CORPORATE
BOARD MEMBER®

2007 SPECIAL SUPPLEMENT

Boardroom Liabilities

Protecting Directors in a Sea of Risk

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Managing Boardroom Liabilities

Keeping You and Your Company Afloat

Although the number of U.S. directors and officers liability claims has declined, the severity among settlements has increased. Thus, most experts agree the seas of litigation are still churning, and it's no time for directors to relax.

In fact, this is an excellent time for corporate boards to analyze the depth and breadth of their D&O insurance coverage. While accepting a board seat has always carried a certain amount of risk, the level of recent recoveries sought by plaintiffs in the post-Enron environment has raised the stakes even higher. This year's $41.5 million *Just for Feet* settlement that reached into directors' pockets may be an extreme case, yet for many governance gurus, corporate attorneys, and insurance underwriters, it raises a red flag about the growing state of boardroom liability.

The good news is today's market is still relatively soft and affords many options for directors. They may want to add layers to an existing Side A program, purchase an independent directors liability (IDL) policy, or examine their terms and limits. Insurance underwriters or brokers, along with the board's legal counsel, can provide guidance to make sure directors undergo a thorough evaluation of these elements. After all, the most important insurance is sleep insurance–knowing that your personal and corporate assets are covered in the event of a crisis.

To help spark discussions in your boardroom on these important matters, *Corporate Board Member* brought together two expert panels in this year's Boardroom Liabilities supplement to illuminate the necessity for managing boardroom risk and properly evaluating D&O insurance coverage. We are pleased to continue our association this year with Bingham McCutchen LLP and to welcome the addition of Anderson Kill & Olick P.C., each of which partnered with *Corporate Board Member* to outline the issues and act as roundtable moderators.

We hope this timely publication helps your board evaluate its risks and take informed steps to ensure both personal and corporate assets are protected through any rough seas ahead.

Stakes Are High for Directors

To be prudent, board members should take a proactive stance and evaluate their D&O policy to ascertain whether it should be bolstered with additional coverage or limits.

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William G. Passannante: What is happening in the D&O insurance marketplace, and how should directors and officers react?

Heather Fox: I think most people would agree that the current D&O insurance marketplace is fairly stable. Although there has been some price softening and relaxing of coverage terms, it's not what one would call an extremely soft market. As is always the case, it would serve directors well to get a good understanding of the coverage available to them and to evaluate, with the assistance of their risk manager, broker, and lawyers, whether they have a program that is adequately meeting their company's needs. Additionally, with the price softening on traditional D&O coverage, now is a great time to evaluate either buying Side A coverage (nonindemnifiable, loss-only protection) for the first time or adding layers to the Side A program that is already being purchased.

Mark S. Lamendola: I agree. I'd call it a relatively stable environment from a capacity standpoint, although there are some new entrants in the marketplace. Prices, however, are softening and, as Heather said, some coverage terms are getting broader. From a claims perspective, the frequency of securities class actions in 2006 was down from 2005; however, so far in 2007, the trend has leveled off compared to the number of actions filed in 2006. Severity continues to concern us. This year alone there have been nearly 30 reported settlements totaling more than $50 million. This is a bit alarming and will put pressure on underwriting margins and add a degree of volatility to future results.

When the Private Securities Litigation Reform Act (PSLRA) was enacted in 1995, we anticipated a decrease in claims frequency and securities class-action filings, but also acknowledged that the claims that survived would have real severity potential. We didn't really see that decrease in claims frequency until the past two years, and although severity has steadily increased since then, it has escalated significantly over the past two years, probably more than we might have originally thought.

As far as advice on how directors should react, I think risk managers and directors should be vigilant and thoughtful in the selection of their D&O carriers. Cycles come and cycles go and frankly, so do some carriers. It's important to realize that not all carriers have the same financial stability, commitment to the marketplace, claims-paying ability, and more importantly–reputation. I would encourage directors to factor these qualities into their D&O buying decision. Your broker can certainly help you prioritize and rank the quality of the carrier you will be partnering with.

Passannante: Is there any movement back to multiyear programs, or are programs still primarily single year?

Fox: For public company D&O purchasers, the policies are virtually all single year. In the late 1990s, multiyear policies were prevalent and the D&O insurance marketplace learned a valuable lesson. When you bind up a policy for several years and the liability landscape changes over the course of those years, the insurance carrier doesn't have the opportunity to reflect the changes in the landscape in the terms and conditions of the policies covering the exposure. This also negatively impacts the client because when multiyear policies are up for renewal, after several years of being bound up at extremely favorable terms in relation to the risk, carriers must react with drastic changes to the program in terms of the coverage and premium. More than likely, the premium increases sought were not forecasted in the client's insurance purchase budget.

Lamendola: I agree 100%. It would be hard to support multiyear deals for all the reasons Heather stated. This market changes so quickly, it's hard enough trying to make decisions once every 12 months, let alone once every 36. I am pretty sure the reinsurance marketplace also would not be supportive of multiyear deals, at least not for publicly traded D&O accounts. As an industry we are not fast learners, but with respect to this issue, I think we learned our lesson, unfortunately, the hard way.

Passannante: David, what is your general reaction to what is happening in the D&O insurance marketplace and how directors should react?

David A. Bell: I would first like to discuss the forces that are softening the market. One is the availability of capacity that exceeds what is currently demanded in the marketplace, which, like anything that trades, is based on the supply and demand relationship. Another is the perception that the decreasing number of securities class-action suits has driven a more competitive environment. These are the forces that really fuel the current state of the D&O marketplace.

As far as how directors should react, it is my view that despite the apparent buyers' market, the reaction of directors should not be significantly different. Frankly, the requisite due diligence of a prudent director remains essentially the same, regardless of the state of the D&O marketplace. However, I would suggest a few specific points for directors to consider. First, review the corporate bylaws to determine the extent of indemnification provided by the corporation. Second, confirm the ratings and financial viability of your insurance carriers. Third, seek to maintain relationships with your insurance carriers, because, obviously, certain complexities may arise when you switch from one carrier to another. Fourth, review the policy terms and conditions before the coverage is bound. Such a review is more important now than ever before due to the significant changes in terms and conditions that are being offered in the current marketplace. Fifth, determine the sufficiency of overall program limits. Sixth, ensure that the D&O program includes sufficient limits that provide Side A coverage. And finally, consider purchasing independent director liability (or IDL) coverage, particularly since we are in a softening market and insureds generally are enjoying some reductions in the overall premiums associated with their D&O towers.

Carl Pursiano: To build on some of the earlier comments, I'll start with David's assertion that, like many products, D&O is governed by the laws of supply and demand. Right now there's something like $1.8 billion in global D&O capacity theoretically available to any one account. That figure continues to grow as new competitors enter the market. So we're seeing rates falling 10% to 20% on average for smaller-cap publicly traded firms and about 5% to 15% for larger publicly traded firms, as well as some financial services accounts. The reason rates are coming down is due to a few factors. One is a decrease in the number of U.S. securities class actions in 2006 and what is, among some carriers, perhaps an overly optimistic perception that the trend will continue for the foreseeable future. Second, there's a strong desire among some carriers to maintain market share. Some of these carriers are publicly traded, so they have a strong motivation to do so. Third, there's a general perception that the D&O insurance underwriting business has been profitable over the long term, which seems to be attracting some of that new capacity. But let's look at the rate situation more objectively. The decrease in the number of securities class actions in 2006 will likely prove to be a temporary phenomenon, whether you attribute it to the indictment of Milberg Weiss, the impact of Sarbanes-Oxley, or a four-year equities bull market. It's a pretty safe bet that the number of securities class actions will revert to at least the mean at some point in the future. Further, D&O carriers that chase market share often don't do very well under soft-market conditions, and quite a few have failed trying. Finally, it's a bit shortsighted to assume that profits in any insurance product line will continue in

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> ALLIED WORLD ASSURANCE CO.

the long term based on recent results, particularly for U.S. D&O insurance, which has experienced some difficult accident years. Board members need to understand that D&O insurance is an inherently volatile product. Prices for the coverage will fluctuate, and, as Mark mentioned, D&O carriers will come and go.

