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A Securities Litigator's Guide To D&O Insurance, Part I


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Law360, New York (October 13, 2010) -- Success in the defense of a securities case may be only half the battle for a client. Counsel must take care to assure that the costs of defense and any settlement or judgment are paid by the client's insurer. Directors and officers liability insurance policies (D&O policies) vary widely in terms of coverage and exclusions, and there are many issues to keep in mind in order to protect coverage.

This article is the first in a two-part series which highlights some basic considerations and important issues for counsel representing companies and individuals in securities litigation. Part I focuses on coverage issues, while Part II discusses some practical considerations for counsel seeking payment from D&O insurers.

Entity Coverage vs. Individual Coverage

Coverage issues may arise in a number of contexts when a potential securities law violation comes to light. Shareholders may file a class action lawsuit against a company and its directors and officers. They may file a derivative action against directors and officers in the name of the company, seeking to recover for the company damages caused by breach of fiduciary duties.

The U.S. Securities and Exchange Commission may conduct an investigation or file a civil or administrative proceeding against a company, its directors and officers. Finally, a parallel grand jury investigation may be conducted by the U.S. Department of Justice. In each case, available coverage may differ.

Traditional D&O policies usually cover only claims made against a company's directors and officers (known as "A-Side" coverage), not claims against the company itself. If there is no other coverage, when a company and its directors or officers are jointly represented in one or more of the types of matters listed above (assuming it meets the policy definition of a covered "claim"), defense costs must be allocated between the individual defendants, who are covered, and the company, which is not.

Because many tasks undertaken by counsel in defense of a securities claim benefit both the company and the individuals, the allocation of costs may be arbitrary and can lead to coverage disputes between the insureds and the insurer.

Insurers also offer coverage under D&O policies for the company's liabilities ("C-Side" coverage) as well as for the company's expenses incurred in directly indemnifying qualified employees ("B-side" coverage). Although policies covering both the corporate entity and the individuals may eliminate the need to allocate defense costs among defendants, they raise different considerations.

For example, the deductibles — also known as "retentions" — may be higher in D&O policies that include entity coverage. In such cases, defense costs incurred solely on the company's behalf (e.g., the company's document production) are fully covered, and they will serve to exhaust the retention amount applicable to all defendants more quickly. As a result, the carrier may be required to begin payout of defense costs for directors and officers earlier.

This means that coverage limits may be exhausted more quickly when there is entity coverage. Most policies are of the "wasting" variety: every dollar paid in defense costs reduces the coverage available for a settlement or judgment. Companies can rapidly incur high litigation costs in defending securities law claims, significantly depleting the amount of coverage remaining to pay the individuals' defense costs, fund a settlement or satisfy a judgment.

Today, entity coverage is commonplace but not universal. Whether it is part of the D&O policy has practical consequences, which counsel should bear in mind as the litigation proceeds. For example, after a long SEC investigation and Wells process, a company may be loathe to litigate a threatened enforcement action while the individual defendants are more willing to do so, especially if they are no longer with the company.

In such cases, counsel representing the individual defendants should determine how much coverage remains available after a corporate settlement, before entering an appearance in defense of an enforcement action in federal court.

Covered Events — The Definition of "Claim"

Most D&O policies are "claims made" policies, and therefore the filing of a derivative or class action complaint will trigger coverage (subject to exclusions). However, counsel may become involved in a matter prior to the filing of a lawsuit in response to a demand letter, grand jury or administrative subpoena, or informal inquiry by the SEC.

In addition, the company may seek to retain counsel to conduct an internal investigation when it learns of a triggering event, such as an internal complaint by a whistleblower, a customer or competitor's complaint, or an inquiry from the company's auditors.

Whether any of these events will trigger coverage depends on interpreting the definition of "claim" found in the applicable policy. Insurers are highly unlikely to advance costs for internal investigations voluntarily initiated by a company, while they may concede coverage when the investigation is triggered by a government inquiry or subpoena.

See, e.g. Minuteman Int'l Inc. v. Great Amer. Ins. Co., 2004 WL 603482 (N.D. Ill.) (denying insurer's motion to dismiss coverage claim for SEC investigation in which subpoenas were issued pursuant to a formal order of the commission); Jemmco Partners Inc. v. Executive Risk Indemnity Inc., Docket No. SOM-L-486-07, 9 N.J. Super. Ct. Law Div. 2007 (denying an insurer's motion to dismiss on the ground that a grand jury subpoena was a "claim" under relevant policy language).

