

Understanding Directors and Officers Coverage

*August 14, 2024
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Management Liability Today

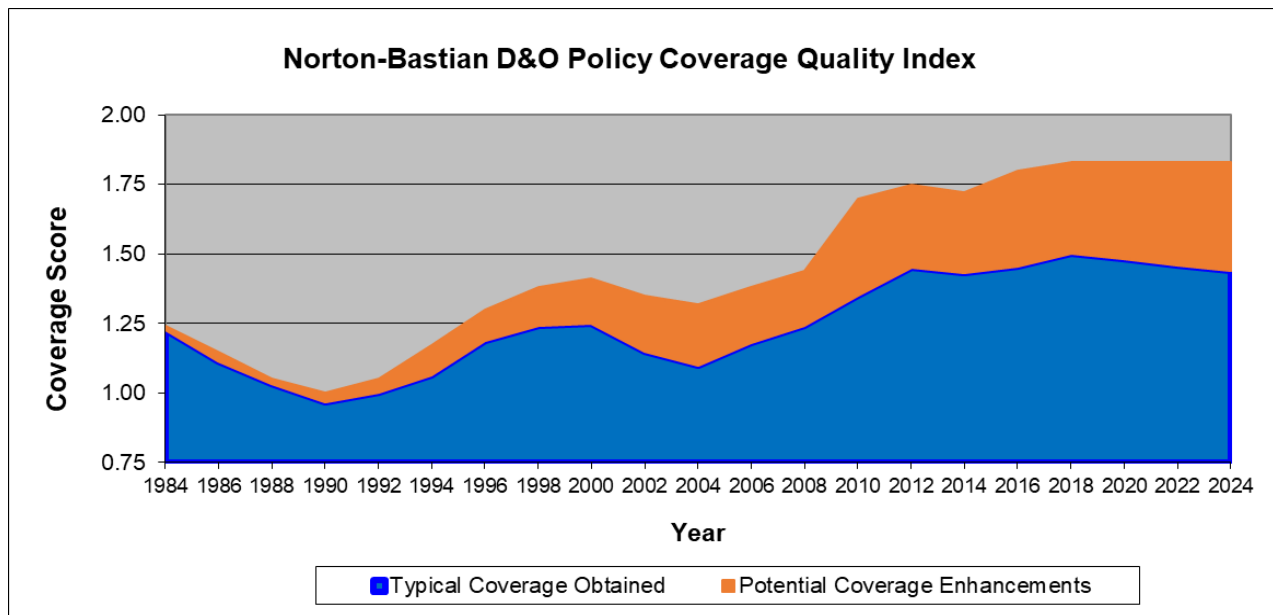
Directors & Officers Liability, and....

- Employment Practices Liability
- Fiduciary Liability
- Crime / Employee Dishonesty
- Errors and Omissions
- Special Crime (Kidnap & Ransom, Extortion)
- Cyber Liability
- Representations & Warranties
- And everything else that doesn't fit with P&C (Trade Credit, Political Risk, Tax ...)

Fundamentals

What is Directors & Officers Liability Insurance?

- Define D&O; unique, manuscript, lack of uniformity
 - Carrier by carrier subtleties and many, many endorsements



Blue area is the base policy form – including off the shelf enhancements that are automatically available; the orange area shows coverage improvements gained through negotiations by the broker. Notes: 1985-1990 hard market
2001-2004 hard market
2010 landmark changes to policy form
2014 restrictions for M-O claim retention, healthcare accounts, Private D&O anti-trust exclusion, conduct exclusion refined and more.

A Short History of D&O

- The Great Fire of London (1666)
- Edward Lloyd's
 - 1688 coffee shop
- Underwriters
- Lloyd's 1930s
- The St. Paul 1962
- 1970s: Lloyd's, AIG, CNA
- 1980s: M&A mania
- 1990s: Birth of the Class Action "Racket"
- 1996: current era proceeds after PSLRA (Dec 22 1995)



Fundamentals

Duties of Directors & Officers

- Loyalty [to the corporation first and foremost; avoid conflicts of interest]
- Care – Diligence is key: time, expertise, breadth and depth of analysis
- “Obedience” – consider laws, rules, regulations, charter and so forth
- Disclosure – timely and accurate disclosure of material information

These duties create exposure to D&O losses!

All of this is daunting, but perhaps the Business Judgment rule helps

Fundamentals

The Business Judgment Rule

- Designed to provide a director of a corporation immunity from liability when a plaintiff sues on the basis that the director violated the duty of care.
- Can be effective if directors' actions are within parameters of this rule. They presume the director of the corporation:
 - Acted on an informed basis – collecting all material information reasonably available to them; used expertise as appropriate to be informed; pondered and discussed such information for a reasonable amount of time
 - Acted in good faith
 - Acted on the belief that the decisions made were in the best interests of the company

Note: this rule does not apply to claims not brought under the duty of care.

Fundamentals

Importance of D&O Liability Insurance?

