MARSH | NACD NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

Evolving Directors & Officers Liability Environment

Emerging Issues & Considerations

MARSH & McLENNAN COMPANIES | Global Risk Center

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Introduction

WHEN IT COMES TO DIRECTORS AND OFFICERS LIABILITY,
THREE WORDS REALLY MATTER:

ARE YOU PROTECTED?

Company directors and officers operate in difficult, complex, and evolving business, legal, and regulatory environments, making challenges and risk exposures unavoidable. But a thorough understanding of risk and insurance issues can help directors and officers protect their personal assets.

In response to corporate scandals over the past two decades, public companies and their directors and officers face more scrutiny by federal regulators regarding corporate conduct and wrongdoing than ever before. Following the Sarbanes Oxley Act (SOX) and the US Department of Justice's (DOJ) renewed focus on individual accountability, directors and officers face increased litigation risks for regulatory noncompliance and corporate wrongdoing.

At the same time, shareholder groups are pressuring corporate management to make swift changes for a variety of reasons, many aimed at remaining competitive in complex world markets. Combined with merger and acquisition (M&A) issues, employment liability, cyber risks, and costly corporate investigations, directors and officers of organizations are exposed to significant litigation.

This Board Leadership Series report prepared by the National Association of Corporate Directors (NACD) and Marsh, provides issue summaries, checklists, and discussion guides to help directors and officers consider how their exposure may be evolving in the changing risk landscape and how to respond to emerging issues. Targeted toward both experienced and new directors, the report provides actionable and timely guidance on liability and insurance issues related to:

- The annual directors and officers review process
- Private company boards
- Mergers and acquisitions (M&A), spinoffs and bankruptcy exposures
- Transactional risks
- Cybersecurity risks
- Emerging trends in employment-related risks
- Global company board members
- Regulatory investigations

There is no single solution for protecting directors and officers from liability. But through a combination of strong corporate governance, broad corporate indemnification, and directors and officers (D&O) liability insurance and other coverages, company directors and officers can help protect their personal assets.

Directors and Officers Liability Insurance

A Ten-Point Annual Review and Checklist

INCREASED SCRUTINY ON DIRECTORS AND OFFICERS

Directors and officers of public, private, and nonprofit companies continue to face many exposures, including regulatory investigations and litigation. Public companies in particular are targets of litigation involving merger and acquisition (M&A) transactions, lawsuits in foreign jurisdictions, and claims in connection with executive compensation.

The US Department of Justice (DOJ) and the US Securities and Exchange Commission (SEC) have renewed their efforts to hold individual directors and officers accountable for purported corporate wrongdoing—the DOJ's recent publication of the Yates Memo[1] is one example of this heightened focus (see page 46 for further detail). As a result, organizations will likely see these regulatory agencies and others focus their civil and potentially criminal actions on individual directors and officers. The SEC and DOJ have continued to push for admissions of wrongdoing as part of their settlements with individuals and organizations. This differs from the past where individuals and organizations would neither admit nor deny the allegations as part of a settlement. While the focus and priorities of agencies such as the SEC and DOJ may shift from administration to administration, liability risk remains an important consideration for companies and boards.

REVIEW POLICIES ANNUALLY

While companies are required to protect their directors and officers—both by state law and by their own company documents and bylaws—D&O insurance provides extra comfort. D&O insurance is basically a form of personal asset protection for directors and officers.

As the stakes for directors and officers continue to rise, all directors—from those who are newly appointed, to highly tenured board members—should perform regular reviews of their D&O liability insurance. Keep in mind that D&O policy terms and conditions that are presented as "standard clauses" are often open to negotiation. Policies should be reviewed at a minimum annually, with an eye toward consistently improving the scope of coverage and narrowing exclusions. Should the risk profile of the company or board change—and depending on changes in the legal environment—more frequent reviews may be warranted.

1 Yates Memorandum, Department of Justice, September 9, 2015, (https://www.justice.gov/dag/file/769036/download)

TEN-POINT INDEMNIFICATION AND INSURANCE CHECKLIST

The ten-point checklist below provides a summary of important indemnification and insurance issues that board members should consider as part of an annual review:

1 Review indemnification language

Directors should understand the indemnification provisions of the company and ensure the indemnification language provides the maximum protection permitted under the law.

Corporate bylaws should require (not just permit) the company to indemnify current and former directors to the fullest extent permitted by law. Importantly, the indemnification provisions should also require advancement of defense expenses (unless there is a final, non-appealable adjudication by the court that indemnification is not permitted). Directors should also explore the possibility of entering into a separate written indemnification agreement with the company and consider the benefits of doing so.

2 Ensure sufficient limits of liability

One of the most common questions from insureds is, "How much limit should we purchase?" Regardless of the quantity of limits that were procured in the past, strong consideration should be given to increasing them. Defense costs are rising and potential liability that is covered under these policies is increasing.

While there is no formula to determine the perfect amount of D&O insurance to buy for any particular year, an examination of a wide variety of factors should be considered, including:

a. A regression loss analysis for multiple types of D&O claims
b. Large loss data
c. Industry-specific claim trends
d. Benchmarking against peer companies with a focus on:
  - **i.** Market capitalization, assets, and revenues
  - **ii.** Beta
  - **iii.** Price/earnings (P/E) and other valuation ratios
  - **iv.** International exposure
  - **v.** Leverage ratios
  - **vi.** Prior claim history

3 Check insolvency protection

For most company directors the most significant litigation scenario is an insolvency event. Because a company may not be able to indemnify its directors in bankruptcy, it is critical to ensure that:

a. The D&O insurance policy does not require directors to pay a retention before coverage applies.

b. Claims brought by a bankruptcy trustee or creditors committee are not barred under the "insured vs. insured" exclusion, which excludes coverage for claims brought by one insured against another insured.

c. The policy includes a priority of payments provision that expressly provides that insured individuals seeking payment of loss have priority of claims for coverage.

d. Insurance recoveries are not subject to a bankruptcy stay.

4 Consider Side-A coverage

Dedicate some component of the D&O insurance program to losses that are not indemnified by the company.

Traditional D&O insurance provides coverage for both indemnifiable loss (Side-B and Side-C) and non-indemnifiable loss (Side-A). Together, all three coverages provide broad protection for individuals and the company. It is important to note, however, that traditional coverage can be exhausted by indemnifiable losses (for example, securities claims against the company and the directors). As a result, more than 90 percent of publicly traded companies purchase Side-A difference-in-conditions (Side-A DIC) coverage. This type of coverage provides additional limits dedicated to individuals—only directors and officers are covered insureds under the policy. Side-A DIC policies can also fill gaps in the underlying traditional coverage (for example, the company refuses to indemnify a director or one of the underlying insurers becomes insolvent). Because the company is not an insured under a Side-A DIC policy, the company's defense or indemnity payments cannot erode the Side-A DIC limit of liability.

D&O INSURANCE KEY TERMS

Side-A: Many companies buy Side-A coverage, which is insurance for the directors and officers that is triggered if the company refuses or is unable to protect or indemnify its directors and officers. Side-A coverage operates as personal asset protection.

Side-B: Reimburses the company for costs it pays on behalf of a director or officer (typically legal defense costs, settlements, or judgments).

Side-C: Protects the company if it gets sued and operates as balance sheet protection.

5 Obtain coverage for regulatory investigations

D&O insurance policies typically provide coverage for damages, settlements, judgments, and defense costs arising from claims. To ensure the greatest possible coverage, directors will want the definition of claim to be as expansive as possible and include regulatory investigations by the SEC and other regulatory agencies against individuals. The policy should allow for recovery of costs associated with expenses relative to interviews, depositions, or document production costs of insured persons. In addition, some insurers are offering solutions for investigation coverage against the entity; the pros and cons of these should be discussed.

6 Check for locally admitted insurance coverage for multinational companies/securities

Directors of multinational entities (including but not limited to companies with securities listed on overseas exchanges), should obtain locally admitted insurance coverage in higher risk jurisdictions.

While securities class actions continue to be more frequent and more costly in the US than elsewhere, there are indications that such lawsuits are gaining ground outside the US. As a result of changes in the applicable laws, a number of countries have seen increased levels of securities litigation activity. The increased levels of regulatory scrutiny both during and after the global financial crisis have bolstered these trends, as has the increased availability of litigation funding. The significance of these trends has been heightened by the emergence of a number of high-profile scandals that have motivated many investors and their representatives to seek collective redress for investment losses.

