



The D&O Insurer and the Directors' Counsel

To protect your personal assets, get to know the ins and outs of your insurance policy.

Editor's Note: This is the second in a series of conversations between top executives as they discuss business scenarios that impact the boardroom.

We recently sat in on a conversation between Lawrence Fine, a senior vice president of Financial Lines Claims at Chartis, and Timothy W. Burns, a partner in the legal firm of Perkins Coie. The two shared their views on what is shaping current trends in director and officer liability insurance—the so-called “sleep protection”—for today’s public company board directors.

Timothy W. Burns: As you know, I spend a good deal of my time counseling boards of directors and officers on insurance issues. If their company is sol-

vent, and their insurance is strong, directors have historically faced very little risk of personal liability. What keeps me up late at night these days, however, is 1937. Here’s what I mean: Eight years after the 1929 stock market crash, the economy went into a tailspin again. And, I’m concerned that perhaps we haven’t seen the end of 2008.

Lawrence Fine: I guess you’re saying that inevitably, big disasters will have their aftershocks.

Burns: Right. And if it happens again, good insurance becomes of critical importance in protecting the personal assets of directors.

Fine: Directors and officers have been exposed for decades, but earlier in the millennium when the WorldCom and Enron scandals made front pages,

JOHN HOLDER

plaintiffs seemed to really step up their game in volume and severity. Those actions brought a new level of awareness to the potential exposure to directors and officers. Our litigious society is becoming a danger for everyone.

Burns: With the credit markets tightening in 2007, and then the economy melting down in 2008 and early 2009, it really forced directors and officers to consider how they may be targeted personally. The good news, though, is that except for certain market segments, the D&O market has—at least to date—remained somewhat reasonably priced.

Fine: But there are a number of plaintiffs' lawyers pushing the envelope with legal theories and increasing settlement demands. That's partly inspired and supported by a lot of anti-corporate sentiment right now. As a result, plaintiffs, who have always threatened that they would try these cases, have actually been doing that lately, with, unfortunately, mostly positive results from their perspective. It seems that juries are not looking favorably on corporate defendants. So, Tim, let's take a moment to talk about these new developments and what directors need to be aware of and prepare for.

Burns: A big issue is that institutional investors definitely seem to be competing among themselves to see who gets the biggest settlement. They're encouraging their lawyers to do the same thing and the bounties that some of these institutional investors are purportedly offering their counsel are designed to confiscate money directly from the personal assets of individual defendants.

Fine: Yes, that poses a difficult and interesting situation. We are now seeing instances in which a particularly competitive institutional plaintiff will seek the money directly from the individual and try to prevent the company or the insurer from reimbursing it. That poses a very difficult circumstance for a board director. This approach can be taken even in the face of a settlement involving the corporate defendant. We've had success in diffusing these situations, because a high percentage of the time, the plaintiff counsel is blustering for effect. The job here is to have them convinced by a practical insurer, through

an experienced claims analyst, particularly one who is known to the plaintiff counsel, that they should just let it go and move on. From the plaintiff's perspective, money is money, so how can they turn down the settlement the insurer is offering to pay? Because we say that there just won't be any settlement if plaintiff counsel insists on going down the other route, seeking the money from the individual, which, while dramatic from the plaintiff's point of view, may well be complicated and uncertain to yield results.

Burns: I am concerned that in these changing times, plaintiffs' lawyers are going to be under increasing pressure from the institutional investors to get more and more. Historically, the dynamics of these cases have favored settlement, but there is a lot of uncertainty out there in this post-crisis environment.

Fine: One reason the plaintiffs are taking more cases to trial is that they are competing for the institutional-investor business. Also, the plaintiff bar has been fragmented and unconsolidated after several of the old-guard plaintiff lawyers were the subject of government investigations, and several of them were sent to prison. The plaintiff lawyers that remain are aggressive litigators, and are much less committed to settling cases, and more interested in making a name for themselves through trying cases. It's harder to get a reasonable dialogue going in a case.

Burns: Insurers, directors, officers and companies all face a wide array of enemies. It's not just the plaintiff securities bar anymore. There are derivative lawsuits. There are government investigations galore. The environment is getting continuously more costly and more difficult.

