

ROUNDTABLE

CHARTIS 

RISKS FACING DIRECTORS AND OFFICERS



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R O U N D T A B L E



R I S K S F A C I N G D I R E C T O R S A N D O F F I C E R S

Continued economic turbulence, a sharpened focus on fraud and a raft of new regulations increase the market risk for directors and officers. Greater accountability and responsibility is a fact of corporate life. To avoid the adverse consequences of litigation and personal liability, compliance programs and risk mitigation strategies must be examined and enforced with renewed vigour, along with other strategies that directors and officers can employ to manage threats and protect themselves. ▶▶

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Snow: To what extent have the duties and responsibilities of directors been put to the test over the last year or so?

Stitt: Directors of Canadian public companies are under increasing scrutiny as a result of a number of recent developments in corporate and securities law. We have witnessed a number of challenges to corporate transactions such as poison pills, takeover bids, proposed mergers and acquisitions, plans of arrangements, and restructurings within the insolvency context, which have closely examined board processes, governance practices and the exercise of business judgment by directors whose deliberations are being put under the microscope in a manner which is unprecedented. In Canada, we also have the oppression remedy under which a director or officer may be personally liable if they engage in oppressive conduct by breaching or failing to take into consideration the reasonable expectations of affected stakeholders.

Verhille: There is a flurry of activity which has not let up after the 2008 global financial crisis. As an illustration, notification levels of claims brought against directors in Europe are consistently 20 percent above 2009 and 2010 levels which were already considered peak years. The notifications have focused on allegations of breach of fiduciary duty, and reinforced existing paradigm shifts in the nature of claims while reaffirming underlying trends. This aggressive environment is here to stay. In terms of shifts observed, directors are now facing far more indigenous claims where the US – though still prolific in terms of very costly litigation for directors – has been joined by other jurisdictions also generating high exposures. Australia and most European countries now showcase costly and long investigations, proceedings or litigation; though the root cause may vary from country to country. Secondly, the number of claims against directors of private companies now outweighs those against their public peers. Finally, empowered regulatory bodies, state attorneys and criminal courts are now the more prevalent sources of action worldwide against directors in comparison to actions brought by civil plaintiffs.

Hanson: Change has always been the greatest source of risk and challenge to corporate directors and officers, especially change that is propagated by outside influences like governmental regulators or unpredictable economic circumstances. The last year or so has packed plenty of each: new statutory standards in the UK regarding overseas business practices, new, intrusive and untested corporate governance legislation in the US, under the Dodd-Frank Wall Street Reform and Consumer Protection Act, as well as sovereign debt and related banking uncertainties not only in Greece, Ireland and Portugal, but in the US and in a number of particular states such as Illinois and now Minnesota. Uncertainty demands adjustment and adjustment creates the opportunity for missteps, both real and perceived.

Smith: Increases in regulatory activity and shareholder activism from union pension fund holders have added to the challenges boards face as corporate stewards. For example, the Dodd-Frank Act gives shareholders a non-binding ‘say on pay’ vote, and, although the Act does not purport to give shareholders additional legal claims with respect to executive compensation decisions, union plaintiffs’ lawyers have been trying to use it in just that way. We already have seen five shareholder derivative lawsuits filed in the wake of negative ‘say on pay’ shareholder votes, and two of those have settled for over \$1m. Administrative rulemaking required by Dodd-Frank will continue throughout 2011, and boards

The lingering effects of the global recession and the credit crisis have spawned an increase in government regulation and enforcement activity. This increased level of scrutiny from the regulators has, in turn, led to an increase in lawsuits against directors and officers.

K. ALAN PARRY

and corporations will continue to face compliance challenges in an increasingly active regulatory environment.

Selvin: The Dodd-Frank Act has expanded the SEC’s powers in a number of areas. For example, the statute confirms that the SEC has authority to bring claims for ‘control person’ liability under the Securities and Exchange Act of 1934. This means that directors and officers are now potentially exposed to liability based on the actions of company employees.

Sheehan: Two of the biggest tests directors face is navigating their companies out of the recession and executing effective business strategies while improving risk management oversight and understanding. This includes adequate and timely response to new regulations, increased regulatory oversight, and shareholder activism. Shareholders, who have been granted unprecedented access to the proxy, now have a voice on executive compensation, albeit on an advisory basis. Increasingly, sales of public companies are followed by lawsuits from shareholders questioning the adequacy of the consideration being paid, the due diligence performed in soliciting alternative bids, and the disclosure around the sales process.

Parry: The last couple of years have been an interesting and challenging time for directors. The lingering effects of the global recession and the credit crisis have spawned an increase in government regulation and enforcement activity. This increased level of scrutiny from the regulators has, in turn, led to an increase in lawsuits against directors and officers. The increase in M&A activity over the past year or so introduces additional challenges for directors, who may face heightened duties in the context of considering potential transactions. Not surprisingly, we are seeing a particular uptick in M&A-related litigation.

Snow: Broadly speaking, what are the key risks facing corporate directors and officers in today’s market? How much of this is linked to a rise in government investigation and enforcement action?

Verhille: Directors rightly view compliance, diligence and transparency as areas of potential liability. These areas are subject to government investigation and enforcement actions which are most definitely a major source of risk for directors. Other risks are also emerging. Social media, for example, can be used to taint ►

corporate or individual director reputations or destroy stock value for purely malicious ends or for financial gain. Current macroeconomic factors are another source of risk. The current sovereign debt crisis, which could potentially morph into a liquidity and currency crisis compounded by growing inflationary pressure, would impact solvency, liquidity and performance – with subsequent capital destruction and even bankruptcies. Many parties will be called to account to compensate for the financial damage caused. Directors will not be isolated from this.

