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Current Issues in D&O Liability & Insurance 2016

Wednesday, May 11, 2016

9am – 1pm

Sponsoring Association Committee:

Insurance Law | Jill M. Levy, Chair

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Current Issues in D&O Liability & Insurance 2016

Wednesday, May 11, 2016

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Harold Neher
Vice President, Claims
Axis Insurance – Professional Lines

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Agenda

9:00 am - 9:10 am **Welcome and Introduction**

Jill M. Levy and Roger M. Moak

9:10 am - 10:20 am **D&O Liability and Insurance Re: Securities Class Actions and Derivative Actions**

- "A&B", "ABC", and Side "A" Insurance Policy Provisions and Triggers
- Violation of Federal Securities Laws, and Breach of Fiduciary Duties
- Securities Class Action & Derivative Action Trends, Statistics and Settlements
- Impact of Recent U.S. Supreme Court Decisions Incl. *Halliburton* & *Omnicare*

Moderator: Scott R. Schaffer
Panelists: Harold Neher, Salvatore Graziano, Jeffrey R. Lattmann and John McNichols

10:20 am – 10:30 am **Break**

10:30 am – 11:40 am **Special Considerations of D&O Claims Handling**

- Differing Perspectives of Insurers, Policyholders, Brokers, Defense Counsel and Mediators
- Allocation Between Covered and Non-Covered Claims, Defendants and Losses
- Interplay Between D&O insurance and Other Insurance Products
- Impact of Heightened DOJ and SEC Investigations and Prosecutions of Corporate Insureds

Moderator: Stephen Weisbrod
Panelists: Steven R. DeLott, John A. Freedman, and Jed D. Melnick

11:40 am – 11:50 am **Break**

(Continued on following page)

11:50 am – 1:00 pm **The "Y2K" That Really Happened (Impact of Cyber Liability upon D&O Liability)**

- Anatomy of a Cyber Data Breach Incident
- D&O Exposures Resulting From Cyber Breach Incident
- Review Notable Cyber-Related Securities Class Actions & Derivative Actions
- Policies Which May Respond to Cyber Data Breach Claims

Moderator: Andre E. Harlfinger

Panelists: R. Damian Brew, John C. Cleary, Richard J. Bortnick, and Steve Barge-Siever

CLE Credit

NY: 4.0 professional practice

NJ: 4.4 general

CA: 4.0 general

PA: 3.5 general

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Notes on Faculty

Steve Barge-Seiver joined Krauter & Company in August 2014 as the Senior Vice President of the Fin Pro Practice in New York. His primary objective is to work closely with our private equity and financial institution clients to actively manage and reduce risk during through carrier oversight and development of innovative and efficient program designs. Prior to joining Krauter & Company, Steve was Vice President within Aon's Financial Services Group. During his time at Aon, Steve focused on the retention and growth of the financial institution book of business and worked with a diverse set of clients ranging from startup hedge funds to Fortune 50 financial institutions. Before working for Aon, Steve was an Assistant Vice President at Beecher Carlson in New York with a focus on distressed financial institutions. Steve began his career with Beecher Carlson's legal team where he was a Claims Consultant. Steve holds a J.D. in Corporate Law from the Cardozo School of Law, a MBA in finance from Eastern Michigan University along with a BA in Economics.

Richard J. Bortnick is Senior Counsel with Traub Lieberman Straus and Shrewsberry. Rick litigates and counsels clients on cyber and technology risks, exposures and best practices; directors' and officers' liability; professional liability; insurance coverage; and commercial litigation matters. He also drafts professional liability insurance policies of varying types, including cyber, privacy and technology forms, and is Publisher of the cyber industry blog, Cyberinquirer.com. He serves as a member of the Executive Corporate Board of The Franklin Institute science museum and is Co-Chair of the Computer & Technology Subcommittee of the ABA Section of Litigation, Insurance Coverage Litigation Committee. He is a regular contributor and columnist for Advisen and was named by Advisen as their Cyber Risk Network 2015 Person of the Year.

R. Damian Brew is a Managing Director and the U.S. Head of Claims for Marsh Inc. FINPRO specializing in directors and officers, employment practices, cyber and privacy, bankers professional and professional liability coverages for the firm's financial institution and commercial clients. Damian has worked with some of the firm's largest clients to manuscript policies with state-of-the-art coverage. In his capacity as a Claims Advocate, Damian has built an extensive network among clients, senior underwriting and claims executives, and securities and coverage attorneys. Damian joined Johnson & Higgins in 1995 as an Assistant Vice President after serving as Senior Claims Counsel at Continental Insurance Company where he specialized in commercial and financial institution directors and officers liability claims. His primary focus at Continental concerned class action claims brought under the federal securities laws. Prior to joining Continental in 1991, Damian was associated with the law firm of Chadbourne & Parke where his practice concentrated on corporate and litigation matters. Damian has spoken at a number of industry and client seminars on D&O and professional liability claims handling issues, the role of the broker in resolving D&O claims, coverage settlement issues and exposures arising from financial institutions and their investors. Damian received his J.D. degree from the New York University School of Law in 1988 after earning his B.A. from Colgate University in 1984.

John C. Cleary, a Shareholder at Vedder Price, has over 25 years of commercial litigation experience for U.S. and international clients, including extensive experience representing

Lloyd's and London Market insurers and reinsurers in U.S. litigation and arbitration. A former Assistant United States Attorney, Mr. Cleary has litigated privacy, secrecy and data security issues on behalf of the U.S. government in a number of settings. He has also represented private sector clients in a variety of privacy and data security matters, ranging from data breaches and cybercrime to pre-breach counseling and preventive law engagements. Mr. Cleary also has experience litigating and negotiating resolutions to multiforum, multidimensional matters involving regulatory agencies and state and federal courts.

John A. Freedman is a Partner in Arnold & Porter LLP's Litigation practice group. His practice focuses on complex commercial litigation, government investigations, white-collar criminal matters, and parallel proceedings involving simultaneous civil litigation and government investigations. Mr. Freedman's commercial litigation experience includes representing corporations, accounting firms and accountants, broker-dealers, investment advisers, corporate boards and committees, and individual corporate officers and directors in securities fraud litigation and investigations; representing clients in shareholder derivative and other fiduciary duty litigation; defending corporations in antitrust class actions and merger litigation; and other commercial litigation. He is a graduate of the Harvard Law School and Williams College.

Salvatore Graziano, an experienced trial attorney at Bernstein Litowitz Berger & Grossman LLP, has taken a leading role in a number of major securities fraud class actions over the past twenty years on behalf of institutional investors and hedge funds nationwide. These high-profile cases include In re Schering-Plough Corp./ENHANCE Sec. Litig. (D.N.J.); In re Raytheon Sec. Litig. (D. Mass.); In re Refco Sec. Litig. (S.D.N.Y.); In re MicroStrategy, Inc. Sec. Litig. (E.D. Va.); In re Bristol Myers Squibb Co. Sec. Litig. (S.D.N.Y.); and In re New Century (C.D. Cal.). Widely recognized by observers, peers and adversaries as one of the top securities and class action litigators in the country, Mr. Graziano has been cited as "wonderfully talented…excellent judgment…a smart, aggressive lawyer who works hard for his clients" (Chambers USA); an attorney who performs "top quality work" (Benchmark Litigation); and a "highly effective litigator" (US Legal500). One of three Legal MVPs in the nation heralded by Law360 for his work in class actions, he is regularly named as one of Lawdragon's 500 Leading Lawyers in America, a leading mass tort and plaintiff class action litigator by Best Lawyers®, and a New York Super Lawyer. Mr. Graziano is a member of the firm's Management Committee. He has previously served as the President of the National Association of Shareholder & Consumer Attorneys, and has served as a member of the Financial Reporting Committee and the Securities Regulation Committee of the Association of the Bar of the City of New York. Upon graduation from law school, Mr. Graziano served as an Assistant District Attorney in the Manhattan District Attorney's Office. Mr. Graziano regularly lectures on securities fraud litigation and shareholder rights.

Steven R. DeLott is Senior Insurance Counsel at Simpson Thacher & Bartlett LLP. Much of his practice is devoted to representing public and private companies and private equity firms in the evaluation and negotiation of directors' and officers' liability insurance policies. He is a former Adjunct Assistant Professor at the College of Insurance in New York City where he taught courses in insurance law and insurance regulation. He is a member of the American Bar Association and the New York City Bar Association. He is a graduate of Brandeis University and Columbia Law School, where he was a Harlan Fiske Stone Scholar and the Executive Editor of the Columbia Business Law Review.

Andre E. Harlfinger is a claims attorney with OneBeacon Insurance in the Lawyers Professional Liability claims group. He was previously in private practice and focused on litigation and complex insurance coverage matters. He is a frequent speaker at industry seminars. Mr. Harlfinger has held positions with law firms, insurers and a major insurance broker. He has advised Fortune 100 clients concerning D&O coverage and major claim handling issues, negotiated resolutions to coverage disputes and developed policy wording for underwriters and brokers. Mr. Harlfinger holds a B.A. in International Relations from the University of Virginia; an M.B.A. from the College of William and Mary; and a J.D. from New York Law School. He is admitted to practice law in New York. Mr. Harlfinger has also served as an Adjunct Professor of Business Law and Ethics for two local New York colleges. He is a member of the Professional Liability Underwriting Society and serves on the Insurance Law Committee for the New York City Bar.

Jeffrey R. Lattmann is widely known in the industry for his knowledge and expertise with Executive Liability products. Jeff's responsibilities include consultative solution design and implementation for Executive Liability risks. Jeff has over 29 years of experience in both underwriting and brokerage in these lines of insurance. Jeff's intimate knowledge of the marketplace and executive liability exposures helps to identify how a company's risks should be treated. Jeff is the head of the practice and responsible for leading a group of professionals in designing and negotiating Directors & Officers Liability, Cyber Liability, Employment Practices Liability, Fiduciary Liability, Crime and other related Executive Liability insurance lines. Jeff has worked extensively on Fortune 1000 and complex Executive Liability risks. Jeff Previously led the U.S. operations for Marsh FINPRO placement. Jeff was also a regional manager for National Union Fire Insurance Company, a member company of AIG. Jeff is the 2013 Immediate Past President, the 2012 President and was on the Board of Trustees of the Professional Liability Underwriting Society (PLUS) since 2006. Jeff was previously President-elect, Vice President and Secretary-Treasurer. Jeff was also the Co-Chair of the PLUS D&O Symposium, which is the largest and most advanced D&O educational venue in the world. Jeff also sits on the AIG NY Advisory Board and held a position previously on the ACE Bermuda Advisory Board. Jeff was recently elected to the Board of Directors of Minority Business Development Institute (MBDI), a non-profit entity which offers comprehensive education and advisory services that outline a road map for the growth and success of minority, veteran and women contractors. Jeff's dedication to educating the industry is very well known. Jeff is a frequent speaker across many mediums, from on stage to webinars to video, on Executive Liability products. Jeff holds a B.S. degree in Business Management and Productions/Operations Management from University of Scranton.

Jill M. Levy is a Partner at Coughlin Duffy LLP. Her practice focuses on representing domestic and foreign insurers in an array of professional liability lines, including directors & officers (D&O) liability, bankers and financial professional liability, errors & omissions, fiduciary liability and employment practices liability. Jill also handles coverage litigation for matters arising out of professional liability lines. Prior to joining Coughlin Duffy LLP, she was a partner at the law firm of Sedgwick, LLP. Jill joined Coughlin Duffy LLP in July 2014.

John McNichols focuses his practice in civil litigation, with emphasis in mass tort, securities, professional liability, and employment law cases. John has tried cases in both state and federal court in Virginia, and has arbitrated cases before the ICC International Court of Arbitration and the American Arbitration Association. John received his B.A. from Yale University in 2000 and his J.D., *cum laude*, from the University of Michigan Law School in 2003. Before joining Williams & Connolly in 2005, he clerked for a year for Judge T. S. Ellis III of the U.S. District Court for the Eastern District of Virginia. John is also a former noncommissioned officer of the U.S. Army Special Forces, having served on active duty for eight years.

Jed D. Melnick, Esq. is a panelist at JAMS and the managing partner for Weinstein Melnick LLC. He has been involved in the mediation and successful resolution of thousands of complex disputes with an aggregate value in the billions of dollars (including, complex, multi-party actions in the securities, D&O coverage, bankruptcy and anti-trust arenas). In addition to mediating over one thousand disputes, he has also published articles on mediation, founded a nationally ranked dispute resolution journal and taught young mediators. Two specific highlights of his mediation career include, the successful mediation of a pro bono case between the Disability Rights Advocates and the New York City Taxi and Limousine Commission, which led to a historic settlement raising the number of taxi cabs that are accessible for people with disabilities from 300 out of 13,000 to 50% of the entire fleet by 2020. The settlement led the Judge overseeing the case to comment, "[T]his is one of the most significant acts of inclusion in this city since Jackie Robinson joined the Brooklyn Dodgers.". Another significant career highlight of his is his appointment (by Judge Kaplan) as one of the mediators in the Lehman ADR Derivative Contract Program, the program that was designed to cause the efficient settlement of the multitude of cases that came out of the Lehman bankruptcy. In 2016, Mr. Melnick, was selected as an ADR Champion by the National Law Journal. Mr. Melnick was selected to the 2010 list of Pennsylvania "Lawyers on the Fast Track," a recognition given to 30 Pennsylvania Lawyers under the age of 40 by Legal Intelligencer and the Pennsylvania Law Weekly. Additionally, three years in a row, he was selected as a Pennsylvania Super Lawyers "Rising Star," the only "Rising Star" in the Alternative Dispute Resolution category in Pennsylvania. He received his B.A. from Grinnell College, and J.D. from the Benjamin N. Cardozo School of Law.

Roger Moak is an ARIAS-U.S.-certified arbitrator and certified umpire with over 30 years of experience as an attorney—with almost 20 of those years as an insurance industry general counsel. A graduate of Cornell University and Georgetown University Law Center, he began his legal career in 1970 as a law clerk with Speiser, Shumate, Geoghan, Krause, Rheingold & Madole in Washington, D. C. After his law school graduation, he moved to the firm's New York office, where he handled a wide variety of litigation and corporate matters and became a member of Speiser & Krause, P. C. He left the law firm in 1980 to head the Legal Department of Insurance Services Office (ISO is now a Verisk Analytics company). He was Senior Vice President and General Counsel of ISO until 1991. Mr. Moak became Senior Vice President, General Counsel and Corporate Secretary of The Home Insurance Companies, including U.S. International Reinsurance Company, after they were acquired by Trygg-Hansa in 1991. He also served for a year as The Home's chief corporate claims officer while still serving as general counsel. Following the Trygg-Hansa/Zurich transaction of 1995, he remained general counsel of The Home and also became Executive Vice President, General Counsel and Corporate Secretary of Risk Enterprise Management Limited (REM), then a member of Zurich Financial Services, and now part of Tristar. For REM, he concentrated on The Home's eight-year voluntary run-off under regulatory supervision and helped REM develop into a major TPA. Along with the rest of its founding senior management team, he left REM in 2004, and he began his arbitration practice. He has had 67 arbitrator or umpire appointments. Mr. Moak is still admitted to practice law in New York, in the District of Columbia, and before many U. S. Courts, including the Supreme Court, and he has a Martindale-Hubbell rating of AV. He was appointed to eight three-year terms on the Committee on Insurance Law of the New York City Bar, including one term as its Chairman. He was elected to six terms as President of the Insurance Federation of New York, Inc. (IFNY) and three terms as Chairman of its Board of Directors, and he is still a Director. He has co-chaired or been a faculty member at many IFNY/City Bar CLE programs and has been on the faculty of ARIAS-U.S. conferences and workshops.

Harold Neher, the Vice President – Claims, Professional Lines, has been with AXIS Insurance since July 2006. Harold manages claim professionals responsible for Lawyers Professional Liability, Design Professional Liability, Fiduciary Liability, Fidelity, Directors and Officers Liability and Medical Malpractice matters, as well as handling complex Directors & Officers Liability and Financial Institutions Errors and Omissions claims. He has a breadth of experience in the professional liability insurance industry, having spent almost three years prior to joining AXIS with Gulf Insurance and Travelers handling both D&O and E&O, some seven years at Risk Enterprise Management involved in D&O, Miscellaneous Professional Liability and Complex Casualty claims and six years prior to that in private practice defending professional liability litigation. Harold is a cum laude graduate of the Benjamin N. Cardozo School of Law and the City University of New York.

Scott R. Schaffer has practiced in the insurance coverage area throughout his legal career, with a current focus on claims under directors and officers liability, professional liability and employment liability policies. As a founding member of the firm’s Insurance-Reinsurance Coverage practice, Scott is a coordinator of the national Directors & Officers and Employment teams. On behalf of insurance carriers, Scott provides counseling and opinions in coverage matters arising from business disputes and corporate insurance defense, with a concentration on directors and officers (D&O), professional errors and omissions (E&O), employment practices (EPL) and cyber liability programs. He serves as national counsel and claims coordinator for D&O, EPL and E&O programs originated in the United States, Bermuda and London, including programs targeting financial institutions, non-profit organizations, franchise businesses, and small to mid-sized “hard to place” for-profit corporations. In his role as national program counsel, Scott is also responsible for drafting policies and endorsements, preparing claims bordereaux, and providing guidance to underwriters on various issues. He is a frequent speaker at seminars in the United States, Canada, Bermuda and Europe, and has written numerous articles on D&O, EPL and E&O liability. For many years now, the New York City Bar Association has published annual editions of Scott’s “Directors and Officers Liability/Insurance Handbook.” Scott’s client service approach emphasizes a high level of professionalism and responsiveness to client needs, with a focus on cost-effective management and resolution of claims through the balanced use of internal and external resources. Scott is particularly adept at advocating his clients’ positions at mediations and settlement conferences, hundreds of which he has attended all across the United States over the years. Presently, Scott is heavily involved in the representation of insurers, along various product lines, still with exposures to the sub-prime mortgage crisis.

Stephen A. Weisbrod is a founding partner of Weisbrod Matteis & Copley PLLC in Washington, D.C. The firm was one of only ten firms in the United States named by The National Law Journal to its 2014 Litigation Boutiques Hot List. Mr. Weisbrod is an experienced trial lawyer who represents clients in financial and commercial disputes, corporate bankruptcy and insolvency matters, and criminal investigations and trials. Most of his clients are businesses and individuals seeking payment from insurers, banks, investment managers, professionals, suppliers, service providers or other parties liable for breach of contract, fraud, or some other kind of misconduct or breach of duty. In insurance matters, he represents policyholders exclusively. His clients have included publicly traded companies, start-up companies, private equity firms, fund managers, law firms, trustees, creditors committees, post-bankruptcy litigation trusts, corporate directors and officers, and individual consumers. Before entering private practice, he served as law clerk to Chief Judge James B. Moran of the U.S. District Court for the Northern District of Illinois and as law clerk to Justice Alan B. Handler of the New Jersey Supreme Court. He is a graduate of the University of Michigan and Harvard Law School.

DIRECTORS AND OFFICERS LIABILITY & INSURANCE OVERVIEW

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DIRECTORS AND OFFICERS LIABILITY & INSURANCE OVERVIEW

This article provides a basic overview of directors and officers ("D&O") liability, including a discussion of the causes and types of D&O claims. This article also provides a discussion of D&O insurance and some of the common coverage elements. D&O liability issues affect directors and officers world-wide in terms of their company's business strategies, corporate philosophies and management styles.

I. Duties and Responsibilities of Corporate Directors and Officers:

Corporate directors and officers are deemed to stand in a fiduciary relationship with the corporation, and must discharge the duties of their respective positions in good faith and with that diligence, care and skill which ordinary prudent men and women would exercise under similar circumstances.

A. Common Law and State Statutory Law Duties

1. Duty of Obedience

Directors and officers are under a duty of obedience, to act within the scope of their power or authority and to see that the corporation is managed in accordance with the corporation's articles of incorporation and by-laws. Directors and officers may face liability for loss to the corporation resulting from their engaging in *ultra vires* activity (activities beyond the powers conferred upon them by its Charter, Articles of Incorporation or By-Laws). With a few exceptions, claims against directors and officers seldom involve alleged breaches of the duty of obedience.

2. Duty of Loyalty

Corporate directors and officers, as fiduciaries of their corporation, are subject to an undivided duty of loyalty to the corporation, which requires them to protect the corporation and refrain from doing anything adverse to its interests. Directors and officers are not necessarily precluded from engaging in other business, but may not use their corporate positions to deprive the corporation of profit or advantage which it might derive in the course of its business. Directors are required to demonstrate utmost good faith and the most scrupulous inherent fairness of transactions in which they possess a financial, business or other interest. Directors and officers must exert all reasonable and lawful efforts to ensure that the corporation is not deprived of any advantage to which it is entitled.

3. Duty of Diligence

Directors' and officers' duty of diligence requires that they discharge their duties in good faith and with the care an ordinary prudent person in a like position would exercise under similar circumstances. Directors and officers must also act in a manner which they reasonably believe to be in the best interests of the corporation. Prior to making a business decision, directors and officers must inform themselves of all material information reasonably available to them.

