



Six Questions Senior Management and Board Members Ask Corporate Counsel About D&O Insurance

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#1

What does our D&O policy cover and exclude, and what's the risk that the insurance company can get out of paying this claim?

Three Insuring Agreements

- **Side A:** Direct coverage for individual D&O's when corporation financially or legally cannot indemnify them (no SIR, non-rescindable)
- **Side B:** Coverage for corporation's indemnification of D&O's – presumptive indemnification (SIR)
- **Side C:** Coverage for corporation's liability (securities) (SIR)

Policy Architecture: Timing of Claims

- Coverage trigger: claims-made-and-reported
- Pre-policy claims based on pre-policy wrongful acts are excluded
- Claims within policy that are related to pre-policy claims are excluded

Policy Architecture: What's Covered?

- “Loss”
 - Defense costs:
 - Compare duty to defend with duty to reimburse
 - Policyholder controls defense and settlement
 - Limits are eroded by Loss
- “Wrongful Act:” any act, error, omission, statement, misstatement, misleading statement; broad coverage is dialed back via exclusions and conditions

Policy Architecture: What's Excluded?

- Risks covered by other policies: ERISA claims (covered by fiduciary policies), bodily injury and property damage claims (CGL policies), employee and employment-related claims (EPLI policies), professional services claims (E&O policies), pollution claims (environmental loss and liability policies)
- Claims by one insured against another (Insured vs. Insured Exclusion; Company vs. Insured Exclusion)
- Contractual liability, exception for concurrent non-contract theory of action
- Allocation

Derivative Actions: Exception to Company vs. Insured Exclusion

- Side A applies when the corporation financially or legally can't indemnify D&O's
- When shareholders sue D&O's derivatively: Is corporation legally able to indemnify them?
 - S.D.N.Y. case construing DE law holds indemnification is prohibited; DE law unclear
 - Means Side A applies, and insurer money goes to corporation
 - If companion class action settles at the same time, it's a pass-through transaction
 - If not, first-party recovery by corporation – which controls the settlement process
 - Should corporation settle derivative and class actions simultaneously?

Risk that D&O Insurer Will Successfully Avoid Coverage?

- Relative strength of the claim
- Profitability of the relationship with the policyholder (premiums less claim payments)
- Performance of insurer's D&O book of business
- Relationship with the broker

#2

We've been sued for securities fraud, yet we've heard that fraud and intentional conduct aren't covered by insurance. Can the insurance company get out of paying the pending claim?

The “Conduct Exclusions”

- Exclusions for fraudulent, criminal, dishonest, malicious, or willful conduct.
 - Includes self-dealing and gain to which the insured is not legally entitled.
- Negotiate narrowly.
 - Ex) “deliberate fraud,” “willful and knowing violation of law.”
 - Instead of excluding claims arising from “profit or advantage” to which the insured is not legally entitled, “financial advantage” – limits the exclusion to monetary benefits.

Allegations Don't Trigger

- Mere allegations of fraud or intentional conduct aren't enough.
- Most policies require a final adjudication that the insured participated in fraud or intentional conduct in the underlying action.
- “Final adjudication” usually means you're at the end of the line, after a judicial finding on the merits and after exhaustion of all possible appeals.
- Avoid the “in fact” approach or other ambiguous approaches, such as “adverse admissions” or “plea of nolo contendere or not contest regarding such conduct.”

Severability Clauses

- Fraud/intentional conduct of one insured cannot be imputed to other insured individuals not engaged in such conduct.
- But, many policies impute the bad acts of certain corporate executives to the company for purposes of denying/rescinding Side B or Side C coverage.
 - Usually the CEO and CFO, sometimes the GC and other officers. Limit list as much as possible.
 - Ensure it is the actual knowledge possessed by executives of the “named insured.”

#3

What if we want to settle the pending case and not risk a trial, but the insurance company wants to roll the dice and refuses to settle? What are our options?

Insurer's Duty to Settle

- Most states imply this duty into liability policies
- D&O: Insured controls defense/settlement subject to insurer consent, not to be unreasonably withheld
- If D&O insurer refuses to settle:
 - Liability within limits:
 - Demand waiver of consent provision;
 - Assert that insurer is unreasonably withholding consent, therefore has waived consent provision; then
 - Settle and chase insurer.
 - Liability exceeding limits: Excess Judgment Rule

Excess Judgement Rule:

- If there is a substantial likelihood of liability exceeding policy limits, and
- Plaintiff makes a demand for or within policy limits,
- Carrier must pay it, or policy limits are waived for excess-of-limits outcome at trial.