Hanson: The risks facing corporate directors and officers have begun to shift this past year in a number of important ways. In the US, while securities class actions remain a common source of both corporate and personal risk, with one exception – Chinese companies whose shares are newly trading on American exchanges – the overall risk of such suits seems to be abating. A combination of legislative initiatives over the course of the last 15 years, a careful US Supreme Court, and the salubrious impact of the much-maligned Sarbanes-Oxley Act seem to have reined in the classic securities class action strike suit to a considerable degree. Taking the place of the usual major threat has been a fast-rising tide of merger and acquisition related shareholder derivative actions.

Smith: Regulatory inquiries and enforcement actions related to legal compliance present a critical risk for D&Os. For example, we have just experienced a record year for FCPA enforcement actions and settlements, with eight noteworthy FCPA settlements occurring in 2010 or early 2011. Several significant FCPA actions have been filed against individuals, and 2011 has already witnessed the DOJ's first successful FCPA jury trial in the 34 year history of the Act with the Lindsey Manufacturing case. In virtually every instance in which a corporation announces a significant regulatory settlement, the board has been sued in a derivative action claiming inadequate oversight. Directors are being challenged to play a much more active role in overseeing compliance and risk management.

Selvin: The risks to corporate directors and officers have increased as a result of recent changes in the regulatory environment. Other than the SEC's expanded powers, the new risks include new incentives for whistleblowers and additional disclosure requirements. The Dodd-Frank Act has provided financial incentives

to whistleblowers who tip off regulatory authorities concerning securities law violations. Thus, the statute provides for bounties ranging between 10 and 30 percent of the SEC penalty that may be levied in an enforcement action. These financial incentives will presumably mean an uptick in regulatory activity and a commensurate increase in regulatory risk to officers and directors.

Sheehan: The key risk for directors and officers arises from two primary areas. The first is shareholders and, in the case of bankruptcy, creditors. The second is regulators. Following the global financial crisis, financial stakeholders – individual and institutional – are more closely scrutinising directors and officers, holding them more accountable for their actions. There has been a marked increase in the regulatory and prosecutorial zeal by the SEC, the DOJ, and states' attorneys general in pursuing improper behaviour on the part of the corporation and its directors and officers. This spike in regulatory activity has increased the likelihood of an officer or director being targeted in an investigation of alleged wrongdoing.

Parry: From a liability standpoint, directors and officers in the US have certainly seen an increase in government investigations and enforcement activity, particularly from the SEC. With the implementation of the various reforms contained in the Dodd-Frank Act, there is every expectation that this trend will continue for the foreseeable future. In recent years, US regulators have also increased their enforcement of alleged FCPA violations, which can result in significant penalties. Of course, when governmental enforcement activity increases, civil litigation generally follows.

Stitt: The key risks to corporate directors and officers in Canada today are primarily statutory, flowing from legislation governing securities, taxation, employment and pension benefits legislation, criminal, money laundering and corrupt practices, insolvency and environmental issues. There is a significant potential for personal liability for both appointed directors and *de facto* directors in this jurisdiction. In the securities regulatory context, there is increased cross-border cooperation and mutual assistance in criminal and securities commission investigations of securities offences involving directors and officers of public companies. It is not uncommon to see directors and officers facing overlapping criminal, securities commission investigations or charges and civil litigation.

Snow: Can you highlight any key legal and regulatory developments that have changed the liability landscape for D&Os?

Selvin: The key development in this area has been the Dodd-Frank Act, which was enacted last year. Among other provisions, this statute expands the ability of the SEC to bring claims for aiding and abetting securities law violations by providing that such claims may be asserted under Securities Act of 1933 and the Investment Company Act of 1940. In addition, the statute also amends existing law so that the level of scienter – state of mind – that is needed to be established by the SEC in connection with such claims is lowered from 'actual knowledge' to 'recklessness'. Previously, applicable case law had been such that the SEC was required to plead and prove that the defendant had 'actual knowledge' of the violation.

Hanson: For corporations subject to American securities laws, the combination of the new Dodd-Frank legislation and changes within the SEC are in the process of greatly altering the liability ►►

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MICHAEL SMITH

profile of corporate directors. Dodd-Frank not only creates vast new financial incentives for corporate whistleblowers to disclose confidential corporate information to regulators, but the law also extends the executive compensation claw-back mechanism created in previous legislation. American trial lawyers are already trolling the internet, seeking disaffected corporate employees that might be able to share information that would qualify them for big personal gains under the new whistleblower regime.

Smith: The whistleblower incentive program promulgated by the SEC under Dodd-Frank will guarantee an increase in compliance-related SEC investigations. Boards will be required to lead internal investigations of whistleblower allegations, and expected to resolve governmental inquiries and remedy deficient compliance processes and controls. Companies with significant multinational operations and sales will face increased FCPA scrutiny and compliance challenges. Although the US Supreme Court continues to narrow the scope of securities fraud class action liability with recent decisions such as *Janus* and *Tellabs*, directors' liability for breach of fiduciary duty for failure of oversight seems to be on the rise.

