



Evaluating how much
D&O insurance to purchase

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The directors and officers of energy companies, on average, are sued less frequently than the directors and officers of, say, technology or pharmaceutical companies, but that is no reason for complacency. Companies of all types are under increasing scrutiny from shareholders, rating agencies, special interest groups, regulators and law enforcement agencies. Regulatory investigations can rack up millions of dollars in costs, and lawsuits sometimes result in tens of millions of dollars in settlements and defense costs. Without adequate insurance, directors and officers may be called to pay those costs out of their own pockets under some circumstances. One of the more important insurance decisions these companies make is selecting the limit for their Directors and Officers Liability (D&O) insurance. On the one hand, the goal is to afford both the corporation as well as its directors and officers coverage for a wide range of covered losses. Companies need to balance the desire for greater coverage with their fiduciary duty to conserve corporate revenues.

While the final decision as to the limit to purchase may hinge on subjective factors such as an organization’s perception of its exposure and tolerance for risk, there are a number of more objective inputs that can be taken into account. These include a review of the sources and types of claims experienced by energy companies and the policy limits that are purchased by similar organizations.

What are the risks?

While largely insulated from some of the most significant sources of D&O litigation, energy companies have not been immune. As many publicly traded energy companies use stock as part of their compensation plans, a good number were subject to both Securities Class Action Suits (SCAS) and Derivative Shareholder Action litigation for stock option grant policies during 2006 and 2007. Energy companies that operate outside of the US are also exposed to regulatory scrutiny – evidenced by the growth of cases alleging violations of the Foreign Corrupt Practices Act (FCPA). Finally, while principally affecting larger organizations, the Enron case stimulated a spike in the number of SCAS.

The most significant securities litigation (measured by settlement values) impacting public companies arises out of SCAS. These suits, generally brought by institutional shareholders, often are triggered by significant stock price drops. These cases frequently take years to resolve and may generate enormous defense costs, even if the case is dismissed. Another common type of case brought by shareholders is a derivative action, or shareholder derivative suit. These cases, brought by shareholders or debt holders on behalf of the corporation, are generally against the firm’s officers or directors. Typically, plaintiffs do not seek to extract monetary damages, but rather seek to protect their long-term interest in the company by imposing corporate governance and management changes. If there is a monetary recovery, it runs to the firm, not to the individual plaintiffs. Finally, mergers are a frequent source of shareholder litigation involving directors and officers with allegations of a breach of fiduciary duty. Other sources of corporate litigation include creditors, business partners, customers and employees.

Energy companies are subject to enforcement actions (e.g. criminal or regulatory investigations) by law enforcement and regulatory organizations including the Securities and Exchange Commission (SEC), the Department of Justice (DOJ) and State Attorneys General. The first indication of a problem for a company may be a “Wells Notice” sent by the SEC indicating the issues in an investigation and the probable recommendations for an enforcement proceeding. A Wells Notice indicates that the SEC has determined it may bring a civil action against a person or firm, and provides the person or firm with the opportunity to provide information as to why the enforcement action should not be brought. The receipt of a Wells Notice frequently triggers the hiring of counsel and other experts to assist in the development of a response and to assist in negotiations leading to a settlement that may be reached with or without the filing of a suit. This may or may not include admission of guilt, fines, penalties, and disgorgement of profits. Companies may be similarly subject to actions by DOJ or state Attorneys General.

In some circumstances the corporation will be subject to concurrent actions arising from the same issue filed by a variety of plaintiffs. For example, derivative actions often are filed in conjunction with securities class action suits, which may follow an investigation by regulators. This combination of actions may be treated by an underwriter as being subject to the same policy period and eroding a single aggregate policy limit. The costs of defense, investigation and settlement can accumulate rapidly.

The costs of responding to investigations and defending lawsuits can run into the tens of millions of dollars – even if a suit is ultimately dismissed. Sometimes the cost of defense exceeds the settlement value. The selection of a limit depends partially on the view as to the possibility of expensive litigation on top of, or instead of, large settlements.

While private energy companies are subject to less severe shareholder scrutiny than their public counterparts, they are still subject to litigation from shareholders. Other external sources of litigation include customers, creditors and competitors. Energy companies may experience litigation for employee contracts, during mergers and after public offerings. Additionally, energy companies are subject to harassment, discrimination and other types of suits by employees, which may be covered by a private company D&O policy.

Who and what D&O insurance covers

While the coverage afforded under D&O insurance policies varies, there are certain common elements. In general, a D&O policy provides three types of coverage.

- **Side A coverage**, refers to coverage that protects individual Ds and Os for claims where the company is not legally or financially able to fund indemnification.
- **Side B coverage**, reimburses the company to the extent it grants indemnification and advances legal fees on behalf of its Ds and Os.
- **Side C coverage**, provides separate coverage for the entity itself for “securities claims.”

