D&O

WHAT TO KNOW

A GUIDE TO THE EVOLUTION OF DIRECTORS AND OFFICERS INSURANCE FROM 1933 TO THE PRESENT

A PARTNERRE E-BOOK

PartnerRe

This paper provides an historical overview of the evolution of Directors and Officers insurance (D&O) in the U.S. market since 1933, taking you through the relevant acts, key court rulings, ups and downs of the market, as well as the evolving coverage features of D&O insurance. This paper is intended for the insurance professional as an additional introduction to this increasingly relevant and ever evolving management liability product. Should there be a need to develop additional information regarding a specific section, all of the research articles and additional citations can be found at the end of this paper.

TABLE OF CONTENTS

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THE ADVENTURE BEGINS

Prior to 1933, there was no need for D&O, largely due to the lack of regulations surrounding the sale of securities and the lack of accountability placed on directors and officers. That all started to change after the stock market crash of 1929 triggered the Great Depression. As a result, several important acts were passed that increased financial regulation and made companies more responsible towards their shareholders and investors. While these acts did not initially generate a large demand for the D&O product, they have implications for directors and officers to this day.

The Securities Act of 1933 and The Securities and Exchange Act of 1934

The Securities Act of 1933 (The Act) was enacted by Congress in an attempt to eliminate some of the causes of the Great Depression. The Act is also known as the "truth in securities" law. The Act has two basic objectives:

1. To ensure that potential investors receive the relevant financial, and all other significant information concerning securities being offered for public sale, and
2. To prohibit deceit, misrepresentations, and other fraud in the sale of securities.[1]

In order to achieve these stated objectives, the Act requires the registration of companies' securities. The registration process requires that the information provided is accurate; however, the Securities and Exchange Commission (SEC, which was created under the 1934 Act) does not guarantee its accuracy. It is important to note that if investors suffer losses on securities found to contain inaccurate or incomplete information, investors do have substantial rights of recovery against the company (including its directors and officers) and the distributors of the securities.

Unless subject to an exemption, securities offered or sold to the public in the U.S. must be registered by filing a registration statement with the SEC. Generally, registration statements require the following information:

- a description of the company's properties and business
- a description of the security offered for sale
- information regarding the management of the company, and
- financial statements certified by independent accountants.[2]

This information is then compiled into a prospectus, which is the document through which an issuer's securities are marketed to a potential investor.

The Securities Act of 1933 does not permit the SEC to bring an enforcement action on behalf of an individual investor; however, individual investors are permitted to bring civil actions under several of its sections as noted below:

Section 5 and Section 12(a)(1) allow purchasers (investors) to sue issuers for offering or selling a non-exempt security without registering it. The purchaser may fully recover the investment (rescission) with interest, or damages if the investor sold the securities for less than the purchase price.

Section 11 makes issuers (the company and its directors and officers) liable for registration statements that contain untrue or misleading statements. The investor retains the right to bring suit under Section 11 even if the purchase was made in a secondary market. Damages are limited to the difference between the purchase price and the value of the securities at the time of the suit.

Section 12(a)(2) creates liability for any person who offers or sells a security through a prospectus or an oral communication containing a material misstatement or omission. The seller can be liable for rescission or damages. Investors bringing a claim under this section can only recover from the sellers.

Section 15 makes "control persons" or persons who "control" defendants jointly and severally liable under Sections 11 & 12. Holding "control persons" jointly and severally liable aides in an investor's ability to recoup losses after a defendant's insolvency.

Section 17(a) provides for liability for fraudulent sales of securities.[3]

D&O What to Know

Following in the wake of the 1933 Act, Congress passed the Securities Exchange Act of 1934 with the purpose of regulating sales that take place in the secondary market. The 1934 Act requires that pertinent information be available to investors. It also provides for direct regulation of the stock exchanges and the participants in the secondary market, such as industry associations, brokers, and stock issuers.[4]

Perhaps the most enduring aspects of the 1934 Act, aside from the formation of the SEC, are the enhanced protections afforded to investors under sections 10(b) and 10(b)(5), which provide recourse for private investors who believe they have been defrauded.

Sections 10(b) and 10(b)(5) of the 1934 Act are the primary statutory "weapons" against fraud.[5] Section 10(b) is the antifraud provision of the Act, while 10(b)(5) creates liability for any misstatement or omission of material fact. Courts have held that the scope of liability under section 10(b)(5) is broad, and it has been used against a wide range of behaviors from misleading statements in company filings and documents to insider trading and market manipulation cases. It is the breadth of sections 10(b) and 10(b)(5), coupled with the fact that individual investors have a cause of action, that make 10(b)(5) suits very common. You will note throughout this paper that sections 10(b) and 10(b)(5) are the basis for several types of lawsuits against directors and officers.

A critical component of a successful 10(b) or 10(b)(5) suit is that the plaintiff alleges and proves scienter. Scienter is a legal term that refers to intent or knowledge of wrongdoing.[6] As relates to 10(b) and 10(b)(5) suits, the plaintiff must allege and prove that the defendants either intended to defraud or withhold material facts, or actually knew that their behavior was fraudulent and actively withheld material information.

The Beginning of D&O Insurance

D&O was introduced by the London insurance market in the late 1930s in response to the increase in securities regulation. The London form consisted of two separate policies; one covering the liability of individual directors, and the other corporate reimbursement of directors and officers. However, interest in purchasing this type of insurance did not develop until 1939, when in New York Dock Co. v. McCollum, a New York State Supreme Court held that the corporation could not reimburse its directors even when they had in fact successfully defended against a shareholder derivative action.[7]

The idea that a corporation's directors would be personally responsible for dollars spent defending them, even when they prevailed in court, was a wakeup call for many boardrooms.