Sheehan: I can't say that there's been a landmark adverse legal or regulatory development that has changed the liability landscape for directors and officers. It is more a case of incremental changes that have raised the bar on governance and for the accountability of directors and officers. There is one aspect of the Dodd-Frank Act, however, that may have a more immediate impact on D&O liability and litigation. Section 922 of the Act provides new incentives to whistleblowers, including substantial bounties in proceedings where the SEC collects more than \$1m in fines or penalties. These incentives could potentially lead to a wave of employee whistleblowing that could result in significant regulatory activity and follow-on civil litigation.

Parry: In the US, the Dodd-Frank Act is probably at the forefront in terms of legal developments that impact liability for corporate directors and officers. For example, the Act includes a provision that gives financial incentives to corporate whistleblowers. Under this bounty provision, a whistleblower who provides information to the SEC that results in a sanction of at least \$1m, could receive a payment of up to 30 percent of that sanction, with no requirement that the whistleblower has first exhausted all available internal channels. The Act also includes an executive compensation claw-back provision that expands the exposure of current and former executives to actions for recoupment of incentive-based compensation.

Stitt: The statutory liability regime found in Part XXIII.1 of the Ontario Securities Act enacted on 31 December 2005 imposes personal civil liability on directors and officers for misrepresentation and non-disclosure in continuous disclosure related to the trading of shares on the secondary market, and has introduced new damages exposures for directors and officers. Class proceedings seeking a remedy under this legislation require leave of the court to proceed, for which the bar has been set relatively low in some much awaited decisions rendered in 2009 and 2010. The threshold test is a reasonable prospect of success which is satisfied where there is something more than a *de minimis* possibility or chance that the plaintiff would succeed at trial.

Verhille: The Bribery Act introduced in the UK in July this year has game changing potential for all companies anywhere in the

The emergence of litigation funding firms in Europe, typically in the UK or in Switzerland, takes the securities exposure of companies in Europe to a new level by effectively removing one of the barriers to entry of mass actions: the funding of plaintiff law firms.

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world with operations in the UK. The dramatic increase in the ability to prosecute and establish liability, along with the probable increase in self reporting of illegal behaviour, has all the signs of creating potential exposure for directors and officers. The emergence of litigation funding firms in Europe, typically in the UK or in Switzerland, takes the securities exposure of companies in Europe to a new level by effectively removing one of the barriers to entry of mass actions: the funding of plaintiff law firms. The introduction of criminal corporate liability in Spain, for specific conduct, will increase criminal prosecution and most likely involve directors as co-defendants.

Snow: What D&O liability issues frequently surface in the context of a corporate bankruptcy, and how is this affecting D&O insurance?

Smith: The Bankruptcy Code's automatic stay temporarily precludes plaintiffs from pursuing litigation against the company, and prevents creditors from obtaining property of the estate, which can include proceeds of D&O insurance policies insuring both the company and the directors and officers. This can make funding the defence of inevitable D&O claims arising out of a bankruptcy extremely difficult, as the company may be unable to advance costs or fund a self-insured retention, and D&O policy proceeds may be inaccessible. For Side A policies covering only the D&Os, courts generally permit an insurer to advance costs, even if they deplete the proceeds, because policy proceeds are not the company's property – a further illustration of the benefit of robust coverage for the directors only.

Selvin: As a matter of US common law, when a company becomes insolvent, or enters the 'zone of insolvency', courts have held that its directors and officers owe their fiduciary duties to the company's creditors. This means that directors and officers may become the targets of a company's creditors, especially if the company is experiencing financial difficulty. The empirical studies have shown that once a company actually enters bankruptcy, the risks of litigation filed against corporate directors and officers also increases. Thus, it is a frequent scenario that shareholders will bring civil actions against corporate directors and officers following the company's bankruptcy, as bankruptcy will have rendered the company's common stock virtually worthless.

Sheehan: Directors' and officers' fiduciary duties move from ►

shareholders to creditors as the company enters or approaches insolvency. Once a company files for bankruptcy, the bankruptcy trustee often sues the directors and officers. Side A D&O insurance is designed to reduce the risk that the D&O policy and its proceeds will be tied up in a bankruptcy proceeding, in part, by covering the individuals and not the entity. Given the huge legal expenses incurred in recent financial institution bankruptcies – more than \$80m in some cases – directors need to carefully assess the amount of available limits. Since a Side A policy only covers the individuals and not the entities, it is quite difficult for the trustee to make the argument that the policy should be an asset of the bankruptcy estate.

Parry: A company that is insolvent may not be able to satisfy its indemnification obligations to its directors and officers. In that situation, the individual defendants will have to seek defence and indemnity directly from the company's D&O carrier, under what is called Side A coverage, rather than looking to the company for reimbursement. A corporate bankruptcy can be particularly problematic when both the company and individual directors or officers are defendants in a pending case at the time of the filing. In some cases, the company's D&O policy has been claimed as an asset of the bankruptcy estate, which creates real problems for the individuals who are looking to that policy for payment of ongoing defence costs. Claims brought against directors and officers by the corporate bankruptcy trustee may also be excluded from coverage unless specifically carved out of the policy's 'insured v insured' exclusion.

Stitt: In Canada, directors have potential personal liability in the event of an insolvency for unpaid wages, vacation pay, source deductions for federal and provincial income tax and employment insurance premium remittances, Canada Pension Plan contributions, corporate income and excise taxes and withholding tax, and, in certain circumstances, pension fund contributions and deficiencies. In addition, a number of potential liabilities exist under the federal Bankruptcy and Insolvency Act, such as, for dividends or for redeemed shares where payment was made one year preceding bankruptcy and the corporation was insolvent at the time the payment was made, or rendered insolvent as a result of making the payment.

