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D & O LIABILITY INSURANCE: The Most Commonly Asked Questions

WHITE PAPER

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Executive Summary

Directors and officers liability insurance (D&O) is a critical component of most corporate risk management programs. Yet despite the fact that D&O has been an ubiquitous insurance coverage for nearly thirty years it remains one of the most complex and often misunderstood insurance policies. This is partly attributable to the fact that D&O can serve multiple purposes, ranging from personal liability coverage for the directors and officers to balance sheet protection for the corporation. Numerous structural changes to the D&O policy form, as well as an evolving regulatory and litigation landscape, have posed challenges for directors and officers in attempting to make sure their D&O insurance covers for current risks.

The purpose of the following discussion is to address three of the most fundamental questions asked by directors about D&O coverage:

1. How do I know that my company has purchased the right policy limit?
2. What exactly am I covered for under the policy?
3. What would not be covered under the policy?

Although the answers to these questions do not reflect a completely scientific approach, they will start a director down the path of ensuring that the D&O coverage in place will work in the unfortunate event of a claim. This article will also explain basic terms in D&O insurance and review common exclusions.

How do I know that my company has purchased the right policy limit?

There are at least three ways in which a buyer, with support from its insurance broker, currently evaluates the adequacy of its D&O limits. Bearing in mind that D&O coverage provides a single aggregate limit of liability for the annual policy term rather than a separate limit per director or officer, it is imperative that a buyer make a good decision.

The first way is the traditional: reviewing peer information as to what other companies of similar size and exposure purchase. This produces a slotting effect where most buyers want to be somewhere in the middle of what the peer group purchases. For more conservative boards, the

figure may be at the upper end. The problem with reliance upon peer information is that a buyer could simply be making the same wrong decision as everyone else, as one very astute chief financial officer once told me. Thus, the peer review is helpful but should not be the final decision maker.

Another method is to look at data tracking the frequency of D&O claims, dismissal rates in respect to those cases successfully defended, settlement amounts in other cases and average defense costs. This data is readily available from several sources and provides a buyer with real-life insight as to the median, mean and worst-case loss amounts. Using this information in combination with a peer review can determine whether peer purchasing habits are keeping pace with case inflation on the claims side.

The final method for evaluating limits involves the use of risk modeling. Although the D&O market was slow to embrace predictive modeling, it is now being applied with increased frequency to publicly traded companies. The science itself is not new. D&O underwriters and brokers have access to vast amounts of financial and governance data for publicly traded companies from SEC filings. That data, combined with the claims data previously discussed, are modeled to determine the susceptibility of a particular company to litigation and the likely outcome (dismissal versus settlement) of any potential claim. The models also produce a settlement range for a given company.

The best practice is to apply all three methods wherever possible. D&O underwriting will most likely never be reduced to an exact science because future claims experience cannot be predicted with absolute certainty. It is possible, however, to make decisions based on "artful science."

What exactly am I covered for under the D&O policy?

Here's the good news: a D&O policy is intended to cover you for any and all actual or alleged wrongful acts you commit in your capacity as a director or officer of the insured company. It may even go

further and cover you in the capacity of a director of an outside organization or company (outside directorship liability) provided that the insured company is aware of and supports your service on that outside entity. This most often happens with respect to service on not-for-profit boards but can also apply to service on for-profit boards if that serves the interests of the insured company.

The basic levels of insurance are Side B, Side C and Side A coverage. Side B coverage reimburses a company for the costs of claims made against its officers and directors where the company has agreed in its charter or bylaws to indemnify those individuals for claims made associated with their work for the company. Side C covers the company for its own liability as a defendant or co-defendant party in litigation, such as securities lawsuits.

What this means is that you could be sharing a single aggregate D&O limit on an annual basis with a lot of other interests. Consequently, it is strongly recommended that a company purchase Side A coverage.

