



## **D&O FACT OR FICTION: CURRENT COVERAGE MISCONCEPTIONS**

By Catherine A. Asaro and Andre O'Reggio

Sometimes there is a fine line between fact and fiction. Succeeding in business requires finding that line and understanding the distinctions. That may be easier said than done. Knowing where to look and who to trust is the most important step in getting the answers. A recent New York City D&O conference sought to address some of the current widespread misconceptions that have generated a buzz in the D&O community and have caused more than just a few executives to seek the advice of counsel. The panel of esteemed veteran D&O counsel spoke from both the client and insurer's perspectives after having reviewed a wide array of industry publications. Unfortunately, a significant number of articles and commentary from self-professed experts on D&O seem to further misconceptions about the scope of coverage, the impact of recent legal decisions, legislation, and industry trends, reconfirming that you can't believe everything you read.

Although invariably the panelists' opinions differed on certain issues, they agreed that important information is being communicated incorrectly and inconsistently within the industry. Based on the audience's reaction, many seemed surprised as to the level of confusion on very basic issues while others openly voiced their disagreement with certain commentary, leading to an

overall lively and interactive forum. How much do you know about D&O coverage issues? Why don't you test your knowledge by taking a look at the following eight issues:

### **ISSUE 1:**

***D&O Insurance Is The Most Important Factor In Settlement Of Securities Actions.***

If you agreed with this statement, you would unfortunately be getting off to a bad start. According to a recent PricewaterhouseCoopers survey, in 2005 D&O settlements amounted to \$17.9 billion with twelve settlements exceeding \$100 million. In these mega settlement cases, insurance is not a factor. No matter how high the tower is stacked, a mega case is sure to topple it. However, during the discussion, further statistics revealed that average settlements in 2005 were about \$71.1 million and median settlements were about \$9.25 million representing a 40% increase from 2004. Moreover, the inclusion of personal payments or agreements not to tap the proceeds of a D&O policy further illustrate the panelists' opinions as to the relative importance of this insurance.

### ISSUE 2:

*Side A Only Policies Offer Uniform Coverage Which Is Better Than Traditional D&O Coverage.*

There is no such thing as a uniform Side A policy, so you would be 0 for 2 if you agreed with this statement as well. Based on a comparison study, it was determined that most Side A policies are different. Some policies offer drop down features, others have less onerous exclusions, some offer full severability, and all have different notice requirements. Stemming from this discussion was the impact of “presumptive indemnification” provisions. Inclusion of such a provision in a Side A policy may result in additional litigation to affirmatively prove that you are not being indemnified. In short, this type of provision if upheld would prohibit recovery under the Side A policy as the underlying act would be deemed indemnifiable.

The basic lesson to be learned here is that it is important to know exactly what Side A policy you are considering. Side A policies are important and board constituents will want to know that you have coverage but, it is equally important to know the scope of that coverage and to fully assess the relative benefit of a particular policy.

### ISSUE 3:

*Bankruptcy Courts Deprive Directors And Officers Of D&O Coverage That Can Be Fixed With A Priority Of Payments Provision.*

This one was a little harder to answer as the issue falls squarely within a gray area. There is a fair amount of confusion on how D&O proceeds apply in bankruptcy proceedings. Priority of payments provisions are meant to address the order in which the policy proceeds will be distributed, but for the most part, the courts decide each situation on a case by case basis making it difficult to identify a specific trend. Insightful commentary during this discussion revealed that even insurers are having difficulty interpreting these provisions. There are two types of priority of payment provisions. One provision assigns a gatekeeper to manage and authorize the distribution of proceeds. This provision potentially exposes the gatekeeper to litigation based on their decisions. The other type of provision permits proceeds to apply to individuals before applying to the corporation. With these provisions, timing could be a problem if the company resolves the litigation before the individuals. Regardless of the type of provision in the policy, an important point both speakers stressed is for the board to know the type of provision contained in the policy before a bankruptcy proceeding commences.

### ISSUE 4:

*Foreign Countries Do Not Honor U.S. D&O Policies.*

Again, this was another issue that lent to some lively debate. There are some countries that have trade barriers requiring a company to purchase a local policy on a primary basis. In that

situation, a U.S. policy could then be structured to respond on an excess DIC basis. Insureds should fully evaluate their local exposures and consult with local experts including counsel to understand their risks and the need to obtain local coverage. Once those issues have been addressed, there are important issues regarding commissions, taxes, and local fees that have to be considered. The bottom line lesson to be learned here is not to venture into uncharted territory without first consulting with your broker.

