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Possible conflicts of interest with D&O insurance in event of shareholders' class actions

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Abstract

Listed companies and their directors and officers run an increasing risk of becoming involved in a shareholders' class action. Since class actions involve significant compensation amounts, it is of vital importance to all parties involved and society (seen the goals of a collective action and of liability law) that the directors/officers and the company being sued have adequate Directors & Officers (D&O) insurance. Nonetheless, conflicts of interest can arise between the company and the directors being sued in respect of the cover. In addition, conflicts of interest between the various D&O insurers could also arise. D&O insurance must be set up in such a way that these potential conflicts of interest are prevented as much as possible. The first conflict of interest can be restricted through the inclusion of either an allocation clause or an order of payment clause. In addition, a choice can be made to make a (greater) division between the Side A and Side C coverage within the D&O insurance policy or to take out a separate Side A policy altogether. The potential effects of the conflicting interests between the various D&O insurers involved can be mitigated by incorporating a properly defined follow form clause and an adequate leading underwriter clause. In that context, but also independently thereof a direct duty of good faith and fair dealing of the primary insurer(s) toward excess insurers should be adopted.

Key words: Directors & Officers insurance, class action, shareholders claims, Side A–coverage, Side C–coverage, follow form clause, leading underwriter clause, direct duty of good faith of primary insurer.

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1. INTRODUCTION

Large–scale loss and the collective settlement thereof have received a lot of attention in legal literature in the past few years. Mass tort claims invariably concerns large numbers of parties incurring a loss that are involved in the settlement of a dispute with a single person or entity responsible for the loss or a limited group thereof, which dispute forms the basis of the same or similar factual and legal liability or other questions (Campos, 2012, 1065; Nagareda, 2008, xii; Cashman, 2007, 1; Hensler, 2000, 3; Hensler, 1993, 966). Large–scale loss is frequently collectively settled instead of via individual proceedings. Legal practice shows that the number of class actions has increased. The financial sector in particular is where the instrument of the class action is increasingly being brought to bear against listed companies. In the process, the claimed compensation amounts as well as the actual settlement amounts for class actions against listed companies in North America and Europe are (very) high.

For instance, in the Cornerstone survey from 1996–2010 the *average* settlement amount for class actions in the United States amounted to USD 40 million (Cornerstone Research, 2011a, 2); *average* amounts of USD 45 million and USD 48 million followed from other surveys (Baker, Griffith, 2010, 22 respectively Klausner, Hegland, 2010, 1). Each year from 2000 to 2009 saw an average of 1 in 15 companies from the S&P 500 index as a defendant / respondent in a class action (Cornerstone Research, 2011b, 12). The ratio in1 the financial sector was even more pronounced at 1 in 8.5 companies. Developments in respect of class actions against listed companies can also be seen in Europe. For instance, in the Netherlands, at least 13 class actions were initiated in the past few years against companies that had been listed on the Dutch stock market (which lists 75 companies), whereby the settlement amounts varied roughly between EUR1 million and EUR1 billion (Van Abeelen, Weterings, 2013, 35).

In short, the risk is high for listed companies of becoming involved in a security or other class action. In these cases, it concerns very high levels of compensation or settlement amounts. The focus of shareholders' class actions is often aimed at, aside from the listed company, holding the directors personally liable. Individual directors and supervisory board members are confronted more often than before with a class action; consequently, finding protection against this liability risk is gaining importance.[1]

In light of the extensive compensation amounts, it is of vital importance to all parties involved that the directors and the company being sued have adequate D&O (Directors & Officers) liability insurance. Without insurance or sufficient insurance, the directors and company being sued might have to bear compensation (in whole or in part) themselves. If they are unable to do so, which is often the case given the amounts being sued for, the class action will not realise its goal. This also has a negative effect on the scope of liability law. All parties involved in a class action have an interest in an adequate D&O insurance policy, but a conflict of interest can arise between the company and the directors being sued. In addition, conflicts of interest between the various D&O insurers involved could also arise which can negatively affect both the insurance cover and the settlement of a promising class action. A D&O insurance policy must be set up in such a way – in the interest of not only the parties involved but also society – that these potential conflicts of interest are prevented as much as possible.

The interest and the role of adequate D&O insurance in the event of shareholders' class actions is first discussed in greater detail below (§ 2). Then the cover under the D&O insurance policy is addressed before the possible conflict of interest between (i) the company and its directors and (ii) the various D&O insurers is described in greater detail (§ 3). Possible solutions will be discussed, such as the limitation of the first possible conflict through the inclusion of an allocation clause or an order of payment clause, or the addition of a (greater) division between the Side A and Side C coverage. It is also argued that a better connection can be created between the cover of the various D&O insurers by implementing a properly defined follow form clause. Further, it will be set out that the potential effects of the conflicts of interests between the various D&O insurers in the settlement of (promising) class actions can be mitigated through the inclusion of an adequate leading underwriter clause and, independently thereof, the adoption of a direct duty of good faith and fair dealing of the primary insurer(s) toward excess insurers (and also a duty of care of excess insurers). I conclude section 4 with a short summary.

