"D&O Insurance Today"

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Audio Archive

As the questions mount regarding director & officer liability, companies - as well as those covered - are taking a second look at their D&O insurance policies. With D&O carriers sometimes looking to amend policies - and more lawsuits naming directors and officers being filed - the playing field for D&O insurance is becoming increasingly complicated. Join these experts:

- **Tom Bentz**, Partner, Holland & Knight LLP
- **Kevin LaCroix**, Executive Vice President, RT ProExec & Editor, D&O Diary
- **Joe McLaughlin**, Partner, Simpson Thacher & Bartlett LLP
- **Pat Villareal**, Partner, Pat Villareal Law

Liz Dunshee, *Editor, TheCorporateCounsel.net*: Hello this is Liz Dunshee, Editor of TheCorporateCounsel.net. Welcome to today's webcast, "D&O Insurance Today."

I'll introduce our panel for today. We have Tom Bentz, a Partner at Holland & Knight; Kevin LaCroix, a D&O insurance broker and Partner at RT ProExec, as well as Editor of the popular blog, D&O Diary; Joe McLaughlin, a Partner at Simpson Thacher & Bartlett; and Pat Villareal, who spent 35 years at Jones Day before opening her own firm last year - Pat Villareal Law - where she works on D&O indemnification and other matters, particularly in the context of distressed companies.

With that, I'll turn it over to Joe to kick us off with a discussion about typical claims against directors and officers.

Typical Claims Against Directors & Officers

Joe McLaughlin, *Partner, Simpson Thacher*: Thanks very much, and good afternoon everyone. A reasonable taxonomy of insurable claims begins with the division between private litigation and regulatory investigations. I'll start by summarizing the most significant recent developments and what we perceive likely to be the "next big thing" concerning underlying claims.

Some of the best news recently has emerged on the regulatory side - or the lack of news, I should probably say more accurately. The SEC filed a total of 17 actions against public companies and their subsidiaries in the second part of 2017. The low rate of SEC enforcement action continued through the first half of 2018 in which we saw only 15 new enforcement actions, which is a 67% decrease from the first half of 2017. That's the lowest number we've seen since 2013.

A very narrow range of industries are being targeted these days with finance, insurance and real estate comprising about 70% of new actions. The settlement numbers are down too; the average settlement was only about $4.3 million in the first half of 2018. The largest one was $14 million, which was by far the lowest in any half-year in recent memory. We are also seeing more investigations, unlike the past, where the Enforcement Division is simply spending a lot of time and effort as they always do with customary robustness. Then they just walk away with no charges being recommended.

That's not a glitch. It's obviously one the priorities of the new administration and a combination of tone from the top, as well as resources being deployed as had been in the past. That said, you know the regulatory news isn't all rosy. One thing we're talking about from time to time is the effect of data breaches. They're going to be with us as long as clever people have computer skills.

It's worth pausing at the recent imposition by the SEC of a $35 million penalty against Altaba, Yahoo's successor, hitting Yahoo for their two-year delay in reporting that massive data breach that Yahoo experienced at the end of 2014. The hacker hauled in what Yahoo called the "crown jewels." It was basically anything an ill-intentioned person would want to have - including encrypted passwords and security questions and answers - but Yahoo waited two years to tell the world.

The SEC's message essentially was, "that's not going to work for us." Yahoo's penalty came on the heels of the cyber security disclosure guidance that the SEC issued earlier this year. Which is worth being aware of and peeking at because it really emphasized the importance to the SEC of cyber security disclosures for all reporting companies. While we're on the topic of data breaches, on the private litigation side, not surprisingly, shareholders have tried to pursue data breach related derivative lawsuits - arguing that boards failed to exercise proper oversight of the company's cyber security systems.

Fortunately, those cases, for the most part, have been quickly dismissed. Target, Wyndham Worldwide, and Home Depot all had cases that were dismissed on the pleadings, basically related to demand futility shortcomings. Interestingly, Home Depot did settle their case on appeal and agreed to adopt certain cyber security related corporate governance improvements plus pay over a million dollars in attorneys' fees. I think that is going to continue to provide some heartening to plaintiffs' lawyers who think there may be something to hang onto out there.

To-date plaintiffs have filed very few cyber security related federal securities class actions because - simply stated - the stock prices have not dropped significantly when most companies have disclosed breaches. My own view is that's bound to change eventually, as companies are forced to make more statements about the robustness of their data protection safeguards. People will assert them as misstatements when and if a data breach comes home to roost.

I want to briefly turn to the Supreme Court, where as you probably know in the past decade, the defendants have technically prevailed in virtually every U.S. Supreme Court securities case over the last decade. Most of those decisions, when they translate into the real world, have turned out to be duds and not led to anything of great moment. I think there have been recent cases that may be the exception to that disappointing trend.