**ISSUE 5:**

*Dura Pharmaceuticals Is A Landmark Decision.*

Despite the U.S. Supreme Court's decision, it seems as though the D&O community is still deliberating on this one. One perspective was that the decision<sup>1</sup> essentially does not mean anything as it is not anticipated to impact the industry. The intended goal of this litigation was to enable class certification to a new group in securities fraud litigation, that being those who held onto the stock as opposed to those who purchased or sold it. In the end, the objective was not achieved, thereby sending the plaintiff's bar back to the drawing board.

The other perspective was that only time will tell. Given that the average lifespan of a case is five years and since *Dura* was only decided last year, the real impact of this decision still remains to be seen. At year end 2005, frequency was

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<sup>1</sup> *Dura Pharmaceuticals v. Broudo et al.*, 2005 WL 885109 (2005)

down slightly from the year before. It is unclear whether this decline can be attributable to *Dura* or if it is reflective of normal market fluctuations given the trends over the past few years. Some speculated that the potential future impact of *Dura* could be dismissals or lower damages. No one would dispute that the plaintiff's bar loves a good challenge and with an abundance of shareholders and prospective plaintiffs, they will find a way to respond to the heightened requirements of this decision.

**ISSUE 6:**

*Private Securities Litigation Reform Act Conferred Major Benefits On Corporate Defendants.*

The general consensus was that PSLRA has not made much of a difference. It did knock the plaintiff's bar back by forcing them to find new ways to forge ahead with securities litigation. A significant trend since enactment was that case values skyrocketed when institutional investors were lead plaintiffs. Institutional investors have quickly developed a reputation for being extraordinarily vocal in their quest to recover shareholder losses and steadfast in their determination to effectuate corporate governance changes. Their size, status and sophistication differentiate institutional investors as a class and enable them to maximize the dollar amount of settlements by holding corporate directors and officers as well as any others that may be involved in the alleged misdeeds accountable.

Frequency was down in 2005 with fewer cases having been filed, however, severity went up. From 1995 to 2005,

there were about 1737 securities actions only seven of which went to trial. Subsequently, six more cases have gone to trial. Therefore, the net effect of the rise in severity may reflect a trend toward trying more cases. The rationale being that because the numbers are so high it is worthwhile to take a chance and go to trial. As a result of the increased number of cases on trial, these days one need only flip through the Wall Street Journal to check out the “Executives on Trial” column for an update.

### ISSUE 7:

#### *Foreign Companies Can't Be Sued In The U.S. For Securities Violations.*

Anyone who thinks that a foreign company can escape the long arm of U.S. law is terribly mistaken. It's very simple, if a foreign company maintains operations in the U.S., that company in all likelihood consented to jurisdiction as part of their approval process and therefore can be sued in the U.S. In 2005, there were approximately nineteen securities violations involving foreign companies. Additionally, there is a section of Sarbanes Oxley which imposes standards on foreign companies operating in the U.S. requiring them to present their financials in accordance with Generally Accepted Accounting Principles (GAAP).

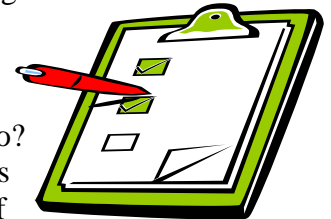
### ISSUE 8:

#### *Insurers Are Rescinding Policies At Record Rates.*

This final issue generated the most debate. Literally, yes, the numbers are up from prior years. The number of rescissions in 2005 doubled the number of rescissions in 2004. However, these numbers still fall below double digits. Is it a trend that insureds need to be concerned about or is it just hype? The enactment of the PSLRA heightened pleading requirements resulting in an increase in allegations of accounting fraud. Over the past few years, issues such as the accuracy of financial documents appended to applications brought the issue of rescission to the forefront. Recent survey responses indicate that a significant number of claims disputes involve coverage denials and allocation issues with only a small percentage dealing with misrepresentations. The majority agreed that at the very least the threat of rescission, notwithstanding its veracity, has proven to be quite a popular strategic tool in negotiations.

### YOUR SCORE!

So, how well did you do? Did any of these responses help? Did you find any of these revelations shocking? Or, do you have anything to add? We would be happy to hear your comments. Given the intricacies of insurance policies, when it comes to D&O liability, certain answers only open the door to more questions. Consulting with a knowledgeable advisor can help ease your concerns and enable you to secure a D&O policy suitable to your specific needs. Oftentimes, knowing where to go to get the answers is the hardest part. Don't get bogged down in trying to separate fact from fiction all on your own. Speak to a broker and get the answers you need to get ahead.



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