

EXECUTIVE SUMMARY

In evaluating the quality and quantity of indemnification and insurance protection for a public company's directors and officers, focus should be maintained on the following question: in the event of a serious claim against a public company's directors and officers, what protection will be available to protect those individuals if the company is unwilling or unable to provide litigation protection to them? Thus, the availability of coverage for additional parties or for non-D&O-specific exposures under a D&O policy is worthwhile only if it does not compromise or impair the availability of insurance resources otherwise earmarked for D&O liability exposures.

There are four key sources of director and officer liability exposure for a public company and its directors and officers that should be given particular consideration when evaluating the quality and quantity of available D&O indemnification and insurance protection: (1) shareholders; (2) employees; (3) regulators; and (4) creditors. Of these, shareholder claims presents the largest potential exposure to the company and to individuals in terms of severity.

D&O LITIGATION RISKS

I. The Frequency and Severity Explosion in D&O Litigation

According to a series of annual surveys conducted by Tillinghast Watson Wyatt Worldwide, claims against directors and officers fall into frequency patterns identifying shareholders as the most frequent source of D&O claims, followed by employees as the second most frequent claimants. The 2000 Tillinghast Watson Wyatt Survey identified shareholder claims as being about 47% of the total claims brought, followed by employment-related claims. Far behind, creditors, regulators and competitors round out the lineup of the major sources of D&O claims. Therefore, when considering strategies relating to underwriting D&O as a line of business, trends involving shareholder and employee claims should be the primary points of focus.

A. Shareholder Actions

The following discussion focuses on shareholder claims and, in connection with the discussion of securities class action shareholder claims, relies both on data collected by the Stanford Law School Securities Class Action Clearinghouse¹ relating to securities class action filings and settlements since 1995, two studies published by Cornerstone Research, and our own experiences in connection with such claims.²

¹<http://securities.stanford.edu>.

²For a full discussion of filing and settlement trends, see "Securities Class Action Settlements: An Empirical Analysis," co-authored by Mukesh Bajaj, Sumon C. Masumdar and Atulya Sarin, November 16, 2000, which can be accessed at the following website address:
http://securities.stanford.edu/research/studies/20001116_SSRN_Bajaj.pdf.

There are three types of shareholder actions within the overall category of shareholder claimants: (1) direct shareholder actions; (2) derivative actions; and (3) securities class actions. A discussion of each type follows:

(1) Direct Shareholder Actions. A direct action is one brought by a shareholder to recover from corporate officers, directors or others for a loss sustained by him or her which is separate and distinct from that suffered by other shareholders. For example, a suit brought by a majority or minority shareholder alleging some corporate action uniquely injured him or her would be a direct shareholder action. Such actions are infrequently brought, and when brought, are generally resolved for relatively insignificant amounts.

(2) Derivative Actions. A derivative action is an action brought by one or more shareholders to enforce a right of action belonging to the corporation, which the corporation could have asserted, but did not. For example, if directors or officers of a company are enriching themselves at the expense of the corporation, a derivative suit is the legally-recognized remedy for that wrong to be addressed. Given the nature of the derivative claim, such actions generally are resolved by management agreeing to adopt new policies and procedures that reflect the concerns of the derivative plaintiffs. The most substantial exposure in such claims generally is the plaintiffs' attorney fee, which is typically calculated to reflect the "value" brought to the corporation by the corporate remedies undertaken as a consequence of the derivative action.

(3) Shareholder Class Actions. In a shareholder class action, one or more shareholder plaintiffs may sue for the benefit of those who have a similar interest in the outcome. This has become the popular vehicle for suing a corporation and its directors and officers when shareholders believe that material information about the company was known, but not disclosed to its shareholders, during a period of time when those shareholders purchased their shares of the company's stock. Given the substantial shareholdings and market capitalizations of publicly-traded companies in the U.S., successful shareholder class actions can result in substantial settlement amounts (and significant contingent fee awards for the plaintiffs' lawyers who bring such suits).

Beginning in the late 1970's, there was a clear trend towards filing more and more of this type of lawsuit each year. Because of the class action structure, a plaintiff's lawyer needed only a single shareholder plaintiff to assert the claim on behalf of the entire shareholder class. Thus, the plaintiffs' lawyers were able to substantially leverage their limited client representation to a potentially substantial settlement with attendant fees. By the late 1980s, an entire "cottage industry" of such plaintiffs' lawyers had developed, led by the Milberg Weiss Bershad Hynes & Lerach firm, with offices in New York and San Diego, and more than 100 attorneys. These firms filed suits whenever a publicly-traded company's stock dropped by more than 20% in a short period of time, alleging that the company's management must have known of the adverse facts resulting in the selloff prior to their actual disclosure, and using the litigation discovery process in an effort to build a successful case on that theory of liability.

