



FOLEY & LARDNER LLP

**Corporate Governance Reform: *What's Next?***

# **General Session Panel Discussions**

**FOLEY & LARDNER'S  
2005 NATIONAL  
DIRECTORS INSTITUTE**

## DIRECTOR AND OFFICER LIABILITY TRENDS

Gordon Davenport III, a partner at Foley & Lardner LLP, moderated "Director and Officer Liability Trends," a session at Foley's fourth annual National Directors Institute (NDI) held on March 10, 2005 in Chicago. Other panelists included Delaine A. Fritz, senior vice president for the Corporate Accounts Division of National Union/AIG, and Phillip N. Norton, Ph.D., president of the Professional Liability Division and national managing director for the Strategic Risk Solutions niche of Arthur J. Gallagher & Co.

The panel discussed various director and officer (D&O) liability insurance issues for 2005, including D&O liability exposure and protection, hot D&O insurance issues, and related D&O trends.

### Directors Becoming Targets

"The liability on directors and officers has never been more disturbing," noted Ms. Fritz. "Business practices that were perfectly acceptable three, four, and five years ago are not necessarily the standards that directors and officers are being held to now for decisions made then," she explained. This trend has been particularly unsettling to many directors and officers.

Ms. Fritz identified certain new trends with respect to the personal risk of the directors and officers, including:

- The public humiliation of directors and officers
- Changes in business practices and corporate governance requirements holding directors and officers to significantly stricter standards
- Institutional plaintiffs that want to set an example and have made it known that they will pay plaintiff's lawyers higher fees if the lawyers are able to get money from the directors and officers personally or obtain public apologies from the directors and officers

Mr. Davenport added that some directors are being forced to pay settlements out of their own pockets. Two of the more notable cases were *WorldCom* and *Enron*, in which the directors have agreed to make personal contributions totaling over \$30 million. However, in Mr. Davenport's opinion, situations in which directors are required to pay out of their own pockets are still very rare. He explained that although it has been referred to as an "emerging trend," for the most part, cases such as *WorldCom* and *Enron* are unique in their facts.

"The only way to ensure against directors being forced to make personal contributions, explained Mr. Davenport, "is to carry enough insurance that you can say no, lose the case, and be fully covered." He continued, "I haven't seen too many plaintiff's lawyers turn down a good settlement when the money is available." He

added “one feature of *WorldCom* and *Enron* was that the insurance coverage was not sufficient and thus there was incentive to go after the directors.”

### **A-Side Only Coverage**

Many companies have been purchasing “A-Side” coverage, which is coverage that is available exclusively to the directors, and in some cases, only to independent directors. The company has no ability to call upon or terminate the coverage. This type of coverage is becoming increasingly popular, with many directors requesting it and many large companies purchasing it.

According to Dr. Norton, many of his larger accounts are purchasing A-Side coverage. He has not seen as much of an increase in purchasing A-Side coverage among smaller companies.

According to Mr. Davenport, A-Side coverage may be a good way to provide protection for directors; however, he explained that “you need to carefully review the A-Side policy because each is different.” For example, some policies only kick in once the company’s insurance has been exhausted, while other policies are independent from the company’s coverage. In addition, some policies are non-rescindable while others are not.

### **Smaller Companies Are Becoming Targets**

Another trend is that smaller companies are becoming targets of plaintiffs’ lawyers. In the past, this was not common. Dr. Norton stated, however, that “the risk of being sued is not equivalent.” “The larger companies still get sued more frequently, and it is largely based upon a company’s market capitalization,” explained Dr. Norton. “However, for certain smaller companies, the size and the limits they need to purchase are not as correlated to the settlement size as it used to be in the past. There is a new breed of plaintiff’s lawyers who now ask what the case is worth rather than what are the insurance limits,” he explained.

### **General Counsel Coverage**

Another issue is whether general counsel are covered by D&O policies for their activities as lawyers. Mr. Davenport explained this issue is often unclear and “some policies expressly include the general counsel in the coverage, but most often the policy is silent.” Insurance companies frequently take the position that general counsel are not covered by the D&O policies; however, this is debatable. Mr. Davenport suggested that companies carefully review their policies to verify this issue.

In addition, Mr. Davenport mentioned that as a safeguard, companies may purchase separate policies covering general counsel — essentially a “malpractice policy” for their general counsel. Ms. Fritz added that these separate general counsel policies

are fairly inexpensive and will generally cover all lawyer activities of the general counsel, including pro bono work outside of the office.

### **SEC Investigations**

D&O policies vary widely on the issue of what is covered during an investigation by the U.S. Securities and Exchange Commission (SEC). Some policies cover costs associated with such proceedings while others do not. In some cases, it is unclear.

Coverage for regulatory proceedings, which is common, does not necessarily include regulatory investigations, which can be extensive and costly. To obtain coverage for investigations, companies need to obtain a specific grant of coverage in their policies.

### **401(k) Liability**

Another trend is employees suing their employers over losses in their 401(k) plans. Mr. Davenport explained that “there has been an increased number of claims for employee losses in 401(k) plans that hold stock in the company.” He further explained that generally these claims are not covered by D&O policies, but coverage is possible under fiduciary liability policies. As a result, it is important for directors of companies with 401(k) plans holding stock in the company to ensure that they have sufficient fiduciary liability policies.

### **D&O Frequency and Severity Trends**

Dr. Norton discussed various D&O claims trends. “The good news is that the frequency of trends is relatively steady,” however, he continued, “the bad news is that the severity of the claims has increased,” Dr. Norton explained that the dollar value of claims has increased, with average securities claim costs now in the range of \$25 to \$40 million. It appears that “mega-claims” have emerged as the new reality.

### **Now Is the Time to Negotiate Insurance Policies**

The panel discussed typical D&O policy costs and coverage trends. According to Dr. Norton, due to competition among insurance carriers, the cost of D&O insurance over the past couple of years has been going down. He explained that he believed that “we are in the eye of the hurricane” with respect to D&O insurance. Even though claim costs to the insurance carriers are increasing, the costs of the insurance to buyers remain low. Typically the cost of insurance increases a couple of years after an increase in claims, and Dr. Norton anticipates that the cost of insurance will likely go up over the next couple of years. Now is the time to renegotiate insurance policies, both for price and coverage.

## **Critical Criteria to Consider When Purchasing D&O Coverage**

When purchasing D&O coverage, it is important to consider various criteria. Ms. Fritz identified the following critical items to consider:

- Financial solvency of the insurance company subsidiary
- Financial solvency of the insurance company's parent holding company
- Years in the product line and market share in total and by asset niche
- Geographic diversity — multiple locations in the United States and internationally
- Claims staff, size, and experience
- Application process — written representations and oral representations
- Policy coverage provisions

### **For More Information**

To learn more about “Director and Officer Liability Trends,” feel free to contact the session speakers.

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