

DIRECTORS AND OFFICERS LIABILITY

Directors and Officers liability is written to protect the personal assets of a company's directors and officers against catastrophic financial loss. The policy also provides reimbursement to the organization when it is required or permitted by law to indemnify the directors or officers for their losses.

The market for Directors and Officers Liability is subject to continuous and sometimes dramatic change. Following the accounting scandals involving publicly held companies in 2001 and 2002, capacity for D&O constricted rapidly and premiums increased dramatically. Since that time, more capacity has been added to the market and premiums have stabilized or have been reduced in some cases. In 2005, there are about 50 companies writing Directors and Officers Liability and capacity increased 11 % between '03 and '04 with more added early in 2005. However, claim frequency has risen approximately 11% leading market analysts to predict a harder market beginning in 2006.

SHOULD PRIVATELY HELD COMPANIES CONSIDER BUYING D&O?

A common misconception is that *only* large, publicly traded companies should be interested in buying D&O because of the responsibilities their directors and officers have to shareholders and due to the close scrutiny to which they are held by the Securities and Exchange Commission. The reality of today's corporate legal climate, however, suggests that smaller, **privately held companies are equally vulnerable to litigation.**

The directors and officers of private companies should consider the following:

- The directors and officers of privately held companies often work in **more demanding environments** than their larger, public counterparts. They may try to cover more corporate bases, unique conflicts of interest may exist and their activities may be conducted under less efficient or effective conditions.
- The applicable **standards of conduct are identical** to those to which directors and officers of large, public corporations are held.
- Although there are typically fewer shareholders, there are usually a **number of potentially adverse shareholders** and other possible claimants.
- **Bad decisions**, even those made in good faith, **are likely to be more visible** in a small environment and attract the attention of shareholders, regulators and others.
- The **costs** of defending corporately targeted lawsuits **may exceed the net worth** of most of a company's directors and officers. Judgments can be financially crippling.
- A small to medium size company may have **difficulty attracting qualified individuals** to its board without Directors and Officers Liability.
- In small and mid-size companies, **decisions** made by directors and officers typically **impact**

finances more quickly than in larger companies.

2003 CLAIMANT DISTRIBUTION

(for companies with fewer than 500 shareholders – Tillinghast Survey)

Employee	51%
Shareholders	30%
Customers/clients	10%
Competitors	6%
Other Third Party	2%
Government	1%

SOURCES/TYPES OF D&O CLAIMS

Employees or former employees: The most common suits are for wrongful termination, discrimination, sexual harassment and other labor law violations. Among the laws governing these matters are the Civil Rights Act of 1991, the Americans With Disabilities Act of 1990, the Older Workers Benefit Protection Act of 1990 and the Family Medical Leave Act of 1993 (among others).

Wrongful termination	Harassment, humiliation
Breach of contract	Discrimination
Pension, welfare, benefit dispute	Union dispute
Defamation	Employment conditions/safety

Shareholders, Investors, Partners and Members: Allegations may come from any shareholder, minority shareholders and former shareholders and may include:

Merger/acquisition disputes	Conflict of interest
Financial performance/bankruptcy	Investment or loan decision
Executive compensation	Inadequate/inaccurate disclosure
Private offering or IPO	Financial reporting inaccuracies

Customers, clients and consumer groups: Customers and clients may allege misrepresentation by a director or officer when entering a contract. Lender and creditor suits may arise if a company has violated certain loan covenants or is unable to repay debt.

Extension, refusal of credit	Restraint of trade
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Debt collection
Deceptive trade practices
Contract dispute

Dishonesty, fraud
Cost, quality of product or service
Lender liability

Other third party claims (including competitors and government claims): Federal, state or local actions may be made against directors and officers for violations of anti-trust laws, fraud, tax issues and civil rights, among others.

Anti-trust
Copyright/patent infringement
Product/company defamation
Business interference
Competitor disputes
Environmental

Prospective company acquisition
Other third party issues
Civil rights
Tax issues
Regulatory allegations
Other governmental issues

EXAMPLES OF D&O SUITS INVOLVING PRIVATELY HELD COMPANIES AND THEIR DIRECTORS AND OFFICERS

Employees and Unions:

- Employees filed suit against the officer of a company after the company's multi-employer plan failed. The insurance carrier for the officers contributed \$700,000 toward a total settlement pool of \$2,000,000.
- An employee filed suit alleging wrongful termination for refusal to certify a false tax return. An adverse judgment was rendered in the amount of \$10,000,000.
- A woman was hired by a company to fill an administrative position. After nine years with the company, she had climbed the corporate ladder and had reached a position as a junior officer. After she was passed over for promotion to a higher position for which she felt she was suitably qualified, she filed suit against two corporate officers and the company alleging breach of contract, racial discrimination, gender discrimination, fraud and emotional distress. Following almost four years of litigation, the woman was paid \$75,000. The defense costs totaled \$272,000.