7 Review cyber insurance coverage

Recent cybersecurity issues have led many directors to consider what role the board should have in overseeing cybersecurity matters. This has prompted questions about liabilities directors may face for cyber breaches and D&O insurance coverage. It is critical that D&O insurance coverage respond in the event of litigation alleging traditional claims for breach of fiduciary duties related to cyber issues. Accordingly, a claim for oversight liability—alleging that directors failed to see that the company implemented appropriate systems to manage cyber risks and to oversee those systems effectively—should fall squarely within the D&O policy.

(See "Cyber Risks Managing Rising Exposures for Directors and Officers" for additional detail.)

8 Select insurers carefully

Insurer selection and program structure (the tower) are important considerations for directors; it matters which insurer leads the insurance program and where each participates or attaches. Care should be taken when selecting insurance providers. There are a number of insurers to select from and a number of factors to be considered, including pricing, consistency of underwriting in the product, claims payment reputation, flexibility with coverage terms and conditions, and financial ratings. Which insurers participate and where each sits on the tower are equally important in claim situations. An insurance advisor's experience on these factors can be valuable given how the severity of D&O losses and the hard and soft market cycles can impact the availability of quality D&O insurance.

9 Review exclusionary wording

It is also important to review exclusionary wording. Most securities claims allege some form of fraud or self-dealing, thus the exclusion applicable to these acts is one of the most important components in a D&O policy. Currently, many insurers will expressly provide that the fraud exclusion only applies in the event of a "final, non-appealable adjudication in the underlying action." This feature is critically important and should prevent an insurer from denying coverage in a securities fraud case by proving fraud in a separate proceeding (for example, an insurance coverage lawsuit). Also, the breadth of both the preamble language and the wording of each exclusion should be considered.

10 Review the warranty letters and severability language

If insurers require, or have required, that a warranty letter be signed, make sure to review the letter in detail and consider its potential impact on future claims/coverage. In addition, and not limited to the application of a warranty letter, consider the severability language in the policy and in the letter to ensure that one individual's knowledge will not be imputed to other directors or the company.

TOP TEN
QUESTIONS FOR YOUR BROKER WHEN BUYING SIDE-A D&O INSURANCE

- ☐ **1.** Does the Side-A coverage require the director to pay a self-insured retention?
- ☐ **2.** Is the coverage non-cancellable and non-rescindable, except for non-payment of premium?
- ☐ **3.** Is the coverage triggered by any refusal or inability to indemnify by the company?
- ☐ **4.** Will the insurer agree to waive the "automatic stay" in the event of a bankruptcy?
- ☐ **5.** Does the insured vs. insured exclusion have a carve-back for a bankruptcy trustee or debtor-in-possession?
- ☐ **6.** Does the policy prioritize payment under Side-A before payments under Side-B, Side-C, or any other insuring clause?
- ☐ **7.** Does the policy provide broad coverage for both formal and informal investigations concerning the company?
- ☐ **8.** Can the Side-A policy "drop-down" in the tower to fill a layer of insurance that does not or cannot pay?
- ☐ **9.** Are the limits adequate for the potential exposure?
- ☐ **10.** Does the Side-A insurer have a strong financial rating?

Additional resources

- Report of the NACD Blue Ribbon Commission on Director Liability (https://www.nacdonline.org/Store/ProductDetail.cfm?ItemNumber=7851)
- Podcast: Directors and Officers Liability Insurance Fundamentals (https://www.marsh.com/us/insights/podcasts.html)
- Webcast: Risk Management 201: Financial and Professional Liability Claims Management (https://www.marsh.com/us/insights/research/rm-201-financial-and-professional-liability-claims.html)
- Insight: How Directors and Officers Can Rein in Product Liability Risks (https://www.marsh.com/us/insights/research/global-directors-officers-risks-product-liability.html)

Private Company Directors and Officers Liability

Five Key Focus Areas

Many corporations owned by private shareholders often think there is no need to purchase directors and officers (D&O) liability insurance. This is due in part to the belief that the only significant source of liability to a director or officer is from a disgruntled shareholder of a public company. However, lawsuits filed by shareholders represent only a portion of all reported lawsuits brought against directors and officers, which means that the remaining D&O lawsuits are brought by other parties, including employees, customers, creditors, competitors, and regulators. These exposures exist regardless of the number of shareholders.

There are many areas of exposure that present potential liabilities to the personal assets of directors and officers of privately held companies, and to the personal assets of their spouses and estates. Though a company's bylaws usually provide some type of indemnification to its directors and officers, there are many situations where corporations are unable (or unwilling) to provide such indemnification. These include bankruptcy or insolvency and non-indemnifiable acts, which public policy prohibits the company from providing indemnification. In this case, the only thing standing between the claim and the personal assets of the directors and officers is D&O insurance.

Private company D&O policies afford coverage to the board of directors and executive officers of a corporation for claims made against them in their capacities as such. These policies further afford coverage to the corporate entity (and in many cases all employees) for D&O claims and claims alleging violations of employment practices laws. For private companies, the price of private D&O insurance typically reflects the differences in exposures.

TOP FIVE
FOCUS AREAS FOR PRIVATE COMPANY D&O INSURANCE

- ☐ **1.** Protect the personal assets of directors and officers and those of their spouses and estates.
- ☐ **2.** Protect the income statement and balance sheet of the company.
- ☐ **3.** Attract and retain qualified outside directors.
- ☐ **4.** Establish a relationship with an insurer before a potential initial public offering (IPO).
- ☐ **5.** Avoid diverting management attention to protracted and costly litigation.

PRIVATE COMPANY D&O EXPOSURE

The applicable legal standards of conduct for directors and officers of privately held companies are identical to those in publicly held corporations. Directors and officers—regardless of the size of their corporation or ownership structure—are subject to three basic duties in performing their responsibilities: obedience, loyalty, diligence.

Virtually all liability lawsuits involving directors and officers have allegations of breaching one or more of these duties. Private companies can face numerous exposures, including:

- **Claims by employees**
  Claims alleging harassment, discrimination, and wrongful termination against the company itself and the directors and officers have increased in both frequency and severity. A properly designed private D&O insurance program can respond to these claims against the entity and the individual insureds.
- **Claims by customers, clients, and consumer groups**
  Common allegations include harassment, discrimination, violation of civil rights, contract disputes, and false advertising.
- **Claims by competitors, suppliers, and other contractors**
  Common allegations include anti-trust violations; unfair competition resulting in lost business by the competitor; and infringement of patents, trademarks, and trade secrets.
- **Claims by other third parties**
  Such claims vary from those relating to environmental contamination to employee health and safety. Additionally, privately held corporations in certain industries can face investigations and claims by certain regulatory agencies with respect to suspected or actual wrongdoing.
- **Claims by shareholders**
  Private companies are not immune to suits brought by private shareholders, bondholders, or other investors. Such claims can include alleged misrepresentation and inadequate or inaccurate disclosure in financial reporting of private placement materials. Other examples of shareholder claims affecting private companies include:
  - Breaches of the duty of care with respect to how the directors and officers handle the sale of a corporation or how they missed a great business opportunity for the corporation.
  - Breaches of the duty of loyalty with respect to deals the corporation enters into with companies owned in whole or in part by one or more of the directors and/or officers.

- **Mergers and acquisitions (M&A)**
  A private company can enter into an M&A transaction as the buyer or seller. D&O insurance can help protect against potential claims, including:
  - Disgruntled shareholder suits.
  - Alleged financial misstatements.
  - Failure to perform appropriate due diligence when making an acquisition.
  - Bankruptcy resulting from a failed transaction.
  - Claims from past creditors and/or vendors of the acquired company.

It is important to note that directors can be held liable for both pre- and post-transaction acts.

PRIVATE COMPANY NON-EMPLOYMENT RELATED D&O CLAIM EXAMPLE

Harassment and discrimination claims appear to saturate the media every day. Companies of all sizes and from any industry are susceptible to these claims. Below are some examples of non-employment related D&O claims.

- A president of a corporation was held liable for breach of contract when his corporation refused to deliver goods to a consumer and sold the goods to another party at the direction of the president.
- The president of a livestock auctioneer corporation was held liable to a secured creditor for conversion of cattle, where the president arranged the sale of cattle, without determining the existence of a security interest in the cattle.
- The president of a construction company was held liable for negligence in the construction of a building because he was at the construction site on a daily basis, undertook to supervise construction, and failed to act with reasonable care.
- A corporate president was held liable to the lessee of adjoining premises damaged by demolition of a building owned by his corporation, because he failed to give the contractor instructions concerning the demolition despite his knowledge that if the demolition was not done properly, it would damage the adjoining property.
- The president and vice president of a waste disposal service were held liable for the corporation's illegal dumping and storage activities.
- Corporate officials were held liable in a trademark infringement case despite their claim that they acted primarily for the benefit of the corporation.

