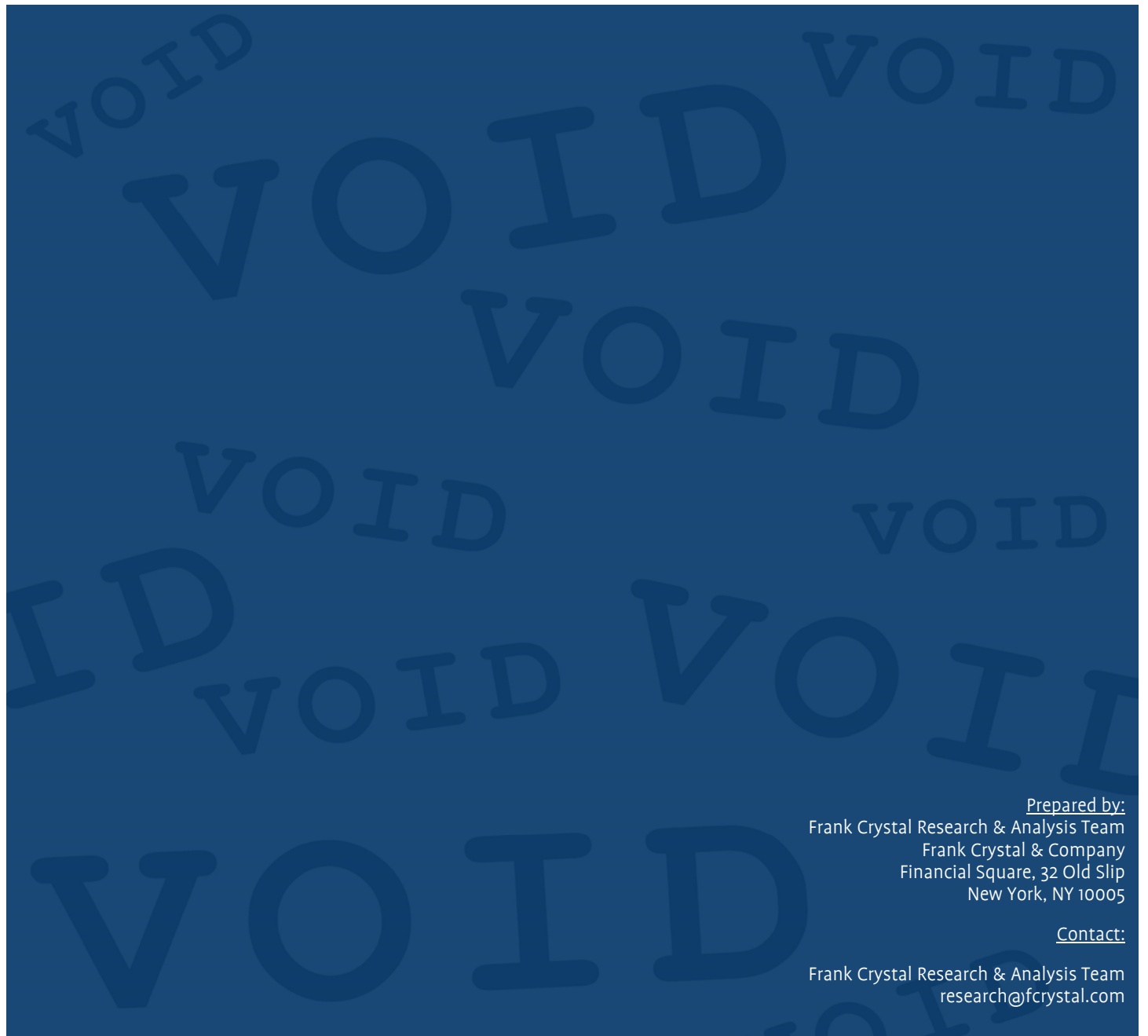


Directors & Officers Liability

Mitigating The Risk Of Rescission



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The rescission of high-profile companies' Directors & Officers Liability insurance policies and the increased frequency of rescission warnings in reservation of rights letters have been cause for significant concern. This paper explores the factors that have instigated policy rescission in the past as well as how an insured can mitigate the possibility of losing Directors & Officers Liability coverage. Individuals with properly structured insurance programs bear little risk of having their coverage rescinded, provided they are not involved in and have no knowledge of any fraudulent activity. The basic knowledge presented in this paper will enable an insured to more effectively identify any gaps that may exist in current coverage and understand how more comprehensive coverage may be obtained.