Directors and officers are entitled to reasonably rely on information, opinions, reports or statements prepared or presented by officers or employees of the corporation, the corporation's counsel or public accountants, or a committee of the board of directors. The duty of diligence also requires reasonable inquiry and monitoring of corporate affairs by corporate directors and officers. Rarely does a claim against a director or officer not allege a breach of the duty of diligence.

4. Duty of Candor

A duty of candor arises whenever a board of directors is required or elects to seek shareholder approval in connection with a transaction or other corporate undertaking. Under such situations, the board of directors is required to disclose fully and fairly all material information within the board's control. Although the duty of candor under state common law closely parallels (and overlaps) federal securities law disclosure requirements, courts utilize the duty of candor to ensure that shareholders have complete information available to them and to offset potential conflicts of interest between corporate fiduciaries and shareholders. The duty of candor is the subject of increasing attention in claims against directors and officers.

In addition to being subject to potential liabilities for breaches of those above-mentioned duties, directors and officers may also face exposure for providing substantial assistance (aiding and abetting) in connection with another's breach of fiduciary duty.

B. The Business Judgment Rule

The business judgment rule is a judicially created doctrine which shields corporate decision-makers and their decisions from interference by the courts. It is a major armament in the defense of claims asserted against directors and officers. The rule is based upon the notion that corporate management is vested in the board of directors and a court should not second guess the judgment of the board. U.S. courts recognize that they may be ill-equipped to evaluate business decisions and the business judgment rule operates to insulate from judicial scrutiny a business decision of a director or officer so long as he does not act in bad faith, with gross negligence or with gross abuse of discretion.

The following elements must be present in order for the business judgment rule to apply:

- *A business decision.* Inaction will not be protected by the business judgment rule unless it is the result of "a conscious decision to refrain from acting."

- *Disinterestedness* (i.e., the absence of personal interest or self-dealing). The Delaware Supreme Court has defined "disinterested" directors as those who "neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all the stockholders generally."

- *Due care* (i.e., an informed business decision following a reasonable effort to become familiar with the relevant and available facts). Whether a business judgment is an informed one "depends on whether directors have informed themselves prior to making a business decision, of all material information reasonably available to them . . .." The standard for determining whether a business decision was an informed one is gross negligence.

- *No abuse of discretion* (i.e., a reasonable belief that the best interests of the corporation and its stockholders are being served). While honest errors of judgment are protected by the business judgment rule, a judgment that cannot be supported by some rational basis is not protected.

- *Good faith.* If a plaintiff establishes that a director's decision was motivated by a lack of good faith, the business judgment rule will not apply.

In sum, the business judgment rule is a vital line of defense in claims against directors and officers for breaching their fiduciary duties, but the defense is not available unless the director or officer can demonstrate disinterestedness, due care and good faith in any conscious decision or course of action adopted by the board.

II. <u>Causes Of D&O Claims</u>:

Over the years, directors and officers liability claims in the United States have increased in variety, frequency and severity.

A. Changes in corporate control

Changes in corporate control will oftentimes result in claims made against directors and officers. These claims may be brought by shareholders of the company, or by hostile bidders and potential acquirers. Claims also arise from friendly merger situations, where the respective shareholders of the corporations believe that the terms of the merger are unfair to their interests. There has also been a significant body of D&O claims brought against directors and officers of corporations for efforts taken in defense of hostile takeovers. There are a number of hostile defensive measures commonly employed in the American corporate arena. These include poison pills, employee stock ownership plans ("ESOPs"), super majority by-law voting, "scorched earth" policies, golden parachutes and various other tactics. Each of these hostile defenses, taken in anticipation of a change of corporate control, can result in a claim being made against the directors and officers of the corporation.

B. Breach of contract

Breach of contract is another area wherein directors and officers may be named as defendants in litigation. Although these claims typically involve corporate obligations, there are certain circumstances in which claims can be made against directors and officers for interfering with or otherwise adversely affecting contractual relations.

C. Poor performance

Poor performance by a corporation is another common cause of claims against directors and officers. Most commonly, the shareholders bring such actions claiming that management has done an inadequate job of realizing profits. Claims against directors and officers asserting mismanagement, corporate waste and fraud are very common in shareholder derivative actions.

D. Corporate insolvency

Corporate insolvency has become a major cause of claims against directors and officers in the United States. More often than not, the insolvency itself causes the debtor (or its trustee), creditors, employees and shareholders alike to seek a "deep pocket" from which to recover losses incurred in connection with the insolvency.

III. Claims Commonly Asserted Against Directors and Officers:

Between 2011 and 2014, the most common form of D&O claim was shareholder derivative actions, at 35%, with shareholder securities class actions at 32%, fiduciary claims at 18%, and other claims including regulatory at 15%.[2]

A. Shareholder Claims

Claims asserted by shareholders account for well more than half of all claims asserted against corporate directors and officers, and generally arise out of dramatic decreases in the share price, insider trading, financial restatements, corporate insolvencies, takeovers, mergers, acquisitions and divestitures, mismanagement and corporate waste.

1. Derivative Actions

A derivative action is a lawsuit brought by one or more shareholders to enforce a right belonging to the corporation. Directors and officers hold fiduciary duties to both the corporation and its shareholders, and if a duty owed to the corporation is breached, shareholders are entitled to enforce the corporation's rights on behalf of the corporation. In such lawsuits, the shareholder named as plaintiff is the corporation's representative and prosecutes the derivative action on behalf of the corporation. Any relief granted inures to the benefit of the corporation.

2. Securities Class Actions

The federal securities laws attempt to protect the interests of public investors through disclosure requirements and prohibitions against fraud and manipulative practices. The federal securities laws govern the: required corporate disclosure with the issuance of securities; required corporate disclosure with proxies and takeover contests; and the financial reporting obligations of corporations. In view of the fact that directors and officers generally control and manage corporate affairs as well as determine corporate policy in connection with disclosure

[2] 2015 JLT U.S. Directors and Officers Liability Survey.

requirements, directors and officers are frequent targets with respect to shareholder claims based upon the federal securities laws.

The federal securities laws are a prolific source of claims against directors and officers of large public companies. The Securities Exchange Act of 1934 ("1934 Act") and the accompanying rules promulgated by the SEC are designed with the goal of ensuring fair and honest securities markets, and to eliminate deceptive practices which might impact the price of a company's stock. The general anti-fraud provision of the 1934 Act is Section 10(b), which sets forth a general prohibition against deception in connection with the purchase or sale of securities.

i. The 1933 Act and 1934 Act

Claims under the Securities Act of 1933 ("1933 Act") involve the issuance of securities by the corporation through a registration statement or prospectus. Claims against directors and officers generally involve allegations that the registration statement or prospectus contain untrue statements of material fact or omit to state material facts necessary to prevent the statements from being misleading. Section 11 places a relatively minimum burden on a purchaser of securities seeking to utilize the 1933 Act's remedies. If a plaintiff purchased a security pursuant to a registration statement, he or she need only show a material statement or omission to establish his or her case. Section 11 does not require proof of reliance, causation or even an intent to defraud.

Section 12 of the 1933 Act is another liability statute that is of special concern to directors and officers. The statute is divided into two parts: Section 12(l) imposes liability on anyone, including corporate directors and officers, who sells an unregistered security; and Section 12(2) imposes liability on anyone who offers or sells a security by means of a prospectus or oral communication containing material misstatements or which fails to state material facts. Liability under Section 12 of the 1933 Act is specifically limited to "sellers" of securities. Since the 1960s, federal courts have been expanding the definition of "seller" beyond persons who actually sell the securities to the ultimate purchaser. The nature of this expansion is such that it can even reach a corporate issuer's directors and officers.

The 1934 Act and the accompanying rules promulgated by the SEC are designed to insure fair and honest securities markets, and to eliminate deceptive practices which might distort the fair price of stock. The statute and rules were designed to support the expectation of the average investor who invests in the securities markets based on the assumption that the markets are free from fraud.

The general anti-fraud provision of the 1934 Act is Section 10(b), which sets forth a general prohibition against the employment of deception in connection with the purchase or sale of securities. This anti-fraud provision covers almost any securities transaction, whether conducted face-to-face, over-the-counter or on national exchanges. The liability of directors and officers for fraud under Section 10(b) depends upon their participation in the transaction or their knowledge of the fraud.

In order to establish a cause of action for liability under Section 10(b), a plaintiff must establish: (1) that the defendant misrepresented material facts in connection with the purchase or sale of a security; (2) the plaintiff justifiably relied on the misstatement; (3) the defendant acted with "*scienter*"; and (4) the defendant's conduct was the proximate cause of injury to the plaintiff.

IV. **Securities Class Action Statistics**:

The number of securities class actions increased sharply in 2015 with 189 filings as compared to 152 filed in 2014.[3] In addition, the amount of "disclosed dollar loss" for securities class actions filed in 2015 rose 86% from $57 billion in 2014 to $106 billion in 2015.[4] But that is still below the historical average from 1997 to 2014 of $121 billion in disclosed dollar loss.[5] Also the number of so-called "mega filings", those with disclosed dollar loss of at least $5 billion, increased in 2015 with five such cases as compared to zero in 2014.[6]

Defense costs, settlements and judgments in securities class actions routinely run into the millions of dollars sometimes even into the billions. The past ten years have seen the following billion dollar settlements of securities class actions including: Enron ($7.2 billion); Worldcom ($6.1 billion); AOL Time Warner ($2.65 billion); Nortel Networks ($2.474 billion); Royal Ahold ($1.1 billion); Tyco International ($3.2 billion); McKesson HBOC ($1.033 billion); and Bank of America/Merrill Lynch ($2.43 billion). Despite non-D&O co-defendants sometimes contributing perhaps the "lion's share" towards these settlements, the amounts involved suggest that even with so-called "towers of insurance", directors and officers, and their corporations, may face significant uninsured exposures.

In addition, in recent years several credit crisis related settlements have topped the $100 million threshold including: Countrywide ($624 million); Charles Schwab ($235 million); Merrill Lynch Bonds ($150 million); New Century Financial ($125 million); Wachovia Bond Holders ($627 million); AIG ($725 million); Lehman Brothers ($417 million); Bear Stearns ($275 million); Citigroup ($590 million); Bear Stearns Mortgage Pass-Through Certificates ($500 million); JP Morgan Mortgage Pass-Through Certificates ($388 million); and IndyMac Mortgage Pass-Through Certificates ($346 million).

In 2015, there were 85 court-approved securities class action settlements, representing a 17% increase over 2014 and the highest number of settlements since 2010.[7] Total settlement dollars rose to $3 billion, an increase of 184% over an historic low in 2014, and 9% higher than the average for the past five years.[8] Cornerstone Research attributes the increase in total settlement dollars to eight $100 million plus "mega-settlements" in 2015 as compared to only

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[3] Cornerstone Research, *Securities Class Action Filings – 2015: A Year in Review* (2016).
[4] Id.
[5] Id.
[6] Id.
[7] *See Securities Class Action Settlements: 2015 Review and Analysis*, Cornerstone Research (2016).
[8] Id.

one in 2014.[9] The average settlement amount in 2015 rose 123% to $37.9 million, while the median settlement remained relatively flat at $6.1 million.[10] There were fewer settlements in the $5 million to $50 million range in 2015 as compared to prior years, although there were more settlements in the $100 million to $150 million range as compared to prior years.[11]

Still, there remains in the "pipeline" numerous pending securities class actions that will be maturing and resolving one way or another in 2016 and in the next few years. Those anticipated resolutions may drive up the average value of class action settlements.

V. Corporate Indemnification:

Under the common law, indemnification of corporate directors and officers was not permitted unless the director or officer was successful in defending the claim. The rationale for this rule was that the corporation would not be justified in reimbursing an officer who had been derelict in his duties. Furthermore, there was the question of whether indemnification of the director or officer served a bonafide corporate purpose or benefitted the corporation in some manner.

In time, however, the law began to recognize that, absent corporate indemnification, many honest and competent businesspersons would refuse to accept positions of directors on corporate boards because this would leave them exposed to significant personal liabilities. Courts determined that reimbursement of a corporate director was necessary for establishing a sound public policy favorable to the development of sound corporate management as a prerequisite for responsible corporate action. Eventually, each of the states adopted legislation and a statutory scheme concerning the indemnification of directors and officers and, in some cases, of employees. These statutes represented an attempt to provide protection to those directors and officers acting in good faith and in the best interest of the corporation, even if their business judgment was erroneous. The statutes also sought to avoid corporate indemnification if an officer has acted unfaithfully to the corporation.

The statutory provisions of the fifty states concerning corporate indemnification of directors and officers reflect many similar patterns. Most states' statutes empower the corporation to indemnify the director or officer under prescribed circumstances if the appropriate standards of conduct are met by the particular director or officer. These statutes also allow the corporation to purchase insurance to fund these corporate obligations. Further, many of the indemnification statutes provide that indemnification may be granted by the corporation in a manner which is broader or more liberal than that provided for in the statutory scheme.

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[9] Id.
[10] Id.
[11] *Securities Class Action Settlements: 2015 Review and Analysis*, Cornerstone Research (2016).

A. Mandatory and Permissive Indemnification

Most states have both mandatory and permissive indemnification. Generally speaking, mandatory indemnification is *required* whenever a director or officer has been successful in defending a claim brought against him. In other words, if the claim is defended on the merits and the director or officer is vindicated of any wrongdoing, it is mandatory that the corporation indemnify those costs and expenses incurred in defense of the action.

Permissive indemnification, on the other hand, provides essentially that the corporation *may*, at its discretion, choose to indemnify the director or officer. As a general proposition, the law draws a distinction between indemnification in actions commenced by, or in the name of the corporation, and those commenced by any other party. Hence, with respect to an action brought by the corporation itself or a derivative action brought by shareholders on behalf of the corporation, most states do not allow for indemnification of settlements or judgments in such actions. The rationale for this rule is that the corporation, as the plaintiff in a direct or derivative action would, in effect, be paying the judgment or settlement amount to itself. To prevent this "circularity" of payment, such indemnification is generally prohibited. These statutes generally do allow, however, for reimbursement of defense costs incurred. Regarding all other types of actions, not on behalf of the corporation or in the corporate name, the statutes generally provide that the corporation may indemnify for judgments and settlements in addition to the costs of defense.

The indemnification statute of Delaware is a good example and many of the fifty states follow its model. Under Delaware law, mandatory indemnification is required when the person to be indemnified has been wholly or partially successful on the merits of this case. Permissive indemnification, on the other hand, is allowed when the person to be indemnified acted in accordance with the statutory good faith standard; that the individual acted in "good faith", in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation. With respect to any criminal action or proceeding, the director must have acted such that he had no reasonable cause to believe his conduct was unlawful. With respect to direct actions by the corporation and derivative actions brought by shareholders in the name of the corporation, persons may be indemnified under Delaware law only for expenses actually and reasonably incurred in the defense of an action. The statute does not specifically provide for indemnification of amounts paid in settlement of direct and derivative actions.

VI. <u>Loss Prevention and Risk Management</u>:

It may not be possible to prevent all liability claims against corporate directors and officers. For example, it may be altogether impossible for the directors and officers of a company targeting the acquisition of a publicly held company to avoid a "strike suit" by the shareholders of the target corporation. Hence, strike suits may be viewed as an unavoidable and non-preventable part of the cost of the acquisition; i.e., the cost of doing business.

Similarly, it may not be possible to prevent other types of director and officer liability claims, such as claims which may arise under the anti-trust and unfair competition laws. Although corporate executives may anticipate and consider the potential application of these laws to a particular merger or acquisition, the reaction of the government agencies with the responsibility of enforcing the anti-trust laws may be unpredictable. While one may anticipate that corporate competitors will be aggressive in utilizing the potential application of the anti-trust laws as a means of blocking the advances of competition, the Justice Department and Federal Trade Commission may take a totally different view of the proposed transaction. In sum, claims against directors and officers may be unavoidable in some circumstances and unpredictable in others.

Many claims against directors and officers, however, can be both predicted and avoided. This is the subject of risk management and loss prevention.

A. General Guidelines for Avoiding Director and Officer Claims

- *Act with Diligence* - Directors and officers must always act with the care that a reasonably prudent person in a similar position would use under similar circumstances. They must perform their duties with "good faith" and in the manner they believe to be in the best interests of the corporation, having apprised themselves of all the material information reasonably available.

- *Act with Loyalty* - Directors and officers must not place personal interests ahead of the interests of the corporation and its shareholders. They must not profit at the expense of either, and they must avoid conflicts of interest.

- *Take Advantage of the Business Judgment Rule* - Whenever possible, directors and officers should take advantage of the business judgment rule: an affirmative business decision, made in good faith by a disinterested board, with due care based upon a thoughtful and reasonable deliberation regarding all information reasonably available. The board should seek out the counsel of independent professional advisors and should carefully document the decision-making process.

- *Select Outside Directors Possessing Experience, Independence and the Willingness to Commit Time to Board Matters* - Do not emphasize friendships or mutual interests as the primary basis for selecting outside directors.

- *Care in Conducting Board Meetings* - Board meetings should be regular and should be attended. There should be distribution in advance of the agenda and materials for consideration by the Board. Consideration should be given to having in attendance non-board members, such as officers and outside advisors, if they can provide valuable assistance to Board deliberations. The Board should give ample time to its deliberation process and engage in meaningful discussion of the issues presented. A brief or hurried meeting with little or no open examination of the issues to be determined can lead to director liability. The Board should adopt and utilize procedures for meetings which will ensure that all documents and information necessary to the deliberation are available and disseminated. All documents and information should be carefully analyzed by every director. The Board meeting should be conducted in a manner which encourages participation by all, with an openness to differing views and opinions.

- *Document All Board Deliberations* - The Board minutes should reflect the care and extent of the Board's deliberation process. This includes recitals of materials, information and authorities relied upon.

- *Where Appropriate the Board May Delegate Responsibilities* - The Board may delegate particular tasks to a committee, which can devote greater time and effort to a matter. Responsibility can also be delegated to members of management, provided that appropriate controls and procedures are adopted to ensure that the Board can monitor and supervise delegated tasks.

- *Avoid Conflicts of Interest* - The Board must adopt rules, procedures and guidelines for increasing sensitivity to conflict situations, and providing mechanisms to avoid improper conflicts. Any corporate transaction which may implicate potential conflicts of interest requires a heightened sense of fiduciary responsibility by the Board. Interested persons should be removed from the decision making process.

B. Guidelines for Avoiding D&O Claims Under the Federal Securities Laws

- *Delegation of Compliance Responsibilities* - The corporation should assign one or more competent employees the responsibility of monitoring the company's securities law compliance. These individuals should possess a general familiarity with the federal securities laws (disclosure requirements, timing of SEC filings, etc.), the Private Securities Litigation Reform Act, the Sarbanes-Oxley Act and the Dodd-Frank Act, and should assume responsibility for such items as reviewing and approving press releases, drafting shareholder reports, due diligence confirmation regarding SEC filings, as well as, discussions with securities analysts and the investing public. Notwithstanding the corporation's assignment of compliance responsibilities, directors should always review significant securities filings and press releases and make reasonable investigation to satisfy themselves that appropriate information has been disclosed. Compliance personnel should also be responsible for the development and implementation of a compliance program, designed to ensure that the corporation complies with all securities laws regulations.

- *Policies to Prevent Improper Disclosure or Misuse of Confidential Information* - Corporations should employ reasonable methods designed to protect against the misuse of confidential information. For example, companies should advise employees to avoid trading stock based on material non-public information. Additionally, companies should only circulate sensitive information on a need-to-know basis, where low-level employees with no decision-making authority have little or no access to confidential information. Companies should also develop mechanisms for maintaining confidential documents. Such documents should only be in the custody of individuals who should properly have access to such documents and should not be left in plain sight for subordinate employees and corporate visitors to read.

- *Survey Director Knowledge* - In order to ensure that corporate disclosures, including press releases and SEC filings, accurately reflect the knowledge of the company's directors. The most effective method to attain this end is to maintain open lines of communication between the company's compliance department and the directors. Sarbanes-

Oxley requires that audit committees of public companies consist of only "independent" directors, at least one of whom is a "financial expert".

VII. <u>D&O Insurance</u>:

Along with corporate indemnification, D&O insurance affords personal financial protection to the directors and officers of corporations for their liabilities arising from the business operations of the corporation.

Generally, D&O policies pay loss" arising out of "claims" first made during the policy period against directors and officers for "wrongful acts" they may have committed in their capacities as directors and officers. "Loss" is typically defined to include damages, settlements and judgments. The definition of loss also includes the cost of defending legal proceedings. Thus, the limit of liability of most D&O policies is inclusive of and depleted by defense costs incurred. However, some non-profit D&O policy forms provide for defense costs in addition to the limit of liability. Traditionally, D&O policies did not provide for a right or "duty to defend"; however, this is not always the case anymore. Today, some D&O policies, particularly those issued to non-profit organizations, and some issued to private companies, include a duty to defend.

