15 Questions You Should Ask Before Buying D&O Insurance

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An Article outlining important questions to consider before buying (or advising your client on buying) D&O insurance.

Purchasers of directors and officers (D&O) insurance policies often focus on the wrong things. Premiums, of course, are an important consideration. But when it comes to policy terms, purchasers too often rely on general checklists or brief summaries.

That is a little like buying a suit without ever trying it on, just because it is on sale. Protection, not just price, should be an important consideration. And D&O policies are not "off the rack" products; they usually have custom features. These 15 questions about D&O policy terms will help a company and its directors and officers get the right protection.

HOW ARE D&O POLICIES TYPICALLY STRUCTURED?

Standard D&O policies typically cover three types of losses, which are commonly referred to as Sides A, B, and C:

- Side A covers a director's or officer's direct losses (meaning those not indemnified by the company). This type of coverage is important because a company may not be able to indemnify its directors or officers if it becomes insolvent or where it is prohibited legally from doing so (see *What Is Separate "Side A Only" Coverage and Do Directors Need It?*).
- Side B covers losses relating to claims made against the directors and officers but for which the company has indemnified them. In other words, the company gets reimbursed when it indemnifies its directors or officers or advances legal costs on their behalf.
- Side C covers losses incurred based on claims against the company itself. This is often referred to as "entity" coverage. It is generally limited to losses related to securities claims.

Some D&O policies also include a Side D insuring clause, which provides coverage for costs arising from responding to a stockholder derivative demand.

A D&O policy has a stated limit of liability, which is the total amount of loss that the insurer will cover during the policy period, regardless of how many claims are made. The limit is shared among all insureds. That means, for example, that one insured's defense fees will deplete the amount of coverage available to other insureds. Because many insureds usually share in a single pool of insurance coverage, this can be a significant issue. However, there are certain ways to address this issue in policy selection (see *What Is Separate "Side A Only" Coverage and Do Directors Need It?*).

Companies typically purchase a primary D&O policy and one or more excess policies. The primary policy usually sets the key terms and conditions for the excess policies that follow it. Once the primary policy's limit of liability is exhausted, the first excess policy is triggered and provides coverage. This continues up through the rest of the excess policies until all coverage is exhausted. D&O policies also have retentions (deductibles) that must be paid before coverage kicks in. Retentions are usually applied only to Sides B and C clauses.

WHAT ARE THE KEY CONSIDERATIONS WHEN DECIDING THE SIZE OF THE RETENTION?

Companies should consider their balance sheet when determining retention size. Higher retentions will result in lower premiums. As a general rule, a company should not retain a payment obligation larger than it can afford to pay in one quarter without materially hurting earnings or cash flow. For companies with good cash flow and sound balance sheets, higher retentions make a lot of sense. However, what appears reasonable in good times may be a big problem when troubles arise. Securities class action lawsuits often hit at the worst time; when large losses have occurred and cash flows have dried up.

For several years, many companies purchased policies with $250,000 retentions. Retentions began to increase in the early to mid-2000s, with the average peaking at $426,000 in 2006. Since that time, retentions appear to be trending downward again. The most recent Towers Perrin D&O Liability Survey reported that the average retention in 2008 was down to $191,000. This average includes companies of all sizes and the study showed that the average retention for companies with an asset size of $10 billion was $3,621,000. Results for 2009 were not available at the time of publication of this Article.

HOW CAN D&O COVERAGE BE STRUCTURED TO PROVIDE PROTECTION IN THE EVENT OF BANKRUPTCY?

The recent global recession has led to a sharp increase in US bankruptcy filings. Statistics from the American Bankruptcy Institute show that there were almost twice as many business bankruptcy filings in 2009 compared to 2006. When a company becomes insolvent, indemnification is often no longer available and D&O policies become the remaining line of defense for directors and officers to avoid covering losses from their personal assets (see *Practice Note, Fiduciary Duties of Directors of Financially Troubled Corporations (http://us.practicallaw.com/9-384-4955)*). A company should ensure that its D&O policies are structured to maximize coverage in the event of insolvency.