- Covers Personal Liability of D's & O's
- Helps attract good Directors & Officers
- Protects Company, especially balance sheet protection

Fundamentals

Corporate Indemnification

Define *Indemnification*:

- Difference between indemnification and advancement
- Difference between indemnity and defense

Fundamentals

Classic Indemnification Dispute

Delaware Supreme Court decision June 8, 2006 on *In Re The Walt Disney Company Derivative Litigation*

- Michael Ovitz terminated as President of Disney and a derivative suit filed against Disney's Ds and Os for damages related to 1995 hiring and 1996 firing resulting in termination payments of ~\$140M
- Per Potter Anderson law firm, "the Court cited Section 145 of the DGCL, Delaware's indemnification statute, observing that a Delaware corporation generally has the power to indemnify a director or officer for liability incurred by reason of a violation of the duty of due care but not for a violation of the duty to act in good faith. The Court explained that any definition of bad faith that would cause a violation of due care (i.e., gross negligence) to become a de facto act or omission not in good faith would eviscerate the protections afforded by Sections 102(b)(7) and 145 of the DGCL.
- In my words, the Ds and Os were not liable and further could be indemnified for their defense costs in this suit against them for "mismanagement of the hiring and firing of an executive. And we also may surmise that indemnification rights are quite powerful and pretty hard to take away.

Fundamentals

Indemnification – and how it comes about in real life D&O lawsuits

- Mandatory (think bylaws / charter / personal indemnification agreements)
- Permissive – I see this as an ad hoc voting of board members / executive decision; much less often than mandatory (less attractive)
- Court-ordered (really happens – think bad blood and defendant suing to get the indemnification, usually as “promised”)

Points 2 & 3 may get intertwined in reality.

And remember for the Ds and Os, indemnification is far more important than insurance (and D&O insurance is really important!)

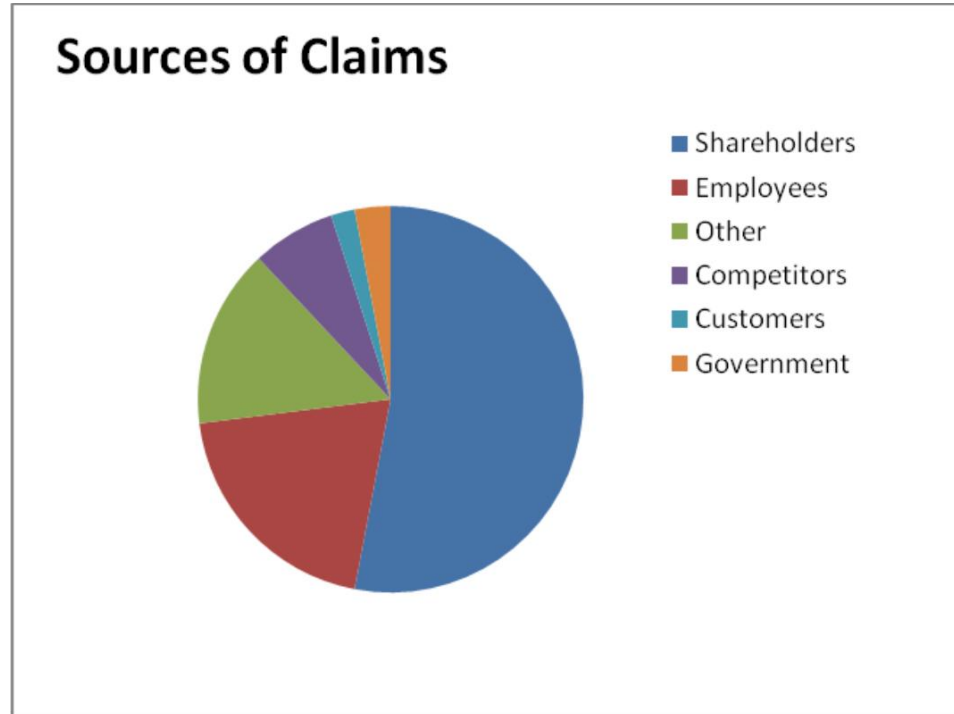
Fundamentals

Sources of D&O Liability

- Securities Laws (Public Companies)
 - But ownership and key decision disputes do pertain to Private Companies too
- Employment Laws (Private/Non-Profit Companies)
- Anti-Trust (Private Companies)
- Trade Practices
- Some Contractual issues
- Other Statutes:
 - Business & Corporate
 - Environmental
 - Criminal

And Disclosure of any of these items and issues; note the rising importance of ESG: Environmental; Climate; DEI and corporate governance in general. Also consider any events that may be tied to a lack of proper supervision on behalf of the board.

And who historically brings the D&O Claims?



The Other category may include creditors, vendors and suppliers; Government has grown recently, including SEC enforcement claims; Shareholders include private company investor claims. Derivative claims are in the shareholder category, although technically for these claims, the shareholders bring the action on behalf of the corporation.

Federal Securities Litigation risk drivers today

Federal Securities Legal Framework

- Securities Act of 1933 (Prospectus Liability)
- Securities Exchange Act of 1934 (Ongoing Risk)
- Securities Litigation Uniform Standards Act (SLUSA)
 - Amends portions of the 2 Acts noted above.
 - Enacted to prevent plaintiffs from circumventing the stringent pleading requirements of PSLRA (more on next page) by pleading their securities fraud claims as violations of state court instead of federal court.
 - SLUSA effectively made federal court the exclusive venue for most securities fraud class actions. (certainly that was the intent)

Federal Securities Litigation – the current era

Private Security Litigation Reform Act of 1995 (PSLRA) –

Overrode veto 12/22/1995

- Procedural changes - reduce abuses (e.g., professional plaintiffs)
- Stricter pleading requirements (which resulted in a much greater focus on insider trading)
- Stay on discovery pending Motion to Dismiss
- “Safe Harbor”- forward-looking statements (although it did not apply to IPOs)

Legislation impacting D&O Claim and Market Trends

Sarbanes-Oxley Act of 2002 (SOX)

- Certification by CEO & CFO (this was a big deal, at least initially)
- Independent Audit Committee
- New Disclosure Requirements
- Corporate Governance
- Section 404
 - 404(a) requires management to document, test and assess the effectiveness of their own company's internal controls over financial reporting.
 - 404(b) requires a publicly held company's auditor to attest to, and report on, management's own assessment of its internal controls.

