

# BEST'S REVIEW

Directors and Officers

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Property/Casualty

## All Things Considered

Recent court settlements suggest including attorneys in D&O renewals, as well as double-checking key policy objectives are prudent measures to ensure proper coverage.

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Recent news reports revealed that former directors of companies such as WorldCom and Enron will be paying record amounts to resolve claims for damages arising from their alleged breaches of fiduciary duty. Reportedly, the settling directors are required to pay these amounts out of their personal assets.

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The settlement is reportedly structured to preclude reimbursement either from directors and officers insurance or their former companies (or their bankrupt estates). Years of expensive litigation preceded these settlements.

Both WorldCom and Enron were extreme cases involving well-documented, egregious and high-profile wrongdoing. These settlements may provide some encouragement to institutional plaintiffs, such as public pension trusts with political appointees running them to seek a "pound of flesh." However, they should not intimidate service on boards of publicly owned companies by outside directors willing to

- Key Points**
- The Enron and WorldCom settlements should remind prudent companies to procure the most suitable D&O coverage.
  - Individuals involved in renewals should be familiar with the current D&O marketplace and the hot-button D&O issues.

put their time, best efforts, and diligent attention into the governance practices, which shareholders are entitled to expect.

What these settlements should do, however, is spark prudent companies to examine existing D&O insurance policies to assure that, in future renewals, the companies procure the most suitable coverage available in today's changing D&O marketplace. It is recommended that, along with company risk managers, either inside or outside counsel participate in D&O insurance

Illustration by Angel Nagron



renewals. All individuals involved in such procurements should be familiar with both types of coverage practically available through negotiation in the current D&O marketplace, and with typical hot-button D&O coverage issues.

Although there is no bulletproof method for assuring the adequacy of D&O policy limits to cover foreseeable claims, methods exist to assist in determining the prudent amount of coverage to obtain for companies of varying market capitalization and in various industry segments. Additionally, the following checklist contains important objectives to consider when approaching upcoming D&O insurance renewals:

■ **Protect independent and “innocent” directors and officers.** Ideally, D&O policies should not be rescindable, except in the most extraordinary circumstances wholly unrelated to “securities fraud” allegations. Alternatively, D&O policies should guarantee severability of representations in both the application and the insurance policy to protect and preserve coverage for innocent directors and officers. Policyholders should avoid representations or warranties in the application or the policy that incorporate by reference previous publicly filed financial statements and should avoid endorsing these financial statements as being material to the issuance of the D&O insurance policy. Securities fraud lawsuits always are based

upon a contention that publicly filed financial statements were intentionally or recklessly misleading. Insurers invariably seek to rescind policies containing such representations or warranties when faced with securities fraud claims based upon financial statements incorporated by reference into the application or the policy. Furthermore, D&O policies also should include severability provisions in conduct-related exclusions but otherwise try to limit or avoid them entirely.

■ **Seek an alternative to entity coverage.** Entity coverage has caused more problems than it was ever worth, particularly in situations of (a) insolvency or bankruptcy; and (b) change in control of entity management resulting in hostility toward former directors and officers. Although court rulings have helped to establish that D&O policy proceeds are not assets of a bankrupt estate subject to Chapter 11 injunctions and freezes, this has not entirely stopped trustees or administrators from raising this issue. Additionally, erosion of policy limits by even a solvent corporate entity often left individual directors and officers with little or no residual coverage for their own defense and settlement. “First come, first served” rulings from courts literally promoted fierce competition at times for policy proceeds between corporate entities and directors and officers “on the outs.” With the demise of entity cover-

age, consider a preset allocation formula in policy applicable to claims by corporate entity and the individual directors and officers.

■ **Obtain protection against possible insolvency of the policyholder company.** Provide that deductibles or self-insured retentions, which may be substantial, do not apply if the company is insolvent. Consider priority of payments provisions to identify those insureds who should be able to access policy proceeds first.

■ **Review important policy definitions.** Analyze the definition of “insured” to make sure it covers all of those for whom protection is sought. Also, it is important to negotiate suitable definitions of important policy terms. For example, policyholders should consider the following points with regard to the definition of “claim”:

- A broadened definition helps to ensure the availability of D&O insurance coverage for administrative, regulatory, civil, and criminal proceedings.

- A broadened definition also helps to ensure coverage not only for litigation, but also for alternative dispute resolution proceedings and even investigations. Ensuring the D&O coverage is available for investigations is becoming increasingly important in light of the many investigations undertaken in recent years by state attorneys general offices and federal agencies like the SEC.

- However, policyholders should consider the effect that this definition



may have on the timing of notice.

Policyholders also should review the definition of "loss" in light of some recent cases such as *Vigilant Insurance Co. vs. Credit Suisse First Boston Corp.* which have held that even settlements may constitute "disgorgement" of ill-gotten gains. D&O policies contain no such exclusion or provision supporting these arguments against coverage. However, a broad definition of "loss," including coverage for various kinds of claims, for example, damages under Section 11 of the Securities Exchange Act, may help preserve intended coverage. The extent of coverage for "fines" and "penalties" and attorneys' fees should also be considered carefully, to ensure the availability of coverage, and minimize the possibility for disputes, should a claim arise.

■ **Maximize coverage for defense costs.** Review the insurer's list of panel counsel and negotiate alternatives, if desired. Avoid provisions granting the insurance company the right to recover payment of defense costs. Also, review "consent to settle" clauses to assure they will neither frustrate legitimate company or individual decisions to settle nor give the insurer bargaining leverage to

reduce the amount owed in coverage. Ask to review the insurer's billing guidelines before purchase, and amend them if necessary, to avoid disputes when claims arise. Policyholders also should review carefully any provisions governing advancement of defense costs and related provisions seeking to allocate responsibility for defense costs. After the demise of companies such as Enron, insurers increasingly are returning to allocation provisions that were phased out in the late 1990s.

■ **Ensure coverage for all international risks and global exposures.** Policyholders should review their D&O policies to make sure they cover all operations and individuals for which protection is sought. Policyholders also should consider whether their policies make clear that their D&O policies cover liabilities that may arise under foreign law.

■ **Review all exclusions, but especially consider and modify or eliminate the potential impact of "conduct" exclusions in D&O policies.** D&O policies typically include a variety of exclusions that seek to preclude coverage for certain "bad"

conduct. These exclusions include deliberate fraud or criminal acts, dishonesty and personal profit. Policyholders are best protected when these conduct exclusions are written to require a final adjudication of the facts relating to the alleged conduct or breaches of duty. For example, it is desirable when coverage is preserved unless and until a court enters a finding of fraud in a securities litigation. Policyholders also should try to include severability provisions to assure that the exclusionary effect of conduct exclusions is limited to the allegedly "bad" actors. Other exclusions that deserve review include prior acts, prior notice, and insured vs. insured. An "insured vs. insured" exclusion should not apply to preclude coverage when a trustee in bankruptcy is involved for an insolvent policyholder. With recent claims against financial institutions and mutual funds, insurance companies also increasingly are including market-timing or late-trading exclusions in not only financial institutions' policies but other types of insurance policies as well. Policyholders should examine the text of these exclusions carefully. **BR**



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