D&O insurance policies are generally written on a "claims made" basis, meaning that the claim must be "first made" against the insureds during the policy period. Some D&O policies also require that the claim must be reported to the D&O insurer during the policy period or within a limited time period thereafter. In addition, some D&O policies require that the wrongful acts take place during the policy period or after some designated date.

A. D&O Liability & Corporate Reimbursement

Traditionally, D&O insurance policies afforded coverage under two insuring agreements. "Side A" provides direct liability insurance for directors and officers when they were not indemnified by their corporation. Under Side A, the insurer pays on behalf of or reimburses the directors and officers for loss arising from claims made against the directors and officers during the policy period for their wrongful acts committed in insured capacities. "Side B" provides indemnification insurance for the corporation but not for its own wrongful acts. Under Side B, the insurer pays on behalf of or reimburses the corporation to the extent the corporation indemnifies its directors and officers for loss arising out of claims made during the policy period against the directors and officers for their wrongful acts committed in insured capacities. "Loss" is typically defined to include damages, settlements and judgments and, customarily, defense costs. As such, the liability limits are generally inclusive of and are depleted by defense costs.

B. Entity Coverage

Present generation D&O policies also provide some form of "entity coverage", or Side "C" coverage, for the wrongful acts of the corporation, itself, and even its employees. Entity coverage may be limited in scope to securities claims and/or claims of wrongful employment practices, and may require that at least one director or officer be named as a defendant along with the corporation in order for such coverage to be triggered.

C. Side "A" Coverage

As a further response to those claims in which the policy limits were exhausted by payments made under entity coverage, D&O insurers introduced “Side A” only policies. This policy is specifically designed to only afford coverage for directors and officers when the corporation does not or cannot indemnify the D&Os. Side A only coverage is classically triggered when the corporation is in bankruptcy or, if solvent, with respect to settlements and judgments in derivative actions in most jurisdictions. Side A only policies can be issued on an excess basis above a traditional D&O tower of “A, B and C” coverage, or on a primary basis with “difference in conditions” coverage.

D. "IDL" Coverage

Certain D&O insurers have also marketed “non-rescindable” Side A policies for outside directors of public companies. These “IDL” policies are particularly attractive to those companies that need to demonstrate to their boards of directors that there is D&O insurance set aside for them even if there are claims made against the corporation and its insiders; claims where the D&O coverage may be rescinded because of the “prior knowledge” of senior management.

E. Defense Provisions

Unlike many insurance policies, there is usually no right or “duty to defend” under the D&O policy (although this coverage feature is frequently found in D&O policies issued to non-profit organizations, in stand-alone EPL policies and, occasionally, in policies issued to private companies). Rather, the insureds retain their defense counsel of choice, with the consent of the D&O insurer, or select counsel from a reputable panel established by the insurer. Although defense counsel acts at the direction of the insured, it does so with the understanding that the insurer's position cannot be prejudiced. Virtually all D&O policies advance or reimburse defense costs as they are incurred

F. Cooperation Clause

In particular, the directors and officers, the corporation, the broker and the insured's defense counsel have a duty to deal fairly and cooperate with the insurer. This includes the obligation to disclose and turn over relevant information to the insurer during the course of the insurer’s investigation of the claim. Occasionally, an insurer and insured may disagree over the production of documents to the insurer. In this framework, courts have applied the "common interest" doctrine which upholds the attorney-client privilege and work product doctrine protection where those with common grounds -- such as the insured and its insurer -- share the information.

G. Exclusions

D&O policies commonly contain a number of exclusions including the fraud or dishonesty exclusion, personal profit or advantage exclusion, illegal remuneration exclusion, bodily injury and property damage exclusion, Employment Retirement Income Security Act ("ERISA") exclusion, libel and slander exclusion, notice under prior policy exclusion, other insurance exclusion, "insured v. insured" exclusion (oftentimes with certain "carve-outs" including for claims arising out of corporate bankruptcies), change of ownership exclusion, and a takeover exclusion. Additionally, policies can contain a number of exclusionary endorsements including the nuclear energy exclusion, pollution exclusion, captive insurance company endorsement, SEC exclusion (these are most likely to be found in policies issued to private companies), regulatory exclusion, professional errors and omissions ("E&O") exclusion, and anti-trust exclusion. In addition, D&O policies contain "carve-outs" to "loss" such that fines, penalties, punitive or treble damages, and matters uninsurable pursuant to applicable law, are not covered.

G. "No Loss" Doctrine

D&O insurers have also advanced the argument that rescissionary or restitutionary damages do not constitute "loss" under a D&O policy. In Level 3 Communications, Inc. v. Federal Ins. Co., 272 F.3d 908 (7th Cir. 2001), the plaintiff in the underlying case sold shares in their corporation to Level 3 and alleged that it had done so because of misrepresentations that Level 3 had made. In effect, Level 3 was accused of having obtained the plaintiffs' company by false pretenses and the plaintiffs sought to rescind the transaction and recover their shares, or rather the monetary value of the shares, because the company could no longer be reconstituted. In essence, it was alleged that Level 3 had stolen cash from the plaintiffs and had been forced to return it, and was now asking its insurance company to pick up the tab. The D&O insurer maintained that its policy was designed to cover only losses that injure the insured, not losses that result from returning stolen property. The D&O insurer contended that if such an insurance policy did insure a thief against the cost to him of disgorging the proceeds of the theft, it would be against public policy and would be unenforceable.

The U.S. Court of Appeals for the Seventh Circuit agreed with the D&O insurer. In Level 3 Communications, Inc., the Seventh Circuit found that securities fraud cases seeking to divest the defendant of the present value of the property wrongfully obtained is equivalent to imposing a constructive trust on the property in favor of the rightful owner. It found that the wording of the claim or judgment order or settlement is irrelevant. The interpretative principle is that "an insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it has stolen, even if a more polite word than 'stolen' is used to characterize the claims for the property's return."[12]

In Conseco, Inc. v. National Union Fire Ins. Co., 2002 WL 31961447 (Ind. Cir. Ct. 2002), an Indiana state court held that an $81 million settlement of a class action securities fraud case alleging violations of Section 11 under the 1933 Act did not constitute "loss" under a D&O

[12] Id. at 911.

policy. The Conseco court held that the damages sought were restitutionary in nature and dismissed the "bad faith" coverage lawsuit against the insurer. In Alanco Technology v. Carolina Casualty Co., 2006 U.S. Dist. LEXIS 31988 (D. Ariz. 2006), the U.S. District Court for the District of Arizona held that the defense expenses incurred in a stock-for-asset purchase did not constitute "loss" under a D&O policy. The underlying lawsuit against the insured was brought by shareholders of another company relating to a stock-for-assets purchase of the other company. The insurer successfully argued that, in essence, the claimant-shareholders were seeking rescissionary-like damages; i.e., consideration that the insured should have paid to the shareholders when it obtained the other company's assets in exchange for the insured's stock. The Alanco Court cited to the Canseco decision in dismissing the coverage action with prejudice.

VIII. Conclusion:

Today's corporate executive faces widespread liability risks. In the United Sates, these risks arise from a complex array of state and federal laws, both common law and statutory. Claims against directors and officers can arise from these laws and can involve nearly every aspect of doing business: employee relations, the environment, the level of competition, regulatory compliance, and every other imaginable subject.

Directors and officers are accountable to the corporation, and its shareholders, creditors, employees, customers and competitors, and the government and related agencies. All of these parties have demonstrated the ability to hold directors and officers accountable, and both the frequency and severity of these claims have increased dramatically over the years.

The risk of personal liability can be managed and controlled to some extent, but the liability exposure remains significant. Even in those cases where directors and officers face frivolous claims, the costs of litigation can be oppressive.

In facing the potential liabilities presented, today's corporate executive can rely to some extent on corporate indemnification. But corporate indemnification may not be available or appropriate in all circumstances, and even where it is appropriate, the corporation may not be in a position to fund the prohibitive costs of litigation. D&O liability insurance represents the safety net of personal liability for today's corporate executive.

The Risk Manager

The Latest News on Managing Your Risk

BEECHER CARLSON

March 2016

THE YATES MEMO'S IMPACT ON D&O LIABILITY

By Britt Eilhardt and Beata Aldridge

We are in an environment where corporate directors and officers are held to strict standards of accountability. In September 2015, Deputy Attorney General Sally Yates issued a memorandum putting everyone on notice that the Justice Department is going to actively pursue individuals responsible for corporate misconduct as well as seek evidence from corporations which implicates culpable executives (the "Yates Memo"). In response to the criticism that the Justice Department did not do enough to pursue individuals in the wake of the recent housing and financial crises, the Yates Memo issued a clear directive to United States Attorneys: they should "proactively investigate individuals at every step of the process" regardless of their ability to pay.[1] Moreover, as a threshold requirement for receiving any cooperation credit at all, the Justice Department is now putting the onus on corporations to actively investigate and disclose all relevant information about the individuals involved in the purported misconduct. (This is especially important for

[1] Deputy Attorney General Sally Q. Yates, "Individual Accountability for Corporate Wrongdoing," September 9, 2015, ("Yates Memo") at 4, available at http://www.justice.gov/dag/file/769036/DOWNLOAD. \

Additional Resources

For more information on how Beecher Carlson can help with your insurance needs please contact:

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About Beecher Carlson's Executive Liability Practice

Beecher Carlson's Executive Liability Practice is comprised of experienced and knowledgeable attorneys, brokers, and claims advisors dedicated to identifying your risks and best positioning you in the marketplace. Our forward thinking practice was the first to provide revolutionizing analysis of our clients' Directors & Officers and Cyber risks.

companies like those in the healthcare and life sciences industries that could face treble damages for statutory violations.)[2]

Widespread concerns regarding compliance with the Yates Memo and its effects are causing corporate directors and officers to review their insurance policies and bylaws closely to reexamine their directors' and officers' coverage.

Increased Risk Of Individual Prosecutions

The government ramped up enforcement actions overall in 2015, so it is likely that companies can expect more of the same in 2016 as the effects of the Yates Memo begin to make themselves felt. Because the Yates Memo acknowledges that it can be difficult to prove the knowledge and intent required for a criminal conviction, it is expected that the government will increasingly turn to civil actions to enforce the new guidelines, especially in light of the Memo's directive to look beyond an individual's ability to pay.

The investigation and prosecution of individual executives is likely to become more common. One such example is the ongoing case, *United States v. Berkley Heartlab*, in which Tonya Mallory, the former CEO of Health Diagnostics Laboratory ("HDL") is named as an individual defendant. Even though HDL itself has already settled with the government for $47 million and denied any wrongdoing, the Justice Department seeks to hold Mallory and two other executives liable for payments to referring doctors that caused the government to pay over $500 million in false claims for lab tests.[3] Though the government alleges that these payments are illegal kickbacks, HDL, just one of several labs under investigation, describes them as a "longstanding, industry-wide practice." [4]
The avenues which the Justice Department may explore in seeking to secure criminal convictions are ever-expanding. For example, the Patient Protection and Affordable Care Act made violations of the Anti-Kickback Statute *per se* violations of the False Claims Act.[5]

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[2] In later speech, Assistant Attorney General Leslie Caldwell explained that cooperation credit might still be available where a company assists the government with gathering evidence but is unable to identify culpable individuals despite a thorough investigation. Remarks at the 2nd Annual Global Investigations Review Conference, Sept. 22, 2015, available at http://www.justice.gov/opa/speech/assistant-attorney-general-leslie-r-caldwell-delivers-remarks-second-annual-global-0.
[3] *United States v. Berkley Heartlab Inc.*, No. 9:14-cv-00230 (Dist. S.C. Aug. 2015). For a summary of the allegations, see U.S. Government Sues Tonya Mallory, HDL's Former CEO and Co-Founder, VIRGINIA BUSINESS, Aug. 10, 2015, http://www.virginiabusiness.com/news/article/u.-s.-government-sues-tonya-mallory-hdls-former-ceo-and-co-founder.
[4] HDL called the practice of paying processing and handling fees to physicians who referred specimens for testing a "longstanding, industry-wide practice" that it ceased after the Department of Health and Human Services (HHS) Office of the Inspector General issued a fraud alert in June 2014 saying such payments represented "a substantial risk of fraud and abuse under the anti-kickback statute." *See* "Health Diagnostic Library P&H Key Facts," at http://hdlinckeyfacts.com/p-h-facts/, *and* HHS, Office of the Inspector General, "Special Fraud Alert: Laboratory Payments to Referring Physicians," Jun. 25, 2014, at http://oig.hhs.gov/fraud/docs/alertsandbulletins/2014/OIG_SFA_Laboratory_Payments_06252014.pdf .
[5] Scott Oswald and David Scher, *Healthcare Law Expands False Claims Act Liability under the Anti-Kickback Statute*, 17 WESTLAW JOURNAL, No. 11 (2012), https://www.employmentlawgroup.com/wp-content/uploads/AntiKickback-Statute-False-Claims-Lawyers.pdf.

More charges may be brought under statutes with lower burdens of proof like the Food, Drug, and Cosmetic Act. Further, under the "Responsible Corporate Officer" doctrine, senior corporate officials are being held liable for a company's actions even when there is no evidence the official knew about the wrongdoing.[6]

How will your D&O policy respond in light of the Yates Memo?

With the release of the Yates Memo, D&O coverage is more important than ever.

1) **Adequate Limits:** With defense, judgments, and/or settlements on behalf of both the corporation and the individual, D&O litigation and investigations will become lengthier and more expensive. Companies may need to re-evaluate the adequacy of their limits to ensure they match rising costs.

2) **Side A/DIC:** While directors and officers will want to review corporate bylaws for mandatory advancement and indemnification provisions, they should also consider including an excess Side A/DIC policy or re-assessing the limits of existing policies. In the event that a company wrongfully refuses or is unable to indemnify or advance costs to officials, Side A/DIC insurance policies provide a necessary layer of protection.

3) **Investigations Coverage:** Most D&O policies do not cover costs incurred relating to informal or internal investigations of the company or individuals. Market offerings address this significant gap in coverage either as a D&O add-on or as stand-alone coverage.

4) **Conduct Exclusions:** Even though many D&O policies contain exclusions for criminal acts, directors and officers will want to check that any such "bad acts" or "personal benefits" exclusions are not triggered until a final, non-appealable adjudication so that payments can be made for the duration of the case. Otherwise, D&O coverage for corporate executives could be precluded when it is needed most.

About the Authors

Britt A. Eilhardt is a Vice President in Beecher Carlson's Executive Liability Practice in New York with a JD from Brooklyn Law School and a BA in Art History from Bates College. Britt is a member of the New York and New Jersey State Bar Associations and as an attorney formerly in private practice, has litigated a number of high profile insurance coverage cases arising from domestic and London market policies. Britt can be reached at beilhardt@beechercarlson.com.

Beata Aldridge is a second-year student at Rutgers School of Law focusing on the evolution of international corporate law, new technology, entrepreneurship, and intellectual property. Prior to law school she worked in digital marketing and received her undergraduate degree from the University of Notre Dame. Beata is currently working as an Executive Liability Intern and can be reached at baldridge@beechercarlson.com.

[6] *United States v. DeCoster*, No. 15-1890 (8th Cir. 2015)(undecided). Summary available at http://www.chamberlitigation.com/united-states-v-decoster.

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SPECIAL CONSIDERATIONS IN D&O CLAIMS HANDLING

Steven R. DeLott
Simpson Thacher & Bartlett

John A. Freedman
Arnold & Porter

Jed D. Melnick
JAMS/Weinstein Melnick

Scott R. Schaffer
Wilson Elser Moskowitz Edelman & Dicker

Stephen A. Weisbrod
Weisbrod Matteis & Copley

New York City Bar Association

May 11, 2016

Weisbrod Matteis & Copley

A Hypothetical Problem

- The entities and individuals described are fictional.
- The difficulties they face are realistic.

2

Weisbrod Matteis & Copley

The Boiler Group

- The Boiler Group Inc. is a publicly traded private equity firm.
- Burton Boilowitz is CEO.
- Its largest fund is the Yuge Opportunities Fund.
- Boiler's funds are managed by Boiler Management Corp. ("BMC").
- Rhoda Dakota is BMC's Chief Strategy Officer and oversees most of the funds managed by BMC.

MARCH 2, 2017

- Boilowitz and the Boiler Group decide to form the Camden Real Estate Investment Trust (the "Camden REIT").
- Boilowitz calls Dakota and says that the Camden REIT would be a "really yuge" opportunity for the Yuge Opportunities Fund and will make "Camden great again."
- Boilowitz sends Dakota a "draft" copy of the Camden REIT private placement memorandum ("PPM").

MARCH 3, 2017

- Boilowitz has lunch with Dakota.
- Boilowitz tells Dakota that the Camden REIT will invest in waterfront properties in Camden, New Jersey and similar areas.
- Boilowitz reminds Dakota that, because the Camden REIT is offered as a private placement, shares in the Camden REIT should be marketed and sold exclusively to qualified investors (*i.e.*, sophisticated or institutional investors).
- He warns Dakota that marketing the Camden REIT to unsophisticated investors would cause the REIT to lose its exemption from SEC securities registration requirements.

MARCH 11, 2017

- Hog Swine LLP helps finalize the Camden REIT PPM and starts working on acquisitions for the REIT.
  - Noted Wall Street securities lawyer Henry Hog leads the representation.
  - An associate, Funjibal Bilingunitavtam, introduces an error into the PPM that nobody notices at the time.
  - The PPM states that Camden REIT's investment guidelines require investment in "properties in and around Camden, Maine and similar New England luxury vacation communities."

MARCH 25, 2017

- Funjibal Bilingunituvtam describes his time as follows: "Inspect Camden, NJ crackhouse (1.5); confer with C. Soprano re crackhouse purchase (2.0); telephone conference with H. Hog about why anybody in his right mind would buy crackhouse, and related financing issues (.2); stare out window on NJ Transit train from NYC to Trenton, drive to and from Camden in rented Corvette, and stare out window on train back to NYC (5.5); review egregious errors in PPM (.4)."
- Hog's time entry states: "Conf w/F. Bilingunituvtam re Camden (.5)."

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MAY 16, 2017

- The Widow Schmidow sets up the Schmidow Family Trust to benefit her nieces and nephews.
- At a charity event, Widow Schmidow encounters Dakota, who mentions several investments being pursued by the Yuge Opportunities Fund, including the Camden REIT.
- Having recently reviewed the error-containing PPM, Dakota comments that the Camden REIT investment is "low risk because the investment guidelines require the REIT to invest in New England vacation properties."

8

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MAY 17, 2017

- Dakota emails Boilowitz: “Good news! I talked to Widow Schmidow yesterday, and realized that she would be a perfect investor – really rich and not very smart. I told her all about the opportunity. She called me this morning and said she’s in for $30M.”

June 1, 2017

- Over lunch, Boilowitz comments to Dakota that the Camden REIT is under-subscribed.
- That afternoon, Dakota decides to increase the Yuge Opportunities Fund’s investment in the Camden REIT. 75% of the fund’s assets had been invested in an S&P 500 index fund, 20% in a money market fund, and 5% in the Camden REIT.
- By the end of the day, 5% of the fund’s assets were invested in the S&P 500 index fund, 20% in the money market fund, and 75% in the Camden REIT.

SEPTEMBER 1, 2017

- Widow Schmidow calls Dakota to express concern about the Yuge Opportunities Fund and the Camden REIT.
- Her monthly statement shows that the trust she set up has suffered a paper loss of 50% on her investment in the fund.
- Widow Schmidow recently discovered that the REIT's largest property – the Waterside Inn – is in Camden, New Jersey, not Camden, Maine. She is disappointed because, as a girl, she used to vacation at the Waterside Inn in Camden, Maine.

SEPTEMBER 7, 2017

- Consuela Genera, the General Counsel of Boiler Group, circulates an email to all directors and officers of Boiler and BMC: "Our liability insurance policies will renew on September 15, 2017. As part of the application process, we are required to inform our insurers of all potential claims against the firm. Please let me know if you are aware of any errors, omissions or other facts that reasonably could give rise to a claim against the firm. Please respond by September 10, 2017."
- Nobody responds.

OCTOBER 5, 2017

- Boilowitz and Genera call Hog.
- Boiler Group, Boilowitz, BMC, Dakota and Camden REIT have received an informal email from the SEC Enforcement Division concerning the Camden REIT.
- There's no official "Wells" notice from the SEC.
- They decide that Hog should lead an "independent internal investigation." Everyone on the call hopes that the report will be favorable and appropriate to submit to the SEC.
- Hog's rate is $1,500 per hour.

OCTOBER 11, 2017

- Boilowitz forwards Dakota's email dated May 17, 2017 to Genera, stating "With the benefit of twenty-twenty hindsight, I wish Rhoda hadn't done this. Give me a call."
- When they meet and discuss the facts, Genera opines that Widow Schmidow "could be annoyed."
- Genera points out that Dakota does not work for Camden REIT and that the error in the PPM was introduced by Hog's team.

