DIRECTORS & OFFICERS
LIABILITY COVERAGE

Overview and Current Market Trends

Who Needs Directors and Officers Liability Insurance?

Liability insurance for the errors, omissions, and other wrongful acts of directors and officers has been available since the early 1960's. Since that time, the increase in public awareness and expectations, and the more litigious nature of society, have resulted in a virtual explosion of litigation against corporate managers as well as judicial analysis of the conduct and standards applicable to Directors & Officers. The result is that Directors & Officers are frequently being "second guessed" by the courts.

Obligations of Directors & Officers

Essentially, Directors & Officers are considered to have a duty of care, whereby they follow the "prudent person rule", make informed decisions, perform in good faith, and act in the best interest of the company. They also have a duty of loyalty that includes no furthering of personal interests and refraining from personal action damaging to the corporation. Finally, they have a duty of obedience to perform duties within the corporate charter/by-laws and act in accordance with all laws, statutes and regulations pertaining to their industry.

Breach of any of these obligations can incur personal liability to the individual Director or Officer involved as well as an allocation of blame to the other Directors & Officers on the board, possibly extending to the corporation itself (80% of lawsuits now also name the corporate entity as a defendant.)

Common Allegations Against Directors & Officers

Most allegations involve decisions, acts, errors or omissions that have lowered stock values, compromised competitive industry position, wasted corporate assets, or overlooked significant growth or investment opportunities. These can result in financial injury to stockholders, employees, investors, and any other third party.

In the past, Directors & Officers were somewhat protected from liability due to the business judgment rule, particularly in the question of duty of care. That is, they acted in the best interest of the company and with due care, honest and reasonable belief, good faith and without a conflict of interest. Today, the judgment rule has lost much of its effect.

Providing Business Insurance Since 1895

InsurePro is a division of Gaston & Associates, Inc., a NY based insurance agency tracing its roots through 4 generations of family, and incorporated in 1895. InsurePro's marketing territory is national in scope, and we hold property-casualty and life-health licenses in all U.S. states & DC — except Alaska, Hawaii, Iowa, North Dakota, Oklahoma, and West Virginia.

Our customers range from start-ups to public companies. We serve about four thousand clients nationally and throughout the world. We specialize in providing personal and commercial lines of property and casualty insurance, group health coverage, and individual life insurance.

InsurePro has become a world leader in all forms of professional liability insurance products for medium to large private and public companies by proactively anticipating changing client needs in order to offer the most up-to-date solution.

Mission Statement

The mission of Gaston & Associates is to provide professional insurance services to the clients we represent.

- We strive to develop a customer base that will appreciate our service orientation and value added approach.
- We provide our clients with competitive, high quality insurance oriented products.
- We endeavor to maintain long-term customer relationships that are based on coverage and service.
- We embrace automation as a means to enhance service and improve communication.

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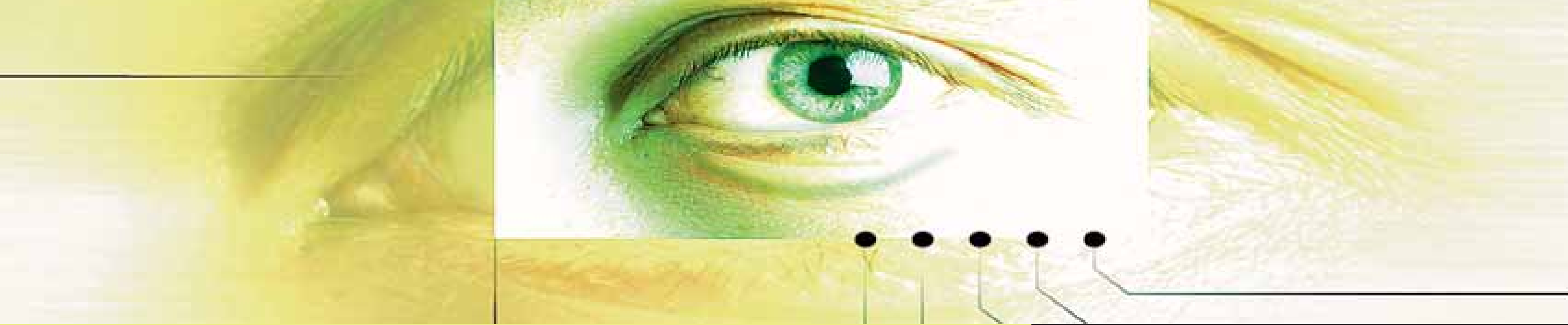

