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CURRENT TRENDS IN DIRECTORS AND OFFICERS LIABILITY INSURANCE

Beginning in 2001 and continuing through most of 2003, many public companies faced rapidly rising costs of directors and officers liability insurance ("D&O Insurance") combined with tightened coverage terms. This "hard market" for D&O Insurance was largely attributed to extensive shareholder litigation after the recent corporate scandals and the downturn in the economy, as well as the prior lengthy "soft market" conditions experienced since the mid-1990s. Since the fourth quarter of 2003, however, the market has shown significant signs of softening with respect to rates, terms, and conditions. This is being attributed, in part, to increased competition caused by the entry into the market of new D&O Insurance carriers. However, while pricing for D&O Insurance appears to be decreasing in 2004, it certainly has not returned to pre-2001 levels. Given the current securities litigation environment, the expectation is that the softening of the market may let up a bit in the fourth quarter of 2004.

A troublesome trend in D&O Insurance that seems to be surviving the "hard market" is that D&O carriers appear to have become more aggressive in attempting to rescind D&O Insurance policies or to limit coverage based on allegedly material misstatements in the insurance application materials. Recent high profile bankruptcy cases have also called into question whether directors and officers will be able to access their D&O Insurance proceeds to defend themselves if their companies file for bankruptcy. In the face of such challenges, many directors and officers are demanding that their companies secure better coverage to protect themselves in today's environment in which the frequency of shareholder lawsuits appears to be rising, and the Securities and Exchange Commission (the "SEC") and other governmental agencies have become increasingly aggressive in using their investigative and enforcement powers.

It is imperative that public companies understand the current state of the D&O Insurance market and the legal issues that should be considered when negotiating (or renegotiating) such coverage so they can secure the best possible protection for their directors and officers. Companies that are unable to negotiate favorable coverage may want to explore supplements or other alternatives in order to attract and retain talented directors and officers. This article discusses some recent trends in the D&O Insurance market, legal issues affecting the availability of such coverage, and possible supplements (or alternatives) to traditional D&O Insurance.

We have prepared this article with the assistance of Aon's Financial Services Group ("FSG"), a subsidiary of Aon Risk Services, Inc., the retail insurance brokerage and risk management division of Aon Corporation. FSG is one of the largest D&O insurance brokers in the world.

THE D&O INSURANCE MARKET

The D&O Insurance market for public companies is largely affected by the securities litigation environment. Liability for securities claims is one of the largest financial exposures covered by D&O Insurance, so it is important for public companies to be aware of current trends in securities litigation to understand the potential risk. According to the Aon Corporation Database (which analyzes data reported by Stanford Law School's Securities Class Action Clearinghouse combined with Aon's own compiled data), since the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), the average number of consolidated federal securities class actions has increased 15%, from an average of approximately 190 per year

(from 1991 to 1995) to an average of 218 per year (from 1997 to 2003). If the 2003 rate of securities class action filings continues, a public company that is listed on a national securities exchange or Nasdaq faces a 9% probability it will be the subject of at least one securities class action lawsuit over the next five years. The number of SEC enforcement actions has also increased from 484 in 2001 to 679 in 2003.

In addition, since 2002, there has been a significant increase in the severity of the settlements of securities class actions. According to the Aon Corporation Database, the average settlement value of securities claims has increased every year since the passage of the PLSRA. The average securities settlement in 1996 was approximately $9.4 million and in 2003 was approximately $22.8 million. Even more concerning to a small to mid-cap public company is the fact that the median securities settlement has increased from $4.15 million in 1996 to approximately $5.75 million in 2003. In 2002, there were 21 cases that settled for more than $20 million, and in 2003, that number increased to 23. During the first half of 2004, there have already been 17 settlements for more than $20 million.