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A well designed D&O policy will include coverage for a wide range of the costs that might be incurred in a claim. This includes defense, investigation, damages, settlements, and judgments. D&O policies may also include additional coverage including outside directorship liability, professional liability, employment liability, and fiduciary liability.

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Techniques to evaluate limits

Numerous techniques are available for deciding the appropriate D&O limits to purchase. These include benchmarking against similar organizations and reviewing the size of the losses that have affected similar organizations. Additionally, sophisticated models meld together a number of factors to provide insight. In this paper, we compare the purchase practices of energy companies to the types of losses that they have experienced. The focus of this discussion is on combined A-B-C forms and we will not consider the additional limits sometimes purchased as Side A cover.

In this analysis we first examined the D&O policy limits purchased by private energy companies with revenues between \$25 million and \$1 billion. In selecting energy companies, we looked for companies in the oil & gas, utilities, alternative energy and mining industries. We divided the companies into four revenue size groups - \$25 million to \$50 million, \$50 million to \$100 million, \$100 million to \$250 million and \$250 million to \$1 billion. Table I presents the mean (average), median (midpoint), third quartile (75th percentile) and highest policy limits in each revenue size group. Note that some of the highest limits are purchased by public power authorities. Information regarding claims against these energy companies as well as their directors and officers is relatively scant.

Table I – Privately held energy companies D&O insurance limits purchased

	Revenue Size Group			
	\$25M to \$50M	\$50M to \$100M	\$100M to \$250M	\$250M to \$1B
<i>Policy Limit in Thousand Dollars</i>				
Mean (Average)	4,000	8,000	18,000	49,000
Median (Midpoint)	2,000	10,000	15,000	30,000
Third quartile (75%)	5,000	10,000	20,000	50,000
Largest	10,000	10,000	30,000	150,000

We then examined the limits purchased by publicly traded energy companies. Table II presents the mean (average), median (midpoint), third quartile (75th percentile) and highest loss sizes for each revenue size group. While we continued to look at companies with revenues between \$25 million and \$1 billion, we used market capitalization as the proxy for their D&O exposure. This is because the likelihood of claim and the size of loss increases as market capitalization increases. We divided the companies into five market cap size groups – less than \$25 million, between \$25 and \$100 million, \$100 million to \$250 million, \$250 million to \$1 billion and over \$1 billion.

We also examined the securities class action cases (SCAS) filed against this size of publicly traded Energy companies since 1996. We found sixteen cases with settlements or awards involving energy companies. For this analysis, we used the market cap at the beginning of the class period. As there is no way to determine which portion of these losses would be subject to coverage by a D&O policy, we assume for the sake of analysis that the entire settlement was covered. The values do not include any defense costs and also exclude any related actions (regulator and derivative shareholder) that may have taken place that would add to costs in the same policy period. By some “rules of thumb” adding 20% to the settlement values takes in account the cost of defense, though conservative insurance buyers may want to consider a higher multiple. Table II presents the mean (average), median (midpoint), third quartile (75th percentile) and highest loss sizes for each market cap size group.

Table II – Publicly traded energy companies D&O insurance limits purchased and losses experienced

	Market Cap Size Group			
	\$25M to \$100M	\$100M to \$250M	\$250M to \$1B	>\$1B
<i>Policy Limit in Thousand Dollars</i>				
Mean (Average)	5,000	14,000	27,000	69,000
Median (Midpoint)	5,000	17,500	20,000	65,000
Third quartile (75%)	7,500	20,000	40,000	75,000
Largest	6,000	20,000	100,000	150,000
<i>Loss Size in Thousand Dollars</i>				
Mean (Average)	2,500	8,200	12,700	27,600
Median (Midpoint)	2,500	9,100	12,300	27,600
Third quartile (75%)	2,800	9,800	14,600	31,900
Largest	3,000	10,500	26,000	36,150

Tables I and II demonstrate that both the limits purchased by Energy companies increase as their revenues and/or market capitalization increase. While the tables are not directly comparable, publicly traded companies tend to purchase higher limits than private companies. The size of loss experienced by publicly traded Energy companies similarly increases as their market capitalization increases. The single largest loss of \$36.2 million (to which defense costs would be added) demonstrates that very large losses do occur and energy companies should consider this possibility when selecting their limits. Comparing losses to policy limits suggests that smaller publicly traded energy companies are generally purchasing adequate limits, but some larger companies (market capitalization over \$1 billion) may be leaving their directors exposed. Furthermore, it should be kept in mind that these loss amounts do not reflect defense costs, which can run in the millions of dollars, nor do they account for the growing possibility of multiple lawsuits being filed related to the same underlying event.

D&O insurance policy limit selection is an important process where the purchaser needs to be aware of the interplay of a number of factors. These include the types of cases that may be filed, the coverage available, the practices of peers as well as the size of losses settled or awarded in the past.

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