As a result of this decision, several states began to enact corporate indemnification statutes.[8] In 1967, the State of Delaware passed new indemnification laws specifically authorizing corporations to purchase D&O liability insurance; by 1973, 25 other states had followed Delaware's lead.[9] Until this time, it was unclear if a corporation could legally pay the cost of the individual liability of a director or officer under the corporate indemnification section of the D&O policy.

Despite its earlier introduction, real interest in D&O insurance did not increase until the late 1960s. In 1968, a court decision, Escott v. Barchris Const. Corp, brought to light the potential personal liability faced by directors and officers.

D&O What to Know

The relevant outcome of the case was that all but one of the inside directors were held personally liable under Section 11 of the 1933 Act for issuing registration statements containing omissions and misrepresentations. The court found that there was no evidence of fraud, but the directors were found to have had reasons to believe the documents contained incorrect information. In addition, an outside director was found liable when he failed to detect the misrepresentations. Because the corporation was insolvent, the directors were forced to pay defense expenses and liability awards out of their own pockets without the benefit of corporate indemnification.[10]

By the early 1970s roughly 70% of public companies were buying D&O.[11] In 1976 the London market introduced a policy form called Llando No. 1, which was designed to clarify some of the difficult language of earlier policies.[12] The form combined what had been a separate policy format into a single contract containing two insuring agreements. These two insuring agreements are known as Side A and Side B coverage:

Side A covers the individual directors and officers for loss (including defense costs), when indemnification by the company is not available. Indemnification is typically not available when the company is bankrupt or when the company may be legally prohibited from indemnifying its D's and O's, i.e. shareholder derivative suits. Side A has no self-insured retention (SIR) or deductible associated with its coverage.

Side B is designed to cover a corporation's obligation to indemnify its directors and officers. Side B typically is subject to a SIR or deductible.[13]

THE TURBULENT EIGHTIES

The 1980s was a turbulent time for the D&O marketplace. By this time, almost all publicly traded companies purchased D&O insurance. In the early eighties, the economy was still suffering an economic hangover from the previous decade. As the economy picked up steam in the mid-1980s, mergers and acquisitions were commonplace across industries. There was an influx of D&O claims from both bankruptcies in the early eighties, as well as from mergers and acquisitions in the late-1980s. In addition to the increase in claims activity, both the average cost of paid claims and the average cost of defense expenses increased by 50% and 35% respectively.[14]

Similar to the London form introduced in the seventies, during the mid to late-1980s, U.S. insurance companies began issuing a singular policy with both side A and side B insuring clauses. A leading domestic carrier took advantage of merging the two policies together to allocate certain policy exclusions to each particular insuring clause, thus in many ways enhancing coverage. At the time, this was very innovative and later became the standard we have today.[15]

Also, during this time, a stand-alone Side A policy was introduced. Corporate Officers & Directors Assurance Ltd. (CODA) was formed by 53 U.S. corporations to provide a solution to the lack of D&O insurance for personal asset protection.[16] CODA offered both primary and excess Difference in Conditions (DIC) coverage on both one and three-year annual aggregate policies with guaranteed renewal terms based on formula rating.[17] This policy remains in existence today.

In 1985, the Delaware Supreme Court ruled in Smith v. Van Gorkom, that outside directors and officers can be found equally liable as inside directors, suggesting a broader scope of potential liability than had previously been assumed.[18] The Smith v. Van Gorkom case is also known as the “Trans Union” case. The importance of this case is the impact on the director’s duty of care, and the limitations to the use of the business judgment rule as protection for directors and officers. In the wake of this ruling, Delaware adopted the General Corporation Law, which with shareholder approval, allowed charter amendments to relieve directors from personal liability for breaches of duty of care. Additionally, fairness opinions, typically provided by investment banks, essentially became a legal requirement in any public merger.[19]

Trans Union had proposed a leveraged buy-out merger with Jay Pritzker for a proposed price of $55 per share at a time when the stock was trading at $37.25 per share. However, the $55 share price was determined by Van Gorkom, the CEO and Chairman of Trans Union, and not based on any actual facts or calculations other than a consultation with the CFO. The board approved the merger without seeking any expert advice, and in doing so, breached its duty of care.[20]

The directors were personally sued, and agreed to pay $23.5 million.[21] Approximately $10 million of the settlement was covered by insurance and Jay Pritzker paid the remainder even though he was not part of the lawsuit. Pritzker paid as he did not agree with the court and some of the defendants were unable to pay the settlement.[22]

In 1988, the U.S. Supreme Court in Basic, Inc. v. Levinson, allowed for plaintiffs seeking class certification to not have to prove that each of the individual class members relied on the alleged misrepresentation, but rather that in an efficient marketplace, a company's share price reflects all publicly available information including the alleged misrepresentation, and that the plaintiff class members relied on the market price. This is also known as "fraud on the market theory". This theory made class certification easier for plaintiff attorneys.[23]

As a result of both the "Trans Union" and "Basic" cases, along with the stock market crash in 1987, the D&O insurance market had challenging results and a lack of reinsurance capacity.

By the mid to late-1980s, only the London market and two large domestic carriers were providing D&O.[24] Renewal premium increases were in excess of 200%. In addition to premium increases, deductibles increased dramatically, coverage became more restrictive, and policy limits were reduced. Many insureds in the financial institution and energy sectors were forced to create/join captives in order to obtain D&O coverage.[25]

D&O What to Know

An important exclusion introduced in the mid to late 1980s was the insured v. insured exclusion. Insurers added the insured v. insured exclusion to their D&O policies to address exposures caused by financial institutions collusively suing their own directors and officers for their allegedly poor business decisions in an attempt to recover their losses with proceeds from their D&O policies.[26]

An example of such a supposed "collusive" suit was when Bank of America sued six of its officers for millions of dollars in damages in Bank of America v. Powers. Bank of America blamed its directors and officers for their alleged bad decisions related to their mortgage-backed securities practice, and sought D&O insurance coverage for the claims. Although the case ultimately settled, the insurer argued that the D&O policy did not provide coverage because Bank of America had registered its claims in an effort to negate its capital losses by suing its own directors and officers in order to gain access to their insurance coverage.[27]

THE ROARING NINETIES

As the economy expanded in the 1990s, restrictive terms and conditions, and increasing rates attracted capacity back into the market.