Verhille: Typical underlying factors in bankruptcy litigation affecting directors are continued trading when directors knew or should have known that the company would not be able to pay;

A key area of potential D&O liability relates to IP theft or trade secret exposure. For example, a corporate officer who is hired by the company after having worked at a competitor may be subject to a claim for IP theft or for the misappropriation of trade secrets by the competitor.

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non payment of taxes and social security premiums creating personal liability; mismanagement in the form of rapid expansion of the business to foreign countries without proper diligence; stripping of assets of a subsidiary; accounting irregularities in the years preceding the bankruptcy; and waste of corporate assets, such as past decisions to pay an excessive price for an acquisition. Defending such allegations is costly and long-drawn. The potential effects of litigation on directors are wide ranging and usually traumatic, from the preventive seizure of assets of directors when strong indications of liability appear, high damage awards if liability is determined and potential disqualification to act as a director.

Hanson: The financial and economic crisis that began in 2007 carried with it the possibility of greatly increased claim activity against corporate directors and officers, but overall the scope of claim activity relating to bankruptcies was modest. Certainly if one calls the Madoff and Stanford matters bankruptcy claims, there has been serious activity, but by and large corporate boards in legitimate businesses have done a good job of managing the economic trauma, and legal risks, associated with a severe economic downturn in individual businesses. Heightened awareness of the liabilities associated with 'deepening insolvency' and companies operating 'in the zone of insolvency' may explain this.

Snow: Are you seeing more claims against D&Os arising from non-traditional sources, such as claims related to intellectual property? If so, do you expect this trend to increase going forward?

Selvin: A key area of potential D&O liability relates to IP theft or trade secret exposure. For example, a corporate officer who is hired by the company after having worked at a competitor may be subject to a claim for IP theft or for the misappropriation of trade secrets by the competitor. Indeed, such was the case when Mark Hurd, formerly the CEO of Hewlett-Packard, was hired last year by Oracle. Hewlett-Packard responded by suing Oracle and Hurd on the theory that Hurd would necessarily have to use Hewlett-Packard's trade secrets in carrying out his responsibilities at Oracle. Because the scope of the coverage under a D&O policy – which is normally triggered by the commission of a 'wrongful act' – is so broad, several US courts have recently held that such claims would be covered under such policies.

Sheehan: We are seeing a greater number of D&O claims arise out of announcements that have a significant adverse financial impact on a company. Examples of these would include a massive product recall, a large environmental catastrophe, a mining disaster, or a large FCPA settlement. Additionally, we have seen an increase in the frequency of derivative claims related to activities such as corporate mergers and executive compensation. The frequency of traditional 10b-5 litigation has remained relatively stable over the years with a few minor anomalies. As the plaintiffs' bar looks to grow its business and regulatory activity evolves, we are likely to see plaintiffs continue to explore new areas of liability and a diversification of D&O litigation away from the traditional 10b-5 claim.

Parry: When a joint venture or other business relationship terminates on unfriendly terms, one company may bring a claim against its former business partner or its individual executives alleging misappropriation of trade secrets or similar claims. Another potential source of 'non-traditional' claims involves so-called 'cyber liability', where claims are asserted following hacking incidents or ►►

other high-profile breaches of confidential data. If the company faces exposure for the data breach in the form of government action or third-party claims, the board and management can become the target of shareholder suits alleging failure to properly oversee the security of critical data. As more and more business is done in cyberspace, the potential for these types of claims will only increase.

Stitt: The claims arising out of intellectual property issues in this jurisdiction appear to be conducted more at the corporate level rather than being directed at individual directors and officers and more frequently involve CGL rather than D&O policies. Having said that, there is no question that under our federal legislation governing patents, trademarks, copyright, and other forms of intellectual property claims may be made against individuals depending on their degree of involvement in the infringement activities. Tort claims arising out of intellectual property violations, breach of confidence and unfair competition may also be made against individual directors and officers personally if certain requirements are satisfied.

Verhille: There is a growing trend toward the ‘personalisation’ of enforcement or litigation. This leads to a trend of claims against individual directors which in the past were unusual. This trend is likely to continue. We have seen cases brought by the court of accounts against directors for alleged abuse of public funds, aiding and abetting claims brought against board members of the company providing offer terms in acquisitive transactions, joint and multiple claims for tortious contract interference, and criminal investigations into directors’ conduct linked to product liability cases or corporate manslaughter. In addition to such cases we see the rise of derivative claims and claims brought directly by companies taking directors to account for breach of fiduciary duty on the back of internal failings which will vary depending upon the companies’ activities.

Hanson: The D&O claim mix is changing, certainly, but in fairly predictable fashion. Increased merger and acquisition activity in the world economy has always led to more suits in that area. The cost of dealing with such suits, both in settlement, deal adjustment and defence, has skyrocketed, however. Whistleblower and regulatory actions are expected to increase sharply, and soon, but have not yet really done so. As for intellectual property, such suits have always been possible under the statutory framework that has been in place for many years, but with the exceptions of circumstances in which an individual has a particular role, such claims remain fairly rare.

Snow: Would you say that more directors and officers are being drawn into litigation? What are the sources of such conflict?

