

## What to Watch Now in the World of D&O

Each fall, we publish the anticipated list of the current hot topics in the world of directors' and officers' liability. As is to be expected, there is much to discuss in the world of D&O, with further changes just over the horizon. The year ahead could be very interesting and eventful. Here is what to watch now in the world of D&O:

### What impact will Dodd-Frank have on D&O Liability?

The massive Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, enacted by Congress this past July, represents the most significant reform of financial regulation in decades. It will affect virtually every aspect of our financial system. However, exactly what the impact will be and how that might affect the liability of directors and officers remains to be seen.

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What is clear at this point, is that some of the proposed reforms were not incorporated into the final version of the Act. Thus, for example, the law did *not*, as was proposed, legislatively overturn the U.S. Supreme Court's decision in *Stoneridge* and enact a private right of action for aiding and abetting. The Act also did *not* incorporate a proposed legislative provision that would have extended the extraterritorial jurisdiction of the U.S. securities laws in cases brought by private litigants. (The Act did include a provision regarding the SECs extraterritorial jurisdiction, however).

One reason that the Act's ultimate implications remain unclear is that much of the work remains to be done. The Act calls for more than 240 rulemaking efforts and nearly 70 studies by 11 different regulatory authorities. Most of the details of the key provisions - and the ways those provisions will be implemented - remain to be spelled out by the various regulators in the months ahead.

Though much of the picture has yet to be fleshed out, there are certain provisions that will clearly impact directors and officers, even if the ultimate effect is uncertain. For instance, the Act provides rules regarding:

- Executive compensation and corporate governance generally applicable to U.S. public companies, including requirements on shareholder "say on pay"
- Broker discretionary voting
- Compensation committee independence
- Executive compensation disclosures

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- Executive compensation "clawbacks"
- Disclosure regarding employee and director hedging
- Disclosures regarding Chairman and CEO structures; and
- Shareholder proxy access

These provisions do not expressly create new causes of action against directors and officers, but they do create a host of new obligations that undoubtedly will drive shareholder expectations. The probability of claims arising from these new requirements seems high, particularly with respect to the new disclosure requirements.

Second, among the specific parts of the Act that seem most likely to lead to future claims are the new whistleblower provisions. The whistleblower provisions include the creation of a new "whistleblower bounty" pursuant to which individuals who bring violations of securities and commodities laws to the attention of the Securities and Exchange Commission or the Commodities Futures Trading Commission may expect to receive between 10 percent and 30 percent of any recovery in excess of \$1 million.

Many commentators have predicted that these incentives could lead to a dramatic increase in complaints of accounting misconduct, corrupt practices, and other violations. (The specific possibilities for increased reporting related to the Foreign Corrupt Practice Act are discussed below.)

Any resultant increase in enforcement activity also seems likely to generate a related upsurge in follow-on civil litigation, as the underlying violations are disclosed.

At 2,319 pages, the Act's scope is so sweeping that many of its specific implications inevitably will reveal themselves only with the passage of time. Be prepared for years of commentaries about the Act that begin "*Though the provision was little-noticed at the time that the Dodd-Frank Act was enacted, ...*" In the meantime, the laws of unintended consequences will be hard at work.

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### **What happens next with the Subprime and Credit Crisis-Related litigation wave?**

For several years beginning in 2007, corporate and securities litigation was largely driven by lawsuits arising out of the subprime meltdown and the global credit crisis. Beginning in the second half of 2009, the litigation wave began to lose steam, and the related lawsuits dwindled as we moved into 2010.

While the pace of new lawsuit filings has dwindled, new filings have not entirely gone away. Even now, well into 2010, the credit crisis-related lawsuits continue to arrive (although as time goes by, it becomes harder and harder to maintain absolute definitional certainty around what makes a particular case "credit crisis-related."). By our count, there have been as many as 22 new subprime and credit crisis related lawsuits filed during 2010, out of approximately 125 new securities class action suits so far this year (as of September 30, 2010).

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In the meantime, the vast amount of litigation that accumulated over the last four years continues to work its way through the court system. Overall, there have been over 220 subprime and credit-crisis related securities class action lawsuits filed since the first suit was filed back in 2007. About two-thirds of the cases remain pending and many have yet to reach the motion to dismiss stage, though the dismissal motion rulings are starting to accumulate.

And while a number of courts have seemed skeptical about the fraud allegations in light of the magnitude of the global financial crisis, there have been a number of decisions where the courts have found the plaintiffs' allegations sufficient.