Recent Court Decisions of Impact – Part 1

***Trulia* January 22, 2016 Delaware Court of Chancery Decision**

- In a case that arose from the stock-for-stock merger between real estate companies Zillow and Trulia, plaintiffs agreed to release their claims regarding misleading disclosures in exchange for supplemental disclosures about the financial opinion that Trulia directors relied on, as well as plaintiffs' counsel being awarded \$375,000 in fees. Once the Delaware court rejected the settlement and no fees were awarded, there was indeed a surge in federal merger objection cases, which contributed significantly to a D&O hard market!
- The Delaware Court of Chancery's 2016 decision in *In re Trulia, Inc. Stockholder Litigation* changed the landscape for "disclosure-only" settlements in class action suits. Recognizing a trend that had been building in the Court of Chancery, in *Trulia* Chancellor Bouchard [formally rejected a settlement] and declared his intent to reject [all] disclosure-only settlements unless the resulting supplemental disclosures are "plainly material" and any releases are "narrowly circumscribed". (Harvard Law School Forum on Corporate Governance)
- The *Trulia* decision clearly seemed to have inspired plaintiffs' firms to bring challenges to merger transactions largely in federal courts (and state courts outside of Delaware) in the hopes of escaping its effect. It did not work out well for them.
- What did happen was a huge annual increase of nearly 200 M-O (merger objection) claims into federal courts pushing federal securities claim counts to approximately 400 per year for 2017 to 2019, but then falling off dramatically after that as the dismissal rates reached 90% for this M-O subset of cases (per Cornerstone Research).
- As of 2022, the impact was essential gone.

Recent Court Decisions of Impact – Part 2

***Cyan* March 20 2018 Supreme Court Decision**

- *Cyan* found that “SLUSA did nothing to strip state courts of their longstanding jurisdiction to adjudicate class actions brought under the 1933 Act...SLUSA does not permit defendants to remove class actions alleging only 1933 Act claims from state to federal court.”
- This allowed 1933 Act cases (IPOs) to be brought in State courts (or even parallel in both state and federal courts) – which created an instant IPO hard market!

***Sciabacucchi* March 18 2020 ruling**

- Decided that federal forum selection clauses designating federal forum for securities claims brought under the Securities Act of 1933 are facially valid.
- Clients allowed to have forum provisions (i.e., specify federal court); this helps reduce your client risk profile.

Sciabacucchi prevailed as Parallel and State only actions in the year following *Cyan* decision were 52 filings in 2019, but only 13 such filings in 2021 in the year following *Sciabacucchi* ruling – a big win for clients. More recently in 2023, the number of state filings fell further to only 4.

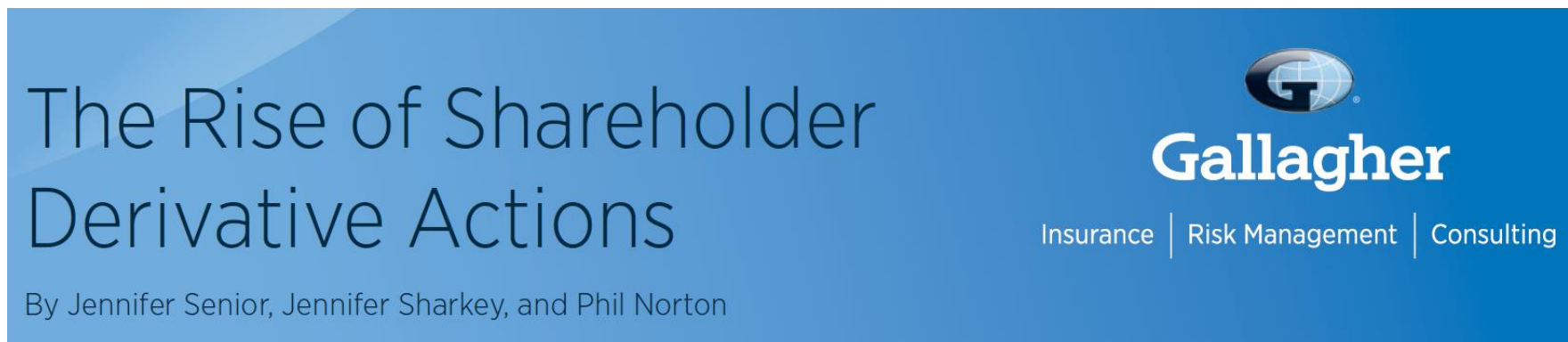
Note: This *Sciabacucchi* case involved three IPO companies that had designated federal forum selection clauses in their charter. The case was eventually appealed to the Delaware Supreme Court regarding the validity of these clauses and the court held in March last year that these provisions are facially valid. The question remained how states other than Delaware would view these clauses and there have now been a handful of subsequent cases in California upholding their use. Interestingly, the case’s appeal was funded by a consortium of D&O carriers and two brokers. Gallagher was thrilled to be one of the two brokers contributing to the cause.

