

Key Issues in Evaluating and Negotiating D&O Insurance Coverage

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I. Introduction

Over the last decade directors and officers of public and private companies have increasingly become targets in civil litigation, government investigations, and enforcement actions. In today's claims and regulatory environment—with civil actions of many stripes often naming individual directors and officers as defendants and stepped up enforcement activity by the SEC and Department of Justice—directors and officers are sharply aware that their personal assets may be at risk whenever events occur in the life of their company that could make shareholders, customers, employees, or regulators unhappy, or could otherwise fetch the attention of plaintiffs' lawyers.

Because of the increasing risk to their personal assets, directors and officers are more frequently calling on outside and in-house counsel to evaluate the adequacy of their company's D&O insurance, looking for assurances that their coverage is as broad as possible with limits sufficient to protect them. This is a challenging task for an attorney because D&O policies are densely written and complex, filled with turgid terms, exclusions, and conditions that must be weighed to evaluate possible shortfalls in coverage. In addition, a client's D&O insurance program will often consist of a primary policy and multiple excess policies (including different types of excess policies) which are frequently issued by many different insurers, often resulting in a crazy quilt of different contract forms. Also, D&O policies are intended to (or at least should) mesh with both the company's indemnification obligations to its officers and directors and the company's other liability insurance policies—further complicating efforts to take comprehensive stock of the client's coverage.

In approaching the task of assessing D&O coverage, it is important to recognize that D&O policies are not issued on standard forms and the coverage extended under D&O policies can differ in many game-changing ways. While most D&O policies follow the same basic structure and have common traits, insurance companies typically develop and use their own policy forms; there are many differences in the specific terms offered by primary and excess insurers in the market. Seemingly minor differences in policy language can make a big difference in whether directors and officers have the coverage they expect when a claim arrives.

Additionally, there is a range of difference in the willingness of insurers to negotiate policy terms. Depending on the insurer, the nature of the client's business, the risk tolerance and premium tolerance of the client—among other factors—many D&O policy terms are subject to negotiation. In any event, you don't know

whether a term is negotiable until you ask, and it is difficult to ask until you know what to ask for.

The purpose of this article is to identify and discuss some of the key policy terms to review and other issues to assess in evaluating a company's D&O coverage and in negotiating D&O policies.

II. Threshold Practical Considerations for D&O Policy Negotiations

Before discussing the details of D&O policies and key terms to evaluate in policy negotiations, there are a few front-end tips to consider in approaching the task.

The broker's role. The services of an experienced and well informed insurance broker are absolutely vital in negotiating and procuring D&O coverage. Brokers who have experience placing D&O policies should know what insurers are willing to offer and at what price, and how far one might be able to push insurers in negotiations over terms and price in light of the dynamics of the current D&O market. The lawyer's job in evaluating and assisting in the negotiation of D&O policy terms differs substantially from the broker's job. The broker typically interfaces directly with the insurers to obtain policy proposals and, if she is doing her job, proactively pushing for coverage enhancements. A lawyer should not try to take on the broker's job because it would be hazardous to the client and the lawyer.

It is best if counsel works with broker and client together to identify the client's goals and needs in obtaining D&O coverage and assess the current policy terms and the terms that can be negotiated at renewal, comparing different proposal by different insurers. A good broker will have a better understanding of the terms that are available in the market and the intent behind those terms. Counsel is usually in a better position to evaluate how policy terms have been, or will be, applied and interpreted by the courts, and where there are gaps between expectations regarding coverage and how the policy terms will actually play out when coverage disputes arise.

The timing of policy negotiations and the parties involved in the process. For policy and renewal negotiations to be successful, counsel should encourage clients to start the process early to provide plenty of time to evaluate current coverage, identify gaps or concerns in coverage, assess the client's current liability exposures (taking into account any business plans that might impact liability risks), and then give the broker enough time to negotiate with several insurers to obtain the most favorable prices, terms,

and coverage enhancements available. This process can take months, not weeks or days. An insurer who knows that the expiration date on the client's current D&O policy is imminent will be much less motivated to engage in negotiations over coverage enhancements.

Counsel should also identify the executives and divisions of the company that should play a role in assessing risk exposures and identifying D&O coverage needs and goals. The risk management department frequently has primary responsibility for D&O policy negotiations and procurement, but many other officers and executives have responsibilities related to the D&O coverage and are constituents of the D&O policy. For example, the general counsel or the company's in-house legal department may need to be involved in addition to other executives who have to report to the board regarding the company's coverage. This is another reason to stress that ample time should be allocated for the D&O negotiation and placement process, so that all of the key players are provided more than a last minute opportunity to ask questions and raise concerns about the D&O coverage and the risks of liability that are of greatest concern for the company and its officers and directors.

III. Common Features of D&O Coverage

A. The Kinship between D&O Insurance and Corporate Indemnification of the Directors and Officers

D&O insurance is chiefly intended to protect directors and officers from personal liability arising from their work for the companies they serve by providing them with coverage for defense costs, settlements, and judgments for claims asserted against them. Even when a corporation broadly agrees to indemnify its officers and directors, there will be times when the company is not financially able or legally permitted to advance defense costs or fund indemnification. For example, under many states' laws, corporations are not permitted to indemnify executives for shareholder derivative actions or for liability due to the individual's breach of the duty of good faith. As another example, the SEC has long taken the position that it is against public policy for a corporation to indemnify directors and officers for violating the registration and anti-fraud provisions under the Securities Act of 1933.