Additional resources

- NACD Private-Company Governance Resource Center (https://www.nacdonline.org/Resources/BoardResource.cfm?ItemNumber=29253)

Unique Directors and Officers Exposure to Consider

Mergers and Acquisitions, Spinoffs, and Bankruptcy

Company-level transactions present risks to the company's directors and officers. Mergers and acquisitions (M&A), bankruptcy, and spinoff transactions pose specific risks to directors and officers that can be addressed by a company's directors and officers (D&O) liability insurance.

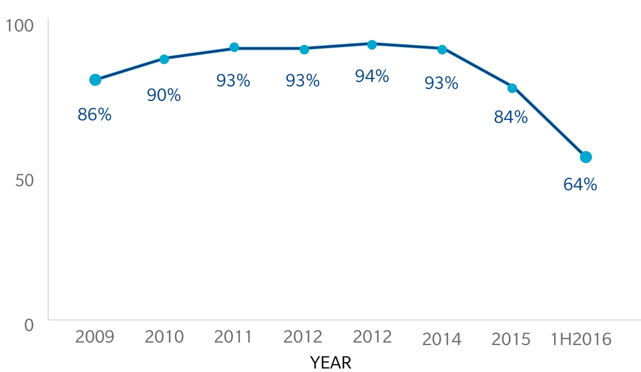
MERGERS AND ACQUISITIONS
MERGER OBJECTION LITIGATION AND A CHANGING RISK LANDSCAPE

M&A activity raises the risk of litigation to directors and officers due to challenges from shareholders seeking increased compensation and disclosures. The significance of M&A events tends to draw increased scrutiny from both shareholders and plaintiffs' attorneys.

Recent rulings in the Delaware Chancery Court have significantly shifted the landscape for M&A litigation risks for directors. Traditionally, once a company announced a merger or acquisition, plaintiffs would file lawsuits alleging that directors breached their fiduciary duties by agreeing to an unfair deal and failing to provide sufficient disclosures to shareholders. From 2009 to 2015, an average of 90 percent of public M&A transactions valued over $100 million were subject to one or more of these types of lawsuits (see Exhibit 1). Plaintiffs typically agree to settle the dispute by demanding additional corporate disclosures, agreeing to broad releases of any defendants' liability and seeking a plaintiffs' attorney fee award. As the state of incorporation for many companies, Delaware courts saw the majority of these M&A lawsuits and, for many years, approved these "disclosure-only" settlements that provided no remuneration to shareholders.

Exhibit 1

PERCENTAGE OF M&A DEALS VALUED OVER $100 MILLION
CHALLENGED BY SHAREHOLDERS



Source: Cornerstone Research Shareholder Litigation Involving Acquisitions of Public Companies: 2015 and 1H 2016

Delaware judges have recently questioned the value of these settlements, and in some cases refused to approve them. In one instance, the judge rejected the parties' proposed settlement after characterizing merger objection lawsuits as a "systemic" problem that has distorted the legal system. Following the shift in how Delaware judges view these lawsuits, the number of M&A lawsuits in Delaware has significantly declined. According to Advisen, through the first three quarters of 2016, plaintiffs filed over 50 percent fewer M&A lawsuits in Delaware, compared to the entire year of 2015.[1] Plaintiffs are instead turning to other jurisdictions.

In addition to filing in other state courts, plaintiffs have increasingly filed merger objection lawsuits in federal court. It remains to be seen how these courts will deal with the increase in M&A lawsuits. Some states may follow Delaware's lead and resist disclosure-only settlements that provide broad releases to defendants and six figure awards for plaintiffs' attorneys. Other jurisdictions, however, may be more amenable to these types of settlements even though shareholders receive no remuneration.

Although many plaintiffs have shifted their filing of M&A lawsuits to other jurisdictions, some plaintiffs still choose to file in Delaware. Those plaintiffs may believe they can structure a settlement that can withstand the scrutiny of Delaware judges. Alternatively, they may simply be willing to litigate the matter through trial and have no intention to agree to a disclosure-only settlement. In recent months, the percentage of cases resolved before the close of the transaction has decreased, potentially as a result of the difficulty in obtaining disclosure-only settlements.

These trends present greater risks to directors and officers: If the traditional disclosure-only settlement is no longer available, M&A lawsuits may take longer to resolve and become more costly. In addition, if the underlying M&A transaction closes while the lawsuit is still pending, the scope of potential remedies narrows, because defendants cannot simply issue supplemental disclosures to remedy the alleged violations.

Furthermore, after the transaction closes, the directors of the merged company may no longer represent the interests of the defendants who are often the directors of the now-defunct company. In extreme cases, the directors of the merged company may even refuse to provide corporate indemnification for the former directors. To avoid the prospect of having to personally pay for legal costs, directors should ensure they have a runoff insurance policy (often referred to as "tail" insurance) with robust Side-A coverage (coverage dedicated to individuals—only directors and officers

1 Quarterly D&O Claim Trends: Q3 2016, Advisen, October 11, 2017, slide 14, (http://www.advisenltd.com/wp-content/uploads/2016/08/q3-2016-DO-claims-trends-slides-2016-10-13.pdf).

are covered insureds) in place. It may become even more important for directors and officers to ensure they have adequate policy limits, given the uncertainty around settling M&A lawsuits and the trend of such lawsuits taking longer to resolve.

BANKRUPTCY CONSIDERATIONS

Although the potential for bankruptcy is not typically a primary focus when a director agrees to join a board, bankruptcy has significant insurance implications. Directors should ensure that their D&O insurance policy adequately covers them both during and after a potential bankruptcy.

While bankruptcy proceedings are ongoing, a company's obligation and ability to indemnify its directors will be suspended. Directors will therefore have to rely on insurance to protect their personal assets against any claims. Side-A coverage under a D&O policy is intended to cover directors when a company is unable or unwilling to provide indemnification—such as in a bankruptcy. Directors should ensure that their insurance policies have adequate Side-A limits and language that ensures the policy proceeds will be available to the directors in the event of a bankruptcy. In particular, directors should ensure that the Side-A coverage is not cancellable or rescindable for any purpose, except for non-payment of premium.

Directors should also ensure that they have adequate insurance coverage for any claims that might arise after the bankruptcy. A runoff insurance policy will continue to cover the directors for any claims based on their actions that occurred prior to a specific date, which is often the date the bankruptcy proceedings conclude. Purchasing the runoff policy prior to entering bankruptcy is recommended as it may be more difficult to purchase it after the company has filed for bankruptcy. Side-A coverage is also critically important in this context. Indemnification might be unavailable to the directors, because the company may no longer exist or it reorganized and is refusing to indemnify the former directors who arguably led the company into bankruptcy.

SPINOFF TRANSACTIONS

Over the past few years, particularly with increased shareholder activism, there has been more of a push for management and boards to consider spinoff transactions in an attempt to unlock shareholder value. Some of the unique exposures to spinoff transactions relate to whether:

- The D&O insurance program for the existing public company should be put into runoff and a new go-forward program be placed for each company with no prior acts coverage.
- The existing company should retain all of the prior acts liability and the spinoff should purchase a program containing no prior acts protection.

How to deal with the prior acts coverage depends on the verbiage in the separation agreement between the companies, as well as management's preference for each specific transaction. Purchasing three programs (two for ongoing and one for the runoff of old liabilities) is more costly but can clearly delineate where the liability falls. This also ensures full aggregate limits are available to each entity even if claims are made on the announcement of the spinoff but prior to the transaction, which is common. Discussing the potential issues involved in structuring the D&O insurance programs with a knowledgeable insurance broker and outside counsel is important to understand the pros and cons of each option.

Another important issue in spinoff transactions is making sure that both entities purchase uniform D&O coverage, at least in the first year post-transaction. Having common insurers and terms and conditions ensures that any common, inter-related claims are definitively covered under one program or the other. Also, potential "finger pointing" between insurers as to which program should provide coverage can be mitigated by having uniform D&O coverage. The primary D&O policies of the two entities should have a common endorsement stipulating that any claims that might "straddle" the two programs will fall into one program or the other. This is especially important since it is likely that litigation arising within the first year of the spinoff will have allegations that may overlap both policies. Often there will be common management, board members, or individuals who might have been involved in earlier decisions that moved from the existing company to the spinoff. Only one D&O policy and one retention should apply to these "straddle" claim situations, so ensuring the policies are drafted correctly is integral to protecting directors and management.

