What You Always Wanted To Know About D&O Insurance

by Michael A. Rossi

Directors' and Officers' Liability and Corporate Reimbursement ("D&O") insurance is one of the more important insurance products for publicly traded companies in the United States. In the last two years, the D&O insurance market in the US has experienced nothing short of a monumental change that has re-written the rules of the game and raised new issues that never before needed to be addressed. Now, more than ever, great care must be taken when handling D&O insurance claims and, more importantly, when placing D&O insurance policies lest the company and its directors and officers be left with an uninsured or underinsured loss.

Exposing corporate assets to uninsured or underinsured losses is one thing; exposing the personal assets of individual directors and officers of the company to uninsured or underinsured losses for which they previously enjoyed full coverage under older-form D&O policies is quite another. This article will address the issues that a risk manager must understand and appreciate when handling D&O claims and placing D&O insurance to protect the directors and officers, while maximizing coverage for the corporate entity. No doubt, this article does not address all the issues that must be considered by the risk manager, but it does address the ones that, in my experience, are most often overlooked.

Handling D&O Claims in Today's Environment

Okay, so the claim has been made. What do you do? First, look at the notice provisions of your D&O policy. Is notice supposed to go to the broker, insurer or some other person? Follow the instructions in the policy. If the policy says you must give notice to the insurer, do not merely give notice to your broker. There are actually reported court decisions addressing coverage disputes arising out of the fact that the insured gave notice to the broker when the policy required that notice be given to the insurer's home office. Such disputes can be avoided simply by following the instructions in the policy. Of course, if you want to keep your broker in the loop, which is advisable, just send your broker a copy of the notice.

Second, analyze the claim to determine whether any other of the company's insurance policies potentially apply. The most commonly overlooked overlapping coverage is provided by CGL policies. There are a host of issues to consider in that event.

Responding to the Reservation of Rights Letter

What do you do when you receive a lengthy reservation of rights letter that lists umpteen different reasons why the policy does not or may not provide any coverage? In the past most thought the best way to respond to such a letter was to fully address every issue raised. The thinking on that strategy has changed over the years. Rather than waste money to prepare a response to all of the issues raised, now I simply send a brief letter stating that my client disagrees with every point made in the reservation of rights letter. Typically, the insurer points are wrong as a matter of law. Those points that are not wrong raise issues that are too premature and speculative to warrant further attention, because they are based on hypothetical developments of facts that might never be borne out. I do, however, take the insurer to task on several issues.

The Insurer's Litigation Practices and Procedures

One issue presented in a typical reservation of rights letter is the assertion that the insured's defence counsel must follow a litigation practices and procedures guide promulgated by the insurer - typically a lengthy document filled with onerous conditions that no defence lawyer who represents only the insured, not the D&O insurer, would follow. I meet this assertion head on, explaining that there is absolutely no basis in the policy or law for the insurer to insist on such a requirement. I have not had a D&O insurer yet refuse to withdraw its demand after I've stated such an objection. My advice is not to tolerate that sort of conduct, and to encourage the insurer to address the real issues presented by the underlying claim.

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But Were Afraid To Ask

Hiding from the press may become the diet of senior executives

Sharing Privileged Information

One of those very real, potentially dangerous and often overlooked issues is how to respond to the insurer's request for privileged information. Most states recognize that disclosure of confidential and privileged information by the policyholder to its liability insurer does not act as a waiver of the privileges and protections that attach to that information. The two most common protections sought to be preserved are the attorney-client privilege and attorney work product doctrine. Courts recognize that waiver of such protections would not make sense when the liability insurer's policy contains a "duty to defend" that obligates it to appoint counsel to protect and defend the interests of its policyholder.

However, whether disclosure of privileged and otherwise protected information to a D&O insurer whose policy does not contain a duty to defend acts to waive such privilege and protection is a serious question addressed by only a handful of courts. Policyholders are encouraged not to treat this issue lightly. The policyholder should research the law that applies to its insurance claim and determine whether such protections are preserved or waived by disclosure to an insurer whose policy does not contain a duty to defend. Some courts have squarely addressed the issue, holding that such a disclosure would waive the protections and that, therefore, the policyholder is not required by the cooperation clause of the D&O policy or any other reason to disclose any privileged or protected information to the D&O insurer. Other courts, however, have held that the policyholder is required to disclose such information to its D&O insurer.