2. D&O INSURANCE AND SHAREHOLDERS' CLASS ACTIONS

2.1 Connection D&O insurance and shareholders' class actions

The collective settlement of large–scale loss is preferential to individual settlement(s) for all parties involved. The economic benefits, associated with the proceedings or not, of bringing a class action are evident. For the parties being sued and their insurers, it is beneficial that only one set of proceedings has to be followed instead of multiple lawsuits, which has a beneficial effect on the defence costs (Hensler, 2000, 121; Rosenberg, 1987, 571). Another important advantage for these parties is that in a collective settlement they have more security regarding the number of claims and the scope thereof and, consequently, their compensation obligations vis–à–vis the injured parties. It also prevents them from being confronted with conflicting or inconsistent rulings. For injured parties, it is beneficial that they receive compensation in the short or shorter term without every party needing to conduct expensive, time–consuming, burdensome and uncertain proceedings (Bone, 2012, 69–70).

Collective settlement promotes the unity of law and reduces furthermore the gap between the so–called repeat player and the individual injured party in respect of the importance of winning the proceedings, the *know-how* and the financing (Bone, 2012, 69; Rosenberg, 2000, 393; Hensler, 2000, 4). The preventive effect of the class action can also be mentioned as a important side effect (Bone, 2012, 71; Scherer, 2012, 27 et seq). The existence of the instrument of the class action can have a deterring effect as a result of which potential violators of standards are encouraged to comply with the regulations and a class action is ultimately no longer necessary (more on this in § 2.2).

Nonetheless, a financial shareholders' class action can only in fact be settled collectively or individually if the director and/or company being sued can bear possible compensation (on the basis of a settlement or not). Given the high amounts involved in a class action, directors will often not be able to meet all or a large portion of these costs themselves. The same holds true for the company, or compensation to be paid will have a (strongly) negative effect on the financial

[1] In the United States, a shareholders' class action has been the most frequently occurring claim against a listed company and its directors for years already (Towers Watson, 2011, 19; Baker, Griffith, 2010, 21).

position of the company. That certainly holds true for young companies (Bondt, 2010, 621). For this reason, the presence of a liability insurance policy is of vital importance for the success and effectiveness of a class action and collective settlement.

2.2 Importance of D&O insurance in event of a class action

In light of the risk of possible personal liability and exposure of their private assets, directors and supervisory board members of a listed company automatically have a major interest in a D&O insurance policy. Most listed companies take out such insurance for their directors and officers (Baker, Griffith, 2010, 44).

In a shareholders' class action, the D&O insurance policy will also be the only resort for the company involved (Katz, 1996, 31). In such cases, a Commercial General Liability Insurance (GCL) policy often fails to provide any solace since cover is 'only' offered for (liability for) bodily injury and property damage (Kalis, Reiter, Segerdahl, 2013; Maniloff, 2012). Shareholders' claims, however, concern purely pecuniary loss. There is no standard cover for the company's liability under the D&O insurance, but the policy can be expanded, so that cover for the company is also included (more on this in § 3.1).

Furthermore, a D&O insurance policy with adequate cover can be a good way for a listed company to be able to attract and keep good and experienced directors and officers who will critically follow the recent developments regarding shareholders' class actions – the company's indirect interest (Kalis, Reiter, Segerdahl, 2013, 11; Baker, Griffith, 2007, 502; Black, Cheffins, Klausner, 2006, 1140; Parr, 2004, 13). In addition, a D&O insurance policy prevents the fear of liability and class action from causing directors to act excessively cautiously and not to take enough entrepreneurial risks, where running a business in fact assumes taking acceptable risks in the interest of the shareholders and other stakeholders (Baker, Griffith, 2010, 57; Black, Cheffins, Klausner, 2005, 169).

Shareholders too have a major interest in D&O insurance. In that way they are, after all, assured that in the event of a class action, compensation will take place without the value of their shares being negatively affected at all or too much by the compensation to be paid.

D&O insurance is not only important for the directors, shareholders and the company concerned, but it also has a societal relevance. The presence of D&O insurance ensures that there are solvent, liable parties in the event directors (and officers) and/or the company are held liable vis–à–vis shareholders.[2] These improved means of recovery have a positive effect on both the compensatory and preventive functions of liability law (Hensler, 2000, 121–122; Rosenberg, 1987, 563–566). In class actions, the compensatory function plays an important role, as on the one hand liability claims are bundled to ensure that efficient settlement takes place and access to liability law (or other law) is increased, while on the other hand the total amount sued for is often significant to very extensive (Hensler, 2000, p. 3–4). That compensatory function can, however, only be properly fulfilled if there is sufficient insurance cover.