With the increasing number of dismissal motion rulings, the cases that survive are likely to head towards settlement. Just in the last few months, there have been several high profile subprime-related lawsuit settlements, namely:

- The \$624 million settlement in the Countrywide case
- The roughly \$124 million settlement in the New Century Financial case
- The \$235 million total settlement in the Schwab Yield Plus case

All settlement figures reflect aggregate settlement amounts. By our calculation, there have been only 15 subprime and credit crisis related lawsuit settlements so far; however, those few settlements total over \$1.8 billion.

The one thing that seems clear is that - when all is said and done on the subprime and credit crisis-related litigation wave - the total costs will be staggering. The defense costs alone associated with this litigation will be enormous. (By way of illustration, the defense expenses associated with just the Lehman bankruptcy are tallying at about \$5 million per month, and those costs are likely to accelerate in the event the SEC files an enforcement action or the DOJ files criminal charges). Though not all of these costs will be insured, many of them will be.

In the aggregate, the subprime meltdown and credit crisis represents an enormous event for the D&O insurance industry. Just how big of an event it is will continue to unfold in the weeks, months and years ahead.

### **Will the wave of bank failures lead to a new wave of Failed Bank Litigation?**

Since January 1, 2008 and through October 8, 2010, 129 banks have failed in the United States, and the total number of failed banks continues to grow. Indeed, in its most recent Quarterly Banking Profile, the FDIC reported that one out of ten banks in the United States is a "problem institution" (meaning that the bank's financial and operational criteria is rated a "4" or "5" on a scale of one-to-five – with one being the best).

During the S&L crisis, the banking regulators pursued claims against the directors and officers of the failed institutions in connection with about a quarter of the bank failures. These efforts proved worthwhile for the FDIC, since its S&L crisis D&O claims led to recoveries of about \$1.3 billion. Given that history, it seems probable that the FDIC will pursue D&O litigation as part of the current bank wave.

Although the FDIC, as part of the current bank failure wave, has filed only one lawsuit against former directors and officers of a failed bank to date, there is every reason to expect that there will be more claims to come, perhaps many more. The FDIC has sent claims notice letters to the directors and officers of many failed banks, and otherwise taken steps to preserve its right to pursue claims and also to assert its priorities over other claimants.

During the S&L crisis, the lag between the peak of the bank failures and the timing of the FDIC's recoveries was about three years. Since the current wave of bank failures did not really start to emerge until late 2008, and did not really gain serious momentum until 2009, it would seem that the FDIC's failed bank lawsuit will begin to accumulate in earnest some time during 2011.

The FDIC has authorized more than 50 lawsuits against former directors and officers of failed banks, according to an October 8, 2010 *Bloomberg* article. But merely because the lawsuits have been authorized does not necessarily mean we will see 50 lawsuits, as it appears that the FDIC approval was calculated in part to encourage pre-litigation settlements.

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In the meantime, other claimants are also asserting claims against the failed banks' former directors and officers. Unlike during the S&L crisis, when most of the failed institutions were privately-held, many of the banks that have failed during the current wave were publicly traded. According to a recent NERA report, about 45 of the roughly 240 subprime and credit crisis related securities class action lawsuits have involved depository institutions.

Of the 20 failed banks that produced the largest losses prior to 2010, 13 involved publicly traded securities, of which eight had been named in securities class actions as of the end of 2009.

The investors of privately held banks are pursuing claims, carefully crafted to avoid running afoul of the FDIC's priority rights to the claims of the failed institutions.

In some respects, these investor lawsuits could be competing with the FDIC for the proceeds of the D&O insurance policies insuring the directors and officers of the failed institutions. However, while the FDIC generally has priority, the investors may be able to access the policies' proceeds when the FDIC may not; if, for example, the relevant policies have exclusions precluding coverage for claims by regulatory bodies.

For now, the extent to which the FDIC will pursue litigation against former directors and officers of the failed institutions remains to be seen. In the meantime, numerous investors are pressing ahead with their own claims. In all likelihood, an extensive amount of litigation related to failed and troubled banks seems likely to accumulate as we head into next year.

### **Will the mix of litigation involving directors and officers continue to shift away from Securities Class Action Lawsuits?**

One of the more interesting litigation phenomena of the last several years, at least as relates to the exposure of directors and officers, has been the material shift of litigation away from securities class action lawsuits and towards other types of lawsuits.

This shift was first discernable in the litigation that arose from the options-backdating scandal, beginning in 2006. Though there were over 30 options-backdating related securities class action lawsuits filed, there were over 160 options-backdating related shareholder derivative lawsuits filed.