When a bankruptcy is filed, a judge typically issues a stay that is intended to protect company assets that may be used to pay creditors. D&O policies that provide entity (Side C) coverage for losses in securities actions have been determined to be company assets in some instances. To preserve this particular asset, a few bankruptcy courts have denied requests by directors and officers for reimbursement of ongoing defense costs. Relying on these cases, insurers now commonly refuse to pay attorneys' fees or costs until the bankruptcy court issues an order permitting payment. The following provisions can help prevent this from happening:

- **Order of payments.** D&O policies that provide entity coverage should include an order of payments provision that requires Side A claims to be paid before claims under Side B or Side C. This language provides strong support for the argument that the D&O policy is first and foremost a policy for the individuals and not a company asset that should remain available to satisfy creditor claims in bankruptcy.
- **Bankruptcy.** D&O policies should also include a bankruptcy provision that clearly establishes that bankruptcy or insolvency of any insured will not relieve the insurer of its obligations. This prevents an insurer from rescinding its policy if insolvency occurs.
- **Insured versus insured exclusion.** The insured versus insured exclusion in a D&O policy should make sure claims brought against any directors or officers on behalf of an organization in bankruptcy are covered (see *Insured versus Insured*). In other words, it should be clear that any claim brought on behalf of an examiner, trustee, receiver, liquidator or rehabilitator (or any assignee) of the organization is covered.

In addition to these provisions, also consider whether the company should purchase a Side A only policy. Side A only policies can provide valuable protection to directors and officers because these policies are never seen as company assets in the event of financial insolvency.

WHAT IS SEPARATE "SIDE A ONLY" COVERAGE AND DO DIRECTORS NEED IT?

Side A policies have grown in popularity in recent years. A *2008 study (http://www.towersperrin.com/tp/getwebcachedoc?webc=USA/2009/200908/DO_Survey_Report_20088_Final.pdf)* showed that 43% of public companies and 73% of companies with assets over $10 billion have purchased Side A policies. The study also found that 15% of companies with assets over $10 billion carry only Side A coverage and do not carry any Side B or Side C coverage. In comparison, only 5% of companies in the early 2000s purchased separate Side A policies.

Why have separate Side A policies grown in popularity? This is because they provide an extra layer of protection to directors and officers in situations where the company is unable to indemnify them. Some Side A policies also provide more favorable coverage terms than a traditional D&O policy. These policies are referred to as Side A Difference in Condition (DIC) policies. Companies should ensure that their insurance program includes this additional protection for the directors and officers, either in the primary policy or by using separate Side A DIC coverage for the following reasons:

- **Reduced chance of coverage depletion.** Unlike most D&O policies, the limit of liability for a Side A DIC policy is shared only among the individual officers and directors. The company is not an insured and therefore cannot use the Side A policy to reimburse it for its indemnification obligations or its own losses.
- **Coverage during a company's insolvency.** Side A DIC policies are not considered company assets during bankruptcy proceedings and can provide coverage to directors and officers when primary policies are frozen or insurers withhold payment.
- **Broader terms of coverage.** Side A DIC policies often have broader terms of coverage than standard D&O policies. Unlike most standard D&O policies, Side A DIC policies may provide coverage for losses that are not indemnified by a company even though indemnification is legally and financially permissible. These policies may also have more favorably worded claim, conduct and insured versus insured exclusions. In addition, Employee Retirement Income Security Act (ERISA) and pollution exclusions, regularly included in standard D&O policies, may be narrowed or removed from Side A DIC policies.

- **Coverage when underlying insurer is unable or fails to pay.** Side A DIC policies can be structured to cover losses when an underlying insurer cannot pay due to financial insolvency or refuses to pay. Without this coverage, directors and officers may be required to bridge any gap in coverage themselves for non-indemnifiable losses.
- **Coverage of derivative settlements.** A recent trend of large derivative settlements has underscored the need for directors to ensure they have adequate Side A coverage. In one of these settlements, Side A DIC policies paid out $40 million of a $118 million settlement.

Insurers also have begun offering individualized Side A policies that are also worth considering. These include Independent Director Liability policies, which provide coverage for a board's outside directors (and not the company's officers), and Officer Liability policies, which provide coverage just for a company's current and former officers. These types of policies can prevent the possibility that an early settlement or defense fees of some insureds may deplete the coverage available to others. Other variations of Side A coverage include policies covering specific officers or directors and policies covering individual directors for potential liability they may have from sitting on multiple boards.

SHOULD DIRECTORS AND OFFICERS INSIST ON SEVERABILITY CLAUSES?

Directors should always insist on severability clauses. Without severability provisions in both the insurance application and misconduct exclusions, each insured is at the mercy of the other officers and directors. A misrepresentation or act of misconduct by any one of them could cause all of them to lose their insurance. Severability clauses address this problem by preserving insurance coverage for innocent directors and officers, despite any improper conduct by other insureds.