The idea behind the preventive function of liability law is that directors and companies, out of fear of liability and the obligation to pay compensation to their shareholders, are encouraged to act carefully and to prevent loss for the shareholders (Griffith, 2012, 337; Shavell, 2004, 268 et seq). However, if a director and/or company do not have sufficient assets to be able to pay the compensation, which in particular cannot be ruled out in shareholders' class actions, the deterring effect of liability law will not be robust enough. Since the relevant party cannot pay anyway, the right behaviour incentives are not given (judgment proof problem). The lack of a deterring effect becomes even greater if shareholders waive the right to a claim in advance due to insufficient assets on the part of the directors and the company. In the event of a D&O insurance policy, it will be possible for directors and companies to be held liable more often in appropriate circumstances and the incentives to act carefully are stronger then. On the other hand, there are also fewer stimuli to act with due care due to the presence of the D&O insurance policy, since the directors or companies no longer have to bear the loss themselves in whole or in part (Shavell, 2005, 63–77, Parsons, 2003, 448–471, Dionne, 2000, 153 et seq., Baker, 1996, 267 et seq., and Pauly, 1968, 531–537). Nonetheless, insurers are taking measures to retain as much of those incentives from liability law as possible, amongst others a maximum insured sum, exclusions, deductibles, scope of the premium, monitoring behaviour, etc (Weterings, 2012).

Finally, a proper D&O insurance policy will have a positive effect on the goals of class actions: (i) efficiently and effectively settling class actions out of court, whereby injured parties receive reasonable compensation; (ii)

[2] In the United States (where relatively speaking many more internal liability claims occur), it has even emerged in the literature that for that reason a D&O insurance policy is more in the interest of the legal entity/shareholders than in the interest of the director for whom the D&O insurance policy was taken out by the company (Boyer, 2005; Gutiérrez, 2003; Romano, 1991).

avoiding many individual lawsuits pertaining to the same issue; and (iii) increasing access to the law.

3. POSSIBLE OPPOSITE INTERESTS OF PARTIES REGARDING TO COVERAGE

3.1. D&O insurance cover

A D&O insurance policy initially covers claims against a director or supervisory board member for the purpose of compensating loss caused by his/her acts or omissions in his/her capacity of director or supervisory board member (Kalis, Reiter, Segerdahl, 2011, 9, 11, 12). This could relate to a claim against the director by the company where the director is or was working: internal liability. There is also cover for claims of third parties, such as a receiver, a client or a competitor – external liability (Weterings, 2012). Shareholders' claims – given the ample cover for both internal and external directors' or other liability – will also be covered in the event of either an individual action or a class action. Both the compensation to be paid that could ensue from such claims and the defence costs against claims are covered (Kalis, Reiter, Segerdahl, 2011, 11–25 et seq; Baker, Griffith, 2007, 500).

The cover for directors and officers, related to the risk of personal liability for acts of management, is referred to as Side A coverage. In addition, Side B coverage also generally exists, which is also known as corporate reimbursement cover (Kalis, Reiter, Segerdahl, 2011, 11–4 and 11–9; Baker, Griffith, 2007, 46–47 and 499; Mathias, 2006, 6–18). Most listed companies have issued an indemnification to their directors and officers and on the basis thereof assume the liability risk of the director/officer as well as the compensation and defence costs possibly associated therewith. For a Side B coverage, a company that – on the basis of an issued indemnification – must, in the event of a liability claim vis–à–vis a director, bear the defence costs and/or the compensation can have these costs covered by the D&O insurance policy (O'Leary, 2007, 37).

In most D&O insurance policies, both Side A and Side B are covered as standard. Further, the option exists of expanding the D&O insurance with Side C coverage (Griffith, 2012, 339; Mathias 2006, 6–20). This corporate entity cover protects the company against claims that are brought directly against the company itself (Baker, Griffith, 2010, 47–48; Baker, Griffith, 2007, 499; Philips, 2007, 698). The coverage is often limited to so–called securities claims, mostly defined as claims by securities holder of the corporate policyholder (Kalis, Reiter, Segerdahl, 2011, 11–10).

This Side C coverage (and the scope thereof) is important for nationally and internationally listed companies for the purpose of ensuring they are able to protect themselves against the risk of shareholders' class action claims. Moreover, in the event the Side C coverage is absent or insufficient, that is detrimental to the shareholders. The company being sued will in that case have to pay the claims in whole or in part out of „its own pocket" – which negatively affects the company's assets, possibly in a significant manner. Ultimately, that can or will have an impact on the functioning and the value of the company (share value). This could result in the shareholders, as it were, bearing their own loss in whole or in part. In addition, a decline in corporate assets could also affect other stakeholders, such as creditors and employees. If viewed in this light, a D&O insurance policy with Side C coverage is desirable for every listed company.