D&O RUNOFF COVERAGE

A common topic in M&A, bankruptcy, and spinoff transactions is the need for runoff coverage (often referred to as "tail" insurance) for the D&O program. Standard purchase and sale agreements generally stipulate the purchase of a six-year D&O runoff policy to protect the management and board from claims that might arise post-closing for decisions that were made prior to the transaction. Similarly, these issues may arise in bankruptcy situations if there is a change of control in the voting stock of the company of over a certain percent as part of the corporate restructuring. If this occurs, either the change of control provision needs to be waived or runoff coverage should be secured to protect the directors and management of the company who were involved pre-bankruptcy.

Spinoff transactions do not necessarily require the purchase of a separate runoff policy as the existing company often retains the "oldco" liabilities going forward. But some companies elect to put all old liabilities into a D&O runoff program and purchase a new program with no retained liabilities going forward for each company post-transaction.

Additional resources

- Private equity and M&A services (https://www.marsh.com/us/services/private-equity-mergers-acquisitions.html)
- NACD Governance Challenges 2016: M&A Oversight (https://www.nacdonline.org/Resources/Article.cfm?ItemNumber=27364)
- M&A and Transaction Risk Oversight (NACD Advisory Council on Risk Oversight) (https://www.nacdonline.org/Resources/Article.cfm?ItemNumber=23139)
- NACD Amicus Brief Regarding Shareholder Litigation Involving Rural/Metro Corp (https://www.nacdonline.org/Resources/Article.cfm?ItemNumber=14936)

TOP FIVE
RUNOFF COVERAGE QUESTIONS TO ASK

- ☐ **1.** Is the cost of the runoff coverage—or the factor of the annual premium—competitive? Can it be lowered as you move up the tower (the D&O program of insurance) from one layer of insurance to the next rather than following whatever the primary insurer charged?
- ☐ **2.** Is there a fresh (or new) aggregate limit of liability or are claims on an extended limit, which may erode what is available to the runoff program?
- ☐ **3.** Is the proportional unearned premium being applied to the total cost of the runoff?
- ☐ **4.** Does the runoff insurance program need to include an endorsement that specifically allows the acquiring company to have access to the policy, especially if that entity is the one indemnifying the individual directors and officers post-close?
- ☐ **5.** Although not typically required in the purchase and sale agreement, should you also consider standalone runoff coverage for ancillary management liability lines, such as fiduciary liability, employment practices liability, and cyber/errors and omissions liability?

Transactional Risk Insurance

Mitigating the Uncertainty of Acquiring a New Asset or Business

Acquiring a new asset or business entails risk. With the right kind of contractual protections in the underlying purchase agreement and/or by using transactional risk insurance, some of the uncertainty can be mitigated. Once an esoteric insurance product, transactional risk insurance was traditionally used to protect against risks that arose during due diligence. However, transactional risk insurance is now a commonplace feature in the global M&A landscape and is used by both buyers and sellers as a strategic component of M&A transactions.

Private equity funds, corporate buyers and sellers, as well as individuals, can benefit from transactional risk coverages, including:

- Representations and warranties insurance.
- Tax indemnity insurance.
- Contingent liability insurance.

REPRESENTATIONS AND WARRANTIES INSURANCE

Representations and warranties (R&W) insurance generally provides coverage for all representations and warranties contained in an acquisition agreement. The policy protects the insured against financial loss, including defense costs, resulting from breaches of the representations and warranties made by the target company or the seller(s) in a purchase agreement. Either the buyer or seller—but not both—can be the insured under the policy. The vast majority of policies are written for buyers.

R&W–BUYERS	R&W–SELLERS
Adds protection beyond the negotiated indemnity cap and survival periods in a purchase agreement.	Backstops negotiated indemnity obligations (this is a key benefit for private equity or venture capital funds at the end of their life cycle).
Allows buyers to distinguish a bid in an auction (for example, requiring only minimal or no survival of the representations and warranties in a bidder's draft purchase agreement).	Protects minority/passive sellers concerned with joint and several liability.
Protects against collectability/solvency risk of an unsecured indemnity (for example, financially distressed, non-US, or multiple sellers).	Provides additional comfort for individual or family sellers.
Preserves key relationships by eliminating the need for the buyer to pursue claims against management sellers working for the buyer post-closing.	Provides a solution for situations where there is a lack of ownership history (for example, restructuring and "loan to own" scenarios).

R&W insurance policies are fully customized and negotiated on a deal-specific basis. A few exclusions apply, such as those for:

- Asbestos/polychlorinated biphenyl (PCB).
- Pension underfunding.
- Net operating losses.
- Criminal fines/penalties.
- Post-closing purchase price adjustments.
- Actual knowledge of breaches or fraud by the insured's deal team.

TAX INDEMNITY INSURANCE

Tax indemnity insurance is most often used in one of two scenarios:

1. To provide protection in the event a taxing authority challenges a historical tax position taken by the target entity—either assumed by the buyer or retained by the seller via an indemnity.

2. To insure a particular tax structure being used in the transaction.

Buyers and sellers typically purchase tax indemnity insurance when the likelihood of the potential tax liability is low but the amount of liability is so substantial relative to the size of the transaction that the parties cannot agree on escrow or indemnification for the issue. The policy generally covers the tax liability (to statute limits), fines and penalties, interest, legal costs, and tax gross-up.

Tax indemnity policies have been used for various issues, including:

- Real estate investment trust (REIT) status and related risks.
- Successor liability.
- Tax credit recapture risk.
- Net operating losses.
- S-corporations/maximizing tax benefits under tax code 338(h)(10).
- Capital gains versus ordinary income.
- Tax-free reorganizations.
- Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48).

CONTINGENT LIABILITY INSURANCE

Contingent liability insurance provides coverage for one-off, known exposures in an M&A transaction. In these situations, a claim may arise immediately or sometime in the future after the closing of a transaction. This is different from R&W insurance, which does not cover known issues.

Areas of potential coverage include:

- Fraudulent conveyance
- Successor liability
- Open-ended indemnities
- Potential litigation risk

Similar to tax indemnity insurance, buyers and sellers typically purchase this insurance when the likelihood of the potential contingent liability is low but the amount of the liability is so substantial relative to the size of the transaction that the parties cannot agree on escrow or indemnification for the issue.

CURRENT LANDSCAPE
TRANSACTIONAL RISK INSURANCE

- ☐ Niche insurance underwritten by a limited, but growing, number of well-established insurers with global capabilities.
- ☐ Policy limits of more than $500 million per transaction are available.
- ☐ For R&W, one-time premiums range from 3 to 4 percent of total limit for entire policy period (3 to 6 years depending on type of rep). premiums slightly lower outside US and Canada.
- ☐ For tax indemnity, one-time premiums range from 4 to 8 percent of total limit for entire policy period (typically up to 6 years or applicable statute of limitation).
- ☐ Quoting process can be started with just a draft purchase agreement or analysis of tax issue.

Additional resources

- Private equity and M&A services (https://www.marsh.com/us/services/private-equity-mergers-acquisitions.html)

Cyber Risks

Managing Rising Exposures for Directors and Officers

The business world today has become digitized, wherever you look and in every conceivable way. With the benefits of technology, however, also comes the growth of cyber risk. Businesses are potentially exposed to cyber attacks regardless of their industry, size, or the quality of their cyber controls.

The new reality is that cyber breaches are going to happen and will continue to be a part of doing business going forward. As a result, cyber-risk exposure has evolved into a key directors and officers (D&O) liability insurance issue at the board level. One of the five key principles in NACD's Director's Handbook on Cyber-Risk Oversight states: "Board-management discussion of cyber risks should include identification of which risks to avoid, which to accept, and which to mitigate or transfer through insurance, as well as specific plans associated with each approach."[1]

Cyber-risk management and oversight needs to be proactive, and organizations cannot afford to focus exclusively on technology to prevent cyber attacks. Companies need to evolve their cyber resiliency capabilities—the ability to anticipate, prepare, and learn from cyber attacks—to carry on in the face of inevitable risk. Additionally, all parts of an organization, including the board, must embrace and do their part in supporting a comprehensive cybersecurity program that is robust, focused on the business, and continually monitored and reviewed for improvement based on the changing cyber-threat environment.

For example, a large tech company recently victimized by a massive data breach also made the news for cooperating in 2015 (allegedly against their chief information security officer's (CISO) recommendation) with a US government request for access to millions of user email accounts. While there does not appear to be any correlation between these two events, there may be far-reaching consequences for the company's cybersecurity preparedness, breach response, and legal/compliance decisions—core issues that ultimately fall under the board's oversight.

Several shareholder derivative lawsuits in recent years have concerned these very issues in the wake of breaches by certain large companies. In these derivative claims, board members were alleged to have breached their fiduciary duties by not having a proper cyber incident response plan in place, in addition to neglecting to implement other cybersecurity measures relating to quantification and preparation. Separately, breaches that result in a drop in share prices can also lead to a shareholder class action, which occurred in the wake of one large breach in 2015.