If the law in your jurisdiction provides that disclosure of privileged information is not protected, and that the insured is not obligated to share that information, you should advise your D&O insurer of the issue and not give the information. If the law in your jurisdiction is not settled, what I do is advise the insurer of the issue and ask how the insurer wants to address it. Insurers typically suggest entering into a confidentiality agreement or entering into an agreement with plaintiffs in the underlying claim that they will not take the position that any information disclosed by the policyholder to the insurer waives any protections and privileges that attach to that information. Again, I cannot overemphasize how important this issue is and that it is imperative that insureds address the issue immediately after the D&O insurer requests privileged information, lest the policyholder or its defence lawyer divulge information that is sensitive to the underlying claim and is discoverable by the plaintiffs.

Getting Defence Costs Paid

Another issue that should be addressed at the outset of the claim is whether the D&O insurer must pay defence costs on behalf of the insureds as costs are incurred, or must indemnify such costs as they are incurred, or need not pay anything until the underlying claim is resolved. The answer to this question depends upon the particular terms of the D&O policy and the state's law that applies to the interpretation of that policy. Many D&O policies contain a provision that expressly states that the insurer has no obligation to pay any costs until the final resolution of the underlying claim. If your D&O policy contains such a provision, ask yourself about what value, if any, the "pay on behalf of' language in the D&O insuring agreements have. If the insureds are forced to fund the defence until the underlying claim is resolved, the "pay on behalf language" is functionally gutted and rendered practically useless.

Let's assume that your D&O policy does not contain a provision that says the insurer does not have to pay any costs until the final resolution of the claim. With respect to such policies, some courts have held that the D&O insurer is obligated to pay defence costs as they are incurred. Those courts focus more on the language "legally obligated to pay" in the insuring agreements rather than the "pay on behalf of' language, reasoning that an insured is "legally obligated to pay" defence costs as soon as a lawyer is retained to defend it. It does, however, help from a cashflow standpoint to have "pay on behalf of' language rather than "indemnify" language (because with "indemnify" language the insured has to pay then seek indemnification from the insurer, whereas with the other language the insured does not have to go out *of* pocket, because the insurer pays all costs on behalf of the insured).

In addition, when the D&O insurer must pay defence costs as they are incurred, an additional question is raised. What *if* the claims are only potentially covered at the time the defence costs are incurred, and what if, at the end *of* the claim, it turns out that the claims ultimately are not covered? Is the D&O insurer entitled to reimbursement of such costs? In other words, was the D&O insurer merely "advancing" defence costs, or was it "paying" or "indemnifying" defence costs as they were incurred? Again, it depends upon which state's law applies to interpret the policy. Some courts have held that the D&O insurer is merely "advancing" defence costs and can seek reimbursement from the insured if the underlying claim ultimately is not covered. Other courts have held that the D&O insurer's payment or indemnification of defence costs as they are incurred in connection with potentially covered claims are final-that the insurer cannot seek reimbursement at the end of the claim. Such courts reason that the same "potentiality" standard applicable to "duty to defend" policies can apply to a policy that does not contain a clause that says that the insurer is not obligated to pay any costs until the underlying claim is resolved.

Litigation as a Final Option

I believe that litigation is the final option, not the first option. Rarely, if ever, does it make sense to litigate first, and ask questions later. However, let me suggest one bit of strategy that I have used successfully several times in the past on D&O claims. On more than one of my past claims, my client and I have argued until we were blue in the face that the D&O insurer at issue was obligated to provide full coverage for any proposed settlement of the underlying claim. After months of negotiation, we reached a stalemate. Both sides said, "see you in court!" But in each instance the underlying claim was pending in a federal district court. So we filed our lawsuit with a notice of "related action" and got our lawsuit and the insurer's lawsuit both brought before the same federal judge that presided over the underlying claim. We immediately requested a settlement conference with the judge, requesting that the parties submit confidential settlement conference briefs.

Every time I've done this, the judge has been able to persuade the D&O insurer that my client and I were right. For some reason, some D&O insurers are much more inclined to fund a settlement of an underlying claim when the insured's position is shared by the judge presiding over the underlying claim and coverage lawsuit(s). So if you ever reach a stalemate with your D&O insurer, keep this tactic in mind. You might be surprised how quickly a D&O insurer will pay a claim along the lines that you had been arguing for months, just because a judge agrees with your position.