In securities cases, the question often arises whether the cost of an investigation conducted by a special board committee is covered by the insurer. Special committee investigations may be initiated after a pre-litigation shareholder demand or any of the types of triggering events discussed above.

Generally, D&O policies do not cover the costs incurred by a special board committee in this context. Insurers take the position that such costs are not associated with the defense of claims made against the insured, but rather legal costs incurred during a voluntary investigation of a potential claim. However, the U.S. District Court for the Southern District of New York recently granted summary judgment in favor of an insured seeking coverage for a special committee investigation.

The court held that, based on the language of the D&O policy at issue, the insurer was required to reimburse the insured for legal fees and other related costs incurred by the insured while responding to subpoenas and oral requests issued by the SEC pursuant to a formal order, oral requests for documents as part of an investigation by the New York Attorney General's Office, and costs incurred by a special litigation committee of the board in connection with shareholder derivative litigation. See MBIA Inc. v. Fed. Ins. Co. et. al, No. 08-CV-4313, 2009 WL 663507 (S.D.N.Y. Dec. 30, 2009), appeal docketed, No. 10-355 (2d Cir. Jan. 29, 2010).

The court based its decision, in part, on its finding that defense counsel, in effect, represented the company through the special litigation committee, because the committee was comprised only of board members and was tasked with determining whether engaging in litigation was in the best interest of the company. Id. at 9.

Exclusions

Even where there appears to be coverage on the face of the policy, almost every policy contains exclusions. The most relevant exclusions in securities cases apply to claims brought by the company against an officer or director, or by shareholders in the company's name against an officer or director in a derivative action (known as "insured vs. insured" claims); claims resulting in civil penalties imposed in SEC enforcement proceedings; claims brought by a group of shareholders for a "bump-up" in the consideration they receive in a buyout; and fraudulent or intentional misconduct.

The insured vs. insured exclusion may come into play in derivative cases, where the recovery sought by shareholders in a suit against directors and officers would go directly to the company itself. In the past, this exclusion was more common and prevented directors and officers from obtaining coverage when sued by their company (or a shareholder suing on the company's behalf) for malfeasance or breach of fiduciary duty.

With the increasingly prevalent practice of filing derivative actions together with securities class actions, this exclusion has been dropped from many policies. Nevertheless, the insured vs. insured exclusion can preclude coverage for directors and officers in derivative actions. See, e.g. Voluntary Hospitals of Amer. Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa., 859 F. Supp. 260 (N.D. Tex. 1993), aff'd 24 F. 3rd 239 (5th Cir. 1994) (applying exclusion where shareholders in a derivative action were assisted by former officer).

In addition, civil penalties, whether judicially imposed or paid as part of a settlement in an SEC civil enforcement proceeding, often are excluded from the policy definition of "loss" for which coverage is provided. Even if not expressly excluded, the SEC usually requires as a matter of policy that civil penalties be paid by the company directly, or personally by the defendant director or officer.

The rationale for this policy is that the alleged wrongdoer should bear the financial responsibility, and that this will serve to deter directors and officers from acting unlawfully. This type of exclusion also may encompass "claw backs" under Section 304 of the Sarbanes Oxley Act of 2002, 15 U.S.C. § 7243, for "ill gotten gains," which could include unearned salary and bonus based on allegedly fictitious company performance, profits from sales of company stock at artificially inflated prices and other compensation.

The SEC has become increasingly aggressive in seeking such recovery from directors and officers. For example, the SEC filed suit last year against the former CEO of CSK Auto Corp., seeking the return of more than $4 million in bonuses and stock sale profits received while CSK allegedly was committing accounting fraud. See SEC v. Jenkins, Case No. 09-cv-01510 (U.S.D.C. D. Ariz.).

A recent decision from the Second Circuit raises further doubts concerning whether officers and directors can be indemnified for § 304 claw backs in any event. In a case of first impression, the Second Circuit ruled that a settlement in a derivative action releasing and indemnifying a corporation's former CEO and CFO against liability under § 304 violates that statute because it effectively nullified the SEC's authority to pursue a remedy or to grant an exemption under that statute. See Cohen v. DHB Industries Inc., 2010 U.S. App. LEXIS 20197 (2nd Cir. Sept. 30, 2010).

Claims that securities were sold at an inadequate price, and therefore a "bump-up" in the price should be paid, may not be covered "losses" under policies. Some policies contain an explicit "bump-up" exclusion barring coverage.

