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PEAS IN A POD: ARE EXPOSURES AND INSURANCE NEEDS OF DIRECTORS AND OFFICERS THE SAME?

Because directors generally oversee the performance of senior officers, the directors have far less involvement in company performance, disclosures and problems than officers. As a result, directors typically have far less liability exposure than officers and in some situations, are actually in conflict with the officers. However, too often the financial protection for directors and officers is identical and does not reflect these significant differences and conflicts. As liability concerns for directors continue to increase, more directors are now realizing that their interests are not always properly addressed unless directors retain separate advisors who are independent from and not beholden to the company's management. One of the more important areas where directors especially need this independent perspective is the evaluation of the company's D&O insurance program.

Conversely, officers usually are the principal beneficiary of a D&O insurance program since the frequency and severity of claims against officers far surpass that of directors. It is therefore understandable that D&O insurance policies are structured with the primary goal of reasonably responding to officer exposures. In other words, officers should not blindly follow the desires of directors in making D&O insurance decisions since officers want protections that may not be consistent with the interests of directors.

The following discussion summarizes recent events which indicate the future liability exposure of directors and officers will likely be increasing, which will further aggregate the disparate interests of directors and officers. Specific examples of these differing and sometimes conflicting interests in claims and insurance matters are also identified to highlight the importance of addressing the legitimate concerns of each group through proactive but independent planning.

A. PERSONAL LIABILITY EXPOSURES INCREASING

In many situations when a company encounters problems due to alleged wrongdoing, the company addresses the problem through expensive internal investigations, remedial actions, settlements with regulators and special public relations activities. All of those costs are uninsured losses borne by the company. However, there now seems to be a growing sentiment that individual directors and officers who are responsible for the problems rather than the company should pay a greater portion of these costs. Since payment of these costs by the company effectively constitutes a payment by the shareholders, some have argued that the shareholders who are the victims of the wrongdoing are being further victimized by indirectly paying for the consequential costs of the wrongdoing.

This argument is particularly compelling with respect to company payments to resolve shareholder litigation. A company settlement payment in a shareholder lawsuit merely constitutes a redistribution of money among shareholders and therefore arguably is an inappropriate method of resolving claims for alleged wrongdoing by management. This argument obtained considerably more credibility in September 2009, when U.S. District Court Judge Rakoff rejected a proposed $33 million settlement by Bank of America in a securities lawsuit brought by the SEC. In that lawsuit, the SEC alleged that Bank of America lied to its shareholders in the proxy statement that solicited shareholder approval of the $50 billion acquisition of Merrill Lynch & Co. ("Merrill") by Bank of America. According to the SEC, Bank of America misrepresented to its shareholders that Merrill had agreed not to pay year-end performance bonuses or other incentive compensation awards to its executives prior to the closing of the merger, when in fact Bank of America had agreed that Merrill could pay up to $5.8 billion in bonuses to Merrill executives. According to Judge Rakoff, the proposed settlement would require the victims of the alleged fraud (i.e., the Bank of America shareholders) to pay an additional penalty for the misconduct of management. The Judge stated that such a result is both unfair and unreasonable since the financial burden of the wrongdoing is imposed upon the victims rather than the individuals who were allegedly responsible for the wrongdoing. According to the Judge, such a result would further victimize the victims. Therefore, the proposed settlement was not approved, and the SEC was encouraged to pursue claims against the responsible officers and directors of Bank of America.

Partly in response to Judge Rakoff's highly publicized opinion, a thoughtful commentary in the September 28, 2009 *BusinessWeek* magazine questioned whether securities class action lawsuit settlements which are directly or indirectly funded by the company make sense from several perspectives. First, like the Bank of America proposed settlement, a settlement payment by the company in a securities class action does not result in the wrongdoer compensating the victims of the securities fraud, but instead causes a wealth transfer among equally innocent third parties (i.e., from one shareholder group to another shareholder group). Second, shareholders who purchase stock at an inflated price during the class period are harmed, whereby shareholders who sell their stock at the inflated price during the class period realize a windfall. Because most investors are diversified in the market, on average their losses are offset by their windfalls. Third, a company settlement payment does not deter future wrongdoing since the executives who made the misrepresentations incur no personal loss.