A typical severability clause provides that, if material information is omitted from the application, coverage will be denied for the director or officer with knowledge of the omission. A similar severability clause in a policy's misconduct exclusions will protect innocent directors when another insured has engaged in fraudulent conduct. This kind of provision typically provides that knowledge possessed by any director or officer will not be imputed to other directors or officers for purposes of the policy's misconduct exclusions.

Some insurance companies have tried to either narrow their severability clauses or eliminate them entirely. For example, some insurers make severability inapplicable when the person signing the insurance application knew of misstatements in the application. Another version imputes the knowledge of a company's chief executive officer (CEO) and chief financial officer (CFO) to all insureds, but severs innocent officers and directors from misconduct or misrepresentations known only to others.

These modified severability provisions pose significant risks. Fortunately, many insurers continue to offer broad severability clauses in both their applications and misconduct exclusions, although sometimes at a higher premium. Still, a broad severability provision may be money well spent.

In addition, ensure that these clauses will apply to all of the policies in the company's D&O tower; otherwise coverage under an excess policy may be denied. Most excess policies adopt all of the primary policy's key terms and conditions and are not a concern. Excess policies that contain their own knowledge exclusions, however, should either include their own severability clauses or explicitly reference the company's primary policy clauses.

WHAT CAN A COMPANY DO TO AVOID HAVING ITS POLICY RESCINDED?

Rescission is the scariest risk faced by purchasers of D&O policies. Most states, including California and New York, allow an insurer to cancel a policy based on a material misrepresentation or omission in the application for insurance. An insurer may be able to rescind its policy even if the misrepresentation or omission was innocent. This risk can be compounded depending on the number and scope of representations made in insurance applications. Many applications also incorporate by reference all of a company's SEC filings for the past year or two.

So what happens if the company is one of the hundreds of companies each year that must restate its financials? The insurer has the ability, at least in theory, to respond by rescinding its policy. At the very least, the insurer may reserve its right to rescind and may use the threat of rescission during heated settlement or allocation negotiations.

A company can take several actions to reduce its risk of rescission. A company should exercise extreme care in preparing its application. Sometimes a company can avoid submitting an application by simply renewing its policy with its existing insurer. Other insurers will issue a renewal policy based on an abbreviated renewal application. A company should be careful in responding to requests made by some insurers for answers to supplemental questionnaires (customized questionnaires appended to the standard form of application). When policyholders seek to increase their limits of liability at the time of renewal, insurers will often require the company to sign a warranty letter containing a knowledge exclusion clause before extending additional coverage. Companies should use caution when signing these letters. Warranty exclusions have been used to deny coverage of defense costs when claims allege individual insured persons had knowledge of accounting improprieties when the warranty letter was signed.

Concerning policy provisions, ensure that the company's D&O policies include a non-rescission provision that prevents an insurer from rescinding Side A coverage under any circumstances. This type of provision has become relatively common in standard D&O policies. Also, the company should ensure that only material misstatements or omissions trigger adverse action on the part of the insurer. Finally, as previously noted, ensure that the application has a broad severability clause.

CAN A COMPANY DO ANYTHING TO EXPAND THE CLAIMS COVERED BY D&O INSURANCE?

There are certain steps a company can take to expand the claims covered by its D&O insurance. Many insurers offer endorsements that broaden the definition of a "covered claim." Some of these endorsements can prove to be critically important. In many D&O policies, "claim" is defined to mean written demand letters, civil complaints and formal administrative or regulatory proceedings commenced by a notice of charges or similar document. But what if the company receives a subpoena from a regulatory agency? Or becomes the target of an SEC investigation? What if the company's officers and directors are subpoenaed to testify before some regulatory body? Or what if the Department of Justice launches a criminal probe? None of these very expensive legal matters may be covered under the standard policy.

Expanded claim endorsements are available to cover some or all of these situations. For example, endorsements are available to cover arbitrations, criminal informations and indictments, civil, criminal, administrative and regulatory investigations, and subpoenas from the SEC or other securities regulators. However, in many cases, an expanded claim endorsement applies only to directors and officers and does not modify the definition of claim used in a company's entity coverage.

Some insurers are now offering products that seek to clearly delineate what types of actions are covered under the policy. One insurer, for example, recently introduced a policy that includes coverage for investigations of individual insureds.

WHAT SHOULD A COMPANY LOOK FOR IN A "FRAUDULENT CONDUCT" EXCLUSION?

It seems like a fundamental problem: virtually all securities lawsuits allege fraud and virtually all D&O policies exclude fraud acts from coverage. Does that mean that D&O insurance does not cover most securities class actions?