In response to perceived abuses by the plaintiffs' law firms, in 1995, the U.S. Congress enacted (over the veto of then-President Clinton) the Private Securities Litigation Reform Act of

1995 (the “PSLRA”). The PSLRA attempted to curb these perceived abuses by requiring, among other things, the following changes to securities class action pleadings:

- requiring that the plaintiff class be represented by a plaintiff with the most substantial holdings at stake in the defendant company and litigation;
- imposing a stay on discovery until a motion to dismiss the complaint based on the sufficiency of the pleadings had been made by the defendants and decided by the court; and
- requiring the plaintiff to specifically allege “scienter” or the level of intent necessary to establish a showing of securities fraud.

Seven years later, the PSLRA has not succeeded in its stated goal of reducing the frequency of such litigation. The Securities Class Action Clearinghouse has identified the following patterns in litigation during the five-year period since adoption of the PSLRA. In particular:

- The absolute number of issuers sued does not appear to have changed dramatically since passage of the PSLRA, once the effects of the IPO Allocation Litigation are excluded. Litigation activity declined in 1996, but that decline was likely a transition effect.
- Since passage of the PSLRA, a larger percentage of litigation activity centers on allegations of accounting fraud, with revenue recognition issues emerging as particularly significant causes of litigation.
- Since passage of the PSLRA, a larger percentage of litigation activity also alleges trading by corporate insiders during periods when frauds are allegedly “alive” in the market.
- The dollar magnitude of settlements during this same period has increased noticeably, particularly in the settlement of “mega-cases.” There have been five post-PSLRA settlements in excess of \$200 million. The Cendant litigation was settled for \$3.525 billion (\$3.185 billion in the common equity settlement and \$340 million in the PRIDES settlement.); the Bank of America litigation settled for \$490 million; Waste Management settled two separate class actions for \$457 million and \$220 million; and 3Com settled a class action for \$259 million.

To provide some perspective on less-significant settlements, the following are several defendant public companies that settled securities class action litigation brought against them and their directors and officers within the last few months: Protection One (\$7.5 million); Provident (\$38 million); Gateway (\$10.25 million); Timco (\$32.91 million); Silicon Graphics (\$30.91 million); PartsBase.com (\$87.65 million); Dollar General (\$162 million); and Towne Bancorp (\$3 million).

The average amount of settlements has increased over the same period as well. PriceWaterhouseCoopers has issued its 2001 Securities Litigation Study,³ and reports that the average securities litigation claim settlement in 2001 was \$17.2 million. This is a reported increase from the running average for prior years of \$14.1 million. Other published research has reported average settlements over \$20 million.

While the trend of average settlements remains within the existing D&O insurance purchasing patterns of publicly-traded companies, the substantial change in severity has been driven by the increasing number of settlements in amounts above the published averages, and the few extreme settlement amounts discussed above. Thus, we believe that the historical ranges identify only the potential floors for future settlements, and should not be viewed as outside extremes.

B. Employment-Related Claims

Federal, state and even local statutes and regulations relating to employment practices and rights of employees give rise to potential liabilities for corporate officers in particular and, in some respects, directors.⁴

The following is a listing of some of the more significant statutory and regulatory schemes under which directors and officers can be held liable:

- Title VII of the Civil Rights Act of 1964;
- 42 U.S.C. § 1981;
- Age Discrimination in Employment Act;
- Americans with Disabilities Act;
- Fair Labor Standards and the Equal Pay Act;
- Family and Medical Leave Act;
- OSHA; and
- state non-discrimination laws.

Except in the few cases where employment discrimination is alleged on behalf of a large class of claimants, most employment practices claims are brought individually, and pose more of a litigation frequency concern to companies, and not a severity exposure.

C. Creditors

Although creditors are an only infrequent source of claims when a company is solvent, in an insolvency context, creditors emerge as the most frequent source of D&O claims. When a corporation is solvent, corporate directors and officers owe their primary fiduciary duties to the corporation and its shareholders. However, when a corporation is deemed insolvent - - even if

³ See <http://www.pwcglobal.com/us/eng/main/home/index.html>.

⁴ See generally *Knepper & Bailey*, Liability of Corporate Officers and Directors, *Chapter 7* (6th ed. 1998).

the company has not yet filed for bankruptcy protection under the Bankruptcy Code - - directors may owe their primary fiduciary duty to the corporation's *creditors*.

For purposes of determining when the directors' and officers' fiduciary duties shift from being owed to shareholders to being owed to creditors, the corporation must be considered "insolvent." The corporation may be deemed "insolvent" under several alternative tests: (1) at the time of bankruptcy filing; (2) when its liabilities exceed its assets (the "balance sheet" test); (3) when the corporation is unable to pay its debts as they become due (the "equity solvency" test); or (4) when the corporation is in the "vicinity of insolvency."