Passannante: Forrest, what is your perspective as a buyer of D&O liability insurance?

Forrest Shoaf: Well, I am the only consumer participating in this discussion, and we just recently finished our renewal process. So I'm glad to hear that the market seems to be softening. But I've noticed carriers now seem to be concentrating more on our basic business. Following the Enron and WorldCom debacles, carriers were, appropriately, very concerned about corporate governance practices, and they're still concerned. But the tenor of the questioning this time focused more on our basic business, which I think is something carriers should be focused on, and I was glad to see it.

As for what directors should be doing, this is no time to relax. While there are fewer strike suits and claims and settlements against companies, the stakes have gone up dramatically. Echoing the previous comments, I would say, first, make sure your corporate governance practices are best practices. Second, boards certainly need to review their limits every year and get expert advice. Many directors vaguely know what D&O insurance is and they certainly want it to be there, but they need to rely on a good broker if they're not experts themselves or if their risk manager is not. And, finally, they should get to know their carrier. There are more carriers entering the market because, obviously, it's a lucrative arena once again. But we've found that the people we've dealt with before and those that we have known for some time are more likely to be around if things get tough again.

Pursiano: It's important for board members to work closely with their risk managers and brokers. Members of the board should be active participants in choosing a D&O carrier, or a set of D&O carriers, that have demonstrated a long-term commitment to the product line. The D&O market is inherently volatile and the coverage is long tail, meaning that claims, particularly securities claims, can take years to settle. So it's important to select carriers and underwriters with a demonstrated ability to succeed under both hard market and soft market conditions, because, quite simply, the board needs to be sure that its D&O carriers will be there when it comes time to pay the claims.

Lamendola: If they really want to take it to the next level, directors may also want to consider the carrier's underwriting strategy–what industries does it want to play in and what is its philosophy of underwriting primary or excess coverage? Risk characteristics change daily, as does the marketplace you operate in, and if your company experiences a change in one of those risk characteristics that impacts how the primary or excess carrier views your company, the carrier could completely alter its approach to your risk at renewal.

Here are some questions to underwriters that risk managers and directors may want to consider:

• What is your primary and excess philosophy? Do you insure other companies of similar size operating in the same industry?

• Are there specific risk characteristics that you rely on more so than others? What are they and how do you evaluate them?

• Do you rely on a pricing and risk selection model or is your process more subjective?

The answers to these questions will provide insight as to the carrier's commitment to the marketplace with regard to your insurance program.

Passannante: In the *Enron* and *WorldCom* cases, we are familiar with the dynamics that caused assertions of individual payments against directors and officers, as well as the more recent account in the *Just For Feet* case. Should directors be concerned about these events, and is there a solution to this problem?

Fox: In large part, these cases are fairly recent. When people mention *Enron* and *WorldCom*, many think, "Those are really unique situations and not something I have to be concerned about," yet there are still valuable lessons to be learned from those cases. It's important for directors to understand the extent of corporate indemnity available to them from the organization. That means reviewing the bylaws and any indemnity agreements with the company, which is a distinct analysis from what is available to

them from an insurance perspective. Those are two distinct avenues of redress for a director if he or she is sued.

As far as whether we should be concerned, yes, it's something to think about. Perhaps you have some concern about the amount or type of insurance being purchased or the carriers being utilized because your organization's cash flow is not as strong as you'd like it to be, or because you're new to a board. There are solutions available. There's a director liability insurance product available that directors can purchase independently or can have their company pay for. If there is a claim against an individual director, the organization's insurance pays first, as well as the indemnity of the company, and then this policy comes in as the last avenue of redress before a director would have to pay from his or her personal assets. It serves as a last line of defense and most important, it is not diluted by anyone else's liability. In some of the larger cases mentioned, one of the reasons the personal settlements were extracted was due to the fact that insurance proceeds in those cases were quickly exhausted as a result of defending the so-called black hats. It is purely theoretical at this point, because we have not seen it happen, but in a meltdown scenario, one would think directors would be in a much better position to preserve their own personal assets when attempting a settlement if they have an insurance product that only funds their own liability. In conclusion, while these cases have been fairly unusual, there is a product available that is relatively inexpensive to eliminate, or at least mitigate, the exposure.

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> **HEATHER FOX**
> AIG

Bell: I would instill a slightly greater sense of urgency on this subject. Regardless of how unlikely such a payment might be, outside directors should not only be concerned about such an issue, they should directly address it by obtaining the type of coverage to protect their personal assets, as Heather has outlined. These directors are typically high-net-worth individuals and by virtue of sitting on the board of a publicly traded company, the significant assets they have accumulated over a lifetime are at stake. All it takes is a single class-action lawsuit combined with some other event, such as a corporate bankruptcy or insufficient D&O limits, as demonstrated in the *Just For Feet* case, and the result can be financial catastrophe for a director. The Just For Feet directors contributed more than $40 million out of their own pockets to settle the lawsuit.

Passannante: There's one further issue of concern arising out of the *Enron* and *WorldCom* situations. There was a punitive component intended to make the directors pay out of their own pockets rather than simply permit them to draw on their insurance for the loss. Does the IDL product address that angle of the problem?

Lamendola: In any scenario you have to look at the individual policy language, but I would generally say no. If the intent of the kind of scenario that you outlined is to avoid the collection of insurance proceeds, frankly, I think it's going to be very difficult to circumvent that intent.

Pursiano: The *WorldCom* situation may prove to be an anomaly in that the insurance proceeds were not permitted to be part of the personal contribution portion of the settlement. But it's important to realize that although the number of instances where directors have actually had to make a personal payment is low, it's necessary to remain vigilant and to understand the potential for personal loss. D&O insurance is meant to eliminate some uncertainty in that regard. Looking ahead, securities claims frequency rates and settlements may very well increase. The average settlement in 2006 was $100 million. Now that was an unusual year, no doubt brought on by massive market-cap losses during the bear market of 2000–2002. It's probably a safe bet that, at least in the near term, settlements will likely be smaller. But look at it this way. This current four-year equities bull market is bound to end, as all bull markets do. But if the stock market marches even higher before that occurs, or volatility increases, not only can directors and officers expect an increase

in the securities claims frequency rate, but there is also a reasonable expectation that settlement values may begin to rise again, perhaps including the necessity of personal contribution. Directors who serve on boards have worked very hard to accumulate their personal assets and those assets are worth protecting. So the advice you're hearing from this group is to purchase as much Side A Difference in Conditions (Side A DIC), independent director limits, and standard D&O limits as is reasonably affordable, from quality carriers. There are quite a few threats out there in a very uncertain environment.

