

How Will Directors and Officers Insurance Policies Be Impacted by the Credit Crisis, and Why Does It Matter to the Health Industry?

Patricia M. Connally, Esquire
Crowell & Moring LLP
Washington, DC

It is impossible to escape reading about the current credit crisis, the consequent recession, and its impact on the availability of credit and ongoing business operations. News reports are filled with articles about corporate bailouts, government investigations, and lawsuits resulting from the credit crisis. What impact does all this activity have on Directors and Officers Liability Insurance (D&O Policies)? The short answer is that professional liability insurance such as D&O Policies, Errors and Omissions Policies, and Surety Lines have been greatly impacted by these unprecedented events, and we have just begun to see the scope of this impact. Why should the health industry pay attention? Because the recession is spreading beyond the confines of financial institutions, and *all* industries in most jurisdictions have been greatly impacted by these global events.

This article first discusses the type of investigations and lawsuits arising out of the credit crisis, and how these investigations and suits may impact D&O Policies. Secondly, the common forms of D&O Policies will be reviewed. Thirdly, the article will discuss some of the D&O Policy coverage issues that we are likely to see in the coming year. The article concludes with a discussion of what the current credit crisis means for D&O Policies going forward, and considerations that health industry corporations and professionals should keep in mind when seeking insurance protection for the acts of Directors and Officers.

Of Accountability, Investigations, and Lawsuits

As the fallout from the credit crisis dramatically demonstrates, D&O Insurance is no longer an unnecessary luxury designed to provide Directors and Officers with an extra level of comfort—to be tucked away and never called upon. It is now a business necessity.

The credit crisis has only accelerated the heightened governmental oversight of corporations and their Directors and Officers that began in the aftermath of the Enron, WorldCom, and HealthSouth scandals. Accountability of these Directors and Officers to shareholders and to the public is likewise on the rise. Governmental investigations and securities-related lawsuits—from AIG to Madoff, to Stanford to litigation involving failing financial institutions—are being filed at never-before-seen levels. Indeed, the number of subprime-related lawsuits filed in 2008 alone—576—exceeds the total number of lawsuits filed during the entire six-year period of the savings and loan crisis—559.¹ Similarly, regulatory and criminal investigations are skyrocketing; witness the New York Stock Exchange forwarding 146 potential insider trading cases to the Securities and Exchange Commission (SEC) last year—an all time high.² The SEC itself is launching new investigations on a seemingly daily basis.

The vast majority of these investigations and lawsuits focus on credit default swaps, mortgage-backed securities, or Ponzi schemes, and target the financial industry.³ More than 120 suits have been filed in 2009 related to the Madoff and Stanford Ponzi schemes.⁴ However, this culture of increased governmental oversight and private enforcement is being felt by all industries, including the health industry. Indeed, prior to the current spate of SEC investigations and Ponzi schemes, one of the largest cases of securities fraud and insider trading arose out of the healthcare industry—the case of Richard Scrushy and HealthSouth. As one court noted, “the guilty pleas entered by

¹ See Jeff Nielson, *Subprime Mortgage and Related Litigation 2008: Seeking Relief*, Navigant Consulting, Mar. 2009 at 2.

² See *News and Developments in Executive Liability Insurance*, AON Risk Services, Jan. 2009, at 2.

³ See Navigant Consulting Report, *supra* note 1, at 6.

⁴ *Ailing Economy May Spur D&O Class Action Suits: Advisen*, Business Insurance, Mar. 2, 2009 (citing *Securities Litigation in 2008, Implications for the D&O Market in 2009 and Beyond*, by Advisen).

former HealthSouth officers and employees indicate that much of HealthSouth's unprecedented growth may have been the result of unprecedented fraud."⁵

Other more-recent investigations into the healthcare industry include the recent SEC investigation into the sale of securities by BarrierMed Gloves, a developer of latex free gloves; the SEC investigation into Sunrise Senior Living for insider stock deals; and the SEC investigation of revenue statements made by Medquist, a medical transcription company, and its Directors and Officers. A spate of shareholder and derivative actions has similarly been filed against healthcare providers such as the recent settlement of a shareholder suit against Candela Corporation based on allegations of misstatements in Candela's public financial statements.

When tempted to discount these investigations as simply securities cases, consider the recent healthcare investigation by New York Attorney General Andrew Cuomo into the out-of-network rate charts used by the largest health insurance providers. The health insurance companies and the Attorney General's office (OAG) settled this investigation but only after the Attorney General's office "collected and reviewed documents, analyzed data, and consulted with representatives of insurers, consumer advocacy groups, medical societies and organizations, and experts in the fields of health care economics and statistics."⁶ Each of the health insurance companies that entered into settlements agreed to pay its share of the cost of the OAG's investigation, not to mention the companies' own costs in responding to the investigation and the costs associated with compliance with the settlement.