Simultaneously, D&O insurers began to grapple with the issue of allocation in the settlement of lawsuits. Previously, D&O had only provided two coverages: Side A, which provided indemnification for the directors and officers themselves, and Side B, which was designed to reimburse the corporation for its indemnification of the directors and officers. What was lacking was coverage for the corporation itself. The judicial court case that directly led to the introduction of Entity Coverage (Side C) was first litigated in 1990, and subsequently appealed to the U.S. Court of Appeals, Ninth Circuit for adjudication in April 1995. The plaintiff in the case was Nordstrom, Inc., and the defendant was Chubb Insurance Company.

The underlying suit was the result of an alleged fraudulent concealment from investors of a companywide Nordstrom policy to have employees work "off the clock".[28] Following an investigation, Nordstrom was found to be in violation of wage laws and the next day, Nordstrom's stock fell 10%. The primary complaint was brought under section 10(b)(5) of the 1934 Exchange Act alleging fraud and deceit.

In April 1991, a settlement of $7.5 million was reached between the parties, and in May 1991, Chubb agreed that the settlement was reasonable. However, Chubb only agreed to fund half the settlement because it contended that the uninsured corporate entity was partially responsible for the loss. The controlling language in Nordstrom's D&O policy stated "...pay on behalf of the Insured Organization all Loss (emphasis added) for which the Insured Organization grants indemnification for each Insured Person..."[29] Nordstrom contended that based on this language, they should be indemnified for the full amount that they had become legally obligated to pay. The ultimate outcome of the Nordstrom decision was two-fold: 1) that, barring a formula for allocation in the controlling D&O policy, defendants could not rely on "larger benefit" or "reasonably related" as an allocation basis, and 2) insurers began to introduce Entity coverage in D&O polices, commonly known as Side C.

The outcome of Nordstrom v. Chubb compelled D&O insurers to address the issue of the uninsured entities effectively covered in joint settlement scenarios. By explicitly providing coverage for the formerly uninsured entity, insurers could expressly charge for the coverage that they were surreptitiously providing to the uninsured entity, as well as bypass the allocation concerns that were raised by the Nordstrom decision.

The solution was to provide Side C coverage. The initial Side C policy language was broad in its intent to indemnify the company for any prevailing securities litigation derived from offering the company's shares through a prospectus or in the secondary market. As the industry's understanding of exposures continued to evolve, the initial policy wordings were refined to eliminate coverage for privately offered shares, and further, limiting the coverage offered to an entity as only attributable to a "Corporate Act". A "Corporate Act" is typically defined as an alleged error or omission, misstatement, misleading statement, neglect, or breach of duty by the Company arising from or in consequence of a Securities Law Violation.[30]

Entity coverage grew rapidly in the marketplace in the late 1990s. It is estimated that less than 30 percent of U.S. corporate insureds purchased Entity (Side C) coverage in 1996, but by 2001, that number was estimated to have grown to 90 percent.[31]

It is important to note the distinction between public companies and private or non-profit companies as respects Entity coverage, since the coverage only responds to securities claims; the allocation process for claims that fall outside the scope of securities claims requires an explicit formula for the handling of defense costs in the policy.[32]

The introduction of Entity coverage raised several issues in the D&O marketplace. Despite the fact that many large corporations welcomed the coverage enhancement, many of the corporations retained a higher SIR for securities related claims. Therefore, by arguing for more and more claims to be labeled "Securities Claims", many companies wound up retaining a larger portion of these claims as a result of wanting to avoid the allocation related issues of non-securities claims actions.

Additionally, many insureds purchased policies with pre-negotiated allocation provisions dictating a 70% or 80% defense cost

allocation, whereas a "reasonably related" rule for defense costs in combination with a "larger settlement" rule for the insured would have provided for a 100% reimbursement.[33]

Several issues emerged in the wake of the introduction of Entity coverage, including the potential dilution of policy limits, whereby directors would have separate counsel than the entity, each drawing down on the same pool of defense dollars. Also, entities do not have the "due diligence" defense that is afforded to directors and officers. Therefore, by including entities in the settlement proceedings under the same policy limits, often a settlement was required to alleviate the exposure of the entity due to the lack of defenses available, diminishing the remaining policy limit capacity available to defend the directors and officers.[34]

In response to concerns about Entity coverage draining the resources allocated to defend the liability of directors and officers, many companies today look to purchase non-rescindable Independent Directors Liability (IDL) coverage. This coverage protects outside independent directors in the event of voidance of coverage related to Entity claims. In addition, the option exists to purchase separate Side A coverage that protects only the directors, not officers, and which serves to protect the independent directors as well. It is likely that we will continue to see the importance of Side A coverage increase, with the increasing presence of excess Side A or Side A (DIC) policies in the marketplace. This is to ensure that adequate protection is available for directors in the event of the dilution of policy limits related to the inclusion of Entity coverage.