Federal Securities Litigation & Derivative Claims

Derivative Claims

- Demand Requirement, futility, settlement
- Derivative Claims- shareholder lawsuits on behalf of corporation

Note: The trend for Stand-alone derivative action claims is of concern with significant severity on the rise. (see my white paper on this subject)

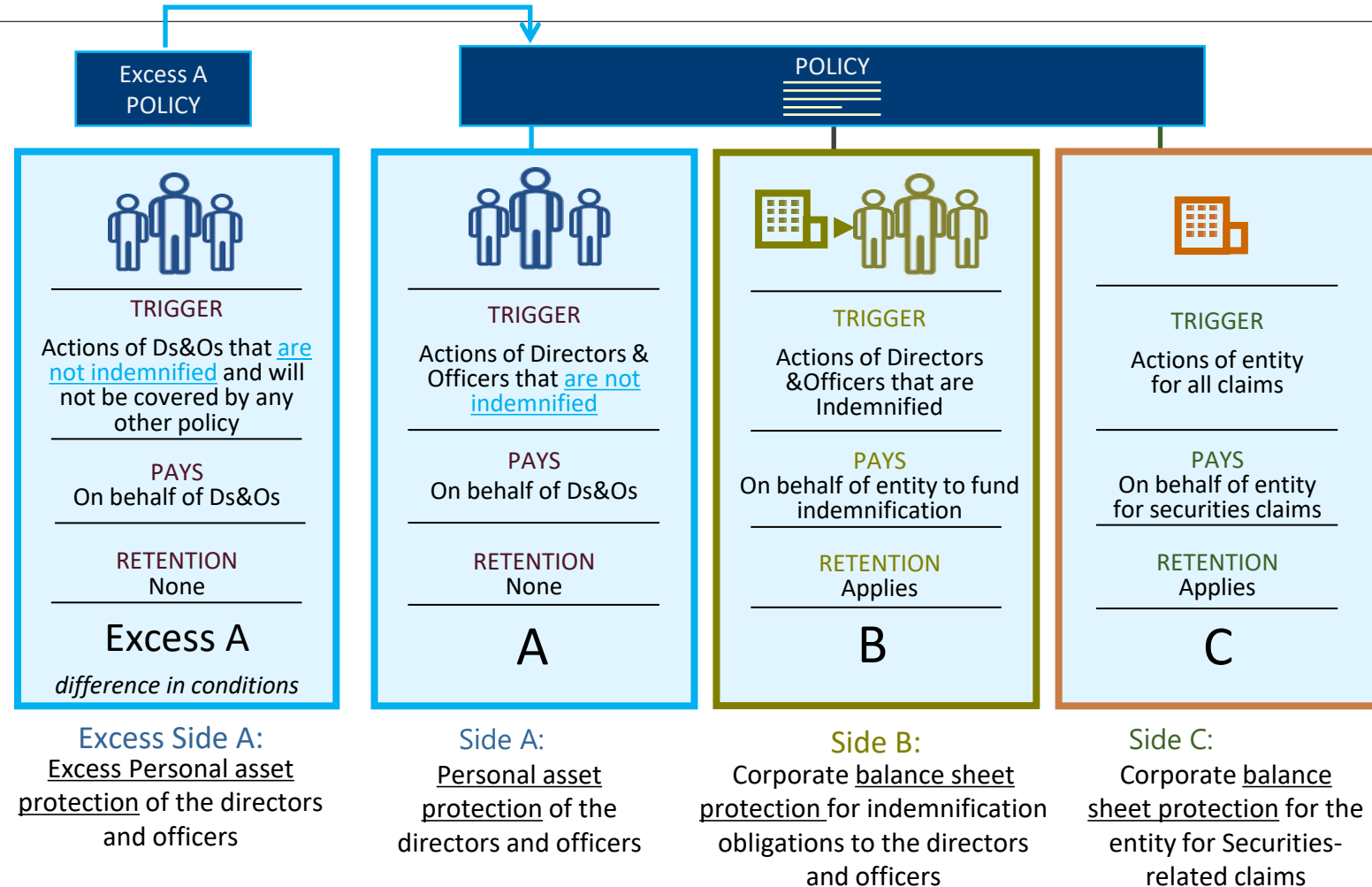


Outlining a D&O Policy

- Application Forms
- Insuring Agreements
- Covered Persons/Organizations
- Covered Damages
- Coverage Triggers
- Limits, Retentions, Coinsurance
- Defense Provisions
- Exclusions
- Miscellaneous Provisions, including some that are quite valuable!

D&O Insuring Agreements

Indemnification First,
Insurance Second



The D&O Policy

Coverage for Non-Bodily Injury or Property Damage Losses resulting in:

- “Claims” made against directors and officers, arising from
- “Wrongful Acts” in their capacity as directors and officers of the company
- EXCEPT for when things are added that don’t really fit. The 2 coverage additions that seem most valuable in view of current trends are:
 - Derivative Demand Investigations Coverage
 - Books & Records related Coverage

What is a Claim?

- Written demand for money
- Civil or criminal suits
- Formal administrative or regulatory proceedings
- Other Nuances – Waiving statutes of limitations for example (Tolling)

What is a “Wrongful Act”?