The potential for the rescission of Directors & Officers Liability (D&O) insurance policies has become a great concern for many executives. Warnings of rescission have become common in insurers' reservation of rights letters, particularly after an insured has restated financial statements. If fraudulent or illegal activities have occurred, making the possibility of rescission real, the only protection available to the innocent director or officer is that afforded by an aggressively negotiated and professionally structured Directors & Officers Liability insurance policy. Many policies in place today do not provide adequate coverage for innocent directors and officers.

This paper has been written to improve executives' understanding of Directors & Officers Liability insurance policy rescission and the policy nuances that must be considered to ensure adequate protection. The paper will:

- Explain rescission
- Identify issues that may lead to policy rescission
- Clarify the difference between rescission and severability
- Discuss recent high-profile D&O rescission cases and the precedents they set
- Explain how to prevent policy rescission and structure alternative coverage

Insurance coverage can be structured in such a way that the risk of rescission is minimal. Moreover, alternative coverage can be obtained to secure further personal protection independent of the insurance available through the corporate entity.

What is Rescission?

Rescission is the voiding of a contract *ab initio* – from its beginning. When an insurance company rescinds a policy, it returns all premium payments and abrogates its responsibility to indemnify for claims filed during the policy period. While specific laws vary by state, the rescission of an insurance policy is generally limited to those instances in which: (1) the applicant has made a material misrepresentation in the policy application; and (2) the insurance company has relied upon the misrepresentation in its decision to provide coverage. Some states also limit the ability of insurance companies to rescind coverage if a misrepresentation is neither willful nor intentional.

What May Lead to Rescission of a Directors & Officers Liability Insurance Policy?

To rescind an insurance policy, an insurance company generally must prove that a material misrepresentation resulted in the issuance of a policy that would not have been issued otherwise. Insurers typically incorporate an applicant's financial statements within the insurance application, which states that the underwriters have relied upon the truthfulness of those statements. If the company later re-files its financial statements upon discovery of fraudulent accounting methods, the financial statements included with the insurance application may be deemed as materially misleading. While coverage would be immediately void for the individuals with knowledge of the misrepresentation (as well as for all individuals to whom the actions may be imputed), the insurance company may also seek to rescind the policy and void coverage for all individual insureds, whether guilty or not, on the grounds that the risk of loss is much greater than the risk of loss assumed when the policy was underwritten and premiums calculated.

Policy Rescission vs. Policy Severability

The terms *policy rescission* and *policy severability* are not synonymous. Policy rescission is an action taken by an insurance company to void a policy in its entirety, retroactively denying the insureds the right to any coverage from the policy's date of inception. Policy severability is a coverage condition that precludes the insurer from imputing the fraudulent acts of one (or several) individual insured(s) to any other individual insured(s).¹

When severability is fully applied, the act of one (or several) individual insured(s) may not be imputed to any insured director or officer not possessing knowledge of such action. As a result, coverage is withheld from the guilty insured(s) only. However, when the severability condition is not included and a misrepresentation is made in the application,

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the insurance company may rescind the policy as to the guilty party *and any party to whom the misrepresentation was imputed* for any related losses. Each policy's language must be read carefully to determine the level of severability. While almost no insurer will offer a policy with full severability, many will offer policies with partial severability. Typically a partial severability clause imputes all misrepresentations and acts to the corporate entity but not to innocent individuals.

Because severability and rescission are not interdependent, it is possible for a policy to be fully rescinded even if a severability clause is included in the policy. However, the inclusion of a severability clause does make the rescission of a policy more difficult to uphold.

Timeline: The Development of Directors & Officers Liability Insurance

- 1930's: Underwriters at Lloyd's of London develop an insurance product that protects directors and officers from the personal liabilities arising out of their corporate roles. The coverage received little attention.
- 1940's: Courts begin to recognize that the protection of corporate officers from personal liability will promote more effective corporate management and corporations begin to lobby for the ability to provide this protection.
- 1950's: State legislatures begin to enact laws that allow corporate indemnification and that mandate corporate indemnification in the event that a final adjudication is made in favor of a corporate director or officer.
- 1960's: Interpretations of the securities laws begin to change, increasing the personal liability exposures of corporate directors and officers.
- 1980's: Directors & Officers Liability insurance becomes an instrumental means of protecting corporate officials from personal liability in the event that the corporation cannot provide indemnification (as in the case of bankruptcy or certain derivative actions) or in the event that the corporation refuses to provide indemnification.
- 1990's: Insurers introduce entity coverage for securities claims.
- Today: Supplemental Directors & Officers Liability insurance coverages are introduced to the marketplace to ensure that coverage exists for innocent directors and officers in the event that a primary policy is rescinded due to allegations of corporate fraud and material misstatements in the application for insurance.