Severability issues were also raised from the introduction of Entity coverage. The issue is that the mis-representation of one director may void coverage of other non-culpable directors. If the knowledge of one director making a false statement cannot be attributed to another director, the severability clause easily functions. However, with the introduction of Entity coverage, the question arose as to whose knowledge was to be attributed to the company for the purposes of Entity coverage?[35] This issue required the delineation of whose knowledge would also count towards the greater "knowledge" of the company when the Entity submitted statements that contain false information. Frequently, this issue is related to the knowledge of the senior management team versus outside independent directors. Without this delineation, it would be possible for Entity coverage to be voided alongside the coverage of the culpable directors and officers, leaving the Entity, non-culpable directors and officers, and independent directors with either no coverage or reduced limits of protection.

The Private Securities Litigation Reform Act of 1995

> **As the number of securities class actions brought against companies and their directors and officers increased, many in the business and political community felt that a large portion of these actions were frivolous.**

In response, the Private Securities Litigation Reform Act (PSLRA) was passed in 1995.

The PSLRA was designed to limit frivolous securities lawsuits. Prior to the PSLRA, plaintiffs could proceed with minimal evidence of fraud and then use pretrial discovery to seek further proof. This set a very low barrier to initiate litigation, which encouraged the filing of weak or entirely frivolous suits. Defending against these suits could be extremely costly, even when the charges were unfounded, so defendants often found it cheaper to settle than to litigate.

The PSLRA legislation was designed to address the process for certifying class action suits. It was also designed to promote responsible governance practices and plaintiff behavior, including:

encouraging voluntary disclosures, providing sanctions in certain instances for unsupported claims, limiting liability in proportion to responsibility, and enhancing audit requirements in order to better combat fraud. More specifically, the Act addresses several different aspects of the securities litigation process as follows:

Class Action Procedures

This portion of the act establishes the "most adequate plaintiff" as the lead plaintiff in a securities class action suit, which is typically the plaintiff with the largest financial interest in the case. The lead plaintiff will then select and retain counsel, as well as authorize the filing of the lawsuit. Prior to the introduction of these procedures, lawsuits were often filed by "professional plaintiffs" who may have purchased the stock in question expressly in order to participate in an action. This section of the PSLRA also requires the plaintiffs to disclose the action and/or any potential settlement to other potential injured parties in a widely circulated fashion. This portion of the Act also limits attorneys' fees to a "reasonable" percentage of the total award, as well as awards a separate amount for attorneys' costs so as not to further reduce the award to the injured parties.[36]

Projections

This section of the PSLRA offers a safe-harbor provision for forward looking statements that directors and officers may make in order to offer investors more meaningful information. The forward looking statements must be accompanied by "meaningful cautionary statements" that identify factors that could create a deviation in the actual results from the projections.

Pleading Standards

The Reform Act requires that the plaintiff identify each false or misleading statement and state why it is misleading, and delay all discovery until a motion to dismiss based on the adequacy of a complaint is ruled upon. The identified false or misleading statements must give rise to a "strong inference" that the defendants intended to deceive investors (scienter).[37] Prior to the introduction of these provisions, a plaintiff could file a lawsuit and then through the discovery process "fish" for fraudulent behavior.

Attorney's Fees

The PSLRA gives the victims of abusive lawsuits the opportunity to recover their attorney's fees.

Proportionate Liability

This section of the Act replaces joint and several liability with a "fair share" allocation of liability. There had been congressional concern that under joint and several liability, the pressure for innocent parties to settle meritless claims outweighed the risk of potentially exposing themselves to disproportionate liability.

Auditor Disclosure

Auditors would now be required to search for and report fraud to management.

The introduction of the PSLRA was initially successful, diminishing the number of Securities Class Action suits (SCAs) from 220 in 1994 to 122 in 1996.[38]

The 1990s was a very active period for developing legislation, case law and enhancing coverage and terms in D&O insurance policies. Insurance companies became increasingly attracted to the D&O marketplace. The increase in D&O capacity logically led to broader terms and cheaper prices in the late 1990s. Premium rates were reduced approximately 50% from 1996 to 2001.

In addition to the softening rate environment, the D&O policy began to change. Language such as "final adjudication" became more standard and severability provisions evolved. Also, the policy

coverage itself shifted to provide individual protection through Side A, and balance sheet protection through Sides B and C. Side A continued to cover directors and officers for non-indemnifiable loss such as derivative lawsuits and insolvency cases without insurance policy retention. Side B coverage offered reimbursement to the directors and officers for indemnifiable loss by the entity; and Side C offered coverage to the corporate entity for securities claims only. For sides B and C, retentions applied, and were typically for different amounts.

Insurers started to offer three-year single aggregate policy terms at discounted prices at the same time as corporate valuations began to dramatically rise.[39] What followed was a perfect storm of loss activity and poor results.

THE PERFECT STORM

Following the immediate reduction in filed SCA lawsuits, in 1996 as a result of the passage of the PSLRA, SCA's began to increase dramatically in the late 1990s and early 2000s.

There were 167 suits filed in 1997 and 483 suits in 2001, a 190% increase. In addition to increasing frequency, the severity of claims increased as settlement values increased by an average of 150% from 1996 to 2001. In dollar terms, the average value of a settlement increased from $7 million in 1996 to $17.2 million in 2001.[40]

A leading cause of the increase in the frequency and severity of claims settlements was a large increase in the number of corporate accounting restatements. The restatements stemmed from accounting rules that did not keep pace with new financial instruments. A more active SEC and larger corporate valuations equated to larger losses. Also, insurance carriers now bore 100% of settlement costs due to policy language evolution. In addition, the internet boom (tech bubble) in the late-1990s led to drastically overvalued Initial Public Offerings (IPOs). The combination of broader policy language, increased insurance capacity, and lower insurance rates placed the D&O insurance industry to be in a precarious economic state. It is estimated that inclusive of defense costs, the total volume of D&O losses increased from $427 million in 1996 to $5.6 billion by 2001.[41]

The burst of the internet bubble exposed significantly overvalued IPOs that cost investors billions. One of the main culprits of the overvalued IPOs was a practice known as IPO laddering, where in exchange for a higher initial allocation of shares, a customer agrees to buy shares of an IPO at increasingly higher prices in the secondary market, artificially inflating the value of the securities.[42] By January 2001, an estimated 700-800 laddering lawsuits had been filed.[43]

With the D&O market already leveraged from overcapitalization coupled with insufficient rates and loose policy terms, the D&O market was at its most vulnerable.

