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Reassessing Risks And Coverage Of D&O Insurance

Law360, New York (December 16, 2011, 3:34 PM ET) -- As the year comes to an end, many companies, along with their officers and board members, are considering renewals for directors and officers (D&O) insurance coverage.

The coverage offered under various D&O policies varies from insurer to insurer, and the language of key provisions is often negotiable.

The purpose of this article is to remind individual and corporate policyholders of the protection available under D&O liability insurance and to highlight five issues that should be at the forefront of the minds of risk managers, in-house lawyers, and directors and officers as they consider the coverage afforded under these policies.

Five Issues to Keep in Mind When Assessing Coverage

The claims environment faced by corporations and their directors and officers today continues to be rife with shareholder suits, U.S. Securities and Exchange Commission and U.S. Department of Justice investigations, Sarbanes-Oxley claims, and state regulatory investigations.

As a result, directors and officers must remain vigilant to ensure that their participation in corporate decision-making does not subject them to potentially catastrophic losses. Corporations, too, are vulnerable to unforeseen liabilities, including restated financials and the inevitable shareholder derivative lawsuits that follow.

Unfortunately, these claims are not likely to go away any time soon, and the risk of potential liability remains a significant threat.

To aid in the evaluation of coverage and to help avoid potential coverage disputes, the following are five specific issues that should be addressed when renewal negotiations are underway, so that maximum insurance protection under D&O policies can be secured.

Seek Broad Definitions of "Claim" and "Defense Costs"

More and more claims against individual directors and officers as well as corporate insureds are being initiated through investigations by federal and state regulatory agencies such as the SEC, DOJ and states' attorneys general.

As the potential for these liabilities increases, D&O insurers are becoming more aggressive in limiting or denying coverage for the costs incurred by individual and/or corporate policyholders in connection with such investigations.

Individual and corporate insureds can seek to avoid these potential coverage disputes at the outset by seeking expansive definitions of "claim" and/or "defense costs," such that these terms are defined specifically to provide coverage for all costs incurred in connection with investigations initiated in response to governmental or shareholder demands.

Where D&O liability insurance policies have contained broad language to encompass the costs of pre-suit investigations, courts interpreting such policies have found in favor of policyholders to require coverage for investigation costs. See, e.g., MBIA Inc. v. Federal Ins. Co. (2d Cir. 2011), finding that costs incurred in connection with a governmental investigation were "Defense Costs;" Nat'l Stock Exch. v. Federal Ins. Co. (N.D. Ill. 2007), finding that an SEC investigation qualified as a "Claim."

Individual and corporate policyholders should review their D&O liability insurance policies to ensure that such costs are included within broad definitions of "claim" and "defense costs."

Obtain Broad Selection of Defense Counsel and Immediate Advancement of Defense Costs

Often, defense costs in response to investigations and claims are the most significant liability facing corporations and their officers and directors.

Based on the language found in some D&O liability policies, insurers often (i) seek to limit a policyholder's selection of counsel and (ii) withhold reimbursement of the policyholder's out-of-pocket defense costs until after coverage has been fully adjudicated.

We counsel our individual and corporate policyholder clients to negotiate favorable language during the renewal process that avoids this circumstance by including clarifying language to ensure that defense costs are paid as they are incurred.

Seek Nonrescindable Coverage or Severability

Corporate policyholders continue to face significant shareholder claims based on restated financials. Insurers, in turn, use these unfortunate circumstances to deny coverage at a time when the policyholders are most vulnerable.

Because restated financials must be signed by directors or officers who attest to their accuracy, insurers commonly seize this opportunity to seek rescission of D&O liability insurance for the corporation and for the individual directors and officers.

Such a situation threatens to leave the corporate and individual insureds completely uninsured while at the same time facing potential liability to shareholders based on the corporation's restated financials.

D&O policyholders can avoid rescission by seeking nonrescindable coverage and/or severability. Nonrescindable coverage is exactly what it sounds like — the insurer is foreclosed from seeking to rescind coverage based on alleged misrepresentations in connection with the application for insurance.

Where nonrescindable coverage is not available, policyholders can seek to obtain severability of coverage to avoid imputation of misrepresentations to "innocent" insureds. By shielding "innocent" insureds from rescission, D&O insurance coverage should be available to many policyholders even where an insurer seeks to rescind coverage as to certain other insureds.

Obtain Separate, Nonrescindable Side A Coverage

Typically, D&O liability policies include three separate coverage parts: Side A, which covers directors and officers for claims not indemnified by the company; Side B, which reimburses the company for amounts paid to indemnify officers and directors; and Side C, which covers the company for claims made directly against the company, often limited to securities claims.

However, the limits under a D&O liability insurance policy are shared among all three coverage sides — meaning that if the policy carries limits of $1 million, and a claim against the company, triggering Side C coverage, depletes the entire $1 million in limits, there would be no coverage available for a subsequent claim against an individual director or officer under Side A coverage.

As a result of the potential exposure borne by individual insureds in the event that policy limits become depleted, individual insureds may seek to obtain separate, nonrescindable Side A coverage through a separate Side A policy that provides a new set of limits available only for claims against individual directors and officers.

Seek Severability of Exclusions

D&O liability policies contain a variety of "conduct"-based exclusions, such as exclusions for fraudulent or dishonest acts, intentional and willful violations of law, and improper gain of personal profit or advantage.

It may appear upon reading such exclusions that they were intended to preclude coverage for the individuals alleged to have engaged in such excluded "conduct;" however, insurers have sought to extend these exclusions to deny coverage to other "innocent" insureds as well.

For example, where securities claims or claims under Sarbanes-Oxley allege wrongful conduct against certain individual directors or officers, insurers often rely on these exclusions to limit or deny coverage for all other individual insureds and the corporation, even though these individuals and the entity had no involvement in the alleged wrongful conduct.

Such an inequitable and unintended result can be avoided by seeking severability of exclusions.

To avoid imputation of alleged wrongful conduct by one insured to other insureds, policyholders may seek severability of these conduct-based exclusions. Where severability is available, insurers are precluded from seeking to impute the alleged wrongful conduct of one individual insured to exclude coverage for another individual insured or to the corporation itself.

In such a situation, the corporation and the "innocent" insureds will be shielded from the alleged wrongful conduct of the individual insured, and the exclusions cannot be relied upon to limit or deny coverage for the "innocent" insureds.

Implications

Today's claims environment poses a real risk for directors and officers as well as corporate policyholders. In many cases, just the cost to defend against a single claim can be enormous and will erode policy limits that otherwise would be available for losses.

To mitigate such risk, individual and corporate policyholders should play an active role in the review of D&O liability insurance at the time of procurement and renewal, and they should seek to understand the scope of coverage and request assistance with policy negotiations to obtain the broadest protection available.

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