3.2 Protection of directors versus protection of company

While a D&O insurance policy regularly provides three types of protection, only Side A coverage protects the director. A major disadvantage of also protecting the company against liability (Side C) is that a major claim against the company can reduce or even exhaust the insured sum, as a result of which the directors become underinsured or end up having no cover at all if they are then confronted with another claim in the same insurance year. It can also occur that the shareholders file claims vis–à–vis both the company and the directors, but that the insured sum is insufficient to make a payment on behalf of both the company and the directors, or is entirely insufficient to provide cover for one of the insured parties in a class action (Bordon, 1998, 170). Class actions often involve extensive amounts (many dozens or hundreds of millions of dollars/euros) and this is a realistic scenario. This is even more the case since the insured sum is used to pay for the defence costs first, and the lawyer's fees for class actions are (very) high to begin with (Eisenberg, 2004, 51–54; Alexander, 1991, 511–512). In that case, the various insured parties – the company and the directors – have conflicting interests in respect of the division of the insured sum or what remains thereof.

It is for that reason that allocation clauses and/ or order of payment clauses are incorporated into the D&O insurance policy. In the event of an order of payment clause (also called a priority of payment clause), the directors must be paid first (Mathias, 2006, 6–14). Most D&O insurance policies contain such a clause. That will only have an effect, however, if claims

against the directors and the company are running concurrently. Otherwise, the principle of "first come, first served" will be in effect, as is the case in the event such a clause is absent from the policy. Moreover, whereas this clause can be advantageous to the insured director(s), the disadvantage to the insured company is that it could be left partially or wholly out to dry in the event of a shareholders' class action. In spite of the insurance taken out against shareholders' claims (Side C), the company might be forced after all to bear all or part of the compensation and the defence costs itself, which will negatively affect its share value.

For an allocation clause, the insureds must endeavour as much as possible to arrive at an honest and appropriate division of the insured sum (payment and defence costs), if it is insufficient in satisfying every insured party (Ostrager, Newman 2010, 1531; Ferrara, 2005, 13–29; Bordon, 1998, 170).[3] Whereas the pain is then shared by the various insured parties, each one is then confronted with underinsurance.

In such an event, these clauses attempt to properly regulate the problem of division in the event of underinsurance under the D&O insurance policy (with a combined Side A–B–C coverage). It appears more desirable, however, to separate the Side A and Side C coverage and to strive to prevent underinsurance as much possible. At some point, D&O insurance was introduced with only Side A coverage for the purpose of offering directors and officers protection against the risk of personal liability. The insurance is called "Directors' and Officers' Liability Insurance" for good reason. The protection of the company was added later to the cover provided by the D&O insurance policy (Side B and Side C). That is another type of coverage, for another insured party, for other situations. That is why it is preferable to make a division between the cover of the director – for whom the D&O insurance was originally intended – and the cover of the company against shareholders' claims – against which risk it is difficult to obtain protection beyond the D&O insurance policy (O'Leary, 2007, 36).

3.3 Division of Side A and Side C coverage

A choice can be made to make that division within the D&O insurance. This can be done by including separate sub–limits. In that case, separate insured sums are in effect for both the Side A and Side C coverage. Whereas that is the simplest solution, there is a chance that the cover for the directors will be temporarily or permanently affected by claims against the company (or vice versa). This can be the case in the event of an insolvency of the company, for instance, because either the receiver cancels the entire D&O insurance policy or the receiver and/or creditors believe that the D&O insurance policy is part of the assets of the company, whether it is insolvent or not. Furthermore, claiming exclusion [of liability] in connection with acts of the company, such as a failure to disclose information, can affect the entire policy and, consequently, the Side A coverage too.

It is preferable to opt for separate insurance policies for Side A on the one hand and Side C (and Side B) on the other hand. In some cases, D&O insurers offer a separate D&O insurance policy with only Side A insurance (stand-alone Side A coverage) for the personal liability of directors. In other case, there is a regular D&O insurance policy (with Side A, B and C coverage), whereby an excess cover is used for the Side A portion (Kalis, Reiter, Segerdahl, 2013, 11–41; Philips, 2007, 720). This excess cover is called on as soon as the cover limits have been reached for the primary cover under the D&O insurance policy. In that case, that excess coverage is there only for the directors (Rossi, 2005, 7). In both situations, there can be broader policy conditions under the Side A coverage than is usually possible for a D&O insurance policy (with A–B–C coverage), such as a broader description of loss, a more limited exclusion for acts of other insured parties and exclusions which have no effect on defence costs.