RETURN TO BASICS: D&O LESSONS FROM RECENT CLAIMS

ACE Directors & Officers - The ACE Report - Issue No. 45 - April 2002

A number of recent large and highly publicized claims against directors and officers provide valuable lessons for others who wish to avoid being subjected to similar claims and the adverse publicity, embarrassment and potentially catastrophic financial consequences resulting therefrom. Ironically, the underlying causes of these claims are not new or exotic. Rather, almost without exception, the subject directors and officers strayed from simple and basic concepts of fiduciary duties, prudent management processes and common sense. It may be tempting to rationalize that in today's highly competitive and sophisticated environment, equally sophisticated new rules of corporate governance should apply. However, just the opposite is true: as a company's affairs become more complex, basic fiduciary duties and corporate governance principles do not change but simply become more important.

The following summarizes numerous D&O lessons that can be gleaned from recent corporate debacles and some D&O insurance implications resulting from those debacles.

D&O LESSONS

Don't Ignore Basic Fiduciary Duties. Directors and officers owe to their company and its shareholders basic fiduciary duties of care and loyalty. Several recent claims primarily involve alleged breaches of the duty of loyalty, which generally precludes directors and officers from engaging in personal conduct that would injure or take advantage of the company. In some instances, officers routinely participated in transactions with the company and otherwise created blatant conflicts of interest with seemingly little regard for their fiduciary duty of loyalty. D&Os should make a renewed commitment to avoid even the appearance of conflicts of interest whenever possible, and should fully disclose and remove themselves from any truly unavoidable conflicts. In addition, in some cases directors failed to appreciate and respond to the risks and dangers faced by the company (many of which resulted from officer decisions). In fulfillment of their duty of care, directors should thoroughly understand the basic operations and economics of the company and periodically assess the company's strategy and key performance indicators. Management should encourage and directors should raise challenging questions, and directors should insist upon satisfactory answers. The primary responsibility of directors is not to simply approve Board resolutions, but to effectively oversee the business and affairs of the company by probing into all aspects of the company and by exercising healthy skepticism about what is presented.

Insurance

Ever since entry of domestic Directors & Officers Liability Insurance in the 1960's, there has been a lack of uniformity of policy terms and conditions. There is no standard form of D&O coverage, and at this time there are over 40 different insurers writing D&O insurance, and over twice that many different basic D&O policies.

Unlike many types of insurance, where a price comparison may be made based on similar forms of coverage, D&O policies must be analyzed and understood if they are to meet the expectations of the Directors & Officers as well as the business entity.

As much of importance in understanding what IS covered by D&O, it is also important to understand what is NOT covered by D&O Insurance

Common Exclusions

- Arising out of the Directors, Officers, or Company gaining in fact any profit or advantage to which they were not legally entitled.
- Arising out deliberate fraudulent, dishonest, or criminal acts
- Bodily Injury or Property Damage
- Discharge of Pollutants
- Acts committed in the capacity of Director for any Outside Entity
- Acts committed as Director of a Subsidiary that occurred prior to acquisition of the Subsidiary

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DIRECTORS & OFFICERS LIABILITY COVERAGE

Overview and Current Market Trends

Investigate Warning Signs. In most instances, alarming company disclosures are preceded by warning signs visible to senior management and directors. D&Os should be vigilant in identifying those warning signs and should adequately respond thereto on a timely basis. For example, some of the recent claims involve the company entering into numerous transactions designed for financial reporting purposes rather than economic substance; an excessive number of related-party transactions; and highly complex transactions in which the structure, purpose, terms and effect of the transactions were not understood by some senior managers and the directors. Such activity should be thoroughly investigated and the transactions should be approved by knowledgeable, informed and truly independent persons based on the advice of qualified outside advisors where appropriate.