The first three tests are self-explanatory; the fourth is less intuitive. In *Credit Lyonnais Bank Nederland, N.V. v. MGM-Pathe Communications Co.*,⁵ the Delaware Chancery Court recognized a potentially broad theory for imposing fiduciary duties to the creditors of financially distressed companies. Recognizing that shareholders and creditors would expect different management strategies when the corporation is in the "vicinity of insolvency," the court ruled that directors should view the corporation as a "community of interest."

Unfortunately, the simultaneous, but potentially inconsistent, obligations owed to different fiduciary constituencies may result in a finding of management liability for any path or strategy taken – all without the benefit of a defense other than the "business judgment" rule, which applies as an affirmative defense to all alleged breaches of the fiduciary duty of care (but not the duty of loyalty).

The *Credit Lyonnais* holding has been supported by more recent case law and, therefore, cannot be argued to be an aberrant decision.⁶

DISCUSSION OF AVAILABLE INDEMNIFICATION AND EXPENSE ADVANCEMENT

I. State Law

The authority of a corporation to indemnify its directors and officers is provided in the business laws of the state where the company is incorporated. This statutory authority generally is non-exclusive, and allows the corporation to extend indemnification rights beyond those granted in the statute. Such statutes also generally permit corporations to purchase insurance for director and officer liabilities, whether or not the corporation would have the power to indemnify him against such liability under such statute.

⁵ 1991 WESTLAW 277613 (Del. Ch., Dec. 30, 1991).

⁶ See, e.g., *Ashanase v. Fatjo*, 1993 U.S. Dist. LEXIS 7911 (S.D. Tex. 1993) (applying "vicinity of insolvency" test); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 790 (Del Ch. 1992) (rejecting defendants' argument that duty to creditors does not arise until statutory bankruptcy or other insolvency filing); *In re Healthco International, Inc.*, 208 B.R. 288 (Bankr. D. Mass. 1997) (applying "unreasonable risk of insolvency" standard).

II. Articles of Incorporation/By-Laws

The articles of incorporation or by-laws of a public company typically address indemnification and insurance of the company's directors and officers. Such provisions typically are consistent with the broadest indemnification available under state law. Defense expenses typically are advanced prior to a decision on indemnification, conditioned upon the submission of a written undertaking by the requesting individual to repay such amounts if it subsequently is determined that the requesting party is not entitled to indemnification.

DISCUSSION OF D&O INSURANCE COVERAGE

I. History of D&O Coverage

Director and officer liability ("D&O") policies had their origins in the United States in the 1930s. At that time, following the collapse of the U.S. stock market in 1929, and a series of Congressional hearings identifying market manipulation and trading abuses by managers of publicly-held companies, the U.S. Congress enacted the Securities Act of 1933 (the "1933 Act"). The 1933 Act imposes liability upon corporate entities and related natural persons for material misrepresentations or omissions contained in offering documents, and conferred upon private investors the right of action to sue corporations and their directors and officers for such material misrepresentations or omissions. At the same time, Congress formed the U.S. Securities and Exchange Commission (the "SEC"), which was given regulatory and enforcement powers to be a "watchdog" over the investing marketplace.

The following year, in 1934, Congress passed the 1934 Securities Exchange Act (the "Exchange Act"). Where the 1933 Act addressed liability for material misrepresentations in offering documents, the Exchange Act imposed liability for material misrepresentations or omissions made in connection with purchases and sales of stock.

II. The Background of the Insuring Agreements

Given that U.S. companies have broad indemnification responsibilities for the acts of their directors and officers, the U.S. publicly-held companies began a search for insurance coverage protection with respect to these newly-enacted statutes. In the late 1930s, the Lloyd's market responded with the first D&O policy, an indemnity-type policy which, through its single insuring agreement, agreed to reimburse the corporate insured for the indemnification of its directors and officers.

As time passed, it was recognized that the corporation could not be counted upon to provide indemnification in all circumstances. For example, corporate indemnification is prohibited with respect to derivative lawsuits, in which the shareholder sues the directors and officers on behalf of the corporation for alleged wrongful acts in connection with their management of the company's affairs. To permit indemnification for damages arising from such unlawful conduct would effectively put the company in a position of paying itself; a circular result. Also, if the corporation filed for bankruptcy and had no funds, indemnification obligations inuring to the benefit of the directors and officers were worthless.

For these reasons, a second type of D&O policy was constructed. It too had a single insuring agreement and insured the directors and officers for only those situations where corporation indemnification was unavailable either because the corporation was prohibited from providing indemnification (e.g., a derivative action) or was financially unable to do so (e.g., financial insolvency).