According to the mid-year 2010 corporate and securities litigation study by the insurance information firm Advisen, this shifting mix of litigation has continued and securities class action lawsuits have represented a progressively smaller proportion of overall corporate and securities litigation for several years now.

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The remainder of the corporate and securities lawsuits are a broad mix of claims including individual securities lawsuits, shareholder derivative lawsuits, and breach of fiduciary duty lawsuits.

This shifting mix has a number of important considerations. The first is that the dialog about litigation levels tends to focus on securities class action lawsuit filing patterns. Though class action lawsuit filings levels have always ebbed and flowed over time, it seems that as filing levels decline or climb (as they inevitably do), some commentator will make some sweeping generalizations about permanent changes in the filing levels.

The fact is, the dialog about shifting class action filing levels may be beside the point. The real story may be that the kinds of cases that are getting filed have changed.

In any event, the growing importance of lawsuits other than securities class action lawsuits does alter the issues that should be considered in the context of directors' and officers' liability exposures. The changing mix of litigation could have important implications for D&O insurance terms and conditions and limits of liability.

At a minimum, the changing litigation mix provides an important context within which to consider information relating to securities class action filing levels. Even if fewer class action lawsuits are being filed (at least lately, anyway), that does not mean the overall threat of litigation has declined. To the contrary, the Advisen report shows that the threat of corporate and securities litigation generally continues to increase. That is, the litigation threat is not declining; it is simply changing.

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### **What will be the impact of the Supreme Court's most recent Securities Law decisions?**

It seems that every year, or at least recently, the U.S. Supreme Court has issued important decisions affecting securities litigation. The Court's most recent term, which was completed in June, proved to be no exception. The Court issued two cases that could potentially have a significant impact on future securities lawsuit cases and filings.

First, on June 24, 2010, the Supreme Court issued its long awaited ruling in the *Morrison v. National Australia Bank* case. The case was much anticipated because it was expected to provide much-needed guidance on the questions of the extraterritorial jurisdiction of the U.S. securities laws.

The Court threw everybody a bit of a curve ball, when it discarded many decades of jurisprudence analyzing when there was sufficient "conduct" in the U.S to support the application of the U.S. securities laws to a foreign company. The Court said that, rather than a "conduct" based test, the securities laws required a "transaction" test, and effectively held that the U.S. securities laws do not apply to transactions that take place outside the U.S.

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The *Morrison* case clearly rules out so-called "f-cubed" cases, which involve claims asserted against foreign-domiciled companies by foreign domiciled claimants who bought their shares on foreign exchanges.

Since the *Morrison* case came down, plaintiffs in other cases have tried to argue that *Morrison* does not preclude so-called "f-squared case" – that is, cases in which U.S. investors bought a foreign company's shares on a foreign exchange. So far, courts have not proven receptive to that argument, but the issue is far from resolved.

In the meantime, the *Morrison* case seems likely to affect the many U.S. securities cases that have been filed in recent years against foreign domiciled companies. At a minimum, the cases in which the complaints have sought to assert claims on behalf of "f-cubed" claimants seem likely to be narrowed to exclude those claims. (We know many plaintiffs' lawyers may contest the extent of this statement, and in recognition of their arguments, we duly acknowledge their objections.)

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The larger impact of *Morrison* may be that there will be fewer, or at least narrower, U.S. securities lawsuits filed against foreign domiciled companies. The many claimants who may now be unable to pursue claims in the U.S. may seek to resort to the courts and laws of their home countries, and perhaps, to the extent the home country laws fail to provide adequate relief, seek legislative change to allow greater investor protections.

The other significant decision during the past term was the Court's April 2010 ruling in the *Merck* case, in which the U.S. Supreme Court addressed the question of what is sufficient to trigger the running of the statute of limitations for securities claimants. The Supreme Court held that the running of the statute of limitations is not triggered until the plaintiffs have, or with reasonable diligence could have had, knowledge of facts constituting the violation, including facts constituting scienter.

The practical effect of the Court's decision in *Merck* is that it could postpone the running of the statute of limitations, potentially lengthening the time within which plaintiffs might file their claim. This effect seems particularly significant in light of the relatively recent phenomenon that has developed in which plaintiffs have been filing securities lawsuits well after the proposed class period cutoff date.

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Although there have been relatively few new filings that have reflected potential longer limitations periods so far, the possibility for an increase in belated filings remains. The challenge this presents for D&O insurance underwriters and companies alike is that it is harder to be sure when a company that has had adverse developments in the past may be "out of the woods" as far as possible securities lawsuits.