Shoaf: First, let me address the prior question of whether directors should be concerned about digging into their own pockets to settle a claim. I think so. If they're not concerned, they're not paying attention. The chances of that happening may be remote, as one panelist has already pointed out, but if it happens to you, it's a catastrophe, particularly as we just saw in the $41.5 million *Just For Feet* settlement. Having said that it is a concern, I would say that directors should take a great deal of comfort, however, from the resolution of the Walt Disney derivative litigation in which shareholders alleged that the directors had breached their fiduciary duties in awarding excessive compensation and severance payments to a former executive. In August 2005, Delaware Chancellor Chandler, although critical of the corporate governance practices of Disney's board, nonetheless ruled that directors had acted in good faith and on an informed basis and were therefore entitled to the protection of the business judgment rule. His decision was later affirmed by the Delaware Supreme Court. And although we have some pretty severe examples in *Enron*, *WorldCom*, and *Just For Feet*, I think directors, while they should be wary and should get as much insurance as they can, should also remember that the business judgment rule is still there and that it is still their best defense against ever having to reach into their own pockets.

Passannante: Under what circumstances should a director opt for an IDL policy, or is a well-constructed Side A policy just as good?

Fox: The circumstances in which we see people purchasing IDLs include when a director joins a new board and may not be entirely comfortable that he or she understands everything that is happening in the organization. Remember, this is an extra layer of protection just for that director, and that protection can't be diluted by other people. Another circumstance we've already discussed involves the situation where you have a high-net-worth individual who desires an extra layer of protection. The Side A policy coverage should be virtually identical to the IDL policy coverage, other than who is insured under each contract. The broadest Side A coverage available is what is referred to as Side A difference in conditions coverage (or Side A DIC). It is an extremely broad layer of nonindemnifiable loss protection that has fewer exclusions than you typically find in a standard D&O contract, and it responds even when a company fails to indemnify an individual despite its obligation to do so. The coverage found in the IDL and the typical Side A DIC is comparable, so the determining factor is whether a person desires a segregated limit. If you do, then you're going to purchase the IDL. If you're looking for protection for the entire board, then you will be looking to purchase a Side A DIC policy.

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> **MARK S. LAMENDOLA**
> ST. PAUL TRAVELERS

Lamendola: I'd like to make some additional points. In today's environment, outside directors are being held to a higher standard than ever before. The SEC is particularly focusing on independent outside directors' involvement and actions. The options backdating issue is a good example and highlights how the independent director's role has evolved from strategist to guardian–even auditor–or governance champion. That changing dynamic puts the independent directors squarely in the middle of potential litigation and sometimes at odds with senior management and inside directors. Therefore, when you have meltdowns such as WorldCom, Enron, and Just For Feet, you have the black hat/white hat scenario, and more often than not, it's the independent directors who are the white hats. So this dichotomy really gets to the heart of policy division and the protection of individual interests. There are a lot of reasons why someone would buy an IDL, as Heather stated, but over the long run, I think it will become a standard purchase in some

form or another. Of course the idea is to provide the independent directors a level of protection and comfort they may not currently have.

Bell: I have always found it very puzzling that the take-up rate for IDL policies has not been higher. In fact, I have asked buyers, both brokers and risk managers alike, to explain the rationale behind the sales process. What I have learned is very interesting and it is essentially the same story across the board. Generally for the person controlling the purchase, which is the risk manager, treasurer, or CFO, and sometimes the general counsel, you are talking about a product that, frankly, does not cover those individuals. Thus, the brokers have told me that the sales process of agreeing to spend money on an IDL product is very difficult because you are advocating the purchase of something that specifically and intentionally excludes coverage for the decision maker. In my opinion, IDL coverage, no matter how effectively it is marketed, will not get any more prevalent in the marketplace until outside board members fully understand the unique coverage it provides and start requiring it as a condition for board service.

Pursiano: It's important to point out that an independent director liability policy provides insurance protection for an outside director who, for example, may have been unaware of the improper activities of his or her fellow board members or corporate officers. So it basically offers the same features and benefits as a Side A DIC policy, but it's tailor-made for the outside director who understands that litigation defense costs can quickly erode underlying D&O policy limits, leaving less insurance money available for a settlement and increasing the possibility of a personal contribution. It's also useful for outside directors, particularly those with significant assets, who serve on a large board and who want an IDL policy to sit atop a Side A DIC policy as an extra layer of personal asset protection.

Shoaf: Speaking again as the consumer in the group–and with some trepidation, because this is a technical issue and I may be outside my expertise–there is something to be said for a properly constructed Side A policy because it puts all the directors in the same boat. Having said that, if I understand the common denominator in *Enron*, *WorldCom*, and *Just For Feet*, those companies all became insolvent, thus there was no indemnification for wrongful acts alleged before the bankruptcy petition. So D&O protection was the only source of coverage those directors had and the WorldCom board was barred even from using that. Once that was depleted, their personal contribution followed. So from what I understand about IDL, it would probably be best suited for directors at companies where there's a genuine risk of financial insolvency. If the director faces a turnaround situation or if the company is highly leveraged or the industry is in a downturn, I think IDL would be something a director should consider. But in all other cases, I have to speak up for the conventional Side A arrangement in which everyone is in the same boat, so to speak.

Passannante: What are the questions and concerns that directors and officers should bring to the table when the issue of D&O insurance policy language is on the board's agenda?

Fox: I think the severability of the application is probably still the biggest topic board members should familiarize themselves with because, in general terms, it defines who will be protected under the contract. When a serious claim arises, the severability of the application clause will determine whose knowledge is imputed to whom for purposes of availability of insurance proceeds. In some of the more egregious D&O cases, often there will be the black hat directors who had scienter, or prior knowledge, of the facts triggering the claims. Without a good severability clause, the D&O policy could be rescinded and even innocent directors could lose their insurance protection. With solid severability of the application, the knowledge of those black hat directors will not be imputed to other board members. Instead, everyone's knowledge will be judged independently so that those who did not have scienter will still get protection under the insurance contract.

> "It's important for board members to work closely with their risk managers and brokers."
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> **CARL PURSIANO,** LIBERTY INTERNATIONAL UNDERWRITERS

Something else that has come to the forefront recently is the issue of global protection. To the

extent that a company has multinational operations, board members should consider how broadly the U.S.-based D&O insurance policy can respond to exposure in foreign jurisdictions. There are requirements in some foreign jurisdictions that a local insurance policy must be placed in order to pay a loss in that jurisdiction. This is an issue that every multinational company should consider. We've mentioned a lot about the Side A DIC product, but it bears repeating. All board members should know how much A Side is being purchased and how broad the product is.

Finally, I would add that no language discussion is complete unless you also evaluate the carriers that are backing up the language. Certainly language is important, and you should spend a lot of time understanding what your policy covers, but equally important is the carrier that will be backing up that language–its claims-paying ability and history and its experience in the marketplace. You can't underestimate–during a serious claim–the importance of choosing a carrier with a great amount of experience dealing with your type of claim.

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> CBRL GROUP INC.

Pursiano: Generally, D&O coverage terms are broadening in this soft market, though no single carrier will likely offer its full suite of policy enhancements on any one risk. But it is still possible to purchase some strong coverage protections at a fairly reasonable cost. A key part of the buying decision is how much D&O limit to buy, and the board should consider purchasing as much limit as possible from quality carriers while taking advantage of today's lower D&O insurance prices. The relative merits of purchasing a standard D&O policy, Side A DIC policy, and independent director liability policy, or some combination thereof, should be thoroughly discussed.

On the severability front, I agree with Heather. It remains an absolutely key provision of a strong D&O policy to the extent that it protects innocent directors and officers who may be unaware of the improper activities of their fellow directors or officers. The board should want to avoid a policy rescission situation like that seen in *Cutter & Buck* and preserve coverage for these white hats, which is a protection critical to attracting and retaining quality board members. Also, nonrescindable Side A coverage is now commonly available, and there is also a movement to provide affirmative coverage for Section 11 and other claims for IPOs and secondary offerings.

