Investment advisers and directors of registered investment companies are now grappling with a host of D&O insurance issues raised by an already volatile D&O insurance market coupled with the new regulatory landscape as a result of the Sarbanes-Oxley Act of 2002 (the “Act”). Among the questions being asked: What impact will the Act have on our coverage? On our premium? How much coverage is enough? Should joint D&O policies be abandoned in favor of separate policies? What will the impact be on our insurance if we can’t find an audit committee financial expert?

Background

Unfortunately for director and officer insureds, Congress’ adoption of the Act coincided with a significant hardening of the D&O insurance market. For several years prior to the corporate events that preceded the Act, D&O insurers competed heavily for business. As a result, they tended to underwrite riskier companies and to underprice related D&O insurance policies. These underwriting practices led to large losses due to the increased number and severity of claims. The increased incidence of corporate fraud over the past 18 months and the SEC’s regulations under the Act have added an additional layer of risk and uncertainty for D&O insurers.

Insurer’s Risk Considerations

Generally, the cost of D&O insurance is partly a function of the insurer’s perception of the extent of the risk that the insured presents. For example, insurers generally view private litigation as much riskier than SEC enforcement actions. An SEC enforcement action is largely a legal expense issue for an insurer. While the insurer is obligated to defend a claim covered under the D&O insurance policy, the insured is generally responsible for payment of any fines or penalties. Private causes of action, on the other hand, often involve significant monetary damage claims for which the insurer could be responsible. Although D&O insurance policies contain an exclusion for fraudulent conduct of a covered person, this exclusion is only available when there is a final adjudication of the matter. Because the vast majority of private actions settle, the insurer could face substantial potential liability.
Some provisions of the Act and the SEC’s rules thereunder contain provisions that either expressly prohibit or discourage private rights of action. However, two provisions of the Act expressly contemplate private rights of action (violations of the pension fund blackout trading and whistleblower rules). The remainder of the Act is silent on private causes of action. Another provision, Section 804, alters the statute of limitations for securities fraud suits thereby increasing the potential for litigation. Moreover, certain members of the Delaware judiciary have observed publicly that an increase in plaintiffs’ suits against directors and officers in state courts is likely. The uncertainty regarding the potential for increased private litigation against insureds is a significant contributing factor in D&O insurers’ decisions regarding coverage and pricing.

Policy Coverage/Pricing Provisions

The confluence of factors discussed above has caused D&O insurers to increase premiums and narrow coverage on their D&O policies. It has been reported, for example, that some insurers will (1) seek to add broader exclusions for fraud and reporting errors; (2) narrow the definition of “claim” under the policy to reduce coverage for administrative or criminal investigations; (3) redefine “loss” to exclude civil or criminal penalties or delete coverage for punitive damages; (4) delete or rewrite the severability clause so that the bad acts of one insured may affect coverage for all insureds; (5) place limits on advancements for defense costs; (6) increase deductibles and/or institute co-pay provisions under which the insured is responsible for a greater percentage of any loss; or (6) refuse to issue multi-year policies. Some D&O insurers are ceasing to write new D&O insurance altogether because of heavy loss experienced, or they are refusing to write coverage for insureds deemed to be “high risk.”

Implications for Advisers and Funds

Advisers and their funds generally review D&O insurance coverage at least annually. In light of the difficult insurance market, it would be advisable to start preparing for renewal as early as possible. The following are some steps that advisers and funds should consider to obtain the most cost-effective policy with the broadest coverage available:

1. Approach the Renewal Process with More Diligence. First and foremost, funds and advisers will need to devote more time and planning to the D&O insurance process this year than in the past. For example, advisers and their funds will need to prepare a thorough and convincing presentation for insurers that demonstrates a commitment to regulatory compliance and accountability at all levels of the fund complex. Participation by the chief executive and accounting officers in the renewal process may also be beneficial to the process. In addition, advisers and their fund boards should fully understand policy terms before agreeing to coverage. It is likely that the terms of D&O policies will vary considerably this year, as insurers attempt to
narrowly tailor policies to reduce their risk. For that reason, legal counsel experienced in insurance matters should carefully review the terms of D&O policies for coverage and exclusion issues. D&O policy terms that once appeared formulaic and boiler plate may now contain traps for the unwary.

2. **Document Reporting Procedures/Accountability.** The Act requires that registered investment companies maintain adequate disclosure controls and procedures for reporting purposes. A disclosure controls and procedures reporting process that appears thoughtful, complete and well organized may contribute to the insurer’s overall evaluation of the risk presented by the investment adviser and fund. Disclosure controls and procedures should therefore be carefully considered and memorialized. In addition, flow charts and diagrams of the reporting process may assist insurers in understanding accountability within the fund complex.

3. **Audit Committee Financial Expert Determination and Related Disclosure.** The Act and SEC rules require boards of registered investment companies to determine whether the Board has an audit committee financial expert within the meaning of the rules. A determination that there is no financial expert or a decision to forego searching for an expert may impact on the fund’s D&O insurance coverage. Similarly, the quality, credentials and independence of any expert so designated by a board may impact on coverage. It has been reported that insurers plan to study audit committee financial expert disclosure carefully to determine whether increased risk factors are present that could affect premiums. Therefore, the disclosure regarding the audit committee financial expert should be clearly and carefully written. There should also be adequate written documentation for the board’s determination. In that regard, audit committee financial expert questionnaires may be useful in demonstrating a thorough process.

4. **Revisit Joint Policies.** Investment companies often participate in joint D&O insurance policies with their investment advisers or other service providers or funds. Generally, these joint policies probably still represent the most cost-effective method of maintaining D&O insurance, especially for smaller funds. However, funds and advisers should re-evaluate the risks presented by the other parties on the policy to determine if separate policies would be less costly, or if an adjustment in premium levels among the parties is justified to account for an imbalance in risk among the insureds.
Conclusion

Advisers and their funds should be aware of the increasingly cautious mindset of D&O insurers. Underwriting in the current environment is bound to be more exacting and time-consuming than in the past – with more information sought and more pointed questions asked. Advisers that are more proactively involved in the early stages of the insurance renewal process will fare better in the current climate.

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