Specter, D-Pa., introduced S.B. 1551, the Liability for Aiding and Abetting Securities Violations Act of 2009. The bill proposes amending securities law to allow private litigation against a person who provides "substantial assistance" in the violation of a securities law. Business partners of alleged violators could, under the proposal, also be drawn in as contributors to the violation, suggests LaCroix. If this law were passed, the definition of "securities claim" in a D&O policy would need clarification as to whether it applied to the purchase or sale of the insured company's own stock or to violations of securities law in general. Exclusions for securities claims would have to be revisited, he indicates.

The growing number of bank failures portends increased numbers of plaintiff filings against bank directors and officers. Falsified financial statements, failure to apply apt and required accounting standards to corporate books, and reckless mergers or acquisitions—among other complaints—are expected to dominate the filings. With all the flim-flam on values of mortgage-backed securities and credit default swaps, finding the real numbers and assigning guilt for the promulgation of the false ones will likely prove a costly and drawn out affair.

Directors and officers claims are contentious and complicated, and the "Americanization" of overseas corporate markets—coupled with the persistent pain felt by stock-value losers and invigorated regulators—promises a wild run in the D&O sector over the next several years. And the frenzy is likely to continue, even when the bulls reclaim the Street. CA

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