Bell: Another issue that directors should be concerned about is the follow-form nature of their excess policies. Rarely will companies have one carrier function as the sole provider of their D&O insurance. Oftentimes there are two to four, or up to 15 or more, carriers in a tower. The single, largest source of coverage defense, which affects the extent of coverage provided, involves differences in the excess policy language as you move up the tower. For example, you have coverage from your primary carrier, and that is generally where the most comprehensive review of coverage language takes place. However, I believe some people may have a false sense of comfort after reviewing the terms and conditions contained in their primary policy and may assume that the same coverage language applies to their entire D&O insurance tower. In reality, you find the coverage is chipped away little by little as you move up the tower through each excess carrier, and by the time you reach the highest excess policy, the language is substantially different. So the best recommendation I could give directors is to make certain that they and someone on their behalf are ensuring that the follow-form policies truly follow the form of the primary policy, and that they understand which specific provisions contained within those excess policies are not follow-form. This will allow them to evaluate the impact of non-follow-form wording on certain coverage scenarios.

Shoaf: To reinforce some points already made by Heather and Carl, the first and most essential questions we pose are what is the financial stability of our carriers, how long have we known them, and, most important, what is their claims-paying history? And then the two provisions in the policy itself that we pay most attention to are nonrescindability and application severability.

Striking a Balance

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Jordan D. Hershman: Stock options backdating practices have been widespread and have garnered much attention in the recent past. In fact, the *Wall Street Journal*'s Options Scorecard indicates that as of June 1, 2007, more than 140 companies have come under scrutiny for past stock option grant practices. What are the takeaways for directors arising from these stock options backdating scandals?

Robert H. Hotz: From my perspective, there is a need to be very focused on process, whether you serve on the compensation committee or any other committee. I would guess that for many directors this situation came as a complete surprise, and I think it serves as a reminder that in today's environment, outside directors must be very diligent.

Paul T. Dacier: The compensation committee should have a very robust review process in relation to annual stock option grants as well as out-of-cycle grants–those made to high-potential individuals or awarded because of extenuating circumstances. The CEO and other senior management should also assure the committee that the process is clean, not subject to manipulation, and that the date listed is the real date. From a general investment perspective, you never hit the absolute high and you never hit the absolute low. You just have to go with the date that the grant is made, and if you've made money or lost money, that's life. But it has to be bulletproof. If there is any variance in the process, it has to be approved by the compensation committee chairman. Frankly, there must be zero tolerance of any manipulation of the process, and people should be fired if there is evidence of manipulation.

John Rafferty: Although it's early, there is a sense that [protection by the] business judgment rule must be earned, at least coming out of the Delaware Chancery Court. If there is evidence of deliberate violations of a shareholder-approved stock option plan, or what appears to be intent to mislead shareholders, the court may very well find such conduct to be an act of bad faith and some of the business judgment rule protections directors need and want might be absent. Along the same lines, fraudulent concealment by defendants might also allow a tolling of the statute of limitations, which is a hurdle plaintiffs normally have. Thus far, companies taking some of these derivative actions that have headed down a path toward resolution are also finding the protection provided by the business judgment rule is fact specific to the actions of each individual director and/or officer and needs to be earned.

Dacier: [Applications of] the business judgment rule and any standard of conduct for a director are subject to the particular facts of each case. Without speaking specifically to any one matter pending in Delaware–barring personal knowledge by a committee member or director about options backdating for which disclosure and appropriate accounting treatment was not made–I believe committee members or directors who have exercised reasonable diligence in their work, such as on compensation committees where plans and grants are reviewed and grants are voted upon, either in person or in writing, won't be found personally liable if the process has been manipulated below them.

Joe O'Donnell: When it comes to this issue, directors are secondary defendants. It's the officers who have the greatest exposure to worry about. From an underwriting standpoint, one of my concerns, and I think it's one directors share, is that if the appropriate controls, processes, and procedures are not in place relative to stock option grants, what other potential weaknesses could they be exposed to? Stock options backdating is the first systemic Side A issue to arise in the insurance circles. But what is the next potential systemic problem to which directors could be susceptible, and are they doing everything possible to make sure their organization won't be a part of it?

Hershman: I'd like to ask a related question that picks up on that last point. The Justice Department has

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pursued criminal action in several options cases, and a number of criminal investigations remain ongoing, such as the Brocade Communications Systems case. Are the risks associated with serving on corporate boards increasing, and, if so, what can boards do to lessen those risks?

Keith M. Thomas: Directors oftentimes get caught up in the asymmetrical flow of information. Because of time constraints, or perhaps the lack of a budget at the board level, they rely too heavily on their independent advisers. Or, in the case of the backdating issue, they may have relied too much on management's hired compensation analysts as opposed to their own. That's also true in an M&A context where they need to be able to step back and have their own resources validate whether or not it's appropriate to move forward on a deal, rather than to rely too heavily on management's view of the issues. So directors need to be able to do their homework–and that's a challenge given the time constraints and all the issues surrounding Sarbanes-Oxley.

Hotz: We've been on a course toward greater risks and potential liabilities for directors since the beginning of this decade. There are two ways directors can deal with increased responsibility and increased liability. One is to spend more time on being directors. And the other, as Keith said, is that directors must rely more heavily on outside advisers to do work that they reasonably cannot do on their own.

Dacier: I would say the risks have always been there for directors. The only difference is that over the past few years, the question has come up as to whether or not directors should be put on the bull's-eye for those seeking recovery. For example, there is a statute under Massachusetts law that details standards of conduct for directors and committee members. If that's being followed, then the chance of liability goes out the window. Under the statute I'm referring to, a director or committee member has the express right to rely on representations and statements of management and to seek the advice of those and others as they deem appropriate. I know it's in vogue for directors and committee members to seek outside counsel and outside independent expert advice, and in some instances that's warranted, but for states like Massachusetts with this type of statute, the board and committee members can rely on management's statements.

Hershman: Boards and management work together very closely on most issues, but there are some instances where directors may need to insulate themselves from management. One such issue is executive compensation, which continues to attract shareholder and media attention. What steps can boards take to minimize the risks presented in the context of making executive compensation decisions?

Hotz: Compensation committees can rely on outside advisers and consultants to help determine relevant ranges of compensation for similar-size companies, establish objectives to meet compensation goals, and create a framework around which decisions can be made as to the appropriate compensation level for the CEO as well as other senior members of management.

> "While the board should be aware, the CEO and general counsel are the ones tasked with minimizing the company's potential exposure."
>
> **PAUL T. DACIER**
> EMC CORP.

Thomas: Companies obviously have to be cognizant of the optics around the executive compensation plan. If they hit targets with the dollar amounts, then that will be how it is played in the press. But perhaps more important is the interaction, because there are so many people watching, whether they are activists or the union with which your company is about to renew its contract. Understanding the interaction between accounting assumptions, movements in those assumptions, and their impact on compensation is important because the greater transparency coming out of the new disclosure rules gives people a better line of sight, and they're going to be looking for changes. Keep in mind, it's the people already handling the accounting side who drove results that led to certain levels of compensation. So, I think the

new level of interaction will facilitate an understanding of why assessments were made and assumptions were moved or not moved–and will show that they're all in agreement.

Dacier: We've always advised our compensation committee members that no matter what they do, it will be subject to review, comment, and criticism. They need to make what they believe to be the right decisions, with the right data, under the right circumstances–meaning they should take into account the company's goals and objectives, the strength of the management team as led by the CEO, the company's culture, and then add the matrix, which should always include pay for performance. If there is any notion of varying from what the compensation plan calls for due to extenuating circumstances, then that should be clearly vetted and approved in advance by the compensation committee. But I think the best thing a compensation committee can do is say to itself, "We're going to help the company and the executives with running the business, but we're not going to take a position that we can't do certain things because of public criticism."