This public debate, when combined with Judge Rakoff's logical opinion, will likely put mounting pressure on plaintiffs to negotiate settlements which involve greater payments by or on behalf of the defendant directors and officers rather than the company. Even absent this backlash against the company funding a securities settlement, some recent settlements in shareholder litigation demonstrate that the personal liability exposure of directors and officers for non-indemnified settlement amounts can be significant and may be growing. Examples of recent large settlements by directors and officers which were not indemnified by the company and which in some instances were not paid by insurers include the following:

- $61.55 million settlements by outside directors of Peregrine Systems in a securities lawsuit arising out of the company's restatement of $509 million of revenue and criminal guilty pleas by the company's CEO and CFO. The D&O insurers denied coverage for those settlements based upon the guilty pleas by the company's executives, and the company did not indemnify the defendant directors because it filed bankruptcy.

- $118 million settlement by directors and officers of Broadcom Corp. in a shareholder derivative lawsuit arising out of stock option backdating practices. The settlement did not include claims against two senior officers. The settlement, which was not indemnifiable by the company under state law, was one of the largest shareholder derivative lawsuits in history.

- A $115 million settlement by former officers of AIG in a shareholder derivative lawsuit alleging the defendants authorized improper payments to and transactions with a company owned by the defendant officers. The settlement, like the Broadcom settlement, was not indemnifiable by the company under state law and constituted one of the largest shareholder derivative lawsuits in history.

Although it is tempting to distinguish each of these recent large settlements based upon the unique facts in each case, it is undeniable that the number and size of these and other non-indemnified settlements are increasing, which suggests that the personal asset exposure of directors and officers is now entering a new era. These non-indemnified exposures will likely be further aggravated in the near future as the number of bankruptcy and insolvency claims against directors and officers inevitably increase in the aftermath of the Great Recession.

B. <u>DIFFERENT LIABILITY EXPOSURES</u>

Historically, most have viewed the liability exposure of directors and officers as generally the same. In reality, though, there frequently are significant differences in both the frequency and severity of claims against outside directors and officers. Because officers directly control the operation of and disclosures by the company, officers have far greater opportunity for committing wrongdoing and are typically the target of criticism when problems arise. As a result, officers are far more likely to be named as defendants in litigation and typically have far greater liability exposure than outside directors. In fact, most securities class action lawsuits, which represent by far the greatest D&O exposure, do not even name outside directors as defendants.

When claims are made against outside directors, plaintiffs typically allege that the directors failed to adopt or enforce effective controls or other procedures which would have prevented the company's problems or the officers' wrongdoing. As recognized by the Delaware courts, this type of claim against directors for lack of oversight "is possibly the most difficult theory in corporate law upon which a plaintiff might hope to win a judgment" since the "imposition of liability [on this theory] requires a showing that the directors knew that they

were not discharging their fiduciary duties." See, *In re Caremark Intern. Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996); *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). According to these Delaware decisions, plaintiffs must establish that the directors committed a sustained or systemic failure of oversight by showing that the board knew that internal controls were inadequate, that the inadequacy could leave room for illegal or material harmful behavior, and that the board chose to do nothing about the control deficiencies that it knew existed. Obviously, this is a far higher burden for plaintiffs in claims against directors than is applicable in claims against officers.

There are, though, a few situations where director liability exposure is greater than officer liability exposure. For example, D&O litigation involving mergers and acquisitions invariably focuses on the conduct of directors rather than officers since the directors make the decisions about approving or rejecting M&A transactions. In addition, claims for alleged violations of Section 11 of the Securities Act of 1933 are more frequently brought against directors. In fact, such a claim (which alleges misrepresentations in the SEC Registration Statement filed by a company in connection with a public offering of securities) statutorily may be brought only against officers who signed the Registration Statement (i.e., typically the CEO and CFO) whereas all of the directors of the company at the time the Registration Statement is filed may be sued in such a claim.

To reflect the different degree of liability exposure for directors and for officers when both groups are named as co-defendants in a lawsuit, it is common practice for each group to be represented by separate defense counsel. This is often necessary because, for example, directors frequently raise as a defense their reliance upon information and advice provided to them by the officers, who have far greater knowledge of the company's operations, financial condition and prospects than the directors.

In summary, the liability exposures of, and appropriate loss prevention practices for, outside directors and officers is much different and need to be separately evaluated and addressed. In today's volatile world, more outside directors are now understanding these differences and understandably are insisting upon using advisors who are independent of management to guide the outside directors with respect to the directors' unique and sometimes conflicting interests.

C. DIFFERENT D&O INSURANCE INTERESTS

Not only are liability exposures of outside directors and officers different and to some extent conflicting, but their respective interests with respect to their D&O insurance program are likewise different and in some respects conflicting. The following summarizes examples of various policy features which arguably should be structured differently from the standpoint of the outside directors on the one hand and officers on the other.

