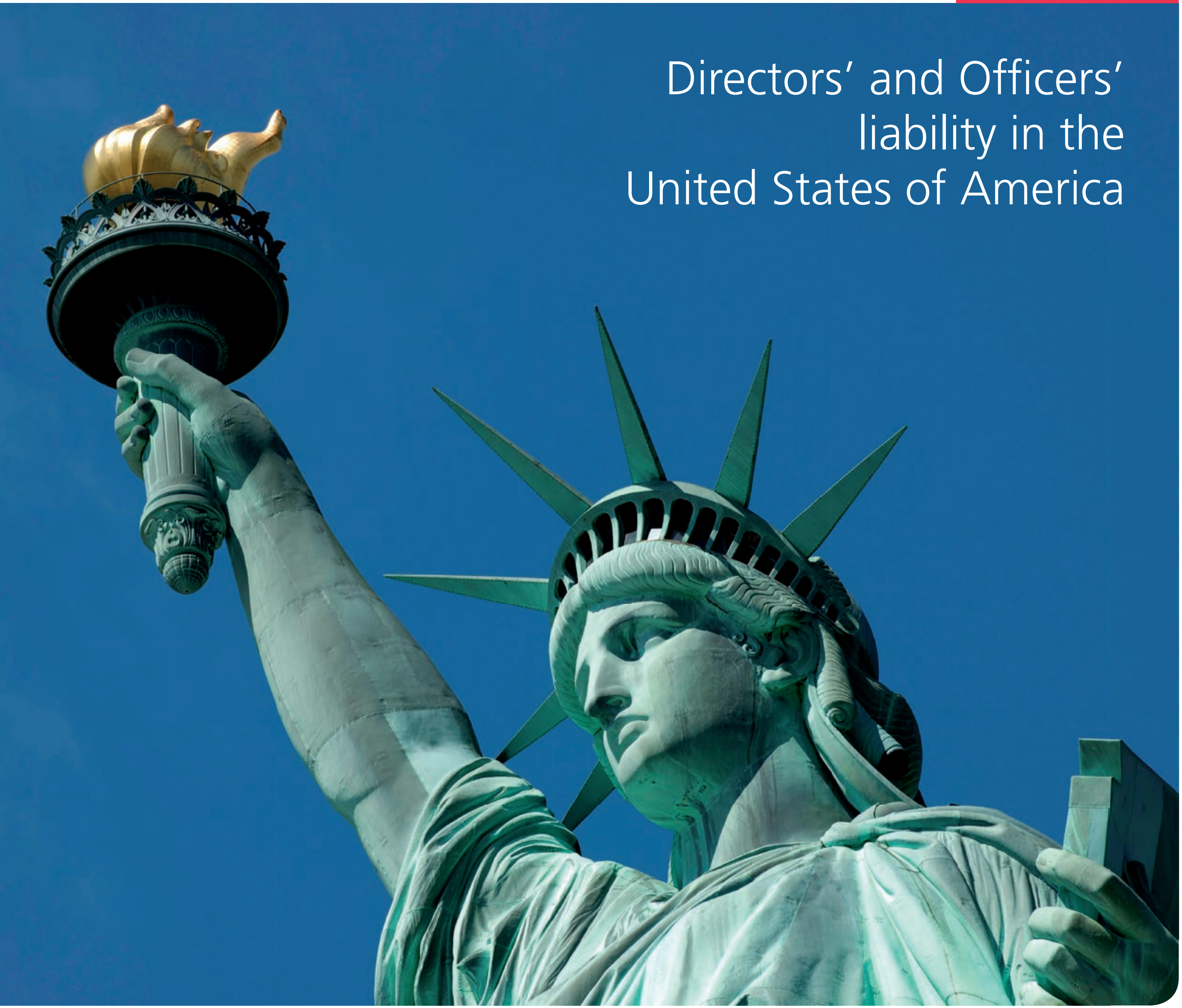
Directors' and Officers' liability in the United States of America



The information provided in this section is a general overview of liability exposures and insurance coverage issues that corporations in the United States of America face in the D&O context. Both liability exposure and insurance coverage are governed primarily by state law. As a result, claims generally must be evaluated under the applicable state law and the outcome of any liability or insurance issue is not uniform across the United States.