D&O insurance is often viewed as filling in the gaps where advancement of defense costs or indemnification by the company is unavailable. Accordingly, D&O insurance should be structured to insure individual directors and officers when the company cannot or will not indemnify them due to insolvency, legal restrictions, or for other reasons. To achieve this and to guard against gaps occurring in the D&O coverage, the D&O policy should be evaluated in connection with the mandatory and permissive rights of advancement of defense expenses and indemnification that the com-

pany extends to company executives through its charter and other governing documents or indemnity agreements.

Be aware of “presumptive indemnification” provisions. There are a number of places in a D&O policy where a company's indemnity obligations to its officers and directors intersect with the policy terms. For example, many D&O policies include a “presumptive indemnification” clause that could determine whether an individual director or officer must personally pay the self-insured retention before she can access coverage under the policy.

Most companies buy D&O policies with a large self-insured retention, ranging from thousands to millions of dollars depending on the size of the company and other factors. The retention must be paid by the company before the policy will indemnify the company for losses, but the retention typically does not apply to coverage extended directly to individual directors and officers for losses that are not indemnified by the company—such that the insured individual is not required to pay the retention as a condition of obtaining coverage for losses the company does not indemnify.

However, if the policy contains a “presumptive indemnification” clause, the policy will generally provide that if the insured company is *legally permitted* to indemnify a director or officer but fails to do so for reasons other than insolvency, then the individual insured will have to pay the full retention from her own pocket before the insurer is obligated to step in and provide coverage. This term builds a presumption into the policy that the company will indemnify its officers and directors to the fullest extent permitted under governing law. This term is designed to guard against the risk to the insurer that the insured company will elect not to indemnify officers and directors to force the insurer to indemnify them. Unless the individual insured has the financial resources to pay the large retention, a presumptive indemnification term could effectively bar an individual insured from gaining access to D&O insurance.

Even if an insurer refuses to remove a presumptive indemnification provision from the policy, there are ways to eliminate the risk that an individual executive will have to personally pay a huge retention. (See the discussion below regarding the “drop down” coverage provided by “Side A-only excess DIC policies.”) But one way to address this risk is to try to ensure that the terms of the company's D&O policies align with the indemnification provisions in the company's charter documents and indemnity contracts.

B. The Many Sides of D&O Coverage.

Almost every D&O policy provides liability coverage to individual officers and directors for losses resulting from claims made against them arising from wrongful acts in

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connection with their role and responsibilities as executives for the company. D&O policies also usually provide coverage to the insured company for certain types of losses and claims, although the extent and nature of the insured entity's coverage can vary substantially.

The ABC's of Coverage. D&O policies typically include several different insuring agreements, often referred to as Side-A, Side-B, and Side-C coverage. While this naming convention is a bit obtuse, it is useful to understand the ABC's of D&O coverage grants because these terms are routinely used in D&O policies and by brokers discussing the core terms of coverage.

Side-A coverage (or Insuring Clause 1) – The Side A coverage grant insures individual directors and officers against losses that the company is not legally or financially able to indemnify, often referred to as insurance for directors' and officers' "non-indemnifiable losses." This coverage protects the personal assets of directors and officers in the event the company does not pay defense costs or fund indemnification.

Side-B coverage (or Insuring Clause 2) – This coverage provides the company with balance sheet protection by agreeing to reimburse the company if it advances legal fees to officers or directors or indemnifies them against losses.

Side C coverage or "entity coverage" (Insuring Clause 3) – This coverage provides insurance directly to the insured company for certain types of claims. In policies issued to public companies, Coverage C is almost always limited insurance for "Securities Claims" — claims based on state or federal securities laws. In D&O policies issued to private companies, the entity coverage (sometimes referred to as "management liability coverage") often applies broadly to a wide range of claims against the company arising from wrongful acts by the insured company or its officers or directors.

Other Insuring Agreements – Many D&O policies extend other types of entity coverage to the company. For instance, it is fairly common to see policies include an insuring agreement (Side D) that provides a company with separate coverage for costs incurred in connection with internal investigations incurred in response to a shareholder derivative claim. Such coverage is typically subject to a "sub-limit" that is often insufficient to cover the likely costs of such investigations. Thus, a company with a D&O policy that carries a \$10 million limit of liability may provide a sub-limit of \$250,000 for corporate investigations in response to a demand from an unhappy shareholder.

When a policy contains an insuring agreement that is subject to a reduced sub-limit of insurance for entity coverage extended to the insured company, counsel should

evaluate whether the additional insuring agreement is a backhanded effort to impose a lower limit of liability on certain types of claims, expenses, or losses that might otherwise be covered under the policy without being subject to a reduced limit of liability. Additionally, counsel should keep in mind that any additional coverage extended to the insured company can exhaust the limits that would otherwise be available for directors and officers. Also note that an insuring agreement subject to a sub-limit typically does not increase the total limits of liability under the policy, meaning that (using the example discussed above regarding the derivative claim) if \$250,000 is incurred for an internal investigation, the \$10 million in limits will be eroded by those covered expenses.

IV. Key Policy Terms, Exclusions and Conditions to Review and Assess

A. Limits of Liability and Self-Insured Retention

A threshold issue in any review of D&O coverage is determining the appropriate limits of liability that the client should have. A companion issue is determining the size of the self-insured retention, i.e. the amount the insured must pay out of pocket before the D&O coverage is triggered.

Determining Limits – How Much is Enough. There is no science or formula for forecasting the amount of D&O insurance a company will need for the upcoming policy period. Like most insurance, determining the amount of insurance to obtain is a matter of weighing tomorrow's unknown future liability scenarios against today's premium dollars. At bottom, D&O insurance limits need to be sufficient to pay for a vigorous defense of claims for all of the directors and officers and perhaps for the company itself, with enough remaining to settle claims and satisfy judgments so that plaintiffs are not motivated to pursue individuals director's and officer's personal assets.