Any actual or alleged breach of duty, neglect, error, misstatement, misleading statement, omission or act

- *in his or her capacity as an Executive (and solely by reason of his or her status as such)*

Underwriting Data – Big Picture

- Applications and attachments, supplemental information
 - SEC Filings (publicly traded)
 - Press Releases
 - Projects underway; events concluded (good and bad)
- Financial Condition
- Industry factors
 - Susceptibility to litigation
 - Volatility of results / stock price
 - Size/outlook of the industry

Underwriting Data – Board Performance

Evaluation of Management and Corporate Governance

- Control by Chairman, CEO
- Board selection criteria, composition, turnover
- Compensation
- Conflicts of interest
- Knowledge of organization
- And the many things tracked by corporate watchdogs such as Institutional Shareholder Services (ISS)

Underwriting Data – Quantifying Risk

Exposure Base

- For Example: Market Cap, Assets, Revenues, Employee Count, Budget, Board Members

Company factors

- Conduct issues (hopefully positive press)
- M&A activity/divestitures
- Public offerings
- Litigation profile
- Federal Forum Provisions per Sciabacucchi (think back to the days when forward looking statement disclaimers were first paramount in 1996)

D&O Rating Modifiers to the Exposure Base

- Business Class
 - Industry
 - Ownership Structure
- Financial Condition
- Loss History / Claims
- Other Litigation
- Management Strategy
- M&A Activity
- Insider Holdings
- Insider Trading Activity
- Changes to Policy Wording
- Unusual Ownership issues
- Geography | Locations
- Approach to Risk Management (on D&O and possibly EPL)
- Corporate Governance
 - Board Composition/Issues
 - Audit Committee
 - Takeover Defenses
 - Compensation/Ownership

Corporate Governance Example – Institutional Shareholder Services (ISS)

QUALITYSCORE OVERVIEW

Board Structure 3

- Board Composition
- Key Committee Composition
- Board Practices
- ★ Board Policies
- Related-Party Transactions
- Board Structure Controversies
- Diversity and Inclusion

QualityScore

2

Low Risk High Risk

Scores indicate decile rank relative to index or region. A decile score of 1 indicates lower governance risk, while a 10 indicates higher governance risk.

Compensation 3

- Pay-For-Performance
- Non-Performance-based Pay
- Use of Equity
- ★ Equity Risk Mitigation
- Communications and Disclosure
- Termination
- Compensation Controversies

Audit & Risk Oversight 1

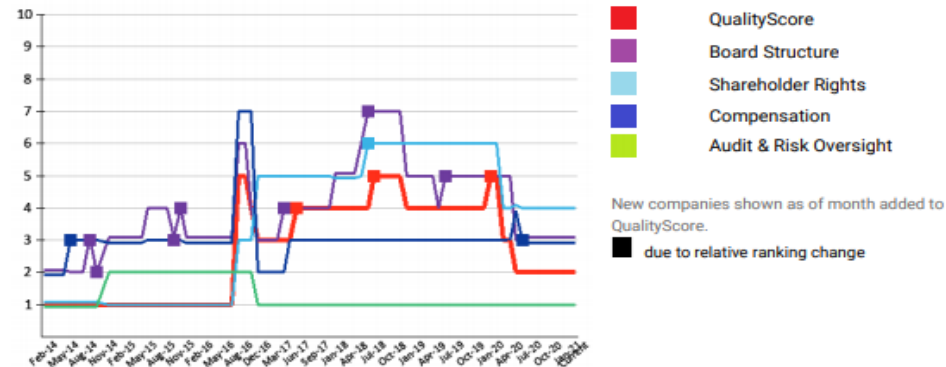
- External Auditor
- Audit and Accounting Controversies
- Audit - Other Issues

Shareholder Rights 4

- One Share, One Vote
- ★ Takeover Defenses
- Shareholder Rights - Other Issues
- Meeting and Voting-related Issues

The total number of points in this subcategory is at the ★ top ■ bottom ● middle of the possible range.

SCORE HISTORY



KEY RISKS

Board Structure

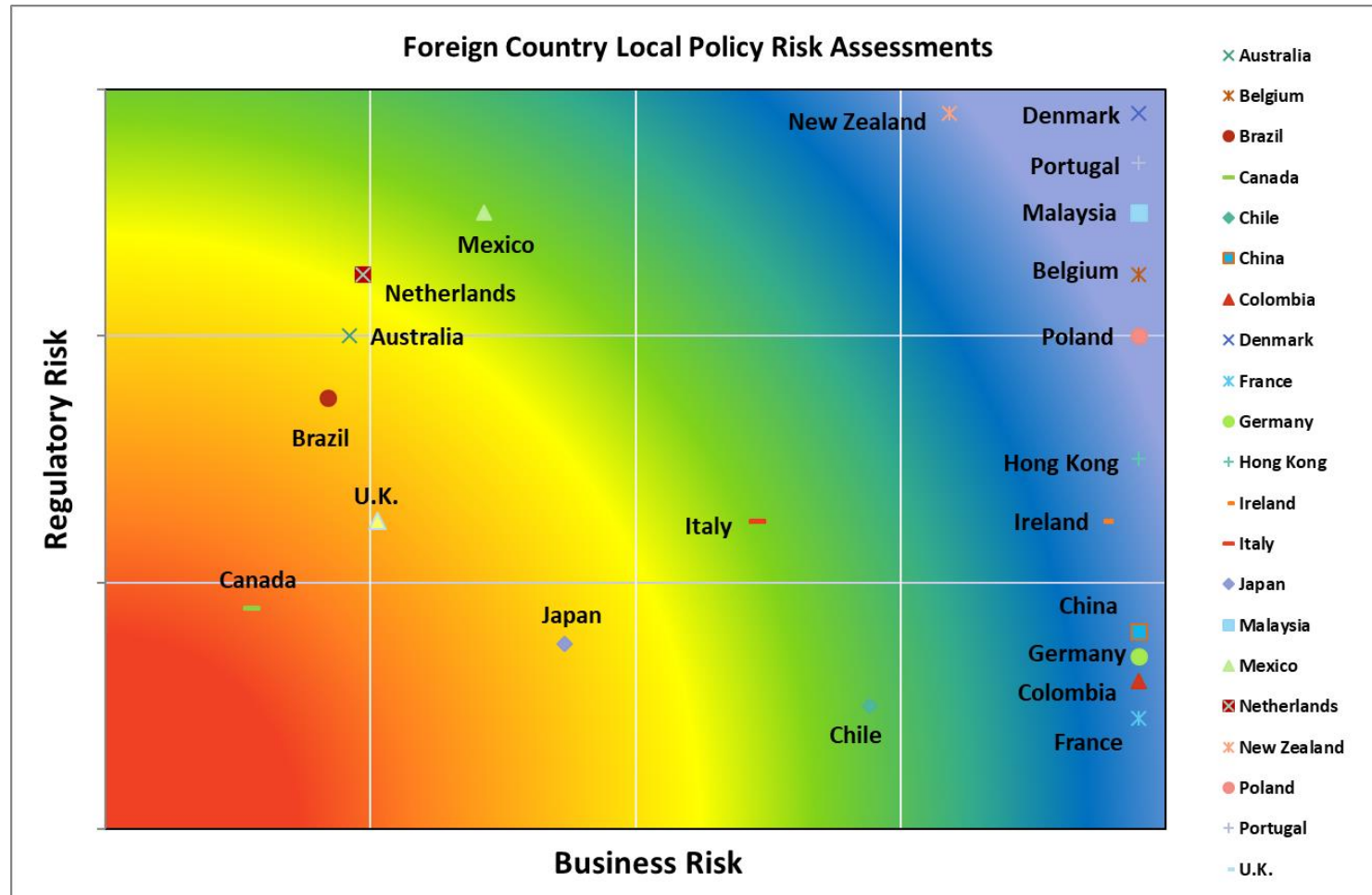
- 0 woman/women is/are (a) named executive officers at the company as of the last annual meeting. (Q387)
- The roles of Board Chair and CEO have not been separated. (Q14)
- 55.56% of the non-executive directors on the board have lengthy tenure. (Q13)