Two decisions that should reduce the number of class actions companies will need to address are first, the recent *Epic Systems v. Lewis* case in which the U.S. Supreme Court said that arbitration agreements in which an employee agrees that he or she will arbitrate any claims against their employer on an individual rather

than a class or a collective basis are totally enforceable and don't violate the National Labor Relations Act.

The Supreme Court has been very consistent in enforcing arbitration agreements as written. The courts below have been adopting and accepting that without serious question. I think we're going to be seeing a lot more widespread use by employers of agreements that bar class actions altogether, which is a great development for employers.

Two days ago, the Supreme Court had another very helpful decision that there's really no way around. It says that the traditional tolling of the statute of limitations associated with a commencement of a class action will only toll the statute of limitations for individual claims and does not toll the claims for a putative class. In the past, many courts were allowing what was called "stacking" or "piggybacking" of class actions, which had the effect of allowing class actions to perpetuate almost indefinitely until some plaintiff succeeded in getting a class certified. Now this means that if asserted a class cert is denied, people can't file successive class actions after the statute of limitations has expired.

The other noteworthy securities-related decision in this area is the recent *Cyan* decision which preserves the plaintiff's ability to pursue class action securities claims under the Securities Act of 1933 in state court, as well as federal court. Not surprisingly, we're seeing a virtual explosion of Section 11 claims being brought in state court as opposed to federal court.

The next major impasse here is moving the chess game and what happens in Delaware, where there have been several challenges to recently-adopted bylaws in various companies that have said if you're going to bring a Section 11 case it has to be brought in federal court. Those are being challenged as contrary to Delaware and federal law, so we'll have to wait and see whether those provisions are going to stand up.

The last thing I want to talk about, and I suspect we'll be hearing more about this as well, is the effect of the #MeToo Movement to end gender discrimination and assault. I think that's going to result in materially increased claims activity and a material change in how insurance is procured and how much it's going to cost.

When you think of the employment liability claim itself and the underlying harassment claims, you don't immediately jump to say, "Oh yes, that's a D&O exposure." D&O insurance can be a potential source of cover for some sexual misconduct related claims, particularly if the policy has an Employment Practices Liability – which is often called "EPL coverage."

In smaller companies, D&O and EPL coverage are almost always under one management liability policy along with fiduciary and cyber liability. Some D&O policies, particularly in the private company area, have exclusions specifying that coverage is precluded for loss based on employment-related wrongful acts. There's also going to be some skirmishing about the potential application of an insured versus insured exclusion to the extent someone is seeking coverage for the actual claim of harassment.

What's certain is that derivative shareholder claims, much like the cyberspace area, are going to be claims of inadequate supervision. For example, one of the largest shareholder derivative settlements ever, they're usually not that lucrative for the plaintiffs' bar, but senior management of 21st Century Fox agreed to pay $90 million that apparently was disclosed and funded entirely by insurance. They settled allegations that management perpetuated a culture of sexual and racial harassment to permeate the company, which resulted in reputational and financial harm to the company. I think that's not going to go unnoticed by the plaintiffs' bar.

Similarly, in the federal securities context, there could be potential liability arising out of the #MeToo Movement for directors and officers when the company makes inaccurate or misleading statements regarding its sexual misconduct protections and the safeguards it has in place to prevent it. Those kinds of claims traditionally are tough to bring, but I think there's too much going on out there. People recognize that in the current environment, courts are going to be more reluctant to axe those kinds of cases upfront, given the momentum of the movement.

All of this, of course, is going to be related to risk management and underwriting implications. We're all used to an environment where traditional underwriting examines financial controls. Now underwriters are going to be assessing work

environment and corporate culture controls, which is more like mercury. How do you get your hands or arms around that? I'm sure underwriters are going to be asking more questions about instances of reports of harassment, and specific questions about employee handbooks. It's not enough to say, "Oh, we have a handbook on our website," because they're pretty much off the shelf these days.

They are going to be asking serious questions and you are going to need good answers. Questions like, "are employees asked and required to sign off on them and indicate that they have read it and understand them?" This is needed to perpetuate a whole culture of training and handling awareness of harassment for both. It's the right thing to do, but it is also a good risk management practice. If anyone wants to chime in on that kind of substantial start, that's great - otherwise we can move to our next topic.

Tom Bentz, *Partner, Holland & Knight*: Joe this is Tom Bentz, I wanted to just jump in on one topic that I think is important. It is the number of securities class actions that we saw filed last year compared to previous years. Depending on how you count these, there were 412 filed in 2017 which is over double the historical average of 193.

