

WSGR ALERT

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WHY "SIDE A" MATTERS TO YOU THE INS AND OUTS OF D&O LIABILITY INSURANCE

The well-publicized *WorldCom* and *Enron* cases have heightened the attention given to directors and officers' (D&O) liability insurance. In *WorldCom*, outside directors had agreed to pay approximately \$18 million out of their own pockets toward a total settlement of \$54 million in order to settle litigation against them.¹ In *Enron*, the outside directors agreed to pay \$13 million out of pocket toward a total settlement of \$168 million.

Both *WorldCom* and *Enron* have caused much ink to be spilled over the question of whether or not better D&O coverage would have eliminated the need for the outside directors to settle using their personal assets. It's an excellent question, but may well be unanswerable given the unique context of those cases. It is, however, a certainty that a director or officer who either lacks D&O coverage or has weak coverage will feel the pressure to settle far more strongly than one who can rely upon D&O coverage to fund what might prove to be a costly defense.

With so much at stake, it is critical that directors and officers of public companies understand the issues involved in D&O liability insurance. This article briefly discusses the structure of a typical D&O policy, focuses on some key terms in the policy, and then discusses the advantages of securing stand-alone Side A coverage to protect outside directors.

D&O Policy Structure and Key Terms

D&O insurance policies are divided into several sections: There are the insuring agreements, the definitions, the exclusions, and the general terms and conditions. Each can have an important, and sometimes surprising, impact on coverage. For example, even though one might logically expect the exclusions section of the policy to say what was not covered by the policy, the definition of a "loss" itself may operate like an exclusion and prevent recovery for certain claims.

Public-company D&O policies typically have three basic insuring agreements, often referred to as Side A, Side B, and Side C. Side A is the coverage that applies when the company cannot indemnify directors for claims against them. A company cannot indemnify if it is insolvent. It also is not permitted to indemnify directors or officers for settlements and judgments in derivative actions (lawsuits brought on behalf of the company against the directors or officers). Even the attorneys' fees spent in defending such a derivative lawsuit may not be indemnifiable if a director or officer is ultimately adjudged liable to the corporation. In those instances—that is, where the company is bankrupt or where indemnity is prohibited by law—a director would look to Side A coverage for protection.

Side B coverage, on the other hand, is really a form of company coverage. Under Side B, the insurer reimburses the company for the expense of indemnifying its directors or officers as a result of claims made against them. Thus, while Side A operates as personal asset protection for the directors and officers, Side B operates as balance-sheet protection for the company.

Finally, Side C coverage insures the company for claims made directly against it. In public-company D&O policies, the company is usually only covered for securities law claims, i.e., suits brought by a shareholder against the company in connection with the purchase or sale of securities. In contrast, Side A and B are not limited to claims brought by shareholders, but instead, subject to exclusions, cover claims based on a variety of acts committed by a director or officer in his or her capacity as such.

A key exclusion in the D&O policy is the so-called "dishonesty exclusion." It provides that an insurer will not cover any loss resulting from deliberate dishonesty. However, the condition that triggers this exclusion can vary considerably. For example, some policies may allow the insurer to trigger the exclusion if there is a "written admission" evidencing dishonesty. In other policies, the carrier may be allowed to trigger the exclusion only if there is a "final adjudication" of dishonesty, such as a judgment against the individual insured. Since securities-fraud lawsuits always involve allegations of dishonesty, it is

¹ In early February, the *WorldCom* settlement fell apart after the court invalidated a provision of the settlement agreement unrelated to personal contributions.

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important to negotiate the narrowest exclusion possible. Indeed, one would expect considerable disagreement between an insurer and an insured as to whether or not a particular document constitutes a "written admission" of dishonesty. Having such highly subjective language in a policy can result in costly and time-consuming side disputes over the carrier's responsibility to cover the loss.

As noted, even the definitions of the policy can significantly limit coverage. For example, some policies define the term "insureds" to include not simply directors and officers, but also all employees of a company. While this expands the class of people covered under the policy, because of the "insured-versus-insured" exclusion, it also may limit coverage for the directors and officers. The insured-versus-insured exclusion basically says that the insurer does not have to cover claims brought by one insured against another. Therefore, if all employees are insureds, then any lawsuit brought or solicited by an employee against a director will not be covered by the policy unless the insured-versus-insured exclusion is carved back to allow such coverage. In deciding whether or not to include all employees as insureds, one must carefully weigh the risks and benefits.

It is also very important that the D&O policy contain a "severability-of-the-application" provision. This provision can help protect innocent insureds against the risk that an insurer can rescind the policy.

The need for severability arises from the fact that companies fill out applications when they apply for D&O insurance. The application may be very detailed and may require the company to attach a variety of public filings. When the insurer is offering coverage for the first time, the application may also ask whether or not

anyone proposed for coverage is aware of any facts, circumstances, etc., that he or she believes might give rise to a claim.² If a misrepresentation is made in the application or in the documents attached to the application (such as the company's SEC filings), the insurer might be entitled to rescind the policy. For example, a restatement of the financial statements attached to the application might give rise both to a securities lawsuit and a rescission claim by the insurer. If the insurer succeeds in rescinding the policy, unless the policy is severable, it will be void not just for the person who made the misrepresentation, but for every insured.³

Ideally, severability language should prevent this from happening to any innocent party, such as any director who did not know of the misstatement. Because there are a variety of severability provisions in the market, close attention must be paid to the language that the carrier is offering. For example, the severability provision might say that the knowledge of one insured person will not be imputed to another except for the CEO or CFO, whose knowledge is imputed to everyone. If financials attached to an application are restated and the CEO or CFO knew that the financials were false and misleading, then every insured is in danger of losing coverage. This is obviously undesirable. Care must be taken to either prevent the inclusion of such language in the policy or, when that is not possible, to mitigate the impact of such a provision.

