

# YOUR D&O POLICY: CLOSING THE GAP – GAINING AN EDGE

## NEW COVERAGE FOR SECURITIES-RELATED INVESTIGATIONS

**Chartis Insurance (formerly AIG) has introduced *Investigation Edge*<sup>™</sup>, a new insurance product designed to provide coverage to corporations for their costs responding to securities-related investigations. No carrier has offered this type of “entity securities investigations” coverage before.**

Traditionally, protection against such exposure has been limited to a D&O policy’s coverage for individual executives targeted by investigating bodies. More recently, limited coverage for informal investigations involving corporate executives has evolved with no coverage available for the public company itself. But, as SEC investigatory zeal heats up (in the wake of the Madoff scandal and enactment of the Dodd-Frank Financial Reform Act), hourly rates from leading securities attorneys continue to rise and investigations with multimillion dollar price tags mount, many publicly-traded companies may find that now is the time to address this previously non-transferable balance sheet exposure.

### ***Investigation Edge***

This new product does not replace a company’s traditional D&O policy.

- It covers only a single exposure – entity securities investigations – coverage not provided by D&O insurance
- It does not cover directors or officers, just the organization

As such, the policy sits alongside and contours a company’s traditional D&O program.<sup>1</sup> Its purpose, in the event of a securities investigation, is to pay attorney’s fees, including traditional and



electronic discovery costs and internal investigation expenses (but not including other fees common to SEC investigations, such as forensic accounting fees) associated with the company’s response, while the company’s separate D&O policy covers the costs incurred by any targeted directors or officers. *Investigation Edge* will also cover insurable settlement values (such as those not designated as disgorgement, fines or penalties) paid to resolve an investigation on behalf of the corporation.

**NOTE:** *Investigation Edge* policyholders will be limited to selecting one of Chartis’s panel law firms in order to qualify for coverage. Chartis maintains preset rates and litigation guidelines with dozens of leading securities law firms in most U.S. states, and is therefore able to ensure quality legal expertise while controlling defense costs.<sup>2</sup> Some companies, however, may have difficulty with this provision if their customary securities counsel is not listed on the Chartis panel.



**Thus, governmental industry sweeps, such as those launched by former New York Attorney General Elliott Spitzer under the Martin Act, are *not* covered. Other important limitations include investigations arising from events known or existing prior to the policy's inception date, investigations into violations of the Foreign Corrupt Practices Act and similar foreign statutes, such as the UK Bribery Act of 2010 and Canadian Corruption of Foreign Public Officials Act ...**

On its face, the insurance application for *Investigation Edge* is a rather simple three-question form primarily concerned with a company's recent securities-related investigation history and instances of employee whistleblower complaints regarding accounting or disclosure issues.<sup>3</sup> However, despite its brevity, special care, such as consultation with in-house or outside counsel and the company's insurance broker, should be taken when completing the application, as it also addresses the company's anticipated exposures; a company's response could be used as a basis for denying claims if it is deemed inaccurate or incomplete.

Coverage under the form extends to both specific investigations launched by an enforcement body (e.g., the Securities and Exchange Commission (SEC) or Department of Justice) and matters voluntarily reported to such bodies after internal investigation by the policyholder into actual or alleged violations of the 1933 Securities Act or the 1934 Exchange Act. Thus, governmental industry sweeps, such as those launched by former New York Attorney General Elliott Spitzer under the Martin Act, are **not** covered. Other important limitations include investigations arising from events known or existing prior to the policy's inception date, investigations into violations of the Foreign Corrupt Practices Act and similar foreign statutes, such as the UK Bribery Act of 2010 and Canadian Corruption of Foreign Public Officials Act (although coverage for up to \$5,000,000 for such investigations is available for an additional premium and upon completion of additional application questions). Chartis is also willing to add derivative lawsuit investigations coverage for investigation demands brought by shareholders, but this coverage can also be found under most D&O policies these days.<sup>4</sup> Finally, at least for the time being, *Investigation Edge* is not being offered to financial institutions or life sciences companies.

According to our discussions with Chartis, *Investigation Edge* will cost between \$30,000 and \$60,000 per million dollars of coverage, carry a minimum \$500,000 retention and 15% coinsurance feature. Limits available will range from \$5 million to \$25 million.

## IS IT WORTH THE COST?

Think of it this way: in 2010, investors filed approximately 176 securities class action lawsuits,<sup>5</sup> the central risk which drives many companies to purchase D&O insurance towers sometimes hundreds of millions of dollars high. By contrast, in 2010 the SEC launched a total of 952 investigations and filed 531 cases,<sup>6</sup> but those same D&O buyers have no coverage for the investigations against the company – and these investigations can be expensive, ranging from modest legal expenses under \$1 million for smaller, quickly satisfied matters, to multi-million dollar fees for major investigations with deep discovery requirements. In one well known case, Office Depot, Inc. reportedly incurred \$23 million in expenses after the SEC launched an investigation in June 2007.<sup>7</sup> As the company's D&O policy only covered formal investigation costs for individual directors and officers, its ultimate insurable loss was reportedly only \$1.1 million.