It is evident from a survey conducted in the US by insurance broker Willis that roughly 55%–60% of the companies from the Fortune 100 and 35%–40% of the companies from the Fortune 500 have some form of separate Side A coverage (Willis, 2004).[4] In most cases it concerns an A–B–C insurance policy with a supplemental excess Side A coverage. What is striking about these results is that in the period of the survey (2002–2003) the settlement amounts resulting from shareholders' class actions were the highest, and upon renewal of the insurance policy many listed companies opted for a broader Side A coverage (excess cover). All this was confirmed in a survey by Towers Watson, a risk management consultancy firm (Towers Watson, 2008, 15, 16 and 18). From this survey it emerged that 41% of the public limited companies in 2008 had a separate Side A coverage and that this applied to 80% of the large cap businesses. In 2011 those figures came in at 78% and 78%, respectively (Towers Watson, 2011, 16–17).

[3] Incidentally, an allocation clause often concerns a division of insured and uninsured amounts between, for instance, the insured director and the uninsured company (because shareholders' claims are not covered on the basis of Side C). There are, however, also clauses that relate to the division of insured amounts.

[4] These results were confirmed in the 2007 survey.

This is often different in Europe, where it is common to have a traditional, combined A–B–C coverage without a separate Side A coverage. In exceptional instances, the latter is the case though, and then it concerns an excess Side A coverage. The expectation is, however, that in the event class actions increase, demand will increase for a separate Side A coverage or an excess Side A coverage given that this provides directors and officers with the best protection against underinsurance (due to the exhaustion of the insurance limits by the company). In that case it will also be easier for listed companies to attract directors and officers and they will be less encouraged to act excessively cautiously. In addition, it will also give the listed company the best protection against liability if they have a separate Side C insurance policy, at least a separate (stand–alone) Side A insurance policy, as a result of which the Side C coverage is burdened less quickly and less heavily.

Generally speaking, the company is the policyholder. It enters into an insurance contract with the D&O insurer. The company, however, is represented by the (board of) director(s), which is in fact the party that takes out the D&O insurance. If D&O insurance is taken out without Side C coverage as well and/or without separate Side A / Side C, the shareholders will possibly argue that the director has not acted in the interest of the company and its stakeholders, which can be a separate or related ground for directors' liability. Consequently, for a director of a listed company, where a significant risk of a shareholders' class action is present, it is pertinent to make arrangements for both sufficient Side A coverage and sufficient Side C coverage. Since that interest has increased in the past few years and will strongly increase in the future, the expectation is that this will also activate and change the European D&O insurance market. In that context, the director must ensure that the conflicting interests of the company and the directors in the insurance package are in balance and that sufficient cover is present for both the directors and the company. A role for the insurance broker could also be laid away here. Engaged by the director, the broker might nonetheless encounter the problem that it must make (conflicting) recommendations concerning the cover to both the company and the directors. Brokers must therefore perform their work with due care when advising on the insurance structure and the insured sums, for the purpose of avoiding being held liable.

3.4 Possibility of no matching covers of different D&O insurers

If a D&O insurance policy is relied upon by listed companies and/or their directors due to class actions – and therefore in connection with high claims – a conflict of interest can arise between the various D&O insurers. D&O insurance policies with high insured sums generally involve several insurers. The larger listed companies in Europe often have a coverage between EUR 100 million and EUR 200 million, while the smaller listed companies have a coverage starting at EUR 50 million (Weterings, 2010, 166). Insurers, however, have a maximum capacity that is usually below this. There is often a maximum capacity of EUR 10 million, EUR 15 million or 25 million (and on exception EUR 50 million).[5] Since a listed company usually needs and desires to have a higher insured amount (for instance EUR100 million), the insured sum must be shared amongst the different insurers.

That can take place in a variety of ways. In the event of coinsurance, the insured amount is divided horizontally. There is one insurance policy with a single insured sum, whereby different insurers assume the defence costs and possible compensation in proportion to their share of the insurance. Mostly, however, the insured amount is divided vertically for a D&O insurance policy. In that case, the D&O insurance policy consists of a „tower" with many layers of insurance policies and insured sums (Baker, Griffith, 2010, 53). The insurer(s) on the first layer (the primary insurer) must be first to provide cover for defence costs and possible compensation (Anderson, Stanzler, Masters 2002, 13–16). The layers above this are excess insurance policies (Stempel, 2005, 2–92 and 2–93). It is only when the insured amount under a layer has been exhausted that the insurance policy at the next level can be called upon to pay for the excess (Richmond, 2000, 29 et seq.)[6]

This should then prevent the various insurers from taking a different position in respect of the cover, as well as the settlement of the claim. That chance exists in the event of a class action given that several layers will often be called upon in that case (Baker, Griffith, 2010, 145–147). Deviating positions of the insurers concerned could frustrate an efficient and effective settlement of a class action. A follow form clause can be used to ensure that there is no substantive difference between the conditions of the primary insurance policies and those of the excess insurance policies (Anderson, Stanzler, Masters, 2002, 13–29). Most D&O insurance packages contain such a clause in the excess insurance policies

[5] This is also the case for American D&O insurers (Griffith, 2012, 340, Anderson, Stanzler, Masters, 2002, 13–19).