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DECEMBER 17, 2017

- Genera reviews a stack of insurance coverage charts prepared by Boiler’s insurance broker.
- Boiler has D&O insurance.
- Boiler has separate E&O insurance.
- Camden REIT has combined D&O and E&O insurance.

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DECEMBER 17, 2017

- Boiler's D&O insurance chart shows:
  - Self-insured retention $1M
  - Bridgeport Insurance Co. $10M
  - Wanderers Insurance Co. $20M xs of $10M
  - Marble State Insurance Co. $20M xs of $30M
  - Greek Re Ltd. $20M xs of $50M
- Claims arising out of “Professional Services” are excluded.
- Each policy has its own arbitration clause

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DECEMBER 17, 2017

- Boiler's E&O insurance chart shows:
  - Self-insured retention $1M
  - Spade Insurance Co. $5M
  - Greek Re Ltd. $10M xs of $5M
- The policy covers claims arising out of "professional services" rendered to "customers."
- Greek Re's excess policy requires "actual payment" by underlying insurer of its aggregate coverage limit to trigger excess coverage

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Weisbrod Matteis & Copley

DECEMBER 17, 2017

- The Camden REIT D&O/E&O insurance chart shows:
  - Self-insured retention $1M
  - Beirut Assurance Co. $5M
- Beirut's insurance policy is governed by the laws of Lebanon and the policy's forum selection clause requires litigation of any claim under the policy in Lebanon.

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JANUARY 15, 2018

- Hog issues a written report concluding that nobody at Boiler committed any fraud but that certain internal controls should be improved. The report notes that Dakota created risk to the firm by recommending investments to Widow Schmidow.
- Total fees for the report: $3 million

JANUARY 16, 2018

- Hog, Boilowitz and Genero meet and conclude that the firm should approach Widow Schmidow and offer to make her whole for her investment loss.
- When Hog and Genero call to offer $15 million to Widow Schmidow, she happily accepts payment, agrees to sign a release, and states that she will remain a loyal client of Boiler.

JANUARY 18, 2018

- Unimpressed with Hog's internal investigation report, the SEC issues "Wells" notices to Boiler, BMC, Boilowitz , Dakota and Camden REIT.
- When Boiler reveals this publicly, its stock drops 20%.

JANUARY 20, 2018

- Two shareholders in the Yuge Opportunities Fund sue Boiler, BMC, Boilowitz and Dakota, alleging negligence (against all defendants), breach of contract (against BMC for violating the fund's investment guidelines), tortious interference (against Boiler and Boilowitz for causing the fund to violate its guidelines), and securities fraud (against all defendants).

JANUARY 21, 2018

- A state pension fund that owns shares in Boiler Group sues Boiler and Boilowitz, alleging securities fraud based on their failure to disclose Boiler's exposure to problems relating to the Camden REIT and the Yuge Opportunities Fund.

QUESTIONS:

- What insurance coverage defenses are insurers likely to raise?
  - Notice issues
  - Warranty issues
  - Defense cost issues
  - Consent-to-settlement issues
  - Allocation issues
  - Exhaustion
  - Other issues

QUESTIONS:

- How should Boiler have handled insurance issues differently?
  - Negotiate different program terms
  - Deal with insurers differently
- How can brokers help?
- How can counsel help?

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QUESTIONS:

- How should Boiler try to resolve its liabilities and insurance disputes?
  - SEC
  - Boiler class action
  - Yuge Opportunities Fund class action
  - Insurance disputes
- Is mediation an option?

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QUESTIONS:

- Do these facts raise any important ethics questions for counsel?
  - Privilege issues
  - Conflicts of interest

Thank you

Weisbrod Matteis & Copley

Is Your D&O Insurer Really On Your Side?

by Stephen A. Weisbrod and Andrew W. Lamb

A lawsuit arrives, a regulator calls—and one of your first responses is to check the status of your directors and officers insurance coverage. Your brokers may have assured you that you have a strong policy that keeps you well covered. However, companies often discover that their D&O insurer works harder at seeking coverage loopholes than living up to their policy.

Directors and officers (D&O) liability insurers are in the business of selling protection against legal proceedings that target companies and their executives. When policyholders actually have to fend off allegations of misconduct, however, D&O insurers often go on the attack against the very people that they are supposed to protect.

In many cases, D&O insurers assert policy interpretations that improperly diminish or eliminate coverage, try to cancel policies, or use linguistic gymnastics to allocate much of the insureds' losses to uncovered conduct. Companies and executives need to fight back. They should not let their D&O insurers escape the coverage obligations paid for with substantial premiums.

The need to insure against defense costs in fraud cases is probably the single most important reason for D&O coverage. Still, that does not stop some insurers from trying to avoid paying fraud defense costs.

☐ *Abuses of crime/fraud exclusions.* D&O insurers often distort contract terms known as "exclusions" to deny coverage. Insurance policies usually state first the general terms that establish coverage, but then carve back that coverage with various exceptions, called "exclusions." Generally, courts interpret exclusions narrowly. Insurers, however, often seek the most expansive interpretations of exclusions, in their effort to pay out as little as possible.

The "crime/fraud" exclusion is an insurer favorite. The need to insure against defense costs in fraud cases is probably the single most important reason for buying D&O coverage. Still, that does not stop some insurers from pointing to crime/fraud exclusions to try to avoid paying defense costs.

An unfortunate fact of corporate life is that disappointed investors and government regulators often accuse executives and companies of deliberate misconduct. For example, investors may file a stock-drop lawsuit when a company's share price goes down. The lawsuit may allege inaccurate statements by executives in corporate disclosures or financial presentations that the investors allegedly relied on when deciding to invest. Such lawsuits typically at least suggest deliberate criminal or fraudulent acts, and investors often accuse executives of such acts outright. Some insurers exploit this fact with excessive applications of the crime/fraud exclusion. This exclusion typically bars coverage of any loss resulting from a claim of deliberate crime or fraud—but only if the claim is established by a final "adjudication."

Insurers have wrongly argued, however, that crime/fraud exclusions (or similar judicially-created doctrines) reach so far as to bar coverage for out-of-court settlements alleging crime or fraud. Ordinarily, this cannot be right. Out-of-court settlements usually resolve lawsuits without any final adjudication or admission of fault. The typical crime/fraud exclusion thus cannot apply. Policyholders should not be intimidated when insurers initially say "no" to paying for settlements based on crime/fraud exclusions.

Some insurers also assert that crime/fraud exclusions bar all coverage for defense costs incurred in

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defending against accusations of deliberate crime or fraud. Crime/fraud exclusions typically do not work like this, since defense costs are incurred prior to any final adjudication. In addition, such exclusions generally should not bar coverage of defense costs, even if the plaintiff alleged intentional crime or fraud, so long as the plaintiff's case could succeed on a different theory of liability, such as negligence or recklessness.

Insurers have tried to stretch crime/fraud exclusions in other ways. Insurers have argued that the exclusions let the insurers themselves establish an insured's deliberate crime or fraud, by obtaining a judgment against their insureds in a case brought by the insurers. According to this view, even if no deliberate misconduct is established by the litigation for which coverage was sought, the insurer still can bring costly litigation later, to try to establish some deliberate crime or fraud that would make the exclusion apply.

If the insurer delays payments, the insured's lawyers must work for at least some time without insurer payments.

Such insurer-driven litigation can be costly, makes defending the original litigation much more difficult, and can delay any coverage payments owed, even if the insurer's efforts are unsuccessful. If the insurer delays payments, the insured's lawyers defending against the original lawsuit must work for at least some time without insurer payments. Any insurance litigation could also require witnesses to testify a second time on subjects about which they would prefer to testify only once (or not at all).

Strong responses by insureds can help, though getting the insurers to pay may not be possible without enduring some of the cost and difficulty of suing insurers. Courts have made clear that the crime/fraud exclusion requires a final "adjudication" in the case for which coverage has been sought—not in a case brought by an insurer. Moreover, as long as there has been no final adjudication, insurers should pay defense costs if the litigation for which coverage was sought asserts any potential liability that does not require proof of such intentional wrongdoing.

Given the aggressive tactics of many insurers, insureds and their legal counsel should pay close attention to crime/fraud exclusions and other policy terms. They should take care, as far as possible, not to jeopardize coverage by arguments and tactics used in the insured's defense in the original litigation.

Potentially responsible insurers should be given notice promptly. It may be prudent to give notice of a potential claim even before a claim formally has been made, in order to "lock in" coverage under the current year's policy before it expires. The policy for the coming year may not cover claims anticipated before the new policy's start date.

The insured's defense counsel should coordinate with insurance counsel as soon as a claim is anticipated, and continue to coordinate their efforts until all matters are resolved. If the lawyers do not communicate with one another regularly and effectively, seemingly innocuous statements or seemingly uncontroversial steps could have surprising and unintended consequences. Coordination among counsel helps to preserve the strongest case for the most coverage.

Some D&O insurers will deny all coverage based on a shockingly broad reading of a "professional services" exclusion.

☐ *Abuses of "professional services" exclusions.* A "professional services" exclusion is another exclusion of choice for D&O insurers. These exclusions are common in D&O policies sold to companies that provide professional services (such as financial-services companies, fund managers, accounting firms, consulting firms, law firms, and hospitals). D&O insurers often seek to reinforce their policies' exclusive focus on executive-level coverage by excluding losses "arising out of" a business's professional services.

Such language may seem innocuous. After all, D&O policies are designed to cover directors, officers, and their companies for losses due to executive-level misconduct. "Professional services" exclusions plainly seem to be about something else. Also, professional-services companies usually buy malpractice or "errors and omissions" (E&O) insurance to protect against professional-services liabilities that their D&O policies do not cover.

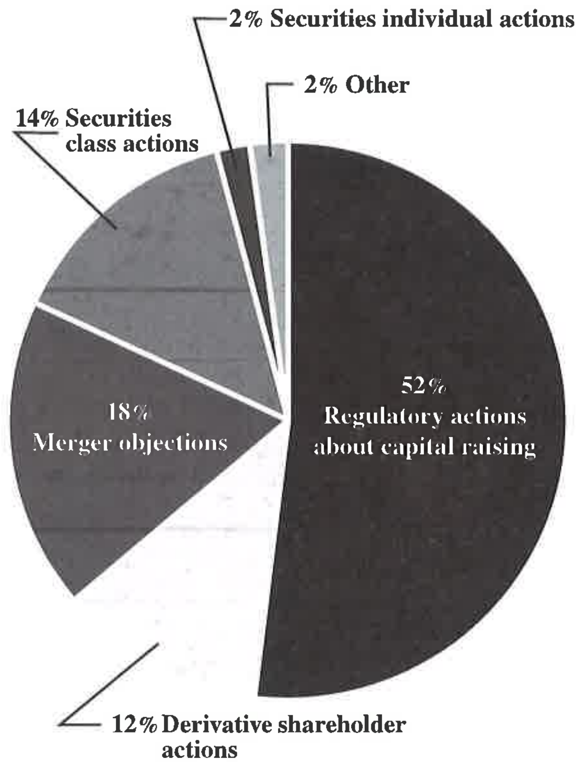
However, some D&O insurers will deny all coverage based on a shockingly broad reading of a "professional services" exclusion. For example, a public company that manages mutual funds and its CFO may be sued by investors, alleging that they made investment decisions in reliance on inaccurate financial statements by the company about its profits from managing mutual funds. The company and CFO were not engaged in "professional services," even though the profits discussed by the statements resulted from professional fund-management services.

Even so, if the D&O policy had a "professional services" exclusion, some insurers would cite it to deny all coverage. They would point out that the profits described in the financial statements would not have been earned by the company if the company had not provided professional services to clients.

Some policyholders avoid this argument by buying a single insurance policy that covers both D&O liability and professional liability. This can help reduce coverage disputes over what is and is not a professional service, because the insurer may conclude that it has to pay regardless.

D&O Triggers

The Most Common Claims



Source: Advisen Ltd. D&O Claims Trends: 2014 End of Year Wrap Up

A broad reading of "professional services" coverage exclusions can produce absurd results, creating D&O policies that would cover little if anything.

When a company buys a D&O policy that contains a "professional services" exclusion, as many companies do, insurers should not get away with arguments that unfairly expand the exclusion.

Most courts read "professional services" exclusions far more narrowly than insurers do. A broad reading of "professional services" exclusions can produce absurd results. If every claim against a professional-services firm or its executives were a "professional services" claim simply because the firm's business involves professional services, then any D&O policy would cover little if anything. For these reasons, courts have often rejected insurers' expansive interpretations of "professional services" exclusions.

Care should be taken from the start in handling possible coverage under policies with "professional services" exclusions. Court papers and other documents that insurers might come to see should properly describe the lawsuits or other demands for which coverage might be sought.

For example, it should be kept clear if allegations are not really about professional services, even though the company may be in the business of providing them. Sloppy descriptions may prove problematic when parroted back by a D&O insurer keen on avoiding as much coverage as it can. Coordination between defense and coverage counsel can help companies and their executives avoid such problems.

☐ *Leveraging one bad actor to deny coverage for all.* Another common D&O-insurer strategy is to deny coverage for all insureds based on the alleged wrongful conduct of just one. Insurance applications, investigations, and lawsuits often address companies and their executives as a group. Lawsuits and other legal demands, however, may specify only the bad acts of a few. Most of those covered will not be involved in, or even know about, the purported misconduct. Insurers, however, often try to deny coverage for everyone based on general allegations of fault or one allegedly bad actor.

To address this, most policies have one or more "severability" provisions, but insurers often try to argue around them. A common severability provision is for exclusions. A "severability of exclusions" provision typically forbids an insurer from using information about one insured to determine if any other insured may be excluded from coverage. Such severability clauses are very important, and can make the difference between innocent insureds getting coverage—or having to fend for themselves.

Some insurers go so far as to argue that they can cancel the policy due to an innocent mistake in the application. In most jurisdictions, this argument will not work—if the insured fights back.

"Severability of exclusions" clauses do not always prevent insurer mischief, however. Sometimes insurers cite the conduct of others to invoke clauses that exclude coverage, but are not labeled in the policy as "exclusions." The insurers insist that they are not imputing the acts of someone else to the insured for the purpose of triggering an exclusion. Rather, the insurers argue, they are noting that the acts of someone else pull the claims outside the policy's initial grant of coverage.

For example, an insurer may assert that the insured should have sought coverage for a lawsuit under an earlier year's policy rather than the current policy because the lawsuit alleged facts involving somebody else in earlier years. These arguments can be very complicated, and insureds should resist them, especially when they would have the effect of eliminating coverage for some employees, such as newly hired officers not covered under older policies.

D&O insurers often use a related tactic, trying to cancel policies based on alleged misstatements or omissions in insurance applications. Most companies rely on a single executive to procure their D&O coverage. If this person provides inaccurate or incomplete information, the insurer may try to cancel the entire policy for everyone. Some insurers go so far as to argue that they are entitled to cancel the policy due to an innocent, unintentional mistake in the application.

In most jurisdictions, such arguments will not work if the insured fights back. Some policies also have application-related "severability" provisions that address this situation. These prohibit cancelling policies for one insured based on the acts or knowledge of anyone else. As with severability provisions for exclusions, however, application severability provisions are sometimes construed in a convoluted ways by insurers trying to avoid paying out coverage.

☐ *Over-allocation of losses to uncovered liabilities.* Executives and their companies also need to look out for allocation of losses among "covered" and "uncovered" liabilities. Defendants often face lawsuits with wide-ranging allegations and multiple conceivable bases for the plaintiff to recover. A D&O policy might insure against a plaintiff's recovery based on some grounds but not others, or the policy might cover some defendants but not others. Where the plaintiff recovers based on both covered and uncovered grounds, policies and courts sometimes call for the recovery to be allocated among those grounds. The D&O insurer may agree to cover all amounts allocated to covered grounds, but not the rest.

Insureds should thus be very careful in dealing with their D&O insurers from the start. Insurers frequently treat far too much of any loss as uncovered and push for allocations that are inappropriate. Pushing back can mean the difference between obtaining coverage for most or all of the losses, or having to pay most or all of the losses out of pocket.

D&O insurers often attempt to allocate as much as possible of their insured's loss to uncovered allegations. During litigation, they will depict the lawsuit as focused mainly on those allegations and will look for any evidence to support their view.

Where lawsuits include both covered and uncovered liabilities, insurers may also push to allocate as much of the defense costs as possible to uncovered allegations. Many jurisdictions, however, require insurers to pay defense costs in full, even if the lawsuit alleges both covered and uncovered liabilities. Moreover, if the cost of defending against uncovered liabilities is also incurred to defend against covered liabilities, the cost should be fully covered. That is because the cost would have been incurred anyway, even if only covered defenses had been made.

Courts also often require coverage for all defense costs "reasonably related" to the covered claims and construe "reasonably related" fairly broadly. Insured executives and companies should thus use caution when an insurer seeks to allocate defense costs. They should consult with insurance counsel to avoid abandoning valuable coverage for defense costs or any other potentially covered loss.

Likewise, allocations may not be appropriate for out-of-court settlements, and even for some adjudicated recoveries. The specific written terms of the settlement may be important in subsequent insurance allocation disputes. Since the amount of coverage depends on the allocation, care should be taken from the start to ensure that any ultimate allocation recognizes all of a lawsuit's covered grounds of relief and the extent to which those provide the basis of any plaintiff's recovery.

Work closely with D&O insurers as claims are defended to help reduce coverage disputes.

D&O insurance is a critical risk-management product for companies and their executives. However, when plaintiffs file lawsuits or government regulators launch proceedings, D&O insurers often turn against their clients.

Careful policy drafting can prevent some disputes from arising. Working closely with D&O insurers as claims are being defended also can help reduce the likelihood of coverage disputes. Policies demand a reasonable level of cooperation between insureds and the insurers. However, many disputes are inevitable.

The potential for early mistakes to jeopardize coverage makes it crucial to handle coverage claims properly from the start. As soon as you face significant potential for a covered loss, seek counsel to protect as much coverage as possible. Fortunately, there are ways to fight back against the aggressive tactics of D&O insurers and to obtain the coverage that those insurers were paid to provide. ■

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District of Columbia
Court of Appeals

FILED
FEB 11 2016
DISTRICT OF COLUMBIA
COURT OF APPEALS

No. 14-CV-659

CARLYLE INVESTMENT MANAGEMENT, LLC, *et al.*,
Appellants,

v. **CAB-3190-13**

ACE AMERICAN INSURANCE COMPANY, *et al.*,
Appellees.

On Appeal from the Superior Court of the District of Columbia
Civil Division

BEFORE: Thompson and Easterly, Associate Judges; and Reid, Senior Judge.

J U D G M E N T

This case came to be heard on the transcript of record, the briefs filed, and was argued by counsel. On consideration whereof, and as set forth in the opinion filed this date, it is now hereby

ORDERED and ADJUDGED that the trial court's order of dismissal is vacated, and the case is remanded to the trial court for discovery, and for dispositive motions or trial.

For the Court:

Julio A. Castillo

JULIO A. CASTILLO
Clerk of the Court

Dated: February 11, 2016.

Opinion by Senior Judge Inez Smith Reid.

Notice: This opinion is subject to formal revision before publication in the Atlantic and Maryland Reporters. Users are requested to notify the Clerk of the Court of any formal errors so that corrections may be made before the bound volumes go to press.

FILED 2/11/16
District of Columbia
Court of Appeals
Julio Castillo
Julio Castillo
Clerk of Court

DISTRICT OF COLUMBIA COURT OF APPEALS

No. 14-CV-659

CARLYLE INVESTMENT MANAGEMENT L.L.C., *et al.*, APPELLANTS,

v.

ACE AMERICAN INSURANCE COMPANY, *et al.*, APPELLEES.

Appeal from the Superior Court
of the District of Columbia
(CAB-3190-13)

(Hon. Frederick H. Weisberg, Trial Judge)

(Argued May 12, 2015 Decided February 11, 2016)

Stephen A. Weisbrod, with whom *Martin Bienstock*, *Andrew W. Lamb*, and *Sean J. Williams*, were on the brief, for appellants.

Louis H. Kozloff, with whom *Lawrence H. Mirel*, *Luke D. Lynch, Jr.*, and *David Kuffler*, were on the brief, for appellees.

Before THOMPSON and EASTERLY, *Associate Judges*, and REID, *Senior Judge*.

REID, *Senior Judge*: This case involves efforts by appellants, Carlyle Investment Management (―CIM”), TC Group, L.L.C. (―TCG”), and TCG Holdings, L.L.C. (―TCGH”) (collectively, ―appellants”), to obtain declaratory relief indicating that they are entitled to insurance coverage for defense costs incurred or to be incurred in underlying lawsuits. The trial court granted the Super. Ct. Civ. R. 12

(b)(6) motion of appellees, Ace American Insurance Company and fifteen other insurance companies, including Chartis Property Casualty Company and Chartis Specialty Insurance Company (“the insurance companies”), and dismissed appellants‘ complaint. The trial court concluded that, as a matter of law, all of the claims in the underlying lawsuits arise from “professional services” provided to the Carlyle Capital Corporation (“CCC”), and hence, the claims fall under the insurance policies‘ “Carlyle Capital Corp Exclusion” (“the professional services exclusion” or “the CCC exclusion”). For the reasons stated below, we vacate the trial court‘s order of dismissal and remand the case to the trial court for discovery, and for dispositive motions or trial.