Two major D&O carriers went insolvent, and the reinsurance market was overexposed to the D&O segment as insurers were reinsuring as much as 90% of their D&O limits. With the burst of the internet bubble, IPO laddering cases began to further increase pressure on D&O insurers. The subsequent collapse of Enron and WorldCom ultimately prompted the U.S. Government to take action in the form of the Sarbanes-Oxley Act of 2002.[44]

In February 2001, an article in Fortune magazine titled "Is Enron Overpriced" appeared.[45] Enron had been considered one of the most innovative energy companies in the world, essentially inventing the market for securitizing the flow of energy in the U.S. Despite the failure of many of Enron's expansion efforts, including forays into power plants, water supply, broadband, and internet video, Enron's revenues rose from $13.3 billion in 1996 to $100.8 billion in 2000.[46]

The ability to fraudulently show revenue growth in the wake of mounting losses was attributed to Enron's use of "mark-to-market" accounting that allowed Enron to price its futures contracts on unrealistic projections of the value of the underlying assets, translating to increased booked revenues. In addition, Enron was engaged in the use of Special Purpose Entities (SPEs) that were used to remove assets or debt from Enron's books. Problematically, the SPEs were being improperly accounted for by Enron and approved by Arthur Andersen, its outside accounting firm; in reality, the assets had not been moved off of Enron's books at all, ultimately leaving Enron on the hook for the losses that would follow.

On October 15, 2001, Enron was forced to deduct $1 billion from its third quarter earnings in the wake of the collapse of some of the SPEs.[47] This forced the stock price down into the $20s per share, from a high of around $90 in August 2000. In November 2001, Enron announced that essentially its entire financial performance since 1997 was a fallacy, having been largely a result of the SPEs that were now defunct. This announcement meant that Enron would have to restate their financials for prior years, wiping out $600 million of reported profits. A failed merger with Dynegy would soon follow, and on December 1, 2001, Enron filed for bankruptcy.[48]

Following only seven months after the failure of Enron, WorldCom imploded in the largest bankruptcy filing in history at the time, several times larger than Enron.

A failed merger with Sprint in 2000 led to a deteriorating stock price and forced WorldCom to accelerate their use of fraudulent accounting methods that had been used to prop up WorldCom's stock. In this case, WorldCom had been wrongly accounting certain

expenses as capital expenditures, and inflating revenues from fake accounting entries. All told, the illegal accounting had inflated WorldCom's assets by $11 billion.[49]

The collapse of WorldCom provided the momentum needed to push the Sarbanes-Oxley bill through the Senate, becoming law on July 30, 2002.

The Sarbanes-Oxley Act (SOX)

The Act was designed to enhance the reliability of financial reporting and to improve the quality of corporate auditing. The Act has four key components:

1. The establishment of independent oversight of public company audits.
2. The strengthening of audit committees and corporate governance.
3. Enhancing transparency, executive accountability, and investor protection.
4. Enhancing auditor independence.[50]

SOX required the establishment of an internal audit committee made up solely of independent board members. This independent committee is charged with oversight of the work of external auditors who evaluate whether the financial statements prepared by management accurately reflect the financial state of the company in accordance with the appropriate reporting framework. SOX also requires the establishment of procedures to handle whistleblower complaints.

The Act clearly defines and places the responsibility for a company's financial statements on the CEO and CFO, requiring that these executives certify that they have reviewed the report, that the report is fairly presented, that the report does not contain an untrue statement or omits a material fact, that they recognize their responsibility over financial reporting, and that they have reported any changes in controls over financial reporting.

SOX also adds additional investor protections as follows:

- enhanced disclosures of off-balance sheet transactions,
- implanting a rapid reporting requirement for material changes in the financial condition or operations of the company,
- board members, officers, or investors who own more than 10% of the company's shares must disclose the purchase or sale of securities within 48 hours of the transaction,
- the implementation of blackout periods, whereby board members and executives are prohibited from selling shares surrounding the disclosure of earnings or other material non-public information.

While SOX encourages greater corporate responsibility, it does not directly modify the laws that give rise to claims against directors and officers.

Given the already challenged state of the D&O market in the early 2000s, the IPO laddering claims, and the accounting scandals, SOX compliance was another tool that D&O underwriters could now use to ensure that the companies they were evaluating presented a sound underwriting risk.

In addition to all the events specifically impacting the D&O insurance line, a related line of business, Financial Institutions E&O, was also suffering from challenging results. In 2002, research analysts at investment banks were accused of issuing self-serving market research reports promoting the stocks that their own companies were underwriting. Approximately 65 SCAs have been associated with research analyst claims.[51]

In 2003, and into 2004, late trading/market timing in mutual funds drove loss activity in the D&O segment. The actions stemmed from two types of activities: 1) mutual funds allowed certain large investors to purchase funds after the market closed for the day at that days net asset value, which would likely be different than the opening value the following day; and, 2) mutual funds allowed certain investors to buy and sell fund shares rapidly, taking advantage of time zone differences in various markets. Forty-seven SCAs have been associated with late trading/market timing.[52]

In 2004, the New York Attorney General alleged that insurance brokers and insurance companies engaged in transactions that resulted in business being funneled to insurers who paid the highest contingent commissions. These claims also alleged that the brokers and insurance companies participated in bid-rigging by having certain companies submit inflated quotes that enabled the broker to direct business to a preferred carrier.[53] These actions resulted in E&O and D&O claims against insurance companies and insurance brokers.

