The Veil of Tiers

Shareholder Lawsuits and Strategic Insurance Layers

by Boris Feldman

Shareholder lawsuits are stressful for a number of reasons. They divert management attention from productive endeavors, cost millions to defend and present gargantuan damage exposures. Small wonder, then, that the first question asked by most executives sued in a securities fraud class action is: "How much insurance do we have?" Perhaps a better question, however, would be: "How is our insurance structured?"

In many cases, the manner in which insurance is layered can be as important a factor in the outcome of the litigation as the aggregate amount of coverage. The consequences of layering can affect not only the plaintiffs' expectations, but also relations between the policyholder and its carriers. The "strategic tiering" of directors' and officers' (D&O) insurance is a useful consideration in designing an effective risk management program.

Carrier/Policyholder Relations

We begin by considering the effects of tiering on relations between the defendant company and its insurance carriers.

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This discussion (like the comments throughout) assumes that the lawsuit in question is not an "outlier"—that is, neither a clear case of fraud nor obviously frivolous—but rather a run-of-the-mill case in which the company, although fundamentally honest, has made certain statements (such as overly optimistic earnings projections) that seem inappropriate with the benefit of hindsight.

Until the last year or two, the relationship between carriers and policyholders in a shareholder class action was often quasi-adversarial. A principal source of tension, for instance, was the issue of allocating defense and settlement costs. Because the company's exposure (as opposed to the directors' and officers' exposure) was not insured under most D&O policies, carriers insisted that a substantial portion of the fees and costs be allocated to the company and therefore treated as uninsured. This often led to protracted squabbles over who bore the blame—the directors and officers, or the company.

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A second area of tension historically involved the interim advancement of defense costs. Most D&O policies required the carrier to reimburse the policyholder for legal fees only after the lawsuit was concluded. In many cases, this meant that companies had to spend millions of dollars defending a case, often for several years, without any help from the carrier.

A third factor in this dynamic was the threat of non-coverage. Some carriers took the position that, if the company felt it had a serious exposure in the suit, then one of the exclusions (e.g., for "dishonest conduct") would probably kick in, obviating any need for the carrier to pay. Some carriers would routinely assert the possibility of rescinding the policy, based on some amorphous misrepresentations in the application process.

A fourth factor that often marked shareholder litigation was the near-invisibility of excess carriers. In many instances, the insurers writing the upper layers showed little interest in a case and sought no direct contact with the insureds, receiving their information almost exclusively from the primary carrier's coverage counsel. As a result, the education process often had to start all over for cases in which settlement required participation by excess carriers—with concomitant delays in resolution.

The net effect of these factors was often (although not universally) a sour relationship between carriers and insureds. In many cases, resolution of the underlying lawsuit required the intervention of a settlement judge to pressure the carrier into accepting terms agreeable to the company. At the end of some suits, the policyholder felt no more goodwill toward its carrier than toward the plaintiffs.

The good news, however, is that the landscape is no longer so bleak. The last few years have seen a palpable improvement in carrier/company relations in shareholder litigation. The allocation debate, for example, has been toned down, if not eliminated altogether. A wave of court decisions pointed toward payment entirely, or almost entirely, by the carriers. Insurers began to offer policies with the allocation defined in advance; a higher allocation rate cost a higher premium. In addition, some carriers began offering "entity coverage" endorsements, so the company was insured for its own exposure, not just the directors' and officers' exposure. As a result of these changes, there is often early agreement in

many cases as to who bears what portion of the costs or settlement. Even in those cases without a fixed allocation, the trend in judicial decisions has led to bargaining within a much narrower range, usually with less passion than before.

In addition, some carriers now offer endorsements that specifically provide interim funding of defense costs. In other instances, carriers have generally become more agreeable to reimbursing the company before a case is over—especially when the carrier wants to encourage the company to fight, rather than to fold its hand early.

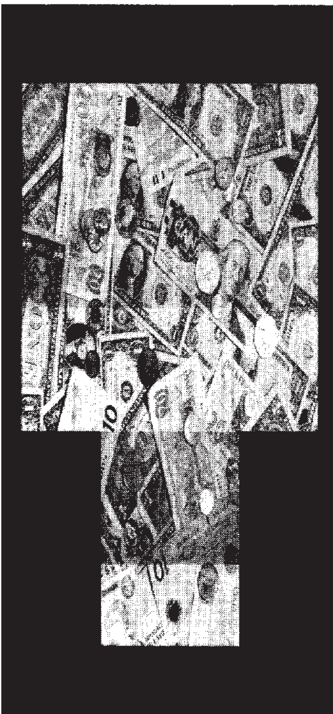
Threats of rescission or exclusion have also become somewhat less common. The truth is that this dog was always more bark than bite. Given the contours of insurance law, a carrier was extremely unlikely to avoid its coverage obligations in run-of-the-mill cases. Even in lawsuits that involved notorious frauds, carriers were often eager to toss in their policy limits and flee the scene, lest they commit an act that could later be construed as bad faith. In apparent recognition that the talk of rescission generated intense ill will and little tangible benefit, one hears far less of it from carriers than in the past.