Sheehan: The frequency of traditional federal securities class action activity appears to be fairly stable. While it is more difficult to track non-federal securities class action activity, my sense is that there has been an increase in the frequency and severity of litigation against directors and officers. Most notably, there has been a marked increase in breach of fiduciary duty claims arising out of corporate merger and acquisition transactions. There has also been a notable increase in private litigation arising out of FCPA investigations and SEC investigations. In fact, the DOJ and SEC are currently conducting more than 250 civil and criminal investigations into alleged FCPA violations initiated against

The types of disputes where directors and officers are now in the cross-hairs cover a wide range of potential liabilities – securities, competition, product liability, corporate transactions, pension disputes, insolvency related disputes, mass tort, and oppression claims.

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companies and individuals. Another area where we have seen an increase in activity is in lawsuits against directors and officers of failed financial institutions.

Parry: Recent reform legislation brought on by the financial crisis has led to an increase in government investigations and enforcement actions, which in turn is fuelling an increase in litigation by shareholders and others against directors and officers. In the current economic climate, every board decision is subject to enhanced scrutiny, and regulators and shareholders are particularly sensitive about executive compensation. In addition to these factors, directors and officers make attractive defendants because they usually have the company and multiple D&O insurance carriers standing behind them.

Stitt: Directors and officers are increasingly being drawn into litigation in Canada, in order to expand the scope of mandatory oral and documentary discovery and maximise available insurance proceeds. The types of disputes where directors and officers are now in the cross-hairs cover a wide range of potential liabilities – securities, competition, product liability, corporate transactions, pension disputes, insolvency related disputes, mass tort, and oppression claims. While Canada has not seen a particularly large number of derivative actions that have been permitted to proceed against directors, there are other remedies in our corporate statutes that shareholders and other stakeholders may use to involve directors in litigation, and to seek court-mandated investigations into conduct which may ultimately feed civil and criminal proceedings.

Verhille: In the past the company may have been the sole target. Today, individuals are far more frequently being named and brought to account. Corporations, individuals and the state have also become far more diligent in seeking recovery of damages and addressing wrong-doing. Whistleblowing provisions and self-reporting exacerbate this trend. Furthermore, legislation and case law has also opened new avenues to access individual liability and increased the arsenal of regulators or state attorneys to obtain disqualification, disgorgement or fines and even imprisonment.

Hanson: While overall claim rates against directors and officers in the US seem to be growing at only a modest pace, it is the rising severity of some specific types of claims, such as shareholder derivative actions, that cause alarm among insurers, risk managers ►►

and corporate management. Judicial rulings in the US that have held the line against efforts to expand the availability of class actions in more and more circumstances have kept the tide from rising too precipitously. However, the legislative initiatives of recent months, coupled with a four or five fold increase in the number of lawyers working at the SEC in recent years, almost certainly promise to increase the suit count against directors and officers substantially in the next few years.

Smith: Unfortunately, claims against D&Os are on the rise. So-called ‘stock drop’ securities class action filings increased in 2010 and the first half of 2011. Although such lawsuits collectively challenge an array of alleged misrepresentations, several discernable categories of claims have come and gone from vogue over time – for example, stock options backdating, financial crisis related claims, and ponzi scheme cases. Another claim category which has recently spiked is mergers and acquisitions, with claims that the directors followed an inadequate process or made inadequate disclosure relating to a sale or merger of their company. We have also seen increases in derivative suit filings following announcements of regulatory investigations or settlements, most notably involving FCPA violations.

Selvin: As the Dodd-Frank statute contains whistleblower bounty and anti-retaliation provisions which are designed to encourage the reporting of wrongdoing by company insiders, these provisions will likely increase potential regulatory and civil exposure for corporate directors.

Snow: What lessons can D&Os learn from recent high-profile cases and settlements?

Parry: Directors and officers should take note of not only the volume of claims, but also the ever-increasing magnitude of the settlements and other litigation costs. Last year, securities litigation involving directors and officers of Countrywide Financial settled for \$600m, and the Washington Mutual securities litigation recently settled for over \$200m. These are extreme examples, but it is not uncommon to see settlements in the tens of millions of dollars, with defence costs reaching into the millions as well. The best take-away for directors and officers is the importance of understanding the sources and potential magnitude of the liability ex-

posure, as well as the mechanisms available to mitigate that risk.

Stitt: Because of the increase in litigation and regulatory enforcement, boards need to be careful, for example, in how the minutes of their meetings are prepared to allow directors to assert available defences and provide evidence of the due diligence procedures of the board with respect to corporate disclosure. Where boards are relying on external advice, the scope and nature of that advice and any qualifications should be evident. The time spent by the board in deliberating a matter and the weight that may be given to factors should also be clear in the minutes. Documentation for consideration at board meetings should be distributed in advance of meetings to permit an opportunity to review fully and corporate records should be kept to demonstrate this practice. In Canada, there is much focus now on the process which is followed by a board to reach a reasonable and informed business decision. It need not be perfect, but evidence of process is critical.

Verhille: One of the lessons learnt from recent cases is that, despite the personalisation of litigation and the growing trend of tagging individuals as co-defendant parties, strong defence of directors to fight against the establishment of liability often pays off. Initial judgements or regulatory decisions have often been to an individual’s detriment with high amounts at stake. However, seeking appeal has served individuals well in either dismissing cases or substantially reducing an award or fine. It is therefore particularly important not to underestimate any litigation, investigation or proceeding, to address such situations immediately, to hire high calibre counsel and seek early support in the claims adjustment, and to draw on the experience of the insurance carrier.

