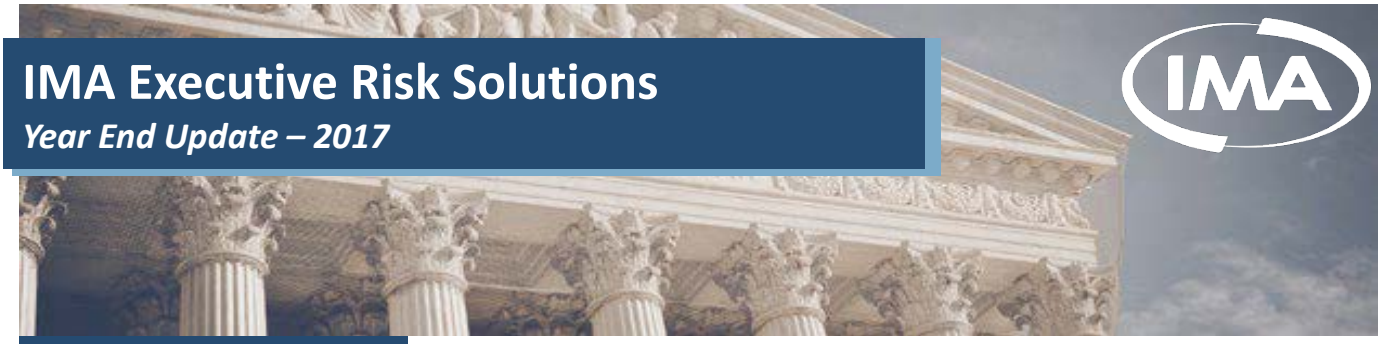

IMA Executive Risk Solutions

Year End Update – 2017

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Cases of Interest

Insured versus Insured Exclusion Bars Coverage for Claim by former Officer

This case stands as another example of how the Insured versus Insured exclusion in a directors and officers liability policy can preclude coverage for claims brought by former employees.

The claimant here was a former director and officer who retained an interest in the company following his departure. His ownership interest was acquired during his employment and, prior to ending his employment, he sought assurances that his stake would not be affected by no longer being an employee of the company. After receiving assurances his ownership interest would remain the same, and moving on to other ventures, the company was sold.

Prior to the sale of the company, claimant's ownership distributions decreased and eventually ceased altogether. He then asserted claims against the company as well as the directors and officers who oversaw the sale process. The matter was tendered to the company's D&O carrier, who denied the claim, asserting the insured versus insured exclusion precluded coverage. Subsequently, a verdict was rendered in favor of the claimant (against the company) and this coverage action ensued.

In concluding the denial of coverage was proper, the court relied on the plain language of the exclusion and its exceptions. The relevant exception to the insured versus insured exclusion provided that if a claim were brought by an insured, it would only be covered if it was brought "solely in [his] capacity as a securities holder of the Company and where such claim is solely based upon and arising out of Wrongful Acts committed subsequent to the date" he was no longer an employee.

Because the claim arose out of alleged misrepresentations made during claimant's employment, and because it regarded his ownership interest in the company, the court concluded the exception to the exclusion inapplicable and barred coverage. *Scottsdale Insurance Co. v. Nationwide Medical, Inc., et. al.*, Case No. 15-436-DDP (FFM) (C.D. Ca. December 13, 2017).

Of particular note is the specific policy language at issue in this case, and how it contrasts with alternative language typically available in the marketplace. Once again, we are reminded of the importance of securing proper language within a D&O policy.

Cases of Interest

Intent to Sue Letter without a Demand is not a Claim

In this case, the court addressed whether a statutory Notice of Intent to Sue qualified as a 'Claim' under a "claims made and reported" professional liability policy.

In 2010, the insured received a letter threatening a lawsuit for alleged violations of California's Health & Safety Code (Proposition 65). The letter did not contain any settlement offers or other demands.

Over one year later, a lawsuit was filed and the insured sought coverage for the matter with its insurer, who denied the claim. The insurer took the position that the claim was "first made" when the insured received the 2010 letter, not when the actual lawsuit was filed over one year later, and therefore denied coverage.