1 NACD Director's Handbook on Cyber-Risk Oversight (https://www.nacdonline.org/cyber)

Information security controls, procedures, and technology based on a structured and risk-based approach to assessment of cyber exposures (see Exhibit 2) can do a great deal to reduce the frequency of cyber attacks. These are not fail-proof measures, however, and it is also difficult to blunt the potentialseverity (in terms of financial cost) of a catastrophic cyber attack. For these reasons, organizations should turn to risk transfer, typically in the form of cyber insurance.

Exhibit 2

STRUCTURED AND RISK-BASED APPROACH TO ASSESS CYBER EXPOSURES

UNDERSTAND YOUR POTENTIAL AREAS OF RISK

- Consider organization's internal and external business environment.
- Examine current systems, practices and controls for monitoring, reporting and response, with regards to cyber-related risks.
- Articulate organization's cyber risk appetite.
  - Use risk consequence criteria/levels of impact.

UNDERTAKE A RISK ASSESSMENT

- Include a variety of personnel across business, including:
  - Key business assets and critical information systems.
  - Information system/security, legal and risk personnel.
- For each cyber loss exposure considered, identify potential scenarios of threat sources and risk drivers.
- Assess effectiveness of current controls and practices in place to manage each threat source and risk driver.

RISK TRANSFER AND LOSS FUNDING OPTIONS

- For identified threat sources and risk drivers, confirm available contractual risk transfer and loss funding options.
- Undertake analysis of expected first- and third-party insurance policy response to each risk event/scenario.
- Enlist help from organization's insurance broker as needed.
- For non-insurance key risk events:
  - Review vulnerabilities they cause.
  - Develop strategies and initiatives to improve system and controls.

DEVELOP UNDERWRITING INFORMATION

- Provide information amassed during previous steps to insurance market. This will help:
  - Cyber insurance market underwrite on an informed basis.
  - Organization's insurance broker negotiate best available cyber insurance policy cover, limits pricing, and terms.

Source: Marsh Analytics

QUESTIONS TO EVALUATE D&O COVERAGE FOR CYBER RISKS

In order to directly protect the directors and officers of a company in the event of cyber incidents, it is critical to ensure that a company's D&O liability insurance—in addition to cyber coverage—will respond in the event of litigation alleging traditional claims for breach of fiduciary duties relating to a cyber event.

Specifically, companies should consider

- Does the policy include regulatory investigations coverage?
- Is there an applicable professional services exclusion?
- Is there an invasion of privacy exclusion? If so, can this be eliminated, or alternatively what can be done to soften the wording?

On a broader level, while the area of potential D&O exposure to a cyber-related claim continues to develop, it is critical to ensure that the company has sufficient D&O limits of liability, including Side-A limits—limits that protect only the directors and officers for non-indemnifiable loss—among other things.

BROADER ORGANIZATIONAL BENEFITS OF CYBER INSURANCE

Although cyber insurance may not cover all the costs from the impacts of a cyber attack and the remediation (see Exhibit 3), it is an effective way to reduce the immediate cost of a cyber attack. But it also may come with other benefits as well. Cyber insurance can bolster cyber resilience by creating important incentives that drive behavioral change, including:

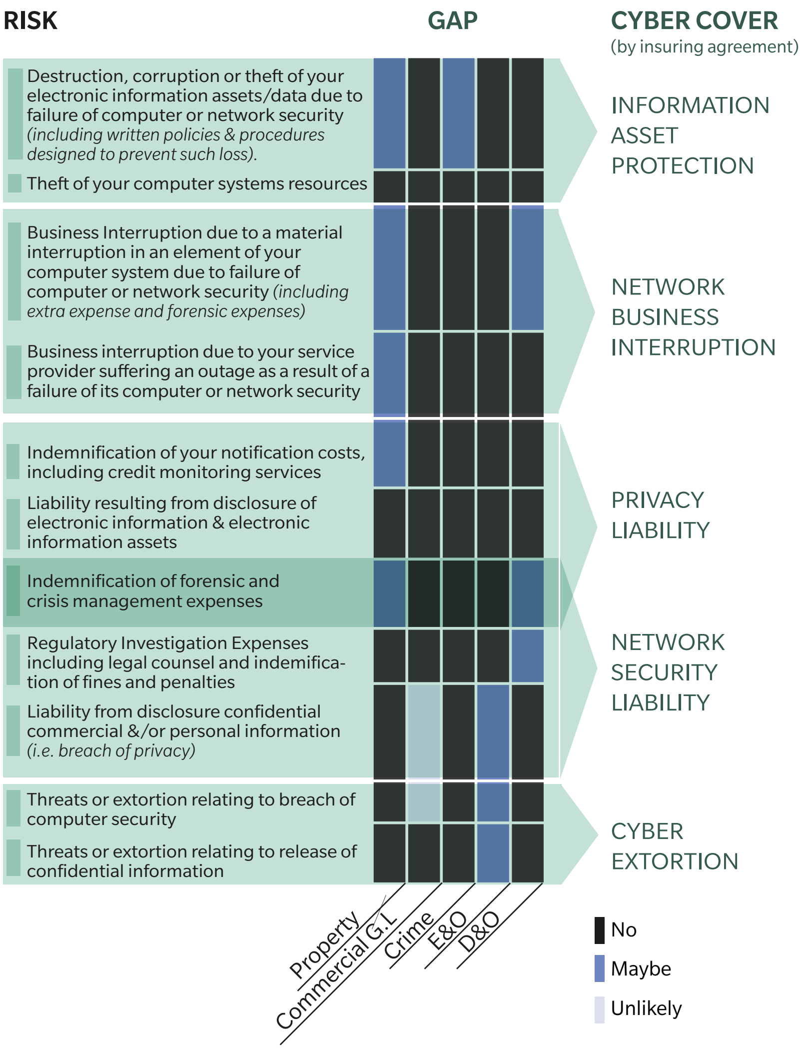
- Raising awareness inside the organization of the importance of information security.
- Fostering a broader dialogue among the cyber risk stakeholders within an organization.
- Generating an organization-wide approach to ongoing cyber risk management by all aspects of the organization.

Applying for insurance forces organizations to assess the strength of their cyber defenses—particularly amid a rapidly changing cyber environment. Whether urged by a board of directors or driven by the desire to obtain coverage as inexpensively as possible, prospective cyber insurance buyers may also conduct gap analyses against industry benchmarks. The purchasing of cyber insurance can also prompt an evaluation of potential consequences by using statistical modeling to assess different damage scenarios.

Once a cyber insurance policy is purchased, the insurer has the incentive to help its policyholder avoid or mitigate cyber attack. As a result, many insurers now offer monitoring and rapid response services to policyholders. Ultimately, in the event of a debilitating attack, cyber insurance can limit an institution's economic damage and help accelerate its recovery. This combination of economic incentives has driven significant increases in the purchase of cyber insurance.

Exhibit 3

PRIVACY AND CYBER PERILS – RISK AND INSURANCE ANALYSIS



TOP FIVE
QUESTIONS TO EVALUATE CURRENT CYBER INSURANCE

- ☐ **1.** Do we have a dedicated cyber insurance policy, or are we relying on add-on products or blended coverages?
- ☐ **2.** What are the limits of liability of cyber insurance that we have available, and how can we determine if they are sufficient?
- ☐ **3.** What exposures does our cyber insurance coverage address? What risks have we elected not to insure? For what risks were we unable to find insurance?
- ☐ **4.** When did we last seek a detailed review of our coverage relative to current best standards? These should be done at least every two years as the coverage changes rapidly.
- ☐ **5.** How have we compared our cyber insurance program to our fundamental risk profile, as well as to similarly-situated peers in our industry, or those with similar risk/threat profiles?

Additional resources

- NACD Cyber-Risk Oversight Resource Center (https://www.nacdonline.org/Resources/BoardResource.cfm?ItemNumber=20789)
- MMC Cyber Handbook 2016 (https://www.marsh.com/us/insights/research/mmc-cyber-risk-handbook-2016.html)
- Podcast: Cyber Insurance fundamentals (https://www.marsh.com/us/insights/podcasts/cyber-insurance-fundamentals.html)
- Benchmarking Trends: Operational Risks Drive Cyber Insurance Purchases (https://www.marsh.com/us/insights/research/cyber-benchmarking-trends-2016.html)

Rising Litigation and Liability Related to Employment Risks

Five Issues to Consider

Directors and officers face increasing liability around employment-related risks. Employment practices liability (EPL) insurance is designed to provide coverage for claims brought by employees, former employees, and applicants against the company, its directors, officers, and employees—often related to wrongful acts allegedly committed in the course of the claimant's employment.