Hanson: First, if it seems too good to be true, it almost certainly is not true. Second, insurance protections deserve to be critically and thoroughly examined by a disinterested party with great regularity. Third, an ounce of prevention is worth pounds – or hundreds of millions or even billions of dollars – of cure. Corporate cultures that encourage both insiders and outside consultants to share uncomfortably different views from those of established management have the best chance of avoiding the group think that has been at the root of the big problem cases of the last few years.

Smith: In the past few years more big securities class actions against issuers and directors and officers have gone to trial than at any time since securities litigation reform was enacted in the US in the mid-1990s. Results have been mixed for defendants, but the landmark *Vivendi* trial in 2010 – a case involving over \$9bn in claimed damages – illustrates that directors and officers can win these claims at trial. The *Vivendi* trial produced an unusual split verdict – the corporation was held liable but the directors and officers, including the former CEO, were exonerated. The average time from filing to trial in securities class actions is over five years, and defence costs alone can completely erode the insurance tower.

Selvin: On the civil litigation front, the US Supreme Court issued a key decision last year, *Merck & Co., Inc. v Reynolds*, 130 S.Ct. 1784 (2010), dealing with the accrual of the statute of limitations in securities fraud cases. In that case, the court held, among other things, that for statute of limitations purposes a plaintiff’s awareness of the facts giving rise to the alleged violation includes facts concerning scienter. This decision is favourable to securities fraud plaintiffs, because it effectively delays the accrual of the statute of limitations until facts establishing scienter are known by, or ►►

The legislative initiatives of recent months, coupled with a four or five fold increase in the number of lawyers working at the SEC in recent years, almost certainly promise to increase the suit count against directors and officers substantially in the next few years.

KEITH HANSON

within the constructive knowledge of, the plaintiff.

Sheehan: Unfortunately, I don't think that the risk of a D&O lawsuit can be eliminated for any organisation. That being said, I think a board can dramatically reduce its exposure by ensuring that it exercises effective governance, which includes being fully informed of all the facts in every decision, inculcating a culture of ethical behaviour in the firm, ensuring the firm has strong risk and compliance controls, and proper transparency. From a liability protection standpoint, directors and officers should pay close attention to the corporate indemnification afforded to them. Finally, it is important to have a properly drafted D&O contract with adequate limits of liability that are reflective of the company's exposure.

Snow: In your experience, are boards adapting the way they operate to deal with increased scrutiny from shareholders, creditors and regulators?

Stitt: Canadian public company boards are putting into place more rigorous governance processes and not merely paying lip service to whatever requirements may exist in corporate or securities legislation. In some corporations, at the direction of the board, the general counsel is taking on a greater role in the risk management exercise and in establishing processes to ensure, and to report credibly to the board, that the activities at the operational level are being conducted in a manner which will not attract liability. Perhaps the greatest area of change is in corporate disclosure practice which is much more tightly controlled than a decade ago, with more careful regard to what is stated in forecasts, for example, and the timing of announcements of material information.

Verhille: The situation is mixed. Greater governance and transparency, and a more diligent attitude, especially toward compliance has emerged in many instances. What is certain is that any current or retired director that has been faced with shareholder activism, governmental investigation, criminal proceedings, or any litigation involving them personally have taken away very valuable lessons from such circumstances and usually implemented effective change in their organisation to address such scrutiny in the future. No one can truly be prepared for the brutality, costs, and trauma that such situations impose on individuals.

Hanson: Clearly, corporate boards are responding to the changing legal, economic and social environment in a profound way. In the US, the reforms required by the Sarbanes-Oxley Act were much criticised by commentators, lawyers and corporate managers as unnecessary, expensive and ineffective. The record of the last several years shows something much different, as the number of accounting restatements has plunged since SOX forced deeper digging into economic reality within corporations. The use of more independent directors, outside lead directors, more careful selection of board members, and a greater emphasis on director professionalism have all changed the way the typical board does business today.

Smith: Directors are working harder since the financial crisis, and they are also working smarter. Many responsibilities that were previously addressed on a more episodic basis – for example, having annual sessions dedicated to risk management, strategic planning and succession planning – are now addressed on a continuous basis, receiving attention at every meeting and even between meetings. Boards have also realised that their own development

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should be addressed on a continuous basis, especially as corporate strategy and risks may change quickly. Board leaders regularly consider the qualifications and skills that will promote the work of the board, and they have integrated the processes of director recruiting, orientation, training and evaluation to improve board performance.

Sheehan: I think that boards have reacted in numerous ways to the increased scrutiny. Two areas in particular stand out. The first is in the area of risk management. Boards have become much more involved in overseeing the financial, operational, and strategic risk management of a company. While risk oversight is something the whole board is focused on, firms approach the execution of risk oversight differently. Some boards create dedicated risk committees, some rely on their audit or governance committees, and others keep the responsibility of oversight at the board level. The second area of change that I have noticed is the increased focus on executive compensation issues.

Parry: Many boards are taking steps to improve their decision-making processes and minimise the risks of serious challenges down the road. One way they do that is by identifying early on any directors and officers who even arguably have conflicts of interest and taking steps to insulate the ultimate decision from challenge on that basis. Sophisticated boards are also heeding the dangers of emails and other informal communications, which can often come back to haunt parties in litigation, by taking much greater care with what is, and is not, committed to writing.

Snow: What changes have you seen in the D&O liability insurance market over the last 12-18 months? Has there been a meaningful shift in pricing and documentation?