FACTUAL SUMMARY

According to appellants‘ complaint, The Carlyle Group formed CCC as an independent company under the laws of the Island of Guernsey, Channel Islands, in 2006.[1] CCC is governed by a small Board of Directors, and is managed by CIM

[1] CCC has described The Carlyle Group as “a private global investment firm” that, among other activities, “originates, structures and acts as lead equity investor in management-led buyouts . . . [and in] equity private placements . . . .” Appellants‘ complaint also characterizes (1) The Carlyle Group as “a global private (continued…)

and its affiliates—TCG and TCGH.[2]

“CCC invested primarily in AAA-rated residential mortgage-backed securities issued by Fannie Mae and Freddie Mac.” Initially Class A shares in CCC were issued to beneficial voting shareholders. In September 2006, CCC prepared a private placement memorandum governing the private placement of non-voting shares. In late 2006 and in part of 2007, CCC offered its Class B shares to qualified investors and raised $945 million. Among the investors in CCC were Michael Huffington, and the National Industries Holding Group (“NIG”) of Kuwait. After CCC collapsed in 2008, due to “the confluence of the mortgage and liquidity crises,” several legal actions were filed against The Carlyle Group, CCC, CCC Directors, CIM, TCG, TCGH, and David Rubenstein (co-founder of The Carlyle Group); plaintiffs in these actions included Mr. Huffington (2011 complaint), NIG (2009 complaint), the CCC liquidators (2012 complaint), and various shareholders (2011 complaint). As the legal actions unfolded in various courts, CIM, TCG and TCGH gave the insurers notice of the lawsuits and made claims against the insurance

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(…continued)
equity firm comprised of numerous companies, including CIM, TCG and TCGH”; (2) CIM as “a subsidiary of TCG”; and (3) TCG as “a subsidiary of TCGH.”

[2] CCC and CIM (but not TCG and TCGH) executed an Investment Management Agreement on September 20, 2006.

companies for the advancement and reimbursement of defense costs. The insurers have denied the claims.

After the formation of CCC, The Carlyle Group had arranged for expanded insurance coverage through a $15 million policy issued to TCG by American International Specialty Lines Insurance in 2006/2007, and a $10 million policy issued to TCG by the same company in 2007/2008 and 2008/2009. In 2009/2010, Chartis Specialty Insurance Company (the new name for the former insurance company) issued a $10 million private equity management and professional liability policy to TCG; this policy was known as the TCG Program. Other insurers issued excess policies to TCG, beginning with $50 million excess coverage for the year 2006/2007, $75 million in 2007/2008, $100 million in 2008/2009, and $145 million in 2009/2010. In addition, The Carlyle Group and CCC purchased another policy for CCC through Chartis Europe Limited; this policy was known as the CCC Program and covered CCC Directors and CIM only for professional liability claims.

In 2007 (and continuing through the 2009/2010 insurance coverage period), American International Specialty Lines, Chartis Specialty Insurance, and the excess insurers added Endorsement #2, the ―Carlyle Capital Corp Exclusion," to the TCG policy. This professional services exclusion specified that, ―In consideration of the premium charged, it is hereby understood and agreed that the Insurer shall not be liable to make any payment for Loss in connection with any Professional Services Claim arising from Professional Services provided to Carlyle Capital Corp."[3]

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[3] The 2009/2010 policy defined –~~p~~rofessional services claim" as –~~a~~ [c]laim made against any [i]nsured arising out of, based upon or attributable to [p]rofessional [s]ervices provided by an [i]nsured." The policy defined professional services as:

> (1) [T]he giving of financial, economic or investment advice regarding investments in any debt, equity or convertible securities, collateralized debt obligations, collateralized loan obligations, collateralized mortgage obligations, . . . , including without limitation the giving of financial advice to or on behalf of any [f]und (or any prospective [f]und) or any separately managed account or separate account holder or any limited partner of any [f]und (or prospective [f]und) or any other investor or client of, in or with an [o]rganization;
>
> (2) [T]he rendering of or failure to render investment management services, including without limitation investment management services concerning any of the foregoing investments, and including without limitation, the rendering of or failure to render investment management services to or on behalf of any [f]und (or any prospective [f]und) or any separately managed account or separate account holder or any limited partner of any [f]und (or prospective [f]und) or the rendering or failure to render investment management services to or on behalf of any other investor or client of, in or with an [o]rganization;

(continued…)

Appellants' complaint for declaratory relief and damages, filed in the Superior Court of the District of Columbia on May 7, 2013, alleged two causes of

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(…continued)

> (3) [T]he organization or formation of, the purchase or sale or offer or solicitation for the purchase or sale of any interest(s) in, the calling of committed capital to, a [f]und or prospective [f]und;
>
> (4) [A]ny activity relating to the offer, purchase or sale or solicitation for the purchase or sale, or disposition or divestiture of any [p]ortfolio [e]ntity (or prospective [p]ortfolio entity) or any interest(s) in a [p]ortfolio [e]ntity (or prospective [p]ortfolio [e]ntity);
>
> (5) [T]he providing of advisory, consulting, management, monitoring, administrative, investment, financial or legal advice or other services for, or the rendering of any advice to, or with respect to, an [o]rganization, a [f]und (or any of its limited partners or members) or a [p]ortfolio [e]ntity (or a prospective [o]rganization, [i]nvestment [f]und or [p]ortfolio [e]ntity)
>
> (6) The solicitation, offer, syndication, promotion or calling of capital by an [i]nsured for any manner of co-investment in a [p]ortfolio [e]ntity or [p]rospective [p]ortfolio [e]ntity, including but not limited to fund-raising, road show, investor relations or pre-IPO activities;
>
> (7) [T]he payment or non-payment of any distribution, dividends, redemption (whether in cash or in-kind) by any [i]nsured], [p]ortfolio [e]ntity or any of their respective parents, subsidiaries or affiliates; or
>
> (8) Other similar or related services.

action. Count one sought a declaratory judgment concerning its policies, and, as relief, appellants requested, in part, “a judgment declaring that Carlyle has satisfied the terms and conditions of the policies,” as well as:

> a judgment declaring Carlyle‘s rights to coverage under the policies in the TCG Program for CCC-related claims, including Carlyle‘s rights to advancement of defense costs, Carlyle‘s rights to reimbursement of indemnification payments made to or on behalf of the CCC Directors and Mr. Rubenstein, and Carlyle‘s rights with respect to payments of judgments or settlements.

Count two alleged breach of contract and requested damages.

In response to the complaint, appellees filed a joint motion to dismiss on July 19, 2013, pursuant to Super. Ct. Civ. R. 12 (b)(6). Appellants lodged an opposition to the motion on September 20, 2013; appellees filed a reply and appellants a surreply. The parties also filed exhibits in support of the motion and opposition. In addition, on March 19, 2014, appellees moved to stay discovery pending a decision on their motion to dismiss. Appellants opposed the motion on April 17, 2014, and the parties filed additional pleadings pertaining to the motion to stay discovery. On April 29, 2014, the trial court granted the motion to stay discovery, asserting that despite the passage of time since the filing of the motion to dismiss, “it would be inefficient, and potentially unfair to [Appellees], to launch the parties into expensive discovery while the court considers whether [Appellants] have a basis to go forward with their complaint.”

Subsequently, on May 15, 2014, the trial court signed an order granting appellees‘ motion to dismiss. In essence, the trial court concluded that key terms are so broadly defined in the insurance contract that everything alleged in the various underlying complaints (Huffington, NIG, etc.), for which appellants sought defense costs, is excluded from coverage. Specifically, the court declared that the terms ―Professional Services” and ―Professional Services Claim” ―are specifically defined in the contract, the definitions are broad and unambiguous and, as used in the Exclusion, they operate to exclude coverage for all of the losses (and defense costs) at issue in this case.” The court asserted:

> Although plead in a plethora of different legal theories and multiple counts, the gravamen of all of the underlying complaints is that [appellants] enticed the investors into unsafe investments by falsely promising high returns with minimal risk, misled or failed to warn investors about increasing risk, and mismanaged the investments by failing to guard against their inherent risk, even after deteriorating market conditions should have dictated a variety of conservative strategies designed to decrease leverage and prevent the insolvency of the company and investor losses that occurred in 2008.

The court acknowledged that appellants correctly contended:

> that the court is required to consider each claim in each

> complaint in deciding the coverage issue presented, but the ‗eight corners rule‘ neither requires nor permits the court to scrutinize each count in each complaint with a dictionary in one hand and The Chicago Manual of Style in the other to see if there is an allegation that could be contorted so as to bear an interpretation that would take it out of the Exclusion[;] [t]he exclusion is not ambiguous.[4]

The trial court rejected appellants‘ argument that ―management-liability claims‘—those related to acts, errors, and omissions in corporate governance or ‗D&O‘ claims—are not excluded." As the court put it:

> Whatever might be true in the insurance industry generally, in [the] insurance contract [at issue], ―Loss in connection with any Professional Services Claim arising from Professional Services provided to Carlyle Capital

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[4] The trial court concluded:

> Each claim in each complaint arises from the provision of Professional Services to CCC, whether it relates to the alleged false marketing of the shares to private investors (Huffington and NIG), the alleged failure to make required disclosures to purchasers of publicly traded shares (Shareholder Class Action), CIM‘s alleged mismanagement of CCC under the IMA (Huffington, NIG, Shareholder Class, and Liquidators), the alleged misrepresentations or failure to warn investors and failure to take appropriate actions to maintain adequate liquidity when the market was showing signs of collapse and CCC was over-leveraged (same), or the operation of CCC with divided loyalties by acting as ―*de facto* directors" or ―shadow directors," allegedly for the benefit of other Carlyle interests and to the detriment of CCC and its outside shareholders (Liquidators).

> Corp." was expressly excluded from coverage[;] [t]hose terms were defined in the contract broadly enough to include virtually all of the conduct alleged against [appellants] (and those they are indemnifying) in the underlying lawsuits, whether or not such conduct would be characterized as professional services or corporate management in the industry generally or in some other insurance contract.

THE PARTIES' ARGUMENTS

Appellants contend that the trial court erred by granting appellees‘ motion to dismiss, pursuant to Super. Ct. Civ. R. 12 (b)(6). They essentially argue that the trial court erred by construing the professional services exclusion ―broadly" and ―expansively" rather than ―narrowly." They assert that the court further erred by failing to recognize that the professional services exclusion of the insurance contract is ‗―reasonably or fairly susceptible to different constructions or interpretations,‘ at least one of which allows some coverage," and that the professional services exclusion ―is reasonably construed not to apply to the many [u]nderlying [c]laims concerning CCC‘s corporate governance; conduct occurring after CCC was publicly traded; or statements allegedly made to induce investors to hold onto interests in CCC, which plainly are not ‗solicitation[s] for the purchase or sale of any interest[s].‘" They also argue that the professional services exclusion is not reasonably construed to apply to *de facto* and shadow director claims in the liquidators‘ law suit; and that the trial court wrongly branded as “irrelevant” the professional services definition‘s “recipient-entity requirements” (that is, for example, the requirement in some of the subparts of the definition that the services be rendered to a “Fund,” “Organization,” or “Portfolio Entity).” They fault the trial court for failing to “specif[y] what part of the “[p]rofessional [s]ervices” definition purportedly applies unambiguously to corporate governance,” and for failing to “consider[] whether the definition of ‘[p]rofessional [s]ervices‘ is ambiguous due to its use of *undefined* phrases such as ‘investment management services‘ and ‘management services‘” (emphasis in original).

Appellants contend that “[r]eversal is warranted here, [because] the terms ‘investment management services‘ and ‘management . . . services‘ do not unambiguously encompass corporate governance,” that “corporate governance is not a ‘service,‘” and interpreting those services “as not encompassing corporate governance comports with common usage in the business world.” Appellants further contend that “[n]o other part of the [p]rofessional [s]ervices definition comes close to encompassing corporate governance.”[5] Finally, appellants emphasize that

[5] Appellants further claim that their policy interpretation is “reasonable” under principles of contract interpretation, and “fits the objective context in which the parties agreed to the [p]olicy and [e]xclusion,” a context that recognizes (continued…)

the trial court must “analyz[e] each *cause of action* in each [underlying] lawsuit” (emphasis in original). And, they insist that, here, the trial court failed to apply the correct standard in dismissing its complaint under Rule 12 (b)(6) – the “defense-cost standard” that “precludes dismissal unless beyond doubt there is no possibility for any coverage for any [u]nderlying [c]laim.”

Appellees urge this court to “hold as a matter of law that there is no coverage for the [u]nderlying [l]awsuits and affirm the Superior Court‘s dismissal of the [c]omplaint.” Appellees stress the plain words of the professional services exclusion and the presence of the term “arising out of” in the professional services claim definition. Specifically, they contend that, “The breadth of the definition . . . assures Carlyle broad coverage for the range of activities it undertakes as part of its private equity operations,” but “it bars coverage for [c]laims ‗arising from‘ the provision of those same services to CCC.” They further maintain that, “[b]ecause the CCC Exclusion excludes “‘[p]rofessional services claims *arising from* [p]rofessional [s]ervices provided to Carlyle Capital Corp.‘ [emphasis in original],

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(…continued)
“industry custom and usage,” as well as “the simultaneous underwriting of the TCG and CCC Programs” and “the CIM-CCC relationship.” They maintain that the trial court erred by failing (in the absence of the benefit of discovery) to understand that the professional services exclusion was an “E&O” (errors and omissions) exclusion and not a “D&O” (directors and officers) exclusion.

the [c]ourt need not determine that literally every allegation in the [u]nderlying [l]awsuits alleges an [i]nsured‘s provision of [p]rofessional [s]ervices to CCC.” They insist that each underlying claim arises from professional services provided to CCC.

Appellees “push back” against appellants‘ arguments by stressing the broad definition of professional services, which they claim is unambiguous. They declare that, “the breadth of the definition of [p]rofessional [s]ervices” simply bolsters the Superior Court‘s conclusion that whatever phrases like ‘management services‘ and ‘professional services‘ might mean in the abstract and out of context, as used in the [p]olicy, they easily encompass both ‘operational management‘ and ‘corporate governance‘ services.” Moreover, appellees agree with the trial court that whether CCC, “at any given point in time, was a [f]und, [o]rganization or some other form of entity relevant to the [p]olicy‘s definition of [p]rofessional [s]ervices,” is irrelevant, because “the CCC Exclusion explicitly provides that it applies to all [p]rofessional [s]ervices ‘provided to CCC.‘”

ANALYSIS

Standard of Review

―We review *de novo* the trial court‘s dismissal of a complaint under Super. Ct. Civ. R. 12 (b)(6).” *Logan v. LaSalle Bank Nat'l Ass'n*, 80 A.3d 1014, 1019 (D.C. 2013) (citation omitted). In this notice pleading jurisdiction, which has ―adopted the pleading standard[s] articulated by the Supreme Court,” *Equal Rights Ctr. v. Properties Int'l*, 110 A.3d 599, 602 (D.C. 2015) (per curiam), a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face.” *Logan*, *supra*, 80 A.3d at 1019 (citing *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009)) (internal quotation marks omitted); *see also Comer v. Wells Fargo Bank*, 108 A.3d 364, 371 (D.C. 2015) (―to survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face.”) (internal quotation marks and citation omitted). ―Bare allegations of wrongdoing that are no more than conclusions are not entitled to the assumption of truth, and are insufficient to sustain a complaint.” *Logan*, *supra*, 80 A.3d at 1019 (citing *Iqbal*, *supra*, 556 U.S. at 679). ―However, [w]hen there are well-pleaded factual allegations, a court should assume their veracity and then determine whether they plausibly give rise to an entitlement to relief.” *Id*. (internal quotation marks and citation omitted). We draw all inferences from the factual allegations of the complaint in the plaintiff‘s favor. *Equal Rights Center*, *supra*, 110 A.3d at 603 (citing *Grayson v. AT&T Corporation*, 15 A.3d 219, 288 (D.C. 2011) (en banc)). ―A complaint should not be dismissed because a court does not believe that a plaintiff will prevail on [its] claim[;] [i]ndeed it may appear on the face of the pleadings that a recovery is very remote and unlikely but that is not the test." *Logan*, *supra*, 803 A.3d at 1019 (citing *Grayson*, *supra*, 15 A.3d at 229 (internal quotation marks omitted)). "Dismissal is proper only where it appears, beyond doubt, that the plaintiff can prove no facts which would support the claim." *Schiff v. American Ass'n of Retired Persons*, 697 A.2d 1193, 1196 (D.C. 1997) (citations omitted).

Discussion

In this "private equity management and professional liability insurance" contract case, that the trial court dismissed under Rule 12 (b)(6) and that involves a demand for a declaratory judgment indicating that appellants are entitled to coverage for defense costs and for settlements and judgments, we are unable to agree with the trial court and appellees that appellants did not state a claim to relief that is plausible on its face because, as a matter of law, the policy's professional services exclusion is so broad and unambiguous that it precludes any coverage pertaining to appellants' defense of underlying lawsuits filed against them by Mr. Huffington, NIG, the CCC liquidators, and shareholders. Before explaining our conclusion, we set forth legal principles governing insurance contract interpretation.

Legal Principles Governing Interpretation of the Insurance Policies

Contract principles are applicable to the interpretation of an insurance policy. *Stevens v. United Gen. Title Ins. Co.*, 801 A.2d 61, 66 (D.C. 2002) (citation omitted). “The proper interpretation of a contract, including whether a contract is ambiguous, is a legal question, which this court reviews *de novo*.” *Tillery v. District of Columbia Contract Appeals Bd.*, 912 A.2d 1169, 1176 (D.C. 2006) (citation omitted). This court “adheres to an objective law of contracts, meaning that the written language embodying the terms of an agreement will govern the rights and liabilities of the parties regardless of the intent of the parties at the time they entered the contract, unless the written language is not susceptible of a clear and definite meaning.” *Aziken v. District of Columbia*, 70 A.3d 213, 218-19 (D.C. 2013) (quotation marks and citation omitted). “The writing must be interpreted as a whole, giving a reasonable, lawful, and effective meaning to all its terms, and ascertaining the meaning in light of all the circumstances surrounding the parties at the time the contract was made.” *Debnam v. Crane Co.*, 976 A.2d 193, 197 (D.C. 2009) (internal quotation marks and citation omitted). “Where the contract language is not susceptible of a clear and definite meaning—i.e., where the contract is determined by the court to be ambiguous—external evidence may be admitted to explain the surrounding circumstances and the positions and actions of the parties at the time of contracting.” *Aziken*, *supra*, 70 A.3d at 219 (internal quotation marks and citation omitted).

“[I]f the provisions of the contract are ambiguous, the correct interpretation becomes a question for a factfinder.” *Debnam*, *supra*, 976 A.2d at 197-98. However, “a contract is not ambiguous merely because the parties do not agree over its meaning, and courts are enjoined not to create ambiguity where none exists.” *Tillery*, *supra*, 912 A.2d at 1177 (internal quotation marks and citation omitted). Generally, we “determine what a reasonable person in the position of the parties would have thought the disputed language meant.” *Travelers Indem. Co. v. United Food & Commercial Workers Int'l Union*, 770 A.2d 978, 986 (D.C. 2001) (internal quotation marks and citation omitted). We also examine the document on its face, giving the language used its plain meaning, unless, in context, it is evident that the terms used have a technical or specialized meaning.” *Interstate Fire & Cas. Co. v. Washington Hosp. Ctr. Corp.*, 758 F.3d 378, 383 (D.C. Cir. 2014) (citing *Beck v. Continental Cas. Co.* (*In re May*), 936 A.2d 747, 751 (D.C. 2007)) (internal quotation marks omitted). We follow “[t]he general rule applicable in the interpretation of an insurance policy . . . that, if its language is reasonably open to two constructions, the one most favorable to the insured will be adopted.” *Chase v.*

State Farm Fire & Cas. Co., 780 A.2d 1123, 1127 (D.C. 2001).

The Contract's Definition of Professional Services

Here, the definition of “professional services” in the insurance contract at issue is not a simple one; nor are the corporate structure of CCC and the underlying complaints simple. The professional services definition consists of eight subparts and is not easy to interpret, although it generally uses ordinary words. Significantly, important terms are not defined, including “investment management services” and “management services,” although terms such as “management control” are defined. The definition of professional services makes no mention of other important terms such as “corporate governance” and whether that is subsumed under the concept of “management services.” Still other terms which are used repeatedly in the subparts of the definition, including “fund,” “organization,” and “portfolio entity,” are not defined, and there are no discovery documents or depositions bearing on their meaning. Nevertheless, principles of contract interpretation require that we interpret the policy “as a whole, giving a reasonable, lawful, and effective meaning to all its terms, and ascertaining the meaning in light of all the circumstances surrounding the parties at the time the contract was made.” *Debnam*, *supra*, 976 A.2d at 197. Thus, we cannot, as appellees urge in support of the trial court‘s approach, declare some parts of the professional services definition as “irrelevant,” instead of allowing the case to proceed to discovery so that the court may have the benefit of “the surrounding circumstances and the positions and actions of the parties at the time of contracting.” We believe that the term “professional services” as used in the insurance policy is reasonably open to more than one construction, and hence, the one most favorable to the insured must be adopted. *Chase*, *supra*, 780 A.2d at 1127. In short, we hold that the definition of professional services in appellants‘ private equity management and professional liability insurance contract is ambiguous, *Aziken*, *supra*, 70 A.3d at 219, and thus, the correct interpretation [of the professional services definition and the contract] [is] a “question for a factfinder,” *Debnam*, *supra*, 976 A.2d at 197-98.