### **What will be the impact of securities cases the Supreme Court will be considering in the upcoming term?**

As discussed above, the U.S. Supreme Court in recent years has seemed particularly interested in taking up securities cases, and the Court's docket for the upcoming October 2010 term is no exception. With Justice Kagan newly added to the Court's lineup, the Court will be considering at least two potentially significant securities cases.

First, the Court has granted a writ of certiorari in the *Matrixx Initiatives* case. The question presented is whether plaintiffs must allege that adverse event information is "statistically significant" in order to establish that the defendants' alleged failure to disclose the information was material. Although the issues involved appear narrow, the case could potentially address broader issues of securities claim pleading sufficiency.

Even if the Court confines itself just to the narrow question of statistical significance, the Court's consideration of this issue has the potential to be important, since companies are regularly receiving customer complaints and must decide when the level of complaints are significant.

The larger possibility for this case is that the Court might take the occasion as an opportunity for a more comprehensive consideration of the issue of materiality. Were the Supreme Court to take up this larger question, the Court's ruling could potentially have significant ramifications for many future securities class action lawsuits.

Second, the Court also granted certiorari in the Janus Capital Group case, which involved the question of who may be a "primary violator" under the securities laws. The defendants in the case are the holding company and the management company for a family of mutual funds. Investors claim they were misled by statements that the funds did not engage in market timing; the funds later entered a settlement for market timing.

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As the Supreme Court recently affirmed in its *Stoneridge* case, there is no private action for aiding and abetting liability under the federal securities laws. Accordingly, the Janus entities can only be liable – if at all – if they are "primary violators," that is, if they are directly responsible for the allegedly wrongful conduct. The Janus entities contend that as mere service entities for the actual funds, they cannot be held primarily liable.

The Fourth Circuit ruled that "a service provider can be held primarily liable in a private securities fraud action for 'helping' or 'participating' in another company's misstatements." The Fourth Circuit's ruling is at odds with the decisions of other Circuit courts. Some courts hold that only someone that "makes" a statement and has it attributed to him can be held liable as a primary violator. Other courts, similarly to the Fourth Circuit, have held that someone that "substantially participates" in the activities that led to the creation of the allegedly misleading statement can be held liable as a primary violator, even if the statement is not attributed to him or her.

At some level, this "substantial participation" test starts to sound a lot like the "aiding and abetting liability" that the Supreme Court had rejected in connection with private lawsuits in the *Stoneridge* case. That may, in fact, be why the Supreme Court took up the case – not just to reconcile an apparent split in the Circuits, but to align the principles of primary violator liability with those of the secondary violator jurisprudence. In any event, and at a minimum, the case will draw greater clarity around what constitutes a primary violation of the securities laws.

### **What will happen to the level of business bankruptcy filings?**

According to the latest report from the Administrative Office of the U.S. Courts, business bankruptcy filings rose 8.34% for the 12-month period ending June 30, 2010. Not only did the filing levels rise relative to the prior period, but they remain well above levels in recent years – for example, the filing rate during the twelve month period ending June 30, 2010 is

76% greater than the comparable period ending June 30, 2008, and 150% greater than the comparable period ending June 30, 2007.

The level of business bankruptcy filings directly affects the overall level of D&O claims activity because so many bankruptcies involve claims against the former directors and officers of the failed entity. These claims are asserted by investors, creditors, the bankruptcy trustee and others. As long as the business bankruptcy filing rate remains at relatively elevated levels, D&O claims activity levels will also remain at higher levels.

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The one positive note from the recent bankruptcy filing statistics is that the rate of business related filings may be slowing, albeit while remaining at relatively elevated levels. Thus, during the period ending June 30, the number of business-related filings declined during each of the three months period during the twelve month stretch. During the first three months of the twelve month period, there were 15,303 business related filings; in the second three months, there were 15,156 business-related filings; in the third three-month period there were 14,697; and in the final three months, there were 14,452.

We can all hope that the economic recovery will lead to fewer business-related bankruptcy filings in the months ahead. However, as long as the filing levels remain elevated compared to historical norms, associated D&O claims activity will also continue.

These issues are important because the interaction between the D&O insurance policy and the processes of the bankruptcy court are intricate and fraught with complexities. The ongoing heightened risk of business bankruptcy has important implications for D&O claims exposure as well as for issues surrounding the D&O insurance placement process.

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### **What will be the next sector to get "hot"?**

One of the well-established patterns of securities class action lawsuit filings is that periodically some industrial sector will get "hot" and suddenly numerous companies in that sector will find themselves the targets of securities class action lawsuits.

