FEDERATION OF REGULATORY COUNSEL, INC.

QUESTIONS A POTENTIAL INDEPENDENT DIRECTOR SHOULD ASK ABOUT THE COMPANY'S DIRECTORS & OFFICERS LIABILITY INSURANCE BEFORE JOINING THE BOARD OF DIRECTORS

(FORC Journal: Vol. 21 Edition 2 - Summer 2010)

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INTRODUCTION

Directors and Officers Liability Insurance policies offer unique insurance coverages and present a variety of unusual issues. While many people know that defense costs are charged against the liability coverage limits, there are many potential concerns that can be surprises to the uninitiated. Since the company purchases the D&O insurance, many directors do not realize what the gaps may be in the protections they expect. This article discusses questions a potential director should be asking about the D&O insurance policy.

In contrast to most liability insurance policies, a Directors and Officers liability policy does not require the insurance carrier to provide a "defense," even if the claims are covered by the policy. Instead, if a claim is covered, the carrier will reimburse (or advance) defense fees and costs and if it agrees, fund a settlement. That means insureds must arrange for their own defense, although usually the selection of counsel does require the consent of the carrier.

1. What is Covered - Key Definitions.

D&O insurance policies typically provide that the insurance company will pay all loss for which the insureds become legally obligated to pay on account of a claim for a wrongful act. The following definitions are key to gaining an understanding of what is covered by the policy, as well as what is not covered.

a. Claim

A claim is commonly defined as a demand for money from an insured or a lawsuit which has been filed against an insured. For a company in a regulatory environment, it is important to check and make sure that a claim also covers a criminal proceeding as well as an administrative or regulatory proceeding.

b. Loss

A loss is often defined as the amount which the insured or the company becomes legally obligated to pay on account of a claim. It includes damages, judgments, settlements and defense costs.

c. Defense Costs

A common definition of defense costs includes reasonable and necessary costs including attorneys' fees and expenses incurred in defending or investigating the claims against the insureds.

d. Wrongful Act

A wrongful act is often defined as any error, misstatement, act, omission or breach of duty, actually or allegedly committed by any of the insureds in his or her insured capacity, i.e., as a Director or Officer, etc.

2. Is There Side A, B and C Coverage?

The primary concern of potential Directors is whether the company D&O insurance will cover their liability, if any, and defense costs in the event a claim is made against them. This type of coverage is referred to as Side A Coverage.

Side B coverage refers to amounts the carrier would pay to the company as reimbursement for indemnification paid by the company to insureds.

Side C coverage protects the company for liability the company itself may have due to a claim. These coverages generally work together, depending upon the factual circumstances. It is important that the Directors know that not only are they covered, that the company is also properly protected if a claim is made by having coverage for both (1) reimbursement to the directors and (2) the company's own liability.

3. What are the Limits?

In contrast to most insurance policies, defense fees and other costs that are covered by a D&O policy are charged against the policy limits. Thus, legal fees often seriously erode the policy protections. Legal expenses, in fact, may exceed the policy limits, leaving the insureds with the predicament that they must fund their own defense fees and costs as well as come up with their own money for settlement.

What is the amount of the coverage? Is there a single limit for each claim and all claims in the aggregate? Are there separate sub-limits for some coverages? How likely is it that potential liability and defense costs could exceed that amount?

4. What is the Retention?

The self-insured retention or deductible in a Directors and Officers liability policy is often a significant sum such as, for example, fifty thousand dollars or a hundred thousand dollars. If a claim is made, will the corporation pay that retention before the D&O coverage kicks in?

5. Who pays the Defense Costs and Expenses in the first instance?

Does the D&O carrier advance the defense costs and expenses, or is it only at the carrier's option? In other words, must the company and/or Director incur defense fees and costs initially and then get reimbursed under the policy? Similarly, if the corporate bylaws provide for indemnification, do they require the corporation to advance defense fees and costs, or do the bylaws only provide for reimbursement?

6. How broad are the claims made provisions?

a. Claims that occurred before the policy incepted

A D&O policy generally only covers those claims made during the policy period unless expressly agreed otherwise. Does the policy cover claims made during the policy period when the events giving rise to the claim occurred before the policy inception? If so, and there is such a claim, will there be enough coverage left once that claim is resolved?

b. Claims made after the policy is terminated

Are you covered for claims made after the policy expires? If so, for how long? Is there additional cost? Is it paid for in advance?