[6] Incidentally, various insurers can be involved in an insurance layer, so that a horizontal division (coinsurance) exists within that level (Anderson, Stanzler, Masters, 2002, 13–19).

(Stempel, 2005, 2–92 and 2–93). A follow form clause can, for instance, read as follows:

> "This Policy is subject to the same terms, definitions, exclusions and conditions (except as regards the premium, the amount and Limits of Liability and except as otherwise provided herein) as are contained in or as may be added to the Underlying Policies prior to the happening of an occurrence for which claim is made hereunder."

If a clause has not been incorporated at all or properly, all kinds of problems can arise which will result in insufficient or deviating covers. Specifically, it regularly occurs that the policy conditions of an excess insurer deviate and, for instance, the excess insurance policy contains supplemental and/or special conditions that are not included in the conditions of the primary insurance policy or an underlying excess insurance policy, such as an exclusion of cover, an arbitration clause, a choice-of-law or another clause, or a stricter notification period (Stempel, 2005, 2–93). Another problem is that possibly not every excess insurer must adhere to the conditions of the primary insurer, but rather to those of an excess insurer from a layer below, or that uncertainty exists as to which insurer must be followed. It is also possible that it can be derived from the text of the follow form clause that the insurer with the narrowest cover must be followed. The following is an example of such a clause:

> "The insurer will provide the insured coverage in accordance with the same terms and conditions of the primary policy and any more restrictive terms and conditions of any other underlying policy, except as otherwise provided herein."

In order to avoid such problems and to realise complete and matching cover for the directors and the company, a follow form clause must therefore clearly indicate that the conditions of the primary insurer will be followed and must leave as little room as possible for deviating covers, so that there is no gap between the various layers. Specifically, this is a frequently occurring problem in class actions in the United States (Stempel, 2000, 16).

3.5 Position of different D&O insurers during settlement of class actions

It is also relevant for the insured directors and the company on the one hand and the injured parties on the other hand that in the collective or individual settlement of a financial class action the various insurers work together as much as possible instead of against each other. The risk of obstruction is, however, strongly present given the differing interests of the D&O insurers at the various layers and the fact that in class actions several insurance layers will be called upon.

In the event of an individual or class action, the primary insurer will lose its entire insured sum anyway when high levels of compensation have been claimed. This might apply to the insurers on the first excess layers as well. In that case, they will not have a strong interest in a settlement. But if the outcome is uncertain in respect of liability, they will be sooner inclined to go to court (Squire, 2012, 3 and 14). If those proceedings are successful, they need not pay out, whereas in the case of a settlement they will have to cough up the insured sum or a large portion thereof.

The other insurers, on the other hand, have a strong interest in a settlement given that in that case their insured sum is not called upon at all or only in part (Squire, 2012, 3, 17 and 26). Proceedings generate uncertainty for them regarding their position and, consequently, a risk. The directors and the company will also often have (too great of) an interest in a settlement of a class action. In the event of a settlement, the amount to be paid will often wholly or largely come in below the insured sum, which prevents them from having to pay compensation themselves.

In any case, the insured benefit from clarity and a unified response from all insurers within the D&O insurance package as a result of an announced class action. The deviating interest problem within the 'insurance tower' can, after all, produce delays in the settlement of a (promising) class action and even result in the breakdown of settlement negotiations that had good prospects (Squire, 2012, 26).

This problem can be avoided, or at least limited, through the inclusion of a to follow clause, also called the follow the leader clause or Leading Underwriter Clause (Meyenburg, Stahl, 2006, 22). In that case the primary insurer is authorized to control the defence of claims, so that the excess insurers must, in principle, follow the decisions of the primary insurer in respect of the defence against and/or the settlement of the claim. Such a clause can have the following contents:

> "The underwriters of this policy shall bind themselves to follow any decision taken by the underwriters of the Underlying policies."
>
> or
>
> "All claims, advices and settlements to be agreed by the Leading Underwriters."