Buying a D&O Policy that Provides "Entity" Coverage for Securities Claims

There are many options available for dealing with the issue of allocation. Far and away the most popular in the US is buying "entity" coverage for securities claims. However, the fact that "entity" coverage forms are "manuscripted" by

Companies are having to bite the bullet when it comes to D&O coverage

D&O insurers and for the most part have not yet been "tested" by courts in the US gives rise to two unique problems when initially placing or renewing a D&O policy that provides "entity" coverage:

* Virtually every "entity" coverage form offered by insurers in the US is different - the insurers define securities-related claims differently, they define claim differently, they use different exclusions that apply to the corporation, etc.
* It is difficult, if not impossible, to discern what impact, if any, such differences will have on coverage for securities-related claims and non-securities-related claims. About the only concrete observation that can be made is that risk managers must examine D&O policy forms and endorsements offering "entity" coverage very carefully when placing such coverage for the first time or renewing an "entity" coverage program.

How I Explain "Entity" Coverage to My Clients

What does "entity" coverage really do? If the insured is in a jurisdiction that does not have favorable allocation rules applicable to D&O policies, the coverage buys "good law" on allocation. Such allocation rules can make it very easy for a corporation sued along with one or more of its directors or officers to successfully argue that all of the defence and settlement costs incurred in connection with the underlying lawsuit are covered by a D&O policy, even if the policy does not expressly provide "entity" coverage. Although these allocation rules are all fine and good, what happens if the corporation alone is sued, or if the directors and officers sued along with the corporation are not held liable but the corporation is, or if the directors and officers sued along with the corporation eventually are dismissed from the case? Has this happened? Unfortunately, yes, and the D&O insurers involved denied indemnity coverage for the settlement because their policies did not afford "entity" coverage. Accordingly, "entity" coverage secures coverage in those circumstances where a policy not providing "entity" coverage might not apply.

What if the insured buys "entity" coverage for securities-related claims but not "predetermined allocation" or "concurrent liability" coverage for non-securities-related claims? How, if at all, does that affect allocation issues for non-securities claims? There does not appear to be any law on this issue, because "entity" coverage only recently has been purchased on a regular basis. In the absence of policy provisions to the contrary, insurers are likely to argue that, if the insured does not buy "predetermined allocation" or "concurrent liability" coverage for non-securities-related claims but does buy "entity" coverage for securities-related claims, then the insured should not be entitled to favorable allocation rules for non-securities-related claims. In such circumstances, D&O insurers are likely to argue that the "relative legal exposure" and/or "relative benefit" analysis or worse should apply to all allocation issues posed by any non-securities-related claims.

However, there is a very straightforward way to reconcile an insured's decision to purchase "entity" coverage for securities-related claims but not buy "predetermined allocation" or "concurrent liability" coverage for non-securities-related claims (if the policy is silent on allocation issues for non-securities-related claims). Even if the insured believes that the "reasonably related," "derivative liability," "concurrent liability" and "larger settlement" rules apply to allocation issues under its D&O policy, the "entity" coverage is being purchased to protect against a contingency with respect to which such allocation rules might not apply-where only the corporate insured is sued or a judgment is rendered against only the corporation while the same judgment exonerates all directors and officers named in the lawsuit along with the corporation. Thus, it is not inconsistent to buy "entity" coverage for securities-related claims but not buy "predetermined allocation" or "concurrent liability" coverage for non-securities-related claims. By doing so, an insured should not be precluded from applying favorable allocation rules to its D&O policy for non-securities-related claims.

How Broad is the Securities-Related Claims Coverage?

Not every "entity" coverage form defines securities-related claims in the same way. Chubb, for example, uses the phrase "Securities Transaction," while AIG and most other insurers use the phrase "Securities Claims." The language used to define "Securities Transaction" in Chubb's form differs from the language used to define "Securities Claims" in AIG's "Securities Plus" endorsement, which is different from the language used to define securities-related claims in other forms. Regardless of the phrase or definition used, the important issue to analyze is the breadth of securities-related claims coverage afforded by the policy form or endorsement. The definitions used should be as broad and all-encompassing as possible, because only those claims that fall within the scope of such definitions will be subject to the "entity" coverage afforded by the policy.

