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Corporate Spying and D&O Coverage

The corporate boardroom can be a tense place these days. Stakeholders, internal and external, are watching board activity closely – sometimes, it seems, with class-action litigators waiting in the wings. Such pressures may have helped one boardroom implode recently. Suspicions of boardroom leaks led to internal investigations, which in turn generated allegations of spying. As events unfolded, we observers of Directors & Officers (D&O) Liability expanded our vocabularies to include the term "pretexting," which means falsifying one's identity in order to gain access to otherwise potentially private information. A full-scale scandal erupted around allegations that pretexting had been used to spy on executives, board members and members of the news media. Formal government inquiries, criminal charges and, ultimately, derivative and securities litigation followed. While the dust is still in the air, we consider how most D&O insurance policies would respond to such a claims scenario.

First Response to a Crisis

Several D&O insurance contracts specifically include an extension which provides Crisis Fund coverage (sometimes referred to as the "Spin Doctor" extension). A boardroom scandal (including the resignation of key executives) and a resulting stock drop can trigger this extension. It provides a designated amount of first-dollar coverage – so the policy's retention does not apply – for retaining pre-selected public relations firms to handle public communications about the crisis. One rationale behind such coverage is that the utilization of a public relations quick response team may ultimately reduce the potential fallout from a burgeoning scandal.

Derivative Allegations, Demands and Claims

Allegations made against corporate executives of breach of fiduciary duty as well as failure to properly manage the company and supervise its employees are often brought under state law, or in Canada under federal or provincial law, as derivative claims. This can be an important distinction. First, any derivative claim must be preceded by a derivative demand (unless it falls under a limited exception to this legal requirement, such as "futility"). Many, but not all, D&O policies contain specific coverage extensions for the costs associated with responding to derivative demands. Similar to a Crisis Fund extension, the Derivative Demand coverage found in most D&O policies is available on a first-dollar basis and is subject

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to a sublimited amount of coverage; typically this ranges from $100,000 to $250,000.

After the company has responded to the derivative demand, and assuming that the plaintiffs are *not* satisfied with the outcome, a derivative claim in the form of a lawsuit is the likely result. The good news for directors and officers is that derivative suits are typically covered by D&O policies, including the costs of investigation, defense, settlements and court awards. These last two are most important, as there are high legal hurdles against corporate indemnification of settlements or court awards of derivative claims against corporate executives, making this protection limited or nonexistent. From a D&O insurance perspective, this, in turn, has potentially two very important implications: one relates to the policy's retention and the other to the limit or total amount of coverage.

Since the executive cannot seek corporate protection for nonindemnifiable losses, the D&O policy operates so that the deductible or retention, which could range anywhere from $100,000 to $100 million, does *not* apply to nonindemnifiable claims. (These fall under the A side of the standard D&O policy and are often referred to as A-side claims.) This is very good news for the executives and not such good news for the insurance carrier. The second implication, relating to the limit or total amount of available insurance coverage, is that if and when the insurance runs out, the executives will be *personally liable* for the settlement or court award. As defense costs are covered within the limit of coverage of the D&O policy, and serve to erode the amount of money available to pay court awards or settlements, the potential for personal exposure should not be underestimated.

Coverage would also be triggered under a nontraditional, stand-alone, A-side D&O policy designed to provide coverage only for nonindemnifiable claims. Whether the entire D&O program is strictly A-side or the stand-alone A-side coverage acts as additional, excess insurance, it is likely to come into play for any resulting derivative settlement or court award. Please note that under certain circumstances, some or all of the costs associated with a successful criminal prosecution of a company's executives might not be indemnifiable, thus triggering the A-side coverage in both the primary and/or excess policies.

For more on derivative claims, please see our Alert, *"Anatomy of Derivative Claims," from March 2005, available on the Publications page at www.willis.com.*

Formal Investigations and Criminal Charges

The policy's definition of a Claim will be critical to determining if and when there is coverage for an investigation. Typically, only formal investigations targeting individual directors and officers will find coverage.