Over time, the two distinct types of D&O policies were merged into a single policy form with two alternate insuring agreements: a corporate reimbursement insuring agreement which reimbursed the corporation for its indemnification obligations to its directors and officers, commonly referred to as “Side B” coverage; and an unindemnifiable loss insuring agreement, commonly called “Side A” coverage, which provided coverage directly to the directors and officers when indemnification was unavailable.

The D&O policy form remained relatively unchanged through the early 1990s. By 1992, following an explosion in class action securities litigation through expanded court acceptance of the class action litigation device, securities class action lawsuits had come to pose the highest frequency and severity exposure for D&O insurers. Given that the D&O policy, up until that time, insured only the directors and officers, and not the company itself, conflicts inevitably arose between D&O insurers and their corporate insureds given the fact that the corporate entities typically were co-defendants along with their directors and officers, in such actions. This conflict related to the issue whether, and to what extent, the corporate entities should themselves bear financial responsibility for the defense and settlement of such cases if such defense and settlement benefited the corporate entity too.

Those arguing against an allocation of such settlements and defense costs argued that since a corporate entity can act only through its directors and officers, its liability necessarily is derivative only of those directors and officers, and the D&O insurance provides coverage for such acts. D&O insurers, on the other hand, argued that because the federal securities laws imposed liability directly on the corporation, as well as on the directors and officers, and because the corporation’s liability could also derive from the acts of employees and agents other than the directors and officers, it should bear uninsured its own significant liability exposure in such litigation.

After a series of court challenges to the insureds’ demands for allocation, as described above, D&O insurers began offering a third insuring agreement in the mid-1990’s: one which insured the corporation for its own liability, and then only with respect to liability for federal securities law violations. In this way, D&O insurers sought to resolve the issue of liability with respect to the area which posed the greatest amount of allocation friction: U.S. securities law liability.

III. What Does the D&O Policy Cover?

In its current form, the D&O policy continues to provide liability coverage for the corporation’s wrongful acts, but only in claims where the corporation is sued for federal

securities law violations. In all other respects, the D&O policy retains its original structure and purpose: the insurance of only director and officer wrongful acts.

Although earlier forms of D&O policy wordings limited the coverage to negligent acts of the directors and officers, over time, the coverage has broadened to include all levels of conduct short of intentional misconduct, including dishonesty, fraud and criminal conduct. Thus, the D&O policy would be expected to respond to allegations of gross negligence and recklessness, as well as allegations of simple negligence.

It is useful to distinguish the types of liability for which directors and officers can be held liable, from that liability (other than federal securities law liability) for which the corporation can be held liable. Thus, for example, a D&O policy typically will not provide coverage for contractual obligations a corporation has with its creditors, customers, banks or employees. Nor would the corporation have coverage for engaging in anti-competitive conduct.

On the other hand, where directors and officers expose themselves to liability by directly participating in corporate wrongful conduct, or themselves make material misrepresentations with respect to corporate activity, insured D&O liability can result in tandem with uninsured corporate liability -- as long as the individuals' conduct giving rise to the liability is not found to constitute intentional misconduct or is otherwise specifically excluded.

IV. Exclusions

There are numerous exclusions in a D&O policy, and a review of the exclusions can be both confusing and overwhelming. Also, not all exclusions are found in the Exclusions section of the D&O policy. Some can be structured as limitations to defined terms in the policy; others can be added by endorsement to the policy. Therefore, it is useful to understand the type of exclusion being reviewed in order to understand its purpose. There are four basic types of exclusions in D&O policies, as follows:

A. "Other Insurance" Exclusions

These are exclusions which are intended to remove from the scope of the D&O coverage any liabilities which are more properly and directly insured under another type of policy. The wording of such exclusions is intended to mirror the coverage grant of the other insurance coverage. For example, the "bodily injury/property damage" exclusion is intended to mirror the insuring agreement of a comprehensive general liability policy. Other kinds of "other insurance" exclusions can include the ERISA exclusion, which liability is covered under a fiduciary liability or pension trust liability policy, and the "prior reported acts" and "prior/pending litigation" exclusions, for which the alleged wrongful acts should be covered by a prior D&O policy issued to the company.

B. "Conduct" Exclusions

These are exclusions which are intended to avoid coverage for such matters as deliberately fraudulent or criminal conduct or the gaining of any personal profit or advantage to which an insured was not legally entitled. Conduct exclusions historically mirrored the limitations on indemnification available by the corporate principal of a director or officer seeking

indemnification, and are generally viewed as exclusions of “moral hazards” which, under the common law of all fifty U.S. states, is uninsurable as a matter of public policy.