Even the excess carriers have begun to play a larger role. In recent years, upper-layer insurers have had greater direct contact with policyholders and consequently, more detailed understanding of claims. In many instances, this has facilitated a rapid, coordinated response among several carriers seeking to resolve risky lawsuits.

Carrier Concerns

In light of the recent transition from an often adversarial relationship to a more cooperative environment, one can isolate several factors of importance to a carrier in the typical shareholder class action. First, obviously, is the desire to save part of the policy. A carrier that receives a settlement offer that would allow it to keep a substantial portion of its policy will be more willing to settle than one that is asked to toss in the entire limit. Similarly, a carrier may be less enthusiastic about fighting a case to the finish if the anticipated defense costs are likely to deplete a policy even if the defendants prevail. In most instances, a carrier that is being asked to contribute its full policy to a settlement will have a strong incentive to postpone the day of reckoning for as long as possible: Given the high investment yields of insurance companies, a policy-limits settlement after five years of litigation costs the carrier a fraction as much as a similar settlement in the first year. Thus, the overriding dynamic that the policyholder must understand—and that must be hammered home with the plaintiffs' lawyers—is that the settlement process needs to create an incentive for the carrier to contribute money sooner rather than later. As we will discuss below, this is a key element of the notion of strategic tiering.

A second factor that has become increasingly important in the carrier/policyholder relationship is repeat business. Carriers appear to be influenced deeply by whether or not a defendant company has renewed its policy during the course of the litigation. Only slightly less important is whether the company has



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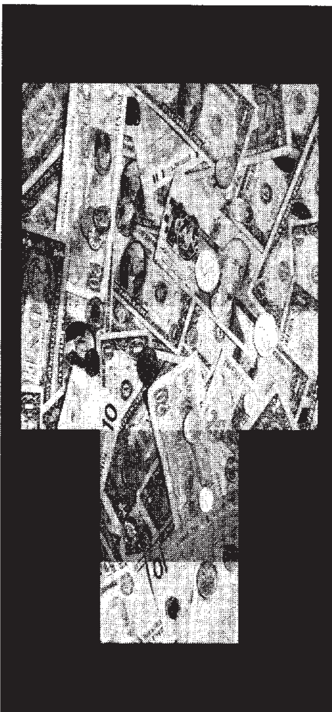
indicated that it plans to keep renewing with the carrier after the litigation is over. From the standpoint of the carrier, they often receive requests from corporate insureds for many things that are not required under the policy (such as advancement of defense costs or approval of shadow counsel). In return, the carrier often wants a sign of reciprocal commitment to an ongoing relationship by the insured. It is clear that, absent extraordinary circumstances, a policyholder should not switch carriers during the course of a shareholder lawsuit.

Plaintiff's Calculations

Let us turn now to what the plaintiffs want to get out of the case. The relevant settlement considerations can be divided into "demand-related" and "supply-related" factors.

The demand side reflects the financial recovery that plaintiffs hope to obtain from the case. One factor on the demand side is the strength of the plaintiffs' case. Although some scholars believe that the merits have little impact on the settlement amount, that has usually not been my experience. In many suits, the merits are a significant factor in determining the gross level, if not the precise amount, of a settlement. A case in which the plaintiffs can point to consistently aggressive revenue recognition, for instance, is likely to settle for more than a case based on inaccurate, but good-faith, forecasts of future results. A related consideration is the judge handling the case: Plaintiffs are more eager to litigate a case before some judges than others.



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The other key demand-related factor is potential damages. The stilted methods used to calculate damages in shareholder class action generate what I call "Monopoly-dollars damages." That is, an extremely "small" case will often have damages of "just" $20 million to $30 million dollars. For a medium-size, actively traded company, the damages can quickly approach half a billion dollars. In my experience, the potential damages figure (like the merits) causes the plaintiffs to calibrate on a particular region (such as under $5 million or over $30 million), rather than on a precise dollar amount that they will require to settle.

These demand-related factors—the merits and potential damages—suggest to plaintiffs what they would like to recover in the case. But the plaintiffs know that they must temper their desires by considering the supply-related settlement factors. The first of two key factors is the possible contribution by the company. The defendant's ability to pay is an oft-discussed topic in settlement negotiations; companies with one foot in the grave often receive substantial discounts off the demand-driven target that plaintiffs would seek otherwise.

The second supply-related factor, of course, is insurance. While the merits and potential damages may determine the broad settlement bracket for a particular case, it is often the insurance situation that dictates the particular point within that range. What matters about the insurance is not just the total amount. The number, size and identity of each tier are also critical factors in the negotiating process. ➢

Each separate layer of insurance constitutes a firebreak. It is extremely difficult, in ordinary cases, for plaintiffs to jump from layer to layer in funding a settlement—especially early in the litigation. For plaintiffs to reach the first excess layer, for example, they must persuade the primary carrier to contribute its entire policy. That may be feasible if the first layer is small and likely to be consumed by defense costs. On the other hand, if the primary layer is substantial, the carrier may conclude that, if it will pay the policy limit at some point in the next five years, it's better off earning income from the float for as long as possible.

