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A FOLEY & LARDNER INFORMATION BULLETIN FOR CLIENTS AND FRIENDS

TRANSACTIONAL AND SECURITIES UPDATE:

Directors' And Officers' Liability Insurance - A Changing Landscape

As a result of the events at Enron, WorldCom and other companies, recent financial restatements and allegations of financial misreporting, increased responsibilities for directors and officers as a result of the Sarbanes-Oxley Act and a rise in securities litigation, directors' and officers' ("D&O") liability coverage is more important than ever, but the cost of D&O insurance is going up and coverage is becoming more restrictive. The following are some key points for companies and their directors and officers to consider when buying or renewing D&O coverage:

1. D&O Policies Are Negotiable

   - Unlike most other kinds of insurance, D&O policies are not standardized. Coverage terms are frequently negotiable.
   - It pays to shop around, and it pays to negotiate. This is particularly true in the current "hard" D&O market.

2. All Insurers Are Not Equal

   - Insurance companies are rated for financial strength by A.M. Best & Co. and other internationally-recognized rating agencies. Financial strength of your insurer is essential when buying D&O coverage. Obtain insurance from an A+ (A.M. Best) rated company.
   - Some insurers delay or refuse to pay valid claims; others are commercially reasonable and have a history of good faith and fair dealing. Conduct appropriate due diligence on your prospective insurer.

3. Continuity of Coverage Is Very Important, But Becoming Harder To Get.

   - "Continuity of coverage" means ongoing coverage with no uninsured gaps.
   - Uninsured gaps are possible because all D&O policies are written on a "claims made" basis. That means the policy only covers claims that are asserted while the policy is in effect and that are based on acts committed after the "retroactive date". This can lead to situations where there is no coverage, even though a company has had D&O policies continuously in place.

     Example: Company switches to a new D&O policy on January 1, 2003. The new policy has a

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retroactive date of January 1, 2003 (policy inception date). A claim is asserted during 2003 based on acts committed during 2002. The new policy will not cover the claim because the acts were committed before the retroactive date. The old policy will not cover the claim because the claim was not asserted during that policy period. Result: no coverage.

- To get continuity of coverage and avoid uninsured gaps, companies must either (i) negotiate for earlier retroactive dates on new policies or (ii) purchase tail coverage (known as "discovery period" coverage) on old policies, if available.
- Insurers are becoming more reluctant to provide continuity of coverage. Insurers also are writing policies for one year at a time rather than the two or three years that was previously available, which makes continuity of coverage a more serious issue.

4. Application Risks Have Increased

- The insurer can rescind the policy (resulting in no coverage) if it discovers the application contained false information. Insurance companies are taking a harder look at this opportunity in the wake of recent accounting scandals. If the financial statements or other documentation submitted with the application contain false information there is great risk that the policy will be rescinded and coverage denied.
- Some insurance companies are expanding the definition of what counts as part of the "application" to include public filings and prior applications. This increases the risk to the policyholder and heightens the importance of severability provisions (see below).
- It is critical to review carefully the policy's provisions regarding the application and all information submitted with the application.

5. Severability Has Taken On Added Importance

- As a result of some of the recent corporate frauds, severability provisions have become very important. A severability clause gives the insurer the right to deny coverage only for the directors or officers who committed fraud; the coverage remains in place for the innocent directors and officers. If there is no severability clause, then fraud by any one insured will defeat coverage for everyone, including innocent officers and directors.
- Some insurers now seek to get rid of or limit the severability clause. This is an issue well worth fighting for, because innocent directors and officers reasonably rely on the D&O coverage being available to protect them in these kinds of crises (*e.g.*, where a rogue officer has cooked the books, etc.).

6. Exclusions Make A Difference

- Some exclusions are standard; some are not. Each must be reviewed carefully, and some can be negotiated.
- D&O policies generally exclude most types of intellectual property claims (*e.g.*, patent infringement, trademark infringement, etc.). Coverage can usually be purchased by policy endorsement or a separate policy. (Some coverage for intellectual property claims may be

available under a company's comprehensive general liability (CGL) policy.) Some policies totally exclude coverage for punitive damages; others do not. This is a negotiable term.