C. “Public Policy” Exclusions

In addition to conduct exclusions, certain types of damages, judgments and settlements are viewed under common law as being uninsurable. So, for example, fines and penalties imposed by law are generally viewed to be uninsurable because there is a deterrent motive in applying the fine or penalty which is lost if another party (e.g., an insurer) pays that amount instead. As such, fines and penalties are generally applied to types of criminal conduct, which can be found only by a showing of requisite uninsurable intent. This is a substantial split among different state courts as to whether punitive damages can be insured. For this reason, many D&O policies limit the definition of “Loss” to exclude civil or criminal fines or penalties, taxes, punitive or exemplary damages, the multiplied portion of a multiple damages award or any amounts for which an Insured is not financially liable or which are without legal recourse to an Insured.

D. “Laser” Exclusions

These are exclusions drafted uniquely for the specific risk being insured by the D&O insurer. Such exclusions are almost always contained in endorsements attached to the policy, and are directed at specific risks of the insured that the D&O insurer is not prepared to cover.

The foregoing overview is intended to provide a frame of reference for understanding the nature and scope of typical D&O coverage, and to provide a general understanding of the structure of a typical D&O policy.

D&O POLICY ISSUES TO BE CONSIDERED

I. Dilution through Shared D&O Limits

The dilution issue relates to the risk that a single claim or multiple claims for which both a public company and its directors and officers are insured could result in a scenario under which the D&O insurance would be either exhausted or diverted, leaving the company’s directors and officers without available insurance protection. Most D&O policies do not fully address the issue of unavailable indemnification, particularly if A public company became insolvent.

The insolvency issue relates to the risk that in the event a public company becomes insolvent, because its liabilities to securities holders are insured under the D&O policy, the D&O policy and its proceeds may be argued to constitute part of the debtor’s estate under the Bankruptcy Code. If treated in such a way, the company’s directors and officers could be precluded from accessing the D&O coverage to defend and settle any claims pending or brought against them individually while the automatic stay is in effect. Because the directors and officers themselves have not filed for bankruptcy, no automatic stay precludes claimants from pursuing the individuals for alleged wrongful acts outside the bankruptcy proceeding.

Most courts agree that the D&O policy itself is property of the debtor company's bankruptcy estate. There is, however, a secondary issue: do the *proceeds* of the insurance policy also constitute an asset of the bankruptcy estate? This is a critical determination that will dictate, among other things, whether the use of D&O policy proceeds to pay defense costs erodes the available limit of liability and therefore may contravene the automatic stay

Although most courts have held that the D&O policy itself is property of the bankruptcy estate of the debtor,⁷ there is a split of authority over whether D&O policy proceeds are property of the bankruptcy estate of the debtor company which purchased the policy.⁸ In large part, this distinction may turn on what type of coverage is afforded to the debtor under the D&O policy. By subjecting the proceeds to the priority scheme of the Bankruptcy Code, the position which characterizes the proceeds as property of the estate attempts to maximize the recovery to all creditors. The proceeds of the D&O policy are most likely to be considered property of the estate when the policy provides entity coverage.⁹ However, some courts have found the proceeds to be property of the estate based solely on the existence of corporate reimbursement coverage.¹⁰

Other courts have held that the proceeds of the policy are not property of the corporate debtor's bankruptcy estate regardless of the existence of corporate reimbursement or entity coverage.¹¹ This position is premised upon the notion that the policy was purchased for the

⁷ See, e.g., *The Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Reinsurance Corp.* (In re *The Minoco Group of Cos., Ltd.*), 799 F.2d 517, 519 (9th Cir. 1986) (citations omitted) (debtor company's D&O liability policy is property of the debtor's estate because such estate is "worth more with them than without them").

⁸ See, e.g., *In re Daisy Systems Securities Litigation*, 132 B.R. 752, 755 (N.D. Cal. 1991) (stating that proceeds of D&O policy were not property of estate); *Duval v. Gleason*, No. C-90-0242-DLJ, 1990 U.S. Dist. LEXIS 18398, *18-19 (N.D. Cal. Oct. 19, 1990) (finding that advancement of defense costs did not implicate automatic stay because future concern of whether debtor would have to indemnify D&Os was premature and involved no direct action against property of debtor's estate). See also *Louisiana World Exposition, Inc. v. Federal Insurance Co.* (In re *Louisiana World Exposition, Inc.*), 832 F.2d 1391, 1399 (5th Cir. 1987) (holding that D&O policy itself was property of estate but proceeds of D&O policy were not as debtor was not named insured and thus had no claim or interest in policy proceeds).

⁹ See, e.g., *In re Sacred Heart Hosp. of Norristown*, 182 B.R. 413, 421 (Bankr. E.D. Pa. 1995) (finding that debtor had sufficient interest in proceeds of D&O policy to bring proceeds into debtor's estate where debtor itself was covered by policy).