Brokers have sophisticated, data-driven methods that they use for recommending D&O insurance limits by identifying and comparing the amount of limits that other similar companies obtain and, in some cases, using formulas for forecasting likely defense costs and settlement value ranges for certain types of liability risks, such as class action securities suits. This sort of benchmarking serves a good purpose but it is only part of the picture.

Counsel can assist in this endeavor by evaluating key liability risk exposures for directors and officers and potential litigation expenses associated with those risks, tak-

ing into account claims that can be reasonably anticipated with particular attention paid to those that could be enterprise threatening. This requires a thorough understanding of the client's liability risk exposures and the client's business plans during the upcoming policy period. A company that is actively pursuing mergers and acquisitions, preparing for an initial public offering, or that has other strategic plans that could increase the risk of claims should take these plans into account when evaluating the adequacy of D&O limits.

All of the Insureds Draw from the Same Well. Keep in mind that the same bucket of limits is being used to defend and protect all of the insured directors and officers (and other employees who qualify as individual insureds) in addition to the company. And the same limits of insurance will be depleted to pay defense costs for all of the directors and officers who are targeted in claims – some of whom may have radically conflicting interests based on the claims asserted against them.

Some directors and officers may be more culpable than others for the potential liability arising from a claim—e.g., some officers may be alleged to have knowingly participated in fraudulent acts, while others are alleged simply to have breached their duty of care. Nevertheless, the so-called innocent (or “white hat”) directors and officers—such as outside directors who are named as defendants in a lawsuit—are sharing defense costs with the directors and officers implicated in the alleged wrongful acts that led to the claims, the so-called “black hat” D's and O's).

Consequently, directors and officers may rightfully object to being represented by the same counsel, and in some cases multiple lawyers will end up representing different directors, officers and the company—all of whom will want to draw from the same trough of insurance limits to pay their fees.

Defense Costs Erode Limits. Also bear in mind that in most D&O policies, defense costs reduce the limits of liability. Unlike commercial general liability insurance, which pays defense costs outside the limits of liability, D&O policies are “wasting policies” where legal fees and other defense costs erode the limits.

Self-Insured Retention. As noted above in connection with “presumptive indemnification” clauses, counsel should work to ensure that the self-insured retention does not apply to coverage for claims against directors and officers that the company does not indemnify (Side A coverage). Counsel should discuss with the broker options for either avoiding or navigating around a scenario in which an insured executive will be required to pay a retention if the insurance company takes the position that the insured company has “wrongfully refused” to indemnify its officers or directors by failing to indemnify them to the full extent permitted under law.

B. Definition of an Insured “Claim”

The definition of “Claim” in the policy is a key term because it determines the events that trigger coverage under the policy—ranging from a lawsuit or criminal indictment to a regulatory investigation or subpoena. Equally important, the meaning of “claim” in the policy also determines the events that trigger an insured's obligation to timely report a claim to the insurer to ensure coverage is not jeopardized by violating the notice requirements under the policy. The definition of Claim routinely includes (and should include):

- Written demands for monetary damages. The definition also frequently includes written demands for non-monetary or injunctive relief. Under this definition a mere letter to the insured demanding damages or arbitration or mediation would qualify as a “claim” under this prong of the definition.
- Civil, criminal, regulatory, or administrative proceedings commenced by service of a complaint, criminal indictment or similar document.
- “Securities Claims,” typically defined broadly in the policy to include any claims involving the violation of any state or federal securities laws. In recent years insurers have been willing to expand the definition of Claim. Thus, counsel should look to see if the meaning of “claim” includes the following events, and if it does not, consider requesting that the definition be expanded to include them:
 - A request to the insured to toll the statute of limitations period with respect to a potential claim.
 - A shareholder derivative demand or claim for breach of fiduciary duties by an officer or director.
 - The commencement of government or regulatory investigations of the insured company or of officers or directors of the insured company.
 - The issuance of subpoena to the insured company or its officers or directors by a governmental agency or regulatory body.

Insures are typically willing to include governmental or regulatory proceedings and formal investigations within the meaning of a “claim,” but policy terms differ substantially on what actions the enforcement authority must take before a covered “claim” commences. Some policies define a claim to include “civil, administrative or regulatory investigations”

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against an insured so long as it is commenced by the filing of a notice of charges, investigative order, or similar document. Some policies state that an investigation that qualifies as a “claim” commences when the insured person receives a target letter or SEC Wells notice. However, requiring a formal charge or order to be issued before a claim commences under the policy may leave some serious and costly governmental investigations uncovered if no formal charge or order is obtained.

One coverage dispute that has been litigated several times between D&O insurers and their insureds involves the issue of whether D&O insurance covers the costs a company incurs responding to an “informal” investigation by a regulatory agency such as the SEC or the Department of Justice before any formal order of investigation is issued, or the costs incurred for a follow-on internal investigation by a special litigation or audit committee often triggered by a government agency’s investigation. Policies that do not insure informal investigations could leave a big hole in coverage because such investigations, which typically require the company’s full cooperation, often means hiring outside counsel and accounting firms, resulting in substantial legal fees. A coverage dispute about whether such fees are insured could be avoided by negotiating with the insurer to expand the definition of “claim” in the policy to include informal regulatory and administrative investigations of any insured for a “wrongful act” covered by the policy.

Finally, counsel should emphasize to the client that there are backhanded hazards to expanding the definition of claim to broadly include all administrative or regulatory proceedings, investigations, subpoenas, and written demands requesting monetary, nonmonetary, and injunctive relief. Most notice terms in D&O policies require insureds to report claims to the insurer as soon as practicable or words to that effect. If the insured fails to report a regulatory investigation or even a simple letter demanding damages, and then a related formal civil, administrative or criminal action subsequently arises, the insurer may take the position that there is no coverage for the action because the insured violated the requirements in the policy to report a “claim” as soon as practicable.