O'Donnell: I agree. The underwriting experts we utilize very much believe in benchmarking. Companies should be doing a lot of benchmarking in compensation and in a number of other areas, as well as aligning both annual bonuses and longer-term incentives with shareholder interests. We like to see annual bonuses aligned to operational-type issues and the longer-term incentive plans aligned with indexes and things that cannot be manipulated or are more difficult to manipulate. I agree with Keith; we want to know what those metrics are, because historically those are the areas that seem to end up getting manipulated on the accounting side, which causes big problems for underwriters when those companies eventually must restate their financials.

Thomas: Compensation committees also need to be sensitive to the impact on staff–the general line employees–especially with regard to the issue of mitigating or pulling back on benefits, whether it's pensions, 401(k) matches, or post-retirement health and welfare plans, especially if they are going in one direction for general line employees and another direction for management. We've had potential claims activity resulting out of that, and it polarizes employees, so it's something to be cognizant of. It's a marketplace you have to deal with no matter what the current pricing structure is for the management levels, and it's certainly something to keep in mind as it may impact your business from a productivity standpoint.

Hershman: Do you think the SEC's Form 8-K amendment regarding executive compensation, which became effective in late 2006, has changed companies' compensation practices?

Thomas: Most of the companies I've met with have made some adjustments around the edges, particularly on the perquisite side where they're peeling back things that may not look very favorable in the press, whether it's buying a second home or having a home on each coast. We've also seen more compensation schemes built on some type of index so that if your entire space, for example oil and gas, enjoys a great runup, you don't automatically achieve a certain financial reward. There needs to be some other metric driving the reward.

Dacier: It's definitely something that is asked by our compensation committee, but it does not affect its decisions.

> "We've been on a course toward greater risks and potential liabilities for directors since the beginning of this decade."
>
> **ROBERT H. HOTZ**
> HOULIHAN LOKEY HOWARD & ZUKIN

Hershman: Another area where shareholder and management interests can potentially diverge is in the context of M&A, when members of management may be involved in the acquisition. Do you see risks to directors arising in the M&A context, and, if so, how can boards minimize those risks?

Hotz: Clearly there are substantial risks in any transaction involving management participation in the buyout process. There are a number of tried-and-true approaches, but most important there's the creation at an early date of a special committee with appropriate outside advisers, both legal and banking,

to ensure that the process is designed to maximize shareholder value and avoid conflict.

Dacier: Management involvement in a proposed buyout is one of the newest areas of the law with great risk. This is one of the few instances where the CEO does not have the authority to act without board approval. The lead director, the M&A committee, and the board should be fully cognizant of the CEO's inclinations from a strategic point of view and whether or not those include a strategic transaction for the company that leads to a change of control. If the board gives its assent for the CEO to pursue an opportunity, then a special committee should absolutely be formed, and inside directors cannot be part of that process. The law in this area will continue to develop, though I must say the so-called go-shop provisions are a clever way to deal with this issue. The law will continue to be weighed by a number of courts–I presume at some point Massachusetts and others–though for now it's in Delaware. But I can't stress enough that this is an area where the board has to make it clear to the CEO that it is not within his or her purview to act without the board's prior knowledge and consent.

> "Companies should be doing a lot of benchmarking in compensation and in a number of other areas."
>
> **JOE O'DONNELL**
> ARCH INSURANCE GROUP

Rafferty: There are three big Ds that flow out of this topic: diligence, documentation, and disclosure. As has been pointed out, there is diligence that needs to be brought to the decision-making process. For example, don't limit the scope of a transaction to financial buyers, but consider strategic buyers if you've reached the point of thinking that your company could be up for sale. The documentation component becomes very important because of the scrutiny that will come as the transaction unfolds, and certainly later if a party is unhappy with the transaction. The documentation showing that the directors engaged the appropriate outside experts and considered the right things independent of management must be thorough, because it will be a tremendous protection should someone later question their decision making. And disclosure needs to be accurate, complete, and timely. That can be a real balancing act for companies and boards so as not to be put in a position in which they have disclosed prematurely and perhaps led shareholders to take a position with their stock, only to see it fall if the transaction fails to materialize. But they also should not be delinquent to the point that whoever might have sold the shares of the company feels that with the appropriate information, they could and should have been able to hold on to the stock and reap the benefits.

Hershman: With regard to the documentation issue, what role does a fairness opinion play in that context?

O'Donnell: Obviously you want to see fairness opinions–they are important for transparency as well as to document that you're following the right process and to demonstrate that you have received an opinion from an independent third party. Having said that, D&O underwriters need to take into consideration and evaluate the potential conflicts involved.

Dacier: I agree. There's an automatic conflict when the CEO or the management team is part of a transaction or proposes a transaction. This is one of those instances where a director must be very diligent and cannot say, "Well, I didn't know." The CEO must be very candid in board meetings and, frankly, should be quizzed about the company's strategic plan and whether or not it includes a transaction that could lead to a change of control that may involve the CEO, the management team, or both. If the CEO has retained a banker, that banker as well as any other advisers are off the table with regard to who issues the fairness opinion–the board has to bring in someone else.

Hershman: It is often said that you should keep your friends close and your enemies closer. Do you think it benefits a board to look at the company through the kind of lens used by its critics, such as activist or dissident shareholders, and, if so, how?

Thomas: Most of the underwriters participating in this discussion use outside resources, particularly in the area of accounting, whether it's a firm such as CSRA or Audit Integrity, that tear apart companies' financials. Companies need to understand that

investors also buy these reports and utilize these online services, particularly hedge funds, and they make a trading strategy built around these types of matrices that can cause significant volatility in the stock and lead to issues and potential lawsuits. So, I think understanding what they're saying about your organization is important, as is understanding what they're seeing in your financials.

Dacier: Boards should be aware of what dissidents or activists have to say about their company. We are very familiar with a number of activists. They have approached us, and we try to engage with them in what we believe is constructive dialogue. We're always willing to talk with our shareholders and receive their input and weigh those factors reasonably. What we are finding, though, is that some of the activists and shareholders have their own agendas, and they want us to do certain things that we do not believe are in our company's reasonable best interest. We're willing to have a dialogue with them and we're willing to explain why we would agree to certain changes and otherwise why not, but we feel that some groups purport to listen, when in fact, they don't. So we have to balance that on a regular basis.

Rafferty: I agree. The key is balance. Boards should be neither dismissive nor paralyzed by the various kinds of scrutiny and opinions that can flow off of these dissident shareholders or activist groups. Top-quality management teams and boards of directors have vision, superior execution, and conviction in the face of adversity. And again, they try to strike the right balance between conviction and stubbornness, and between being conservative versus risk averse. I think it's important to have an open mind, to listen, and to be aware of the opinions and proposals out there. And frankly, this environment challenges boards and companies to articulate their strategy and their case for the path that they're on.

Hotz: I think companies and board members have little choice today but to listen to what their shareholders are saying. In an era where more than half of the larger company boards are not classified and therefore all board members can be replaced at one annual meeting, directors who disregard and fail to respond to shareholders run a high risk of not being around to influence the company's direction. At the end of the day, board members must make decisions that are appropriate for the company and its shareholders, but it is a very costly exercise to not hear what the dissidents are saying and, when possible, be responsive.

Hershman: I'd like to turn your attention to issues related to electronically stored information. In late 2006, changes were made to the Federal Rules of Civil Procedure regarding electronically stored information and electronic discovery. What should board members and officers know about those new rules and the risks they might present?