¹⁰ See, e.g., *Aetna Casualty & Surety Co. v. Jasmine, Ltd.* (In re *Jasmine, Ltd.*), 258 B.R. 119, 128 (D.N.J. 1999) (finding that D&O policy proceeds were property of estate because debtor's duty of indemnification was established prior to its filing for bankruptcy); *In re Circle K Corp.*, 121 B.R. 257, 260 (Bankr. D. Ariz. 1990) (finding D&O policies and their proceeds to be property of bankruptcy estate where policies provided coverage for debtor's indemnification obligations). But see *Zenith Laboratories, Inc. v. Sinay* (In re *Zenith Laboratories, Inc.*), 104 B.R. 659, 665-66 (D.N.J. 1989) (finding that policy was not property of estate when debtor was not required to indemnify D&Os and thus, policy did not affect assets or liabilities of debtor).

¹¹ See, e.g., *Louisiana World Exposition, Inc. v. Federal Insurance Co.* (In re *Louisiana World Exposition, Inc.*), 832 F.2d 1391, 1398 (5th Cir. 1987) (noting that mere existence of indemnification coverage did not affect issue of whether policy proceeds were property of estate); *In re Daisy Systems Securities Litig.*, 132 B.R. 752, 755

personal benefit of the directors and officers who rely on such coverage when accepting their positions.

If the proceeds of a D&O policy are determined to be property of the debtor's estate, the bankruptcy court theoretically controls the distribution of the proceeds just as it would any other asset of the debtor's estate. To the extent that the court determines that the proceeds are not property of the estate, the proceeds are available on a "first come, first served" basis to competing claimants, including the directors and officers and creditors of the debtor company, without any regard to the priority scheme of the Bankruptcy Code. Given the potential, however, that both the policy and proceeds could be deemed assets of the bankruptcy estate, there can be no assurance -- once entity coverage is purchased under a D&O policy -- that those proceeds will be available to protect the directors and officers if the company files bankruptcy.

Given this bankruptcy concern, an issue often raised is whether the D&O policy can be endorsed to specifically provide that in the event of bankruptcy, the policy proceeds will be paid on behalf of only the directors and officers, and not the debtor. However, courts have consistently held that an insurer may not modify a policy based solely on the debtor's: (i) filing of a petition in bankruptcy; (ii) insolvency; or (iii) financial condition.¹² The Bankruptcy Code specifically prohibits these so-called "*ipso facto*" clauses, or provisions, which are triggered by the occurrence of any one of the three foregoing conditions.

The "policy vs. proceeds" issue can be avoided by the insertion of an "order of payments" clause, which provides that under all circumstances -- whether or not the company is in bankruptcy -- the proceeds will be paid out in a specified order which favors the directors and officers. Such provisions are likely to meet bankruptcy court approval because they are not triggered by the: (i) filing of a petition in bankruptcy; (ii) insolvency; or (iii) the insured entity's poor financial condition.

ISSUES FOR DISCUSSION AND DECISION-MAKING BY A PUBLIC COMPANY

I. Comments on Accounting Issues

The type of catastrophic corporate event for which D&O insurance can provide the greatest protection is a substantial (i.e., greater than 50%) drop in market capitalization caused by a disclosure of the type of accounting irregularities that require a restatement of the company's financial statements. This type of event often creates a chain-reaction series of related, but independent, problems including, for example, regulatory and criminal investigations, withdrawal of available credit or increased borrowing costs, loss of key personnel and reputational loss, that create a downward spiral from which a company cannot recover. Therefore, there can be no assurance that a single development such as a financial restatement

(N.D. Cal. 1991); *Ochs v. Lipson (In re First Central Financial Corp.)*, 238 B.R. 9, 17 (Bankr. E.D.N.Y. 1999) (holding that proceeds of D&O policy were not property of estate even though policy provided entity coverage because entity coverage was narrow and was also "hypothetical" in any event, as no claims had thus far been filed against debtor which would implicate such coverage).

¹² 11 U.S.C. §§ 365(e)(1)(A)-(B). See also *In re Pak*, 252 B.R. 215, 217 n.1 (Bankr. M.D. Fla. 2000).

could not quickly create a chain reaction of events requiring a commitment of all available insurance protection.

II. Insurance Protection Improvement Strategies

The issues confronting a public company in connection with the next D&O renewal begin with the trends associated with primary D&O and other insurance costs. The data we have reviewed reflects a substantial trend in both materially higher premium pricing and coverage restrictions. While there remains some level of competition among D&O insurers to mitigate the potential for an extreme price increase from the incumbent D&O insurer and provide alternatives, companies should evaluate the strength of their relationships with insurers other than the incumbent, along with any unique institutional ties or trading partners to determine whether D&O insurance may be available from another insurer, in the event renewal discussions with the incumbent D&O insurer are unproductive.

Given the D&O market dynamics, we recommend that public companies begin the renewal negotiation process as early as possible. The company's broker and current D&O insurer should be able to quickly provide information on cost and availability of a renewal D&O policy.