In the past, the answer to this problem was simple. The typical exclusion for "fraudulent conduct" took effect only after a final adjudication of fraud by a court of competent jurisdiction. An adjudication was not final if a matter was settled or if it was challenged on appeal. The final adjudication could not be made in separate litigation commenced by the insurer. As a practical matter, then, the fraudulent conduct exclusion was almost never invoked. The insured could, almost always, avoid an adverse final adjudication by settling before trial.

Now some fraudulent conduct exclusions contain broadened versions of the "final adjudication" language. These policies provide that the fraudulent conduct exclusion takes effect once "there is a judgment against, final adjudication against, adverse finding of fact against, adverse admission by, or plea of *nolo contendere* or no contest by an insured person as to such conduct." The phrase "adverse finding of fact" may be used to argue that **any** adverse finding, even one before trial, may form a basis for invoking the fraudulent conduct exclusion. Other policies replace the final adjudication language with a requirement that fraudulent conduct be determined "in fact." Courts generally have interpreted the in fact language broadly, allowing the assessment of whether fraudulent conduct has occurred to be conducted in a separate coverage proceeding. If possible, companies should avoid policies with these variations of fraudulent conduct exclusions.

WHAT ELSE SHOULD A COMPANY WORRY ABOUT WHEN PURCHASING D&O INSURANCE?

In addition to the terms already discussed, review the provisions set out below to avoid unexpected coverage issues.

PERSONAL PROFIT EXCLUSION

Most D&O policies exclude claims where an insured has gained personal profit, advantage or remuneration to which they were not legally entitled. Insurers now see this exclusion as potentially applicable to various disgorgement provisions in the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), including the provision requiring disgorgement of an executive's bonus and incentive-based compensation following a restatement of financial reports.

When a policy contains a personal profit exclusion, ensure there is accompanying language stating that settlements of claims involving violations of Sections 11 and 12 of the Securities Act of 1933, as amended (the Securities Act) do not constitute disgorgement, restitution or the return of ill-gotten gain unless there is a final judgment, final adjudication or final administrative determination stating otherwise. For more information on liability under Sections 11 and 12 of the Securities Act, see *Practice Note, Liability Provisions: Securities Offerings (http://us.practicallaw.com/6-381-1466)*.

INSURED VERSUS INSURED

Most D&O policies exclude claims brought by one insured against another. Sarbanes-Oxley, however, creates several corporate rights against officers and directors and imposes several new duties on CEOs, CFOs, audit committee members and directors. Each of these new remedies and duties creates the possibility of claims between a company and its officers or directors or among the directors and officers of a company. Because the company and its officers and directors are all insureds, the insured versus insured exclusion could exclude these claims from coverage.

While this language is standard in D&O policies, ensure that the exclusion does not apply to whistleblower actions and stockholder derivative claims brought and maintained without any active participation by an insured. It is also necessary to ensure that this exclusion contains language that allows for coverage of claims brought on behalf of an organization in bankruptcy or by the examiner, trustee, receiver or liquidator of the organization.

PRESUMPTIVE INDEMNIFICATION

Many policies state that the company is presumed to indemnify insureds to the full extent permitted by law. This means that the Side B retention amount may apply even if the company is legally obligated to indemnify an insured, but refuses to do so. For policies with high retentions, this may mean that directors and officers may face up-front costs of several million dollars before receiving coverage. Policies can be improved by waiving the retention for directors and officers when indemnification is withheld and one insurance carrier has recently come out with a policy that does this.

As previously noted, one of the key benefits of separate Side A DIC policies is that they rarely contain a presumptive indemnification provision and can provide coverage in these instances.

UNDERLYING INSURER INSOLVENCY AND REPUTATION

Under a typical insurance program, an excess policy does not provide coverage until the underlying policies have all been exhausted (meaning the underlying insurers have paid their limits in full). For example, if a company purchased one primary and two excess policies each with $1 million in coverage, the primary policy would cover the first $1 million, the first excess policy would cover the second $1 million and the second excess policy would cover the third $1 million. In this example, if the first excess insurer became insolvent, the second excess policy may never be required to cover any losses. To avoid this situation, it is important that a policy allow a company to bridge a coverage gap resulting from the insolvency of an underlying insurer (in the above example, the company would pay the $1 million).

Another important thing to consider is the reputation of the insurer. The company should consider the following questions:

- Are they easy to deal with?
- Do they have a reputation of treating claims as part of the business relationship or, rather, do they have a reputation for denying any claim they can?
- Are they financially stable?

For other important questions to consider when choosing a D&O carrier, see *Choosing a D&O Insurance Carrier Checklist (http://us.practicallaw.com/8-385-7929)*.