Similarly, excess carriers, which receive smaller premiums than the primary carrier, are not eager to attend the party. Although excess carriers are monitoring cases more directly than in the past, they nevertheless remain more resistant to early pay-outs than the first layer.

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The plaintiffs' securities bar is quite sophisticated about the dynamics of the insurance relationship. They generally recognize that if they want to settle the case quickly, they must provide the carriers an economic incentive. An experienced plaintiffs' lawyer knows that a case with a single policy of $10 million presents a vastly different settlement picture than an identical case with a primary layer of $5 million and an excess tier of $5 million.

Implementing Strategic Tiering

In exploring particular aspects of strategic tiering, some caveats are in order. First, in some instances, tiering may not enter into the settlement equation at all. For example, in a case with very bad facts and a defendant with ample financial resources, plaintiffs may manage to obtain a huge settlement irrespective of the D&O structure.

Second, I believe that the effect of tiering is greater earlier in the litigation process and diminishes as the case approaches summary judgment and trial. The pressures on the respective sides begin to shift as the case progresses. In general, plaintiffs tend to be wed to their demand-side number more rigidly after a lengthy battle. Carriers, on the other hand, may feel pressure from the policyholder to avoid a trial start as the time of reckoning approaches.

Third, there is no magic formula as to the right amount or structure of a D&O portfolio. The thoughts that follow are general suggestions that you must work through with your own broker and counsel.

With those disclaimers, let us turn to four issues: overall amount, number of tiers, size of tiers and identity of carriers. As to overall amount, you should consider several factors. What are the likely damages if you get sued? Obviously, this is difficult to predict in advance of the stock drop that triggers a shareholder suit. But you can base a reasonable estimate of the potential exposure on your company's market capitalization, stock price volatility and daily trading volume. The aggregate amount of insurance that you purchase should reflect that risk profile (along with, obviously, what the company can afford).

The second issue is the number of tiers. Here are the trade-offs. At one extreme—a single primary tier, with no excess layers—you have no firebreaks. Assuming that you've purchased the right amount of coverage, this is likely to be viewed as a fat, juicy insurance case. At the other extreme—five or more tiers—you may expend substantial energy trying to keep your insurance house in order

during a lawsuit. Moreover, should you find yourself in a situation where you really need all of that insurance to settle a troublesome claim, it will be harder to get carriers to participate as you go higher up the chain (remember, the farther from the primary layer, the lower the premiums). For most companies, the right number will be somewhere between two and five, depending upon the overall coverage.

The third issue is the size of each tier. In my opinion, as a general rule, the higher up the chain, the larger the tiers should be. This avoids setting up too tempting a target for plaintiffs with a large primary layer, while providing you with strong protection in the event of a meltdown. So, for example, if your company had $40 million in coverage spread across four layers, a prudent structure might be $5 million primary, $5 million first excess, $10 million second excess and $20 million third excess. This structure would provide strong, natural firebreaks at $5 million and $10 million, depending upon the demand-related factors (the merits and damages). It's a safe bet that the identical claim against your company would settle for less with that structure than if, for example, you structured the $40 million aggregate coverage as 15/10/10/5.

On the other hand, you must avoid being too clever. Structuring the coverage with inordinately small amounts at the first few tiers may cause plaintiffs to dismiss the layering entirely. For example, for a medium-size public company to have a primary and several initial excess layers of $1 million or $2 million each probably does not make sense because a settlement discussion might begin with plaintiffs taking the position that all of those layers would have to be wiped out. Tiering only works if the layers are sized realistically.

The fourth issue is the identity of the carriers. Although I'm not going to tell you which carriers to avoid, you should talk to other executives and risk managers in your area who have survived a shareholder suit to see what their experiences were with particular carriers (especially recent experience, since some carriers with a tough demeanor in the past have shown a more human face lately). From a

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structural standpoint, consider having the carrier (or an affiliated carrier under the same parent company) that provides the primary layer coverage also provide the top excess layer. My experience is that a primary carrier in that situation has added incentive to be responsive to the company's desire for an early resolution to protect the higher layer.

It bears repeating, however, that none of the foregoing is gospel. This is one approach to risk management that, in the right case, might help you land a settlement at a more attractive level than would occur if the insurance package were structured without considering these factors. The one item that I would present as near-truth is this: Don't forego D&O insurance on the theory that lack of insurance will dissuade plaintiffs from suing you. In most cases, plaintiffs have no idea whether you have insurance—or how much—when they decide to sue. If they do sue and discover that you have decided not to purchase insurance, their settlement demands can sometimes become almost punitive. In general, my experience has been that companies that do have D&O insurance find a shareholder suit to be less harrowing than those that do not. Moreover, should the company find itself in financial trouble, the individual defendants will sleep better at night if they have ample D&O insurance. In the unfortunate event that the company goes bankrupt, the shareholder claims against it will be discharged—but those against the officers will survive, and they will become the sole targets for plaintiffs. In that event, the officers will be very grateful that they are insured. RM

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