Compensation

- The ratio of the CEO's "all other compensation" amount to base salary is 101.22%. (Q237)
- The basis for the CEO's golden parachute is Salary + Most Recent Bonus. (Q247)
- The company has one or more agreements that include excise tax gross-up provisions, but also made a commitment not to provide excise tax gross-up payments upon a change in control in future agreements. (Q162)

The Key Risks section is company specific and highlights the most concerning issues at this company. This section will be different for each company and include factors where there is a potential misalignment with ISS policy and/or common market practices.

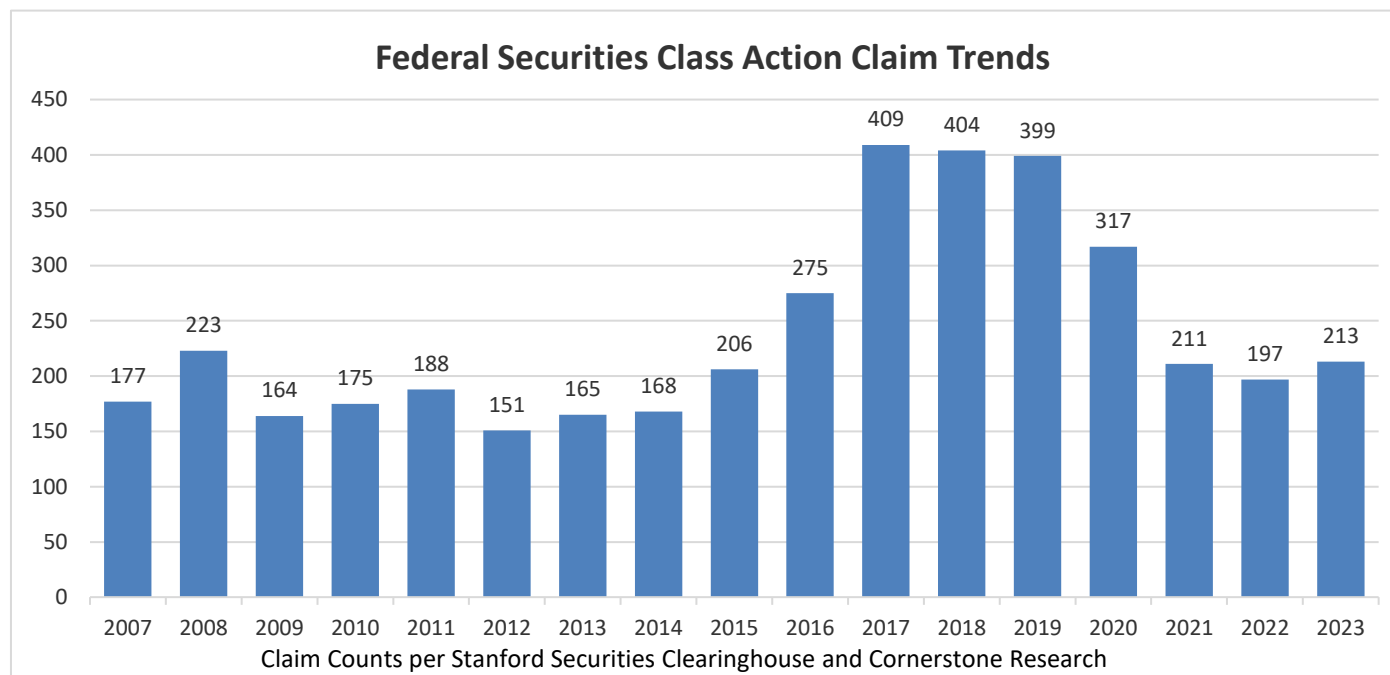
Sample International D&O Risk Analysis (Compliance; control)