The First Circuit has recently held that such an exclusion precluded a company from recovering amounts it paid to defend against and ultimately settle claims by groups of shareholders that they received inadequate consideration for their shares. See Genzyme Corp. v. Federal Insurance Co., 2010 WL 3991739 (1st Cir. Oct. 13, 2010).

The particular language of the exclusion, however, applied only to the company itself and not to the company's officers and directors, who, that court found, were covered under the policy and entitled to reimbursement for their defense costs and settlement amounts paid on their behalves. The resulting dichotomy between the company and its officers and directors, the First Circuit recognized, created particularly thorny allocation issues.

Finally, the most common exclusion is for deliberate fraud, used to deny coverage where the director's or officer's conduct is determined to be deliberately and intentionally fraudulent. The key questions in this instance are when and by whom must such a determination be made.

A recent Fifth Circuit case addressed these issues in the context of a money laundering exclusion. In a declaratory judgment action, directors and officers sought an injunction requiring their D&O insurer to pay their defense costs. The insurer argued that it was not required to do so because the policy excluded liability for defense costs "arising in connection" with acts or alleged acts of money laundering.

Mere allegations of money laundering were not sufficient to trigger the exclusion, however, and the insurer was required to pay defense costs "until such time that it is determined that the alleged act or alleged acts did in fact occur." Pendergest-Holt v. Certain Underwriters at Lloyd's of London, 600 F.3d 562 (5th Cir. 2010).

The court rejected the insurer's argument that in the first instance the insurer could make the determination that money laundering occurred, finding instead that the factual determination must be made by a court in a separate, parallel coverage action in which all admissible evidence would be considered. Id. at 574.

The court emphasized that if the insurer had wanted to reserve the unfettered discretion to determine whether to advance defense costs, the policy should have clearly stated that right. Id. at 571.[1]

Having worked through these basic coverage questions, counsel may confront practical barriers to securing coverage of defense costs, settlements and judgments.

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[1] Ultimately, after a trial, the directors and officers were found to have engaged in money laundering and their conduct, therefore, was found not to be covered under the policy.

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A Securities Litigator's Guide To D&O Insurance, Part II

Law360, New York (October 20, 2010) -- In Part I of this two-part series, we focused on basic coverage issues confronting defense counsel in securities litigation. This article, Part II, discusses some barriers that may stand in the way of securing payment from directors and officers insurers of defense costs and settlements and judgments.


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Application Misrepresentations

Even if all of the obstacles to basic coverage are overcome, a director or officer may lose coverage if a material misrepresentation was made in the application for the policy. D&O insurance policies typically provide that there will be no coverage as to any insured who knew of misrepresentations made in the insurance application or to whom such knowledge can be imputed.

In the context of securities litigation, such exclusions can be triggered by misrepresentations in the company's annual, quarterly and other U.S. Securities and Exchange Commission filings, which may have been made part of the original insurance application. Assuming misrepresentations were made by others, the issue for the insured is whether knowledge of the misrepresented facts can be imputed to the insured so as to void coverage under the policy.

Policies differ on this point. Some contain "full severability" language, which precludes the imputation of one director's or officer's knowledge to another for the purpose of voiding or excluding coverage. See, e.g., In re HealthSouth Corp. Ins. Litig., 308 F. Supp. 2d 1253, 1261 (N.D. Ala. 2004).

Others provide for only "partial severability," i.e., only knowing misrepresentations made by one who signed an insurance application can be imputed to other directors and officers to preclude coverage and allow rescission of the policy. See, e.g., Cutter & Buck Inc. v. Genesis Ins. Co., 306 F. Supp. 2d 988 (W.D. Wash. 2004).

Here, the terms of the policy and the content of the application are critical in determining whether the insurer can deny coverage. See, e.g. Rivelli v. Twin City Fire Ins. Co., 359 Fed. Appx. 1 (10th Cir. 2009) (affirming declaratory judgment for the insurer which denied coverage where insureds were alleged to have known about application misrepresentations).

Approval of Counsel and the Duty to Cooperate

Most policies provide that the insurer must approve, in advance, counsel selected by the insured, and that such approval "shall not be unreasonably withheld," or words to that effect. This right of approval is a means by which insurers attempt to assure that experienced counsel is selected, in order to reduce costs.

Many insurers maintain lists of approved counsel from which a company, director or officer must choose, although they often grant permission to go "off-list" and choose different counsel if the insurer is persuaded that the client has selected someone with sufficient experience to defend the case efficiently.