Rafferty: Before we get to your specific question, I want to mention a survey conducted in May by DiscoveryBox and Strategic Discovery Inc. of nearly 350 senior technology executives across the country. Over half were at companies with more than 5,000 employees, so it was a good representative sample. The results were quite interesting. Twenty-three percent of the respondents said they were not aware that the federal rules had changed; only 17% said they had a comprehensive system in place to prevent employees from deleting data that might be needed in litigation investigations, and nearly half of those who had been instructed to hold documents for litigation purposes were admitting in the survey that they were not able to collect the requested data. So with that backdrop, it would seem that the first issue of the day might be education on what has changed as well as the fact that electronically stored information is discoverable and can include archived or embedded data on documents, such as the author or revisions made to documents, that perhaps no one focuses on in terms of the trail or lineage of a document. The burden in litigation going forward will be on the producing party to establish the fact that certain requests create an undue burden or undue cost to produce data that is not readily accessible. The inability to produce that

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>
> **JOHN RAFFERTY**
> HARTFORD FINANCIAL PRODUCTS

data or the substantial cost or time it will take to produce the necessary information will throw some companies for a loop.

Dacier: That's fascinating information. We have always informed our audit committee and board, and of course senior management, about the risks, liabilities, and exposures of discovery. I would think every general counsel and every attorney would inform his or her clients about this, so it sounds like there is a lot of work to be done. We have a very robust process in litigation matters, but this is an area of the law where a lawyer must have absolute control, lead the businesspeople, and make sure all information is gathered and produced. We do it electronically. We produce a number of products in-house to help with gathering documents that may be produced in discovery.

> "Directors need to be able to do their homework—and that's a challenge given the time constraints and all the issues surrounding Sarbanes-Oxley."
>
> **KEITH M. THOMAS**
> ZURICH, NORTH AMERICA

Hershman: Picking up on Paul's point, a cautionary tale is the case of *Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co., Inc.*, where as a consequence of failures in the discovery process, ultimately the company was on the wrong end of a $1.45 billion jury verdict, which included punitive damages. There was an instruction given to the jury so that it could make an adverse inference based on the fact that certain documents were destroyed after litigation began. And that case was adjudicated before these new rules came out. So Paul's point is correct concerning the risks associated with this process. What steps should boards take to address those risks?

Dacier: This is where the board must hear from the general counsel as to what process he or she has in regard to how litigation is handled generally, but also specifically in discovery. The general counsel more than likely is also the compliance officer, and he or she should be updating the board on litigation.

Rafferty: The board has to ensure communication is effectively flowing throughout the entire organization so all parties know what is expected. For example, everyone must understand the pitfalls of e-mail and how to follow proper e-mail protocol. In particular, e-mails forwarded home can lose some of the protections that might be robust within the organization. The board must also make sure management is steering the right kind of financial resources to IT systems in case the electronic disclosure systems or document preservation systems need to be enhanced. The board obviously has to be a strong voice to make sure these issues are considered priorities.

Dacier: I would suggest something a little different. While the board should be aware, the CEO and general counsel are the ones tasked with minimizing the company's potential exposure. If the board were to go beyond awareness, it creates a whole host of other issues, such as whether the board is really managing the day-to-day business of the company, which is not really a requirement of the board of directors.

Stock Options Backdating, Spring-Loading, and Bullet-Dodging: Practical Lessons

By **JORDAN D. HERSHMAN AND T. PETER R. POUND**

Throughout 2006 and into 2007, stock options backdating, spring loading, and bullet-dodging regulatory investigations and lawsuits have garnered much attention. Upward of a hundred lawsuits, primarily shareholder derivative cases, but also numerous class actions, have been initiated and are winding their way through the courts. As of July 25, 2007, more than 140 U.S. companies have come under scrutiny by government agencies for past stock option grant practices. Furthermore, many companies have voluntarily initiated investigations into past options practices. While this era has by no means come to a close, it is an opportune moment to pause and evaluate what lessons have been learned and identify what steps directors and officers can take to best protect their companies and themselves from challenges to stock options grant processes.

But first, what are the alleged problematic stock options grant practices? In the recent decision of *Desimone v. Barrows*, in which the Delaware Court of Chancery dismissed all claims regarding the challenged options grants, Vice Chancellor Strine describes three common types of stock options manipulation that have been challenged as of late:

> Stock options "backdating" is a practice whereby a public company issues options on a particular date while falsely recording that the options were issued on an earlier date when the company's stock was trading at a lower price. The options are purportedly issued with an exercise price equal to the market price on the date of the option grant. But, in fact, because the grant dates were falsified, the options were "in the money" when granted. The practice of "spring loading" stock options involves making market-value options grants at a time when the company possesses, but has not yet released, favorable, material non-public information that will likely increase the stock price when disclosed. Conversely, "bullet-dodging" options are granted just after the company releases negative information to the market thereby allowing the recipient the benefit of a lower exercise price that reflects the price decline caused by the negative information.

Desimone v. Barrows, 924 A.2d 908, 918 (Del. Ch. 2007) (footnotes and citations omitted).

While there are questions regarding the extent to which challenges to these practices can support a viable claim or give rise to liability—depending upon the specific factual context—each of these practices may raise thorny legal issues, including, but not limited to, the following:

- Are a company's SEC filings misleading in light of its disclosures regarding options practices?
- Have problems been triggered by the company's accounting for the compensation costs of stock options?
- Have directors or officers who approved and/or received problematic options grants run afoul of their fiduciary duties?
- Have options practices violated tax rules regarding issues such as whether tax deductions were properly taken?
- Has Sarbanes-Oxley been violated, particularly the requirements concerning the reporting of options grants?
- Have options practices violated the terms of a company's stock option plan, and, if so, what are the contractual implications of such a breach?

Such issues may have a substantial impact on a company—not the least of which may be the costs associated with investigations, litigation, and settlement. For example, in the past few months there have been at least two high-profile SEC settlements: Mercury Interactive LLC agreed to pay a $28 million civil penalty while Brocade Communications Systems Inc. agreed to a $7 million fine.

Rather than focusing on the unfortunate situation in which many companies now find themselves, we'd like to offer some observations regarding what has been learned from the regulatory and internal investigations and litigation regarding options grant practices that can help directors and officers decide how best to protect their companies and themselves when proceeding with future options grants. First, it should be noted the following are general recommendations focused on avoiding liability—best practices relating to stock options grants are clearly still evolving and will continue to do so as the regulatory landscape and accounting regime change. Second, the implementation of any solution regarding options practices must be specifically tailored to a particular entity's needs—one size does not fit all.

That said, there are general parameters that should frame any stock options grant program. It goes without saying that such a program must comply with all applicable laws and regulations and be thoroughly reviewed by appropriate legal counsel. More generally, however, a grant program should

- be governed by a comprehensive written policy;
- have its implementation thoroughly documented;

- be applied consistently, in accordance with the terms of the written policy;
- provide a clear delegation of responsibilities, where appropriate; and
- include an internal system of controls to ensure accountability, including oversight by the company's compensation committee or board of directors.

In addition, those persons establishing or implementing an options grant program should consider the following suggestions:

- It is safer to grant options at meetings, rather than by unanimous written consent.
- If action must be taken by written consent, it is safest to ensure that all consents are signed on or before the grant date.
- Options should not be granted during regular blackout periods preceding the announcement of quarterly or annual financial results or during special blackout periods, unless the grant was scheduled in writing before that special blackout period was created.
- Granting discounted options, absent extraordinary circumstances, should be avoided, but when done, should be expensed in a manner consistent with relevant accounting rules.