What about the rare (but increasingly less so) investigations that result in criminal charges against corporate executives and/or the company itself? Again, the definition of Claim is crucial: many, if not most D&O policies will restrict coverage for criminal prosecutions to cover only the executives, and *not* the corporate entity. As indemnification from the company in such situations may be limited or denied outright, this restriction of coverage can actually be of great relief to the executive.

Should these charges or any other claims be settled with a payment which is labeled a fine or penalty, it should be noted that these are generally excluded from most D&O policies under the definition of Loss. Usually, derivative claims provide for make-whole remedies which should not fall into this category.

Claims Proliferation and the Securities Stock-Drop Claim

In the aftermath of a scandal, stock prices often suffer. Corporate directors and officers may face separate, simultaneous securities stock-drop litigation in the form of a securities class action suit. This, too, is likely to be covered under the typical D&O policy unless interrupted by an exclusion.

Possible Relevant Exclusions: Privacy

Most D&O policies include a standard exclusion for bodily injury and property damage, which may also exclude coverage for claims alleging libel, slander and *invasion of privacy*. In the context of our example, this exclusion may apply to the criminal charges alleging violation of privacy laws and any similar exposures. Fortunately, this exclusion is normally written in a narrow manner and should not eliminate full coverage for the rest of the claims.

Possible Relevant Exclusions: Fraud/Dishonesty

Virtually every D&O policy includes at least one personal conduct exclusion that addresses intentional illegal conduct and dishonesty. Both the wording of such exclusions and their triggers will be important in any coverage analysis. Narrower exclusions are always preferred by directors and officers, and of course avoiding the exclusion altogether is the best outcome. This may be achieved by setting a high standard or trigger for applying the exclusions. A low standard will include "in fact" wording. A high standard will refer to "final adjudication." The good news is that while these exclusions are raised by carriers in just about every D&O claim, in practice, they rarely apply.

Timing Can Be Critical

In our claim example, the alleged pretexting may have first started some years back, during an earlier D&O policy period. While most D&O policies will provide coverage for earlier actions, it is possible that for all or part of the current program, warranties or representations may have been made to insurance carriers. For example, if additional insurance was purchased the prior year, the new insurance carriers probably looked for assurance that there were no outstanding D&O claims or events likely to lead to D&O claims. If any of the executives alleged to have known or participated in the pretexting provided misleading assurances to the insurance carrier, coverage might be eliminated for those executives, for the company, or, possibly, for any and all claims made against this additional layer of coverage.

A review of the specific policy wording dealing with the severability of the application is needed to determine the likelihood of these possibilities. Today, fully nonrescindable D&O policies are available that essentially convert the application severability provision into a claim exclusion – so in the worst case, the individual providing the misleading information may lose coverage but everyone else would be unaffected. If a fully nonrescindable policy is not available, it is still possible to significantly narrow the scope of the policy's knowledge imputation provision. Another alternative is for the D&O policy to be nonrescindable or noncancelable for purely nonindemnifiable losses.

Understanding the intricacies of D&O coverage may not relieve the pressures of the boardroom, but it certainly can help should boardroom-related claims arise.

Fidelity Bond Provisions Tucked into the PPA

For most companies subject to US laws, the US Pension Protection Plan Act of 2006 (PPA) introduced a host of changes relating to pension plan assets, funding and enrollment. A number of changes will be of special interest to investment advisors, broker-dealers and similar entities that provide investment services to Employee Retirement Income Security Act (ERISA) plans. These organizations will want to become familiar with changes addressing issues such as the block trading of securities, electronic communication networks and foreign exchange transactions. We would like to turn a spotlight briefly on those modifications made to ERISA's bond requirements.

- The PPA raises the minimum fidelity bond limit of liability per plan to $1 million, but only for those plans that hold employer securities. The effective date of this change is December 31, 2007.