Although fines and penalties are not covered under insurance policies, defense expenses are covered. AIG independently agreed to pay fines and restitution to the Department of Justice, SEC, and New York Attorney General's office for approximately $1.6 billion.[54] Marsh & McLennan, a leading global insurance brokerage, agreed to independently pay $850 million to resolve the actions brought by the Department of Justice.[55]

In 2005, a landmark case decided by the U.S. Supreme Court, Dura Pharmaceuticals v. Broudo, determined whether an inflated stock price due to a misrepresentation by the company is in and of itself sufficient to prove "loss causation".

In other words, if a company's misrepresentation drives a stock price up and then, later on, the stock price subsequently falls when the misrepresentation is discovered, does that automatically mean that any shareholder who suffered the fall in price can automatically win a suit against a corporation's directors and officers?

In the suit, the shareholders alleged the company's misleading statements about its antibiotic sales and the possibility of FDA approval of an asthma device caused the price drop. The U.S. Supreme Court rejected the notion that price inflation resulting from misleading statements alone was grounds for finding for the plaintiffs, as other factors may have contributed to the price drop.[56] This decision makes calculation of damages more difficult by requiring investors to eliminate other economic factors, which may make it easier for directors and officers to successfully challenge, or at least reduce, large damage claims made by investors.[57]

In late 2005 and 2006, stock option backdating became an issue for public companies. Backdating stock options is not necessarily illegal; however, it becomes illegal when a company's shareholders are misled as a result of the practice. For instance, public companies generally grant stock options in accordance with a formal stock option plan approved by shareholders at an annual meeting. Many companies' stock option plans provide that stock options must be granted at an exercise price no lower than fair market value on the date of the option grant.

When the company engages in backdating, it is misleading to shareholders because it results in option grants that are more favorable than what the shareholders approved in adopting the stock option plan. In addition, the investing public, who may purchase the stock based on financials that do not clearly disclose the value of the option grants, allege that the financial information provided was false and misleading. The majority of actions filed relating to stock options backdating were filed by shareholders on

the corporation's behalf, known as a derivative action. There were 165 derivative suits filed vs. 34 SCAs.[58]

In 2006 a scandal occurred at a leading Plaintiff firm. Four prominent plaintiff lawyers: Melvyn Weiss, Bill Lerach, David Bershad and Steven Schulman of the firm Milberg Weiss, were charged with secretly paying clients approximately $11 million to pursue securities fraud class actions. The firm was credited with over $45 billion in securities lawsuits decisions/settlements for investors and bringing their firm over $1 billion in attorney fees from 1979 through 2005.[59] As a result of the scandal, there was a noticeable drop off in the number of SCAs filed in the mid-2000s.

In 2007, the U.S. Supreme Court decided Tellabs, Inc. v. Makor Issues Rights, Ltd. Under PSLRA, plaintiffs bringing securities fraud complaints must allege specific facts that give rise to a "strong inference" of scienter as established by the 1934 Act. The plaintiffs alleged that Tellabs misrepresented the strength of their products and earnings to conceal the declining value of the company's stock. The District Court dismissed the allegations as too vague to establish a "strong inference" of scienter. Ultimately the U.S. Supreme Court ruled by an 8-1 vote in favor of Tellabs.[60]

The Tellabs decision increased the hurdle that civil litigants must clear in order to recover damages for securities fraud because it made it more difficult to demonstrate scienter, which is a necessary element of the claim. Instead of being able to reasonably deduce scienter from the alleged facts of the case, a claimant must also demonstrate that fraud is at least as likely as other, more innocent explanations.

In another landmark case in 2007, the U.S. Supreme Court heard arguments in the Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc. This case is significant because it pertains to the scope of liability of secondary actors, such as lawyers and accountants, for securities fraud under the Securities Exchange Act of 1934. In a 5-3 decision authored by Justice Anthony M. Kennedy, the U.S. Supreme Court held that “aiders and abettors” of fraud cannot be held secondarily liable under the private right of action authorized by Section 10(b) of the Exchange Act. Such defendants can only be held liable if their own conduct satisfies each of the elements for section 10(b) liability.[61] Therefore, the plaintiff must prove reliance in making a decision to acquire or hold a security upon a material misrepresentation or omission by the defendant.

A study produced by Cornerstone Research analyzing D&O SCA lawsuits through 2006 noted that over 60% of all settlements are for less than $10 million. But when the amounts from larger settlements are added to the total number, the average settlement amount increases to $100.6 million (excluding Enron).[62]

The table below shows the 10 largest settlements in SCAs as of December 2014 (note, 8 of the 10 settled within between 2000-2010):

The 10 largest securities class actions as of December 2014.
Source: Stanford Securities Class Action Clearinghouse.[63]

SCA	Settlement ($ millions)	Year settled	Type
Enron	7,227	2008	Accounting fraud 10(b)(5)
WorldCom	6,133	2010	Accounting fraud 10(b)(5)
Tyco	3,200	2013	Accounting fraud 10(b)(5)
Cendant	3,186	2010	Accounting fraud 10(b)(5)
Nortel	2,935	2007	Accounting fraud 10(b)(5)
Salomon Smith Barney	2,650	2004	10(b)(5) (knowingly issuing false and misleading analyst reports related to WorldCom)
AOL Time Warner	2,500	2006	10(b)(5) (material misstatements concerning the merger of the two entities)
Household International, Inc.	2,464	2014	Accounting fraud 10(b)(5)
Bank of America	2,425	2014	10(b)(5) (merger with Merrill Lynch; material misstatements concerning the purchase of Merrill)
Royal Ahold	1,100	2006	Accounting fraud 10(b)(5)

THE CREDIT CRISIS

The credit crisis started as a result of banks loosening mortgage standards for less qualified buyers in the late 1990s. These mortgages were purchased by investment banks and bundled into investment vehicles and sold as mortgage-backed securities. The principle behind this securitization was that as long as the underlying mortgages were paid, the security would continue to increase in value. As the banks did not keep any of these mortgages on their books, they continued to offer more loans to less qualified individuals. Banks were counting on the real estate market to continue to grow and real estate prices to keep increasing.