Particular emphasis must be paid to the written policy. A comprehensive written policy is the cornerstone of an options grant program. It should be process-focused and should

- expressly state that backdating equity grants is forbidden;
- set forth, in detail, the company's practices by grant type and provide clear guidelines for each type of grant;
- provide for an appropriate grant approvals process, which ensures prompt and suitable memorialization of the grants;
- be administered by a senior executive who is specifically charged with supervising the implementation and operation of the policy (a gatekeeper, so to speak);
- provide that certain aspects of the policy are discretion-free (e.g., regarding whether options are approved, in what amounts, or to whom equity grants are made);
- address and accommodate the SEC's new Form 10-K disclosure rules;
- be reflected properly in the company's Sarbanes-Oxley documentation;
- detail processes for addressing human or other errors in the granting process;
- be amended as grant practices or types of grants change or evolve over time;
- ensure that the compensation committee or the board of directors exercises an appropriate level of oversight;
- require that the compensation committee or board of directors approve the stock options policy on an annual basis;
- provide that a report regarding options grants be made to the compensation committee or board of directors on a quarterly basis;
- stipulate that internal audit personnel test the grant processes and controls on a regular, perhaps yearly, basis; and
- be provided to all employees involved in the options-granting process, along with communication to all such employees (written documentation, training, and updates) that stresses the importance of following the procedures in the policy and any amendments to it.

Finally, the numerous investigations and lawsuits regarding options grants should serve as a reminder to directors and officers to review the terms of their D&O insurance policies. Companies should also review the terms of such policies with their legal counsel and/or insurance broker to evaluate how the claims and exclusions language might apply in the context of claims relating to options grants and to note where gaps in coverage may exist. In addition, companies should expect that carriers may require questionnaires be completed regarding options grant practices. If directors and officers consider this advice regarding an options grant program and a written policy regarding the same, they will likely be well positioned to respond to such a questionnaire. Last, directors and officers should consider whether a Side A policy should be purchased to cover nonindemnified claims.

While the era of intense scrutiny of options grant practices has yet to pass, directors and officers should reflect on what has been learned so far and evaluate their companies' options grant practices to ensure they are in accord with best practices.

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The Advancing Majority: A Sensible Answer to Disputes over D&O Defense Costs

By **WILLIAM G. PASSANNANTE, ESQ.**

You are a director of BigCorp Inc. Due to the botched acquisition of a major subsidiary, the plaintiff's class-action bar is circling like a hungry shark. The fall in BigCorp's stock price is the blood in the water. You get sued. Personally.

BigCorp refuses to indemnify you because of unresolved allegations of bad faith and self-dealing. Thank goodness you have the protection of the D&O liability insurance policy sold to you by the Really Big Insurance Group (RBIG). You ask them to pay your legal fees. They refuse to advance defense costs pending the final outcome of the matter.

D&O Insurance Companies Are Required to Advance Defense Costs

When faced with a wrongful failure to advance defense costs, a policyholder may need to seek court intervention to compel the proper advancement of fees. Summary judgment is particularly appropriate to determine an insurance company's duty to defend or advance defense costs in a D&O matter.

For example, in June the Delaware Superior Court stated unequivocally that an excess D&O insurance company following the form of a primary policy requiring the advancement of defense costs must also advance defense costs once the underlying limits are exhausted. *Sun-Times Media Group, Inc. v. Royal & SunAlliance Ins. Co. of Canada,* C.A. No. 06C-11-108 RRC, 2007 WL 1811265 (Del. Super. June 20, 2007).

In awarding the plaintiff policyholder's partial summary judgment motion on the issue of advancement of defense costs, the *Sun-Times* court dismissed each of the insurance company's coverage defenses holding that

> [T]here is no genuine issue of material fact regarding choice of law that precludes summary judgment as to defense costs. In addition, the Court has determined that, at this juncture, there has been no showing by Defendants that the personal conduct exclusions have been violated so as to preclude the advancement of defense costs. Furthermore, this Court has also determined that, at this juncture, Defendants have not made a sufficient showing that either the cooperation clause or the consent-to-settle provision have been violated, so as to preclude advancement of defense costs. Lastly, the Court has determined, on the present record, that the priority-of-payment clause does not prevent the present advancement of defense costs. Therefore, Plaintiffs' motion is GRANTED.

Sun-Times, 2007 WL 1811265, at *1.

Courts have found that an insurance company may not invoke an exclusion as the underlying litigation progresses unless every allegation of the underlying complaint falls solely and entirely within specific and unambiguous exclusions from coverage.

Moreover, an insurance company cannot escape its duty to advance and reimburse defense costs by merely contesting coverage *Fed. Ins. Co. v. Kozlowski,* 792 N.Y.S.2d 397 (App. Div. 2005.) In *Kozlowski*, the insurance company unpersuasively argued that a coverage dispute over the application of an exclusion excused the insurance company from its duty to advance defense costs. In rejecting this argument the court stated

> This court has recognized that under a directors and officers liability policy calling for the reimbursement of defense expenses as in *Gon* and *Okada* "insurers *are required to makes contemporaneous interim advances of defense expenses where coverage is disputed*, subject to recoupment in the event it is ultimately determined no coverage was afforded."

Id. at 403 (*quoting Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Ambassador Group, Inc.* 556 N.Y.S. 2d 549, 553 (App. Div. 1990) (emphasis added).

Other courts agree. In 2004, *Brown* v. *AIG, Inc., et al.* reiterated the rule that D&O liability insurance companies should be required to advance defense costs during the defense of a D&O claim. In *Brown*, the insurance companies attempted to avoid advancing defense costs by relying on an exclusion for "related acts." The *Brown* court concluded that the insurance company failed to prove the applicability of the exclusion. The court thus required advancement of defense costs.

If the insurance company arguments were legitimate, the D&O policy itself would be "rendered a nullity," and the coverage it supposedly provided would be completely illusory. *See United States v. Weissman, (S.D.N.Y. 1997).* Furthermore, a policyholder may seek a ruling on the duty of an insurance company to provide defense costs even if the total amount of liability for those defense costs is not yet ascertainable. *See General Accident Insurance Co. of America v. Allen* (1997). Directors and officers should receive the fair protection and compensation they are entitled to under the D&O policies. *See In re Adelphia Communications Corp.* (Bankr. S.D.N.Y. 2002):

> In many cases, officer or director insureds might be severely prejudiced by a refusal to grant relief from the stay to

> recover defense costs. … D&O policies are obtained for the protection of individual directors and officers…

Advancement of Defense Costs Is Consistent with the Purpose and Language of the D&O Policy

In *Adelphia*, the court considered the directors and officers' requests for advancement of defense costs from a D&O policy. The court found that

> [W]here the debtor has had a material interest in the proceeds of the D&O policy for its own economic exposure—e.g., by way of reimbursement for any indemnification payments it might make, or for "entity coverage," satisfying issuer obligations on account of securities fraud liability—courts have recognized the interest of the debtor in the policy proceeds as well as the policy itself, with the result that the proceeds are property of the estate.

Id. at 591. The Adelphia Creditors' Committee argued that defense costs constituted property of the estate because (1) the Adelphia policies reimburse the estate to the extent that the estate advances defense costs to directors and officers; and (2) the Adelphia policies contain entity coverage protecting the estate from securities claims. *Id.* The Creditors' Committee also argued that unfettered resort to the Adelphia policies would deprive a debtor trying to reorganize an asset it needs to secure independent directors who will not serve without insurance coverage. *Id.* at 592-93. The court agreed with the Creditors' Committee and held that

> [A]n important factor is whether the estate is worth more with the D&O policy than without it. Here the [Adelphia] estate is worth more with the D&O Policy than without it by reason of the entity coverage, and the [Adelphia] estate is worth more with the D&O Policy by reason of the amalgam of the entity coverage and the need for the policy itself to secure independent directors. Under the facts of these cases, then, the proceeds of the D&O Policies are, like the policies themselves, property of the estate, and requests by insureds to draw down on policy proceeds do indeed require motions for relief from the stay.