C. The Conduct Exclusions Barring Coverage for Fraud, Intentional Violations of Law, and Illegal Personal Profit

All standard D&O policies exclude coverage for certain bad acts by the insureds, such as fraud, dishonesty, violations of law, and unlawful personal profit or remuneration. The wording of such exclusions must be examined with care because these exclusions are implicated in most claims against

directors and officers. It is standard fare, for instance, to see securities or other claims alleging that an executive knew or should have known that the information provided to investors was false or fraudulent.

There are three aspects of the conduct exclusions that should be examined for the purpose of trying to narrow their scope and application.

Conduct Exclusion Issue 1 – What event triggers the exclusion? In almost every D&O policy, there must be some finding or ruling that the insured actually engaged in the prohibited conduct before the exclusion will apply; an allegation that the director or officer engaged in the bad acts listed in the exclusion (e.g. fraud or illegal personal profit) is not enough for the exclusion to bar coverage.

Many policies on the market today provide that the exclusion applies only if there is a judgment or “final adjudication” adverse to the insured that establishes that the bad acts referenced in the exclusion occurred. The final adjudication trigger in a conduct exclusion can substantially reduce the risk that an insurer will be able rely on the exclusion to bar coverage because most matters are settled before there is a final adjudication.

However, counsel must try to ensure that the policy terms make clear that the exclusion applies only if the referenced bad acts (e.g. fraud or illegal personal profit) are established by a final, non-appealable adjudication in the underlying action or underlying judicial proceeding. Restricting the final adjudication to the underlying action means that the exclusion will not be triggered if the insurer files a coverage action in an effort to establish that the insured engaged in the bad acts referenced in the exclusion.

Also, note that if the exclusion states that there must be a final adjudication in an “underlying proceeding,” it would be best to refer to it as an “underlying judicial proceeding,” to try to eliminate triggering the exclusion based on an administrative proceedings. It has become more important of late to distinguish judicial proceedings from administrative proceedings, in part, because of the SEC’s recently announced policy that it will require enforcement action defendants in “egregious” cases to admit wrongdoing as a condition of settlement. This requirement could impact D&O coverage for directors and officers who make such admissions in order to settle the SEC’s action, because the insurer may take the position that such an admission constitutes a final adjudication in an underlying proceeding.

Instead of a final adjudication trigger in the conduct exclusion, some policies merely provide that the conduct exclusion applies if the referenced bad acts occurred “in fact.” For instance, the exclusion might state that the insurer will not pay losses for claims made against the insured arising out of or based upon “the committing in fact” of any deliber-

ate criminal or deliberate fraudulent act by the insured, or the “gaining in fact” of any profit, remuneration or financial advantage to which the insured was not legally entitled.

This “in fact” trigger is regarded as much less favorable for insureds because it is unclear who gets to determine whether the bad acts referenced in the exclusion “in fact” occurred. Insurers may take the position that they can make the determination and unilaterally deny coverage, or they can file a coverage action to have a court make the determination for purposes of denying coverage. Some courts have held that this “in fact” trigger is not satisfied unless there is an adjudication in the underlying action, but other courts have not imposed this interpretation on the “in fact” trigger in conduct exclusions. Counsel should steer clear of an “in fact” trigger in conduct exclusions if possible.

Conduct Exclusion Issue 2 – Limiting the bad acts that trigger the exclusion. Work to make sure that the appropriate modifiers are used to describe the bad acts that are listed in the exclusion. If it just says “fraud,” change it to “deliberate fraud.” If the exclusion just says “willful violation of law,” see if the insurer will accept “willful and knowing violation of law.” Where policies refer to excluding claims arising from “profit or advantage” to which the insured is not legally entitled, change it to “financial advantage,” to limit the exclusion to illegal monetary benefits received by the director or officer rather than non-monetary advantages. Generally speaking, whatever words the insurer uses to describe the bad acts, look for ways to add modifiers or other terms to describe the nature of the bad deeds to limit the potential breadth of the exclusion.

Conduct Exclusion Issue 3 – Severability clauses. Finally, the policy should include a term stating that for purposes of applying the exclusions, the facts pertaining to and knowledge possessed by one insured director or officer will not be imputed to, or attributable to, any other insured individual, such that the bad acts of one officer does not impair the coverage for the rest of the directors and officers insured under the policy.

Many standard D&O policies include such terms – sometimes referred as non-imputation or severability of exclusion clauses. However, many policies will provide that the bad acts of certain corporate executives may be imputed to the company to determine whether the coverage extended to the corporation under Side B (reimbursement for indemnification of directors and officers) or Side C coverage (entity coverage) is barred based on the conduct exclusions. Insurers almost always insist that the knowledge of the Chief Executive Officer and Chief Financial Officer can be imputed to the company, but frequently insurers want the general counsel and other officers on the list as well. Obviously, it is more advantageous for the insured to limit the corporate executives whose knowledge can be imputed to the corporation. And it is best to make it clear that only the

actual knowledge possessed by the chief executive officer or financial officer of the “*named insured*” under the policy – as distinguished from every subsidiary or affiliated company that might also be insured under the policy – will be imputed to the insured company for purposes of applying the conduct exclusion.