Some directors and officers (D&O) liability insurance policies, such as those for small companies with few shareholders or nonprofit entities, are designed to include EPL insurance coverage. Rather than allow an EPL claim to erode D&O limits, many large companies and organizations elect to purchase a standalone EPL policy to cover this type of exposure.

AN INCREASING AREA OF LITIGATION: WAGE AND HOUR CLAIMS

Wage and hour claims—an increasing area of litigation—include allegations by employees regarding overtime pay, meal and rest breaks, and misclassifying workers. For example, claims may arise from allegations of misclassifying workers as "exempt" versus "non-exempt" from the minimum wage and overtime protections of the Fair Labor Standards Act (FLSA) and similar state laws, or as independent contractors versus employees. Oftentimes, wage and hour claims are difficult to insure under any traditional line of insurance despite the seemingly clear connection to a company's employment practices. Specifically, wage and hour claims are typically excluded from EPL insurance policies.

A handful of states (including California and New York) recently enacted legislation geared toward holding certain individuals—rather than corporate entities—liable for wage and hour violations, which is of particular concern for directors and officers. For instance, the California Labor Code finds that any employer or "other person acting on behalf of an employer...may be held liable as the employer for"[1] wage and hour violations. California's legislature defines "other person acting on behalf of an employer" as "a natural person who is an owner, director, officer, or managing agent of the employer."[1]

Other recent developments provide additional wage and hour litigation opportunities for plaintiffs. For example, the US Department of Labor's (DOL) Administrator's Interpretation in early 2016 and the National Labor Relations Board's (NLRB) late 2015 decision in *Browning-Ferris Industries* both served to significantly broaden the concept of who constitutes a joint employer of a

1. Id. § 558.1(b)

single employee.[2]Historically, an employer had to exercise actual control in order to be found a joint employer of an individual. Under the new standard, an employer's mere right to control is conceivably enough to find joint employer liability.

Similarly, the DOL issued an Administrator's Interpretation of the FLSA's definition of "employ" in July 2015. It concluded that "most workers are employees," rather than independent contractors.[3] While the Internal Revenue Service (IRS) applies a "right-to-control" test, many other statutes such as the FLSA apply a more employee-favorable standard known as the "economic realities" test.[4] As many observers have noted, however, the recent DOL guidance is not the model of clarity, and provides little direction to businesses striving to appropriately classify their workers as either employees or independent contractors.

RISING INDIVIDUAL LIABILITY

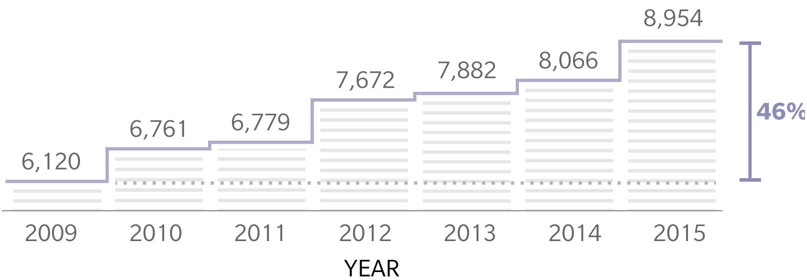
This push for individual liability is a critical development for directors and officers, given that the number of wage and hour lawsuits filed in federal courts has risen dramatically over the past several years and continues to outpace all other types of workplace class-actions. In 2015, wage and hour claims rose for the sixth straight year, to a record high 8,954 total federal filings, spiking 11 percent over such filings in 2014. This represents a 30 percent increase over the past five years (see Exhibit 4). The DOL recently sought to update (and increase) the salary and compensation levels needed for so-called "white collar" workers (executive, administrative, and professional employees) to be "exempt" and, therefore, not entitled to overtime pay. However, the US District Court for the Eastern District of Texas issued a nationwide injunction prohibiting the implementation and enforcement of the proposed rules, which had been scheduled to take effect on December 1, 2016.[5] Even so, more wage and hour claims are expected on the horizon, as the federal injunction does not impact state law (which can be more employee-friendly than the FLSA), and the DOL's Wage and Hour Division is likely to continue its aggressive pursuit of FLSA violations.

These developments are notable from a D&O insurance coverage perspective because the FLSA/wage and hour exclusion in a D&O policy is generally a "full" exclusion, without a carve-back for defense expense

2 U.S. Dept. of Lab. Administrator's Interpretation No. 2016–1
3. U.S. Dept. of Lab. Administrator's Interpretation No. 2015–1
4 See Frank J. Cavaliere, et al., Independent Contractor Status: Control Versus Economic Realities, 15 Southern Law Journal 1 (2005) (http://www.southernlawjournal.com/2005/8cavaliere-mulvaney-swerdlow.pdf)
5 Nevada et al. v. U.S. Department of Labor et al., No. 4:16-CV-00731

coverage. This means there is no coverage under a D&O policy for any portion of a wage and hour claim. Moreover, US courts typically interpret FLSA exclusions broadly to include state laws such as those underlying the new California legislation. Fortunately, coverage for this potential personal exposure is available under a relatively new type of insurance policy –a standalone wage and hour (W&H) insurance policy or hybrid EPL and W&H insurance program.

Exhibit 4
FLSA FILINGS IN FEDERAL COURT



Source: Seyfarth Shaw LLP, 12th Annual Workplace Class Action Litigation Report, 2016 ed., available at http://www.seyfarth-classaction.com/2016wcar/index.html

TOP FIVE
EMPLOYMENT PRACTICES LIABILITY (EPL) ISSUES FOR DIRECTORS AND OFFICERS TO CONSIDER

☐ **1.** If the company you serve does not have a current EPL program, consider the advantages and disadvantages of obtaining a standalone EPL policy.

☐ **2.** Confirm your EPL program (if any) includes appropriate coverage for punitive damages.

☐ **3.** Given increasing individual liability, explore the need for W&H insurance.

☐ **4.** Determine if a combined EPL/W&H solution is better for your company based on its loss history.

☐ **5.** Verify that your D&O insurance program includes dedicated Side-A difference-in-conditions (DIC) coverage (which protects the directors and officers against non-indemnifiable loss) without any EPL- or wage and hour-related exclusions.

Additional resources

- Wage and Hour Liability Insurance: Market Trends Video (https://www.marsh.com/us/services/financial-professional-liability/wage-and-hour-preferred-solution.html)
- Webcast: How to Improve Workplace Safety and Reduce Costs (https://www.marsh.com/us/insights/research/how-to-improve-workplace-safety-and-reduce-costs.html)
- Employment Practices Liability Insurance Liability Fundamentals Podcast (https://www.marsh.com/us/insights/podcasts.html)

Globalization of Directors and Officers Litigation

What to Look for in a Global Directors and Officers Program

Many organizations—whether public, private, or not-for-profit—operate on a global scale. Although risk-taking is a fundamental and necessary driving force for businesses, the potential cost of failure can sometimes be easily underestimated. This is especially true when working in global locales where the language, laws, and culture are very different from those of the head office.

The US no longer has the monopoly on litigation against directors. Increasingly, regulators, stakeholders, competitors, and clients and customers are seeking redress from global-company board members in foreign jurisdictions (outside the firm's home country). Some suggest that this trend is gaining momentum and point to a number of discrete events as catalysts (See Exhibit 5).

Exhibit 5
FOUR FACTORS DRIVING THE GLOBALIZATION OF D&O LITIGATION

REGULATORY ENFORCEMENT AND GLOBAL COOPERATION

- SEC Office of International Affairs (OIA) provides advice on crossborder securities investigations and prosecutions.
- US enforcement tools are gaining wider acceptance across the globe and include: plea bargaining & deferred prosecution agreements

WHISTLEBLOWER BOUNTIES

- US SEC's Office of the Whistleblower accepts assistance and information about possible securities law violations from tipsters from all parts of the globe and offers bounties to tipsters.
- Program modeled in the US was introduced in Ontario, Canada, and more jurisdictions expected to follow.

INCREASING TRANSPARENCY

- Mass leaks of document through the "Panama papers", "Luxembourg Leaks", and "Wikileaks".
- Sites and leaks revealed details on financial and attorney- client protected information, tax rulings, and up to 1.2 million documents.
- Have put increased public and regulatory scrutiny on corporate tax strategies.

FALLING BARRIERS TO LOCAL LITIGATION

- Changes to local rules are dismantling hurtles in an increasing number of jurisdictions around the globe.
- Litigation funding or crowd sourcing is emerging as way to cover litigation costs.
- A growing list of jurisdictions now permit mass actions, including Australia, Brazil, Canada, Germany, Japan, Mexico, etc.