Given this climate where the risk of a claim is increasing and the settlement value of that claim has increased exponentially, a company should have a good D&O insurance program in place to recruit and retain highly qualified Directors and Officers.

What Does a Typical D&O Policy Look Like?

D&O Policies generally provide coverage for claims made against a company's Directors and Officers for wrongful acts committed in their capacity as Director or Officer

⁵ *In re HealthSouth Corp. Ins. Litig.*, 308 F. Supp.2d 1253, 1259 (N.D. Ala. 2004).

⁶ See, e.g., *In the Matter of UnitedHealth Group Incorporated*, Investigation No. 2008-161, *Assurance of Discontinuance under Executive Law § 63 (15)*, New York Office of the Attorney General, at 4.

(or sometimes employee in a managerial or supervisory position). In the broadest possible terms, a Director or Officer has a duty to protect the company (or its investors and shareholders) and when the value of the company diminishes, particularly with regard to investment decisions (whether they be fraudulent or otherwise), the Director or Officer is a target for governmental investigation or a legal action by investors or shareholders. Every policy is slightly different and will define the scope of coverage and who or what is covered.

Who Is Covered?

There are three common insuring clauses in D&O Policies known as Side A, Side B, and Side C Coverage. *Side A* coverage provides cover for the individual Directors and Officers themselves. A typical *Side A* clause includes language such as:

*This policy shall pay the loss of each and every Director or Officer of the Company arising from a Claim first made against the Directors or Officers during the Policy Period . . . for any actual or alleged Wrongful Act in their respective capacities as Directors or Officers of the Company, except when and to the extent that the Company has indemnified the Directors and Officers.*⁷

Side B coverage provides reimbursement to a Company for amounts that it in turn pays to indemnify its own Directors and Officers. Again, while the policy language may differ from policy to policy, typical *Side B* language includes clauses such as:

*This policy shall pay the loss of the Company . . . arising from a Claim first made against the Directors and Officers, during the Policy Period . . . for any actual or alleged Wrongful Act, but . . . only when and to the extent that the Company has indemnified the Directors and Officers for such Loss . . .*⁸

Some insurance carriers will also agree to provide coverage for claims made directly against the company itself and claims made against the Directors and Officers. This so-called *Side C* coverage, or entity coverage, is often limited to securities-related claims but can contain broader, less-limited language such as an agreement to reimburse the company for a claim brought against the company for a wrongful act during the policy period.

D&O Policies are typically written on a “claims made” basis, meaning that to be covered a claim must be brought against the insured individuals or entity during the term of the

⁷ Holmes’ Appelman on Insurance 2d, § 146.2 [B] [1].

⁸ *Id.*

policy. Importantly, D&O Policies also typically have one single aggregate limit of liability that encompasses both payments made for defense costs and indemnity payments. In other words, payments made to reimburse a director for legal fees in defending against an investigation will erode—perhaps completely—the available limits to indemnify for any subsequent settlement or judgment. Similarly, if entity coverage is provided, the limit of liability may be exhausted by the company itself, leaving nothing for the Directors and Officers.

What Is Covered (or Not Covered)?

What a D&O Policy will cover can vary greatly but it will typically cover “wrongful acts” commonly defined as:

“Wrongful Act” means any actual or alleged error, misstatement, misleading statement, act or omission, or neglect or breach of duty by the Directors and Officers in the discharge of their duties solely in their capacity as Directors and Officers of the Company, individually or collectively, or any matter claimed against them solely by reason of their being Directors or Officers of the Company.⁹

Thus, in order for an act to be “wrongful,” a director or officer must first owe a duty that he or she has or is alleged to have breached. From this broad grant of coverage are carved several common exclusions, two categories of which have particular importance to the current economic crisis.

Conduct Exclusions

D&O Policies commonly exclude two broad categories of conduct by Directors and Officers: fraud, dishonesty, or criminal acts (which usually requires a finding of fraud “in fact” such as a judicial determination or written admission of fraud) and personal gain or advantage. Similarly, most D&O Policies exclude the payment of fines and penalties from the definition of loss. This exclusion is based on public policy—the fine or sanction loses its deterrent effect if it is reimbursed by insurance.