CAN A COMPANY GET INSURANCE COVERAGE FOR DERIVATIVE CLAIMS?

The problem usually arises when it comes to settling the derivative suit. Even though most D&O policies explicitly cover settlements of derivative lawsuits, some insurers have been reluctant to pay cash settlements to the company. Given the recent trend of large derivative settlements, it has become increasingly important that the policy is clear that derivative settlements and judgments are covered, subject to the policy's other terms and conditions.

Directors and officers can usually at least get coverage for attorneys' fees in a derivative case, but the company may not. A company can spend hundreds of thousands, if not millions, of dollars investigating derivative claims or seeking early dismissal of a derivative suit. To combat this problem some insurers offer endorsements that provide coverage subject to a sublimit for the company's costs of investigating derivative claims. At least one carrier has recently introduced a policy that expressly provides coverage for the costs of seeking dismissal of a derivative suit.

WHAT COVERAGE IS AVAILABLE IF THE COMPANY MERGES OR IS ACQUIRED?

Generally, "tail" policies are available to deal with mergers and acquisitions. Under a tail policy, D&O policies continue to provide coverage until the end of the policy period, but only for claims related to wrongful acts occurring before the effective date of the merger or acquisition.

Some policies have automatic tail coverage available after an acquisition at the option of the policyholder. Other policies leave this open for negotiation. Companies may want to ensure that tail coverage provisions are drafted to provide a company that is being acquired with the flexibility both to control the tail coverage procurement process itself and take the opportunity to improve terms of coverage, if possible.

Two other alternatives exist. If a smaller company is acquired and its employees or assets do not exceed a set threshold, then the target company can be treated as a subsidiary under the acquiring company's existing policy. However, if the target company exceeds the threshold, then the acquiring company will need to obtain a revised policy.

WHAT TERMS SHOULD A COMPANY LOOK FOR WHEN ACQUIRING TAIL COVERAGE?

When negotiating tail coverage, a company should consider seeking improvements in coverage terms and insurance amounts. The following are examples of tail coverage terms that the company should consider modifying:

- **Presumptive indemnification.** If the company's primary policy contains a presumptive indemnification provision, consider removing it from the tail coverage. Otherwise, if the surviving company does not indemnify the directors (even though it is supposed to under the merger agreement), the directors must pay the retention.
- **Insured versus insured.** One possible scenario that arises out of a merger or acquisition is that another insured (for example, the surviving company) sues the acquired company's directors and officers for misrepresentations or mismanagement. When obtaining tail coverage, clarify that the insured versus insured exclusion does not prevent coverage for these types of claims.
- **Contribution/aggregation.** Many D&O policies include a provision addressing situations where a loss is covered by

more than one insurance policy. These contribution clauses typically state that coverage will not be provided until the other policy has been exhausted. Tail coverage should make clear that it provides coverage regardless of whether there are other policies that also may provide coverage for the claim. This will avoid situations in which two insurers each deny coverage based on the existence of the other's policy.

WHAT SHOULD A COMPANY LOOK FOR IN THE DEFENSE COSTS PROVISION?

Look for a "pay as you go" or "current basis" clause. Some D&O policies provide that defense costs and expenses will only be reimbursed after a matter is resolved. This means a company would have to advance all of its attorneys' fees and costs and wait years to get reimbursed. Other polices provide that defense costs will only be reimbursed on a periodic basis. A company should insist on language that requires the insurer to pay defense costs as they are incurred. Often this language will refer to "advancing" defense costs on a current or quarterly basis.

SHOULD A COMPANY BE CONCERNED ABOUT VENUE AND CHOICE OF FORUM PROVISIONS?

Venue and choice of forum provisions are crucial. Many companies treat venue and forum selection clauses as unimportant boilerplate. But some policies require coverage issues to be litigated in New York, London or Bermuda. Others require arbitration of coverage disputes before arbitrators with insurance expertise. Similarly, many insurance policies require application of New York law, which can be more favorable to insurers. Arbitration is usually not the best forum for an insured and inconvenient venues can be a real detriment in any coverage dispute. Bottom line: it pays to focus on the boilerplate.

DOES A PRIVATE COMPANY NEED D&O INSURANCE?

Even if a company is not public, it still needs D&O insurance, especially if it is involved in raising capital or anticipates merger or acquisition activity. Both of these events can expose a company and its directors and officers to litigation. For example, if a company deteriorates financially after successfully raising money, recent investors in the company may sue management for not disclosing the company's problems. In addition, stockholders of a target company in an acquisition may sue its directors and officers for selling the company too cheaply or for breaches of their fiduciary duties.

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