- Some policies exclude coverage for employment claims; others do not. Separate employment liability coverage can be purchased.
- Some policies exclude coverage for securities law claims, others do not. For public companies, securities law coverage is critical and, unfortunately, expensive. It is important to check the details of the securities law coverage, because not all securities provisions are the same. For example, the costs of Securities and Exchange Commission investigations may or may not be covered. Securities coverage may be necessary even for private companies if private debt or equity placements have occurred or are planned.
- Policies generally exclude coverage for fraud or intentional dishonest acts, but differ as to whether coverage is excluded based on a mere allegation of the proscribed conduct or an actual finding. This is a significant difference.
- There is no industry-wide standard language for exclusions. Therefore, the precise language of your policy is crucial.

7. Who Is Covered Makes A Difference.

- Some policies cover claims made directly against the corporation (entity coverage); others do not. Entity coverage is good for the corporation, but can dilute the amount of coverage available to officers and directors. That is, the insurer is only committed to pay the maximum policy amount without regard to the number of people who may be entitled to coverage. The more people who are entitled to coverage, the less coverage available to any single individual.
- Some policies cover employees as well as officers and directors; this can dilute coverage.

8. New Bankruptcy Provisions Are Appearing

- The recent high-profile bankruptcies have increased the focus on coverage issues when a company files for bankruptcy protection. This has prompted some insurance companies to introduce new bankruptcy-related provisions that can have a dramatic impact on coverage.
- One major coverage issue in bankruptcy is whether the insurance proceeds are the property of the insured corporation's bankrupt estate, such that the officers and directors cannot access the coverage they thought they had. This is an issue in the Enron bankruptcy. Some insurance companies are addressing this by adding "order of payments" provisions, which specify the order in which insurance proceeds will be paid out (*e.g.*, first to officers and directors, then to the bankrupt company). Others are offering "A-side only" coverage, which is separate coverage available only to the officers and directors and not to the corporation. Some insurance companies are attempting to eliminate entity coverage altogether, and some are attempting to impose blanket bankruptcy exclusions, eliminating all coverage for claims relating to bankruptcies.
- It has become very important to evaluate carefully what coverage will be available in the event of a bankruptcy.

9. Defense And Settlement Provisions Are Important.

   - Some policies allow the insured (company, director or officer) to select defense counsel and control the defense and settlement of claims; more often, these rights are reserved to the insurance company. Most insureds prefer to choose their own legal counsel and control their own defense, particularly if there is a large deductible.
   - Even if the policy allows the insured to control the defense, some policies have a "hammer clause," which allows the insurer to cap its liability if it wants to accept a settlement and the insured disagrees. Some insurers are willing to remove the hammer clause; others are not.

10. Prompt Notice Of Claims Must Be Given.

    - All D&O policies require prompt notice of claims. Failure to give prompt notice can void coverage.

11. Deductibles And Co-Insurance Can Reduce Coverage.

    - Premiums can be reduced by purchasing higher deductibles. But, of course, this increases the uninsured risk. Deductible amounts need to be carefully considered.
    - The deductible generally does not apply to claims made directly against directors and officers (but does apply to reimbursement of the company for amounts it has paid to indemnify officers and directors).
    - Some insurance companies offer co-insurance, which operates like a co-pay on health insurance. This can reduce premium costs, but increases uninsured exposure.

D&O coverage is, of course, only one piece of what should be an overall plan to protect directors and officers. For example, indemnification should also be available to a director or officer under applicable state corporate law, the company's Articles of Incorporation and/or Bylaws or under an indemnification agreement. But, to the extent that these protections depend on the continued existence or financial solvency of the company, they alone are not sufficient. The D&O insurance market continues to change and evolve. One insurer recently introduced an individual D&O policy that is personal to the particular director or officer.

In light of the importance of comprehensive D&O coverage, it makes sense to spend a little more time and attention with your D&O insurance when it comes up for renewal. D&O policies are complex, and your insurance broker can help you evaluate your options and negotiate to maximize your coverage.

We have seen the problems cited above play out in real life. We are familiar with the D&O policies issued by each of the major D&O insurers, and we would be happy to assist you in evaluating your current (and/or proposed) D&O coverage. As lawyers, we can appreciate that much of the language in a standard D&O policy is difficult to understand. Our goal is to make sure you understand what insurance coverage you have (or seek), what is possible in the current D&O insurance market, and that you are aware of the potential pitfalls and risks in your coverage. If we can assist you in reviewing or negotiating your D&O coverage, please contact us.

If you have any questions concerning the matters discussed in this Foley & Lardner *Legal News Update*, please contact your Foley & Lardner attorney, or contact:

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