By late 2006, the housing market began to crumble. Real estate prices decreased across the U.S., and not just in geographic pockets as the experts predicted would happen.

As a result, along with adjustable rate mortgages readjusting to their higher pre-determined rate, many homeowners began to default on their mortgages, impacting the value of the mortgage-backed securities on the purchasers' balance sheets. A domino effect on home prices and defaults led to the Global Financial Crisis and a recession that officially began in 2007.

Exacerbating the impact of the devalued mortgage-backed securities (MBS) on institutional balance sheets was the existence of credit default swaps (CDS) that served to spread the impact of the failed loan securities beyond banks and hedge funds and into the realm of insurance companies as well. A CDS is effectively insurance on the performance of a MBS. The CDS would then indemnify the purchaser if a particular security or set of securities was to diminish in value as the underlying mortgages soured.

An AIG unit in London was the largest issuer of CDSs ($441 billion worth, $57.8 billion of which were backed by subprime loans) and when the MBS market began to incur substantial losses, it turned out that AIG was the primary counterparty on many of the CDSs designed to insure against the default of the mortgage-backed securities. AIG became the main source to indemnify the holders of the devalued mortgage securities.[64] What effectively occurred was a "run" on this unit of AIG. It necessitated substantial cash outflows to MBS holders and resulted in numerous credit rating downgrades and stock price decreases that threatened AIG with bankruptcy in late 2008.[65]

The Federal Government intervened on behalf of AIG in 2009 and issued an emergency loan of $85 billion in exchange for a 79.9% equity stake in the company.[66] The reason for the intervention was that this unit of AIG revealed a systemic exposure to the entire U.S. banking industry. With the government loan AIG was then able to indemnify their CDS counterparties and stem the fallout of the failed MBS market. All told, the U.S. Government committed $182 billion to AIG in order to stabilize the market, at one point owning 90% of the firm.[67] In 2013, AIG was able to pay back the loan from the government with interest through sales of various AIG units and a reorganization of its core insurance operations.

D&O carriers were highly exposed to the crisis across multiple industry groups as balance sheets took significant losses and bankruptcies increased.

Bear Stearns almost collapsed and was forced to sell to J.P. Morgan. Wachovia and Washington Mutual had similar fates. Lehman Brothers collapsed and was the only financial institution of its size not to receive a bail out. Several cases resulted in massive securities class action lawsuit settlements.[68]

The higher settlement values and implications of Entity coverage in the D&O programs led to rate increases on the primary and lower excess insured layers, especially for financial institutions, and to new opportunities for previously under-utilized products and new coverage enhancements:

Side A Excess Insurance became a regular part of D&O insurance programs. By late in the first decade of the 2000's, Side A evolved into a "difference in conditions" contract (Side A DIC) as the market norm. DIC coverage had been available to directors in some form since the 1980s, but in times of financial crisis there is a heightened need for the added protection afforded to individual directors and officers by DIC coverage.[69] Although they range broadly in the scope of coverage provided, DIC policies generally insure only the company's individual directors and officers and can be insolvency-proof (whether the insolvency is the board member's company or the underlying insurance company's).[70] The primary benefit of the excess/Side A DIC coverage is that it provides separate limits that apply only for the directors and officers, not the organization. Side

A DIC policies are also important as they provide coverage in cases where the organization is unable to indemnify its directors due to:

- bankruptcy or where prohibited by law (i.e. shareholder derivative lawsuit), and/or the underlying limits have been exhausted
- DIC coverage in situations such as where the traditional D&O liability policy is seized by a bankruptcy court as an asset of the estate
- DIC coverage for situations where the underlying D&O liability carrier wrongfully refuses to indemnify the directors or officers
- drop-down coverage for situations where the underlying D&O liability carrier is able to rescind the underlying policy, and
- drop-down coverage in the event the underlying carrier becomes insolvent.[71]

DIC policies differ from **Follow Form Excess (FFX)** policies in that FFX policies do not contain any of the protections immediately referenced above. The DIC policy in many ways acts as an independent limit of coverage, separate from the rest of an excess tower. For example, if the underlying policy is rescinded, the FFX polices automatically follows suit, whereas the DIC policy would remain in place. Additionally, it is important to note that a payment from an excess DIC policy will ordinarily erode the underlying limit for FFX attachment purposes.[72]

For example, if a $100 million ABC tower is in place, and a $25 million DIC policy attaches excess of $100 million, and a $25 million claim is filed that is not covered under the ABC policy but is covered under the DIC, the payment of the $25 million of insured coverage by the DIC policy should trigger any follow on payments by the excess carriers as the FFX language should recognize drop down DIC payments as eroding the underlying limit for purposes of excess attachment.