Recent High-Profile D&O Liability Policy Rescission Cases

There have been several recent high-profile Directors & Officers Liability insurance policy rescission cases, which are described below.

On November 25, 1998, Sunbeam restated its financial results for 1996, 1997, and the first quarter of 1998.ⁱⁱ Shortly thereafter, an insurer rescinded Sunbeam's Directors & Officers Liability policy. Sunbeam followed with a lawsuit in the Miami district court seeking restoration of the coverage. The lawsuit was settled out of court in 2001. The insurer paid Sunbeam \$10 million, but did not reinstate the rescinded policy.ⁱⁱⁱ

In July 2002, just prior to WorldCom's bankruptcy, an insurer threatened to rescind WorldCom's Directors & Officers Liability insurance policy on the grounds that the WorldCom policy was issued based upon a misrepresentation of WorldCom's financial situation. In November 2002, the insurer settled with WorldCom. Coverage was rescinded for the WorldCom entity but the insurer agreed to maintain coverage for the directors and officers on an individual basis.^{iv}

On October 10, 2002, Cutter & Buck restated its financial statements for 1998 through 2001. On December 6, 2002, an insurer sent Cutter & Buck a notice that they were rescinding Cutter & Buck's Directors & Officers Liability insurance policies for the policy periods of 2001/2002 and 2002/2003. In August 2002, former Cutter & Buck CFO Steve Lowber plead guilty to wire fraud and on February 11, 2004, a Seattle district court judge upheld the insurer's rescission of the policies. Cutter & Buck never disputed that Lowber falsified the company's financial statements. The insurer's policy language clearly indicated that the financial statements were included as a part of the application for insurance and that material misrepresentations in the application would be imputed to all directors and officers.^v

In February 2003, an insurer rescinded a series of Directors & Officers Liability insurance policies issued to Tyco on the grounds that former CEO L. Dennis Kozlowski had made material misrepresentations about the state of Tyco's finances and other matters on the applications for insurance. The insurer filed a lawsuit seeking to uphold the rescission.^{vi} On March 14, 2004, the insurer settled with Tyco. Tyco agreed to pay \$92 million to retain its Directors & Officers Liability policies. The settlement did not cover four former executives charged with criminal wrongdoing.^{vii}

In March 2003, after eleven of HealthSouth's officers pled guilty to government charges and after securities, derivative, and ERISA class actions lawsuits were filed against HealthSouth, a number of insurance companies rescinded their Directors & Officers Liability insurance policies. On March 16, 2004, a federal district court held that HealthSouth's primary insurers and first three layer excess insurers could not rescind their policies, except with respect to the entity and to those insured individuals that had personally made willful misrepresentations in the written application for insurance coverage. The primary insurance company had issued a policy with full severability and with language limiting rescission to known material misstatements. While excess insurance policies typically follow the form of the primary policy, the fourth layer insurer had modified the severability clause. As a result, the decision of the insurance companies at the fourth excess layer and above to rescind their policies was upheld.^{viii}

Most recently, the February 25, 2005 edition of the Wall Street Journal reported that an insurer filed a suit in Ontario Superior Court of Justice to rescind D&O policies issued to Nortel Networks Corporation.

How to Prevent Policy Rescission

Many directors and officers are not aware of the limitations of their D&O policies nor are they aware of fraudulent activity that may be imputed upon them. As a result, these executives inadvertently assume large and unnecessary risks to their personal assets and to their reputations. All directors and officers should review the language of their D&O insurance policies with the assistance of a qualified insurance broker or attorney, either of whom should specialize in Directors & Officers Liability insurance. During such a review, the following questions should be considered:

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To what extent does the primary policy grant severability?

A policy's severability language can play a critical role in preventing policy rescission. HealthSouth's primary D&O policy contained a severability clause that stated: "no statement in the application or knowledge possessed by an Insured Person shall be imputed to any other Insured Person for the purpose of determining if coverage is available."^{ix} The court deemed that rescission of the full policy would effectively impute the application statements and knowledge of fraud upon innocent insureds, thus breaching the contract. As a result, the court allowed the policies' rescission *only* as respects the entity and the individuals

with knowledge of the fraudulent activities. Coverage to the entity for indemnification of the innocent individual insureds was maintained.

Would Side-A Excess coverage strengthen my insurance program?