In other words, claims that fall outside the scope of "entity" coverage for securities-related claims afforded by the policy will not be subject to the "entity" coverage afforded by the policy. That is not to say that such claims will automatically be subject to an allocation not favorable to policyholders. As mentioned above, there is a logical way to reconcile the purchase of "entity" coverage with a belief in favorable allocation rules so that the insured's purchase of "entity" coverage should not preclude it from applying favorable allocation rules to non-securities-related claims. Unless the policy provides otherwise (and some do, as explained below), the policyholder should be free to argue that favorable allocation rules apply to its D&O policy.

Nevertheless, from the standpoint of trying to avoid as many coverage disputes as possible by taking time to address issues during initial placements and renewals of insurance policies, it is advisable to deal with this issue up front by using the broadest possible definition of what securities-related claims are going to be subject to the "entity" coverage afforded by the policy. In this way, hopefully the insurer's response to securities-related claims is within the insured's expectations.

Allocation for Non-Securities-Related Claims

Some "entity" coverage forms and endorsements provide that the "relative legal exposure" and/or "relative benefit" analysis in one form or another will apply to the allocation of claims that fall outside the scope of securities-related claims. Chubb's and AIG's forms are examples of such policies. What should a policyholder do with respect to these allocation issues for non-securities-related claims?

It seems self-evident that an insured should insist on removing any and all unfavorable allocation language from its D&O policy. The harder question is whether an insured should leave the policy silent or use "predetermined allocation" or "concurrent liability" provisions for all allocation issues that are not resolved by the "entity" coverage afforded by the policy.

The answer to that question depends upon whether the insured feels confident that favorable allocation rules will be applied to interpret the coverage afforded by its D&O policy. I would like to emphasize that an insured has plenty of carriers from which to choose that issue D&O policies that do not contain unfavorable allocation language for non-securities claims. Just because AIG and Chubb have a predominant share of the US D&O insurance market, AIG and Chubb are by no means "the only game in town".

In 1996 alone I gave advice to policyholders that received quotes with favorable terms and conditions regarding allocation for non-securities claims, as well as many, if not all, of the other issues discussed in this article, from Admiral, Genesis, Gulf, AESIC, Great American, Reliance National and several different facilities out of the London Market.

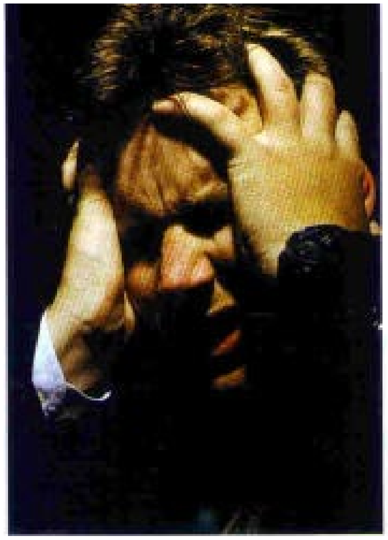
The Risk of Exposing Directors and Officers to Uninsured Losses

Given the differences in forms regarding allocation for non-securities-related claims and the breadth of claims falling within the definition of securities-related claims, a very troubling issue arises if you buy a D&O policy that contains (a) unfavorable allocation language for non-securities-related claims, and (b) a definition of securities-related claims that does not include a derivative action by security holders whether or not the derivative action deals with the purchase or sale of, or offer to purchase or sell, securities of the company. A corporation cannot indemnify a director or officer in connection with a derivative action made against him or her, because the whole purpose of the derivative action is to allow shareholders to force a director or officer to pay money to the corporation. So it would defeat the purpose of a derivative action to allow the corporation to pay back to the director or officer what the director or officer was ordered to pay to the corporation.

If the derivative action contains covered and noncovered claims, the D&O insurer likely will try to apply the "relative legal exposure" and/or "relative benefits" analysis to the lawsuit to determine whether any of the costs of defence and settlement are not covered. Under older-form D&O policies that are silent on allocation, directors and officers faced with such a situation could have argued that the allocation rules proffered by the insurer do not apply. However, if the D&O policy at issue expressly provides that unfavorable allocation rules apply to non-securities-related claims, and does not include a derivative action not dealing with the purchase or sale of, or offer to purchase or sell, securities of the company as a securities-related claim, then the directors and officers facing the derivative action likely would not be able to make that argument. The result could be less coverage for the directors and officers under a newer form D&O policy offering "entity" coverage than under an older form D&O policy that does not provide "entity" coverage. This issue is just one example of why it is so very important to remove unfavorable allocation language from D&O policies providing "entity" coverage and why risk managers must take special care when placing the new form of D&O policy-the personal assets of the directors and officers of the company, more than ever before, are at stake.