The insurer's freedom to select or approve counsel may be limited if it has agreed to provide coverage and advance payment for costs under a reservation of rights. The insurer may wish to preserve its ability to assert a basis for denial of coverage after the facts pertaining to the case are developed.

For example, it may assert the possibility that one or more exclusions apply, or that there is a potential basis for claiming application misrepresentation. In such a case, the law of the state in which the policy was issued may prevent the insurer from controlling the defense while attempting to preserve a possible claim against its insured. See, e.g., Am. Guarantee and Liab. Ins. Co. v. The 1906 Co., 273 F.3d 605, 621 (5th Cir. 2001); Three Sons Inc. v. Phoenix Ins. Co., 357 Mass. 271, 275-77 (1970).

Thus, in some instances there may be a potential dispute with the insurer over payment of defense costs. After receipt of a notice of claim, the insurer usually issues a letter indicating that it will accept the claim for defense. This letter should contain any reservation of rights and should spell out the basis for the insurer's position.

Counsel representing the insured, whether or not previously approved by the insurer, should scrutinize these letters carefully before engaging in negotiations with an insurer over advancement under a reservation of rights. The more extensive the reservation, the stronger the argument that the insured's selection of counsel should be honored.

In addition, counsel should be wary of complying with an insurer's demand for cooperation — a requirement of advancement routinely found in policies — where counsel's investigation of the defense may reveal facts potentially supportive of one or more grounds of the reservation. As a general rule, an insured has a duty to cooperate with an insurer's investigation of a claim. See e.g., Romano v. Arbella Mut. Ins. Co., 429 F. Supp. 2d 202 (D. Mass. 2006).

Most policies require the insured to obtain the consent of the insurer before a settlement is executed, even in the case of settlement with the SEC. Failure to do so can result in denial of coverage. See, e.g. Vigilant Ins. Co. v. The Bear Stearns Cos. Inc., 884 N.E. 2d 1044 (N.Y. 2008) (where company entered into an SEC settlement and only thereafter sought insurer's consent, insurer successfully denied coverage).

However, some courts have held that an insurer's reservation of rights may reduce the scope of an insured's duty to cooperate. See, e.g. Ins. Co. of N. Amer. v. Spangler, 881 F. Supp. 539, 545 (D. Wyo. 1995.) ("[T]he insurer's insertion of a policy defense by way of reservation or nonwaiver agreement narrows the reach of the cooperation clause and permits the insured to take reasonable measures to protect himself against the danger of personal liability.").

This concern should not be ignored by counsel for the insured. At minimum, it may affect the amount of detail which should be included in bills submitted to the insurer, which may not be privileged. In any event counsel should make sure that notice is given to the insurer well before a settlement is executed.

Ultimately, it is more likely that an insurer will haggle with defense counsel over approvable expenses and rates than attempt to deny coverage if the insured has selected competent counsel.

However, many insurers have written "guidelines" restricting the fees and costs for which they will pay. They often retain outside counsel, who will monitor the work and bills of defense counsel and reject "nonreimbursable" litigation expenses. Occasionally, litigation ensues over the reasonableness of fees. See, e.g. Brooks Automation Inc., 2006 Mass. Super. LEXIS 238 (April 6, 2006) (ordering insurer to reimburse an insured for counsel fees, commenting that the case was "life and death" for the insured and that under those circumstances it was eminently reasonable for the insured to seek out the most able law firm, even though that firm's rates were high).

Advancement vs. Reimbursement

Depending on the policy, the insured may have the right to receive payment for defense costs, including attorneys' fees, as they are incurred (advancement). For individual directors and officers, the cost of defense may be prohibitive. For this reason, counsel for these individuals should be familiar with the policy terms on this issue.

Contractual rights to indemnification and advancement under an insurance policy may be different from rights under the company's bylaws and the law of the state of incorporation. Almost all corporate bylaws provide that directors and officers shall be indemnified for litigation expenses arising from claims brought against them in their official capacity. The bylaws usually permit, but do not require, advancement of these fees and costs as well.

Often companies incorporated in Delaware have bylaws providing for indemnification and advancement to the fullest extent permitted by law, thereby incorporating Delaware Corporation Law Section 145, which sets forth broad rights to indemnification and advancement.