Insured v. Insured

Claims brought by an insured against an insured director or officer are similarly excluded. This exclusion was developed after companies or an insured director or

⁹ *Id.* at fn. 34.

officer began filing suit against a director or officer of the same company solely to secure the insurance proceeds. A related and slightly less common exclusion is one that excludes claims against Directors and Officers by their own family members or by a majority shareholder who owns a large or controlling percentage of the company stock.

What Coverage Issues Are Raised by the Credit Crisis?

Conduct Exclusions

Obviously, the conduct exclusions will play a front and central role in any dispute between carriers and policyholders. To the extent that fraud is alleged, a carrier may arguably have a duty to reimburse for defense costs, but the policy may ultimately not pay for any resulting judgment (and the carrier may be entitled to reimbursement of defense costs paid) if that judgment is based on fraud or dishonesty. Similarly, to the extent that a director or officer is subject to an order of disgorgement for reaping ill-gotten gains, such as from insider trading, those funds may not be covered under the personal gain exclusion.

Rescission/Known Loss

Carriers may likewise seek to rescind the policy of insurance to the extent that the company made material misstatements in their public filings and that were relied upon by the carrier in issuing the policy. For instance, if a company overstates its earnings or solvency in the application process and the insurance carrier relies on these statements in issuing a D&O Policy, the carrier may have a claim for rescission of the D&O Policy based on a material misrepresentation. Similarly, a carrier may present evidence of “known loss”; the company knew that it was making material misstatements at the time it was purchasing the insurance. The last round of accounting scandals—Enron, Adelphia, and WorldCom—saw an uptick in these types of defenses.

A recent case involving a hospital operator provides a good example of known loss/misrepresentation. Baptist Health, an Arkansas operator of hospitals, after extensive research and deliberations, adopted an “economic credentialing policy” whereby a physician would be denied clinical privileges at a Baptist Health hospital if he

or she acquired or held a financial interest in a competing hospital.¹⁰ After the credentialing policy was adopted, Baptist Health filed an application for D&O insurance with the following question and answer:

Does anyone for whom insurance is intended have any knowledge or information of any act, error, omission, fact or circumstance which may give rise to a Claim which may fall within the scope of the proposed insurance? Yes ____ No X

The Application also contained the following exclusion:

It is understood and agreed that, without limiting any rights of the underwriter, if such knowledge or information exists, any claim arising therefrom is excluded from this proposed insurance.¹¹

The court determined that the responses to these questions were misrepresentations because, at the time they were made, Baptist Health was aware of legal challenges to the “economic credentialing policies” of other hospitals, participated in hearings by governmental agencies exploring the legality of such policies, and identified doctors who would be adversely affected by the policy and who had complained about the potential enactment of the policy.¹² The court ordered the policy void *ab initio* and rescinded and allowed Platter River to recover defense expenses it had advanced to Baptist Health under the policy.¹³

Prior Acts and Related Claims

D&O Policies that contain an “Interrelated Wrongful Acts” clause treat as a single “wrongful act” all claims that arise out of the same common set of facts. For instance, an investigation by a governmental agency and a separate private law suit that are both based on a common allegation of wrongdoing may be treated as one “wrongful act” for purposes of D&O coverage, even if the public and private underlying claims are made in separate policy periods. The later made claim will be intertwined with the earlier made claims and will be deemed made when the earlier “related claim” was made.¹⁴ Thus, the

¹⁰ *Platte River Ins. Co. v. Baptist Health*, No. 4:07cv0036 SWW, slip op. at 3-10 (E.D. Ark. Apr. 17, 2009).

¹¹ *Id.* at 15.

¹² *Id.* at 31-32, 36.

¹³ Baptist Health was entitled to a refund of any premiums paid under the policy. *Id.* at 39.

¹⁴ See *Seneca Ins. Co. v. Kemper Ins. Co.*, 2004 WL 1145830 (S.D.N.Y. 2004) (containing a detailed discussion of the “Interrelated Wrongful Act” Clause). See also *In re SRC Holding Corp.*, 545 F.3d 661 (8th Cir. 2008) (providing guidance on definition of related claim).

Directors and Officers would be entitled to reimbursement only under the earlier policy based on any such “interrelated acts.”