CODA Ltd. was formed in 1986 to provide personal asset protection for directors and officers. In 1993, a large Bermuda carrier acquired CODA and began issuing exclusive Side A coverage under the CODA brand name.[73] In addition to providing broad form Side A coverage, the CODA form will drop down when purchased in an excess position to fill in any coverage gaps in a primary policy where CODA provides broader coverage.[74]

IDL Coverage, rarely purchased before, became a common feature of many insurance programs for financial institutions. IDL is sometimes called ODL – **Outside Directors Liability** – insurance. It is a stand-alone liability insurance coverage that affords protection solely to indemnify independent directors. This coverage is designed to supplement the liability protections afforded to them by directors and officers/errors and omissions liability (D&O/E&O) insurance.[75]

The **Order of Payments Provision** was included as a response to the concern that should a company become bankrupt, the D&O policy becomes an asset of the estate. In this event, if both directors and officers and the company have simultaneous claims on the policy that exceed the policy limits, the order of payments provision entitles directors and officers to payment prior to the company.[76]

There are drawbacks to typical Order of Payments provisions, including: many order of payments provisions only prioritize losses incurred simultaneously, so if a claim comes in first against the corporation, the limits can be exhausted prior to the directors and officers receiving protection. Additionally, many order of payments provisions do not prioritize payments between directors and officers, therefore directors may find their limits depleted in defense of a company's officers and typically, order of payments provisions do not prevent one insured from settling a claim without the consent of all insureds.[77]

Modification of the Order of Payments clause is possible, which can include language to prioritize payments in favor of independent directors, prevent one insured from depleting more than a certain percentage of limits without consent of other insureds, and prevent the company from depleting available limits if claims remain open against the directors and officers.[78]

The **Interrelated Wrongful Acts provision** is intended to group claims that arise from the same or related or similar facts, events, circumstances, situations, transactions, or occurrences together and treat them as one claim for the purposes of applying the policy retention. Having this provision as part of the policy allows for insureds to have coverage for claims that arise from one set of facts in multiple insured periods. Because D&O policies are triggered on a claims made and reported basis, without this provision, the presence of a Prior Acts Exclusion may exclude coverage from claims that arise from a wrongful act initially alleged prior to the inception date of coverage.[79]

Today we know that the subprime crisis generated many security class action suits, heavy fines, and penalties, yet overall the D&O market was not as heavily impacted as most insurers and reinsurers originally assumed.

Unfortunately, D&O recoveries often are not a matter of public record, so the impact of these and other large cases on the D&O market is not readily available from public sources. In many cases, especially those involving fines, penalties or disgorgement, recoveries are not available under most D&O policies, although defense costs and some costs related to investigations may be recovered.

WON'T GET FOOLED AGAIN?

As a result of the credit crisis, in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was passed and implemented to prevent corporations from having too great an impact on the financial stability of the country, i.e. "too big to fail".

Highlights of the legislation are:

- Heightened consumer protections to protect consumers from hidden fees, abusive terms, and deceptive practices.
- Ends "too big to fail" bailouts by creating ways to liquidate failed financial firms. The law also imposes tough new capital and leverage requirements that make it undesirable for institutions to become overly large.

- The government has authority to provide system-wide support but no longer to prop up individual firms.
- Advance warning system to identify and address systemic risks posed by large, complex companies, products, and activities before they threaten the stability of the economy.
- Transparency and accountability for exotic instruments by eliminating loopholes that allow risky and abusive practices to go on unnoticed and unregulated, including loopholes for over-the-counter derivatives, asset-backed securities, hedge funds, mortgage brokers, and payday lenders.
- Provides shareholders with a say on pay and corporate affairs with a non-binding vote on executive compensation and golden parachutes.
- Protects investors with new rules for transparency and accountability for credit rating agencies.
- Strengthens oversight and empowers regulators to aggressively pursue financial fraud, conflicts of interest, and manipulation of the system that benefits special interests.
- Provides whistleblowers with anti-retaliation protections and awards of up to 30 percent of any government recovery related to the information provided by whistleblowers.80

The Dodd-Frank Act increases regulations for financial institutions, heightening the exposure to lawsuits for these types of insureds. To date, no significant D&O claim activity has resulted from these additional regulations, however, there have been some large "whistle blower" fines/payouts. It remains to be seen how Dodd-Frank will ultimately affect the D&O market.

The outcome of Basic, Inc. v. Levinson, outlined previously herein, was again brought to the attention of the U.S. Supreme Court in 2014 in the case of Halliburton Co. v. Erica P. John Fund, Inc. Ultimately, the Court declined to require plaintiffs to directly prove price impact in order to invoke the Basic presumption; however, the Court did agree that defendants "should at least be allowed to defeat the presumption at the class certification stage through evidence that the misrepresentation did not in fact affect the stock price."[81]

From an insurance perspective, the Court's holding in this case will not have the disruptive impact that it might have had if the Court had overturned Basic. The Court's ruling that defendants may seek to rebut the presumption of reliance by showing the absence of price impact may result in classes being certified in fewer cases, which would be beneficial for defendants and their insurers. However, the dispute of price impact issues could increase overall defense expenses, perhaps significantly, which could have its own impact on the D&O market.

In Conclusion

The D&O insurance market is highly dynamic with loss activity directly affected by changes in laws, regulations, and court decisions. There is also a very real and potent human element driven by greed and fraud that is a driver of both SCAs and derivative actions.

> **The more we evaluate the history of D&O, the better prepared we hope to be to find the markers of increased loss activity.**

Nevertheless, despite the historical perspective, it is very challenging to identify early warning indicators of claims. While future claim activity may have similar characteristics, events never present themselves exactly as they have in the past. Our goal is to continue to monitor activity and engage in productive dialogue with our trading partners to ensure we are all well informed and fully understand the future consequences of ongoing developments in the D&O insurance market.

ABOUT PartnerRe

PartnerRe is a leading professional liability reinsurer with over 15 years of experience reinsuring D&O exposures. With historical portfolio premium volumes between $90 million and $150 million annually, PartnerRe has a strong commitment to the D&O segment.

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