1. Conduct Exclusions. Outside directors have much different interests than officers with respect to the scope and applicability of the fraud and illegal personal profit exclusions within the D&O policy. As a practical matter, only officers have a

realistic liability exposure for claims alleging deliberate fraud or receipt of illegal personal profit. Outside directors almost never directly participate in the deliberate fraud or criminal conduct, but instead are sued for failing to prevent, detect or respond to the officers' egregious wrongdoing. As a result, officers want the conduct exclusions in the policy to be extremely narrow, thereby minimizing the risk that these exclusions will apply to them. For example, officers prefer that the exclusions apply only if a final adjudication in the underlying claim establishes that the officer actually committed deliberate fraud or the other types of egregious wrongdoing described within the exclusions. Since D&O claims almost always settle, such an adjudication in the underlying claim will almost never occur, and thus such an exclusion would almost never apply to an officer.

On the other hand, outside directors are not concerned about these exclusions applying to them, but rather are concerned about "black hat" officers eroding the insurance proceeds to the detriment of the outside directors. As a result, outside directors should prefer a broader trigger for these conduct exclusions so that a "black hat" officer loses his coverage before substantially eroding the available insurance for other more innocent Insureds. For example, outside directors should prefer the exclusions be triggered if an adjudication in <u>any</u> proceeding (not just the underlying claim) or if a written admission under oath or a guilty plea by the officer, establishes that the officer actually committed the deliberate fraud or other egregious conduct described within the exclusions.

2. <u>Non-Rescindable Coverage</u>. Many D&O policies today contain a provision which prohibits the insurer from rescinding coverage for non-indemnified losses, even if the Application for the policy contains material misrepresentations. Like the conduct exclusions, outside directors and officers may have a conflicting perspective on this provision. Particularly if the conduct exclusions apply to an officer only if a final adjudication in the underlying claim establishes the officer actually committed the egregious wrongdoing, a provision preventing the insurer from rescinding coverage for a "black hat" officer will likely result in the "black hat" officer having full coverage under the policy for all defense costs and settlements incurred by that officer, thereby significantly eroding the available insurance protection for the outside directors. Again, officers want this non-rescindable provision to apply to them, but outside directors may want the provision to apply only to outside directors to prevent inappropriate dilution of the policies' limits of liability by "black hat" officers.

3. <u>Entity Coverage</u>. D&O insurance policies typically include coverage not only for claims against directors and officers, but also for Securities Claims against the company. That entity coverage for Securities Claims frequently does not include coverage for SEC investigations of the company. When negotiating the D&O policy, many companies request that entity coverage for SEC investigations be

added to the policy. Since the defense costs in those investigations can be extremely large, such coverage (if available) certainly benefits the company, but potentially dilutes the available insurance limits for the outside directors. Again, officers (who are responsible for the company's financial performance) typically want this additional entity coverage, but outside directors may not want that additional entity coverage added to the policy since it could significantly erode the available insurance limits for the directors.

4. Exclusion Carve-Outs. Some insurers are now willing to add by endorsement to the D&O policy a carve-out to various exclusions (such as the bodily injury/property damage and the conduct exclusions) pursuant to which the exclusions do not apply to claims against outside directors. Obviously, these carve-outs are beneficial to outside directors, but are frequently not requested by the company since the officers who negotiate the policy's terms may not be sufficiently focused on the unique interests of the outside directors.

5. Claims Control. Some D&O policies now delegate to the outside directors control over certain coverage issues which may arise in a claim. For example, the CODA Side A policy states that a majority of disinterested directors of the parent company may elect to waive the applicability of the conduct exclusions with respect to officers, depending upon the circumstances. In addition, the priority of payment provision contained within most primary D&O policies can be amended to permit the outside directors to decide whether the insurer should delay payment of covered company losses until after all covered D&O losses are paid by the insurer. Officers who negotiate the policy's terms may be uncomfortable granting such discretion to the outside directors.

6. Separate Limits. Companies can now include within their D&O insurance program some Side A limits which are dedicated exclusively for outside directors. This separate limit can be provided through an additional Side A policy which insures only outside directors (i.e., Independent Director Liability or "IDL" policy), or through a separate outside director limit of liability in a standard Side A policy which insures both directors and officers. Like other coverage enhancements which benefit only outside directors, this separate IDL limit is purchased by relatively few companies presumably because the officers who negotiate the policies are not sufficiently focused on the unique interests of the outside directors or do not view the benefit of this coverage enhancement as worthwhile. If a separate IDL limit is purchased for outside directors, a separate limit only for officers can also be purchased so that the total limits available to outside directors and to officers is the same.