The background of the follow clause is unity in and streamlining of the settlement of a claim in the interest of all parties involved in the policy. Basically, there is no contractual relationship between a primary insurer

and an excess insurer that gives rise to contractual obligations between these insurers. There are contractual obligations only between the insured and the insurer – the primary or the excess insurer – created by the insurance contract. In my opinion, it must be assumed – given the factual relationship between primary and excess insurers and the possible major consequences of the acts of a primary insurer for an excess insurer or the position thereof – that direct, non–contractual duties lie with primary insurers (and excess insurers) in the context of claims that exceed primary limits or are likely to do so. The primary insurer owes, in my opinion, a duty of good faith and fair dealing not only to its insured but also to excess insurers.[7] Whereas that is argued in the sparse case law and literature, another viewpoint is also regularly assumed, certainly in US case law, in respect of settlement negotiations and settlement decisions; unfortunately no direct duty of good faith is seen from primary insurers toward excess insurers.[8]

Such direct duties can sooner be assumed in the event of to follow clause. Thanks to this clause, an explicit legal relationship arises between the leading/primary insurer and the following/excess insurers (Meyenburg, Stahl, 2006, 22). It can be viewed as a situation in which a power of attorney exists, an agency relationship as it were. The primary insurer receives a "right" to defend and to settle the claim also on behalf of the excess insurer(s). Granting a power of attorney does not yet mean, however, that the party having a power of attorney – the leading insurer – can exercise its powers in an uncontrolled manner and without due care. The primary insurer has – given his duty of good faith and fair dealing to also excess insurers – to act reasonably and for that reason must take the interest of the following insurers (the parties issuing the authorisation) into consideration when making decisions (Schwepcke, 2004, 63). If the leading/primary insurer complies with its duty of care toward the followers, the following excedent insurer does not have, in my opinion, any freedom of movement and must simply follow.[9]

That results, in principle, in a proper consideration of the various interests. The insured and the excess insurers higher in the 'insurance tower' have, after all, a major incentive to settle and to accept a settlement proposal that might be too high, as long as it does not affect them (Spier, 2007, 331; Keeton, 1954, 1138). Whereas that aspect disappears when the primary insurer makes the decision, it must take into consideration the interests of the other insurers (duty of good faith to settle) and it can be sued by the other insurers upon a violation thereof. Since the violation of the duty of care results in a breach of contract of agency or a tort, it can be sanctioned with compensation (damages for bad faith liability). As a result, the strong incentive for the primary insurer to initiate proceedings, or at least to reject reasonable settlement proposals, is removed/mitigated (Sykes, 1994, 77; Syverud, 1990, 1113 and 1127). This is even more the case because the duty of good faith and fair dealing of the primary insurer, which arises from the insurer's exclusive right to control the defence and settlement of claims, also entails that the following insurers must be furnished with sufficient information and that the following insurers are kept abreast of the course of the settlement negotiations and other important developments: the duty of good faith to keep the excess carrier informed of settlement negotiations and adverse developments (Lanzone, Ringel, 1982, 280–281). The duty of care of the primary insurer(s) results, in my opinion, in the fact that the following insurers, if desirable, have a right to consultation regarding fundamental decisions and decisions with significant financial implications: the duty of good faith in deciding whether to settle (Lanzone, Ringel, 1982, 280–281). This could definitely come up for discussion in class actions.

However, a to follow clause is not contained in all D&O insurance packages with several layers. Further,

[7] Cf. in respect of the United States, for instance, Twin City Fire Ins. Co. v. Country Mutual Ins. Co., 23 F.3d 1175, 1178 (7th Cir. 1994): "overwhelming majority of American cases describe the duty that a primary insurer owes an excess insurer as one derivative from the primary insurer's duty to the insured." See also: Anderson, Stanzler, Masters, 2002, 11–76.

[8] That applies in most states in the US. See, for instance, Federal Ins. Co. v. Travelers Casualty & Surety Co., 843 So. 2d 142 (Ala. 2002) and U.S. Fire Ins. Co. v. Zurich Ins. Co., 768 N.E.2d 288 (Ill. App. Ct. 2002) . However, a direct duty was imposed on the primary insurer in, for instance, Schal Bovis, Inc. v. Casualty Ins. Co., 732 N.E.2d 1082 (Ill. App. Ct. 1999), St. Paul Fire & Marine Ins. Co. v. Royal Ins. Co. of Am., No. 91 Civ. 6151 (CMM) (S.D.N.Y. May 2, 1994), and Colonia Ins. Co. v. Assuranceforeningen Skuld, 588 So.2d 1009, 1010–11 (Fla. Dist. Ct. App. 1991) rev. den. 598 So.2d 75 (Fla. 1992). In most states, the doctrine of equitable subrogation is in fact applied and the same result *can* sometimes be achieved via a circuitous route. In that case, the excess insurer is subrogated to the rights of the insured against the primary insurer. This provides fewer options than a direct duty of good faith. See Anderson, Stanzler, Masters, 2002, 11–76.