There's some reasons for that - mostly because the Delaware state courts, where a lot of the disclosure-only cases were filed, put a stop to that and shut down the plaintiffs' bar. Many of those cases are now being filed in federal court as Section 14 claims. I think that explains a big portion of the spike. It's certainly something that insurance carriers are very aware of and conscious of. This is over double the number of claims on a year over year basis.

Trends in D&O Policy Pricing, Coverage, Terms & Conditions

Kevin LaCroix, *Executive VP, RT ProExec*: Tom this is Kevin. That is a great lead in for my discussion of the topic of trends and D&O pricing. The background is that, for really a decade and a half, D&O insurance pricing has gone down annually. Buyers have enjoyed lower premiums on average across the marketplace. Obviously, that changed during the financial crisis for financial companies and certain other companies, but generally the pricing trend has been downward.

That means the revenue the insurers are getting per unit is going down. We have this huge uptick in the number of securities class action lawsuit filings. The problem for carriers is that they now have a much larger portfolio of claims and reserving for those means they're seeing their results deteriorate. If you talk to any of the carriers these days, they'll tell you their results for 2013, 2014, 2015 were poor. Year 2016 is deteriorating and looks worse, and 2017 has a huge uptick in the number of securities lawsuits which means it's likely that figure is going to be even worse. Here we are halfway through 2018, and anybody that looks at the filings for this year will know that the 2017 trend has continued into 2018.

This hasn't translated into carriers trying to seek across-the-board price increases; there's just too much capacity and competition. They're just not able to get traction for that, but what we are seeing is pockets of increases. I think generally public company buyers are paying more for their primary insurance, although perhaps they may be able to offset that with decreases in the excess layers. Certain pockets, for example life sciences companies and developmental stage biotech companies, are seeing their premiums go up as a result of rate increases.

We're also hearing especially some of the largest carriers talking about repositioning their books, maybe getting out of certain areas where they've had poor results and talking about trying to pull back on some terms and conditions. At this point, I don't see across-the-board changes, but I do feel that if there's a disruption in the insurance marketplace as a result of a large catastrophic loss, there could be a momentum in future months or on the road ahead towards more general price increases. But as of today, I think generally we can say insurance buyers enjoy a favorable insurance market with relatively low pricing and generally broad terms and conditions.

One last point, you really know you're in a harder market when carriers start to pull back not just on pricing, but on terms and conditions. To date we're not seeing any significant comprehensive efforts to rein in generally broad terms and conditions.

Pat Villareal, *Partner, Pat Villareal Law*: Kevin this is Pat, let me ask you a question from a company's perspective. I've represented a number of companies

while they are considering D&O insurance and dealt with underwriters on issues related to pricing and what kind of terms and conditions. As someone who has also subsequently represented companies when they have a claim, you're then dealing with a whole host of different people who have a different perspective.

What would you suggest companies do in terms of trying to record the responses they're getting from underwriters about how certain conditions are intended to work and what they've been told, so that's available when there is in fact a claim asserted?

LaCroix: Pat, you put your finger on what is a perennial problem not just in D&O, but it's sort of endemic to the whole insurance space. On the underwriting side, they want to do business and book premiums. You have a transaction-oriented mindset where people are eager to do what they need to do to get the business.

Obviously, on the claims side you have almost the reverse: people that are trying to control lost costs. They have no incentive to be customer-friendly. You're right, sometimes you're in a position where you need to be able to show in the claims context things that were said or things that happened in the underwriting context. You hope that in the process, outside counsel and insurance advisors involved are memorializing those conversations and changes so that the record can be shown later.

One practical thing that I think is important and something the carriers themselves should be encouraging is getting claims personnel more involved on the transaction side. On the reverse side, this is something that we as outside advisors can help assist with, to get the underwriters involved when there are problems on the claims side. From time to time we'll do that when we're having issues getting responses. When you're not getting the answers you need consistent with the requirements of the claim itself, you need something to encourage the process a little bit.

You know behind your question is a problem. I was on the insurance company management side myself, and we didn't do what most insurance companies do. Most insurance companies have their underwriters on one floor and their claims people on a different floor. We didn't do that. We had them all mixed together so

that they could talk to each other about their experiences and see themselves as partners in the same process. Not every carrier is going to do that. It's probably a pity because it does lead to exactly the kind of problems that your question suggested.

Villareal: Thank you.

Bentz: One other important trend, and as a person who works at a big law firm it's probably not the most popular, but one of the things that many carriers have been bringing up is the increase in defense costs and plaintiffs' fee awards. We've seen a huge amount of increase in the last couple of years. One carrier estimated that there's been a 58% increase in their overall legal spending on D&O claims in the last three years.