The structure of corporations in the United States of America

A commercial entity may incorporate in any of the 50 states, and each state has similar but distinct corporate laws. Except for certain federally chartered institutions, the United States has not adopted national legislation governing corporate formation or governance. Thus, the laws under which a corporation's internal affairs are governed vary depending upon the State law that applies.

Who are Directors and Officers?

Standard board structure

Most states' corporate laws require corporations to be managed by a board of directors. The directors are often elected or appointed by shareholders. The scope of their authority is set forth by state law and is further detailed in the corporation's charter, articles of incorporation, and/or by-laws. While the day-to-day management of the corporation usually rests with officers, executives and full-time employees, the board of directors formulate corporate policy and oversee management.

State statutes permit the board of directors to elect or appoint corporate officers. Those statutes often require the officers' duties be set forth in the by-laws or by resolution of the board of directors.

In addition to the authority and duties set forth in an entity's charter, articles of incorporation, and/or by-laws, directors and officers are free to enter into contractual relationships with the entity. Contracts between an officer and a corporation can more specifically spell out the duties and authorities for that officer. Contracts between directors and corporations generally do not limit any authority for the director.

Many jurisdictions also recognize 'de facto' directors and officers. In other words, if a person exercises the duties of a director or officer without objection, that person can becomes a de facto director or officer, and may bind the corporation.

A corporation's directors and officers may also serve as directors, officers, employees or agents of other corporations or similar business enterprises at the request of their own corporation or for its benefit. These outside positions are frequently referred to as 'outside directorships.'

Duties of the board

Some states, particularly the State of Delaware, have laws generally favorable to corporations. Many corporations are incorporated in Delaware to take advantage of that state's corporate law. For this reason, Delaware state law is considered the primary authority on corporate governance and the duties of directors and officers.

Although directors, executives, and employees manage a corporation's day-to-day business affairs, a board of directors is not passive. Board responsibilities include the following:

- authorizing major corporate actions;
- advising and counseling the corporation's management, especially its chief executive officer;
- providing effective audit procedures;
- adopting sound accounting policies;
- reviewing the corporation's investments at regular intervals; and
- monitoring the performance of management.

State corporation laws do not distinguish between inside and independent directors; however, courts are beginning to scrutinize the distinctions from a liability standpoint.

What are the duties and obligations of the directors and officers?

State law establishes that corporate directors and officers owe duties of obedience, diligence, and loyalty to the corporation. The duty of 'obedience' requires the directors and officers to obey the law and ensure the corporation is doing the same. The duty of 'diligence', frequently referred to as the standard of care, usually requires the director or officer to discharge its duties:

1. in good faith;
2. with the care that an ordinarily prudent person in a similar position would exercise under similar circumstances; and
3. in the manner reasonably believed to be in the best interests of the corporation.

The duty of loyalty requires that a director refrains from engaging in personal activities that injure or take advantage of the corporation.

In Delaware and other states, the standard of care is established by common law, which evolves through court decisions. In other jurisdictions, the standard of care has been imposed by both statute and common law.

Most states enforce the standard for each duty to be that of 'ordinary care,' meaning that a director or officer may be held liable for simple negligence. In some situations, the 'business judgment rule' applies, which involves a higher degree of culpability such as gross negligence. Cases involving director neglect tend to be based on the 'ordinary care' standard, while cases involving director decisions generally require a higher degree of culpability.

The duty of loyalty is absolute. Self-dealing is strictly condemned. Consequently, directors who had an interest in the outcome of the Board action are required to establish their good faith and the fairness of the transaction to the corporation.

The business judgment rule

The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, such judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

This rule is an important defense that directors can utilize against claims for mismanagement or breach of the duty of care. Some of the specific claims to which this defense may apply are discussed in the 'Liability of Directors and Officers' section below.

Five conditions must generally be met for the business judgment rule to apply:

1. Act at issue must involve a business decision.
2. Disinterestedness (the absence of personal interest or self-dealing).
3. Due care (an informed decision following a reasonable effort to become familiar with the relevant and available facts).
4. Good faith (a reasonable belief that the best interest of the corporation and its stockholders are being served).
5. No abuse of discretion.

