

D&O INSURANCE: WHAT YOU NEED TO KNOW

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Abstract:

In a constantly changing global economy, every type of business entity should be aware of the insurance coverage provided by directors' and officers' liability policies or «D&O Policies». It is common for companies to assume that their D&O Policy is broad enough to cover any claim that may be asserted against its directors or officers. Such an assumption is risky. Like any insurance policy, D&O Policies have limitations on coverage. Sadly, these limitations may not be



recognized until a claim arises. It is thus good practice to periodically assess whether a D&O Policy provides the appropriate breadth of coverage for your needs or those of your clients. This article highlights D&O Policy terms, conditions, exclusions and limitations that warrant careful consideration.

Keywords:

Directors' and officers' insurance, management liability insurance, coverage clauses, coverage exclusions, coverage limitations, defense cost coverage, claims, loss.

I. Introduction

In a constantly changing global economy, every type of business entity – public corporations, privately held companies, investment firms, financial institutions, non-profit organizations and others – should be aware of the insurance coverage provided by directors' and officers' liability policies or «D&O Policies». Do you know what risks your or your client's D&O Policy covers? Do you know what risks are excluded from coverage? Are you aware of the steps you need to take when a claim or a potential claim arises?

Like any insurance policy, D&O Policies have limitations on coverage. Sadly, these limitations may not be recognized until a claim arises. It is thus crucial to scrutinize proposed policy language when a D&O Policy is being purchased or renewed so that there is a clear understanding of the policy's terms, exclusions, conditions, and limitations. Whether or not a D&O Policy includes a particular provision or endorsement can impact the outcome of a request for coverage.

It is good practice to periodically assess whether a D&O Policy provides the appropriate breadth of coverage for your needs or those of your clients. The following policy provisions, in particular, warrant careful consideration.

II. Basic Coverage Clauses

D&O Policies typically provide three types of coverage known as Side A, Side B and Side C.

«Side A» provides liability coverage to individual directors and officers. This coverage typically is available only when the company fails or refuses to indemnify an individual who is the target of a claim. Insurers expect the company to indemnify its directors and officers up to the fullest extent of the law. Therefore, individual directors and officers should look first to the company for indemnification. Side A coverage provides a backstop and generally responds only when the company is unable – either legally or financially – to indemnify the individual.

«Side B» provides reimbursement coverage to a company for claims for which it indemnifies its directors and officers. This coverage benefits the company by reimbursing it for amounts incurred to

defend and indemnify its directors and officers.

«Side C» provides «entity» coverage to the company for corporate liability such as securities claims. This coverage benefits only the company. It is not available to the individual directors and officers.

Side A, B and C coverage can be expanded by the inclusion of other optional insuring provisions that may provide: (i) coverage for investigations by government agencies or authorities; (ii) derivative demand coverage for internal investigations triggered by a shareholder derivative demand, and (iii) crisis management coverage for amounts incurred in responding to circumstances such as restatements of financials, negative earning or sales announcements, product recalls, mass torts, or loss of key personnel.

Definition of Insured. The definition of «Insured» should be reviewed carefully to ensure that it includes those directors, officers and other individuals and entities the company wishes to cover. On the other hand, it should not be overly broad so as to dilute the available coverage. Separate endorsements may be warranted to clarify who is and is not insured.

Advancement of Defense Costs. From the perspective of individual directors and officers, perhaps the most important coverage offered by D&O Policies is the advancement of defense costs to fight a claim when it is first asserted. A close review is warranted to ensure that the D&O Policy provides «first dollar» or «no-deductible» defense cost coverage under Side A. This ensures that individual directors and officers do not incur costs to defend themselves if the company fails or refuses to indemnify them. The provision is a significant benefit since defense costs are the first type of cost to be incurred and the amounts may be considerable.

Definition of Claim. The term «Claim» should capture the widest array of potential actions that could be brought against any insured. «Claim» should typically be defined to include any written demands for monetary or non-monetary (including injunctive) relief, civil and criminal proceedings, administrative

or regulatory proceedings, civil, criminal, administrative or regulatory investigations by governmental authorities, any arbitration, mediation or other dispute resolution proceeding, securities claims, shareholder derivative demands and extradition requests.

Definition of Loss. The term «Loss» in a D&O Policy refers to the costs and expenses the insurer will be obligated to reimburse. «Loss» should include all defense costs, settlements, judgments and any damages incurred in connection with a Claim, including punitive and exemplary damages to the extent insurable under applicable law. «Loss» should also include pre-and post-judgment interest and, where applicable, investigative costs.

Non-Rescindable Coverage and Severability. D&O coverage is often shared among numerous individual directors and officers. Ideally, a D&O Policy should provide that it cannot be rescinded at all. At a minimum, to the extent the insurer has the right to rescind coverage under certain conditions, there should be adequate «severability» language, precluding the insurer from relying on a single insured's misrepresentation to void coverage for all insureds.

Priority of Payments. Side A, B and C coverage typically share a single policy limit. Thus, individual directors and officers could be at risk if the company's Side C coverage exhausts the available policy limit. D&O Policies therefore should include a «priority of payments» provision, stating that when claims are brought against the company and individual directors and officers, the individuals will be paid first. In addition, many companies opt to purchase a separate «Side A only» policy, which is available exclusively to the company's directors and officers.

Insured vs. Insured Exclusion. A D&O policy typically excludes coverage for claims brought by one insured against another insured under an Insured v. Insured exclusion. The basic purpose of the exclusion is to protect insurers against potentially collusive claims. D&O Policies typically contain «carveouts» or exceptions from the Insured v. Insured exclusion. It is important to review these carveouts to ensure that the D&O Policy extends coverage for shareholder derivative claims, whistleblower claims, claims by bankruptcy trustees, and claims by insured individuals who have not been directors or officers in several years.

Conduct Exclusions (Fraud, Dishonesty, Personal Profit). D&O Policies typically contain «conduct» exclusions barring coverage for claims arising out of criminal, fraudulent, or deliberately dishonest acts, willful violations of law, or the gaining of personal profit to which an insured is not legally entitled. Conduct exclusions should apply only if, and only after, there is a final, non-appealable adjudication adverse to the insured. With such language, the insurer will be obligated to advance defense costs unless and until there has been such a final adjudication.

Tail Coverage/Extended Reporting. Most D&O policies provide the insured company with an option to



purchase an extended reporting period (known as a «tail» period) in which to report claims made after the D&O Policy expires. In some policies, this option is triggered only if the insurer cancels or refuses to renew the policy. Some insurance policies allow this option to be triggered if either the insurer or the insured cancels or chooses not to renew the policy.

Other Exclusions. Other exclusions that appear from time to time in D&O policies relate to restatements of financial results, financial impairment, acts of war or terrorism, pollution, commissions and payments to customers, political contributions, professional services, and the failure to maintain other insurance. Policy holders should evaluate whether it makes sense to negotiate the scope of these provisions.

Other Provisions. Other provisions that warrant scrutiny in D&O policies relate to notice requirements, allocation, changes in control or status of the company, newly created subsidiaries, mergers and acquisitions, and coverage territory.

III. Conclusion

It is common for companies to assume that their D&O Policy is broad enough to cover any claim that may be asserted against its directors or officers. As detailed above, such an assumption is risky. D&O Policies differ, and insurers do not provide unbridled coverage. It is important to understand the scope of coverage provided by a D&O Policy, the limitations it contains, the insured's obligations and the steps that must be taken to ensure that a covered claim is properly reimbursed.