Don't Manage to Securities Analysts. Most public companies have in recent years become increasingly focused on meeting analysts' expectations. Maintaining or increasing the company's stock price can become an obsession. As a result, an environment can be created in which personnel at all levels of the company are pressured to do whatever it takes to meet quarterly budgets and goals. Such a mindset unduly emphasizes short-term performance and may encourage deceptive disclosures. Instead, companies should strive to build long-term credibility with investors and analysts, and should seek to avoid unreasonable expectations by company constituents.

Don't be Arrogant. Successful managers are frequently tempted to believe they have all the answers and can ignore the input of others. Such arrogance typically leads to disaster sooner or later. Instead, directors and officers should recognize that others may have helpful ideas, perspectives and suggestions and may raise legitimate concerns. An atmosphere of candid and open exchange of views should be fostered. Senior executives should encourage and carefully consider concerns and criticisms expressed by subordinates and should meaningfully respond to inquiries. Directors and officers should not surround themselves with "yes" employees and advisors who are either unwilling or incapable of challenging faulty reasoning or decision-making.

Typical Plaintiffs

According to a 1996 survey by Watson Wyatt Company, there are six major sources of Directors & Officers lawsuits. Those plaintiffs, and the basis of the suits, are listed as follows:

1. Stockholders
   - Inadequate/inaccurate disclosure
   - Dishonesty/fraud
   - Financial reporting
   - Disappointing financial performance
   - Fiduciary duty/gross negligence
   - Stock or other public offerings
   - Bid or threat by another company for takeover
2. Employees
   - Wrongful Termination (this is the single most frequent claim!)
   - Harassment
   - Defamation
   - Breach of Employment Contract
3. Customers/Clients
   - Dishonesty/Fraud
4. Competitors
5. Other Third Party
   - Environmental Public Activists
6. Government Agencies
   - EPA

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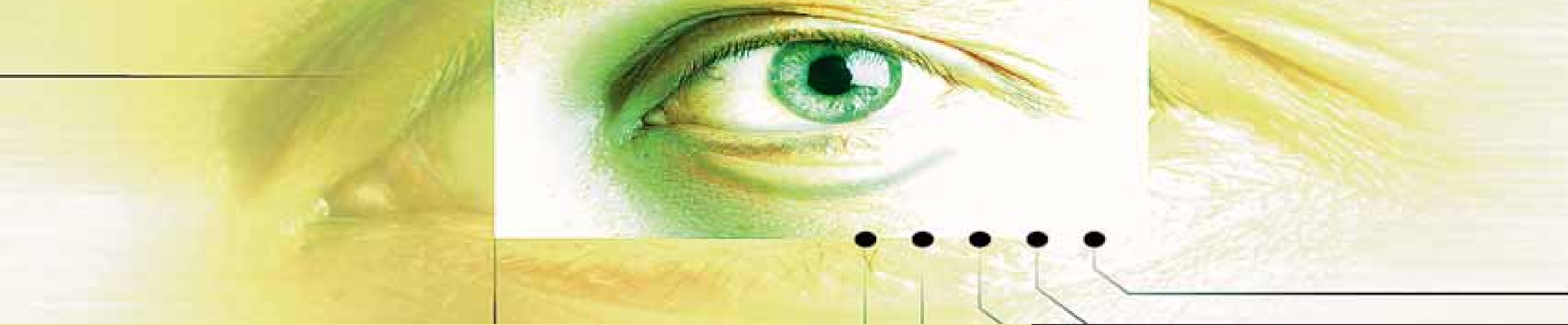

Maintain Reasonable Leverage. Many companies are utilizing ever more complex methods to obtain leverage, including use of various types of complicated derivative instruments and off-balance-sheet financing arrangements. These arrangements present a variety of potentially enormous risk, including credit risk (in the event the other party to the transaction is financially unable or unwilling to honor its obligations), market risk (in the event the price or value of the underlying asset moves in an unexpected direction), valuation risk (in the event the instrument is not properly valued at inception or during the term of the contract), operations risk (caused by inadequate internal controls, deficient procedures, human error, system failure or fraud), and inadequate disclosures (typically resulting in a surprising disclosure to investors and others of large, unexpected losses). Directors and officers should establish policies and limitations on such leveraged transactions and should assure that a specific individual or department within the company (independent from the persons creating or administering the leveraged transactions) is responsible for measuring and reporting risk exposures and compliance with those policies and limitations. "Worst case" scenarios should be anticipated, and decisions to accept leveraged risks should be made with a view towards various possible stress conditions.