Companies in the for-profit education sector saw that during August this year, when, following a government report suggesting the possibility of education loan fraud, nearly a half dozen companies in the sector were hit with securities suits within the space of just a few days. In just about the same way, late last year, a host of exchange traded funds were hit with securities class action lawsuits over a very short time period.

The recent industry-specific litigation outbreak in the for-profit education sector is a reminder of the many odd and circumstance-specific events that can drive securities class action lawsuit filings. Many things determine filing levels, many of which cannot be captured or predicted by historical filing data. As a result, it can be misleading to try to generalize short term trends about future filing levels. Simply put, the numbers vary over time, because, for example, contagion events and industry epidemics happen.

### **Will heightened FCPA enforcement activity lead to increased follow-on civil litigation?**

One of the relatively well-established trends in recent years has been that increasing Foreign Corrupt Practices Act enforcement activity has led to increasing levels of follow-on civil litigation, in which the claimants assert that mismanagement and poor internal controls allowed the corrupt activity to occur. In addition, shareholders also may claim to have been misled about controls, as was alleged, most recently in the securities class action lawsuit filed in August against SciClone Pharmaceuticals and certain of its directors and officers.

For at least a couple of reasons, the heightened level of anticorruption enforcement activity seems likely to accelerate in the months ahead.

First, as noted above, the recently enacted Dodd-Frank Act contains a whistleblower bounty provision that seems likely to produce heightened whistleblower activity in connection with FCPA violations. Under these whistleblower provisions, whistleblowers can receive rewards of up to 30 percent of recoveries over \$1 million. These kinds of rewards could produce some enormous bounties in the FCPA enforcement context, where recent enforcement penalties have been in the range of tens and hundreds of millions of dollars.

Indeed, the top ten FCPA settlements collectively total \$2.8 billion, but the top six, all of which took place just in the last 20 months, represent 95% of the total. Four of the top six settlements were reached just in 2010. Because of the massive scale of the settlements that the SEC has been achieving in this area, the potential rewards for whistleblowers are enormous.

Second, the UK Bribery Act received Royal Assent on April 8, 2010. On July 20, 2010, the U.K. Ministry of Justice released its timetable for the Implementation of the Bribery Act, set-

ting April 2011 as the effective date. The Act is widely viewed in several important respects as more "far-reaching" than the FCPA, and is likely to have significant impacts on business that are either based in the U.K. or have significant parts of their operations in the U.K.

Although the U.K. provisions may be somewhat delayed and the impact of the new Dodd-Frank Act whistleblower provisions may be as yet undeveloped, there is no question that this is an area where many things are happening.

Anti-corruption enforcement represents a significant and growing area of liability exposure for corporate officials, especially in light of the government's apparent willingness to resort to sting tactics and other prosecutorial techniques as part of the heightened enforcement.

Finally, the increased levels of anticorruption enforcement may also represent a growing area of civil litigation exposure, as these kinds of enforcement actions frequently lead to follow-on civil lawsuits. Altogether, exposures arising from anticorruption laws represent an important and growing area of potential liability of corporate officials.

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### **What does all of this mean for the D&O Insurance marketplace?**

The astonishing pace of legislative and judicial changes - just over the last few months alone - underscores how rapidly the liability exposures in the directors and officers arena can be transformed. Given the absolute whirlwind of recent changes, D&O insurers might be excused for taking a conservative approach to risk. Indeed, those outside the industry often assume that is what the carriers would be doing now.

But despite everything, the D&O insurance industry remains competitive, and all signs are that it will remain that way for the foreseeable future. Most insurance buyers, particularly those outside the financial sector and those with reasonably solid financials, can expect to obtain insurance with broad terms and conditions at relatively attractive prices. Though pricing is not declining at the pace we saw in recent years, pricing remains stable at relatively lower levels.

The iron laws of supply and demand are impervious to more trivial forces like legislative or judicial change. On the supply side, the P&C insurance industry is operating with ample capacity, largely due to the absence of large-scale catastrophes. As a result, the D&O insurance marketplace is characterized by a large number of competitors all of whom are continuing to seek to write business. On the demand side, the number of businesses has been

reduced by bankruptcies. Shrinking labor forces and diminished budgets have also reduced insurance demand.

In the absence of some large external event that substantially erodes insurance capacity, the likelihood is that most insurance buyers will continue to enjoy a relatively favorable marketplace.

Nevertheless, the liability landscape for directors and officers is changing rapidly, and well-advised insurance buyers will want to make sure that their D&O insurance program is properly positioned to respond to these changing exposures.

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A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You can access the weblog via our website at [www.oakbridgeins.com](http://www.oakbridgeins.com). To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to refer to The D&O Diary regularly.

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