D. Application Severability and Rescission

One of the frequently litigated D&O coverage issues is whether the insurer may rescind a policy, or deny coverage for a claim, based on fraudulent or deceptive information contained in the policy application or materials that were incorporated by reference in the application as documents on which the insurer relied in issuing the policy. Most D&O policy applications provide that the application materials on which the insurer has relied in underwriting and issuing the policy include not only the information provided in the application but also include (and incorporates by reference) the company’s financial statements, including public filings such as annual and quarterly statements filed with the SEC.

Thus, when securities claims or other claims are made against the company and its directors and officers based on misrepresentations or fraud in the company’s financial statements, insurers may seek to rescind the D&O policy, or deny coverage for a claim, arguing that the policy is void or that there is no coverage for the claim, because of material misrepresentations in the information that the insurer relied upon in agreeing to issue the insurance.

There are several terms that counsel should evaluate to limit or prevent an insurer from rescinding the policy or denying coverage based on alleged misrepresentations in the application materials.

Full severability clauses. Currently, most D&O insurers will include a severability term (sometimes called a “non-imputation” clause) which provides that the knowledge of one insured individual cannot be imputed to any other insured individual for purposes of denying or rescinding coverage based on misrepresentations in policy application materials. (This application severability clause is similar to the severability provision discussed above with respect to the conduct exclusions.) The policy usually affirmatively states that the insurer is permitted to rescind or deny coverage based on misrepresentations or failures to disclose material information in the application materials. However, to protect coverage for directors and officers who were unaware of the misrepresentations, such a term should be subject to a full severability clause making it clear that the insurer cannot rescind or deny coverage for any individuals who had no knowledge of the misrepresentations.

Some insurers may still seek to include partial (rather

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than full) severability clauses, which state with respect to the application materials that the knowledge of individual insureds cannot be imputed to other insureds, except that the policy can be rescinded and coverage voided as to all insureds if the individual officers who signed the application had knowledge of the misrepresentations. Such a term should be vigorously resisted in today's market, where full severability clauses are widely available.

Similar to the severability provision regarding conduct exclusions, the policies will typically provide that the knowledge of certain senior executives can be imputed to the company for determining whether the insurer can deny or rescind coverage for the company under Side B or Side C entity coverage. Counsel's goal here is twofold: (1) try to reduce the list of key executives whose knowledge of misrepresentations in the application materials can be imputed to the company; and (2) make it clear that only the designated officers of the named insured company can be imputed to that company for purposes of voiding coverage, and that this will not impact the coverage for subsidiaries and other insured companies under the policy. With respect to Side B coverage, counsel should also strive to apply a full severability clause to the insurer's obligation to reimburse the company for its indemnity obligation to directors and officers who had no knowledge of misrepresentations in the application. Thus, even if the insurer voids coverage as to certain directors and officers because they had knowledge of the misrepresentations, the insurer remains obligated to provide Side B coverage to the company with respect to other officers and directors.

Non-rescindable policy terms. It is fairly common in today's market for D&O insurers to include (or they will agree to include if asked) terms providing that the insurer cannot rescind coverage for individual directors and officers under Side A of the policy. These D&O policies affirmatively provide that the directors' and officers' coverage extended for non-indemnifiable losses is "non-rescindable." That means even in cases where certain officers made intentional misrepresentations in the policy application or falsified financial statements that are included within the meaning of application materials—which will may result in those officers having no D&O coverage—the Side A coverage for the other individual insureds cannot be rescinded. At the very least, the insured should insist on non-rescindable coverage for claims against directors and officers that the company is financially unable to indemnify or legally prohibited from indemnifying.

However, counsel should pay close attention to policy terms that purport to make the coverage broadly "non-rescindable." For example, some insurers are issuing policies that are fully non-rescindable under Side A, B and C cover-

age. However, these policies will usually also contain terms that permit the insurer to deny coverage for a claim—as distinguished from voiding coverage through rescission—based on misrepresentations in application materials. A broad non-rescindable policy term is usually counterbalanced by another term that allows an insurer to deny coverage for a claim based on misrepresentations in application materials. Just as there is a legal distinction between rescinding coverage under a policy and denying coverage for a specific claim, there is often a policy distinction between the insurer's right to void coverage through rescission (which the insurer may agree to waive) versus the insurer's right to deny coverage for a claim to insureds who had knowledge of misrepresentations in application materials (which insurer will not typically waive). Thus, even in policies that purport to be non-rescindable, ensure that the severability clauses in the policy expressly protect coverage with respect to "innocent" individual directors and officers who were unaware of any misrepresentations in the application materials.

Definition of Application. Finally, counsel should review the definition of "application" in the policy to identify what documents and information fall within the definition, including the materials and information that are incorporated by reference within the definition, irrespective of whether the insurer actually examines or obtains a copy of the documents referenced in the definition. If possible, try to narrow the scope of the definition of application and the information submitted to the insurer with the application. For example, with respect to financial statements incorporated by reference as application materials, seek to limit them only to financial statements filed within the past year.

Definition of an Insured "Loss"

The definition of "loss" in a D&O policy should be examined to determine whether it includes, to the maximum extent permissible under law, coverage for punitive, exemplary, and multiplied damages, and to evaluate the types of things that are carved out of the meaning of a covered loss.

Insuring agreements in D&O policies typically provide that the insurer will indemnify the insureds for "loss" they are legally obligated to pay arising from covered claims. Thus, the term loss identifies the things for which the policy will pay. Loss is typically broadly defined to include damages, settlements, judgments, awards, legal fees and other defense costs. But the definition also includes an exception clause that carves out certain kinds of fines, penalties, and damages. Under this exception clause, loss does not normally include fines or penalties imposed by law or matters that are uninsurable as a matter of law. Policies will also usually list several other exceptions to the definition.

