



June 9, 2009 Session
Highlights of the Presentation
“D&O Insurance – Best Practices and Keys to Success

Directors & Officers Insurance
Best Practices and Keys to Success

Even the most conscientious director runs the risk of being sued, so knowing that your D&O policy is bullet-proof can lead to a better night’s sleep. What steps can a board take to achieve this level of confidence? At its June 2009 breakfast meeting, the New England Chapter of the National Association of Corporate Directors (NACD) convened a panel including Nancy Hawthorne, a director; John Graham, a broker; Jordan Hershman, an attorney; and Stephen Maggiacomo, an underwriter, to discuss best practices and keys to success in obtaining D&O insurance.

Hawthorne is chair and CEO of Clerestory, LLC, a financial advisory and investment firm, and is the lead director at Avid Technology, Inc., where she was formerly interim CEO. She is also on the board of the Metropolitan Series Fund, Inc., a mutual fund established by Metropolitan Life Insurance Company. Hershman is co-chair of the Securities Litigation Practice Group at Bingham McCutchen LLP. He focuses on securities litigation defense, complex business litigation and intellectual property matters, and has handled D&O insurance issues for his clients for his entire career. John Graham is senior vice president and team leader at Aon Risk Services. Helping companies design and implement D&O insurance coverage, Aon places more than \$2.6 billion in D&O premiums annually. Graham’s 25 years of insurance industry experience spans both the brokerage and underwriting sides of the business. Maggiacomo is senior vice president at the Executive Liability Division of AIU Holdings. He has more than 15 years of experience in the commercial insurance industry, specializing in D&O liability. He currently manages the firm’s Commercial and National Accounts – Directors and Officers Liability business in the Northeast Region.

Jordan Hershman: *D&O policies often include terms of art that have unusual meanings, leading to unwelcome surprises after a claim has been filed.*

Serving as the panel’s moderator, Hershman triggered a lively exchange of viewpoints surrounding the issues confronting directors as their companies approach the process of obtaining D&O insurance. He observed that D&O policies are so technical that small changes in wording can make a tremendous difference. He also cautioned that selecting the right advisors is critical. “Some people think that insurance is just insurance, but

there are always accommodations that need to be made, and these are subject to negotiation. It's essential not only to select the right carrier, but to be working with professionals who really know the business," he said.

Nancy Hawthorne: *Be an educated consumer and ask good questions.*

Hawthorne opened the discussion by observing that corporations pay the D&O insurance premiums while the directors receive the benefits. She pointed to several areas where, for this reason, the interests of the company and its directors inherently diverge:

- The dollar amount of coverage the company is willing to purchase,
- Trade-offs frequently made between quality of the insurer and the rate paid, and
- Relationships between coverage for the company and "Side A" coverage for individual directors themselves.

She advised directors to think about these competing interests in terms of what could go wrong for them as individuals. "What if there is a shareholder lawsuit? Will I be able to access funds for my defense before I am exonerated, especially since these cases can grind on for years? And if the judgment goes against me for some reason, will I have to pay these funds back? Is there a possibility that I can do the right thing as a director and still not be indemnified?"

"Boards need to acknowledge these trade-offs and nominate a director to become an educated consumer by participating in the D&O renewal process," Hawthorne said. She advised directors to be aware of the disparities between the company's interests and those of the directors as individuals, and ensure that management obtains the advice of both a broker and outside counsel with extensive D&O experience. The fact that a broker has had a longstanding relationship with management should not be considered as proof of expertise, she cautioned. "Ask good questions; make sure that your interests as a director are being addressed and that management's outside advisors really know what they are doing in this area," she said.

Stephen Maggiacomo: *Every D&O lawsuit alleges fraud, and fundamentally every D&O policy excludes fraud, but most claims get paid.*

Bringing the perspective of an underwriter, Maggiacomo spoke to the steps directors should take to maximize the odds that they will not become liable if they have done nothing wrong. "Every D&O lawsuit alleges fraud and every D&O policy excludes fraud, but most claims get paid," Maggiacomo said. He explained that the test of a D&O policy – as well as the skills of the brokers, underwriters and attorneys involved in writing the policy and then handling the claim – is whether the claim is resolved in favor of those directors who were conscientiously doing their jobs.