Severability

Sometimes a D&O Policy will contain a clause whereby the fraudulent acts or misstatements of a particular named insured will not be imputed to other Directors and Officers for purposes of rescission of the policy as whole. This question, known as “severability,” was one of the central questions in the *HealthSouth* insurance coverage litigation. Richard Scrushy incorporated HealthSouth in 1984, and it became one of the largest physical therapy providers in the nation.¹⁵ Ten of HealthSouth’s insurance carriers sought a declaration that the D&O Policies issued to HealthSouth were void because of pervasive financial misstatements contained in HealthSouth’s public financial filings. At issue was the “Severability” Clause contained in the primary policy, which stated:

No statement in the application or knowledge possessed by any **Insured Person** shall be imputed to any other **Insured Person** for the purpose of determining if coverage is available.¹⁶

The court construed this clause to mean “that statements and knowledge of one insured will not defeat coverage as to another insured.”¹⁷ As such, false statements contained in HealthSouth’s financial statements were not imputed to individual Directors and Officers who had no knowledge of the misstatement.¹⁸

Insolvency

Another consequence of our ongoing recession is the very real threat of corporate insolvency. Directors and Officers should be aware that the bankruptcy laws may impact their access to the D&O Policy. Bankruptcy courts have ruled that a D&O Policy that provides Side B (corporate indemnity) or Side C (entity coverage) is an asset of the

¹⁵ *HealthSouth*, 308 F. Supp.2d at 1259.

¹⁶ *Id.* at 1285.

¹⁷ *Id.* at 1283.

¹⁸ *Id.* at 1285.

bankrupt estate, subject to the Bankruptcy Code's automatic stay and whose assets may be preserved for the benefit of the corporate entity.¹⁹

What Does the Credit Crisis Mean Going Forward?

With the increase in claims against Directors and Officers comes the increase in claims by these same Directors and Officers under D&O Policies. One recent report estimates that the credit crisis will result in \$5.9 billion in losses for D&O Policies over the 2007-2009 timeframe.²⁰ One would expect that this increased claim activity will in turn lead to premium increases and smaller limits of liability and narrowed coverage. This is indeed happening, at least for financial institutions. Premiums for D&O Insurance in the financial sector, after years of decline, are beginning to skyrocket. In a report entitled *Quarterly D&O Pricing Index* published by AON, D&O premiums for financial institutions increased 50% in the fourth quarter of 2008.²¹ However, there is a silver lining for non-financial industries. D&O premiums for the non-financial sector actually decreased by 6.3% in this same quarter.²² The AON Report concludes that "D&O pricing for the Financials sector [will] continue to rise precipitously" but "pricing for non-financials sector clients [will] remain stable."²³ So the health industry, as with other service industries, may not face the surge in premiums that have hit the financial industry.

Market forces are also driving changes to the scope of coverage and limits of liability being offered. For instance, a reduction in the limits of liability any one carrier is willing to take on is now being seen. Carriers, for the most part, increasingly are unwilling to take on the risk of a large coverage block, such as \$25-\$50 million in coverage. Companies are instead spreading their coverage among several different carriers.

¹⁹ Compare *In re Minoco Group of Companies, Ltd.*, 799 F.2d 517, 519 (9th Cir. 1986) (in holding that a policy that contained both Side A and Side B coverage is part of debtors estate, the Ninth Circuit recognized that a debtor corporation's insurance policies may be its most valuable assets) with *In re Louisiana World Exposition*, 832 F.2d 1391, 1399 (5th Cir. 1987) (while a Side A and Side B policy may be part of the debtor's estate, the proceeds of that policy may belong to the Directors and Officers, particularly when a payment under Side A would reduce the potential claim for indemnification under Side B.).

²⁰ See *The Subprime Mortgage Meltdown, the Global Credit Crisis and the D&O Market*, Advisen, Nov. 4, 2008.

²¹ *Quarterly D&O Pricing Index*, AON Risk Services, at 3.

²² *Id.*

²³ *Id.* at 4.

Similarly, the breadth and scope of coverage may be narrowed going forward. To avoid a situation such as a policy becoming embroiled in bankruptcy proceedings, carriers are issuing more Side-A-only coverage, both to limit the risk of liability and to avoid the time and expense of bankruptcy proceedings. It also may be possible that companies and Directors and Officers will face exclusions specifically targeted at credit default swaps or sub-prime liabilities or even a “regulatory exclusion” that was popular after the S&L crisis.

Thus, even if the health industry has been insulated so far from the problems facing financial institutions, this relatively quiet period may not continue as the crisis deepens and continues to spread into other industries.²⁴ If nothing else, the current crisis acts as an important reminder to understand the importance and scope of D&O Policies for the protection, retention, and recruitment of good Directors and Officers.

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²⁴ See *Financial Firms Facing Highest D&O Premiums as Market Hardens*, Insurance Journal, Feb. 26, 2009 (noting that industries that face the largest risk of securities related law suits also face the highest D&O premiums); *Directors and Officers, Hard Times*, Willis Marketplace Realities 2009, Apr. 2009 (the D&O market “will turn for you when the economic downturn hits your company”).