Any exception to what constitutes a loss effectively acts an exclusion under the policy that can have a significant im-

pact on coverage. Counsel should thus seek to limit the list of exceptions in the definition. For example, if “restitution” or “disgorgement” are included in the list of exceptions, counsel should seek to remove them. Including restitution and disgorgement in the list of exceptions to the meaning of a loss may result in a significant reduction of coverage because these are concepts that can apply to damages recoverable under many different types of claims. Counsel can argue that there is no need to carve out restitution or disgorgement from the definition of loss because the policy already excludes illegal personal profit and remuneration in the conduct exclusion.

However, even if restitution and disgorgement are not included in the list of exceptions to the meaning of loss, an insured may have no coverage for such damages because a number of courts have ruled that disgorgement of ill-gotten gains or restitutionary damages are uninsurable as a matter of law. For example, some courts have ruled that losses for violations of Sections 11 and 12 of the Securities Act of 1933 are uninsurable because they amount to the return of ill-gotten gains earned by the insured as a result of selling the company stock at an artificially inflated price due to misrepresentations that violate the securities laws. Most D&O insurers will state (or agree to state if asked) in the definition of loss that losses for violations of Sections 11, 12 and 15 of the Securities Act of 1933 are not considered uninsurable.

E. Who is an Insured and Whether to Obtain Entity Coverage?

Counsel should evaluate how the policy defines an “insured individual” or “insured person,” i.e. who will qualify as an insured director or officer under the policy. Despite the D&O name of the policy, the policy can insure individuals who are not directors or officers of the company. For example, the definition of an insured person might include any employee so long as a director or officer is named as a defendant or targeted party in the claim.

If the definition of insured individual is limited to duly elected and appointed officers and director, evaluate whether the coverage extends to all of the executives that the company wishes to include within its D&O coverage. Some key management team members might not qualify as “officers” of the company and thus they will not be eligible for insurance under the policy. In particular consider whether the general counsel qualifies as an insured individual under the policy.

Counsel should also discuss with the client whether to limit the D&O coverage solely to directors and officers, and forego any entity coverage for the company in the policy. By eliminating coverage for the company—an option that some companies have elected to take—the policy limits are available exclusively for the benefit of the insured officers and di-

rectors. Entity coverage not only threatens to deplete policy limits that would otherwise be available to the individual directors and officers, it can also create coverage issues for the insured individuals if the insured company files bankruptcy. If the company has entity coverage under the D&O policy, the policy is usually deemed to be an asset of the bankruptcy estate, which can substantially interfere with the individual insureds’ ability to access the policy.

If entity coverage is eliminated from the policy, allocation disputes can arise between the insurer and insureds when claims are made against both the company and individual insureds. If the company has no entity coverage under the D&O policy and claims are asserted against the company and its directors and officers, the insurance company will usually take the position that it is not obligated to pay 100% of defense costs or judgment or settlement payments because some percentage of such payments must be allocated to the claims against the entity, which is not insured under the policy. In fact, entity coverage was originally added to D&O policies because of the allocation disputes that arose when a securities claim was made against both the company and insured officers and directors.

Thus, if entity coverage is eliminated from the policy, a predetermined allocation term should be added which sets forth the portion of jointly incurred defense costs and settlement payments that will be paid under the policy. If the predetermined allocation is set at less than 100%—some insurers have agreed to pre-set allocation of 100%—the clause should make clear that the allocation does not apply to coverage under Side A to ensure that insured executives are not personally liable for losses that are not indemnified by the company.

F. Advancement of Defense Costs and Priority of Payments

Under D&O policies, the insurer usually does not have a “duty to defend” the insured against a claim. Rather, the insurer has a duty to indemnify the insured for covered losses, which includes paying defense costs incurred to defend a claim. Even if the insurer does not have a contractual duty to defend, the policy terms provide that the insurer is still involved in the defense of the claim because the insured is obligated to cooperate with insurer with respect to the defense and cannot make any decisions to settle the claim without the insurer’s knowledge and consent. But usually, the insured under a D&O policy hires counsel and controls the defense, although there are often various restrictions in policies regarding selection of defense counsel and the insurer’s right to participate in the defense of a case.

Ensure defense cost advancement obligation is

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spelled out. Counsel should ensure that the D&O policies contain express provisions requiring the insurer to advance defense costs as they are incurred, rather than permitting the insurer to wait and reimburse the insured for defense costs at the end of the case or at the insurer's discretion. Generally, a corporation is obligated to advance defense costs to officers and directors on a current basis as a matter of law, corporate bylaws, or contractual indemnification agreements. D&O policies should contain terms that likewise impose an obligation on the insurer to advance defense costs on a current basis.

Priority of payments clause. Additionally, counsel should ensure that the policy contains a "priority of payments" or "order of payments" clause. This clause specifies how an insurer is required to make defense and indemnity payments if there are competing claims on the policy's proceeds and the aggregate liability that may be covered by the policy exceeds the total limits of liability under the policy. For example, if there are covered claims made against the company and covered claims made against insured directors and officers, most priority payments clauses dictate that the insurer must pay Side A claims first. Indeed, the priority of payments term should make it clear that the insurer is contractually bound to give the directors and officers first priority for any claims that the company is unable or unwilling to indemnify. After the Side A coverage proceeds are paid out, then the insurer can pay Side B coverage proceeds to the insured company and Side C entity coverage proceeds.