That's something else that the carriers are really trying to figure out, and how to deal with it in an effective way that still gives clients the ability to use the law firms that they want and who are top notch and who can handle the claims efficiently.

LaCroix: You know it's funny Tom, that's always talked about and is a problem for the insurers. The truth is, it's a top problem for policyholders too, because defense costs erode the limits of liability. To me that is the path to the solution: getting the carriers and the policyholders on the same page and understanding it's in everyone's interest to control defense costs, and not just a quirky irritant that the insurers are insisting on.

Bentz: Yes.

McLaughlin: Including the plaintiffs' lawyers.

Bentz: Yes, a lot of that is driven by discovery. Discovery has become a significant spend on nearly every case with e-discovery being a significant portion of that. It's no longer just producing a banker's box of documents, you have to get everyone's cell phones, computers, and every email that's been sent and received. It very quickly becomes rooms and rooms full of documents. Someone, or AI,

then must go through all those documents to see what's relevant and what's not. So it becomes a very quick spend.

McLaughlin: Right, which also leads to there being certain key inflection points in a case where a settlement becomes a realistic prospect. Most people will want to take a run at a motion to dismiss and not talk settlement until then. If the motion's denied, that's an opportunity. You're off to class certification discovery. The plaintiffs will often reach out at that point.

Once a class is granted things get a little trickier, because the plaintiffs are now sitting pretty unless you have a reasonably good interlocutory appeal to go through with. Then the case starts to get expensive, because you're getting into expert discovery and all that. The opportunity to settle prior to summary judgment is another inflection point, and that's really the last one before trial.

I just think it requires a lot of moving parts to coalesce, because the plaintiffs need to be reasonable at the same time the defense side and the jurors are being reasonable and that can be tricky, but it's something to always keep your finger on the pulse of.

Villareal: We don't have enough time to go into all the vagaries that affect this topic, but having done a lot of work for distressed companies, including in Chapter 11, the magnitude of defense costs and how those are impacting the available limits for a company that is in distress end up creating a whole host of other issues. And the uncertainty relating to those issues is typically borne by the directors and officers of the policyholder.

How D&O Insurance Fits in With Other Protections

McLaughlin: The old saw that directors and officers are supported by a three-legged stool remains as true as ever. The other two legs past insurance are the availability of an exculpatory charter provision in which the shareholders affirm that their directors won't be liable for money damages arising from breaches of their fiduciary duty of care.

That's a very helpful provision to have and presumably every corporation that has a representative listening today should have that. It must obviously be included in the certificate and it also obviously doesn't protect a director from claims relating to breaches of the duty of loyalty or acts not taken in good faith. Importantly it does not, unfortunately, extend to officers. So the plaintiffs are able to hook in an officer on a case and there's no real protection there.

The other big component of protection, of course, is indemnification. That could be a whole separate conversation, but in short, Delaware law and elsewhere requires that a corporation provide mandatory indemnification to a director or officer who is successful on the merits or otherwise in defending a claim. Related to that, of course, we're talking about this more than outside of settlement. The main thing that we're talking about is advancement of defense costs. Advancement to directors and officers is entirely permissive under Delaware law and elsewhere. A company can provide mandatory, permissive, or no advancement rights at all.

In the era we live in, I'm seeing everyone have bylaws and/or individual agreements that provide for mandatory advancement rights to directors, and frequently to officers. The other people that are out there who you need to be aware of are general employees, because the corporation can, if it wants to, grant mandatory advancement and/or indemnification to employees and agents - or they can be silent on it or they can leave it to the discretion of the corporation.

Historically, some companies provided mandatory indemnification and advancement to employees and agents. I think the more recent trend is to grant only permissive indemnification and advancement to employees and agents, even though arguably they're the people who may need it the most. They're not protected by the business judgment rule and may be looking to the company more for a financial backstop. Pat, do you want to comment?

Villareal: Sure. In my experience, directors and officers often don't look to indemnification the way they should. They usually aren't encouraged by the carriers to consider it. The fact is, unless you have a company which is on the verge of or might get into financial distress, your first line of protection as a

director or officer is the wherewithal provided by the assets of the company – and that's often much larger than what insurance you may have available.

As Joe said, you really do need to think about it in the context of D&O insurance and make the two fit together. In other words, see whether your indemnification bylaws are giving the most protection. I always advise an indemnification agreement. You're never going to need it until you're no longer friendly with the company. That type of agreement can give you much more protection in terms of process, as well as the amount of coverage and indemnification you might receive.