Severability as to Exclusions

One of the more easy to identify issues when placing D&O insurance before the advent of "entity" coverage for



Litigation is growing, fuelled by performance pressures

securities-related claims was the issue of severability as to exclusions. The issue of severability is that the policy should be treated as being separately issued to each director and officer, so that if one director or officer is excluded from coverage for a certain claim, coverage can still be afforded for all other directors and officers.

This issue of severability is very important when it comes to "entity" coverage. Some "entity" coverage forms read as if there is no severability between the corporate entity and insured persons (note that some D&O forms now define "insured persons" to include all past, present and future employees for securities-related claims coverage), so that if one insured person is excluded from coverage for a particular securities-related claim, the corporate entity is also excluded from coverage. Other forms extend severability as between the corporation and all insured persons except for the conduct of a few key officers.

What should corporate policyholders do with respect to this severability issue? The corporate policyholder should insist on complete severability between the corporation and all of its directors and officers. The only exception, perhaps, would be intentionally injurious conduct by an officer or director that is authorized or ratified by the shareholders or Board of Directors of the corporation. The law in many states is clear that a corporate insured can be provided coverage for its vicarious liability based on intentionally injurious acts by its employee or agent (including an officer of the corporation), as long as the corporation's shareholders or Board of Directors do not authorize or ratify the conduct at issue. Accordingly, the corporation should be afforded full coverage for any particular claim otherwise covered by the policy, even if one of its directors or officers is barred from coverage for the same claim. If this type of provision cannot be negotiated into the policy, a compromise provision is to have the D&O policy worded so that the acts of only a few directors and officers can be imputed to the corporate entity-such as the chairman, chief financial officer and president.

Some insurers already offer this compromise language in their forms, and other insurers will add it if requested to do so.

Severability as to the Application for Insurance

When responding to claims, D&O insurers often reserve the right to deny coverage, and sometimes actually deny coverage, on the basis that one or more particulars or statements made in the application for insurance are false. However, many D&O policies provide that there is complete severability as between all directors and officers with respect to the application for insurance. For such policies, if a false particular or statement permits the insurer to avoid coverage as to the director or officer responsible for the false particular or statement, the insurer is not also permitted to avoid coverage as to all other directors and officers.

As one might imagine, this issue of severability is very important for "entity" coverage. The corporate policyholder does not want the insurer to be able to avoid the policy as to the corporate entity merely because of a false particular or statement made by an insured person in the application for insurance. Also, the corporate entity does not want the knowledge of all insured persons (especially if "insured persons" includes past, present and future employees) imputed to it in order for the D&O insurer to assess whether, from the corporate entity's standpoint, there are any false particulars or statements in the application for insurance.

As with exclusions, the corporation should have full severability as between it and all insured persons with respect to the application for insurance. At most, it would appear that the corporation should be willing to agree only that any false particular or statement that the shareholders or Board of Directors have ratified or authorized can permit the D&O insurer to avoid a claim as to the corporate entity (and then only for claims with respect to which such false particulars or statements are materially relevant-as opposed to when the false statement or particular had nothing to do with the claim at issue, but was nevertheless material to the risk of the D&O policy in general). If this type of provision cannot be negotiated into the policy, a compromise provision is to have the D&O policy worded so that only statements made by, and knowledge of, the person(s) signing the application can be imputed to the corporate entity.