The securities litigation environment was certainly an important factor leading to substantial premium increases in 2001 through the third quarter of 2003. However, according to Aon, pricing for D&O Insurance has generally been decreasing this year as a result of increased competition caused by the entry of new D&O Insurance carriers into the market over the past two years. Unlike the older D&O Insurance carriers, these new entrants are not encumbered with existing D&O claims from prior years and, therefore, have sometimes been able to offer more favorable pricing. While pricing has not returned to pre-2001 levels, Aon reports that the prices of policy renewals for its clients during the first six months of 2004 decreased on average 15% compared to the same period in 2003. The decrease was larger for the small to mid-cap public companies and smaller for the Fortune 500 companies. While some decrease has occurred in the pricing for public companies' primary D&O insurance policies, the rates for excess D&O Insurance (which kicks in after the limits in the primary policy have been exhausted) have come down even further as that market is even more competitive. The shift to a softened market began in the fourth quarter of 2003, but given the current securities litigation environment, the expectation is that this trend may let up a bit in the fourth quarter of 2004.

SOME BACKGROUND ON D&O INSURANCE

From the perspective of directors and officers, the purpose of D&O Insurance is basically to protect their personal assets, which could be exposed to liability for claims arising out of their service to the company. While all of the states' corporate codes authorize corporations to indemnify directors and officers for certain liabilities, such rights to indemnification are limited. For example, under Delaware corporate law, if a director or officer is unsuccessful on the merits in the defense of a lawsuit, generally, indemnification is permissible only if a majority of the directors who are not parties to the lawsuit determine that the director or officer acted in good faith and in a manner that he or she reasonably believed to be in or not opposed to the best interests of the corporation. The board of directors of a company that has undergone a change of control may be less likely to determine that an action by a previous officer or director was taken in good faith. In addition, corporate indemnification may be unavailable in cases where the company has filed for bankruptcy or simply does not have the funds necessary for such indemnification. D&O Insurance also generally allows a director and officer to access insurance proceeds to pay for defense costs. While many

[1] This data excludes the years 1996 and 2001. The year 1996 was the first year after the passage of the PLSRA and the number of securities class actions was unusually low as plaintiffs' attorneys became familiar with the requirements of this new law. In the year 2001, there was an unusually high number of securities class actions based on allegedly improper IPO practices by investment banks and issuers. Because these years appear to be anomalies, Aon has excluded them from its analysis.

state corporate statutes permit a corporation to advance legal expenses to a director or officer facing a lawsuit, such statutes are limited in a similar fashion as the indemnification statutes. Thus, the demand for D&O Insurance arises from directors and officers who may be unwilling to accept the risk of exposing their personal assets to liability in the event that corporate indemnification is unavailable.

Most state corporate statutes allow a corporation to purchase insurance on behalf of directors and officers to cover liabilities that such persons may incur arising out of their official capacity, including liabilities for which the corporation is not permitted to indemnify. Thus, D&O Insurance is generally not subject to the same corporate law limitations as corporate indemnification. D&O Insurance is subject, however, to any public policy limitations that may be contained in applicable state insurance law or other applicable law. While insurance codes and case law vary from state to state, public policy can prohibit insurance from covering losses caused by an insured person's fraud, willful misconduct, etc. These limitations, however, are generally more narrow than the limitations contained in state corporate indemnification statutes.

There are generally three types of coverage under D&O Insurance policies:

1. Side A Coverage: This coverage pays for losses incurred by individual directors and officers in claims arising out of their actions (or inaction) in their capacity as officers or directors, when such claims are not indemnified by the company.

2. Side B Coverage: This coverage reimburses the company for claims made against a director and officer, to the extent that the company indemnifies such director or officer for such losses.

3. Side C Coverage: This coverage pays for losses incurred by the company for its own exposure in securities claims brought against it. Side C coverage is also referred to as "entity coverage."

Historically, Side A and Side B Coverage were the only types of coverage in a typical D&O Insurance policy, so the company was uninsured for any of its own liability under securities laws. However, because most lawsuits alleging securities law violations are filed against the company, as well as directors and officers, there were frequently disputes between the insurer and the company as to how to allocate the costs of defending the lawsuit, as well as any settlements or judgments. During the soft D&O Insurance market of the 1990s, insurers began offering entity coverage to companies as part of the traditional D&O Insurance package, often with little or no increased premium. If a company had entity coverage, there would be no allocation dispute for a covered claim because both the company and the individual directors and officers would be covered by the policy.

