Peralta Community College District

Retirement Board of Authority

Directors and Officers Coverage Background

Directors and officers liability Insurance (often called **"D&O"**) is liability insurance payable to either the directors and officers of a company or to an organization(s) itself, as indemnification (reimbursement) for losses or advancement of defense costs in the event a named insured suffers such a loss as a result of a legal action brought for alleged wrongful acts in their capacity as directors and officers. Such coverage can extend to defense costs arising out of criminal and regulatory investigations/trials as well; in fact, it is not uncommon for both civil and criminal actions to be brought against directors/officers simultaneously. Intentional illegal acts, however, are typically not covered under D&O policies and are therefore excluded.

Corporate indemnification:

In the United States, the Articles of Incorporation often includes an indemnification provision holding the officers of an organization harmless for losses occurring due to their role in that organization. The purchased insurance is typically in addition to this indemnification, or reimburses the organization. In some states organizations may be mandated to indemnify directors and officers in order to encourage people to take the positions and in most cases the organizations have the option to indemnify their officers. However, in certain cases the organization may be explicitly forbidden from indemnifying such director or officer. Liabilities which aren't indemnified by the organization are potentially covered by certain types of D&O insurance.

Brief history:

D&O insurance was first marketed in the 1930s by Lloyd's but into the 1960s the volume sold was "negligible". Organizations began to allow for corporate indemnification in the 1940s and 1950s, and the 1960s "merger mania" was followed by costly litigation. In the 1980s, the United States experienced a "D&O crisis" along with the overall liability crisis, with increased premiums, reduced availability and numerous additional exclusionary clauses in insurance policies Due to changes in securities laws in the 1960s, the insurance was sold primarily based on the concerns of directors & officers of "personal financial protection" (protecting personal rather than corporate assets), but the coverages have evolved to include both personal and corporate indemnification. The 1995 decision of the 9th Circuit in *Nordstrom, Inc. v. Chubb & Son, Inc.* resulted in the emphasis in "Side C" (corporate entity) coverage. The decision resolved an "allocation problem" of how to allocate costs between individual insureds, as the organization was typically not insured while individuals were. There is no standard D&O form, but each has shared a similar outline.

Coverages:

Under the "traditional" D&O policy applied to "public companies" (those having securities trading under national securities exchanges etc.), there are three (3) insuring clauses. These insuring clauses are termed: Side-A or "non-indemnified"; Side-B; or "indemnified"; and Side-C; "entity securities coverage".

- Side-A provides coverage to individual directors and officers when not indemnified by the organization as a result of state law or financial capability of the organization.

- Side-B provides coverage for the organizations when it indemnifies the directors and officers.

- Side-C provides coverage to the organization itself for securities claims brought against it (NOTE: securities claims only coverage applies to publicly traded companies and large private companies; not public organizations.

Claims:

The types of claims are dependent upon the nature of the organization. Directors and Officers of an organization may be liable if they damage the organization in breach of their legal duty, mix personal and business assets, or fail to disclose conflicts of interest. State law may protect the directors and officers from liability (particularly exculpatory provisions under state law relating to directors). Even innocent errors in judgment by board members may precipitate claims.

For public companies, claims are primarily due to lawsuits by shareholders after financial difficulties, a 2011 Towers Watson survey found that 69% of publicly traded companies had claimed for a shareholder lawsuit in the past 10 years as opposed to 21% of private companies. Other claims arise from shareholder-derivative actions, creditors (particularly after entering the zone of insolvency), customers, regulators (including those that would bring civil and criminal charges), and competitors (for anti-trust or unfair trade practice allegations). **For nonprofits, claims are typically related to employment practice and less commonly regulatory or other fiduciary claims.**

Purchase and application:

D&O insurance is usually purchased by the organization itself, even when it is for the sole benefit of directors and officers. Reasons for doing so are many, but commonly would assist an organization in attracting and retaining directors. Where state legislation prevents the organization from purchasing the insurance, a premium split between the directors and the organization is often done, so as to demonstrate that the directors have paid a portion of the premium. Problems related to income tax liability may come into play when an organization avoids state specific liability law in order to protect its individual directors and officers through insurance.

If an organization fails to disclose material information or willfully provides inaccurate information, the insurer may avoid payment due to misrepresentation. The "severability clause" in the policy conditions may be intended to protect against this by preventing misconduct by one insured from affecting insurance for other insureds; however, in certain jurisdictions it may be ineffective.

Criminal acts exclusion:

Intentional illegal acts or illegal profit taking are typically not covered under D&O insurance policies; coverage would only extend to "wrongful acts" as defined under the policy, which may include certain acts, omissions, misstatements while acting for the organization. Due to exclusions and as a matter of public policy, coverage is not provided for criminal fraud.

Motivation and controversy:

Directors and officers insurance is provided so that competent professionals can serve as supervisors of organizations without fear of personal financial loss. Directors are typically not managing the day-to-day operations of the organization and therefore cannot ensure that the organization will be successful; further, business is inherently risky. Thus the business judgment rule has developed to shield directors in most instances.

However, insuring negligence in supervising organizations, or wrongful acts and misrepresentation in financial statements is controversial due to its effect on accountability, otherwise known as the moral hazard problem. In the United States, corporate boards have a "duty of care", but if personal financial consequences for violating that duty of care are lacking, the boards may not perform proper due diligence. In the famous[16] case of *Smith v. Van Gorkom* (1985), the Delaware Supreme Court found a board grossly negligent and therefore liable. The decision created a backlash and a statute change in Delaware which allowed a corporation to amend its charter to eliminate directors' personal liability for violation of the duty of care; a version of this statute has been passed in all states, and most large corporations have such an "exculpatory clause".

In some cases, scholars propose that the risk of personal liability for corporate officers be increased.

Monitoring role:

Since insurance companies ultimately bear costs for negligent management, theoretically insurance companies may enforce better management practices and reduce moral hazard. Empirical research, however, has not found that insurance companies perform effective monitoring of management.

Berkshire Hathaway:

Berkshire Hathaway, the holding company managed by Warren Buffett, does not purchase D&O insurance for its directors, unlike most similar companies. Warren Buffett believes that the directors should face consequences of their mistakes the way that other shareholders do.