Side-A Excess coverage has evolved as a solution to mitigate the impact of policy rescission on innocent directors and officers. A properly crafted Side-A Excess policy is non-rescindable, provides follow-form excess coverage for claims in which the company is not permitted or required to indemnify its directors and officers, and provides first dollar coverage if the underlying policies have been rescinded.

Would Independent Director Liability coverage strengthen my insurance program?

Independent Director Liability insurance provides a separate, dedicated tier of coverage to an entity's independent directors. These policies are typically non-rescindable and their limits will remain available in the event inside directors actually or allegedly perpetrate a wrongful act that results in the rescission of the underlying policies or that results in the erosion of the underlying policies' limits.

Does the primary policy include coverage for Outside Directorship Liability?

Some Directors & Officers Liability policies include coverage for Outside Directorship Liability. These policies protect a company's executives for their actions when sitting on the boards of not-for-profit organizations and other companies at the written request of the employer. This coverage is always excess of the coverage provided by the other company, but may be invoked when the other company's policy has been rescinded, provided the executive/director in question is an innocent party.

Should I consider purchasing Personal Directorship Liability insurance?

A new option, called Personal Directorship Liability insurance, has recently been developed for individuals with

multiple board seats and little control over the underlying corporations' and organizations' insurance programs. These policies are purchased by an individual and provide excess coverage for the individual across the entire individual's specified board seats. These policies may be a good solution for individuals concerned that their boards may not be adequately covered.

Summary

Purchasers of D&O insurance should negotiate severability language that restricts the ability of the insurance company to impute one individual's application statements and knowledge to any other individual. While such a policy enhancement will not eliminate the possibility of rescission, it will restrict the likelihood that a full rescission would be either pursued or judicially upheld.

Properly structured Non-Rescindable Side-A Excess, Independent Director Liability, Outside Directorship Liability, and Personal Director's Liability coverages can be incorporated in a Directors & Officers Liability insurance program to protect innocent Directors and Officers in the event that a policy is rescinded.

Three supplemental insurance coverages can provide protection for an innocent individual insured in the event that the primary Directors & Officers Liability insurance policy is rescinded or if further indemnification is unavailable. Non-

Rescindable Side-A Excess coverage, purchased by the company, has become increasingly common. Independent Director Liability policies, purchased by the company, provide the company's independent directors with an additional tier of insurance. Personal Directorship Liability policies, purchased by individual directors, may be a prudent option for individuals with many directorships and little knowledge or control of the underlying policies.

In conclusion, individuals with properly structured insurance programs bear very little risk of having their coverage rescinded, provided they are not involved in and have no knowledge of any fraudulent activity. We strongly urge all directors and officers to review their Directors & Officers Liability policies so that the most comprehensive coverage can be secured in an effort to allay the fear of rescission and to ensure adequate personal asset protection.



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ⁱ The concept of severability also applies in relation to a policy's exclusionary language. Severability of the exclusions precludes the insurer from imputing a single individual's actions for which coverage is specifically excluded to any other individual insured with no knowledge of the act. Sometimes severability of all exclusions is touted as an extra benefit, but this is only rhetoric as the only exclusions which severability would apply would be the conduct exclusions.

ⁱⁱ Form 10-Q/A filed by Sunbeam Corporation with the Securities and Exchange Commission on November 25, 1998. See "Restatement" in Note 1.

ⁱⁱⁱ Lublin, Joann S. and John R. Emshwiller. "The Decisions of Enron's Board Raises Some Liability Questions." In *The Wall Street Journal*. January 17, 2002.

^{iv} "Settlement between AIG, WorldCom Approved by Judge." *Insurance Journal*. November 27, 2002.

^v *Order Granting Defendant's Motions for Summary Judgment and Denying Plaintiff's Motion for Partial Summary Judgment*. No. C02-2569P. United States District Court Western District of Washington at Seattle. Cutter & Buck, Inc., Plaintiff v. Genesis Insurance Company, Defendant.

^{vi} *Fed. Ins. Co. v Tyco Intl.*, 2004 NY Slip Op 50160(U), Decided on March 5, 2004, Supreme Court, New York County. Index No. 600507/03.

^{vii} Maramont, Mark and Christopher Oster. "Tyco Pays \$92 Million to Keep Insurance for Officers, Directors." In *The Wall Street Journal*. May 14, 2003.

^{viii} "Rescission Limited to Individuals Who Made knowing Misstatements in the Application." *Wiley Rein & Felding LLP*. April, 2004. From the decision "In re Health South Corp. Ins. Litig., No. CV-03-BE-1139-S (D. Ala. Mar. 16, 2004)"

^{ix} *Ibid.*

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