Source: Marsh

Given the increasing globalization of litigation, it is important to review directors and officers (D&O) liability insurance policies to address this evolving risk environment. For example, expenses to fight extradition are often included within an organization's D&O liability insurance policy.

BORDERLESS DATA

LUXEMBOURG LEAKS (OR LUXLEAKS): The 2014 disclosure of a database of confidential information revealed that global tax avoidance transactions were set up by a global accounting firm on behalf of its clients. This investigation by the International Consortium of Investigative Journalists resulted in making public the tax rulings for over three hundred multinational companies based in or that transferred profits through Luxembourg.[1]

The Luxleaks affair exposed "sweetheart" deals that saved global firms billions of dollars in taxes.[2] Intense scrutiny of boardroom decisions regarding tax-driven strategies are expected to follow.

PANAMA PAPERS: Earlier this year, 11.5 million documents were leaked from a Panamanian law firm that detailed financial and attorney–client protected information on more than 200,000 offshore entities. Although offshore business entities themselves are not illegal, it is alleged that some shell corporations were used for illegal purposes, including for fraud, kleptocracy, tax evasion, and dodging international sanctions. So far it is the latest and largest leak of this type.[3]

- Australia established a financial crime taskforce evaluating the information.[4]
- Denmark plans to pay for these documents and use them for investigation purposes. [5]
- In the UK, a taskforce led by Revenue and Customs and the National Crime Agency is investigating allegations relating to companies and individuals; the taskforce will work alongside analysts from the Serious Fraud Office and the Financial Conduct Authority who are also conducting investigations arising from the leak. [6]

WIKILEAKS: Established in 2006, WikiLeaks is an international non-profit organization that publishes secret information, news leaks, and classified media from anonymous sources. The site is said to contain over 1.2 million documents.[7] It has been suggested that WikiLeaks has ushered in a new form of the "reputational crisis," in which the way an organization and its leaders operate, think, and respond to internal and external challenges may be made public.[8] The fact that much of this information comes from inside the organization is itself another boardroom challenge.

WHERE DO DIRECTORS OF MULTINATIONAL FIRMS GET SUED?

- Regulators and other enforcement agencies tend to sue in their home jurisdictions—where they have authority.
    - Especially if the organization operates in a highly regulated industry, this suggests the potential for exposure from the local focus of foreign regulators.
    - Increasingly, there is global cooperation among enforcement bodies with formal cooperation agreements in place in many instances.
- In mergers and acquisitions (M&As), unhappy buyers and sellers as well as disappointed "suitors" usually sue in the region where the transaction occurs.
- Similarly, lenders or bond holders tend to bring legal actions where the loan or transaction occurred (and their grievance arose).
- Competitors and customers/clients tend to sue locally.
- Shareholders generally sue in the jurisdiction in which they purchased their shares, when the firm is a public company and listed on stock exchanges in more than one country. This suggests potential liability in multiple jurisdictions.
    - Traditionally, shareholders have preferred to bring a single global class action in the US, but after the seminal National Australia Bank decision from the US Supreme Court, non-US shareholders that purchased their shares on a non-US exchange were barred from bringing an action or participating in an action in the US (referred to as F-squared and F-cubed cases).[9]
    - However, the Dutch courts have signaled that they are open to considering shareholder actions where few or none of the parties are local residents. Importantly, non-admitted insurance is generally permitted in the Netherlands.

EFFECTIVE D&O INSURANCE PRACTICES FOR GLOBAL-COMPANY DIRECTORS

A critical issue for global firms and their boards is that insurance policies are unique types of contracts, most often regulated under local law. The result is that a contract or policy written in one country generally will not meet the local legal requirements in most other countries.

Consequently, a D&O liability policy written in one country generally will not be legal, binding, and enforceable on the ground, locally, in the majority of the world's jurisdictions.[10] In other words, non-admitted insurance is not permitted. In practice, this means that if local payment would be necessary or desired, a locally issued D&O policy may be required. However, such coverage is generally not difficult and/or expensive to procure.

Another critical concern related to D&O insurance for global firms is that such insurance typically works in tandem or instead of indemnification from the organization. In most jurisdictions around the world, however, indemnification may be unknown, unclear and/or untested.

This leaves D&O insurance playing a crucial role in protecting the director of a global company.

Today's international firms may rely on a D&O liability insurance program that includes both local policies and a global tower (or program) of coverage. This structure can result in a number of secondary benefits (other than facilitating coverage in local territories), including:

- Gaining local D&O terms that match unique local exposures.
- Potentially gaining "the best of the best" in terms of coverage for a local claim, as the better of the local terms or those in the global tower may apply.
- Tax compliance as many jurisdictions may assess insurance premium taxes on the purchase of D&O insurance.

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1 *Everything you need to know about the LuxLeaks* scandal, (http://www.euronews.com/2016/04/26/everything-you-need-to-know-about-the-luxleaks-scandal)

2 *LuxLeaks whistleblowers go on trial*, (http://www.advisen.com/tools/fpnproc/fpns/articles_new_5/P/258274857.html?rid=258274857&list_id=5)

3 *What are the Panama Papers?* A guide to history's biggest data leak: (https://www.theguardian.com/news/2016/apr/03/what-you-need-to-know-about-the-panama-papers)

4 *Criminal charges relating to Panama Papers could take years: ATO* (http://www.smh.com.au/business/the-economy/criminal-charges-relating-to-panama-papers-could-take-years-ato-20160916-grhvwp.html)

5 *Panama Papers: Denmark buys leaked data to use in tax evasion inquiries*, (https://www.theguardian.com/news/2016/sep/07/panama-papers-denmark-becomes-first-country-to-buy-leaked-data)

6 *Panama Papers fallout*, (http://www.internationallawoffice.com/Newsletters/White-Collar-Crime/United-Kingdom/Arnold-Porter-UK-LLP/Panama-Papers-fallout?utm_source=ILO+Newsletter&utm_medium=email&utm_content=Newsletter+2016-07-25&utm_campaign=White+Collar+Crime+Newsletter)

7 (https://en.wikipedia.org/wiki/WikiLeaks)

8 (https://en.wikipedia.org/wiki/WikiLeaks)

9 *Morrison v. National Australia Bank*, 56`v. 247 (2010)

WHAT TO LOOK FOR
IN A GLOBAL D&O INSURANCE PROGRAM

- ☐ **1.** Local coverage in the jurisdiction, where the global program may not be recognized (where non-admitted insurance is not permitted). This is especially important where local indemnification is uncertain, unclear, and/or untested.

- ☐ **2** A global program of insurance that recognizes and potentially works in concert with these local policies.

- ☐ **3** Terms in the global "master" D&O program:

  - ☐ i. Clarification that where the local policy provides broader terms for a local claim, these terms will be imported into the global tower if the tower is needed to respond fully to this claim(s).

  - ☐ ii. Wording providing that if the global master's terms are broader, that this will be exported into the local D&O policy where necessary to respond to a local claim.

- ☐ **4.** Terms in local D&O policies

  - ☐ i. "Sister company" wording which clarifies that the local policy extends to all individuals who are directors or officers of the ultimate parent company (whether or not they hold such formal positions at the local entity).

  - ☐ ii. Possible local deductibles (or retentions) that match local norms rather than that which are found in the global master program.

Additional resources

- Risk Considerations for Directors of Multinational Companies (https://www.marsh.com/us/insights/research/risk-considerations-for-directors-of-multinational-companies.html)
- Governing the Global Company: Oversight of Complexity (http://www.mmc.com/content/dam/mmc-web/Global-Risk-Center/Files/governing-the-global-company.pdf)
- Globalization and What it Means for Your Risk Management Program (https://www.marsh.com/us/campaigns/globalization.html)
- Governing the Global Board Podcast Series (https://www.marsh.com/us/campaigns/globalization.html)

  Governing the Global Board – An Overview
  Governing the Global Board – Board Member Liability
  Governing the Global Board – Challenges Facing Board Members
  Governing the Global Board – Insurance Considerations
- "Embracing Global Megatrends," *NACD Directorship* (https://www.nacdonline.org/Magazine/Article.cfm?ItemNumber=13753)
- Director and Officer Liability in Product Recalls (https://www.marsh.com/us/insights/research/director-officer-liability-product-recalls.html)

Regulatory Investigations and Directors and Officers Liability

Individual Accountability and Entity Investigation Coverage

A NEW FOCUS ON INDIVIDUAL ACCOUNTABILITY

The US Department of Justice (DOJ) in late 2015 announced a policy to target individuals involved in corporate wrongdoing in what has become known as the "Yates Memo." Named for its author, Deputy Attorney General Sally Q. Yates, the memo articulates new standards applicable to cooperation credit in the context of corporate wrongdoing. Many see the memo as an effort to address the public perception that corporate individuals were not sufficiently investigated and prosecuted, particularly in the aftermath of the financial crisis. This memo has implications for corporate directors and directors and officers (D&O) liability insurance.