These priority payment terms are extremely valuable to directors or officers who are defending themselves, particularly if the insured company is unable to indemnify them because it is in bankruptcy. As noted above, if the insured company is in bankruptcy, the D&O policy is typically viewed as property of the bankruptcy estate, and is thus subject to the automatic stay imposed by the U.S. Bankruptcy Code, unless and until a bankruptcy judge lifts the stay as to the D&O policy proceeds. Tying up the D&O policy in a bankruptcy proceeding can leave individual directors and officers without access to the policy proceeds that they need to defend themselves and settle claims filed against them. With a priority payment clause that makes it clear that the directors and officers are contractually entitled to first dibs on the D&O limits, bankruptcy courts are usually willing to permit the D&O insurer to continue paying defense and indemnity payments to directors and officers who are entitled to coverage under the policy.

G. The Insured Versus Insured Exclusion and the Carve-Outs to the Exclusion

All D&O policies contain some kind of "insured ver-

sus insured" exclusion, which generally bars coverage for claims made by or on behalf of the company or made by any individual director or officer under the policy. The I v. I exclusion was designed to guard against collusive or friendly lawsuits brought by one insured against another insured for the purpose of tapping the company's D&O policy – e.g., the company sues directors or officers alleging mismanagement or waste solely to get at the D&O policy proceeds to recover for business losses.

The insurer's concerns about barring coverage for such lawsuits may be valid, but there are plenty of non-collusive claims that can be asserted by or on behalf of insureds that should be covered by the policy. Consequently, insured versus insured exclusions will have a list of carve-outs or exceptions, which provide that the exclusion does not apply to certain species of claim. As discussed below, the list of carve-out claims is critically important because the claims on the list are explicitly covered by the policy. As an initial matter, counsel should try to limit the insured exclusion to claims brought directly by the company. Some insurers have agreed to replace I v. I exclusions with E v. I (entity versus insured) exclusions.

If the insurer will not agree to an E v. I exclusion, counsel should look to see if the version of the I v. I exclusion in the policy bars coverage for claims brought by *any shareholder* of the company, rather than claims brought by insured directors and officers. Counsel should seek to remove the "any shareholder term" from the I v. I exclusion because it is potentially over broad in barring coverage for legitimate derivative actions and whistleblower actions that should be covered under the policy.

With respect to the list of exceptions to the I v. I exclusion, counsel should try to make sure that the list carves back coverage for the following claims – all of which are exceptions to the I v. I exclusion that currently available in the market and should thus be available in policy negotiations with the D&O carrier:

- Shareholder derivative actions;
- Corporate whistle blower claims brought under state or federal whistleblower laws;
- Claims brought by or on behalf of the company when it is in bankruptcy, including claims against directors and officers brought by trustees, liquidators, debtors-in-possession, or even creditors' or bondholders' committees;
- Claims brought entirely outside the United States;

- Employment-practices claims against officers or directors; and
- Claims brought by officers and directors who have not served in that capacity for the last four years (or a shorter time period, if possible).

H. The Notice of Claim Requirements (and the Life or Death Importance of Providing Timely Notice of a Claim)

As noted above, D&O policies usually require insureds to give notice of a claim as soon as practicable or words to that effect; and frequently the notice clause also sets a hard “no later than” deadline after the policy expires. For instance, policies will state that the insured must provide notice of a claim as soon as practicable after the insured becomes aware of it but no later than 60 days after the policy expires, unless the insured purchases the extended reporting period coverage under which the post-expiration notice period is extended. It warrants emphasizing again here that late notice can kill coverage under a D&O policy. Counsel should stress to clients that one of the first critical issues to figure out when a claim or potential claim arises is which insurers must be notified.

To mitigate the risk that an inadvertent delay in reporting a claim will impair coverage, the notice clause in the policy should require notice to the insurer only after certain executives first learn of a claim, such as the general counsel or risk manager of the *named insured* on the policy.

I. The Professional Services Exclusion

Most D&O policies include a professional services exclusion. There is wide range of wording used for such exclusions, but a typical one might provide that the policy does not insure claims alleging, arising out of, based upon or attributable to the insured’s performance, rendering or failing to render professional services. These exclusions have created vexing problems for D&O insureds and have been responsible for unintended gaps in coverage.

The D&O insurers’ rationale for including such exclusions is that any liability for the insured’s professional services should be covered by a professional services errors and omissions policy, rather than the D&O policy. However, even if a company has professional services E&O coverage, the professional services liability insured by the E&O policy might not insure liability that should be covered by the D&O policy. Perhaps the claims against the insured do not fall within professional services identified in the E&O policy, or the insured’s alleged wrongful acts giving rise to the claim are only obliquely related to any professional services provided by the insured. E&O policies usually define

the specific professional services that are insured under the policy; while D&O policies often do not define the term professional services in the professional services exclusion. As a result, the E&O and D&O policies may not fit together, leaving a coverage hole for claims to fall through.

D&O insurers will rarely agree to eliminate the professional services exclusion, so counsel’s goal will be to seek revisions that make it as narrow as possible and reduce the risk of gaps between the client’s D&O and E&O policies. To address these issues, counsel can take the following steps:

- Review the wording of the D&O and E&O policy together with the goal of trying to obtain in the E&O policy a definition of professional services as broad as possible (that addresses all of the services the company provides); and the concurrent goal of trying to obtain terms in the professional services exclusion in the D&O policy that precludes coverage only for the services that are insured under the E&O policy.
- Limit the terms of the professional services exclusion in the D&O policy by adding terms making it clear that it applies only to services provided directly to customers or others for a fee and that it does not apply to supervising or failure to supervise professional services or professionals.
- If the professional services exclusion has broad language like “arising out of, based upon, relating to, or attributable to” the rendering of professional services, seek to dial back such terms with something direct and simple, such as “caused solely by,” or “due exclusively to.”