Almost every D&O renewal now requires that the chief financial officers of prospective insureds meet in-person with the D&O underwriters to whom applications have been submitted. Some of the questions likely to be asked of a public company's representative(s) in such a meeting would include the following:

- In the face of a credibility problem faced by the U.S. capital markets and related constituents, how can a company differentiate itself from the broader market?
- What are the financial reporting issues or practices of the company, if challenged, which would be most likely to give rise to a financial restatement?
- What will make the company a good risk in the eyes of D&O insurers?

In addition to starting the renewal negotiation process early, it will be critical to integrate the D&O broker into the renewal process. If used effectively, a broker can add valuable perspective on overall strategy and alternative insuring structures, and can help create a positive view of the company. Other ways to enhance the insurance market's view of the company may include:

- organizing underwriting meetings with several members of the company's management team;
- extending invitations for the D&O broker and D&O underwriters to analyst meetings or presentations; and
- providing detailed information to the D&O underwriters on the company's governance policies and, most importantly, its actual practices.

III. Alternatives to Current D&O Insurance Program Structure

In the event a public company is unable to renew its current D&O insurance program on acceptable terms, in addition to a marketing of the renewal to other insurers, the company may wish to consider the following options, which can operate as alternatives to the existing insurance program, or which may make a limited renewal of the existing coverage feasible.

A. Coinsurance and/or Pre-Set Allocation

As the D&O insurance underwriting environment continues to offer less capacity at higher premium rates, insureds are being asked to elect either coinsurance or a pre-set allocation arrangement in connection with renewal terms, and it is likely that the company will be asked to commit to one of these material coverage changes at its next renewal.

The primary difference between coinsurance and allocation is that the use of coinsurance assumes from the outset that the insured will be responsible for some meaningful portion of Loss in excess of a retention or deductible. Allocation, on the other hand, is the process by which the parties to a D&O policy attempt to determine whether any portion of incurred loss should be allocated to parties other than the D&O insurer. In the case of allocation, there is no starting presumption that the insureds will be responsible for any portion of loss that is potentially covered.

(1) Examples of ground-up coinsurance

Although the term “coinsurance” is broadly used to address a combined insured and uninsured response to loss, in its practical application to D&O policies, two different approaches can be used. Here are examples of each using the same fact pattern:

Fact pattern: A company and its directors and officers have a \$20 million D&O insurance program in place, consisting of two \$10 million policies, both subject to a 20% coinsurance. A covered securities class action claim is made and subsequently settled for \$15 million.

Example 1. (“True Coinsurance”)

The primary insurer pays \$8 million; the excess insurer pays \$4 million; and the insureds pay \$3 million (i.e., \$2 million coinsurance on the primary policy and \$1 million coinsurance on the excess policy).

Example 2. (“Modified Coinsurance”)

The primary insurer pays \$10 million; the excess insurer pays \$2 million; and the insureds pay \$3 million (i.e., 20% coinsurance on the entire \$15 million settlement).

In both examples, the insureds pay the same amount: \$3 million. The key differences are the amounts paid by the primary insurer and the excess insurer.

Even within the “true coinsurance” approach, the limit of liability available to respond to a claim can be structured in one of two ways, as follows: (a) the available limit of liability per claim is never more than 80% of the aggregate limit of liability under the policy (or 80% of an impaired limit, if applicable); or (b) the limit of liability for all claims under the policy is 80% of the limit of liability indicated on the declarations page of the policy. The key difference between the two structures is that in (a), 20% of the limit of liability is reserved for use in connection with other claims made under the same policy. In (b), once the insurer has paid 80% of the indicated limit of liability, its policy limits are deemed exhausted. Thus, under the “true coinsurance” approach, the identified limit of liability on the declarations page may not be the insurer’s maximum limit of liability for a single claim or for all claims.

From an excess insurer’s position, whether the primary insurer uses option (a) or (b) within the “true coinsurance” approach doesn’t matter. The only difference is that if there is a second claim under the policies, only option (a) will provide some remaining coverage (albeit limited to 20% of the impaired primary limit in our example, above) before triggering coverage under the excess program.¹³

In “modified coinsurance,” on the other hand, what is termed “coinsurance” is really an **allocation** of loss up to the insurer’s maximum limit of liability for any and all claims. Thus, an excess insurer would not be obligated to pay unless and until the primary insurer had paid the full amount of the identified limits of liability under the primary policy.

Whether an insurer sits in a primary or excess position will largely determine its preference for one form of coinsurance over the other. Thus, a primary insurer likely would prefer a “true coinsurance” because it would never be obligated to pay more than 80% (still using the above example) of any loss, and would therefore never have to pay the entire amount indicated in its listed limit of liability on the declarations page of the primary policy. An excess insurer, on the other hand, would strongly prefer “modified coinsurance” because it would require that the full limit of liability under the primary policy be paid by the primary insurer **in addition to** the coinsured amount before the excess policy would be obligated to pay loss. In our example, above, the excess insurer would be obligated to contribute \$4 million under the “true coinsurance” example but only \$2 million under the “modified coinsurance” example.