Customers, clients, lenders and creditors:

- The successful defense of a distribution company's directors and officers sued by a retailer over a failed marketing program resulted in defense costs exceeding \$1,000,000.
- A retail customer of a small manufacturing company alleged that the company purposely

delayed and withheld shipments of a product in an effort to give the plaintiff's competitor a territorial marketing advantage. The resulting defense costs were \$315,000.

- A lender sued the directors and officers of a corporation for converting inventory pledged as collateral for a commercial loan. The case was ultimately settled for \$7,000,000.

Shareholders and investors:

- A former shareholder filed suit against a company's officers after its earnings increased following a management buy-out. The successful defense of the officers cost over \$500,000.
- The shareholders of a company alleged that the company and its president aided and abetted securities fraud. In this case, the officer settled for \$1,000,000 and defense costs were approximately \$600,000.
- A former shareholder alleged that an officer and the company were responsible for the bankruptcy of a joint venture. The case was settled before trial for \$5,000,000; defense costs exceeded \$2,000,000.

Competitors and suppliers:

- The officers and directors of a software publishing company were sued by a competitor for copyright infringement relating to development and marketing of a series of educational and inter-related computer games. After three years of litigation, the plaintiff was awarded \$6,000,000; costs of defense were unknown.
- A small business owner wanted to buy a piece of land on which to construct a new facility. He found an appropriate parcel and made an acceptable offer which was contingent upon bank financing. His bank reported that his loan could not be approved due to a past-unpaid debt to a supplier. Suspecting an error, he contacted the supplier who acknowledged that the debt had been paid but that it failed to notify the bank. The supplier promised to do so immediately. The supplier did not act promptly, the deadline to procure financing expired and the business owner was forced to purchase a less desirable property at a higher price. He filed suit against the supplier and was awarded \$200,000.
- An officer of a small manufacturer of electronic equipment solicited the employment of, then hired four employees of a large conglomerate's subsidiary. Subsequently, the smaller company began selling similar products at a much lower price. The conglomerate filed suit alleging the officer and the company had stolen trade secrets and customer lists through the act of hiring its former employees. After two and one half years of litigation, the case was settled for more than \$1,000,000. Defense expenses for the officer exceeded \$500,000.

Government agencies:

- The federal government indicted the president of a company for bribery. The criminal trial resulted in an acquittal but defense costs and fees incurred were over \$2,000,000.

- The federal government sued the president of a company for price fixing. Although the president was acquitted, defense costs and fees exceeded \$4,000,000.
- A restaurant chain became a popular singles place. A majority of its revenues were derived from liquor sales. The company received notification from state authorities announcing that it was suspending the chain's liquor license because it sold liquor to minors. The restaurant chain asserted that it enforced a very strong policy against sales to minors and that if such sales were made, it was because customers used counterfeit identification. Although the company succeeded in retaining its liquor license, it paid lawyers \$175,000.

THE ABOVE CASES ARE CITED FROM WRITTEN MATERIAL MADE AVAILABLE BY INSURERS. MOORE SPECIAL RISK ASSUMES NO RESPONSIBILITY FOR THE ACCURACY OF THIS INFORMATION.

COMMON D&O TERMS

Even the most experienced insurance professionals, who may have special knowledge and expertise in other important industry disciplines but work infrequently in Directors and Officers Liability, do not routinely understand D&O exposures and D&O liability insurance. It is essential to understand frequently used D&O coverage terminology.

- **Claims-made Policy:** A policy in which coverage may be provided for claims, which are asserted during the policy period. D&O coverage is typically offered on a claims-made basis.
- **Allocation:** This refers to the apportionment of responsibility for payment of loss between the insurer and the insured company. The need for allocation may occur when a lawsuit names covered individuals along with those not covered in the insurance policy.
- **Discovery:** This refers to a period of time after a policy has been non-renewed or canceled. During this time, the company can report claims made against directors and officers for wrongful acts committed prior to the effective date of cancellation or non-renewal.
- **Run-off Insurance:** Some D&O policies terminate coverage on the day a company changes ownership. Run-off is extension insurance to an existing policy or a separate policy, which extends coverage for a period of time beyond the acquisition/merger date. It protects directors and officers against claims arising from decisions they made while running the acquired company and from lawsuits, which might stem from the acquisition itself.

- **Insuring Agreement A:** This is one agreement of a typical D&O policy - the D&O liability coverage. It provides coverage for insured persons such as officers and directors and it provides payment on their behalf when the company cannot indemnify them.
- **Insuring Agreement B:** This is the other agreement side of a typical D&O policy - the reimbursement coverage. It reimburses the company for the amount it spends indemnifying insured persons for their wrongful conduct.
- **The SEC Acts of '33 and '34:** These two federal statutes govern most securities activities of publicly held corporations and individuals associated with them, including directors and officers. Generally speaking, the Act of '33 governs the process of a public offering and the Act of '34 regulates public company conduct after a public offering. The purposes of these statutes are to ensure: Disclosure of material facts to the public, fair dealing in transactions relating to a corporation's stock, and regulation of national securities exchanges.
- **Business Judgment Rule:** This is a common law rule, which governs the degree to which directors and officers should be held legally accountable for their business decisions. The rule dictates that the court should examine a director's business decision only to the extent necessary to determine whether it was made with due care, in good faith, and with the honest belief that it would be in the best interest of the company.
- **Entity Coverage:** The entity is the company and should be distinguished from the directors and officers covered in a typical D&O policy. Many claims made against individual insured's directors and officers also include allegations made against the company, "the entity." Some providers of Directors and Officers Liability provide limited coverage for the entity.
- **Severability:** Provides that the policy may (or may not) apply to claims made against officers or directors who purport to have no knowledge of, and did not contribute to, a wrongful act, circumstance or event that may lead to a claim. This is especially important when completing an application for D&O because the corporate officer who completes the application may have no knowledge of damaging circumstances known to others.