However, Delaware law, and most bylaws, preclude indemnification where the individual officer or director is ultimately determined to have acted wrongfully. For this reason, bylaws typically require that directors and officers execute undertakings, promising to repay the company any sums advanced for defense costs should such a determination be made.

Undertakings should not be entered into lightly. While it may be rare that an insured is required to repay, it is not impossible. In Happ v. Corning, 466 F.3d 41 (1st Cir. 2006), the First Circuit held that an undertaking signed by a director required him to reimburse the company for nearly $900,000 in legal fees which had been advanced in connection with his unsuccessful defense of an SEC enforcement action. After trial, a jury found that Happ: 1) was liable for insider trading; 2) violated his duty of trust and confidence to the company; and 3) acted with intent. Id. at 45-46.

The court cautioned that even if the undertaking were "phrased solely in the language of [Delaware] section 145" (discussed above), it would be difficult, based on the court's findings, for the defendant to meet the law's requirements that his conduct was in good faith and in the best interests of the company. Id. at 46.

Although an individual's rights to indemnification and advancement may not be identical under policies and bylaws, they often do intersect in practice. For example, an insurance policy may provide for coverage but not advancement, while the company's bylaws do provide for advancement. In such an instance, the individual's legal fees and costs should be advanced by the company, which would then be reimbursed by the insurer when the insurer is required to pay out for covered losses.

Privilege Issues

Where the insurer will advance costs, counsel may be required to submit bills directly to the insurer. Detailed bills often contain information subject to the attorney-client privilege or attorney work-product doctrine.

The attorney-client privilege exists only between counsel and the insured, not between counsel and the insurer. The work product doctrine may be vitiated by disclosure to third parties. Therefore, counsel must be careful not to effect a waiver by disclosures contained in bills submitted to the insurer.

It can be argued that there is a common interest between the insured and insurer, but where the insurer has accepted coverage under a reservation of rights there is a potential conflict, and disclosure of privileged information to the insurer may not be covered under a common interest or joint defense privilege.

Thus, it is prudent for counsel to raise this issue before submitting any bills to the insurer. Often, the insurer will agree to accept redacted bills, and in some instances where the company is advancing costs (to be reimbursed later by the insurer),

company counsel may agree to accept summary bills. Usually some agreement will be reached to satisfy the insurer's desire to confirm and limit costs while protecting the insured's privileges.

Despite the potential for conflict created by a reservation of rights, it may be prudent nonetheless to submit bills to an insurer with a declaration that there is a common interest and that no waiver is intended.

Bankruptcy

Even where a policy appears clearly to provide coverage, directors and officers can find themselves without coverage if the company later files for bankruptcy. If this occurs, the central question is whether the policy is the property of the bankruptcy estate, in which case it may not be available to pay claims or defense costs as they are incurred by directors and officers in litigation pending against them.

In SEC v. Stanford Int'l Bank Ltd., 2009 U.S. Dist. LEXIS 124377 (N.D. Texas, Oct. 9, 2009), the court exercised its equitable discretion to authorize disbursement under an insurance policy to pay directors' and officers' defense costs. Although the court assumed that the policy was part of the receivership estate it did not address the issue, and in an earlier ruling it had denied the officers' and directors' motion for a preliminary injunction to unfreeze the estate's funds to pay defense costs, on the principle that a defendant cannot use ill-gotten sums to fund his defense. 2009 U.S. Dist. LEXIS 124377 at *19.

However, when the officers and directors later moved for a clarification of the receivership order, the court rejected the receiver's argument that advancement of defense costs to the directors and officers would diminish coverage for potential claims against the estate because no such claims presently had been made and future claims were "speculative," whereas the harm to directors and officers of not funding their defense was "real and immediate." Id.

In In re Downey Financial Corp., Case No. 08-13041 (CSS) Bankr. D. Del. (May 7, 2010), the court went further, holding that the policy proceeds were not part of the bankruptcy estate because there were no direct pending claims against the debtor. Again, the court stressed the importance of the particular policy language used.

Thus, whether coverage can be obtained in favor of a defendant in a securities investigation or lawsuit depends on much more than the availability of a policy or the status of an individual defendant. Counsel must be mindful of the considerations discussed above before concluding that defense costs will be advanced and any settlement or judgment will be funded from policy proceeds.

The policy language must be scrutinized carefully when a claim is made. In addition, companies negotiating coverage with insurers should seek the advice of litigation counsel in advance, with these considerations in mind, in order to assure that the greatest amount of protection will be available when an investigation or litigation does arise.

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