Fine: The competitive nature of litigation means there's more incentive than ever for institutions to opt out of class actions and seek higher percentage returns. That's one of the things that the plaintiffs' lawyers are pitching to them, and that's just another major complication for any given company in resolving all of the issues they face on numerous battle fronts.

Burns: The government appears to be getting more aggressive as well, and I guess that's to be

Timothy W. Burns



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Burns' Insights

- Lawyers' bounties on the rise
- Plaintiffs' attorneys filing cases "under the wire" or just before two-year statute of limitations is up
- Rise in defense costs necessitates more coverage
- Be aware of who has access to the policy
- Settlements are much larger

expected after the recent financial turmoil. But this certainly has directors and officers that I talk to worried about their liability.

Fine: Yes. Sometimes dealing with the government can be a longer, more difficult process than dealing with civil plaintiffs, because it is not, at the end of the day, necessarily a predictable decision maker, in that its decisions may not be governed by practical, quantifiable measurements such as dollars. Mary Schapiro (chairman of the Securities and Exchange Commission) has made many public statements about increasing enforcement and cooperating with other government entities. Recently, the SEC has been utilizing Section 304 of Sarbanes-Oxley, the clawback section, to recover bonuses from individuals who they are not even alleging personally committed any fraud, which is pushing the envelope of what it would seem that SOX 304 was designed for. That's after several years of the SEC not pursuing clawback claims, and receiving some criticism for that.

Burns: Congress is looking to legislatively expand liability exposures for directors and officers, isn't it?

Fine: The tone in Congress is, in many ways, anti-big business, with several bills currently being pushed which could drastically increase exposures to directors and officers. One such bill would lower pleading standards for all civil litigation and turn back the clock a few decades, so that plaintiffs can get by a motion to dismiss in virtually every case, it would seem. The other bill would undo the Supreme Court decision in the *Stoneridge* case, and affirmatively create a civil action for aiding and abetting of securities fraud. It's always been the case that the government can pursue aiding and abetting claims, and the SEC is probably prepared to do that now.

Burns: Some carriers have opined that this aiding and abetting liability, if it comes to pass, might not be covered under D&O insurance policies. I don't really see the logic in that view. It appears to me that aiding and abetting would fall within the definition of wrongful acts in a D&O insurance policy.

Fine: We would agree, but it depends on the exact phrasing of allegations. Basically, Chartis' policies are generally supposed to cover directors and officers for things that they're alleged to have done in that capacity, and we're not sure how or why a carrier would argue otherwise.

Burns: We also are seeing the potential that more and more companies may not be there to back up their directors and officers when things start to go wrong on all fronts.

Fine: When a company has bad news that leads to litigation, one of the worst-case scenarios is that the company may have to file for bankruptcy, whether it's a re-organization or liquidation, as in the case of Lehman Brothers. Your concerns seem warranted, in that bankruptcy filings have been way up recently, and they've been leading to increased litigation against directors and officers.

Burns: The good news is that the trend over the past few years has been for companies to increasingly purchase Side A coverage that protects directors and officers in the event the company becomes insolvent. It appears to me that a lot more of these Side A policies are going to be triggered than in the past.

Fine: Side A policies generally are starting to see more action, from derivative suits as well as bankruptcies. For example, in the *Broadcom* case, \$40 million of the settlement was paid by Side A carriers. Probably, some carriers who have been writing Side A coverage have enjoyed years of low activity, and felt it might be relatively low risk. But hopefully, those carriers are prepared to start paying more on Side A policies.

Burns: It certainly appears from those numbers that some of the Side A insurance policies are likely to come into play. What I'm interested in, and I'm sure others are as well, is your view of the recent statistics on securities class-action filings. Securities-fraud class actions were down last year. What do you make of this?

Fine: It's really a moving target. The numbers for 2009 on the Stanford Securities Clearinghouse website keep increasing as additional suits are added to the list belatedly. The count is now up to 178, nine higher than the 169 suits which were discussed in Cornerstone's 2009 year-end report and press release. Various other commentators such as Advisen and NERA post consistently higher numbers. So there's definitely more to the story than just one headline.