While the foregoing is by no means an exclusive list of issues that outside directors need to focus on when evaluating the D&O coverage that is secured for them, it illustrates that the quality of coverage is heavily dependent on the negotiated terms of the policy. The need for informed advice on the policy terms is paramount.

Stand-Alone Side A Coverage

In the last few years, a number of companies have begun adding a stand-alone Side A policy to their insurance programs. As noted above, Side A covers directors or officers for non-indemnifiable claims (when the company is insolvent or not permitted to indemnify, such as for settlements and judgments in derivative lawsuits). The chance of a non-indemnifiable claim is not as remote as it seems. Delaware cases such as Oracle and Disney demonstrate that risk of a derivative lawsuit, particularly in the current environment, is very real. And one need look no further than Enron and WorldCom to see just how rapidly a company's fortunes can turn.

Indeed, it is a mistake to forgo stand-alone Side A coverage just because a company's balance sheet looks healthy today. D&O policies are "claims-made" policies. This means that the policy in effect at the time a claim is first made against the director is the policy that provides coverage for the claim. If a lawsuit is still pending four or five years from that time (not atypical for a securities litigation) and the company is in bankruptcy, the D&O insurance policy that was in place when the litigation was first brought is the only protection afforded the director.

There are a number of advantages to a stand-alone Side A policy. First, because a traditional policy combines Sides A, B, and C, there is always a danger that the limit of the policy can be exhausted—that is, used up in paying claims if claims against the company or indemnifiable claims are paid before non-indemnifiable claims. In contrast, if a company has a stand-alone Side A policy, the policy can never be used to cover claims against the company or to reimburse the company for the cost of honoring its indemnity obligations. The stand-alone Side A policy is coverage

² There are a variety of different formulations to this question, and the differences in language can be significant.

³ In some states, including California, the insurer may be able to rescind without proving that any insured intended to deceive the carrier when the application was filled out. Instead, the carrier might only need to show that the application contained a misstatement that materially increased the risk.

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dedicated to those instances in which indemnity is not available.

Second, if a company files for bankruptcy, a bankruptcy trustee may seek to freeze the policy, claiming that the policy proceeds are an asset of the estate. This risk is particularly acute where the policy provides Side C coverage (i.e., protects the company for claims made directly against it). If the trustee is successful in making such a claim, directors may find themselves without the D&O policy just when they need it most. The Adelphia lawsuits illustrate that even if the trustee is not entirely successful, litigation over who owns the proceeds of the policy can be protracted. A stand-alone Side A policy, on the other hand, is virtually immune to such claims by a bankruptcy trustee.

Third, in part because insurers recognize that the risk of paying out on a Side A claim is lower than the risk of paying out under a traditional policy, they often are willing to offer terms more favorable to the insured on both policy exclusions and severability. In fact, a number of carriers are willing to offer non-rescindable Side A coverage. In contrast, the Side A coverage in a traditional Side A, B, and C policy often inherits some of the exclusions that carriers insert as a risk-shifting mechanism in recognition of the fact that such a policy also functions to reimburse the corporation.

Anyone considering purchasing stand-alone Side A coverage is well advised to make sure that what is purchased is a broad-form/difference-in-conditions policy. If the Side A is merely an excess policy without the broad-form/difference-in-conditions feature, it only will become available if the underlying insurance is exhausted. In other words, the underlying insurer (or, in some instances, the company) actually must have paid out the limits of the underlying insurance policy.

Here is an example to illustrate this: Suppose that a company has \$10 million of traditional

coverage and \$10 million of Side A excess coverage. The company is insolvent and therefore Side A applies. If the insurer for the \$10 million traditional coverage does not pay out its policy for any reason—because it claims to have rescinded the policy, because it claims an exclusion precludes coverage, or because it, too, is insolvent—then the condition that makes the excess policy available (exhaustion of the underlying policy) will not be met, and the individual insureds will not be able to use the proceeds of the excess policy.

A broad-form/difference-in-conditions policy, on the other hand, is intended to be available whenever both indemnity and underlying insurance are not available. Thus, a Side A broad-form/difference-in-conditions policy has a variety of triggering conditions; it is designed to provide coverage not only where the underlying insurance has been exhausted through payment, but also where the underlying insurer has not paid (e.g., because it claims to have rescinded the policy, because of an exclusion in the underlying policy, or because it is insolvent). Such a policy also may be available if the company wrongfully refuses to honor its indemnity obligations.

Anyone considering the purchase of a Side A broad-form policy also should be aware that such policies can vary considerably in terms of whom they cover (independent directors, one director for multiple boards, all directors and officers) and in terms of the conditions under which the proceeds of that policy become available to the insureds. Deciding which format to choose requires careful consideration of the trade-offs inherent in each.

For more information on D&O insurance issues, please contact Steve Guggenheim in Wilson Sonsini Goodrich & Rosati's litigation practice.



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