State law is not uniform as to whether the business judgment rule applies to a corporation's officers. However, the majority rule is that this does apply to officer decisions.

The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 ('SOX') is a federal statute that regulates several important requirements for corporations. It includes provisions establishing disclosure requirements for companies and their Chief Executive Officers's (CEOs) and Chief Financial Officer's (CFOs), restricting certain officer and director transactions, imposing obligations on corporate audit committees, and enhancing a variety of criminal penalties and enforcement measures for securities-related offenses. The broad scope of SOX will not be addressed in this brief overview, however it is important to note that some commentators believe SOX has had a positive effect on corporate governance.

Liability of Directors and Officers

What are the specific liabilities that directors and officers may have?

A director's or officer's failure to fulfill their duties can lead to a broad range of civil, criminal, or regulatory liability. The nature of the liability varies by the circumstances. This can lead to lawsuits, regulatory fines and penalties to the individual director or officer or to the company, and can sometimes lead to criminal prosecution and incarceration. While this is not an exhaustive list, some of the more common types of liability a director or officer can face are discussed below.

Liability to creditors and third parties

A primary reason for incorporating a business is to shield directors, officers, and/or shareholders from personal liability to third parties based on the corporation's actions. Nonetheless, approximately one-half of all reported claims against directors and officers are brought by third parties, including employees, creditors, competitors, customers and regulators.

Generally, directors' and officers' fiduciary duties extend only to the corporation and its shareholders, not to its creditors or other third parties. Fiduciary duties to third parties can arise when the corporation approaches insolvency or bankruptcy. When a corporation reaches the 'vicinity' or 'zone' of insolvency, directors have the duty to protect the corporate assets in order to maximize the amount of assets available for the creditors.

Additionally, under both the United States Bankruptcy Code and state laws, certain transfers of the assets of a company may be voided if the transfer acts as a fraud on creditors.

Employment-related liability

Decisions involving hiring, termination, pay, benefits and conditions of employment are subject to federal, state, and/or local regulation. Federal employment laws that can be the basis for liability claims against directors or officers include:

1. Title VII of the Civil Rights Act of 1964;
2. Civil rights claims under 42 U.S.C. Section 1981;
3. The Americans with Disabilities Act;
4. The Fair Labor Standards Act;
5. The Equal Pay Act;
6. The Family and Medical Leave Act; and
7. The Occupational Safety and Health Act ('OSHA').

Individual officers of a corporation can face liability as fiduciaries under the Employee Retirement Income Securities Act of 1974 ('ERISA'), which generally covers all employee benefits plans, namely, pension plans and welfare plans.

The United States Department of Labor regulates several areas of employment for US citizens, including:

- ensuring that employers comply with the Fair Labor Standards Act;
- administering the Occupational Health and Safety Act to ensure that working conditions are safe for employees;
- regulating pension or employee benefit plans that employers offer to their employees;
- regulating organized labor and its membership including overseeing union elections;
- administering worker training and worker placement programs; and
- collecting and analyzing economic statistics.

The Department of Labor may bring a lawsuit against corporations and other entities that violate its regulations.

The Equal Employment Opportunity Commission (the 'EEOC') is charged with administering Title VII and other employment related statutes. The EEOC investigates charges of employment discrimination and may bring a lawsuit or take other action on the employee's behalf. The EEOC is also permitted to initiate litigation on its own, and has obtained significant settlements from large corporations for employment law violations. The EEOC may also implement regulations concerning the employment statutes that it enforces.

In the majority of cases, after investigation, the EEOC notifies the employee in writing that it will not take any action on the employee's behalf. The employee then has 90 days to file a lawsuit against their employer before it is barred from filing a complaint alleging a Title VII violation.

A director or officer may also face liability exposure under state non-discrimination laws or common law claims for wrongful discharge, defamation, and infliction of emotional distress.

Each state also has an agency that regulates issues related to employers and employees. These agencies have a wide array of powers to regulate corporations.

Environmental liability

Courts have found that the strict liability provisions of CERCLA and RCRA apply to both the corporation and directors and officers. In making this determination, the courts have adopted two tests to determine whether individual liability exists:

1. the personal participation test; and
2. the prevention test.