Employment Practices Liability Coverage

Another very important issue for risk managers to address when placing D&O insurance is whether, and in what form, to add an endorsement providing coverage for Employment Practices Liability ("EPL") that will cover claims for wrongful termination, discrimination, sexual harassment and the like. Virtually all D&O insurers will put an EPL endorsement on their policy for no extra charge. The question, in my opinion, is whether that is an intelligent thing to do. The EPL endorsement, like some "entity" coverage endorsements, extends coverage to the employees of the corporation. I don't know about you, but if I was a director or officer of a corporation and my personal assets were on the line, the last thing I would want to do is have a claim against a non-director/officer employee for wrongful termination, discrimination or sexual harassment erode policy limits that otherwise could have protected my personal assets in the event of a shareholder securities lawsuit or other covered claim. Accordingly, my advice to clients is to (a) get a stand-alone EPL policy that provides coverage to the corporation (the EPL endorsement offered by D&O insurers typically does not cover the corporate entity), the directors and officers, and the employees, and (b) add the EPL endorsement to the D&O policy but extend coverage only to directors and officers and have the endorsement expressly apply in excess of the stand-alone EPL policy. In this way, the

Still looking for the answers

corporate entity and directors and officers are protected from EPL risks, but the impact of that protection on the D&O policy is minimized.

Final Words of Thought

There is much truth in the adage "insurance is only a small part of risk management." My client risk managers always remind me of that fact when I "speak" to them about terms and conditions in insurance policies. I agree with that adage. However, when it comes to D&O insurance, I sincerely believe that it is imperative that risk managers must understand and appreciate the issues discussed in this article. A correctly worded D&O policy in today's market can maximize protection for the personal assets of the directors and officers of the company, as well as the assets of the company.

An improperly worded D&O policy in today's market can impair the coverage for the personal assets of the directors and officers in an attempt to afford broader coverage for the assets of the company. That unfavorable result can and must be avoided by risk managers. CR

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When a claim is covered by D&O and CGL policies

D&O policies and Commercial General Liability ("CGL") insurance policies sometimes provide overlapping coverages, so that both types of policies can apply to the same claim. Most common types of overlapping claims deal with intellectual property, unfair competition, and other claims brought by competitors. The lesson to be learned is that you should never assume that a claim can apply only to one or the other type of policy. Whenever an officer or director is sued, the claim should almost always be tendered to all potentially applicable CGL and D&O policies.

One of the first issues that needs to be addressed deals with the different defense obligations contained in CGL and D&O policies. Most CGL policies contain a "duty to defend" while most D&O policies do not. A D&O insurer typically relies on this distinction between CGL and D&O policies to argue that it is not obligated to pay anything, defense or indemnity costs, until the underlying claim is resolved either by a judgment or a settlement to which it consents. However, depending upon the specific wording of, and what state's law applies to the interpretation of, the D&O policy at issue, the D&O insurer's argument may not be correct.

Some D&O policies have an exclusion providing that if a claim is covered by a policy that contains a duty to defend, then the D&O policy does not have to pay any defense costs incurred in connection with that claim. *If* your D&O policy has that provision in it, trying to get the D&O carrier to contribute to defense costs in a claim covered in whole or part by your CGL carrier will be very, very difficult. It goes without saying that when placing your D&O policy, check for this type of a provision and remove it if possible during the policy negotiation.

However, some D&O policies merely provide that they do not pay claims covered in part by other policies. *If* that is how your D&O policy reads, then you should be able to argue that the CGL policy covers part of the costs and the D&O policy picks up the rest (i.e., whatever the CGL carrier does not, or will not, pay, the D&O carrier must pay). In such a circumstance, it is often feasible to have both the D&O and CGL carriers contribute to the cost of defending and indemnifying a claim.

Sharing costs might be easy enough when it comes to settlements and judgments, but it is a bit more difficult when it comes to defense costs. Notwithstanding the D&O carrier's protestations that it has no duty to pay for defense costs covered under the CGL policy's "duty to defend" coverage, the CGL carrier might not be paying all defense costs incurred in the action. This particularly is true when the CGL carrier defends under a reservation of rights and, therefore, must pay for independent counsel chosen by the policyholder. In such independent counsel situations, CGL carrier's typically "nickel and dime" their policyholders with a variety of unreasonable positions.

Accordingly, if the CGL carrier fails and refuses to pay for all defense costs incurred by or on behalf of the policyholder, the D&O carrier should be asked to pay the difference. The policyholder also can try to negotiate a joint compromise resolution with its two carriers, so that they split the defense costs between them. The policyholder also can try to negotiate a deal with either carrier, by assigning to it any rights the policyholder has against the other in return for the carrier's full payment of defense costs.

No matter what arguments you make, and not matter how much each insurer pays, the bottom line result should be that all costs are paid collectively by the D&O and CGL insurers so that no costs are borne by the insured. That is the goal for which the risk manager should strive when a claim is covered by D&O and CGL policies.