Burns: Another recent trend that offers some concern is the rash of under-the-wire lawsuits. And, by that I mean lawsuits filed just before the statute of limitations expires. There are an increased number

of cases in which the defendants are sued almost two years after the disclosures on which they are being sued were made. It used to be that your stock would decline, and you'd be sued within the first few days of the decline.

Fine: Directors and officers ought to know that when the stock goes down, they are likely to be sued. The statute of limitations was increased by Sarbanes-Oxley from one year to two years and it gives the plaintiffs freedom to plan when they're going to get the cases filed, and how they're going to manage their inventory.

Burns: There do appear to be a lot of game-changing developments out there. The one thing that provides me some comfort is that in the past, directors and officers who have had strong and adequate D&O insurance have not had to pay personal assets. Even with these recent developments, hopefully that trend will continue.

Fine: Good lawyers are expensive these days. Discovery can be a black hole if it's not managed well and efficiently. The cases are just very expensive, and individual insureds should be concerned about who is spending the limits and how fast the money is going.

Burns: That does pose a concern. You could have a case in which a rogue former officer effectively monopolizes the spending on the D&O policies. And, you're absolutely right that defense costs seem to be getting more expensive. Boards and directors need to pay attention to who is going to have access to these policies. Given the multiple individuals with access, and sometimes the company itself, it's important to seriously evaluate how much insurance the board needs.

Fine: People often ask how much is enough insurance. What type of advice do you give?

Burns: Frankly, I'd say that you want to look at what's been enough in the past, and increase it considerably. Defense costs are rising, potential liability that's covered under these policies is rising, and at the same time, you're looking at increasing D&O insurance limits. You should be careful in deciding from whom to purchase D&O insurance.

Fine: There are other more specialized policies for outside directors that probably bear looking at. But we think that directors are best off to make job one focusing on getting the best possible foundation

for their insurance program with the best primary policy. Not every gap can be filled by the primary policy, however, because of potential bankruptcy issues and whether the debtor has rights in a traditional ABC D&O policy.

Burns: The economics of the purchase of D&O insurance makes Side A, B and C policies a fact for most companies. The company and the board want to protect the directors, officers and the company from liability from securities claims and other liabilities that are covered under these policies. Because of this fact, it is important to make sure that you're purchasing the best ABC Side coverage that you can get.

Fine: Have you been seeing carriers in excess positions being asked to pay more money, and has that been going smoothly or not?

Burns: There are a lot of cases in which the settlements are in the multimillion-dollar range. Excess insurance policies are coming more and more into play. That is an unusual development for most excess D&O insurance companies. Many of them are not in the habit of paying claims day to day, in my experience, and you have to do a lot more work to collect from some excess D&O insurers. You may have to file litigation at times with respect to some excess D&O insurers who just were not expecting to have the number of claims and the size of settlements that we're seeing now.

Fine: We're seeing that when we go to mediations, which increasingly have a lot of different layers of carriers, one never knows at which level there's going to be a hard stop or what the reasons given will be.

Burns: That's a dangerous situation. These cases, in order to be resolved successfully, require that all the parties obligated to participate actually participate in resolving the case.

Fine: The purpose of insurance is to reduce uncertainty and provide reliable protection. You have to be an educated consumer and achieve as much certainty as you can, so saving some money on a premium, but being less sure that the claims will be paid, means that you've really got nothing. So in these times, despite occasional overly reassuring remarks from a pundit, anything can happen, and I think that it's the job of directors and officers insurance to be a reassuring backstop against that world of uncertainty. **D**

Lawrence Fine



Lawrence Fine is a senior vice president and the chief technical officer for Financial Lines at Chartis. Fine manages the claims group that handles all fiduciary liability (ERISA) claims, in addition to some complex D&O and Employment Practices Liability Insurance claims. He is also involved in new policy creation.

Fine's Insights

- Greater number of bankruptcies
- Rising tide of litigation, including more derivative litigation
- Government is more aggressive in its pursuit of cases
- More cases being litigated rather than mediated