Directors and officers can also face personal liability under various water pollution statutes if they personally participated in the alleged conduct. On the other hand, corporate officers do not appear to face liability under the Clean Air Act.

RICO

The Racketeer Influenced and Corrupt Organizations Act ('RICO') was originally designed to serve as a tool to prosecute organized crime. RICO's scope now covers fraud in business and securities transactions and other types of 'white-collar' criminal activity.

Tax

Directors and officers may face both civil and criminal liability for tax evasion and other offenses, such as failure to pay appropriate employee withholding taxes.

Anti-trust

The Sherman Act and Clayton Act are the two principal federal statutes creating anti-trust exposure for directors and officers. Section 1 of the Sherman Act prohibits every contract, combination or conspiracy in restraint of trade or commerce. Courts have prohibited only contracts or combinations that unreasonably restrain competition.

Section 2 of the Sherman Act prohibits any person from monopolizing or attempting to monopolize any part of trade or commerce. Unlike Section 1, a Section 2 violation does not require more than one actor.

The Clayton Act prohibits price discrimination, exclusive dealing and tying contracts, anti-competitive acquisitions and mergers, and interlocking directorates. Where the Sherman Act addresses the 'restraint' of trade or commerce, the Clayton Act prohibits conduct which may 'substantially lessen competition.' Consequently, the Clayton Act has a wider scope.

Intellectual property claims

Typically, directors and officers are not liable for corporate infringement. However, special circumstances exist to impose liability, such as deliberately using the corporation as an instrument to infringe. Personal liability for corporate infringement has been expanded under traditional tort law holding directors and officers liable if they specifically authorize the tortious infringing activity. Consequently, infringement claims based on a statute are more likely to be construed narrowly than infringement claims based on tort law.

Federal securities laws

Most cases under the federal securities laws are brought under Section 11 or 12 of the Securities Act of 1933 ('33 Act'), or Section 1013 of the Securities Exchange Act of 1934 ('34 Act').

The 33 Act

The 33 Act imposes liability upon the issuer of securities and directors and officers for material misstatements or omissions in registration statements filed with Securities and Exchange Commission ('SEC').

Sections 11 and 12 are the basic private liability provisions of the '33 Act. Section 11 imposes liability for a false or misleading registration statement in favor of all purchasers, regardless of from whom securities were purchased.

Section 11 applies to securities issuers, underwriters and experts who assist in preparing registration statements, has no privity requirement, and provides a remedy in damages.

Section 12 allows the purchaser to rescind his purchase of securities or to obtain damages from the seller if the purchaser no longer holds the securities, if the seller used a false or misleading prospectus or false or misleading oral statements in making the sale.

Section 12 applies to 'retailers' of securities, i.e., the securities dealers who sell to the general public, require privity and primarily provide for a remedy of rescission.

Both provisions allow for rescission for a purchaser buying a security directly from an issuer or underwriter that has registered in violation of Section 5 of the '33 Act or on the basis of false or misleading oral representations or a false or misleading prospectus.

Nothing prevents a litigant from pursuing both Section 11 and 12 actions to judgment and then electing his or her remedy.

Section 11 follows a strict liability standard; a plaintiff need not establish a defendant's state of mind to prevail. Furthermore, in most Section 11 cases, a plaintiff need not show that he or she relied on statements in a registration statement.

The 34 Act

Rule10b-5, promulgated by the SEC under the 34 Act, can impose civil liability on a director or officer for fraud in the purchase of a security. To prevail on a Rule 10b-5 claim, a plaintiff must establish that the defendant made a false statement or omission of a material fact, upon which the plaintiff justifiably relied, and which proximately caused the plaintiff's damages.

Under the Private Securities Litigation Reform Act ('PSLRA'), the plaintiff in a private Rule 10b-5 action must plead the relevant state of mind with particular factual allegations that create a strong inference that the defendant acted with the state of mind that imposes liability. Recently, the United States Supreme Court explained the standard necessary to plead a 'strong inference of scienter.' In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), the Court held that:

1. A complaint will survive a motion to dismiss 'only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged;' and
2. In applying this standard, 'the court must take into account plausible opposing inferences.'