Interestingly, however, there has been a lot of debate recently questioning the advantages of entity coverage. D&O Insurance carriers view entity coverage as a contributing factor to the increased costs of insurance, as they believe that companies have no incentive to keep litigation or settlement costs down, as long as the policy limits are not exceeded. Also, the inclusion of entity coverage may reduce the amount of coverage available to directors and officers for covered claims, because the company's exposure is included within the policy limits. Therefore, any payment made to the company under the entity coverage has the effect of reducing the amount of coverage available to individual directors and officers (unless there are specific allocations set forth in the policy). Finally, as described below under "Some Current Legal Issues Relating to D&O Insurance – Special Risks Relating to Bankruptcy," the inclusion of entity coverage in the D&O Insurance policy may increase the possibility that the insurance proceeds will be unavailable to directors and officers if the company is in bankruptcy.

SOME CURRENT LEGAL ISSUES RELATING TO D&O INSURANCE

Following is a discussion of some of the legal issues that companies should consider when negotiating D&O Insurance, because they could affect the availability of such coverage.

Rescission of D&O Insurance. Recently, there have been many high profile cases where insurers have sought to rescind D&O Insurance policies, such as WorldCom, Enron, HealthSouth, Cutter & Buck, Tyco, and others. Generally, the insurer's right of rescission is based on the theory that it issued the policy in reliance on material false representations in the insurance application or other materials provided by the company in the underwriting process. This risk is especially present in cases where a company has restated its financial statements, because insurers generally will have asked for financial statements in the application process. Because restatements of financial statements often lead to shareholder lawsuits against directors and officers, it is important that the insurer's right of rescission be limited in the insurance policy to provide the maximum possible protection. Generally, this requires that the policy contain a full severability of the application clause.

In cases where the carrier has been able to prove that the policy was issued in reliance on a material misrepresentation, the important issue is whether the carrier can rescind the policy with respect to those directors and officers who had no knowledge of the misrepresentation (the "innocent directors and officers"). In recent cases addressing an insurer's right of rescission, courts have looked closely at the language of the policy to determine the scope of the rescission right. Where the policy contains a full severability clause limiting the carrier's right to impute the knowledge or statements of one insured person to another insured person under the policy, courts will generally require the insurer to continue to provide coverage to the innocent directors and officers. A full severability clause should also provide that the application and all supporting materials constitute a separate application for each insured person.

The recent court decision in *Cutter & Buck, Inc. v. Genesis Insurance Company*, 306 F.Supp.2d 988 (W.D. Wash. 2004), underscores the importance of having a properly drafted full severability clause. In this case, the insurer had rescinded the D&O Insurance for all of the directors and officers of Cutter & Buck after the company restated its financial statements. The insurance policy in question had a severability clause that prohibited the imputation of knowledge of one insured person to another, but there was an exception for material information known to the person who signed the insurance application. Because the chief financial officer of the company had signed the insurance application and later pleaded guilty to fraud in connection with the financial statements and other SEC filings that the insurer had relied on in issuing the policy, the court found that his knowledge could be imputed to the other directors and officers under the language of the severability clause. Therefore, the court permitted the insurer to rescind the policy as to all insured persons, even the innocent directors and officers.

In contrast, the court disallowed rescission as to the innocent directors and officers in *In re HealthSouth Corporation Insurance Litigation*, 308 F. Supp. 2d 1253 (N.D. Ala. 2004). In this case, the severability clause in question provided that the written application for coverage shall be construed as separate applications for coverage by each of the insured persons and that no statement in the application or knowledge possessed by any insured person shall be imputed to any other insured person. The court distinguished this language from the severability language in the *Cutter & Buck* case, as here there were no exceptions carved out from the imputation clause. The court found that the policy language did not allow rescission of the policy as to the innocent officers and directors.

Fraudulent Conduct Exclusions. Most D&O Insurance policies exclude coverage for fraudulent conduct, self dealing, or other dishonest conduct by an insured. Historically, such policies required that there be a final adjudication by a court determining that such misconduct occurred before the insurer could apply the exclusion and deny coverage. Because claims against directors and officers generally settle before reaching the trial stage, such exclusions rarely applied. Recently, however, insurers have tried to remove or modify this "final adjudication" requirement to merely require an adverse finding of fact, adverse admission or, in some cases, a plea of *nolo contendere* by the insured. Companies should be wary of such modifications as they could call into question the availability of coverage under the policy at an early stage in any litigation.