Then look at what insurance doesn't cover, or may not cover, and try to get the indemnification to fill in those gaps - or at least identify those. I can't tell you how many times I have represented directors and officers in Delaware derivative cases when it's the first time they've heard that under Delaware law, if there is a judgment against them there is a real likelihood that the D&O insurance is not going to be able to respond and that their personal assets may be at stake.

The policyholders under D&O insurance need to understand beforehand where they are not protected no matter how much insurance you buy. I believe indemnification can be a real tool to provide a much more fulsome protection for directors and officers and their assets than simply D&O insurance - and an agreement that expands that protection as far as Delaware law permits is a much better buy.

Dunshee: Joe had mentioned some of the distinctions between officers and directors. Tom could you talk about who should and shouldn't be covered in the insurance context?

Who Should & Shouldn't Be Covered

Bentz: Sure. I think that's a nice transition, because typically what we say when we look at the policies is we want to make sure you're covering the directors and officers at the parent company level. Occasionally, we see coverage at the operating company level and that can cause problems with missing directors and officers up the chain, because the insurance coverage flows downward, not

upward. You want to make sure that you have coverage for the right folks at the highest levels of the company.

When it comes to who you want covered, the policy will automatically cover "directors and officers," but it doesn't define those terms. For companies that have folks that need coverage but may not be considered an officer, we can certainly add those folks onto the policy. Underwriters typically do not care if you want to add someone to the coverage as long as you're willing to provide the indemnification required by Part B of the insurance contract. Insurers generally do not mind adding individuals to the coverage because, typically, the real risk is with the high-level officers and the board of directors.

It's rare in my experience that shareholders - or even in the private company context, others - bring an action against an individual who doesn't qualify as a director or officer. There are a couple of exceptions to that rule. About fifteen years ago there was some question about whether general counsel or in-house counsel would be covered. That's been addressed by nearly every policy that I've seen in the last 10 years plus.

Some companies choose to add individuals who have a high public profile even though they are not necessarily an officer. For example, a marketing person or a communications director may benefit from the coverage. Again, this typically is not a concern from the insurer's perspective. If you have someone that you want to get added on, in my experience the underwriters are generally happy to do so at no additional cost.

Villareal: Tom, let me ask you a question. At times I've found that perhaps not having a definition of officer may work in a company's interest. If it's undefined, it's easier to make the case that someone is covered rather than attempting to cover the whole host of individuals that might fall within that category.

Bentz: I generally prefer to have some certainty on this point. If a person has any type of title or may be subject to higher risk of a lawsuit, it is generally my preference to add the person to the policy to avoid any doubt regarding coverage. That said, I just haven't seen many claims against folks at the lower levels – it just has not been a real issue for the insureds I work with.

I also think it's important to point out that adding lower level employees means that you are stretching your limit to folks that the directors and officers may not want to share their limit with. That's the other side of this argument. Do you really want to have a director sharing limits with a low-level employee who did something to get sued? Remember these are folks that you typically don't even have to indemnify pursuant to the company bylaws. Adding them to the insurance policy means that you have to provide that indemnification for the insurance to respond. It's worth pointing out too that, in private company policies, employees are typically covered if there's also a director officer named in the lawsuit. In fact, some policies are even broader than that, they go down to independent contractors, leased employees and temporary employees.

These policies are quite broad when it comes to that. Quite frankly, it is because there are so few claims that involve those lower level employees that it's an easy add on and may be more cosmetic than it is anything else.

What Constitutes a Claim

LaCroix: It's funny that at this point in the conversation we should be talking about one of the most basic parts of the whole insurance premise. These are claims-made policies, so you must have a claim to be covered. The definition of claim is critically important because that's going to help identify whether or not what's taking place is or is not a claim.

The definition of claim has expanded over the years. The typical D&O policy definition of claim now is much longer and more comprehensive than 20 or 30 years ago. It now refers not only to lawsuits, civil proceedings and criminal proceedings, but arbitrations, mediations, alternative dispute resolution mechanisms. In public company policies, you'll see reference to Wells notices, and references to requests to toll the statute of limitations. Yet, as it's gotten broader, disputes still arise.

In fact, the dispute of whether or not something is a claim is unfortunately frequent. These days, the battlefield issues are topics such as whether or not a subpoena is a claim. While I do think there's a consensus emerging that in many

D&O policies a subpoena is a claim, you still may not get over the hurdle to coverage because you still need to establish there's an actual or alleged wrongful act. These are liability policies, so there has to be something that's the basis of an assertion of liability, and it's not alone sufficient to show that it's a claim.