DUTIES OF DIRECTORS AND OFFICERS

Decades of litigation and ensuing case law have created three basic duties to which directors and officers must adhere. They are:

The Duty of Care

Directors and officers are expected to perform their duties in good faith and at a level of professionalism they reasonably believe to be in the interest of the corporation and with the care that a reasonably prudent person in a similar situation would use under similar circumstances. This **Duty of Care** is a variable benchmark dependent upon the expertise, experience and background of each

director or officer. It is important to know that the level of conduct expected of a director with little experience or business knowledge might be acceptable but the same conduct, if performed by a director with greater experience or depth of knowledge might not be acceptable and thus, exposing him/her to liability. The greater the capacity for service, the greater the expectations of the courts for that service.

Claims, which may assert a Breach of Duty, may include:

1. **Failure to** fully and sufficiently **investigate** the far-reaching effects an acquisition or merger may have on the corporation and failure to seek appropriate and qualified advice and counsel on such matters;
2. **Approve** and permit **investment** of corporate assets in financially weak or insolvent companies;
3. **Failure to correct** inadequate, inaccurate or misleading statements in corporately published material;
4. The **failure** of directors **to adequately review** and monitor financial statements in situations where officers misappropriated corporate funds.

Duty of Loyalty

The **Duty of Loyalty** prohibits directors and officers from using their positions to further or enhance their private interests and requires them to refrain from engaging in personal activities, which might injure the corporation. It requires an unselfish and undivided loyalty to the corporation and demands that there be no conflict between one's self interest and that owed to the entity. Directors and officers may not realize secret profits or unfair personal gain, may not usurp corporate authority, may not compete with the corporation to its detriment, and may not transact business with the corporation unless the director or officer can demonstrate that the transaction was fair and reasonable to the corporation.

Claims, which assert Breach of Loyalty, may include:

1. Using **insider knowledge** to purchase assets, which the corporation also wishes to purchase;
2. **Soliciting customers** of the corporation while intending to resign but before making such resignation known;
3. Negotiating **advantageous real estate leases** on property a director or officer may own where the corporation is the lessee;

4. In cases where a director or officer may also be a creditor of the corporation, **negotiating more favorable terms** for themselves than for other creditors;
5. Directors and officers **approve unjustifiable bonuses** for themselves.

Duty of Obedience

Directors and officers are required to perform their duties in accordance with applicable statutes and the terms of the corporate charter. A myriad of regulatory bodies and their related, often complicated, statutes exist which govern the conduct of directors and officers. They are not excused from their duties if they are unfamiliar with the laws governing their conduct. Moreover, too frequently, directors and officers fail to observe traditional corporate formality; director and shareholder meetings may not be held, books and records not properly maintained and resolutions approving significant transactions may not be recorded.

Claims asserting **Breach of Obedience** may include:

1. Directors and officers prepare, sign and submit **misleading and/or false documents** to a regulatory agency;
2. **Wrongful discharge or discrimination** of a corporate employee; a knowing violation of the federal body of law and other similarly intended state and local statutes;
3. Authorizing dividend payments **exceeding a statutory authorization**;
4. Authorizing loans to the corporation in amounts **exceeding a statutory authorization**;
5. Knowingly permitting the corporation to **violate patent or copyright infringement laws**;
6. **Failure to oversee corporate compliance** with any applicable statute;
7. Making **false entries** in corporate records.

CAUTION

During the last decade or so, the federal government and some states have enacted statutes which purport to eliminate or limit certain types of directors and officers exposures or to reduce the opportunities for prospective plaintiffs to litigate corporate matters. One such example is the Private Securities Litigation Reform Act of 1995. These statutes vary greatly and should be examined

closely by the insured and its counsel to determine what, if any, benefit might be found. None of these statutes create absolute immunity for directors and officers.

IN ALL CASES, ANY AND ALL MATERIAL RELEVANT TO DIRECTORS AND OFFICERS LIABILITY, INCLUDING PROPOSALS FOR INSURANCE AND POLICY FORMS, SHOULD BE REVIEWED BY INSURED'S COUNSEL PRIOR TO MAKING ANY DECISION REGARDING THE PURCHASE OF DIRECTORS AND OFFICERS LIABILITY.

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