This coverage action followed, with the insurer arguing that the 2010 letter was an *implied* demand for compliance. The court disagreed, explaining that a demand, however phrased, requires the assertion of a right, coupled with a request for compliance. "Although a demand may take many forms, it must request or require some action on the part of the recipient." The 2010 letter in this case did no such thing and therefore did not qualify as a 'Claim' the insured was under an obligation to report to the insurer upon receipt. *Tree Top, Inc. v. Starr Indemnity & Liability Co.*, 2017 WL 5664718 (E.D. Wa. 2017).

Other Insurance Clause does not Alleviate Insurer of Policy Obligations

Following the discovery of an employee welfare benefit plan suffering a loss of $8,000,000 due to fraudulent activities of plan fiduciaries, coverage was sought by the insured under its Fiduciary Dishonesty (Crime) policy.

The existence of coverage was not in dispute. However, the insurer attempted to only pay a portion of the loss by arguing that another insurance policy also covered the loss, and that the 'other insurance' provision within its policy alleviated it of paying its full policy limit.

The insurer argued the loss should be prorated between the two policies under the general principle that when two insurance policies provide concurrent coverage and contain competing 'other insurance' provisions, the loss is prorated according to their respective limits.

The court disagreed, finding that the insurer was obligated to pay its full policy limit regardless of the existence of the other policy or the 'other insurance' provision within its policy. In rejecting the insurer's argument, the court noted "other insurance clauses govern the relationship between insurers; they do not affect the right of the insured to recover under each concurrent policy…Inter-insurer loss allocation by way of 'other insurance' clauses never permits allocation of a loss to the insured. Payment of the insured's claim always takes priority over the allocation of the loss between concurrent insurers."

The insurer was therefore required to pay its policy limits and pursue relief from the other insurer itself, rather than requiring the insured to do so. *Michelin North America, Inc. v. Federal Insurance Co.*, Case No. 17-cv-01599-HMH (D.S.C. 2017).

Cases of Interest

Coverage for SEC Investigation Dependent on Allegation of Wrongful Act

This past fall saw two conflicting decisions issued regarding when coverage is triggered under an insurance policy that requires a 'Wrongful Act' in the definition of 'Claim.'

In the first case, the insured sought coverage from an excess D&O insurer whose policy did not incept until after the SEC had originally begun its investigation. Following the exhaustion of the underlying policies, the insured sought coverage from the final excess insurer. The insurer refused, relying on the 'pending and prior claim' exclusion since the investigation commenced well prior to the policy inception date (which was also the relevant date for the exclusion).

The Court analyzed the various steps of the investigation, from an informal inquiry, to the issuance of subpoenas, and culminating in an administrative cease and desist proceeding. The key issue was when the matter became a 'Claim' under the insurance policies. Holding a subpoena to be a demand for non-monetary relief, the Court had little difficulty finding a 'Claim' had been first made prior to the excess policy inception date.

However, the Court went on to state that the Formal Order of Investigation would also meet the definition of 'Claim' based on the following language in the SEC Order: "information tends to show [the insured] may have been or may be defrauding its clients in possible violation of securities laws". The Court also cited numerous other courts who had come to the same conclusion, including the Second Circuit Court of Appeals. *Patriarch Partners, LLC v. Axis Insurance Co.*, 2017 WL 4233078 (S.D.N.Y. Sept. 22, 2017)

The second case, decided by the Tenth Circuit Court of Appeals applying Colorado law, held an Order of Investigation and subpoenas issued in conjunction therewith did *not* meet the definition of 'Claim' under a D&O policy.

While the opinion fails to quote the entire definition of 'Claim', rendering it difficult to explicitly determine whether this decision is inconsistent with the aforementioned New York court decision, it is hard to come to any other conclusion. Despite an attempt to square its conclusions with the holding in the Patriarch Partners case, the Court held that an Order of Investigation – even one that results in subpoenas being issued to insured persons or the insured organization – does not allege 'Wrongful Acts' and therefore is not covered.