- Effective January 1, 2007, the PPA waives the previously mandated ERISA bond requirement for broker-dealers registered with the Securities & Exchange Commission (SEC). However, we caution any insured that presently maintains an ERISA bond for non-sponsored plans to consult with their compliance officer prior to terminating such policies. Many of these policies have been written for large financial institutions that have both a broker-dealer subsidiary *and* an investment advisory group, and it may not be clear which entity the ERISA bond was written for. It is possible that the investment advisor group would still require the bond.

Please note that the ERISA bond covers theft of plan assets by one's employees and not breaches of fiduciary duty under ERISA.

New Line of ERISA Litigation: 401(k) Fee Disclosure

Readers of our newsletters and *Alerts* may recall our warning that litigation over the fees paid by 401(k) plans and their participants might be coming. With apologies to those facing unwanted suits, we must report that we were right: at least 10 class actions under ERISA were filed against plan sponsors and executives in late 2006 alleging improprieties in the investment fees charged to 401(k) plans. The issue of fees and fee disclosure is one that affects more than just the organizations offering 401(k) plans to employees – it resonates in the world of financial institutions, especially those that service 401(k) plans.

Not to downplay our powers of prognostication, but there was advance notice that this issue was of concern to pension and other regulators, including the SEC's report raising concerns about pension consultants and possible conflicts of interest issued in May 2005. This was followed earlier this year by the Department of Labor (DOL)'s proposed disclosure changes to the annual report filed each year by pension and other welfare benefit plans (Form 5500). The DOL proposed additional disclosure of fees paid to plan service providers. This proposal was greeted with strong push-back, largely from the service providers themselves.

This is all part of the DOL's strategic three-part project on 401(k) plan fees. Part 1 is the proposed revisions to Form 5500's fee disclosures. Part 2, expected in the fall of 2007, is a revision of the service provider regulation to require that providers provide sponsors detailed information regarding fees. Part 3, anticipated by year-end 2007, is a revision of the ERISA 404(c) rules requiring sponsors to provide participants information about direct and indirect fees.

Who Alleged What?

The recent wave of ERISA fee class actions was started by St. Louis-based law firm Schlichter, Bogard & Denton, which is reported to be targeting at least 17 additional major corporations for litigation in 2007. Meanwhile, others in the ERISA plaintiffs' bar have announced investigations as well. The suits we have seen so far allege breaches of ERISA's fiduciary duty by the failure of the fiduciaries to:

- Become informed of, understand, monitor and control the hard dollar and revenue sharing payments made directly and indirectly by the plans
- Establish, implement and follow procedures to determine whether or not the fee arrangements made directly and indirectly were reasonable and incurred solely for the benefit of plan participants
- Disclose to plan participants all of the hard dollar and revenue sharing payments made directly and indirectly by the plans

The issue of fee and fee disclosure will not be going away anytime soon. The latest report from the Government Accountability Office (GAO) on pension returns painted a relatively bleak picture of both the impact of fees on retirement savings, and on the ability of plan participants to determine what they are paying for. What may be particularly frustrating for plan sponsors is actually determining *what* fees are paid, often indirectly, to plan service providers. It is hard to disclose that which you do not know. For Canadian defined contribution plans, the US experience will be closely watched, and may well be a harbinger of things to come north of the border.

Beyond ERISA Plans

We have also seen a spillover of this focus on fees to retirement plans. In November, the Los Angeles Unified School District announced that it is having its service provider list the revenue-sharing arrangements and disclose fees for each of the funds in its new retirement plan to employees in every communications piece they receive. This was apparently achieved by negotiation. At the same time, however, a Florida Sheriff's Department announced that it was suing a major insurer over allegations that its retirement plan fees had unfairly allowed it to make a profit through an undisclosed revenue sharing arrangement.

Looking Forward

In light of the industry-wide changes in the management of pension plans, plan sponsors and their fiduciaries would be well advised to begin to take action while awaiting the coming guidance from the Department of Labor. This could include launching more detailed discussions with service providers on their fee arrangements and potentially enhancing the current level of disclosure.

We close with an observation: one of the most curious things about the spate of recent 401(k) fee suits is that the service providers themselves have been left out of the suits. It may be that another shoe is still to drop.

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