Review of the Underlying Claims and the Duty to Defend

There is another reason why we are constrained to reverse the trial court‘s Rule 12 (b)(6) judgment in this case. Based on the record before us, we cannot be sure that at the early Rule 12 (b)(6) phase of the litigation, the trial court applied legal principles governing not only the disposition of Rule 12 (b)(6) motions, but also pertinent legal principles governing both the duty of an insurance company to defend the insured and the obligation of the trial court to compare the underlying complaints with the insurance contract. We previously indicated that the trial court must accept as true the factual allegations in a well-pleaded complaint and must not dismiss the complaint because the court believes that recovery by an appellant is very remote and unlikely. *See Logan*, *supra*, 80 A.3d at 1019; *Equal Rights Ctr.*, 110 A.3d at 603. We now set forth other pertinent and applicable legal principles.

Applicable Legal Principles

To determine whether an insurance company has the duty to defend an insured, this court examines both the underlying complaint and the insurance policy. *Stevens*, *supra*, 801 A.2d at 66; *see also Fogg v. Fidelity Nat'l Title Ins. Co.*, 89 A.3d 510, 512 (D.C. 2014) (this court applies the “eight corners rule” set forth in *Stevens*, *supra*,—compare the four corners of the complaint with the four corners of the insurance policy). We must construe the underlying complaints in favor of the insured. *Adolph Coors Co. & Brewing Co. v. Truck Ins. Exch.*, 960 A.2d 617, 623 (D.C. 2008). “If the allegations of the complaint state a cause of action within the coverage of the policy the insurance company must defend.” *Stevens*, *supra*, 801 A.2d at 66 n.5. “The duty to defend is broader than the duty to indemnify, and an insurer may have to defend before it is clear whether there is a duty to indemnify.” *Centennial Ins. Co.*, *v. Patterson*, 564 F.3d 46, 50 (1st Cir. 2009) (citation omitted).

If there is no duty to defend, there is no duty to indemnify. *Massamont Ins. Agency, Inc. v. Utica Mut. Ins. Co.*, 489 F.3d 71, 75 (1st Cir. 2007) (citation omitted).

If a professional liability policy contains policy exclusions, the policy ―do[es] not insure against all liability incurred by the insured.” *See Zurich Am. Ins. Co. v. O’Hara Reg’l Ctr. for Rehab.*, 529 F.3d 916, 924 (10th Cir. 2008). However, ―exclusions from coverage are to be strictly construed, and any ambiguity in the exclusion must be construed against the insurer.” *Hakim v. Massachusetts Insurers’ Insolvency Fund*, 675 N.E. 2d 1161, 1165 (Mass. 1997) (internal quotation marks and citation omitted). ―Where an insurer attempts to avoid liability under an insurance policy on the ground that the loss for which recovery is sought is covered by some exclusionary clause, the burden is on the insurer to prove the facts which bring the case within the specified exception.” *Cameron v. USAA Property & Cas. Ins. Co.*, 733 A.2d 965, 968 (D.C. 1999).

―When the underlying lawsuit alleges injuries resulting from the provision of both professional services and non-professional services, a professional services exclusion does not negate the . . . duty to defend.” *National Cas. Co. v. Western World Ins. Co.*, 669 F.3d 608, 615 (5th Cir. 2012) (citation omitted). ―[P]rofessional services exclusions do not limit insurers‘ duty to defend lawsuits alleging injuries that result in part from the performance of administrative tasks…." *Id*. at 616.

The Claims in the Underlying Lawsuits

On the record in this case and at the Rule 12 (b)(6) phase of the litigation, we have substantial doubt as to whether the trial court properly applied the “eight corners rule” in determining whether appellees had the duty to defend appellants. We certainly agree with the trial court that it is not required “to scrutinize each count in each complaint with a dictionary in one hand and The Chicago Manual of Style in the other” in reviewing the underlying complaints. However, more than a cursory review of the underlying complaints and the policy exclusion is required in this case, and it must be clear, without sweeping generalizations, that all claims in the underlying complaints fall squarely within the professional services exclusion, and thus, as a matter of law appellants have not stated a claim for relief that is plausible on its face, *Logan*, *supra*, 80 A.3d at 1019, and they can prove no set of facts which would support their claim for defense costs, *Schiff*, *supra*, 697 A.2d at 1196.

The underlying amended CCC liquidators complaint covers approximately 121 pages and raises nineteen individual claims against CCC‘s directors, CIM, and

Carlyle; these claims pertain to alleged breach of fiduciary and other duties, breach of fiduciary duty as a de facto or shadow director, wrongful trading under Guernsey law, breach of contract, gross negligence or negligence, unjust enrichment, and the claim for the return of CCC's books and records and other property. It is not clear from the trial court's order why all aspects of these claims, as pled, fall under the policies' professional services exclusion, as a matter of law, given our conclusion that the professional services definition is ambiguous. With respect to the Huffington complaint, filed first in Massachusetts and then in Delaware, it is not clear from the trial court's order, as appellants contend, why misstatements and omissions of material fact made after Mr. Huffington's investment took place, fall under the professional services exclusion, as a matter of law. The same may be said with respect to the shareholders complaint.

Accordingly, for the foregoing reasons, we vacate the trial court's order of dismissal and remand this case to the trial court for discovery, and for dispositive motions or trial.

So ordered.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

BEAZLEY INSURANCE COMPANY, INC.,

Plaintiff,

-v-

ACE AMERICAN INSURANCE COMPANY, et al.,

Defendants.

15-cv-5119 (JSR)

OPINION

JED S. RAKOFF, U.S.D.J.

This dispute concerns which of NASDAQ's insurers is obligated to provide NASDAQ coverage in connection with an underlying class action that was filed against NASDAQ in the aftermath of the troubled Facebook IPO in May 2012 (the "Facebook Class Action"). By "bottom-line" order dated October 20, 2015, this Court granted plaintiff's motion for partial summary judgment as to Count One against defendant ACE American Insurance Company. The Court also granted in part and denied in part defendants' motions to dismiss. This Opinion explains the reasons for those rulings.

By way of background, plaintiff Beazley Insurance Company, Inc. ("Beazley") was the first-layer excess errors and omissions ("E&O") insurer to NASDAQ during the relevant time. Beazley issued Excess Insurance Policy No. V15NOP120401 to NASDAQ OMX Group, Inc. for the policy period of January 31, 2012 to January 31, 2013 (the "Beazley E&O Policy"). Non-party Chartis Specialty Insurance Company ("Chartis") was NASDAQ's primary E&O insurer during the relevant time and issued NASDAQ OMX Group, Inc., an errors and omissions insurance policy for the same policy period ("the Chartis E&O Policy"). The E&O policies provided NASDAQ with coverage, in relevant part, for "Damages resulting from any Claim . . . for any Wrongful Act . . . solely in rendering or failing to render Professional Services." Compl., Ex. C. § 1.I. The Beazley E&O Policy followed the form of the Chartis E&O Policy and provided its own excess coverage of $15 million once Chartis's limit of liability was exhausted.

Defendant ACE American Insurance Company ("ACE") was the primary directors and officers ("D&O") liability insurer for NASDAQ during the relevant period. ACE issued ACE Advantage Management Protection Policy No. DON G21666944 010 to NASDAQ OMX Group, Inc. for the policy period of January 31, 2013 to January 31, 2014 (the "ACE D&O Policy").[1] The ACE D&O Policy has a $15 million limit of liability. Defendant Illinois National Insurance Company ("INIC") was NASDAQ's first-layer excess D&O insurer during the relevant time. INIC issued Excess Edge Policy No. 01-656-32-59 to NASDAQ for the policy period of January 31, 2013 to January 31, 2014 (the "INIC D&O Policy"). The INIC D&O Policy follows the form of the ACE D&O Policy and provides excess insurance above that policy's $15 million limit of liability. However, the ACE D&O Policy contains a policy

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[1] ACE acknowledged in an October 8, 2013 letter to NASDAQ that the underlying class action against NASDAQ qualified as a "Prior Covered Claim" under the ACE D&O Policy, and ACE does not contend otherwise in this litigation. *See* Compl., Ex. F.

exclusion "for that portion of Loss on account of any Claim . . . by or on behalf of a customer or client of [NASDAQ], alleging, based upon, arising out of, or attributable to the rendering or failure to render professional services."[2] Compl., Ex. D, § III (as amended by Endorsement Nos. 10 and 19). This litigation turns on the scope of that policy exclusion (the "Professional Services exclusion").

In 2012, Facebook opted to list its shares on NASDAQ -- a choice that was initially perceived as a coup for that exchange. Amid much fanfare and strong demand, Facebook went public on May 18, 2012. The honeymoon ended abruptly on the day of the IPO when trading was allegedly marred by significant technical problems as a result of widespread NASDAQ system failures.

Shortly thereafter, dozens of plaintiffs across the country filed suit against various participants in the IPO. On October 4, 2012, the MDL Panel centralized 41 actions relating to the Facebook IPO in the Southern District of New York before Judge Sweet, including ten actions brought against NASDAQ by NASDAQ members and by retail investors in Facebook, alleging federal securities violations and negligence. *See In re: Facebook, Inc., IPO Sec. & Deriv. Litig.*, 899 F. Supp. 2d 1374, 1377 (J.P.M.L. 2012); *In re Facebook, Inc., IPO Sec. & Deriv. Litig.*, 288 F.R.D. 26, 30 n.3 (S.D.N.Y. 2012). Judge Sweet subsequently consolidated the actions

[2] Though many capitalized terms in the relevant policies are in boldface, the Court has chosen not to maintain such bolding in this Opinion, as it is immaterial to the contractual interpretation.

brought against NASDAQ into a separately consolidated action for pretrial proceedings. 288 F.R.D. at 30.

On April 30, 2013, a consolidated amended class action complaint (the "CAC") was filed against NASDAQ parties on behalf of a putative class of all persons "that entered premarket and aftermarket orders to purchase and/or sell the common stock of Facebook . . . on May 18, 2012 . . . in connection with Facebook's initial public offering . . . and who thereby suffered monetary losses" as a result of the NASDAQ defendants' alleged misconduct. Compl., Ex. A at 1. The CAC was brought by a "Securities Class" alleging violations of the federal securities laws and a "Negligence Class" alleging claims for common law negligence. *See id.*

According to the CAC, on the day of the Facebook IPO, NASDAQ could not timely execute pre-market orders as a result of known system limitations. Rather than suffer the embarrassment of delaying trading, NASDAQ opted to resort to an untested backup system. The subsequent "wholesale breakdown in NASDAQ's trading platforms caused Class Members substantial damages by, *inter alia*: (i) causing erroneous and failed trade executions; (ii) blinding Class Members for hours - if not days - as to their then-current positions in Facebook stock due to late and/or missing trade confirmations; (iii) preventing Class Members from executing orders at the National Best Bid/Offer [] prices for Facebook stock as required by SEC Reg. NMS; and (iv) exposing Class Members to related failures of the NASDAQ trading platform, resulting in, among other things, an artificial downward pressure on the price of Facebook's stock." *Id.* ¶ 15. The CAC also alleged that the NASDAQ defendants "negligently designed, developed, tested, and implemented NASDAQ's IPO Cross software and, as a result, breached their common law duty of care to Class Members in connection with the listing and trading of Facebook's IPO." *Id.* ¶ 40.

On or about May 13, 2013, NASDAQ's insurance broker provided notice of the Facebook Class Action to Chartis, Beazley, ACE, and INIC, among other insurers. *See* Pl.'s Rule 56.1(a) Statement, ¶ 59.[3] According to plaintiff's complaint, Chartis, which (as noted) insures NASDAQ for claims arising "solely in rendering or failing to render Professional Services," issued a reservation of rights letter and agreed to advance defense costs under its primary E&O policy. Compl., ¶ 36. Beazley, for its part, accepted potential coverage under its excess E&O policy, subject to a reservation of rights. Declaration of Carrie Parikh dated July 31, 2015 ("Parikh Decl.") at ¶ 2, ECF No. 23. ACE, however, disclaimed coverage, relying primarily on the Professional Services exclusion.

In April 2015, NASDAQ settled the Facebook Class Action for $26.5 million. In connection with that settlement, NASDAQ entered into an agreement with Beazley that required Beazley to contribute the full $15 million limit of liability on its excess E&O policy within ten business days of final approval of the settlement and by

[3] Facts recited here that are pertinent to plaintiff's motion for partial summary judgment are undisputed.

which NASDAQ assigned to Beazley its claims against ACE and INIC in connection with the CAC. *Id.* ¶ 5; Compl. ¶ 5. On June 25, 2015, Judge Sweet issued an order preliminarily approving the settlement. *See* Parikh Decl. ¶ 5. A fairness hearing was held before Judge Sweet on September 16, 2015, and the settlement received final approval on November 9, 2015. *See* Order and Final Judgment, *In re: Facebook, Inc., IPO Sec. and Deriv. Litig.*, 12-md-2389, ECF No. 373.

On June 30, 2015, Beazley filed the instant action against ACE and INIC, bringing five causes of action. Beazley's first cause of action seeks a declaratory judgment that NASDAQ is entitled to coverage for defense costs under defendants' D&O policies in connection with NASDAQ's defense of the CAC.[4] Beazley's second cause of action seeks a declaratory judgment that NASDAQ is entitled to indemnity coverage under defendants' D&O policies in connection with the CAC. Beazley's third and fourth causes of action seek indemnification and contribution from defendants, respectively, for amounts that Beazley paid in connection with the CAC settlement that Beazley alleges should have been paid by defendants. Beazley's fifth cause of action -- brought in its capacity as NASDAQ's assignee -- seeks damages for defendants' alleged breach of their insurance policies with NASDAQ.

[4] Under the ACE D&O Policy, "the Insurer shall, no later than quarterly, advance on behalf of the Insureds covered Defense Costs which the Insureds have incurred in connection with Claims made against them, prior to disposition of such Claims." Compl., Ex. D, § X.E.

On July 31, Beazley moved for partial summary judgment against ACE on Count One, seeking a declaratory judgment that ACE is obligated to cover NASDAQ's defense costs under the ACE D&O Policy. Simultaneously, ACE and INIC moved to dismiss the complaint in its entirety.

Turning first to Beazley's motion, under Rule 56(a) of the Federal Rules of Civil Procedure "[t]he court shall grant summary judgment if the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." Fed. R. Civ. Proc. 56(a).

Under New York law,[5] to determine whether an insurer owes a duty to advance defense costs, courts apply the same standard used to assess whether an insurer owes a duty to defend. *See Lowy v. Travelers Prop. & Cas. Co.*, 2000 WL 526702, at *2 n.1 (S.D.N.Y. May 2, 2000) ("[T]here is no relevant difference between the allegations that trigger an insurer's duty to defend and the allegations that trigger an insurer's obligation to pay defense expenses."). Furthermore, an "insurer's duty to defend and to pay defense costs . . . must be construed broadly in favor of the policyholder," *Admiral Ins. Co. v. Weitz & Luxenberg, P.C.*, 2002 WL 31409450, at *3 (S.D.N.Y. Oct. 24, 2002), while policy exclusions "are to be accorded a strict and narrow construction," *Pioneer Tower Owners Ass'n v. State Farm Fire & Cas. Co.*, 908 N.E.2d 875, 877 (2009)

[5] The parties agree that New York law applies to the policies at issue.

(citation omitted). Indeed, the New York Court of Appeals "has specifically held that for an insurer to be relieved of the duty to defend based on a policy exclusion, it 'bears the heavy burden of demonstrating that the allegations of the complaint cast the pleadings wholly within that exclusion [and] that the exclusion is subject to no other reasonable interpretation . . . .'" *Cont'l Cas. Co. v. JBS Const. Mgmt., Inc.*, 2010 WL 2834898, at *2 (S.D.N.Y. July 1, 2010) (quoting *Frontier Insulation Contractors, Inc. v. Merchs. Mut. Ins. Co.*, 91 N.Y.2d 169, 175 (1997)).

In disclaiming coverage for defense costs, ACE relies on the Professional Services exclusion in its D&O policy, which provides that "[ACE] shall not be liable for that portion of Loss on account of any Claim . . . by or on behalf of a customer or client of [NASDAQ], alleging, based upon, arising out of, or attributable to the rendering or failure to render professional services." Compl., Ex. D, § III (as amended by Endorsement Nos. 10 and 19). ACE does not dispute that the CAC constitutes a "Claim" under its D&O policy that would be covered but for the Professional Services exclusion.[6]

[6] Insuring Agreement B of the ACE D&O Policy provides coverage for "all Loss for which [NASDAQ] has indemnified [its directors and officers] and which [those directors and officers] have become legally obligated to pay by reason of a Claim . . . for any Wrongful Acts." Insuring Agreement C provides coverage for "all Loss for which [NASDAQ] becomes legally obligated to pay by reason of a Securities Claim . . . for any Wrongful Acts." The Policy defines "Claim" to include a "written demand for monetary damages" and a "civil . . . proceeding . . . for monetary damages." "Loss" is defined to include "Defense Costs," which in turn is defined as "reasonable and necessary costs, charges, fees and expenses incurred by any Insured in defending Claims." It is true that INIC, in its

Rather, it argues (1) that the CAC was not brought "by or on behalf of a customer or client of [NASDAQ]," and (2) that the claims in the CAC are not "alleging, based upon, arising out of, or attributable to the rendering or failure to render professional services."

Neither "customer or client" nor "professional services" is defined in the ACE D&O Policy. Beazley argues that "NASDAQ's customers are the individual companies that choose to list on the NASDAQ exchange and its members, the so-called market makers, through which retail investors may purchase and sell stock listed on the NASDAQ exchange," rather than the retail investors themselves. Beazley Opening Br. at 20, ECF No. 24. ACE, on the other hand, argues that retail investors in companies listed on NASDAQ's exchange (such as Facebook) are indeed "customer[s] or client[s]" of NASDAQ because "each [investor] purchased a service from NASDAQ . . . through a Member," "direct[ing] a transaction in Facebook Stock using the NASDAQ exchange," and because NASDAQ receives a fee for

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motion to dismiss, argues that the CAC is not a "Securities Claim" because "the emphasis throughout the definition [of 'Securities Claim'] . . . is on the Company's securities," and the CAC does "not involve NASDAQ securities." INIC Reply Br. at 3, ECF No. 50. However, this argument disregards the plain language of Insuring Agreement C, which provides that a Securities Claim is "*any* Claim . . . alleging a violation of any federal . . . rule or statute . . . regulating securities, *including but not limited to* the purchase or sale of, or offer to purchase or sell, or solicitation of any offer to purchase or sell, any securities issued by the Company . . . ." Compl., Ex. D, § II.O (as amended by Endorsement No. 12) (emphasis added). There can be no serious argument (and none is offered) that the CAC does not constitute a "Claim . . . alleging a violation of any federal . . . rule or statute . . . regulating securities."

each transaction. ACE Reply Brief in Support of Mot. to Dismiss at 7, ECF No. 44.[7]

Given that the ACE D&O Policy is silent as to the meaning of "customer or client" in the Professional Services exclusion, both parties look outside the D&O Policy to shore up their arguments. Beazley notes the obvious point that not all end users of goods or services are "customers" of every goods or services provider in a distribution chain, and ACE responds with the equally self-evident point that a retail investor can be the "customer or client" of more than one service provider. ACE further argues that basic agency principles dictate that retail investors can simultaneously be the "customer[s] or client[s]" of multiple service providers -- in this case, both their brokers (*i.e.*, their agents) and NASDAQ. But ACE fails to establish why "customer[s] or client[s]" *must* include retail investors in the context of this policy exclusion. Indeed, none of these observations does anything to resolve the ambiguity in the D&O Policy as to the scope of the exclusion.[8]

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[7] Because the application of the Professional Services exclusion is thoroughly briefed in defendants' motions to dismiss as well as on plaintiff's motion for partial summary judgment, the Court draws on the (largely overlapping) arguments made in both sets of papers.

[8] The parties also marshal purportedly dueling dictionary definitions that are not actually at odds or particularly helpful. *Compare* ACE Opp. Br. at 8, ECF No. 38 (a customer is "one that purchases a commodity or service" (quoting MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 214 (10th ed. 1998))), *with* Beazley Reply Br. at 6, ECF No. 45 (a customer is a "person or organization that buys goods or services from a store or business" (quoting Oxford Online Dictionary, http://www.oxforddictionaries.com/us/definition/american_english/customer)).