Furthermore, the costs may continue to increase, with *The Wall Street Journal* recently noting that the average law firm partner bills out at \$635 per hour, with several elite partners asking as much as \$1,000 or more.<sup>8</sup> And legal fees are just the beginning. In 2010, the SEC settled 168 cases against corporate defendants, approximately 50% of which included an average monetary value of \$18 million.<sup>9</sup> The top 10 corporate SEC settlements averaged \$450 million.

## OTHER POTENTIAL SOLUTIONS

Now that *Investigation Edge* has been launched, we expect at least a few leading markets to offer competitive alternatives and others to simply provide additional or excess limits. In terms of lead alternatives, however, our discussions have revealed some conflicting opinions as to the proper way to structure the coverage. As opposed to Chartis's side-by-side policy format, some carriers are likely to favor a "blended" approach, endorsing the coverage directly into the primary D&O policy. If done properly, this structure would provide an efficient and less expensive alternative and may provide clearer coverage. One argument, for example, is that the Chartis format creates the potential for gaps in coverage. Hypothetically, there could be a disagreement between a non-Chartis primary D&O carrier and Chartis over the proper allocation of covered legal fees between the organization and the individuals. The non-Chartis D&O carrier may attempt to allocate a large portion of the costs to the corporation insured under *Investigation Edge*, while Chartis allocates a large portion of the costs to the individuals insured under the D&O policy. In terms of pricing, early estimates for the blended approach is an additional premium of up to 30% of the policy's annual premium, and with some of the carriers proposing this option, there may be no panel counsel requirement as with Chartis.

The blended structure does have its drawbacks, however. Most notably, by incorporating entity investigations coverage into the main D&O program, policy limits intended for directors and officers may erode quicker, further exposing individual insureds for the benefit of the company. This, in turn, may cause the insured company to have to cap their investigations coverage with a sublimit of liability, or buy additional excess limits atop the D&O program, or both; all potentially costly.

## CONCLUSION

Entity securities investigations coverage has clear value as the current risk is uninsured and costs can be staggering. The timing is right because the SEC, seeking an enhanced budget, is feverishly working to enact new rules under Dodd-Frank and bolster its enforcement record. However, determining the right way to integrate the coverage into an existing management liability program will require careful consideration. How significant might the losses be if the company is contacted by the SEC? Should the limits be

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segregated from the company's D&O program so as not to erode protection for individuals, or can sublimits of liability be put in place to cap the coverage? How should investigations limits be measured against the company's overall D&O program? Should higher excess D&O limits be eliminated to offset the expense of investigations coverage? Who are the Chartis Panel Counsel firms and do we want to work with them if there is an investigation? How much will all of this cost?

We expect that by the third quarter of 2011, some strong alternatives to the Chartis form will develop, as some carriers are waiting to see what Chartis's experience is before jumping in. But ultimately, many publicly-traded companies will see the value in this new coverage and do the investigating necessary to properly integrate this protection into their overall risk transfer portfolio.

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<sup>1</sup> Specimen policy, application and highlights can be found at [www.chartisinsurance.com](http://www.chartisinsurance.com).

<sup>2</sup> See [www.briefbase.com](http://www.briefbase.com) for a list of the Chartis Securities Panel Firms.

<sup>3</sup> See our *Alerts* "Executive Risks and the Wall Street Reform and Consumer Protection Act (Dodd-Frank)," of September 2010 and the more recent "Showers, But Not the Deluge That Was Forecast," of March 2011 for a more detailed discussion on new exposures to employee-initiated (i.e., whistleblower) investigations.

<sup>4</sup> Chartis may be willing to provide higher limits than other carriers but will still limit the derivative investigations coverage below the total policy limit.

<sup>5</sup> See Stanford Law School (in cooperation with Cornerstone Research) Securities Class Action Clearinghouse statistics at <http://securities.stanford.edu/>.

<sup>6</sup> See U.S. Securities and Exchange Commission Select SEC and Market Data Fiscal 2010 [www.sec.gov/about/secstats2010.pdf](http://www.sec.gov/about/secstats2010.pdf).

<sup>7</sup> See Order on Cross Motion for Summary Judgment regarding Office Depot's claim for coverage under their standard public company D&O policy in *Office Depot, Inc. v. National Union Fire Insurance Company of Pittsburgh, Pa.* Case No. 09-80554-CIV.

<sup>8</sup> See "Big Law's \$1,000-Plus an Hour Club," *The Wall Street Journal*, February 23, 2011.

<sup>9</sup> See NERA Economic Consulting, *SEC Settlement Trends – 2H2010 Update*. Taking out the \$550 million Goldman Sachs settlement, the 2010 average drops to \$12.2 million. Also note, the Chartis Investigations Edge form does not provide cover for any fine or penalty portion of a settlement, and as such, only a portion of the ultimate settlement would be covered.