It is also important that there be a severability clause with respect to the misconduct of any insured that is determined to fall within the exclusions of the policy. The policy should provide that such misconduct will not be imputed to another insured person for the purpose of determining the applicability of such exclusions.

Special Risks Relating to Bankruptcy. When a company files for bankruptcy, it may be unable to indemnify a director or officer for any defense costs, settlements, or judgments in lawsuits which could be brought against such persons. At such a time, directors and officers will consider it critical to have access to the D&O Insurance proceeds in order to defend themselves against claims that are commonly brought against directors and officers of bankrupt companies. However, in several recent high profile bankruptcy cases, the directors and officers rights to access proceeds of their D&O Insurance policies have been challenged by the creditors of the bankrupt corporation or the trustee, who claim that such policies and proceeds are assets of the debtor estate.

Generally, courts have found that the D&O Insurance policy is the asset of the debtor estate, especially in cases where the policy contains entity coverage protecting the company. However, courts have distinguished between the insurance policy and its proceeds and have split as to whether the proceeds belong to the debtor estate. Generally, the courts will analyze the facts and circumstances of the case. In traditional policies containing only Side A and Side B coverage, it is more difficult for creditors to argue that the insurance proceeds are property of the debtor estate, since the intent of such policies is to protect the directors and officers. However, the existence of entity coverage allows creditors to argue that the policy also was intended to protect the company and, therefore, the proceeds are an asset of the estate. In situations where the D&O Insurance policy contains entity coverage, the insurer may be unwilling to reimburse any defense costs of directors and officers until the bankruptcy court authorizes such payment, which delay could significantly prejudice the directors and officers. Therefore, there has been much recent debate and reevaluation of the desirability of entity coverage.

One way to increase the possibility that directors and officers will be able to access the insurance proceeds in a bankruptcy is to include a priority of payments endorsement, which will prioritize payments under the policy among the competing insured persons. Such a clause could provide that any covered losses sustained by directors and officers would be paid first, ahead of any covered losses sustained by the company. In a recent case involving Enron, the court viewed a priority of payments endorsement favorably when it authorized payments of funds under the D&O Insurance policy to pay for defense costs for directors and officers. While it is unclear how other courts may enforce (or not enforce) such a provision, it does provide persuasive evidence that the intent of the company in purchasing the policy was primarily to protect the directors and officers.

In addition to the priority of payments endorsement, it may be possible to negotiate a pre-petition waiver in the policy, which states that the parties waive and release any automatic stay or injunction to the extent that it applies to the proceeds of the policy. Although a bankruptcy court may not enforce such a provision, it does provide additional evidence of the company's intent to make the proceeds available to its directors and officers in a bankruptcy situation.

Most policies contain an exclusion for claims brought by or on behalf of another insured, which includes the company (under Side B or C coverage). In a bankruptcy, the trustee or creditors committee could bring claims against the directors and officers on behalf of the company. The policy language should guard against the risk that the policy will be unavailable to directors and officers to defend against such claims by providing that the exclusion does not apply to claims brought by a trustee, creditors committee, or other party in the event of a bankruptcy.

SOME SUPPLEMENTS OR ALTERNATIVES TO D&O INSURANCE

If a company is unable to secure D&O Insurance or negotiate favorable terms, it may be prudent to consider supplements or alternatives to traditional D&O Insurance. Unfortunately, most of these supplements or alternatives have their own limitations or raise other issues that companies must evaluate before choosing to pursue them. Some of the supplements or alternatives are discussed briefly below.

Separate Non-Rescindable Side A Coverage. Companies may face demands from their outside directors to purchase separate non-rescindable Side A excess executive liability insurance. Such policies cover losses when the underlying D&O Insurance is rescinded, has its limits exhausted, or is unavailable for certain other reasons. Because the policy benefits only the individual directors, it should not be deemed to be an asset of the debtor estate if the company files for bankruptcy. However, the premiums for such a policy can be as much as the cost of the underlying layer of primary D&O Insurance, and such separate Side A coverage would only kick in if the underlying policy becomes unavailable. A company that is financially sound may decide instead to rely on broad severability provisions in the insurance application and fraud exclusions to protect the outside directors.