In another Supreme Court case, *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), the Court held that a plaintiff cannot satisfy the PSLRA's 'loss causation' requirement simply by alleging that shareholders purchased stock at an 'artificially inflated' price. Additionally, plaintiffs in securities fraud cases must prove that a defendant's misrepresentation was the proximate cause of the plaintiffs' economic loss. It is not sufficient to allege that a misrepresentation caused the price of the stock to be inflated on the day of purchase. The Court made clear that Section 10(b) of the 34 Act does not protect a plaintiff from losses caused by factors unrelated to a defendant's fraud, such as changed economic circumstances, modified investor expectations, new industry-specific or firm-specific facts, conditions or other events. In reaching its conclusion, the Court observed that the securities laws are not intended to provide investors with broad insurance against market losses.

The Supreme Court also recently held that the private right of action under the 34 Act's Section 10(b) does not extend to aiders and abettors under a 'scheme' liability theory. *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 761 (2008).

Foreign issuers

Foreign corporations who cross-list on the U.S. stock exchanges face potential liability exposure under both the 33 and 34 Acts. The exposure generally results from listing Level III American Depositary Receipts ('ADRs') for sale in the United States. In recent years, many of the largest settlements by foreign issuers were made by European companies, despite the fact that European companies constitute only a minority of the foreign issuers sued in the United States.

Merger and acquisition liability (takeovers, mergers and buyouts)

Merger and acquisition activity can create director and officer liability. Directors are asked to analyze and respond to any bid on behalf of the corporation and its shareholders. Essentially, the directors of the acquiring company face 'second-guessing' from shareholders who can assert claims based on:

- Resisting a hostile takeover.
- Approving a friendly takeover.
- Pre-acquisition mismanagement.
- Inaccurate or misleading disclosures.
- Mismanagement of the acquisition itself.

The Delaware Supreme Court has developed three basic common law principles related to corporate takeovers:

1. The board of directors must make a thorough, well-documented investigation before deciding;
2. The defensive measures adopted must be reasonable in relation to the reasonably perceived threat posed by the takeover bid; and
3. If the corporation initiates an active bidding process or abandons its long-term strategy in response to a hostile offer by seeking an alternative transaction involving the breakup of the company, the board must not unreasonably interfere with an open bidding process.

Criminal

Corporate officers face criminal liability for:

1. crimes they personally commit;
2. crimes they aid and abet; or
3. crimes they fail to prevent.

State and federal penal, corporate, and/or securities laws define specific offenses that relate to corporate activities.

For example, the Foreign Corrupt Practices Act of 1977 was enacted to prohibit bribes or kick-back payments to foreign officials or governments. The Comprehensive Crime Control Act of 1984 creates new white-collar and racketeering offenses.

Criminal liability can also be based upon violations of environmental laws, federal securities laws, federal tax laws, OSHA, the Economic Espionage Act of 1996, and for criminal antitrust activity under the Sherman Act, the Clayton Act, or the Robinson Patman Price Discrimination Act.

Who can sue the Directors and Officers?

In addition to third-party liability actions, directors and officers also face remedies in the form of direct actions, class actions and derivative actions.

A direct action is one brought by a shareholder to recover loss separate and distinct from that suffered by other shareholders.

Class actions are lawsuits brought by one or more plaintiffs who sue for the benefit of those who have a similar interest in the outcome. Class action lawsuits have acquired a special status under the federal securities laws and common law fraud.

A derivative action is a suit brought by one or more shareholders to enforce a right of action belonging to the corporation that the corporation could have asserted through its Board of Directors, but did not.

When shareholders are indirectly injured but the corporation itself has been harmed by alleged wrongdoing, the claim is derivative in nature. The harm to the corporation determines the nature of the controversy, not damage to the shareholders. In the context of securities laws violations, the same act or transaction can give rise to securities class actions and derivative actions.

PSLRA sets forth the standards for selecting a class action's lead plaintiff and lead counsel. One of PSLRA's major features allows discovery to be stayed while a motion to dismiss is pending.

PSLRA does not apply to derivative actions. The requirement commonly known as the 'demand requirement' will be excused where such a demand would be useless or futile because the directors are 'incapable of reaching a partial decision to pursue litigation'.

Consequently, the first major battle in a derivative action generally concerns the issue of 'demand futility.'