¹³ “True coinsurance” using option (a) would be difficult to apply as a practical matter because the primary limit of liability would never be exhausted. Given that this option requires payment of less than the entire unimpaired aggregate for each claim made under the policy, 20% of the unimpaired aggregate (using the example above) would always remain unpaid, and the primary policy therefore would never exhaust.

B. Example of co-insurance where a deductible/retention also applies

A question likely to arise where coinsurance is used in combination with a retention or deductible is: how do the two policy conditions interact? The calculation here is straightforward because no allocation of Loss is necessary. Therefore, the coinsurance calculation is performed after the retention is satisfied. The following example illustrates the necessary calculation:

Assume a fully-covered claim is made against an insured, and the claim is settled for \$3.5 million after the insured has incurred \$275,000 in defense costs. The applicable D&O policy provides a limit of liability of \$5 million subject to a 20% coinsurance and a \$150,000 retention applicable to all Loss. Who pays what?

Settlement:	\$3,500,000
Defense Costs:	<u>+ 275,000</u>
Total Loss incurred:	3,775,000
multiplied by Insurer's %:	<u>x .80</u>
	3,020,000
less: Retention	<u>(150,000)</u>
Insurer's obligation:	2,870,000
Insured's obligation:	\$ 905,000 (\$150,000 retention plus \$755,000 coinsurance)

If the company is required to accept a coinsurance obligation in connection with renewal terms, it would be both important and appropriate to ask that the D&O insurer provide some examples of how coinsurance would operate in a given claim scenario, in order to confirm a mutual understanding of the type of coinsurance being considered.

(2) Side A Coverage

Another option to be considered is a so-called "Side-A" D&O policy. Side-A D&O insurance coverage¹⁴ is a more limited version of the current D&O policy issued by AIG to a public company and is designed to apply only to claims under a number of situations where indemnification from the company is unavailable. The two most frequent circumstances under which a company does not indemnify its D&Os (and thus, Side-A coverage applies) are as follows:

- a. the company is financially insolvent, bankrupt or otherwise financially unable to fund the indemnification; or
- b. the defendant directors and officers are obligated to pay a settlement or judgment amount in a shareholder derivative lawsuit.¹⁵

¹⁴ Side-A D&O coverage insures loss incurred by directors and officers which is not indemnified by the company.

¹⁵ In many states, settlements and judgments in shareholder derivative lawsuits may not be indemnified by the company. This indemnification prohibition is intended to defeat the meaningless and circular result which

The following discussion identifies several circumstances where that type of D&O insurance program can provide valuable protections to directors and officers.

a. Financial Inability to Indemnify

If the company becomes subject to a bankruptcy proceeding, the company will likely be unable to fund its D&O indemnification obligations. In that circumstance, Side-A coverage will be the only financial protection available to the directors and officers to protect their personal assets. Because the company is not an insured under a Side-A policy, either with respect to its D&O indemnification obligation or with respect to securities claims against the Company, the risk that the proceeds of a Side-A policy would be deemed assets of the bankruptcy estate is materially diminished.

b. Derivative Settlements/Judgments

Shareholder derivative lawsuits can be filed either in tandem with a shareholder class action lawsuit or as an isolated lawsuit. A typical two-part D&O policy will respond to a settlement or judgment in either type of lawsuit, provided that the class action lawsuit (or any other claim in the same policy period) does not exhaust the available limit of liability before the potentially non-indemnifiable derivative lawsuit settlement is paid. Because tandem class action and derivative lawsuits are frequently settled at the same time, prior exhaustion of the limit of liability is typically not a problem.

However, that is not always the case, and the tandem derivative lawsuit cannot be settled at the same time. For example, in one recent case, a company elected to settle a securities class action for more than \$200 million (thereby exhausting the D&O policy's limit of liability) within a few months after the litigation was filed, even though the tandem derivative lawsuit could not then be settled for a reasonable amount. Approximately 18 months later, the tandem derivative lawsuit was settled for approximately \$15 million. Fortunately for the directors and officers, the company maintained an excess Side-A only D&O policy, which was not implicated in the indemnifiable class action settlement, and therefore was available to fund the non-indemnifiable derivative settlement.

Thus, Side-A only policies, although more limited in scope than traditional D&O policies, may provide the unique coverage, at a more reasonable cost, for which D&O insurance originally was intended: the protection of the corporation's directors and officers when indemnification from the corporation was unavailable.

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would occur if the directors and officers paid money to the company in settlement of the derivative claim, and the company then paid the money back to the defendant directors and officers as indemnification of the settlement amount.