Avoid Vague, Confusing or Exaggerated Disclosures. Directors and officers should insist upon full and meaningful disclosures which are truthful and forthright. Clever "spin" or other vague or confusing communications with investors, analysts and other constituents should not be tolerated. Instead, communications should be plain, easy to understand, and convey the whole truth. Even unsophisticated investors should be able to readily understand the disclosed information. Bad news should not be understated and good news should not be overstated.

Improve Audit Committee Functions. Despite increased accountability of audit committees in recent years, a widespread perception still exists that these committees remain ineffective in many situations. A myriad of suggested reforms are now surfacing, some of which will be left to individual committees to implement and some of which will probably be required by future regulation or legislation. Some of the more compelling suggestions include the following:

- Audit committees should be composed of only financially literate members who can fully understand and critique the company's financial statements and disclosures.
- Audit committee members should be truly independent from management and the auditors. Business, social or other relationships that may impede the independent thinking and decision-making of committee members should be considered when determining a member's qualifications for service on the audit committee.

New Threats

Recent laws governing employment have opened the doors to a relatively new category of potential adversary for Directors & Officers - its own workforce. Laws such as the Americans With Disabilities Act of 1990, the Civil Rights Act of 1991, and the Family And Medical Leave Act of 1993 have contributed to a dramatic increase in claims involving not only wrongful termination, but also discrimination and sexual harassment. These laws are often poorly written and vague, resulting in considerable time and money expended in each case being interpreted by the courts. Unfortunately, statistics are indicating that plaintiffs are prevailing more times than not. In any case, it is an expensive road to travel for the defense.

RISK MITIGATION

It seemed like just a blip on the screen at the time, but even the smallest employee dispute can turn into an expensive litigation. Let us help you make a safe landing with a comprehensive EPL Policy to help protect your company and its employees against the threats of employment-related litigation

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- Audit committees should meet regularly and frequently, not just in connection with the annual audit.
- The audit committee, not the CFO, should have full responsibility for the selection, hiring and termination of outside auditors. A periodic turnover of auditors every five to seven years is advisable.
- The audit committee should adopt and oversee the enforcement of revenue recognition policies within the company and should particularly examine very closely the financial reporting and accounting policies for significant transactions that can materially effect the company's earnings performance for a quarter or year.
- The audit committee should insist upon the highest quality accounting standards, which reflects the true economics of transactions and business operations.
- The audit committee should pre-approve any non-audit services to be performed by the outside auditor. Preferably, the only meaningful business relationship with the outside auditor is the audit.
- In recognition of the increasingly complex and comprehensive responsibilities for the committee, members should be appropriately compensated, which in many instances will require a significant increase in pay.

Encourage Diversification of Employees' Investments. Consistent with sound investment concepts, management should encourage employees to diversify their investments and not include within their investment portfolio an unreasonably large percentage of company stock. Although employees should be encouraged to maintain an ownership interest in the company, thereby aligning their interests with outside investors, an excessive concentration of an employee's investment portfolio in company stock can not only create unnecessary investment risk, but may motivate employees to act inappropriately in order to artificially maintain or increase the company's stock price.

Work with People of High Integrity. Directors and senior management should demonstrate and insist upon a strong commitment to the highest level of legal, moral and ethical conduct. A company's culture of integrity is established primarily through the actions of its leaders. Companies should not tolerate at any level activity that is perceived to be deceptive, manipulative, self-serving or otherwise improper. It only takes one person's illegal conduct to cause enormous harm to the company and to expose numerous other directors and officers to potentially dangerous litigation.

D&O INSURANCE IMPLICATIONS

The D&O insurance market is undergoing a significant transformation, largely as a result of the significant increase in large losses arising from problematic claims. The following summarizes some of the ways in which D&O underwriters are and will likely be responding to these recent claims and issues which Insureds should consider in light of recent claim experiences.