Verhille: The D&O insurance market currently remains a buyer's market. As further capital flows into the market for the eighth consecutive year, the disconnect between exposure and pricing widens. Buyers may use such market dynamics to push carriers to deliver competitive terms. They also need to consider the ability to secure sustainability, the ability to capture exposure changes in a constantly evolving environment, and the ability for their carrier to deliver in practice when their directors – whatever the nature or size of the company – face governmental investigations or claims.

Hanson: D&O insurers have continued to broaden their policies, offer more and more gimmick coverages, and give in to the not

always sensible demands of the brokerage community. Policies which at their core should protect the assets of directors and senior management from loss continue to evolve into corporate all risk liability protections. In so doing, the policies increase the likelihood that in a serious claim situation an honest director may well find that much, or even all of the protections she or he relied on, have been gobbled up either by dishonest executives or by the defence and settlement needs of the corporation itself. While some strides have been made to offset this trend through the use of what have become known as 'A Side Only' forms, the reality remains that the broader the corporate coverage is made, the less senior managers are protected at the end of the day.

Smith: The market remains soft and, on average, D&O premiums for non-financial institution policyholders have decreased approximately 15 percent each year in 2009, 2010, and to date in 2011. Even financial institutions that saw increases in premiums after the 2008 credit crisis and litigation filings have started to see premiums hold flat or decrease slightly. Overall, the soft market has enabled policyholders to buy additional limits or drop their retentions in order for insurers to maintain last year's pricing. In sum, it has been a buyer's market for the past two years and even the insurable losses from the catastrophic losses in Japan, the US tornadoes, and the US floods have not been deep enough to drive an increase in premiums in the D&O and other management lines of coverage.

Selvin: Another key area is that of allocation, which relates to the allocation of loss, including attorneys' fees incurred in defence, between covered and non-covered claims and parties. This problem often arises where a lawsuit that is asserted against corporate officers and directors includes claims that are both covered and not covered under a particular policy. Although the attorney may be duty-bound to defend his or her client in connection with all of the asserted claims, the D&O carrier may attempt to allocate the reimbursement of expenses on some proportional basis as between covered and uncovered claims. In the absence of a policy provision on this subject, the weight of authority in this area has been that a D&O carrier is responsible for funding all defence costs where there is no reasonable means of prorating the costs of defence between covered and non-covered claims. Under this principle, D&O carriers have been found to be obligated to pay all legal expenses as they were incurred, subject to apportionment and reimbursement for defence of uncovered claims.

Sheehan: The US D&O liability market continues to exhibit the characteristics of a competitive market. Generally speaking, rates continue to decline in all areas with the more significant reductions coming for those insureds whose risk profile has shown marked improvement or who pursue an aggressive marketing strategy on all layers of their program. In many cases, excess insurers are trying to capture some of the higher rates at the lower levels to offset falling gross written premiums in their overall book of business; therefore, many are looking to move to lower attachment points in layered programs. In addition, insurers have flexibility to negotiate favourable terms and conditions, particularly if they can use the enhanced coverage as a means to moderate any premium reduction.

Parry: One significant development in the wording of D&O policies has been the recent availability from at least one carrier of a policy that expands the coverage available for costs incurred in responding to government investigations. Historically, D&O policies have provided coverage only for costs associated with formal investigations that target an individual insured. That can leave very

expensive coverage gaps, as the costs of responding to even an informal request for information from a government agency can quickly become very significant. Now there is coverage available that includes costs incurred by individuals before they are identified as targets of a formal investigation, as well as coverage for investigation costs incurred by the company in its own right.

Stitt: D&O liability insurance products have evolved substantially over the past five years and even in the last two years there have been a number of significant changes. Corporations are now purchasing Side A and Side A DIC products to provide enhanced personal asset protections for directors and, in particular, independent directors. Coverage for statutory liabilities in Canada is pretty much the norm. Earlier triggers of coverage for informal investigations are being sought regularly in new programs to provide additional protections for individuals. In negotiating cover, policyholders are looking for the removal of exclusions such as insured versus insured, pollution and ERISA, or for policies that will pay defence costs on a full limits or generous sub-limited basis where claims are made that might trigger these exclusions.

Snow: When seeking a D&O insurance policy, what coverage and wording issues do D&Os need to consider?

Hanson: D&O policies are highly technical contracts. There are no generally accepted standardised contracts as there are in the areas of property insurance or personal lines policies. As such, policy language must be very carefully reviewed, not just at renewal but whenever a corporation or its senior management encounter significantly changed circumstances. The precise definition of an individual insured, for example, could have a devastating impact on the availability of coverage for whistleblower claims in the next year. The precise trigger of coverage for SEC investigations in D&O forms could lead to very different results for two companies facing seemingly identical claims.

Smith: Because base D&O policy limits for the directors are 'shared' with the company, and therefore could be completely eroded by securities litigation claims against the company, D&Os should consider the purchase of 'Side A only' excess D&O coverage; that is, coverage that insures only the D&Os for non-indemnifiable claims. In addition, given the continuing rise in regulatory investigations and their attendant cost, many companies are considering buying a new product introduced to the market last year – a separate policy providing specific and broad coverage for costs associated with regulatory investigations. This separate coverage can ameliorate the limit erosion that can occur when D&Os face parallel regulatory investigations and shareholder litigation, an increasingly common occurrence.

Selvin: Attention must be paid to the definition of 'claim'. In this regard, prospective board members ought to make sure that this definition is sufficiently broad to include not just civil lawsuits, but also administrative and regulatory proceedings, such as SEC investigations, FINRA proceedings and the service of subpoenas by government agencies or law enforcement. For example, traditional D&O policies typically exclude coverage for SEC investigations until and unless such investigations have become formal in nature. Prospective board members ought to insist on getting insurance protection, including the advancement of attorneys' fees, which kicks in once any governmental investigation or regulatory proceeding is commenced or subpoenas are served by government agencies or law enforcement.