This is just a sample graph. Key variables used to assess regulatory risk / importance of a local (underlyer) policy include:

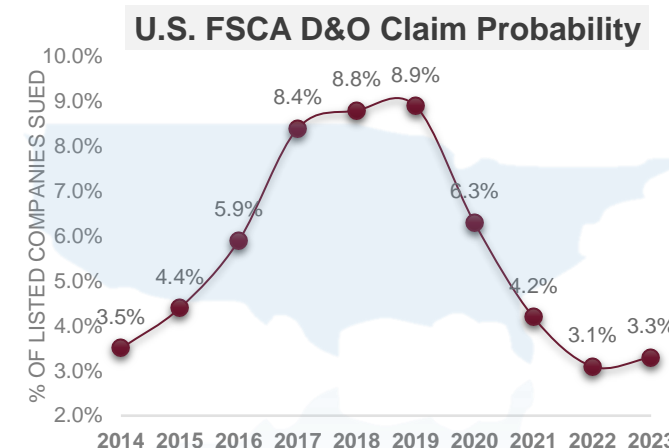
- Mandatory laws
 - Compliance standards
 - Attitude on non-admitted insurance policies
 - Enforcement policies
 - Available insurance from locally admitted carriers
 - D&O Indemnification stance
- Plus business risk data such as revenues from that country and the number of local employees and operating locations there.

U.S Public D&O Loss Trends



Event-Driven Litigation: COVID, SPACs and Cryptocurrency continue to contribute to the number of securities suit filings

- 10 COVID-related filings filed in 2023 (20 in 2022)
- 16 SPAC-related filings in 2023 (26 in 2022)
- 12 Cryptocurrency-related filings in 2023 (23 in 2022)



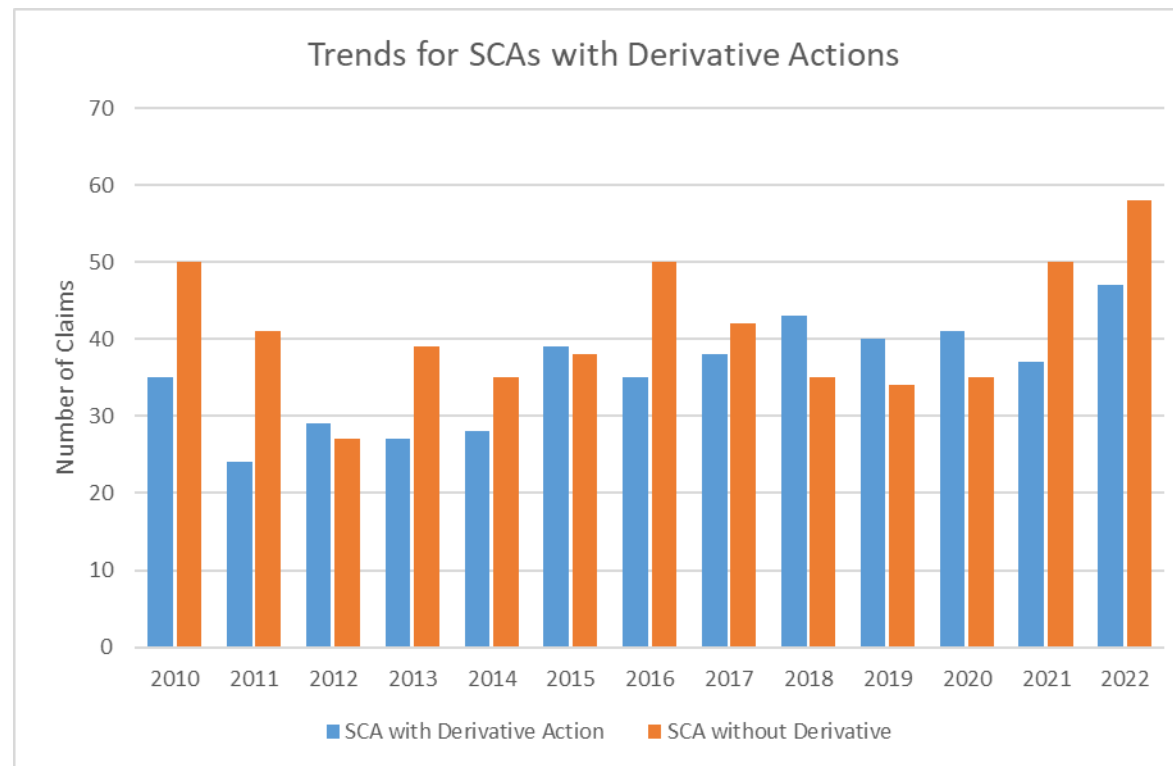
- Only 3.3% of companies listed on major U.S. exchanges were or became subject to a core or M&A filing in 2023.
- With record number of IPOs and SPAC/DeSPAC transactions in 2020-2021, the number of public companies has increased.
- At the same time, we had declining levels of federal securities class actions (SCAs) in 2020-2022; hence the resulting probability of an SCA filing against an NYSE or NASDAQ listed company has dropped from about 9% to 3%.