Side A coverage protects the individual insured persons in situations where the company cannot indemnify due to legal restrictions or financial insolvency. An ample amount of Side A coverage is available in the current D&O market and can be applied to protect the directors and officers in a variety of ways. An additional twist can be to purchase independent director liability (IDL) coverage which functions much like a Side A policy except that it protects only the independent directors. Some companies choose to purchase both Side A and IDL coverage.

A final part of this question involves what amounts are actually covered within the limit purchased. The answer is that both indemnity amounts (settlements and any possible judgments) and defense-related expenses are covered, subject to a retention or deductible that the company will have to absorb under the Side B or Side C insuring clause. With very limited exceptions, directors and officers do not

have to pay any retention or deductible amount.

The insured chooses its own counsel in most cases, subject to consent or approval by the D&O insurer. D&O claims are increasingly expensive to defend, particularly in the age of electronic discovery where attorneys must review hundreds, sometimes thousands of emails and other digital documents. Since the D&O limit is eroded by payment of defense expenses, it is in the best interests of both the insured parties and the D&O insurers to make sure that the defense is not only effective, but cost-efficient. Thus, a joint or unified defense is most often recommended unless there are conflicts of interest or other compelling reasons that justify retention of separate counsel for various defendants.

What would not be covered under the policy?

Here is where the frustration comes in. The truth is that a D&O policy works the way it is supposed to from a buyer's perspective in most claim situations. Nevertheless, there are a lot of exclusions in the D&O policy. What makes it even trickier is that some of the exclusions or restrictions are not even in the exclusions section. Some are found as carve-backs of coverage in the definitions section. Other restrictions come into effect as part of the application process.

For example, a D&O insurer will rely upon any representations or warranties made in an application for coverage to deny claims or seek to void the coverage altogether in a declaratory judgment action if it feels the insured made misrepresentations in the application process. The application can be deemed to include any financial reports or other documents provided by the insured to the insurer over the past 12 months or longer. Of even greater concern is the fact that misrepresentations made by the party signing the application (usually the chairman or CEO) could prejudice coverage rights for all of the directors and officers.

Consequently, it is essential that the policy state that at least with respect to the Side A insuring clause, underwriters will not look to rescind or void the coverage for any reason. It is also imperative that

both the application and exclusions be treated as severable, which means that any wrongful conduct or knowledge by one director or officer will not be imputed to any other individual insured. The concept of all for one and one for all may be great in other circumstances, but in the case of a D&O policy, a director or officer wants to be held accountable only for his or her actions and not those of others whose conduct or intentions may have been improper or illegal. If possible, seek to avoid providing an application altogether.

Other exclusions can include:

- dishonest or fraudulent conduct
- improper or illegal personal profit (i.e. insider trading gains, clawback of compensation in the event of a restatement of earnings)
- fines and penalties
- pollution
- bodily injury and property damage
- a bump-up in share price as part of settlement of a securities lawsuit with shareholders over the merger or sale of a company
- taxes
- acts prior to the inception of the policy
- regulatory claims
- the insured versus insured exclusion, wherein the D&O policy does not cover situations where one insured party sues another. This last restriction is sometimes used by insurers to deny claims made by the bankruptcy trustee or the Federal Deposit Insurance Corp. acting as a receiver for the bank.

There are other restrictions, but this list is long enough already.

The positive side of the equation is that almost all of these exclusions can be amended to allow for more coverage. At the very least, there should be defense costs coverage for these types of claims. Some of these exclusions can be removed altogether. A lot of drafting goes into the policy. No D&O policy should ever be taken off the shelf and accepted as is. Moreover, it is recommended that outside counsel for the board review the D&O policy every

few years to ensure that it remains state-of-the-art.

While D&O insurers understandably do not want to pay claims for risks they did not contemplate nor knowingly accept during the initial underwriting process or where the law has been broken, they recognize that the efficacy of D&O insurance rests upon its ability to perform as intended. With the support of expert draftsmanship by a qualified insurance broker, a company can make sure that the personal assets of its directors and officers are protected against almost all possible claims with the exceptions of the most egregious and outrageous misconduct.