Sheehan: There are numerous issues to focus on but some of the more important considerations are: the severability of the application and exclusions; the final adjudication language in the ‘personal conduct’ exclusions; and the broad definition of claim to include investigation costs and pre-claim inquiry costs. D&Os also need to consider the limited insured versus insured exclusion, including a bankruptcy trustee carveback; definition of loss to include Section 11, 12 and 15 damages; an order of payments provision specifying that individuals are paid first; the A-side difference in conditions policy; and the limited prior notice and pending or prior litigation exclusions.

Parry: Insureds should be mindful of the fact that these are not standard-issue policies. The wording of key definitions and exclusions can and does vary from one policy form to the next, often resulting in material differences in the scope of coverage. The definitions of what is a covered ‘claim’, who is an ‘insured’, and what constitutes covered ‘loss’ are obviously critical. Because slight differences in policy wording can make all the difference, companies should carefully consider the likely sources of claims, and should consult with their advisers on the front end to avoid unpleasant surprises later.

Stitt: Because of the unique statutory and common law exposures for Canadian public companies, careful consideration must be given to the structure of the insurance program and the extent to which both the corporation and the individuals will be insured under it. Frequently, programs are being devised which have Side A/B/C – securities entity claim coverage – at the primary level and initial excess layers, to provide coverage for the substantial defence costs and damages that may be incurred by a public company, its directors and officers in defending securities class actions, with higher layers dedicated to the protection of individual directors, particularly in the event of a catastrophic claim or insolvency. To ensure that individuals are appropriately protected, it is critical to examine the severability provisions of the policy, both of the application and of the exclusions, and to ensure that its Side A coverage is non-rescindable.

Verhille: Directors should consider the core of the cover, which is the protection of their individual assets and ability to serve as directors, and the funding of their defence from investigation to prosecution. They need to ensure that their coverage is clear, ‘road-tested’ by prior claims, and the product of constant empirical improvement through claims experience and proactive endorsement of legal change that affects their exposure. Above all, directors must consider the fundamentals of the carrier behind a policy. These should be a resourced in-house claims team, a wealth of experience, and a commitment to this type of risk underpinned by the necessary underwriting integrity. For directors whose operations are multinational, the existence of a global footprint is paramount.

Snow: Are you seeing more companies develop risk management strategies specifically designed to protect their D&Os? What steps are they taking?

Smith: As companies have become increasingly concerned about the heightened risk of personal liability for D&Os from the continuing expansion of regulation and litigation targeting individual D&Os, they have focused on the primary risk management strategy of making sure they have the broadest D&O coverage available that addresses the specific risks of their industry. Addi-

tionally, many boards are engaging separate legal counsel for the board to ensure the board receives advice from sources other than management and the corporation’s counsel.

Parry: In today’s litigious environment, the scope and extent of D&O insurance protection is something that current and potential directors and officers care a great deal about. As a result, to attract and retain the best of the best to these key roles, companies are focusing on obtaining insurance coverage that provides optimal protection to their directors and officers. For example, many companies now obtain ‘Side A Only’ or ‘Difference in Conditions’ excess coverage, which provides individual insureds with an additional safety net in the event that the company’s primary D&O coverage is exhausted or simply does not provide broad enough protection for a particular claim.

Stitt: Both public and private companies in this jurisdiction are increasingly adopting written indemnity agreements to protect their directors and officers, and using them, in conjunction with comprehensive D&O insurance programs, to protect these individuals. The types of risks to be covered under these mechanisms have been extended greatly to encompass not only traditional damages and legal costs but also taxes, penalties and fines, and mandatory advancement of defence costs or legal and professional fees for civil, criminal and administrative investigations, and regulatory proceedings, arbitrations or alternative dispute resolution processes in which the individual may become involved by reason of being a director or officer.

Verhille: Companies are increasingly taking a view to proactively protect and inform all the directors and officers of their organisations as they view directors’ liability to be a truly global phenomenon, no longer limited to the larger economies of the northern hemisphere. They recognise that the nature of exposures vary between jurisdictions. They are also cultivating the exchange of knowledge across borders and divisions while recognising that certain matters such as corruption and price-fixing could potentially touch everyone in their organisation and must be addressed consistently.

Hanson: Large corporations have been keen to protect their directors and officers from predation by plaintiffs’ lawyers for decades. The shift that is underway today has to do with the level of sophistication and desire for robust protections among smaller, growing, and previously less sophisticated companies. Certainly there is a logical trend to consider peer group analyses when determining levels of coverage that are sensible in today’s economic environment. Given the growing expertise of the plaintiffs bar in bringing suits against directors and officers, there is also a much greater emphasis on A Side Only policy forms with substantial limits and difference in conditions enhancements.

Sheehan: The greater focus is on creating risk management strategies to better protect the company and, ultimately, the company’s shareholders. One of the primary areas of focus is the increase in financial, operational and strategic risk management of a company. In addition, companies are consistently reviewing the effectiveness of and updating their compliance programs in an effort to better manage risk and compliance. With respect to strategies to protect the directors and officers, many firms have done a review of the indemnification provisions in their by-laws to ensure they are as broad as possible and in some cases, put into place individual indemnification agreements for directors. ■



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