Finally, some states permit a Special Litigation Committee to terminate a derivative action based upon an appropriate showing to the court. The procedure for the termination of an action by an SLC and the burden of proof can vary from state to state.

Scope of liability/indemnification

Indemnification

The Delaware indemnification statute has served as a template for many states. Although each state has its own indemnification statutes, most contain the following provisions:

1. Empowering a corporation to indemnify directors or officers;
2. Stating required standards of conduct to be eligible for indemnification;
3. Mandating indemnification for expenses to the extent the person successfully defends a claim;
4. Prescribing the necessary procedure to authorize indemnification;
5. Providing for court-ordered indemnification where appropriate;
6. Permitting advance payment of expenses;
7. Declaring statutory indemnification to be non-exclusive; and
8. Empowering a corporation to purchase and maintain D&O insurance.

Procedural issues

State statutes limiting liability

The Delaware Supreme Court held in 1985 that the business judgment rule did not protect corporate directors from liability for gross negligence: *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). That decision led Delaware and other states to amend their corporate statutes to reduce the liability exposure for directors and officers. Generally, state legislation enacted since 1985 provides for the relief of directors (and sometimes officers) from civil liability, or expands corporate indemnification for directors or officers.

The relevant legislation tends to authorize charter provisions eliminating or restricting personal liability from any damages, or increases the level of proof necessary to impose personal liability.

Limitations

Statutes of limitations vary from state to state and should be researched on a case-by-case basis.

The statute of limitations for claims under Section 11 of the 33 Act is one year after the discovery of the untrue statement or omission, and no later than three years after the securities were offered to the public.

The statute of limitations for violations of Section 10(b) of the 34 Act is three years after discovery of the facts constituting the violation, and five years after such violation occurred.

A good example of the distinction between claims under 10(b) and state law can be found in the recent options-backing litigation, where the plaintiffs asserted theories under 10(b) and state law. While many courts have dismissed 10(b) claims for option grants that occurred more than five years before the date of the filing of the lawsuit, the same courts will often allow the state law claims to go forward because many states permit the relevant statute of limitations to be tolled by concealment of the wrongful activity.

Liability for punitive damages

Generally speaking, directors and officers may be liable for punitive damages if the federal or state statute allows such an award. Punitive damages are available under state law for certain torts, but often require a showing that the directors or officers acted with malice, fraud or oppression.

Enforceability of foreign judgments

The enforcement in the United States of judgments obtained against a director or officer in another country is governed by the laws of each individual state. Many states have adopted the Uniform Foreign Money-Judgments Recognition Act and/or the Uniform Enforcement of Foreign Judgments Act, or some portions thereof. See 13 U.L.A. 194 (1986); 13 U.L.A. 261 (1986). Those statutes generally require that the foreign judgment be final, conclusive, and enforceable where rendered. However, they generally do not recognize foreign judgments if the court did not have jurisdiction over the defendant or if the court was not impartial or did not offer due process of law. Moreover, some states have added provisions that allow or require non-recognition of a foreign judgment if the country in which the judgment was entered does not have reciprocity with the United States – essentially, those states require the foreign nation to recognize a judgment of United States courts.

Insurance of Directors' and Officers' liability

Is directors and officers' liability insurance permissible or legal under local law?

Corporations may purchase and maintain D&O insurance in all 50 states.

Are there limitations in law to what can and cannot be covered under a D&O insurance policy?

Generally, there are few legal limitations on what risks can be covered under a D&O insurance policy. Some states, for example, specifically forbid liability insurers, including D&O carriers, from providing coverage for punitive or exemplary damages.

Can an insurer write D&O insurance on a non-admitted basis? Is a specific license required for the insurer to write D&O insurance?

Typically, an insurer must be licensed in each state that it seeks to write D&O insurance. However, most states allow non-licensed insurers – often referred to as 'surplus lines' carriers – to issue policies in certain specific situations, such as where an insured seeking D&O coverage cannot meet the underwriting guidelines of the licensed insurers in that particular state. While not admitted in each state in which they issue policies, surplus lines carriers must be licensed in their home state or country for each type of insurance they wish to sell on a surplus lines basis.

Are claims made and reported policies permissible under local law, or does the law require occurrence?