These and other examples of conflicting interests between officers and outside directors with respect to the terms and scope of the D&O insurance program highlight the need for an independent analysis of D&O insurance issues for the benefit of outside directors and for

officers. Because officers typically control the insurance procurement process, this means outside directors should utilize the assistance of independent advisors to evaluate and identify available enhancements which especially benefit the outside directors. Absent such an independent critique, outside directors may not have the maximum financial protection available. In other words, the quality of D&O insurance protection today is largely dependent upon the Insureds knowing what to ask for, and outside directors should not assume officers will request all of the coverage features which uniquely benefit the outside directors.

D. IMPORTANT QUESTIONS FOR OUTSIDE DIRECTORS

The following Q&A discussion summarizes various important questions which outside directors should understand and independently evaluate in light of the issues described above. Most of these questions are equally applicable to officers, who can now purchase Officer Only and Retired Officer insurance policies which compliment the Independent Director Liability and Retired Director policies described below.

1. Has the Board independently confirmed that the company's D&O insurance program affords maximum protection for the directors?

   ANSWER: A high-quality insurance program for directors should contain a number of features which benefit only independent directors, not officers. For example, some exclusions should not apply to outside directors, and additional limits of liability can be purchased only for outside directors. In addition, outside directors may have views in conflict with officers regarding the breadth of exclusions applicable to officers or the amount of Side A insurance to purchase. Because officers typically negotiate and approve the company's D&O insurance program, the unique interests of the outside directors may not be considered unless the directors retain their own qualified advisor to evaluate the quality of the directors' insurance protection.

2. If a lawsuit is filed against both you and senior officers of the company, who has first priority to the D&O insurance program?

   ANSWER: Outside directors and officers are both Insured Persons under the standard D&O Policy, so both have the same right to the Policy. If the insured losses exceed the Policy's limit of liability, the Insurer will probably pay losses in the same order the losses are incurred.

3. If officers of the company incur large litigation losses, will there be enough insurance for your litigation losses?

ANSWER: Officers can incur large litigation losses separate from the outside directors' litigation losses. For example, officers frequently retain separate defense counsel than the outside directors, typically have much higher liability exposure than the outside directors, may be sued in separate proceedings from the outside directors and may settle before the outside directors' claims are resolved. In other words, the officers can deplete most or all of the insurance limits, leaving the outside directors with little or no insurance for the litigation against them.

4. Do you want greater confidence there will be enough insurance for your litigation losses?

ANSWER: A company can now purchase insurance only for its outside directors. This independent director liability (IDL) coverage, which is very broad and is excess of the company's standard D&O insurance program, typically protects all outside directors as a group.

5. If you are sued after you retire from the Board, will the company indemnify you?

ANSWER: Several circumstances may arise which could jeopardize your indemnification from the company after you retire. First, the company's financial condition could significantly weaken after your retirement. Because you may be sued several years after you retire and because it may take several years to resolve that lawsuit, your indemnification protection may be dependent on the company's financial condition 5-8 years after you retire. Second, between now and then the company's Board and management may change and become antagonistic toward you, in which case they may not approve your indemnification. Third, the company may be legally prohibited from indemnifying some of your losses, such as settlements in shareholder derivative suits.

6. If you are sued after you retire from the Board, will the company's D&O insurance program cover you?

ANSWER: D&O insurance policies typically insure former as well as current directors and officers. But, the policies only cover claims first made during the policy (i.e., a lawsuit filed against you 3 years from now will be covered under the policy which then exists, not the policy which existed when you committed the alleged wrongful acts). As a result, the quality and amount of your insurance protection for lawsuit filed after you retire will be

dependent on the company's financial ability and desire in future years to maintain the same level of insurance protection, as well as the availability and cost of that protection in the future insurance market.

7. Do you want greater confidence there will be enough high-quality insurance for you after you retire?

ANSWER: A company can now purchase a long-term insurance policy for only retired outside directors which locks in high quality coverage for claims made up to 6 years after the policy is purchased. This retired director policy, which is excess of the company's standard D&O insurance program, can be purchased for all retired directors as a group or for each retired director.

8. Will at least your Side A insurers properly handle any non-indemnified claim against you, and will those insurers be financially able to pay your losses?

ANSWER: Claims handling practices under Side A policies are quite different than under standard D&O policies. Since Side A coverage can be critically important, you should confirm your Side A insurers have a proven history with and commitment to Side A coverage. Also, like many other types of financial institutions, some D&O insurers are in questionable financial condition. You should confirm that especially your Side A insurers are exceptionally strong financially since they may be your only source of protection for non-indemnified claims.

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