❖ Source: Cornerstone Research - 2023 Year in Review report

Derivative Action Claims Trends

Tracking 40 Large Derivative Actions (each closing for more than \$30M)

Year	Closed Claim Costs (\$M)	Closed Claim Counts	4-year Totals Cost (\$M)	4-year Totals Claims
2004				
2005	122	1		
2006				
2007			122	1
2008	115	1		
2009	118	1		
2010	225	2		
2011	89	1	547	5
2012	63	1		
2013	339	2		
2014	275	1		
2015	138	1	814	5
2016	38	1		
2017	280	4		
2018				
2019	82	2	400	7
2020	1,416	8		
2021	463	4		
2022	901	6		
2023	1,076	4	3,854	22

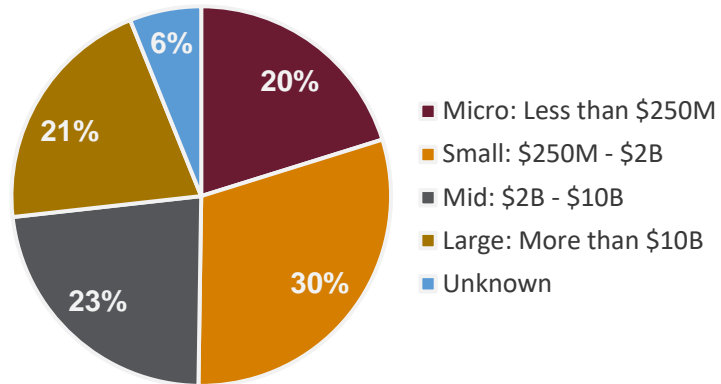


Pivot table is Phil Norton original research for Gallagher. Amounts confirmed by public information sources where cited as "derivative" by one or more of: press releases, articles, ISS, The D&O Diary and Advisen. Chart is based on Cornerstone Research Report on SCA Settlements dated March 28, 2023.

Moving Targets – Plaintiffs’ Bar Adept at Adapting to a Shifting Landscape

2023 SECURITIES CLASS ACTION (SCA) TRENDS

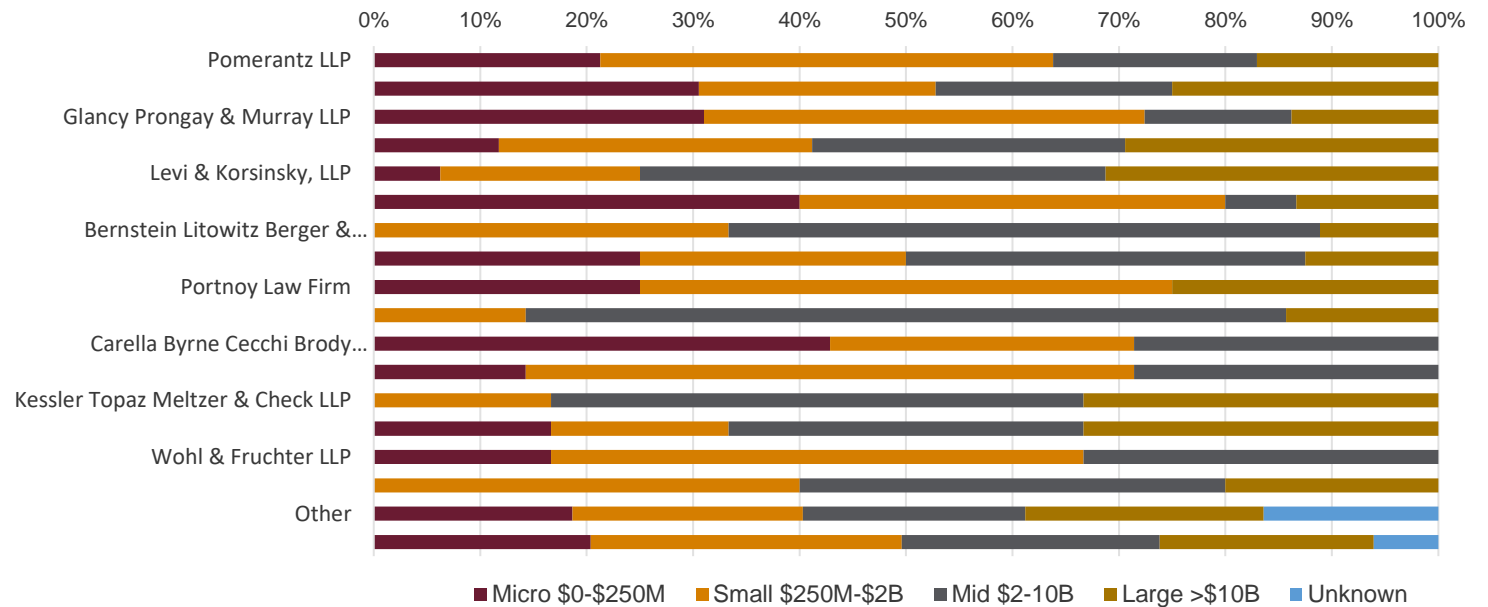
Who is being sued, by Market Cap category



Newer law firms lack the resources to sue larger, strong companies

Smaller companies were viewed as less risky, but that perception is changing

Plaintiff Law Firm Targets by size – 2023 SCA Litigation



Sources: Stanford Securities Litigation database, Ycharts, Yahoo! Finance, ISS

The Popularity of D&O

- Insurance is the oil for the economy
 - Nothing runs without it.
- D&O protects the heart of the machine
 - Execs at publicly traded companies insist on it. The Side-A portion of the policy has become critical for board member protection.
- The D&O policy and its many evolutions has been extremely popular in the US for more than 40 years now (perhaps young from insurance history perspectives).
- It has also been available globally for some time but that buying trend has accelerated since 2008 with both local purchases (risk driven) and local underlyers (compliance driven).

Questions?



Thank you!

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