Indemnification Trust Funds. One option is to have the corporation create a trust fund whose trustee is a separate entity, such as a bank. The corporation would deposit funds in an irrevocable trust, which funds could only be used to indemnify directors and officers that are entitled to be indemnified. The trust agreement would control the circumstances under which such indemnification would be paid. This option provides some security for the directors and officers that funds will be available for indemnification. It is possible that such a fund would be available to directors and officers of a company that has filed for bankruptcy, subject to fraudulent conveyance laws and other bankruptcy laws. However, it would not constitute insurance and, therefore, would probably be subject to the applicable corporate law limitations on indemnification. For this reason, a Side A D&O Insurance policy covering shareholder derivative litigation may still be required to obtain fuller protection for officers and directors.

Captive Insurance Companies. Another option is to have the company form a wholly-owned subsidiary whose purpose is to provide and maintain insurance on behalf of the parent and its other subsidiaries. Because the parent owns the insurance company, it can secure favorable terms in the policy. However, a captive insurance company that is capitalized wholly by the parent corporation may be viewed as an indemnification rather than an insurance vehicle because there is no risk sharing among separate entities. If so, the captive insurance could be subject to the corporate law limitations on indemnification. Applicable corporate law would also have to be analyzed to determine whether the corporation can lawfully form such an entity for the benefit of its directors and officers. In addition, there would be questions as to whether premiums would be tax-deductible if the captive insurance coverage does not constitute insurance.

The risk that captive insurance will not constitute insurance under corporate and tax laws may be alleviated by forming a captive group. A captive group is an insurance company established by separate companies for the purpose of providing insurance to each of such companies. However, the captive group would have to bear the risks of each of the other companies in the group, so a company should carefully evaluate the other members of the group before joining.

Self-Insurance. A company that is unable to secure, or cannot afford to pay for, D&O Insurance may have no option except to set up a self-insurance program. This would involve setting up a special reserve fund to pay indemnity claims from its directors and officers. Like some of the other options set forth above, however, any payment from such a fund would be subject to the applicable corporate law limitations on indemnification. It is also likely that such a fund would not be protected from creditors in the event of a bankruptcy.

Employed Lawyers Professional Liability Insurance. This option is not an alternative to D&O Insurance but is a related insurance for in-house attorneys. Typically, in-house attorneys that are not directors or officers of the company would not be covered by the D&O Insurance unless the policy is expanded to include employees. Even then, a D&O Insurance policy may contain an exclusion for professional services, which could exclude legal work performed by the in-house attorney. If so, an in-house counsel who serves as a director or officer of a company may incorrectly assume that his or her legal work is covered by the D&O Insurance policy.

As a byproduct of the corporate scandals and resulting litigation, there has been increasing interest in employed lawyers professional liability insurance. Such insurance provides specialized coverage against malpractice claims for legal work done by an in-house attorney. In-house attorneys concerned about the risk of malpractice claims should review their company's D&O Insurance policy to determine whether such separate insurance is necessary. Aon reports however, that D&O Insurance policies commonly cover all employees against securities claims, which is generally the risk of greatest concern to in-house attorneys. Also, many of the employed lawyers professional liability policies exclude patent, trademark, and other similar types of work. For these reasons, there does not appear to be a great demand for such policies.

CONCLUSION

The D&O Insurance market has changed considerably in recent years, as has the legal environment for public companies. Because of these changes, public companies should carefully review their existing D&O Insurance policies to understand the extent of the company's coverage and any potential areas of exposure. It may be prudent for such companies to start early in the process when renewing such policies and to seek the assistance of coverage counsel or an insurance broker to assist in this respect. The stability and reputation of potential insurers should also be investigated. Public companies that are unable to secure favorable coverage may want to consider pursuing a supplement or alternative to traditional D&O Insurance after a careful evaluation of the potential risks and benefits of, and legal issues that could arise from, any such supplement or alternative.

As indicated above, Aon's Financial Services Group ("FSG"), a subsidiary of Aon Risk Services, Inc., assisted with the preparation of this article. Please contact Tony Giordano of Aon Risk Services, Inc. at (303) 782-3357 or e-mail him at tony_giordano@ars.aon.com for further information regarding D&O insurance and Aon brokerage services.

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