The parties' discussion of industry usage is more pertinent. Beazley focuses on the "Accommodation Plan" that NASDAQ submitted to the SEC in the aftermath of the Facebook IPO in an effort to compensate its members for the system failures that day. In the Accommodation Plan, NASDAQ explained that its "business and legal relationships are with its members, not its members' customers [and that] *Nasdaq has no contractual or other relationships with its members' customers* . . . ." Declaration of Kevin F. Kieffer dated July 31, 2015, Ex. 10 at 45712 (emphasis added), ECF No. 22-10.

ACE, less convincingly, observes that the CAC itself appears to conceive of retail investors in Facebook as "customers" of NASDAQ. The CAC notes on several occasions, for example, that NASDAQ's system failures "prevented the majority of NASDAQ's customer base from knowing their true positions in Facebook." CAC ¶ 8; *see also id.* ¶ 133 ("Defendants . . . put their own business interests ahead of the interests of NASDAQ's customers and members . . . ."); *id.* ¶ 216 ("NASDAQ's customers were forced to carry significant positions in Facebook over the weekend . . . ."). However, the fact that the CAC might allege that the class members are "customers" of NASDAQ does not make it so. More appropriately, ACE also argues that NASDAQ itself has, on occasion, described retail investors as "customers." But the primary example ACE invokes in support of this argument is not very compelling. Specifically, ACE points to the fact that in the context of a proposed rule change, NASDAQ stated:

> The proposed price reduction [for NASDAQ market data and for trading on NASDAQ] is targeted at retaining the business of members that represent retail investors and that redistribute market data to them in a non-professional capacity. NASDAQ believes that this proposal thereby promotes NASDAQ's and the Commission's goal of better serving long-term, retail investors and restoring confidence in public capital markets. The participation of these investors in NASDAQ's market benefits NASDAQ, its listed companies, its market quality, and the quality of its data products. The proposal is also a competitive response to other trading venues that have used price discounts to entice firms to shift order flow and data consumption, and that may continue to do so in the future. In short, NASDAQ is attempting to compete on price for the business of customers that are highly valued to NASDAQ and important to the health of U.S. capital markets.

Affirmation of Daniel W. London dated Aug. 14, 2015, Ex. F at 3, ECF No. 35-6.

But at best, the reference to "customers" in the last sentence of the passage is ambiguous. Indeed, the reference is more fairly read, in context, to refer to NASDAQ's members.

On balance, the Court is in agreement with Beazley that interpreting "customer[s] or client[s]" to exclude retail investors in a public company listed on NASDAQ is at least one reasonable interpretation of the ACE D&O Policy. As a consequence, ACE has failed to satisfy its "heavy burden of demonstrating that . . . that the [Professional Services] exclusion is subject to no other reasonable interpretation" than the one it has proffered to disclaim coverage, and ACE was therefore obligated to provide NASDAQ with defense costs coverage in connection with NASDAQ's defense of the

CAC.[9] Because, moreover, the Court grants partial summary judgment on Count One against ACE on this basis, it need not at the present time reach the issue of whether the claims in the CAC are "alleging, based upon, arising out of, or attributable to the rendering or failure to render professional services."

The Court now turns to defendants' many arguments for dismissing the complaint. To survive a motion to dismiss, a pleading "must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). With respect to those arguments made under Rule 12(b)(6), the Court must draw all reasonable inferences in plaintiff's favor and accept as true all well-pleaded factual allegations in its complaint. *In re Elevator Antitrust Litig.*, 502 F.3d 47, 50 (2d Cir. 2007).

Three of defendants' arguments raised in their motions to dismiss apply to all or several of plaintiff's causes of action, and the Court addresses these arguments at the outset before turning to defendants' claim-specific arguments.

First, for the same reasons that the Court grants plaintiff partial summary judgment on its first cause of action, the Court

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[9] To be clear, the Court is not interpreting "customer[s] or client[s]" to exclude retail investors as a matter of law, as that is not the relevant question for purposes of plaintiff's motion. Defendants are free, with the benefit of discovery, to renew their arguments as to the meaning of "customers or clients" on summary judgment.

rejects defendants' arguments that plaintiff's claims fail because the CAC falls within the scope of the Professional Services exclusion.

Second, in an argument that is only applicable to INIC, INIC argues that Beazley's claims against it are not ripe because a condition precedent to INIC's coverage obligations has not been satisfied.[10] Specifically, under INIC's D&O policy, INIC's coverage obligations "attach . . . only after the Total Underlying Limits [under ACE's D&O policy] have been exhausted through payments by, on behalf of or in the place of [ACE] of amounts covered under [ACE's D&O Policy]." Compl., Ex. E ("Insuring Agreement"). The INIC D&O Policy goes on to state that "[t]he risk of uncollectability of any part of the Total Underlying Limits, for any reason, is expressly retained by the Policyholder . . . ." *Id.* The Court agrees that this provision plainly constitutes a condition precedent to coverage. *See Ali v. Fed. Ins. Co.*, 719 F.3d 83, 91 (2d Cir. 2013) (finding that a substantially similar provision in an excess insurance policy "establishe[d] a clear condition precedent" to coverage that had not been met). Because Beazley does not allege that the ACE D&O Policy

[10] INIC oddly appears to limit the reach of this argument in its opening brief to Beazley's first cause of action for a declaratory judgment. *See* INIC Opening Br. at 20-21, ECF No. 33. In its reply brief, however, INIC casts the argument as a ripeness argument that is applicable to all claims. *See* INIC Reply Br. at 7-8 ("Accordingly, Beazley's claims against Illinois National are premature.")

limits have been exhausted, INIC contends that Beazley's claims are premature.

INIC is half-right. This Court's decision in *Duane Reade, Inc. v. St. Paul Fire & Marine Ins. Co.*, 261 F. Supp. 2d 293 (S.D.N.Y. 2003) is instructive. There, defendant-insurer sought dismissal of the complaint on the ground that its claims were not ripe. Plaintiff's complaint alleged four causes of action, two of which sought damages for breach of contract and two of which sought declaratory relief. *See id.* at 294-95. The insurance policy at issue provided that defendant's payment obligation only arose 30 days after "presentation and acceptance [by defendant] of proofs of loss," which plaintiff had not filed at the time of suit. *Id.* at 295. Because "payment by defendant [was] not yet due," plaintiff's breach of contract claims were premature and the Court dismissed them without prejudice as unripe. *Id.* The Court found that the claims seeking declaratory relief survived, however, because an actual controversy existed between the parties and "judgment on [the declaratory judgment counts would] almost certainly resolve the primary issue in this case as to scope of coverage." *Id.* at 296.

The same logic governs here. As to Beazley's three claims against INIC for indemnification, contribution, and breach of contract, Beazley has jumped the gun and the claims are dismissed as unripe. Beazley's claims against INIC for declaratory relief survive, however, as "there is a substantial controversy, between parties having adverse legal interests, of sufficient immediacy and reality to warrant the issuance of a declaratory judgment" under the Declaratory Judgment Act, 28 U.S.C. § 2201. *Maryland Cas. Co. v. Pac. Coal & Oil Co.*, 312 U.S. 270, 273 (1941).

Third, ACE argues that Beazley lacks standing to bring this action, largely on the basis that because the settlement of the CAC had not yet received final approval from the district court at the time the parties briefed the instant motions, Beazley has failed to allege an actual loss (either on its part or NASDAQ's).[11] While the settlement of the CAC has now received final approval from Judge Sweet, ACE's argument is not moot "[b]ecause a plaintiff's standing to sue is assessed based on facts existing at the time of filing suit." *Sharehold Representative Servs. LLC v. Sandoz Inc.*, 2013 WL 4015901, at *7 (S.D.N.Y. Aug. 7, 2013); *see also Cortlandt St. Recovery Corp. v. Hellas Telecomms.*, 790 F.3d 411, 422 (2d Cir. 2015) ("A court may not permit an action to continue, even where the jurisdictional deficiencies have been subsequently cured, if jurisdiction [was] lacking at the commencement of a suit." (internal quotation marks omitted)). ACE's argument is, nonetheless, erroneous.

Specifically, as to Beazley's first two counts seeking declaratory relief, NASDAQ had already incurred significant defense

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[11] ACE purports to make this argument pursuant to Rule 12(b)(3) of the Federal Rules of Civil Procedure. Rule 12(b)(3) authorizes a party to move to dismiss on the basis of improper venue -- something neither defendant has done. ACE's argument is properly made under Rule 12(b)(1), which authorizes motions to dismiss based on lack of subject-matter jurisdiction.

costs and the settlement of the Facebook Class Action had already received preliminary approval at the time plaintiff filed its complaint. Given that the parties vigorously dispute their coverage obligations, the Court again finds that "there is a substantial controversy, between parties having adverse legal interests, of sufficient immediacy and reality to warrant the issuance of a declaratory judgment" sufficient to invoke the jurisdiction of this Court under the Declaratory Judgment Act. *Maryland Cas. Co.*, 312 U.S. at 273.[12] As for Beazley's three remaining claims, as noted, NASDAQ had already incurred losses in the form of defense costs at the time this suit was commenced. And, in any case, the injury-in-

[12] It is true, as INIC points out, that the general rule is that "until the underlying action is decided, dismissal of an insurance company's declaratory judgment action for indemnity is appropriate." *Specialty Nat. Ins. Co. v. English Bros. Funeral Home*, 606 F. Supp. 2d 466, 472 (S.D.N.Y. 2009). However, this is not a "*per se* rule" and courts have made exceptions to it where the policy animating the rule -- *i.e.*, that the duty to indemnify (in contrast to the duty to defend) often requires consideration of factual disputes -- is not served. *See Atl. Cas. Ins. Co. v. Value Waterproofing, Inc.*, 918 F. Supp. 2d 243, 261-62 (S.D.N.Y. 2013) (finding exception to rule where policy purpose was not served). That is the case here, where the dispute between the parties turns on the proper interpretation of the "Professional Services" exclusion -- a question of law that will not necessarily require the consideration of factual disputes.

INIC also appears to argue that the Court lacks subject-matter jurisdiction because a claim for indemnification requires a finding of liability, and the Stipulation of Settlement in the Facebook Class Action states that it "shall not be construed as . . . an admission or concession on the part of [NASDAQ] . . . of any fault or liability." INIC Opening Br. at 17, ECF No. 33. This argument is borderline frivolous, as the defendants' D&O policies indisputably insure NASDAQ for "Loss," which is defined to include settlements. As such, defendants' duty to indemnify is implicated by the settlement of the CAC unless the Professional Services exclusion is triggered.

fact requirement under the Supreme Court's standing doctrine does not require injury that has already occurred, but rather a "concrete and particularized" injury that is "actual *or* imminent, not conjectural or hypothetical." *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992) (emphasis added) (internal quotation marks omitted). "An allegation of future injury may suffice if the threatened injury is 'certainly impending,' or there is a 'substantial risk' that the harm will occur." *Susan B. Anthony List v. Driehaus*, 134 S. Ct. 2334, 2341 (2014) (internal quotation marks omitted). Here, there is nothing conjectural or hypothetical about NASDAQ and Beazley's loss. To the contrary, at the time Beazley filed its complaint, the settlement of the CAC had garnered preliminary court approval, such that the threatened injury was imminent. Moreover, the settlement, as noted, has now been finally approved, and "[a]lthough a plaintiff's standing is 'assessed as of the time the lawsuit is brought,' post-filing events may confirm that a plaintiff's fear of future harm is reasonable." *Baur v. Veneman*, 352 F.3d 625, 638 (2d Cir. 2003) (citation omitted).

The remainder of defendants' arguments in support of their motions to dismiss are claim-specific and addressed in turn.

Defendants argue that Beazley's third cause of action, seeking indemnification from ACE and INIC for the amounts it has paid or agreed to pay on behalf of NASDAQ, but for which the defendants are allegedly principally liable, is not cognizable under New York law. To state a common law indemnity claim, Beazley must plead a breach of duty by defendants to NASDAQ, as well as a duty running from defendants to Beazley. *See Perkins Eastman Architects, P.C. v. Thor Eng'rs., P.A.*, 769 F. Supp. 2d 322, 329 (S.D.N.Y. 2011) ("[A] cause of action for common-law indemnification can be sustained only if: (1) the party seeking indemnity and the party from whom indemnity is sought have breached a duty to a third person, and (2) some duty to indemnify exists between them."). "[A] valid claim for indemnity requires, at the very least, that the party seeking indemnification was held liable to the injured party." *Tokio Marine & Nichido Fire Ins. Co. v. Calabrese*, 2013 WL 752259, at *19 (E.D.N.Y. Feb. 26, 2013). Beazley has not pleaded a duty running from defendants to Beazley, nor has it even briefed the elements of the claim. Moreover, according to its own pleading, Beazley has not been "held liable" to any injured party -- rather it pleads that "it has no obligation to [NASDAQ] under the Beazley Policy in connection with the CAC." Compl. ¶ 64. As such, the claim is fatally deficient.

Furthermore, the two cases Beazley cites in support of the viability of its indemnity claim are both unavailing. *Clarendon National Insurance Co. v. Hartford Insurance Co.*, 1998 WL 230936 (S.D.N.Y. May 8, 1998) involved an insurer suing a co-insurer for reimbursement of payments to the insured that were covered under defendant insurer's policy but not plaintiff's, *id.* at *1, but the court never so much as used the term "indemnification." Nor did the court address the elements of a claim for common law indemnification or confront an argument that New York law did not recognize the claim as pleaded.

Beazley also cites a case in which AIG reimbursed an insured roughly $4 million under a theft insurance policy, while defendant-insurer disclaimed coverage. *Luvata Buffalo, Inc. v. Lombard Gen. Ins. Co. of Canada*, 2010 WL 826583, at *1 (W.D.N.Y. March 4, 2010), *report and recommendation adopted sub nom. Luvata Buffalo, Inc. v. AIG Europe, S.A.*, 2010 WL 1292301 (W.D.N.Y. Mar. 29, 2010). AIG sought indemnification from defendant-insurer for its failure to reimburse or indemnify it for any portion of insured's loss, arguing that defendant was the primary insurer for the loss and that AIG was the excess insurer. 2010 WL 826583, at *2-3. The court held that "[w]hether AIG and Lombard are considered co-primary insurers of the loss, or whether AIG is considered to provide excess coverage to Lombard's primary policy for this loss, AIG has standing to seek indemnification against Lombard." *Id.* at *3. However, the cases the court cited in support of that holding were recognizing a cause of action for contribution between co-insurers that were liable for the same loss. *Id.* The case is further distinguishable because AIG did not argue that its policy did not cover the loss at issue *per se*, but rather that its coverage was excess of a primary insurer's that had wrongfully disclaimed coverage. Thus, *Luvata* is inapposite, and the Court finds that New York law does not recognize a cause of action at common law for "indemnification" between insurers under these circumstances. As such, Beazley's third cause of action is dismissed.

Beazley's position, as noted, is "that it has no obligation to [NASDAQ] under the Beazley Policy in connection with the CAC." Compl. ¶ 64. However, with its fourth case of action for contribution, Beazley contends that "in the alternative . . . Beazley and the Defendants insured the same risk [such] that they both are obligated to pay defense costs and indemnify the NASDAQ Parties in connection with the CAC." *Id.*

Under New York law, "when several insurers cover the same risk and payment for loss has been made by one, that carrier has a right to pro rata contribution from other insurers." *State of N.Y. v. Blank*, 27 F.3d 783, 793 (2d Cir. 1994) (citation omitted), *abrogated on other grounds by Ment Bros. Iron Works Co. v. Interstate Fire & Cas. Co.*, 702 F.3d 118, 121-22 (2d Cir. 2012). Defendants argue that they do not insure NASDAQ against the "same risk" as Beazley does, because Beazley provides NASDAQ with E&O coverage while defendants provide NASDAQ with D&O coverage. Moreover, ACE adds, Beazley provides NASDAQ with *excess*-layer coverage while ACE provide NASDAQ with *primary* coverage.

The Court agrees with Beazley that both insurance policies need only be triggered by the same underlying event or action in order for a claim for contribution to lie. In *National Casualty Co. v. Vigilant Insurance Co.*, 466 F. Supp. 2d 533 (S.D.N.Y. 2006), defendant-insurer similarly argued that plaintiff-insurer's policy did not insure against the "same risk" as defendant's because defendant-insurer had a duty to defend while plaintiff-insurer had a duty to reimburse for defense costs. *Id.* at 540-41. Moreover, plaintiff-insurer's policy covered "publishing and advertising liability," while defendant-insurer's policy covered directors' and officers' liability. *Id.* at 537. The court rejected the defendant's argument, however, holding that "[t]o the extent the 'same risk' requirement applies at all in the context of defense obligations, it requires only that both policies be triggered by the same underlying lawsuit." *Id.* at 541; *see also Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Hartford Ins. Co. of Midwest*, 248 A.D.2d 78, 84 (N.Y. App. Div. 1st Dep't 1998) ("The fact that the Hartford policy was a commercial general liability policy, much broader than National Union's, does not establish that the policies did not insure the same risk.").

Significantly, such a rule serves the purposes of contribution, which is "is to accomplish substantial justice by equalizing the common burden shared by coinsurers, and to prevent one insurer from profiting at the expense of others." *Everest Nat. Ins. Co. v. Evanston Ins. Co.*, 2011 WL 534007, at *4 (D. Nev. Feb. 8, 2011). If both the E&O policies and the D&O policies are triggered by the Facebook Class Action, it would confer a windfall on defendants to allow them to escape pro rata contribution simply because their policies are triggered for different reasons.[13]

As for ACE's argument that it insures a different level of risk than Beazley, the cases it relies on are inapt. *United States Fidelity & Guaranty. Co. v. American Re-Insurance Co.*, 20 N.Y.3d 407 (2013) involved the interpretation of an "other insurance" clause and had nothing to do with whether insurers at different levels of risk are immunized from contribution to one another. The others involved the issue of whether an excess insurer was required to contribute prior to the exhaustion of a lower-level policy and related issues of priority between insurers. *See Philadelphia Indem. Ins. Co. v. Emp'rs Ins. Co. of Wausau*, 318 F. Supp. 2d 170, 173 (S.D.N.Y. 2004) ("[T]he cases that recognize an exception to the rule of ratable contribution [under New York law] . . . concern how to effectuate excess clauses that disclose an intent to trump other, merely general, excess clauses."). While Beazley may or may not ultimately be entitled to contribution, its contribution claim is adequately pleaded.

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[13] Admittedly, defendants' position that their policies do not cover the "same risk" as the E&O policies has some surface appeal given that the E&O policies cover risk "solely in rendering or failing to render Professional Services," while the D&O policies *preclude* coverage for any claim "by or on behalf of a customer or client of [NASDAQ] . . . arising out of, or attributable to the rendering or failure to render professional services." The policies need not be mutually exclusive, however. If a claim were brought against NASDAQ by a non-customer or non-client arising out of the rendering of or failure to render "professional services" -- within the meaning of both the E&O and D&O policies -- such a claim would be covered by both Beazley's and defendants' policies.

The Court also rejects defendants' attempt to dismiss Beazley's fifth cause of action for breach of contract in its capacity as an assignee of NASDAQ's contractual rights against defendants.

Defendants first argue in this regard that the ACE D&O Policy's "anti-assignment" clause renders NASDAQ's assignment of its rights to Beazley invalid. That clause provides that "[n]o . . . assignment of interest under this Policy shall be effective except when made by a written endorsement to this Policy which is signed by an authorized representative of the Insurer." Compl., Ex. D, § XXIII. However, it is well settled under New York law that anti-assignment clauses do not prevent an insured from assigning its rights after a claim has accrued. *See Tenneco Chems., Inc. v. Emp'rs Mut. Liab. Ins. Co. of Wis.*, 1977 U.S. Dist. LEXIS 16759, at *7 (S.D.N.Y. Mar. 23, 1977) (holding that "[s]uch clauses do not apply to an assignment of an insurance claim after the loss has occurred" because "[t]he purpose of such provisions is to protect the insurer from any added risks in the event the policy is assigned to a less cautious entity"). To the extent policies purport to limit post-loss assignments, "such assignments are contrary to the public policy of New York." *Id.* at *8.

ACE contends, without citation to any pertinent authority, that NASDAQ's assignment of its rights to Beazley was a *pre-loss* assignment because the settlement of the Facebook Class Action had not received final court approval at the time Beazley filed this action. The Court disagrees, as to so hold would disregard the policy animating the distinction New York courts draw between invalid pre-loss assignments and valid post-loss assignments in the insurance context. As the Second Circuit has explained:

> An assignment could alter drastically the insurer's exposure depending on the nature of the new [policyholder]. "No assignment" clauses protect against any such unforeseen risk. When the loss occurs before the transfer, however, the characteristics of the [assignee] are of little importance: regardless of any transfer the insurer still covers only the risk it evaluated when it wrote the policy.