YATES MEMO GUIDELINES

The Yates Memo outlined six key guidelines:[1]

1. In order for a company to gain "cooperation credit" in an investigation, the company must disclose all relevant facts regarding an individual's misconduct. This is perhaps most significant of the new guidelines. The memo continues to require companies to identify individuals "regardless of their position, status or seniority, and provide to the Department all facts relating to that misconduct."[2]
2. DOJ attorneys to focus on individuals from the outset of the investigation.
3. Criminal and civil attorneys handling corporate investigations should be in regular communication with one another.
4. Absent extraordinary circumstances, no corporate resolution will provide protection from criminal or civil liability for any individuals. From a directors and officers standpoint, this guideline can be particularly significant.
5. Corporate cases should not be resolved absent a "clear path" to resolve related individual cases in advance of the statute of limitations. If there is a decision not to prosecute an individual, the file must be appropriately documented and there must be appropriate approval by DOJ senior leadership.
6. Prosecutors to focus on individuals based on considerations other than an individual's ability to pay. Department attorneys are instructed to weigh the seriousness of the offense, whether the offense is actionable, and whether pursuing the action represents "an important federal interest."[3]

IMPLICATIONS OF INDIVIDUAL ACCOUNTABILITY

The major question following the memo is its implication for corporate directors and officers. Like the DOJ, the SEC recently reemphasized its focus on holding individuals accountable for corporate wrongdoing. As this publication went to press, the transition to a new US presidential administration was underway, and was expected to have potentially significant implications for the priorities of regulatory and executive-branch agencies, including the investigation environment. Companies and boards should continue to monitor these changes with internal and external counsel.

That said, the SEC's focus on individuals has—contrary to popular belief—been commonplace since the mid-2000s. Since 2011, the SEC charged individuals in 83% of its actions; since 2000, the SEC has charged individuals in 93% of its fraud and financial reporting cases. A review of SEC enforcement actions against directors and the agency's statements reveals the following conclusions:[4]

- The SEC will scrutinize director and officer conduct, particularly with respect to financial reporting and issuer disclosure.
- The SEC focus on directors and officers is where there are affirmative steps to participate in fraud or "enabling" conduct by turning a blind eye to obvious red flags.
- Directors and officers are expected to exercise appropriate oversight. As described by a former SEC commissioner, "shareholders elect a board of directors to represent their interests, and, in turn, the board of directors, through effective corporate governance, makes sure that management effectively serves the corporation and its shareholders."
- The SEC seems prepared to pursue negligence-based claims and is looking to bring cases based on internal controls violations as the primary claim. The law firm Jones Day cites a recent settlement involving an audit committee member who had "reason to know" that the company had not disclosed certain executive perquisites.[5]

With a stated emphasis on individual culpability, directors and officers are vested with the responsibility of ensuring that the company has appropriate processes and procedures to ensure it complies with laws to avoid criminal and civil liability.

CORPORATE INVESTIGATION COVERAGE

A recurring issue for public companies is whether costs from government investigations are covered by directors and officers (D&O) liability insurance. In recent years, numerous efforts have been made to structure corporate investigation coverage either as a separate policy or as an adjunct to existing D&O insurance.[6]

The corporate investigation issue arose in the context of formal and informal investigations—usually initiated by the SEC or by other state or federal regulators—that were concurrently brought and maintained with securities claims against the company and its directors and officers. Typically, D&O insurance is limited to defense of the securities litigation, although insureds may assert that costs associated with the investigation relate to the defense of the securities claim. In several instances, however, the uneven timing of the investigation and the securities claims resulted in coverage disputes and litigation.

These decisions, coupled with an increasingly activist SEC, served as a catalyst for clients, brokers, and insurers to reconsider how and when entity costs related to corporate investigations should be covered. There was almost universal consensus that defense costs related to a formal investigation of directors and officers were covered. Insurers affirmed this intent with an added coverage for so-called "pre-claim inquiry costs," which generally responds to costs incurred by directors and officers where another party, usually the company, was the focus of the investigation. This coverage was particularly important in the aftermath of the collapse of Lehman Brothers, where individuals were often subpoenaed in connection with state and federal investigations of the company, which arguably did not necessarily trigger individual coverage.

As market conditions continued to evolve, insurers recalibrated their approach to provide coverage for "corporate" investigations. There are essentially two approaches to coverage for corporate investigations: a standalone policy or an endorsement to an existing D&O policy.
In the former approach, the company purchases a separate policy specifically tailored to cover costs arising from an investigation of the company. There were a number of complications with the standalone policy approach, including:

- Issues regarding an appropriate trigger of coverage—for example, when did an investigation commence?
- Concerns with respect to investigations involving the Foreign Corrupt Practices Act (FCPA).
- Pricing issues.

Despite numerous efforts by major insurers, this market did not take hold.

The more accepted approach became to endorse existing D&O insurance to provide a modicum of coverage, with pricing usually tracking the breadth of coverage. Originally, coverage was offered for corporate investigations to the extent that a securities claim was also pending against a director or officer.[7] Recently, at least one insurer amended its coverage in reaction to a "changed regulatory environment" and the need to build in coverage for costs incurred prior to a claim trigger. The new feature provided so-called "lookback" coverage whereby once coverage is triggered by a securities claim, an insurer was liable for previously incurred entity investigation costs. There were several approaches to the coverage, including for securities violations, securities violations and FCPA violations, and violations of any laws or regulations. This endorsement is subject to additional premium depending on the breadth of the coverage. This latest offering followed a similar offering by Lloyd's of London, which provided a level of "lookback" coverage in addition to coverage for costs incurred after a securities claim is resolved.

The area of corporate investigations remains an evolving coverage with significant implications for the industry. As the number of lawsuits stabilizes and average settlements seem to decline, the exposure presented by SEC and related government investigations takes on added significance. As market conditions remain favorable for buyers, competition may drive increased coverage on improved terms. However, market conditions are volatile and can change, which could affect this coverage.

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1 Yates Memorandum, Department of Justice, September 9, 2015, p. 5, (https://www.justice.gov/dag/file/769036/download)

2 See *Id*.at 3–4

3 See id. at 6–7

4 For additional information from from the Jones Day law firm, as well as recommendations to directors and officers in response to the Yates Memo and other regulatory activity, visit (http://www.jonesday.com/individuals-in-the-cross-hairs-what-this-means-for-directors-03-10-2016/)

5 See *id*.

6 The coverage discussion in this section is for discussion purposes only. Actual coverage is based on the terms, conditions, and exclusions in the policy as applied to the facts and allegations in the lawsuit, investigation, or claim.

7 This approach, some clients and brokers would argue, is tacitly available to the extent that defense costs associated with the corporate investigations are reasonably related to the covered securities litigation.

SIX QUESTIONS TO CONSIDER
WHEN BUYING INSURANCE IN LIGHT OF THE PUSH TO HOLD INDIVIDUALS ACCOUNTABLE

- ☐ **1.** Does the company for which I serve have sufficient D&O limits?
- ☐ **2.** How strong are the company's indemnification obligations to me and how does that effect my insurance needs?
- ☐ **3.** Does the company purchase sufficient Side-A difference-in-conditions limits of insurance?
- ☐ **4.** Do I need to consider whether the Side-A insurance provides coverage for internal investigations?
- ☐ **5.** What is the trigger language for the conduct exclusion in my policy and how narrowly tailored is the exclusion?
- ☐ **6.** What is the severability language in my policy?

Additional resources

- "Focusing on Individual Accountability for Corporate Wrongdoing," *NACD Directorship* (https://www.nacdonline.org/Magazine/Article.cfm?ItemNumber=21605)
- "When Directors May Be Personally Liable for Corporate Actions," *NACD Directorship* (https://www.nacdonline.org/Magazine/Article.cfm?ItemNumber=23802)
- Risk in Context: Expected Fallout From DOJ's Policy of Holding Individuals Accountable for Corporate Wrongdoing (https://www.marsh.com/us/insights/risk-in-context/doj-individuals-corporate-wrongdoing.html)
- Business Law Today: The Spring Meeting Confronts the Yates Memo (https://www.marsh.com/us/insights/research/yates-memo.html)
- How the DOJ Yates Memo Impacts Board Member Liability (https://www.youtube.com/watch?v=I18YgxfrI1M)

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