What if Insurer Has Coverage Defenses?

- In some states, carrier must settle with plaintiff and sue its policyholder to recoup settlement or establish allocation of covered vs. non-covered loss
- In most states, open question

#4

**What happens if, unknown to us,
someone made a mistake or even lied
in the application for our D&O policy?
Will we still be covered?**

Misrepresentations in Application

- Fraudulent or deceptive information in the policy application or materials that were incorporated by reference in the application (financial statements).
- In some states, no fraud need be proved.
 - Insurers can rescind or deny coverage based on material misrepresentations.
 - Insurers can rescind or deny coverage based on innocent, material mistakes.
- Insurers can rescind or deny coverage even if they did not actually rely on the misrepresentations or mistakes.

Non-Imputation Clauses

- Protect coverage for Ds/Os unaware of the misrepresentations or mistakes in the policy application or materials.
- Provide that the knowledge of one insured individual cannot be imputed to any other insured individual.
 - Watch for partial non-imputation clauses.
 - Watch for an exception in which the knowledge of certain senior executives can be imputed to the company for Side B or Side C.

Non-Imputation Clauses

- Non-Rescindable Side A Coverage: Try to get an agreement that an insurer cannot rescind or deny coverage under Side A for individual Ds/Os without knowledge of the misrepresentation or falsification in the application.
- Side B Coverage:
 - Obtain a full severability clause for the insurer's obligation to reimburse the company for its indemnity obligation to Ds/Os who had no knowledge of misrepresentations in the application.
 - Then, even if the insurer rescinds/denies coverage as to certain Ds/Os, the insurer remains obligated to provide Side B coverage to the company with respect to other directors/officers.

#5

What happens when the SEC calls and asks for our cooperation in an informal investigation, and we have to hire counsel to produce documents and prepare witnesses to protect the company? Do we have coverage for the cost of this?

Older Policies: Informal Regulatory Investigations Not Covered

- Rationale: policyholder response is discretionary, insurer does not want to encourage insured to incur avoidable defense expenses
- When regulators were less aggressive, little demand for informal investigation coverage

Real World

- Regulators are more aggressive in the wake of WorldCom, Enron
- When the SEC calls, responding is not discretionary
- Newer policies:
 - Policyholders demand coverage for costs of defending informal investigations and are willing to pay for it
 - Informal investigation defense costs now covered, sometimes subject to sublimit

#6

Are there any gaps in coverage that we should tell our broker to plug at the next policy renewal?

Stand-Alone Side A DIC Coverage

- Coverage to Ds/Os that is not shared with the company. Typically does not have a retention amount and is not subject to cancellation.
- Drops down where other coverage is exhausted or denied. Examples:
 - Exhaustion of limits (Side A DIC is outside the tower).
 - Failure/inability to pay retention (Side A DIC doesn't have a retention).
 - Coverage failures (Side A DIC may cover certain claims excluded by the Side A policy, such as punitive damages, pollution exclusion, insured v. insured, etc.).
 - Company bankruptcy (Side A DIC isn't seen as part of debtor company's estate).
 - Rescission of the policy (Side A DIC will avoid rescission).
- If Side A DIC coverage is too pricey, consider Side A Excess. Same terms as primary – addresses exhaustion of limits but not other coverage gaps.

Tail Coverage

- Coverage for conduct that occurred during the policy period but for which the claim is made after the policy period.
 - Important in change of control or acquisition situations – exiting Ds/Os may face claims for years after their exit.
- The tail or runoff period should be long enough to cover any anticipated statute of limitations. Most common duration is 6 years.

Avoid Exclusions Creating Gaps

- Broad Bodily Injury/Property Damage Exclusion
 - Exclusion for BI/PD claims is fine.
 - Exclusion for “claims based upon, arising out of, or in any way related to bodily injury or property damage” may eliminate coverage for secondary claims by shareholders who sustain financial loss resulting from the BI/PD of others.
- Prior/Pending Litigation Exclusions.
- Breach of Privacy Exclusions.

Avoid Exclusions Creating Gaps

- Corporate Activities Exclusions
- Claims from going private/leveraged buyouts.
- Claims from mergers and acquisitions.
- Claims from IPOs.
- Claims from joint ventures or partnerships.

Conclusion

- Directors and officers usually pay attention to D&O insurance only in a crisis
- The corporate lawyer who knows about D&O insurance is a valuable commodity
 - You don't have to be an expert, just an issue-spotter
 - Insurance recovery counsel can fill in the details
- Gets you a seat at the table at a time when the clients need you most

Questions?



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