Id. at 593. In light of the court's discussion earlier in its opinion, as mentioned above, it appears that the reference to "entity coverage" may include the reimbursement coverage provided by the Adelphia policies.

The "advancing majority" of courts require that defense costs be paid as incurred in D&O matters. Make sure that you forcefully protect your right to this important insurance benefit.

Resolution

Armed with proper interpretation of provisions regarding defense costs advancement, you forcefully insist upon a current advancement of the defense costs from RBIG. RBIG hems and haws, but ultimately relents and agrees to advance all of your defense costs regarding the BigCorp share-price drop.

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Securities Claims against Directors and Officers: D&O Insurance, a Bridge over Troubled Waters

By **CAROLYN H. ROSENBERG AND SARAH R. WOLFF**

In the blockbuster movie *Jaws*, the shark seemed to bite just when everyone thought it was safe to go back in the water. Directors and officers today may well question whether the waters are safe for them. The Enron shareholder lawsuits live on, and we anticipate another significant Supreme Court opinion resulting from them next term. Meanwhile, the Securities and Exchange Commission continues to announce new options backdating investigations even as it files complaints arising from current investigations against directors and officers.

On the flip side, the Supreme Court recently issued its much-anticipated decision in the *Tellabs* case, adopting a heightened pleading burden for plaintiffs bringing securities fraud claims under the Private Securities Litigation Reform Act. Although directors and officers can take comfort from the opinion, the court declined to impose a more draconian pleading burden on future plaintiffs. Directors and officers also need to be concerned with the growing number of institutional shareholder lawsuits, shareholder class actions, and regulatory investigations filed in foreign jurisdictions against U.S. companies.

These days, companies and their directors and officers are also increasingly exposed to triple jeopardy—private securities class actions, SEC and Department of Justice investigations, and state regulatory proceedings. As the SEC and DOJ continue to pursue parallel investigations, directors and officers need to consider how corporate cooperation with the government, including waiver of attorney-client privilege, may impact them. For example, will having a deferred prosecution agreement with the DOJ make it more likely that a company's directors and officers will be pursued?

Finally, companies continue to restate their financials. The SEC inevitably investigates these cases, often with significant implications for directors and officers. In May, the SEC pulled another weapon from its arsenal in settling the Mercury Interactive options backdating case. Even as the SEC settled with Mercury, it filed securities fraud charges against Mercury's former CEO and CFO and for the first time used a provision of the Sarbanes-Oxley Act that allows the commission to seek repayment of bonuses and stock sale profits received by CEOs and CFOs when financial results are later restated.

Similarly, when notified of restatements, some D&O insurers are asserting that, like shareholders, they based agreements to provide insurance on false financials, and are threatening to bring rescission actions to void entire policies, thereby potentially leaving the directors and officers with no coverage.

No wonder a recent survey by Towers Perrin found that directors are increasingly concerned about their personal liability. Outside directors continue to be squarely in the SEC's sights. And just last year, five former outside directors of the bankrupt company Just for Feet paid a combined $41.5 million to settle claims brought against them by the bankruptcy trustee—payments reportedly made personally by the directors.

Faced with a potentially wild ride ahead, what should directors and officers look for in their D&O coverage?

1) A Broad Definition of Claim that Covers Investigations

Because coverage is generally triggered under a D&O policy when a claim is made, the definition of claim is important. That definition typically encompasses lawsuits and may include written demands for monetary or nonmonetary relief. Criminal, regulatory, and investigative proceedings should also be covered, including formal and informal requests for information.

2) Choice of Counsel and Advancement of Defense Costs

Most D&O policies allow the insured to choose counsel with the carrier's consent, with the payment of defense costs depleting the limits of the policy. For defense of securities claims, at least one major D&O carrier requires its insureds to use law firms designated on a panel counsel list, unless the insureds can show a conflict or other justification to go outside the panel list. Insureds who wish to select their own counsel may want to negotiate to include additional firms on a panel counsel list or seek to delete this requirement. Defense costs incurred by individual insureds are typically indemnified by the company, which then seeks reimbursement from the carrier. D&O policies should provide that the carrier will advance defense costs on a current or periodic basis. Individual directors and officers are well served to negotiate a provision that obligates the insurer to advance defense costs where the company may be disputing advancement obligations, without the individual

insured incurring what could be a high retention before triggering the coverage.

3) Severable Conduct Exclusions That Apply Only When Misconduct Is Adjudicated in the Underlying Claim

Two exclusions frequently asserted by carriers, particularly with respect to securities claims, are conduct exclusions: the deliberate fraudulent acts or dishonest conduct exclusion and the illegal personal profit or advantage exclusion. The requirements of Sarbanes-Oxley with respect to the conduct of, and remedies imposed against, directors and officers may increase insurers' attempts to deny coverage based on these exclusions. Where possible, these exclusions should be negotiated so that the carrier may not rely on them to defeat coverage unless there is a final adjudication of fraudulent or dishonest conduct, or personal profit or advantage, in the context of the underlying claim. Insureds should try to make these exclusions severable as well.

4) A Broad Definition of Loss

D&O policies often exclude such things as taxes, fines, penalties, the multiplied portion of any multiplied damage awards, and punitive damages from the definition of loss. Insurers have, however, agreed to cover at least some punitive and multiplied damages awarded. Some carriers cover punitive damages for securities claims if they are insurable under the law pursuant to which the policy is construed. Other carriers cover all punitive or multiplied damages, so long as it is not against public policy to insure them. Policies may further provide that the law of the jurisdiction most favorable to coverage will be applied to the disputes. The efficacy of and any restrictions on these most favorable law provisions, however, should be reviewed under the law of any jurisdiction that may apply to a policy or claim.

5) Worldwide Coverage

Directors and officers should assess if their current program will adequately cover them for claims and regulatory proceedings in foreign jurisdictions. Possible issues to consider include requirements to purchase policies in the host country, adequacy of limits, and the choice of law and forum to resolve a coverage dispute.

6) Nonrescindable Coverage for Nonindemnifiable Claims against Directors and Officers

Side A coverage responds to loss that the company cannot (because of insolvency) or is not permitted to (under its bylaws or applicable law) indemnify for directors and officers. Most policies provide that no retention will be applied to Side A claims. As the Side A coverage is typically the last resort for directors and officers if they are not indemnified, directors and officers are best protected when the insurer agrees it will not rescind the coverage for any reason.

7) Separate Side A Coverage

Directors and officers are increasingly demanding that they be provided separate Side A coverage. They desire separate limits of coverage untapped by claims against the company. The Side A stand-alone policy that is most favorable is a drop down, difference–in-conditions (DIC) coverage. In this case, the policy drops down and functions as primary coverage in the event the full-side policy's Side A coverage does not apply. This could occur if the underlying policy contains an exclusion that the Side A stand-alone policy does not. The Side-A-only policy also functions as traditional excess coverage for nonindemnifiable claims against directors and officers in that it sits on top of the underlying full-side coverage. Typically, Side A DIC policies are nonrescindable.

Although proposing these seven suggestions may be taken as a lucky omen, most directors and officers we counsel prefer to avoid chance and proactively negotiate their coverage, saving the shark-infested waters for more daring souls.

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