Another battleground issue these days relates to investigations. That is a topic that's far beyond the scope of our webcast and we could do a whole session just on that question. I will say the policies these days are more favorable on that issue than in the past, but we are still fighting issues about entity investigative costs for different kinds of investigations. We're probably all accustomed to thinking that the broad definition of claim is something that is in the policyholder's favor. Most ways we think about this question it is in the policyholder's favor, but it creates some potential problems that sometimes comes back to bite the policyholder.

Sometimes policyholders, even very sophisticated policyholders, don't recognize that under the very broad definition of claims, something that's happened represents a claim under their D&O policy. It's only later when whatever it is blows up to the point where they need the involvement of the insurance carrier that they realize the carrier is going to take the position the claim was made at some prior time, perhaps in a prior policy period, or that there may be some type of late notice issue because that demand letter or that administrative proceeding was not recognized at the time it came in as a claim.

That's obviously an area where we as the outside advisors must be proactive to try and inform our policyholders so they know about this potential threat. Make sure they're fully informed about the kinds of things that will represent claims. I will say no matter how much I have that conversation, I still get phone calls because somebody needs $2 million to settle a claim they didn't think was going to be a big one and no, they never noticed the carrier and yes, it was in a prior policy period.

It's a funny thing because we're so used to thinking of an expanded claim definition as undeniably a good thing in the policyholder's favor, but it does create those important potential side issues that have to be watched as well.

Villareal: Kevin, this is going to sound like a cynical question, but in terms of coverage for investigations, many of the policies today as I understand it, continue

to restrict payment of the costs of those investigations until the SEC has indicated that the company is a target or will be a defendant.

LaCroix: Yes, usually the distinction is drawn between formal and informal investigations, but you're right.

Villareal: Yes, formal. But the problem is that almost all the companies or an individual's defense costs are spent before that point. In other words, that's almost the very last step that the SEC takes which is to formally identify its target.

LaCroix: That could be up to millions of dollars can be spent, right?

Villareal: Exactly. I've always thought that isn't really a coverage issue, it's basically a line that the carriers are drawing in the sand saying, "if we move that line, it costs too much."

LaCroix: Well it's both a pragmatic issue and a theoretical issue. The pragmatic issue is on the part that you just mentioned. The carriers are just drawing a line in the sand. I think there is some of that, they don't want to cover it because they are so expensive, and they don't know how to price it.

On the theoretical side, these are claims-made policies. At what point does something become a claim, with liability alleged against an insured person? It's always hard to know. And as I'm often called upon to say, the policy covers loss arising from a claim for allegations of a wrongful act, it doesn't cover just loss. You must have all components. Loss in the form of attorney's fees alone is not sufficient to trigger coverage, so you can have loss that is not necessarily covered.

I will say, Pat, that many public company policies these days have been augmented by so called pre-claim inquiry coverage, which covers requests to individuals to voluntarily provide testimony or documents in advance of the event that in the past might have constituted a claim.

There is that extension as well, but that's again only for the individual so it's not going to extend the vast bulk of the entity investigative costs that are incurred before a matter becomes formal.

Bentz: I also think it's important to remember that we always say these policies are designed to protect the individual assets of the directors and officers. It's sometimes lost when we talk about the entity having these expenses related to an investigation. We want to have those covered. We want them covered unless and until there's not enough limit to cover the individual directors and officers. Sometimes that distinction gets lost in the conversation about why the company's expenses aren't covered. There are questions about why separate policies are needed and people forget the main reason for having the policies.

It's just a hard conversation after the losses come in to say to the company, "you really didn't want that covered in the first place" or "you should have bought more limit if you wanted to have that covered." There's another component to this that, as Kevin was pointing out, philosophically may be a little bit different.

LaCroix: Tom, I agree with you and think the tension point is that the general counsel or CFO looking at the bill aren't really interested in the theory. All they know is they think it should be covered. There's a lot of that not just in this context but in other contexts with an expectation on buyers that certain entity-type costs are going to be covered.

At some point down the road we could move to a point where there are separate entity liability policies to address in some sidecar but aggregate way those entity liability exposures while preserving the core protection the policy is supposed to provide - which is the protection for the insured individual directors and officers.

Villareal: I guess my experience has been that the costs that are borne by the company in terms of the cost of discovery, especially in an SEC investigation, tend to be enormous. Those costs are being borne by the company - usually not by the individuals - and therefore the company is typically the one that is most impacted by these investigations.

LaCroix: The industry has struggled for years to address that very problem. There are solutions out there that are not very good. Going back to where we started Pat, part of it is exactly what you suspected. The carriers are really concerned about going beyond that line in the sand, because they do know how

costly this is. If they were honest, they would admit they don't know how to price it either.

Villareal: Right.