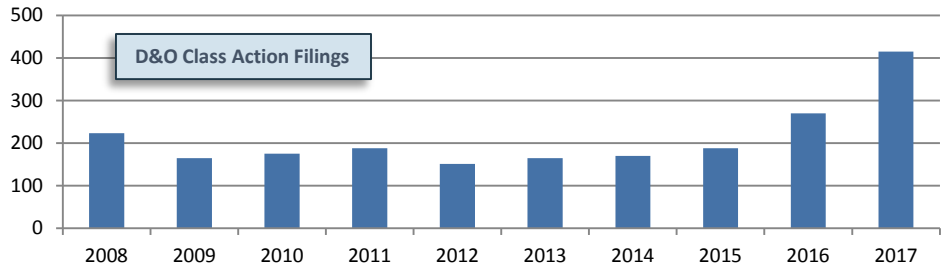
The Court found coverage was only triggered upon the issuance of Wells letters, which were explicitly included within the definition of 'Claim'. It went on to find that a subpoena did not qualify as a written demand for non-monetary relief and the Order of Investigation did not allege Wrongful Acts, both of which are seemingly in direct conflict with New York federal trial courts and the Second Circuit. *Musclepharm Corp. v. Liberty Insurance Underwriters, Inc.*, 2017 WL 4675701 (10th Cir. 2017).

These cases serve as a reminder of the need for a broad definition of Claim and an experienced broker familiar with the varying, conflicting, and often confusing cases impacting insurance coverage.

D&O Filings and Other Developments

2017 – Filings

- As we previously reported, 2016 D&O filings were up 44% over 2015, and at their highest level in over a decade
- In 2017, D&O Class Action Filings were up 54% over 2016 and were at their second-highest level ever (highest = 2001)
    - The annual total of 412 filings exceeds the 2008-2016 annual average of 188 filings by 119%
    - Over this same time period (2008 to 2017), the number of U.S. public companies has *decreased* by 17%
    - At the current rate, **approximately 1 in 10 public companies are being sued for securities fraud**
- Filings against NASDAQ companies remain more common than filings against NYSE companies (54% v. 39%)
- SEC enforcement activity against public companies did decline in fiscal 2017, after hitting an all-time high in 2016



Other Developments and Considerations

- Overall D&O pricing continues to remain competitive, in part due to historically high dismissal rates (~50%)
    - Excess layer pricing is noticeably more competitive than primary layer pricing, particularly in certain sectors
    - Many leading primary layer carriers are expressing a need for increased rate or retentions in 2018, but it is still too early to determine whether this will take hold
- Several securities claims were filed in 2017 based on sexual harassment allegations
    - These suits place blame on the company's directors and officers, alleging they failed to take steps to prevent the misconduct and therefore harmed the company and its investors (who are, as a result, owed damages)
    - One of these cases settled for an amount ($90M) that qualifies as one of the top ten largest derivative lawsuit settlements ever
- As we previously reported in the 3Q17 Update, the U.S. Supreme Court is scheduled to take up several securities cases during the current term. However, one of the cases settled shortly thereafter, leaving unresolved the question of whether the failure to make a disclosure required by Item 303 constitutes an actionable omission under Section 10(b) and Rule 10b-5. In its place, the Court did add another securities case to its docket in December, in which it will address a somewhat obscure question regarding tolling of statutes of limitation in securities class action cases.

Sources: Cornerstone Research; Stanford Law School; Center for Research in Security Prices

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About IMA

IMA Financial Group is a privately held, diversified financial services firm focused on protecting client assets and creating exceptional value for our clients around the world. Our diverse team of experienced and talented professionals shares an unwavering commitment to excellence.

IMA Executive Risk Solutions is our world-class team of 20+ professionals focused on providing thoughtful advice, a unique legal perspective, a broad range of executive risk insurance solutions, and excellent service to our valued clients. Our professionals have deep experience handling complex executive risk exposures for a variety of clients – from pre-IPO start-ups to multi-billion dollar corporations.