Entity Coverage. D&O insurance policies which include coverage for certain claims against the company are more likely to be considered assets of the bankruptcy estate if the company subsequently files bankruptcy. As an asset of the estate, the policy and its proceeds are automatically frozen when the bankruptcy petition is filed. D&Os cannot then access the policy's proceeds to pay defense costs unless and until the bankruptcy court approves such payments. This can result in significant delay in paying defense counsel and necessary experts, thus potentially impeding the ability of the defendant directors and officers to properly defend claims against them. This risk is greatly reduced if the policy does not contain entity coverage. Predetermined allocation can accomplish many of the same benefits as entity coverage without creating this increased bankruptcy risk.

Side-A Only Policy. As concern by D&Os about their financial protection has increased in light of recent claims, interest in Side-A only D&O policies have similarly increased. Those types of policies, which only cover loss not indemnified by the company, provide extra protection to D&Os in a number of ways. For example, a Side-A only D&O policy typically provides much broader coverage for D&Os than the Side-A coverage in a standard D&O policy which also insures the company's indemnification liability. Also, because such a policy does not insure the company for any of its liabilities, the policy proceeds clearly should not be considered assets of the company's bankruptcy estate.

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Don't Aggravate Existing Problem. When a significant problem is identified either internally or externally, directors and officers should promptly address the problem through a comprehensive investigation and analysis, through decisive action and through forthright communications. If at all possible, timely and meaningful explanations should be made to investors, employees, other constituents and the public regarding the source and consequences of the problem and the plans to address the problem. Facts and evidence relating to the problem should be preserved for later reference, particularly if investigations or litigation are expected or pending. In addition, directors and officers should avoid the appearance of receiving special treatment either before or after the matter is disclosed. In any event, do not deny the truth, even if the truth seems harmful.

The enormous publicity given to some of the recent corporate failures has created political pressure for regulatory and legislative reforms relating to corporate responsibility. On March 7, 2002, President Bush released a 10-point plan ("Plan") to improve corporate responsibility and help protect America's shareholders. This plan, which was shaped by a task force headed by Treasury Secretary Paul O'Neill, addresses three core principles: (i) providing better information to investors; (ii) making corporate officers more accountable; and (iii) developing a stronger, more independent audit system.

With respect to better information to investors, the Plan would require the disclosure to investors of more information sooner and would require the information to be stated in "plain English."

With respect to making corporate officers more accountable, the Plan contains the following specific proposals:

- CEOs should personally vouch for the veracity, timeliness and fairness of their company's public disclosures, including their financial statements. CEOs would personally attest each quarter that the financial statements and company disclosures accurately and fairly disclose the information of which the CEO is aware that a reasonable investor should have to make an informed investment decision.
- CEOs or other officers should not be allowed to profit from erroneous financial statements. CEO bonuses and other incentive-based forms of compensation would be disgorged in cases of accounting restatements resulting from misconduct.
- CEOs or other officers who clearly abuse their power would lose their right to serve in any corporate leadership positions. This proposal, which is the only portion of the Plan which would require legislation in order to implement, would authorize the SEC to ban individuals from serving as officers or directors of publicly-held companies if they engage in serious misconduct.

Further, the limits of liability under such a policy are preserved only for loss not indemnified by the company and are not eroded by any company liability. In other words, such a policy better protects the personal assets of D&Os and better fulfills the role of true "sleep insurance" for D&Os.

Co-Insurance. In order to better align the interests of the Insureds and the Insurer in negotiating settlements and otherwise defending claims, many Insurers are now requesting co-insurance in the D&O policy, at least with respect to corporate reimbursement coverage. If the policy also contains a predetermined allocation provision, Insureds should fully understand the interrelationship and the cumulative effective of both a co-insurance and predetermined allocation provision in the policy. Loss is first subject to an appropriate allocation between covered and non-covered matters. Only the amount allocated to covered Loss is then subject to the retention and co-insurance under the policy.

Application. Through much of the 1990's soft market, many D&O Insurers were willing to waive the necessity for an Application in the underwriting process, particularly at renewal. Several recent large cases have sensitized Insurers to the importance of meaningful Applications upon which underwriters can rely. As a result, it is likely that Applications will be more routinely required by Insurers in connection with underwriting both an initial and a renewal policy.