Typical Policy Exclusions

LaCroix: You know earlier when Joe was talking he mentioned a couple exclusions that frequently come into play. He mentioned the insured versus insured exclusion and anybody that has spent even a little bit of time with the D&O claims is familiar with many of these.

It's important to step back and know that there are different sets of exclusions that are there for different purposes. There's the exclusions that are there just to make sure that the claim goes in the right policy, those are the prior notice or the prior and pending litigation exclusions. That's just to make sure claims go in the right policy. Then there are the claims to make sure they go in the right bucket and it's the right kind of policy. D&O policy will have a bodily injury and property damage exclusion because bodily injury and property damage should go under the GL policy and not under the D&O policy.

There are the exclusions that protect you. You could call it moral hazard or things that arguably should not be insured such as fraudulent misconduct or improper compensation. Finally, there are the exclusions that cover things that insurers just don't want to insure. An example of that is the insured versus insured exclusion, and there are others. The insured versus insured exclusion is there because the carriers don't want to take on the risk of collusive claims. They don't want to take the risk of corporate infighting. These days, the insured versus insured exclusion is standard, there's really no way of avoiding it - but there certainly are many coverage carve outs.

One final bucket that's worth mentioning is that some D&O policies, because so many of these policies are customized documents, there can be exclusions that are put in there precisely for a specific insured - whether it's a particular factual circumstance and specific to that company. It may be a prior claim or issues having to do with a prior corporate transaction. Perhaps the company had very public bad

news and the marketplace is just not interested in taking on the risk of that bad news. The only coverage that's available is coverage that comes with excluding that very high-profile risk that everybody knows about.

You really do need to read the exclusions in every policy. Although there are a standard set of exclusions they aren't necessarily standard, and there are some exclusions that vary widely between policies and those variations can really affect the availability of coverage or not. So, clearly a critically important part of the process that Pat was talking about earlier when you're putting the coverage in place that's the time to address these. It is the time when good advisors can make a significant difference, and coverage is available in the event there subsequently is a claim.

How to Improve a D&O Policy – and Negotiation Tips

Bentz: That's a good time to move into the last couple of categories to talk about how to improve a policy and some tips on negotiating the policies. I guess one of the things I would say as a general observation is if you are happy with the off-the-shelf contract, you probably have not spent enough time with the contract.

D&O policies are highly negotiable. And another quirk of D&O contract law is that typically there's no additional premium charge for a lot of these enhancements. It's simply whether you know to ask for them. If you ask for them you get them, if you don't you won't. I've had negotiations where we've added 50 or more enhancements to a policy for no additional premium. While any one of these may not ever come into play, if it does, it can be significant, as Kevin pointed out.

In fact, I've seen a recent trend in both cyber liability and D&O liability policies where risk managers are more and more being called to task for not having enhancements which are available in the marketplace. There was an interesting statistic saying that the average tenure of a chief information security officer is less than 17 months now. That trend is flowing over to risk managers who don't fully understand the coverage and are not asking for a particular enhancement. And because they don't have that enhancement, they can end up not having coverage for a claim.

In one recent example, we recommended to a client that it add a request for a tolling agreement to the definition of a claim. For various reasons the client did not end up making the change. And, of course, shortly thereafter they had a request for a tolling agreement from a government agency. However, since the change was not made, the tolling agreement did not fall within the definition of claim and the insurer did not provide coverage. Had the client made the recommended change, there would have been no question that the expenses would have been covered. That simple change would have benefited the company to the tune of about $6.5 million. The point being that little changes may not individually seem all that significant, but they can have a real impact on the coverage.

A couple of other specific things that you want to look at include the definition of "application." I don't think enough time is given to this important definition. A lot of people fill out an application form without a whole lot of thought or checking to make sure that the information that they're providing is 100% accurate. That can absolutely lead to a voiding of the coverage and even a rescission of the policy. These applications are long, and they're complicated. Often, they have complex questions and a yes or no box that you're supposed to check. It's not always easy to check just a yes or no box.

It's important that you not only look at the application and fill it out accurately, but that you negotiate on questions where it may not be clear from just a simple yes or no.

Villareal: Tom, I'll echo your comments on this, because I've had several situations where although the application form and the policy itself supposes that each director and officer has been asked whether they have information about potential claims, there's been no requests made to any of the officers or directors to underlie that representation that is in almost all the policies.

It's important to look at what's being asked for in the application and make sure you've got records to show that you did what it is the policy is presuming. Otherwise, you're handing the insurance company a ready-made argument that there's either no coverage or that the policy is void.