V. Excess Insurance Issues

A. Follow Form Excess Policies and Exhaustion of Underlying Limits

For many companies, their primary D&O policy is the base of a tower of D&O coverage made up of various excess policies that each provide an additional layer of D&O coverage. A company might have \$100 million in coverage made up of a primary policy that provides \$10 million in limits and then nine excess policies issued by multiple insurers that combine together to provide the \$100 million aggregate protection.

Some “follow form” excess policies don’t really follow form. The terms of the primary policy are obviously keenly important because in most cases the excess policies are “fol-

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low form” policies that generally provide coverage in accordance with the same terms and conditions as the primary policy. However, so called follow form excess policies will usually provide that they follow the terms and conditions of the primary except as otherwise provided in the excess policy. In fact, it is relatively uncommon to see pure follow form excess policies. And in many cases the excess policies will contain terms that differ substantially from the primary policy. For example, such conditional follow form excess policies may contain choice of law provisions, mandatory arbitration clauses, different notice requirements, and other policy terms that stray substantially from the primary policy’s exclusions, rescission restrictions, application definition, or severability clauses.

Too often in policy negotiations, the terms of the follow form excess policies are given scant attention while the focus is consumed by the terms of the primary policy. It is a tedious chore to review multiple excess policy forms that appear on their face to be mostly follow form policies, but the tedium can pay off if a catastrophic claim comes that will tap the client’s excess D&O tower.

Ensuring that the attachment point for the excess coverage actually attaches. One of the excess policy terms that should be consistent from one excess layer to the next is the term that defines when the excess coverage under the policy will be triggered by the exhaustion of the underlying limits of insurance, often called the attachment point.

Some policies provide that the excess insurer’s liability attaches only after each of the underlying insurers beneath the excess policy have exhausted their respective limits of liability by payment of losses under those policies. If an excess policy mandates that it attaches only if the underlying insurers pay the full amount of the underlying limits of liability, this can create a dire situation for the insureds if the underlying insurers refuse to pay their full limits due to coverage disputes, or if one of the underlying insurers becomes insolvent. In many cases where there are coverage disputes between insureds and insurers, the insureds may settle the coverage dispute by allowing an insurer to pay only part of its limits in exchange for a release under the policy. With attachment point language that triggers the excess policy only if the limits are paid by the underlying insurer, insureds that settle for less than full limits with their primary insurer might find their excess insurers denying all coverage on the grounds that the excess policies do not attach, even if the insureds make up the difference between the amount that the primary insurer paid and the limits of liability under the primary policy.

To avoid this, it is best to have attachment language in the excess policies that provides that excess insurer’s liability attaches if the underlying limits are paid by any person

or entity, or at the very least if the underlying insurer(s) or the insureds pay the amount of the underlying limits. This broader attachment language will allow insureds to settle coverage disputes with primary and/or excess insurers by accepting less than full limits payments from underlying insurers without jeopardizing coverage under upstream excess policies.

B. The Benefits of Side A Difference-in-Conditions (DIC) Excess Insurance

Many companies opt to purchase Side A only DIC excess insurance coverage in addition to the company’s tower of traditional Side ABC D&O coverage. Side A-only DIC excess policies insure directors and officers for non-indemnified loss; the policies do not provide any Side B or Side C entity coverage, meaning that the limits are not eroded by any entity coverage. These policies substantially supplement coverage for directors and officers by affording excess insurance that is much broader than standard ABC D&O policies.

The terms of Side A-only excess policies currently circulating in the market vary substantially. Counsel will need to consult with the broker to identify the terms (and the insurers offering those terms) that are most advantageous for the client. In evaluating the terms of Side A-only excess policies, consider the following (non-exclusive) list of coverage enhancements that are seen in many of the policies in the market today:

- The DIC part of the name (difference-in-conditions) indicates that policy will drop down and fill in the gaps for non-indemnifiable claims that are not insured under the terms of the standard ABC coverage, or if one of the underlying insurers becomes insolvent. Thus, if one of the D&O insurers below the Side A-only excess policy denies coverage for a claim that would be covered under the broader terms of the Side A-only policy, the Side A-only policy with drop down terms should step in to provide coverage.
- No exclusion for pollution liability (pollution exclusions are standard in traditional D&O policies) and the policy does not exclude coverage for bodily injury or property damage claims that arise from pollution liability.
- No ERISA exclusion (also standard in traditional D&O policies).
- The insured versus insured and conduct exclusions are much more favorable to the insureds. For example, the conduct exclusion does not apply to defense costs.

- No “presumptive indemnification” provision; thus the policy will provide coverage to directors and officers even if the company wrongfully refuses to indemnify them against a claim.
- The policies are fully non-rescindable.

Additionally, because the company is not an insured under the policy, Side A only excess policies would not be considered an asset of the estate in bankruptcy or subject to the bankruptcy automatic stay in the event the insured company files bankruptcy.

There are also outside director liability (ODL) excess policies available that provide the same sort of coverage provided under the Side A-only excess DIC policy but the coverage is extended solely to non-indemnified losses of outside directors, referring to directors who are not officers of the company or otherwise employed by the company. These policies are designed to provide additional protection for directors whose D&O policy limits might otherwise be eaten up by paying enormous criminal and

civil defense costs and settlements incurred for senior executives of the company who were involved (or allegedly involved) in committing the acts that resulted in fraud claims against all of the directors and officers.

VI. Conclusion

This paper identifies only a handful of the issues that can come up in evaluating a client’s D&O insurance coverage. To undertake the task properly, counsel will need to work with the broker and the client to review the language of each of the policies in the client’s D&O program at every level—and then review proposals made by insurers during policy negotiations—to determine whether the client has the most advantageous terms that can be obtained and that the primary and excess policies fit together cohesively.

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