Severability. Although severability of the Application has and will remain a common feature of most D&O policies, it is likely that a limited version of severability will become more common. Unlike a "full" severability provision that does not impute the knowledge of any Insured Person to any other Insured Person, more Insurers will likely be utilizing a "limited" severability provision that excepts the knowledge of the person signing the Application. Under such a provision, if the Application signer knows of information that is not truthfully

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- Corporate leaders should be required to tell the public promptly whenever they buy or sell stock for personal gain. This proposal would require disclosure of significant stock transactions by directors and officers within two business days of the transaction.
- With respect to developing a stronger and more independent audit system, the Plan would limit the types of non-audit services which an external auditor may perform for an audit client; would require auditors to compare a company's financial controls with the best practices of the industry and report its findings to the audit committee; and would implement reforms regarding regulatory oversight and establishment of standards for the accounting profession.

The President indicated that his intent is to implement these reforms "without inviting endless litigation." According to the President, "it is important to provide regulation and remedies where needed, without inviting a rush of new lawsuits that exploit problems instead of solving them." Although the goal may be to create greater accountability without increasing liability exposures to shareholders, it is difficult to imagine how such a goal could be accomplished. At a minimum, shareholders will be able to cite the heightened standards as evidence of expected behavior, thus enabling shareholders in litigation against D&Os to argue that significant deviation from the heightened standards constitutes sufficient recklessness under existing case law to establish personal liability.

The Plan is as notable for what is not included as for what is included. For example, some influential members of the President's task force unsuccessfully sought to include within the Plan at least two proposals that would have had far greater consequences to directors and officers. One would have lowered the standard for holding D&Os liable under the federal securities laws' anti-fraud provisions from "recklessness" to "negligence." Another would have required D&O insurance policies to have a minimum retention (e.g., $1 million) applicable to non-indemnifiable claims against the CEO and perhaps other senior officers. In addition, the Plan does not propose elimination or substantial erosion of the various litigation and liability protections contained within the Private Securities Litigation Reform Act of 1995.

Although these more significant reforms were not included within the Plan, substantial political support remains for many such reforms within Congress and perhaps within certain state legislatures. Thus, it is far from clear whether these and other similar types of more aggressive reforms will eventually be adopted. Notwithstanding the President's express desire, many of these other possible reforms would significantly increase the personal liability of senior officers to shareholders and would undoubtedly result in meaningful adjustments in the pricing and terms of D&O insurance policies.

disclosed in the Application, coverage may be lost for all Insureds. As demonstrated by several recent large claims, when the signer of the Application participates in the subject fraud, the D&O Insurer is as much a victim as shareholders and other third parties, and therefore arguably should be entitled to full release of its obligations under the Policy.

For-Profit Outside Position Coverage. As a consequence of some of the highly publicized recent corporate failings, D&O Insurers will likely be more conscientious about and less willing to afford for-profit outside position coverage. In some respects, this more conservative approach to outside position exposures is consistent with the interests of all Insureds, since this coverage can result in substantial dilution or exhaustion of the Policy's limits of liability due to the wrongdoing of an unrelated company in which an Insured Person serves in an outside position.

Choice of Law Provision. Several recent large claims have demonstrated the significant disparity in relevant insurance law that exists among various states. As a result, many D&O Insurers are now more sensitive to which state law may apply in administering claims under the Policy. That heightened sensitivity may result in some carriers adding to the Policy a choice of law provision that seeks to apply the law of a favorable jurisdiction.

The foregoing D&O insurance issues are in addition to numerous other policy form amendments that are likely to appear as a consequence of the general tightening of the D&O insurance market. Unlike other hard market terms and conditions, though, the coverage terms discussed above directly result from the recent large claim experience of D&O insurers. Although dramatic increases in D&O insurance premiums appear to be attracting more attention by Insureds, changes in coverage terms and conditions can be far more significant to an Insured in the event of a claim. Therefore, Insureds should understand the reason for and consequence of these changes at the time the policy is purchased.

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To accomplish these goals, we establish departments, standards, workflows and procedures that enable us to provide a consistently high level of service to our customers. We staff each department with competent, ethical, individuals who are dedicated to continuing education and professional development.

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