Bentz: Another area that is often overlooked is the definitions. I used to joke several years ago, probably 15 years ago or more, when Side A policies started first coming out, there was a carrier that put out a policy with essentially no exclusions. The reason that they had no exclusions was because they made their definitions very restrictive. That can be worse for a client than having exclusions in the policy. Partly because the burden of proof and the standard of proof is different for an exclusion than it is for a definition or term or condition.

I think it's important to know what the definitions are and make sure that they do what you think they're going to do, and not do more in terms of excluding coverage by using the definition section.

Villareal: I'd also add that the goal should be that you are eliminating any potential ambiguity in the wording or if there is ambiguity, that it's in your favor. What you want to do is limit any instances where ambiguity is going to give an insurer (i.e., a claims department) the ability to undercut your claim.

Bentz: Yes, I always say you buy this policy as your worst-case scenario. This is the backstop. When everything's going wrong, you want this policy to kick in. You don't want to buy a lawsuit. You don't want to have a fight and spend precious resources figuring out whether or not there's coverage. You want certainty in your definitions.

We really do try to get clarity on these, and that's in the best interests of the client. The same with the exclusions. That's another area that people don't spend a lot of time on. I represented a logistics company and all they did was move product from point A to point B. They had an exclusion on their policy that said, if you lose the shipment or if it's damaged, or there is a delay in shipment and that causes damages to the recipient, there's no coverage.

They purchased this policy, spending hundreds of thousands of dollars for many years, and there was essentially no coverage being provided. Quite frankly, the only three things they could have ever done to a product is either lose it, damage it or delay the shipment. To think that there could be an exclusion on the policy for that was almost comical. I mean it was comical except for the fact they had paid for that policy for so many years.

A couple of final things. The notice provision is important to look at, making sure you limit the notice to the appropriate people at the appropriate level. And the duty to defend provision - whether the company has a duty to defend or the insurer has the duty to defend, and how that may impact the coverage.

Dunshee: Joe, do you have any final tips on either negotiating or handling claims?

Tips on Handling Claims

McLaughlin: Yes, just briefly. I think it really comes down to the fact like a wise person once said that, so many disagreements are avoidable because they arise simply from the fact that people feel they weren't consulted about a particular matter beforehand. That's no less true of insurers than your family and friends.

So, to begin, attorneys should press their clients to make sure that timely notice of the claim is provided to the carriers including all potentially involved levels of insurance. As Kevin adverted to a moment ago, you know insurers have contract rights and they will enforce them. Among those rights is not to be on the hook for expenses incurred before notice of the claim is provided.

In a big SEC investigation, for example, that can pile up very quickly. It's important to have the insurers aware that you know counsel has been brought on and they're approved. That advice has particular force when it comes to settlements entered into before notice is provided. That can create a complete disaster. Defense counsel obviously should be prepared to provide a budget of defense costs through a motion to dismiss, through discovery, summary judgment, trial and appeal all those things.

The final important point, counsel should really familiarize themselves with the billing guidelines, because even though they're not a contract, the insurers approach them as if they are. It's important to make sure that every lawyer working on the matter is familiar with them, because insurers obviously don't have the same view as defense counsel for what should be reimbursed. Things like time in firm conferences, multiple people working on the same task - even if it's a major appellate brief – can be problems.

Basically, up front and frank dialogue between the counsel and carrier are essential to avoiding misunderstandings or disagreements before they get too out of control.

Villareal: I also suggest putting everything in writing. Put it in an email or a letter, because if it's not in writing it didn't happen as far as the insurance companies are concerned. Some of that is practical, simply because they have so many claims, but the fact is you need to memorialize every conversation with them, because it's your best chance of being able to persuade them that your claims should be covered.

Bentz: Yes, you always look at the insurance company as your friend until they're no longer your friend. I think you want to work with them and keep them on your team. In fact, we've been able to use insurance companies' experience in many cases to our benefit as defense counsel.

They see a lot more cases than any one law firm will, they've worked with the law firms, the plaintiffs' firms a lot more than any one law firm will, and they can be a real asset and a real benefit to your clients if you look at them that way. Obviously, if things go sideways with coverage that's a different situation, but I would like to end by saying that the insurance company is your friend until they're no longer your friend.

Villareal: I guess having been on the side of the policyholders, there's an inherent conflict in often trying to be friends. It's in the interest of your clients, you're right, if you can in fact be friends. I think that line is often hard to walk sometimes and once you go to war with them – and I'm not talking about litigation I'm talking about pushing – they have long institutional memories and therefore you know when you're involved with that insurer again what the response is going to be. So, just be ready to fight if you have to.

Dunshee: That's good insight. Thanks so much everybody, that concludes our webcast today. A really helpful overview and tips from all of our panelists.