Maggiacomo outlined the points that directors should consider critical to selecting a primary D&O insurance carrier:

- Financial strength – how do rating agencies evaluate the company; what is the company’s state regulatory environment?
- Market presence and history – how does the carrier fit into the market; is their underwriting philosophy consistent with the board’s priorities?
- Coverage and capacity – has the broker translated solid understanding of the market into state-of-the art coverage for directors; has the carrier consistently been there for policyholders through the up-cycles and the down-cycles?
- Claims handling and underwriting capabilities – what is the company’s attitude and aptitude when paying claims; how extensive is their claims infrastructure; would the attorneys who will defend the directors be happy working with this carrier?
- Relationship and commitment – will this carrier be willing to stay with the directors through thick and thin; does the corporation have a premium history with this carrier that could be advantageous in the event of a claim?

Responding to a question from the moderator regarding the precarious state of today’s capital markets and the health of some large insurance companies, Maggiacomo said, “The key thing to look at is the durability of the franchise. Property and casualty insurance companies are regulated by the states, and the state regulators have done their jobs. The industry is well-capitalized, and the portfolios in which policyholder assets have been invested are generally very secure.”

John Graham: *Obtaining a D&O policy is like buying tickets to a fight.*

Offering the broker’s viewpoint, Graham described the current environment as “tumultuous and claims-intensive.” He observed that, in the years before the market meltdown, many insurance companies shifted their investment portfolios into riskier asset classes like real estate and credit default swaps, leading to markdowns and other capital-related issues for the industry. He described how, as a result of these pressures, two different D&O pricing environments have evolved over the past six years, with policy premiums consistently rising for companies in the financial sector but falling for non-financial companies.

Graham also outlined key D&O coverage issues, key among them:

- Severability – a director’s rights as an individual insured must be kept separate from those of others, so if one insured director or officer had knowledge of or committed fraud, coverage for other individuals remains in effect.
- Investigations – if there is a potential incident, start the internal investigation as early as possible to increase the likelihood that costs will be covered.
- Pollution/climate change exclusions – ensure there is adequate coverage for disclosures related to environmental impacts.

- Final adjudication – be certain that the policy language limits the carrier’s ability to exclude coverage only when a court has made a final, non-appealable determination that fraud has occurred.
- Bankruptcy – make sure the policy addresses a potential bankruptcy by including debtor-in-possession coverage and maintaining coverage in the face of future claims by creditors.

Concluding the panel discussion with an enlightening historical perspective, Graham observed that of 3,500 to 4,000 D&O liability lawsuits over the past 25 years, independent directors were forced to make personal out-of-pocket payments in roughly 13 cases. These were mainly in situations involving egregious malfeasance, insolvency or unavailability of D&O insurance. “It is a different story for inside directors and officers,” he said. “Looking at the securities class action lawsuits filed from 2000 to 2003, insiders were forced to make personal payments – involving fines, penalties and/or disgorgement of funds – in approximately 7% of the cases.” The fines and penalties were typically in the range of \$200,000 to \$250,000, he said.

From the Question and Answer Session

Q. What happens if a claim is filed after the D&O policy has expired, particularly in a post-bankruptcy situation?

A. Almost all D&O policies include a “post-policy reporting window,” which typically extends 60 days after the expiration date. But if the claim is filed after that window closes – i.e., after a bankruptcy when the company’s D&O policy has expired – the insurer is not obligated to provide coverage. Another situation to consider is when a company is acquired or there is a change in control. It is critical for a D&O policy to include “tail coverage,” preferably for six years, covering former directors and officers for claims arising prior to the arrival of new management.

Q, You have addressed the disparities between the company’s interests and the director’s interests, but how about the broker? Where does the broker fit in?

A. Brokers in the D&O field typically work on a fee basis, so they work solely in the interest of the client. Their objective is to provide the client with the best possible coverage, and their negotiations with insurance carriers are transparent and fully disclosed.

For more information about the New England Chapter of NACD, please contact info@nacdn.org.

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