7. Who is Covered by the Policy? Does the policy cover the directors and officers of the named insured's parent corporation, its subsidiaries and affiliates? Are only Directors and Officers who are formally elected or appointed as such covered, or does the policy cover employees in a managerial capacity or otherwise? What is the impact, if any, on your protections under the policy once you leave the Board of Directors?

8. What are the Exclusions? As with almost any insurance policy, D&O policies contain a long list of exclusions. Some key exclusions include any deliberately fraudulent act or omission or any willful violation of any statute or regulation. Also, claims based upon an insured gaining any personal profit or financial advantage to which the insured was not legally entitled are commonly excluded. *See also* the discussions of the *Insured vs. Insured* exclusion and the Regulatory Exclusion below.

9. What is the methodology for Allocations Among Insureds? D&O policies often contain one coverage limit that applies to all claims against any insureds, although there may be sub-limits for specific types of claims.

a. Defense costs

What does the policy provide regarding how defense costs are allocated among various insureds and/or sets of insureds? If there is a Side C coverage and the company itself is insured for direct liability to a third party, is there any methodology specified for allocation of defense costs between the company and individual insureds?

b. Settlement costs

Similar questions arise in connection with a potential settlement – for example, can all of the funds remaining in the policy, up to the unused limits, be utilized to settle a claim against one insured or one set of insureds to the exclusion of the others, leaving some insureds "uninsured?"

10. Is There a Separation of Insureds Clause?

If there are misrepresentations in the application for the policy, does the insurance company have the right to rescind the policy against all of the insureds or only against the person who made the misrepresentations and/or the company itself? For example, a company employee falsely answers a question as to whether the applicant has knowledge about the potential for a claim that has not yet been made. Similarly, if the financial statements were in error and need to be restated, can coverage for all insureds be denied? If there is a misrepresentation in the application and the other insureds had knowledge that the representation was false, is there coverage for those insureds with knowledge

of the misrepresentation?

11. Who Must Consent to a Settlement?

These policies generally provide that the D&O carrier must consent to a settlement. Does the policy also require all of the insureds to consent to a settlement? Can consent by the carrier or the other insureds be withheld under any circumstances or is it limited to situations where consent cannot be unreasonably withheld?

12. How financially strong is the carrier(s)?

Is all the coverage with one carrier or in layers with two or more carriers? What are the A.M. Best ratings of the carrier(s)? Insurance guaranty funds generally do not cover claims under Directors and Officers liability insurance if the carrier becomes insolvent. If the primary carrier does become insolvent, will the other carrier(s) pick up that coverage?

13. What Indemnification is provided?

How are the indemnification provisions in the policy tied in with applicable law and the corporation's bylaws? What does the applicable state law provide for indemnification, and if the bylaws are different, do they provide for maximum indemnification? If so, is it mandatory or discretionary?

14. Is the Insured v. Insured Exclusion Limited?

D&O policies generally contain an *Insured v. Insured* exclusion which is intended to prevent collusion among insureds, such as where the corporation sues its Directors and Officers in an attempt to recover insurance proceeds from the D&O carrier despite the lack of merit to the claims. Does the *Insured v. Insured* exclusion carve-out claims brought by the receiver or trustee of the corporation if the corporation is placed into receivership or bankruptcy? Carriers have often taken the position that since a receiver stands in the shoes of the company, the *Insured v. Insured* exclusion prevents coverage of the lawsuit. This position has been rejected by a number of courts, but the policy should contain a carve-out for this type of litigation so that there is coverage if a claim is brought by a receiver of the company.

15. Is There a Regulatory Exclusion That Would Deny Coverage for Claims Brought By a Governmental Agency?

Does the policy contain a regulatory exclusion which excludes coverage for claims brought by a governmental, quasi-governmental, or regulatory agency? These exclusions go back to the savings and loan crises in the 1980's, and are not necessarily included in policies any longer.

16. Does the company have any experience with the insurance carrier on previous claims?

Have there been any previous claims with this insurance carrier? Have any of the policy limits been used up already? How did the carrier handle the claim and the defense? Were they cooperative and helpful?

17. What are the Additional Insured Rights?

The company purchases the policy and is the named insured. Are the directors additional insureds? What rights does an additional insured have compared to all of the rights of the named insured(s)? For example, can the policy be canceled by the named insured a) without the director's consent, b) without the director's knowledge, or c) over the director's objection?

CONCLUSION

The time to look at these issues and ask questions is before joining a Board of Directors. Once a claim is made, the policy controls and directors may not be protected as they expected.