[9] That can also be found in US case law. The majority of courts are of the opinion that an excess carrier has, in principle, no cause of action against a primary insurer where the primary insurer has refused to settle a case causing the excess insurer to step in. An action will only be successful where the primary's unreasonable failure to settle has resulted in a verdict in excess of the primary policy limits. See for example Fortman v. Safeco Ins. Co., 221 Cal. App. 3d 1394, 271 Cal. Rptr. 117 (2d Dist. 1990).

different language is possible, which can result in the inability to realise the goal described above properly or at all. The text of the provision must be drawn up in such as way as to prevent it from being phrased too broadly and for an excess insurer to have the freedom ensuing therefrom to act independently in part. In connection with this, discussions between the various insurers occur regularly in US practice or elsewhere.

Incidentally, I am of the opinion that if a to follow clause (or a proper one) is absent, it already ensues from the duty of good faith and a fair dealing of primary and excess insurers that (i) insurers are obliged to accept a risky claim, and (ii) the insurers concerned have a duty to contribute in the event of a "tower" of insurance policies. This entails on the one hand that a primary or other insurer must not allow proceedings to take place immediately or later if a risky class action exists (with a good chance of success) and on account thereof there are good reasons to first explore the possibility of a reasonable settlement. On the other hand, this means that excess or other insurers must not attempt to avoid making a contribution to a settlement if a specific settlement amount is reasonable and their policy is called upon as a result thereof.

4. CONCLUSION

The international class action practice shows that class actions are increasingly being aimed at holding listed companies and their directors and officers liable. Nowadays listed companies and their directors are not only being confronted with shareholders' liability claims more frequently than before, but also with significant extensive compensation amounts. Consequently, finding ways to deal with such claims in an efficient and effective manner is also gaining importance. A proper D&O insurance policy ensures that a valid or other shareholders' class action can also be paid, and it not only guarantees the interests of the company, its directors and its shareholders, but it also has a societal function.

The protection that D&O insurance provides can, however, vary depending on the case. Problems can arise, among other things, in the division of the insured amount between the company on the one hand and the director and officers on the other hand. An order of payment clause strives to resolve this problem, but, unfortunately, does not always provide solace. A separate Side A insurance policy or an excess Side A coverage provides better protection.

Another problem also concerns the fact that high levels of compensation are being claimed in class actions. A D&O insurance policy of a listed company generally consists of several layers of insurance; in the event of a class action, several insurers are called upon by the insured directors and the company. Nonetheless, the various insurers can have deviating covers. In addition, differing interest can exist at the insurers involved in respect of the approach to the class action. These aspects can frustrate an efficient and effective handling of a promising class action and must – given the interests of the various parties involved and of society in proper D&O insurance – be prevented as much as possible. A follow form clause – one that is properly formulated – and a leading underwriter clause can provide a solution for such issues. The duty of good faith and fair dealing of both the primary insurer and the excess insurer play an important role as well.

Summary

Listed companies and their directors and officers run an increasing risk of becoming involved in a shareholders' class action. Since class actions involve significant compensation amounts, it is of vital importance to all parties involved that the directors/officers and the company being sued have adequate Directors & Officers (D&O) insurance. Without sufficient insurance, these directors and the company might have to bear compensation in whole or in part themselves. If they are incapable of doing so to one extent or another, which is usually the case in light of the extensive compensation amounts with class actions, the injured parties will receive nothing or incomplete compensation and the class action will not realise its goal. This also has a negative effect on the scope of liability law. D&O insurance is therefore relevant for both the parties involved in the collective action and for society. Nonetheless, conflicts of interest can arise between the company and the directors being sued in respect of the cover if they are underinsured. In addition, conflicts of interest between the various D&O insurers could also arise which can negatively affect both the insurance cover and the settlement of a promising class action. D&O insurance must be set up in such a way – given the various interests and in light of the goals of a collective action and liability law – that these potential conflicts of interest are prevented as much as possible. The first conflict of interest between the company and directors can be restricted through the inclusion of either an allocation clause or an order of payment clause. In addition, a choice can be made to make a (greater) division between the Side A and Side C coverage within the D&O insurance policy or to take

out a separate Side A policy altogether. The potential effects of the conflicting interests between the various D&O insurers involved with regard to the cover and the claim settlement can be mitigated by incorporating a properly defined follow form clause and an adequate leading underwriter clause. In that context, but also independently thereof, in my opinion a direct duty of good faith and fair dealing of the primary insurer(s) toward excess insurers (and also a duty of care of excess insurers) should be adopted.

Key words: Directors & Officers insurance, class action, shareholders claims, Side A–coverage, Side C–coverage, follow form clause, leading underwriter clause, direct duty of good faith of primary insurer.

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