D&O insurance policies in the United States are typically written on a 'claims made' or 'claims made and reported' basis, rather than on an occurrence basis.

Can defense costs be covered inside the limit of liability?

Many D&O policies include defense expenses within the policy limits – such that the limits are eroded as defense expenses are incurred.

If a local company is a subsidiary of a foreign parent and such foreign parent has a worldwide D&O policy which covers the local subsidiary, is a separate local D&O policy also required to be issued for such subsidiary to comply with local law?

There is no local law that requires a U.S. subsidiary of a foreign parent to purchase a separate local D&O policy where that subsidiary is covered by a worldwide policy issued to the foreign parent. However, it is important for the local subsidiary to carefully review the scope of coverage available under the parent company's worldwide policy to determine whether the coverage is as broad as is typically provided in the U.S. If the worldwide policy is more limited, the subsidiary may want to consider purchasing supplemental D&O coverage.

Extended reporting period/discovery in local law

Many U.S. states do have requirements related to an extended reporting period/discovery offered for the claims-made D&O policies, but those requirements vary from state to state. For example, New York requires an insurer to offer an indefinite supplemental extended reporting period to an insured within 30 days after a policy is cancelled or terminated. Other states do not require an insurer to offer the extended reporting period, but have rules related to how much additional premium an insurer is permitted to charge if they do offer the extended reporting periods.

Recent and expected developments

Parties are constantly litigating D&O insurance coverage issues across the country, and judicial opinions construing those issues vary from state to state. Because there are so many litigated coverage issues, it is difficult to identify and summarize all recent significant cases. However, there are several recent cases that could have an impact on D&O coverage issues that are litigated in the United States:

Miller v. St. Paul Mercury Ins. Co., 683 F.3d 871, (7th Cir. 2012). *Miller* involved the issue of whether a D&O policy's 'insured v. insured' exclusion will preclude coverage for an entire lawsuit, where some plaintiffs qualify as insureds under the policy and others do not. *Miller* relied on an earlier Seventh Circuit decision – *Level 3 Commc'ns v. Fed. Ins. Co.*, 168 F.3d 956 (7th Cir. 1999) – to determine that the D&O Policy's allocation provision required the insurer to allocate between the covered portion of the lawsuit (the non-insured's claims) and the non-covered portions (the insured's claims). However, not all D&O policies include allocation provisions similar to those at issue in *Miller* or *Level 3*. Courts interpreting policies without an allocation provision have found that there is no coverage for any claims, even those brought by a non-insured. *See, e.g., Sphinx Int'l, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburg, PA*, 226 F. Supp. 2d 1326 (M.D. Fla. 2002); *PowerSports, Inc. v. Royal & Sunalliance Ins. Co.*, 307 F. Supp. 2d 1355 (S.D. Fla. 2004).

XL Specialty Ins. Co. v. Perry, No. 11-cv-2078 (C.D. Cal. June 27, 2012) (unpublished). *Perry* involved which policy period(s) provided coverage for claims arising out of IndyMac

Bancorp's investment in mortgage-backed securities, and its subsequent bankruptcy filing in 2008. A securities class action was filed against IndyMac during a 2007-2008 policy period, and several more lawsuits and administrative actions were filed during a 2008-2009 policy period. The *Perry* court determined that coverage was only available under the 2007-2008 policy period, finding that the 'interrelated wrongful acts' and 'prior notice' exclusions in the 2008-2009 policies unambiguously and broadly applied to preclude coverage under the later policies for all lawsuits brought after the initial class action in later policy periods. While this is an unpublished trial court decision, it is potentially important as a resource of persuasive reasoning for other instances in which there are several lawsuits or administrative actions involving related wrongful acts.

Office Depot, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburg, PA, 453 Fed. Appx. 871 (11th Cir. 2011). In *Office Depot*, the Eleventh Circuit affirmed a Florida federal district court's grant of summary judgment in favor of an insurer that denied coverage for approximately USD 20 million in legal fees which *Office Depot* incurred in responding to an SEC informal investigation. While the D&O policy's definition of 'Loss' did include 'Defense Costs,' the *Office Depot* court determined that the informal investigation did not fall within the scope of the definition of 'Claim' for either the 'Organization Liability' or the 'Indemnification of an Insured Person' insuring agreements. Specifically, the informal investigation notices failed to allege that any violations occurred or identify any specific directors or officers who could be charged in future proceedings. The court also rejected an argument that the notice condition's provision deeming a 'Claim' to have been made when a notice of circumstances is provided requires the insurer to pay defense costs beginning at the notice of circumstances.