Globecon Grp., LLC v. Hartford Fire Ins. Co., 434 F.3d 165, 171 (2d Cir. 2006) (quoting *Northern Ins. Co. of N.Y. v. Allied Mut. Ins. Co.*, 955 F.2d 1353, 1358 (9th Cir. 1992)).

Here, the Facebook Class Action was brought against NASDAQ prior to NASDAQ's assignment of its rights against ACE and INIC to Beazley. The Court fails to see how the assignment in any way affected the value of the claims in the CAC or how defendants are prejudiced by it. Indeed, NASDAQ assigned its rights to Beazley in connection with the settlement reached in the Facebook Class Action on April 22, 2015. *See* Compl. ¶ 5. Thus, ACE and INIC "still cover[] only the risk [they] evaluated when [they] wrote the policy." *Globecon Grp.*, 434 F.3d at 171.[14] Under such circumstances, there is

[14] Perplexingly, INIC appears to argue that NASDAQ's assignment of rights to Beazley somehow requires INIC to insure against claims arising under the E&O policies and thereby "imposes new and increased risks upon the D&O insurers." INIC Opening Br. at 13. To the contrary, Beazley pleads that NASDAQ assigned its claims against defendants under the D&O policies to Beazley. It would make no sense for NASDAQ to have assigned its claims under the E&O policies to Beazley.

no basis for treating the assignment at issue as a "pre-loss" assignment.

Next, ACE argues that the $2 million retention in the ACE D&O Policy constitutes a condition precedent to coverage that has not been satisfied, such that Beazley's breach of contract claim must fail. The relevant provision provides that, "the liability of [ACE] shall apply only to that part of Loss which is excess of the applicable Retention amount . . . . Such Retention shall be borne uninsured by the Insureds and at their own risk." Compl., Ex. D, § VIII. But this provision is not a condition precedent to coverage. That ACE is only liable for loss in excess of the retention does not mean that its liability only attaches upon payment of the retention. It would be perverse if an insurer could escape coverage because its insured had sensibly not paid a retention following the insurer's wrongful denial of coverage.

Finally, defendants contend that Beazley has failed to plead the elements of a breach of contract claim. "Under New York law, an action for breach of contract requires proof of (1) a contract; (2) performance of the contract by one party; (3) breach by the other party; and (4) damages." *See Rexnord Holdings, Inc. v. Bidermann*, 21 F.3d 522, 525 (2d Cir. 1994) (footnote omitted).

ACE contends that Beazley fails to allege the precise date, scope, or content of the purported assignment such that the Court can determine whether the assignment is valid and whether Beazley has standing to bring the claim. ACE cites no apposite case in support of the proposition that Beazley need plead the assignment with such specificity to survive a motion to dismiss. In any case, the assignment is not the relevant contract at issue for purposes of the "contract" element of the claim. To the extent discovery reveals that the assignment of rights was somehow ineffective, defendants may pursue this argument on summary judgment.

INIC, for its part, argues that Beazley fails to identify a provision of the D&O policies that was breached, but this contention overlooks that Beazley's entire theory of the case is that defendants wrongfully denied coverage for covered claims under the D&O policies.

As to performance, ACE repackages its argument that NASDAQ failed to satisfy the retention under the ACE D&O Policy, which, according to ACE, is a condition precedent for coverage. This argument fails for the reasons stated above.

As to breach, ACE claims that Beazley has failed to plead breach because ACE has not breached. This circular argument is entirely dependent on the applicability of the ambiguous Professional Services exclusion, which the Court has already found to be an insufficient basis on which to dismiss the complaint at the pleadings stage. Moreover, it would appear ACE did breach its policy in light of its failure to advance defense costs to NASDAQ that the Court has now held it was obligated to advance.

As to damages, ACE contends that NASDAQ is being provided coverage by its E&O insurers and thus has no suffered no damages.

Beazley, as NASDAQ's assignee, cannot stand in a better position than its assignor, so if NASDAQ has no damages on a breach of contract claim against defendants, Beazley has no damages as its assignee. *See Int'l Ribbon Mills, Ltd. v. Arjan Ribbons, Inc.*, 36 N.Y.2d 121, 126 (1975). While Beazley's pleading in this regard is somewhat bare, it is certainly plausible that NASDAQ will not be made whole by its E&O insurers and, thus, has suffered damages as a result of the defendants' allegedly wrongful disclaimers of coverage. If discovery reveals that this is not the case, defendants may have a summary judgment argument; but the Court declines to dismiss the claim on this basis at this early stage.

In summary, for the foregoing reasons, the Court, by Order dated October 20, 2015, granted summary judgment against ACE on Count One, dismissed Count Three with prejudice, dismissed Counts Four and Five as against INIC (but not ACE) without prejudice, and otherwise denied defendants' motions to dismiss.

Dated: New York, NY
December 20, 2015

JED S. RAKOFF, U.S.D.J.

OUTLINE
ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK
D&O CLE PANEL DISCUSSSION
TOPIC: The Y2K that Really Happened (The Impact of Cyber Liability on D&O Liability)

Speakers: (1) R. Damian Brew, Esq., Marsh; (2) John C. Cleary, Esq., Vedder Price; (3) Richard Bortnick, Esq., Traub Lieberman; (4) Steven Barge-Siever, Esq., Krauter & Company
Moderator: Andre E. Harlfinger, Esq., OneBeacon Insurance

Date: May 11, 2016

I Anatomy of a Cyber Data Breach incident (John C. Cleary, Esq.)

- Discovery of a Breach or Incident
- Reporting, Documentation and Evidence Preservation
- Stopping the Attack and Diagnosing the Breach and its Origins
- Complying with Laws and Actual or Implied Duties to Those Affected
- Cooperating with Law Enforcement and Regulators
- Closing out a Breach Incident
- Defending Against Lawsuits
- Improving Security Based on Lessons Learned
- Identifying and Pursuing Those Responsible

II D&O Exposures resulting from a Cyber Data Breach incident (R. Damian Brew, Esq.)

Responding to a Cyber Loss-how should the D&O (and other insurance) coverage be managed?

- Interplay between the coverages
- Unique challenges posed by cyber claims
- Notice of circumstances
- Books and records/security holder derivative demands
- Consent to counsel/vendors
- Dialogue with insurers
- Managing/tracking the costs associated with a cyber event

III Policies which may respond to Cyber Data Breach claims (Richard Bortnick, Esq.)

- Cyber; Tech E&O; E&O; D&O ; Crime; CGL; Property
- Gaps in coverage in traditional (i.e., non-cyber/tech E&O) policies

IV Insurer/Client responses to the increased security threat (Steven Barge-Siever, Esq.)

- How have potential buyers of traditional D&O/Management Liability Insurance responded to the increased threat of cyber breach?
    - Which clients are buying cyber insurance and what are they looking for in their policies?
        - Price buyers? vs. Coverage buyers? What should you present your client?
- With all the competition in the insurance market, what are Insurers focusing on to gain market share?
    - Pricing trends and ranges
    - Pre-breach services and post breach mitigation
    - Claims Trends

Got a Data Breach? Call a Cyber Lawyer First!

By Richard J. Bortnick

Traub Lieberman Straus & Shrewsberry

Introduction

The recent breaches at law firms such as Cravath, Weil Gotshal, Kirkland & Ellis, Sidley Austin, and Jenner & Block, not to mention the Panama Papers, may (or may not) be an anomaly. Either way, the size of a law firm isn't necessarily relevant when it comes to a cyber breach. Whether your company is Fortune 500, middle-market or even a mom and pop, you're at risk of a breach. It doesn't matter whether the intrusion is attributable to malicious activity or simple employee or third-party negligence, the effect is the same. Your clients', customers and employees' sensitive information is at risk.

In many cases, the effect of a cyber incident could be devastating, if not fatal, to your company's reputation - and, by extension, its economic viability.

To whom should you make your first call? A cyber lawyer. Unlike a lay advisor, attorneys bring with them the attorney-client privilege and work product protection in many respects. Although vendors and IT specialists can promote themselves as having the appropriate knowledge and training to teach and implement best practices, they do not possess the critical protections afforded by the attorney-client relationship. In a relatively new space like cyber/privacy (CP), where the law is uncertain and developing, the likely privileges become even more important.

The Importance of Protecting a Business's Reputation

A business's reputation and goodwill can be as valuable as, if not more valuable than, its tangible assets.

In the best of circumstances, bad things can happen. And almost inevitably, affected persons (and business partners) will want to blame (and sue) someone. And a breached entity is an easy target.

There is no "one size fits all" to CP security. Both the nature and the potential magnitude of a CP event are unique to every business, although the crisis management tools designed to avoid, mitigate and remediate a loss of personally identifiable information, personal health information and sensitive commercial information are relatively standard.

Perhaps as or more important, the risks vary with who presents the threat. There are casual hackers, people carrying out vendettas, cyber terrorists and major cybercrime groups. All have different goals, strategies and methods. Indeed, some don't have "goals" in the same sense as other criminals, and do not care what they do to systems they penetrate.

Former Defense Secretary Leon E. Panetta has warned that the U.S. is facing the possibility of a "Cyber-Pearl Harbor" and is increasingly vulnerable to non-U.S. hackers who could dismantle the nation's financial networks, power grid, transportation systems, and government. The term "cyber tsunami" also has been thrown around.

FBI Director Robert Muller anticipates that in the near future, cyber threats could surpass terrorism as the FBI's top priority. "There are only two types of companies, those that have been hacked and those that will be. Even that is merging into one category. Those that have been hacked and those that will be hacked again."

Why Executives Should Be Concerned

For a variety of reasons, many companies' management fail to focus on the fact that they hold third parties' personally identifiable information, personal health information and other sensitive data. It is not that they ignore the associated risks and exposures. Rather, it is simply a function of the fact that they typically are too busy running their business to think about it. But they should. Whether it comes down to questions of being unaware of the risks, penny-wise, pound foolishness, neglect or hypocrisy, too many companies are failing to take the steps necessary to protect themselves - or their clients, customers and employees.

SMEs (and Mid-Size Enterprises) Are Particularly Susceptible to CP Threats

Should you conclude that the above concerns don't apply to you and are unfounded rhetoric designed to lead a company to create and deploy unneeded cyber security strategies, please think again.

According to Jake Kouns of Risk Based Security, "[l]arge data breaches typically get a great deal of media attention and it leads many people to believe that all breaches are substantial in size. Indeed, 91.9% of data breaches have exposed less than 10,000 records." In other words, SMEs are more at risk than large ones. Still, the recent Anthem breach demonstrates how bad it can get for some entities.

Think of it this way. If one were planning to rob a bank, would he or she rob one in the middle of a big city that likely has implemented best practices for both physical and cyber security? Or would he or she choose a small local branch in a remote suburb or exurb. The likelihood of a clean get-away is far greater than in the urban environment.

What if you could accomplish the same successful result tens or hundreds of times over without leaving your desk? You could pick small targets and get in and out of their computer systems before anyone realizes what has occurred. Small pickings are only small until they are multiplied through methods the cyber age makes easy for suitably motivated attackers.

To the point, absent a political or social agenda, most cyber intruders choose not to waste their time trying to penetrate a sophisticated, state of the art security system. It's far easier to compromise an SME that has little to no cybersecurity protection beyond, at most, an off-the-shelf software program.

Regrettably, SMEs typically do not have (and many cannot afford) sophisticated and/or updated security procedures and policies, have not adequately trained their employees on data security, do not maintain dedicated information technology specialists, and may outsource security to unqualified contractors or systems administrators. It's a question of asset deployment. And where assets are limited, so too are the security protections and procedures in place.

A study conducted by Symantec found that 31 percent of cyber attacks were aimed at businesses with 250 employees or fewer. Symantec further reported that 40% of nearly 1.4 billion known global cyber attacks were targeted at companies with 500 or fewer employees.

In short, no company, regardless of its size, is safe. This view is borne out by a recent study cited by the U.S. House Small Business Subcommittee on Health and Technology. The House report found that nearly 20% (a somewhat smaller percentage than Symantec found) of all cyber attacks hit small businesses with 250 or fewer employees. Even more troublesome, roughly 60% of small businesses closed within six months of a cyber attack. Whether the cessation flows from reputational damage and/or the business's inability to afford the high cost of loss mitigation, the result is real and palpable

It bears repeating that bad things happen. Sometimes by accident, sometimes by negligence, and sometimes as the result of malicious conduct. But they happen.

Why Best Practices?

Whether we acknowledge it or not, a breach (or negligent loss of information) is more than possible: as observed by former FBI Director Muller, it's virtually inevitable, leading to the loss of personally identifiable information, personal health information and/or confidential commercial information. And, in many instances, the follow-on lawsuit.

In light of this, it is not an overstatement that the most effective defense to a CP-related lawsuit, whether brought by a private or public entity, is best practices. A favorable outcome is more likely if a company can demonstrate that it implemented prudent security procedures in advance of an incident (or, better yet, state of the art security procedures, although the cost might be prohibitive for small and mid-sized companies ("SMEs")), than it would be if a plaintiff was able to show the deficiencies and flaws in a business's risk management plans and procedures and how it could have employed best practices at a reasonable cost. If a company can demonstrate the use of appropriate best practices, the plaintiff's case potentially falls apart.

What Are Some of the "Best Practices" To Be Considered?

In many ways, cyber-related best practices are similar to those employed in other contexts. Formulate and implement an avoidance/loss mitigation strategy, put into place a crisis response plan, and buy cyber/privacy insurance. Of course, the devil is in the detail, particularly when the devil is sitting at a computer terminal half-way around the world outside the reach of local law enforcement authorities.

There is no way to entirely avoid CP events. Human beings sometimes make mistakes. And the loss of a laptop and/or cellphone, for example, is a mistake made more frequently than one would like to think. You can teach, coax, cajole and use all of the tools at your disposal to keep employees (or yourself) from committing human error. It isn't possible to eliminate the risk entirely, though. Negligence happens.

Similarly, if a sophisticated and intrepid hacker wants to get in, he or she will. There is no magic bullet to prevent it. Ask the FBI. Or the CIA. Or Scotland Yard. They all have been breached.

So, what can a company do in an effort to protect itself from a CP incident or a post-incident lawsuit? It would be trite to say that every situation is unique and that every profession has its own set of best practices. But that doesn't change the dynamic that this statement is accurate. The nature and breadth of risk management, loss avoidance and mitigation, and breach response plans depend on the sector involved, the size of the company, the ubiquity of its technology and office locations, the sophistication of its legal, risk management, IT and other related personnel (if any), and other factors. Still, there are common themes that apply.

The following suggestions should be considered in conjunction with a law firm's analysis of its CP risks and exposures:

(1) At the outset, allocate a portion of your firm's budget to IT and data security. You need to determine how much financial, human and technical resources you can deploy so you can spend them wisely;

(2) Appoint a trusted individual to oversee privacy and security development and compliance as an express component of his or her job responsibility. This person should monitor things such as: (a) applicable laws; (b) contractual obligations; (c) internal policies (email and network integrity, Bring Your Own Device (BYOD) policy and oversight, information security, social media, human resources issues, etc.); (d) compliance programs in which you participate; and (e) industry best practices;

(3) Retain experienced legal counsel with the all-important attached legal privileges to "quarterback" the development of cyber incident avoidance, loss mitigation and breach response plans, provide updates on legal developments, monitor competitors' and others' security practices and procedures, report on significant and specific threats, risks and loss events;

(4) Identify and coordinate your plans with computer forensic consultants and other risk avoidance/crisis management consultants;

(5) Work with your legal advisors and human resources personnel to develop written cybersecurity policies and procedures, then communicate them to and train employees, vendors, etc. in their use and application. Issues to be addressed include statutory and legal responsibilities, privacy and security rules and guidelines for employees and third-party business partners, and encryption (this is essential);

(6) Perform periodic analyses of your security plans, procedures and systems to ensure that they are current and appropriate for your business and business sector. You don't want to enable a competitor to get ahead of you and distinguish the breadth of their security processes and procedures from yours;

(7) Periodically audit your administrative, technical and physical infrastructure, among other assets, to reaffirm that they are properly protected;

(8) Implement a protocol that requires senior management to receive and meaningfully review periodic reports on your firm's current information and technical plans and procedures, security issues, and related matters;

(9) Work with counsel to develop templates and information security tools for use with employees, vendors, and third-party business partners, among others. Such documents could include Non-Disclosure Agreements, Business Associate Agreements under HIPAA, indemnity and insurance agreements, and other legal instruments intended to mitigate or avoid economic loss. These documents should be disseminated to all personnel with contracting authority, who also should receive training; and

(10) Treat your clients' and your own trade secrets, "Big Data," and other critical proprietary information with the same level of care and attention you devote to the preservation and growth of other core assets.

(11) Purchase dedicated cyber/privacy insurance. Over 50 underwriters in the U.S. and London currently are insuring such risks. In conjunction therewith, policyholders should retain and work with a sophisticated broker to navigate the markets and ensure that you obtain the policy that is most appropriate for your business operations.

These examples are simply the first steps to properly secure and protect your clients', employees' and your own personally identifiable information, personal health information and confidential commercial information. And, of course, your company's reputation and the continuing viability of your business.

How Does Cyber/Privacy Insurance Factor Into Best Practices?

A business's management should not be dismayed by the obvious need to allocate resources (financial, human and technical) for the implementation of risk management and risk transfer strategies. It's prudent, cost-effective in the long run, and, quite simply, a question of relativities. A company can pay four or five figures now or risk not being able to afford six or seven figures later.

Regrettably, in many cases, executives assume that their commercial general liability ("CGL") forms cover CP risks. This is a critical mistake. Indeed, more than a few insurance brokers and policyholders misunderstand the extent and limitations of general liability insurance. In particular, many mistakenly believe that advertising and personal injury coverage (typically Part B or Part II of a CGL policy) covers a cyber breach. This view is wrong. For this reason alone, a sophisticated insurance broker is a necessity. You could buy a policy. The right broker can ensure that it's the *right* policy for your business.

Although limited CP-related insurance may be provided by a CGL insurance policy, the lion's share of fees, expenses, and other loss incurred following a CP incident would not be covered. CGL policies cover damage to a third party's tangible property (or person) as well as, in certain situations, advertising and personal injury (if purchased).

In stark contrast, CP insurance (depending on the coverage purchased) will cover not only third-party liability claims, but also will extend to first-party loss (i.e., business interruption, extra expense, extortion threats and the like) as well as the frequently large (and unanticipated) crisis management fees and expenses.

Moreover, the desire to purchase cyber insurance should play a significant positive role in incentivizing the adoption of best practices which, if handled correctly, will reduce the risk of a CP incident - as well as the premium associated with the purchase of CP insurance. The more robust your protections, the lower your premiums. It's a significant and critical risk/benefit analysis.

The attorney wielding the applicable privileges also is the safest conduit to respond to an insurer, as the attorney will be in a position to assimilate the information provided by a client and pass along relevant claim information to a business's insurer. Knowledge, of course, is invaluable. And by providing privileged and non-privileged information to the attorney, the company can be more secure that the privileged information is protected while coloring the attorney's ability to properly advise the insurer of those facts necessary to protect the client's ability to capitalize on the insurance coverage available.

Put differently, those who discount the need for CP best practices and CP insurance should consider this thought: do you want to risk having your CGL coverage exhausted by a cyber breach? Or would you rather preserve the limits of liability for legitimate (or even frivolous) claims? After reading the foregoing, if you were considering increasing the limits of your CGL policy to account for CP risks, why not just use the added premium to buy dedicated and tailored CP coverage and add the available first- party and crisis management protections? Although it may be more expensive than excess CGL coverage (although it's still modest by comparison to other insurance products), the additional coverages available are worth it.

Be Proactive!

Many businesses are taking cyber risks and exposure seriously. Regrettably, it's still too few. But there are solutions.

Best practices training and CP insurance are a practical place to start. An attorney can assist a company in formulating and implementing practical and reasonable steps to protect personally identifiable information, personal health information and confidential commercial information.[i] And, by extension, the company's reputation and, perhaps, financial future. All while maximizing protection against that advice being discoverable through the course of litigation.

To the point, the litigation discovery process is one of the key drivers of the rising costs of litigation. And many cases are won and lost in the discovery stage. When used appropriately, a legitimate privilege can shield troublesome documents and evidence from having to be produced to your opponent. And oftentimes, the proper assertion of privilege and the applicable protections afforded can be outcome determinative.

In the long-run, an experienced, knowledgeable cyber attorney's fees will be markedly cheaper than the cost of having to remediate a CP incident, litigate through discovery with an angry client or third party who claims to have been harmed, and, perhaps, lose at trial because documents that otherwise might have been protected from discovery had to be produced. Indeed, the alternative to receiving advice and counsel from a trusted cyber lawyer could be fatal, especially for a business that trades on its reputation and goodwill. Some businesses already have made the mistake of not doing so and paid the price. Literally. Your company should not be among them.

[i] Although there are as almost as many attacks on the attorney client privilege as there are on data, and while there are no guarantees that it will be enforced, the privilege does exist and is enforced when appropriate.

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