Sauter v. Houston Cas. Co., 276 P.3d 358 (Wash. Ct. App. 2012); *August Entm't, Inc. v. Philadelphia Indem. Ins. Co.*, 52 Cal. Rptr. 3d 908 (Cal. Ct. App. 2007). *Sauter* and *August* each involve similar issues – whether a D&O policy covers damages caused by a director or officer's breach of contract. Both found no coverage for several reasons:

1. D&O policies typically contain explicit breach of contract exclusion;
2. there is no 'wrongful act' because an officer can only breach a contract in her/his individual, rather than official, capacity;
3. there is no 'loss' because of a 'wrongful act' because the loss was incurred upon

execution of the contract, not the failure to perform as required under the contract; and

4. parties did not mutually intend to hold the insurer liable for a business deal gone bad.

These decisions could influence similar coverage issues litigated in the United States in the future. However, it is important to note that courts in the United States are rarely influenced by decisions on D&O insurance that are issued in foreign countries.

Other issues affecting D&O insurance

In addition to issues reflected by recent case law, there are other recurring coverage issues. One of these is rescission. The standards for rescinding a D&O policy vary from state to state. In some jurisdictions, an insurer can unilaterally rescind a D&O policy by tendering the premium, while in other jurisdictions; a judgment of rescission must be obtained.

Additionally, some jurisdictions permit insurers to rescind for innocent misrepresentations in the application, where other jurisdictions require a knowing misrepresentation. Some states have adopted legislation that prohibits imputing the knowledge of one director or officer to an innocent director or officer with respect to rescinding D&O policies.

The laws of each U.S. state vary on the issue of severability of a D&O policy's application and conduct exclusions. Some require severability for the policy and/or application as a whole, while some only require severability for specific exclusions.

Whether a claimant can sue a D&O insurer directly – often called a direct action – varies by state. Most states do not permit direct actions against any liability insurers, including D&O carriers. Some states do allow direct actions against insurers, but only after a judgment is entered against an insured and there is evidence that the judgment is unsatisfied. A few states, such as Louisiana and Wisconsin, do permit direct actions against D&O insurers even before an insured's liability is established.

Recent surveys indicate that securities class actions filings are declining in the United States. These surveys attribute this trend to the impact of Sarbanes-Oxley, a relative lack of volatility in the stock markets, and the demise of the class action law firms Milberg Weiss and Lerach Coughlin. Of these three factors, the most significant factor is likely to be the lack of volatility in the stock market. Regardless, until the stock market becomes less stable, the ability to measure the impact of Sarbanes-Oxley is imprecise.

Moreover, while the safe harbor provisions of the PSLRA, in conjunction with the *Tellabs* and *Dora* decisions, raise the bar for prosecuting securities class actions based on false forward-looking statements, none of these factors have any significant impact on defending claims based on financial fraud. Additionally, with the continuing liquidity crunch that is part of continuing worldwide financial difficulties, claims for financial fraud could also be based on false and misleading balance sheets, rather than just false and misleading income statements and revenue projections. Nonetheless, based on the recent Supreme Court Decisions in *Dora* and *Tellabs*, it is apparent that the judicial trend is to make the prosecution of securities class actions more difficult.

Given this trend, creative plaintiff lawyers might resort to the filing of shareholder derivative actions, where they have the ability to file in federal or state court, and the potential to initiate early discovery that is burdensome to the corporation and the directors and officers. The cost of defending derivative actions can be quite expensive because of the dollar amounts at issue, the possibility of extensive internal investigations, audit committee investigations, Special Litigation Committee investigations, and the desire of each individual defendant to be separately represented by counsel.

Finally, the plaintiffs' bar should be viewed as an industry. Participants in this industry have their own budgets to meet. These participants will not only search for the next major scandal, but also will make up in 'severity' any shortfall in 'frequency'.

The need for directors and officers to protect themselves from personal liability is undiminished.

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