

D&O insurance coverage in the USA: will it be there if the worst happens?

John H Mathias, Jr and Lorelie S Masters

Jenner & Block, Chicago

jmathias@jenner.com • lmasters@jenner.com

In today's fiercely competitive global marketplace, the financial stakes have never been higher for winners and losers. Now more than ever, the quality, sophistication, and judgment of company officers and directors determine whether it will be success or failure that is publicly reported to ownership on a quarterly and annual basis. Now more than ever, increasingly more sophisticated, diverse and unforgiving public 'ownership interests' (eg, institutional investors and pension funds) are demanding results and not tolerating mediocrity.

Businesses unwilling to take risks are doomed to failure. Officers and directors unwilling to take risks will likely not survive long either. After all, that is what capitalism is all about: calculated risk taking.

In this context, it is no wonder that modern officers and directors are so concerned about the amount of personal risk they are undertaking by participating in company management at the executive and board levels. They have all heard horror stories about Enron and WorldCom executives having to make big financial payments out of their own pockets, and they are understandably worried that the same thing might happen to them. They are not easily comforted by advice not to worry because Enron and WorldCom were extreme cases of egregious wrongdoing or by studies showing that as near as anyone can tell there have been only 13 instances between 1980 and 2005 in which outside directors of public companies have made personal payments in connection with shareholder litigation claims.¹ They are still worried nevertheless, and they want to know exactly how much risk they are undertaking by participating in company management.

The wise Chief Legal Officer will be well-informed on this subject and capable of answering tough hypothetical questions from senior executives and board members like: 'What is the worst that can happen to me?' Regardless of the probability of 'the worst' ever happening to executives or directors at any given company, prudence dictates careful preparation for it.

In this respect, there are two preliminary cautions worth discussing with interested directors and officers.

First of all, modern directors and officers should be warned that it is a virtual certainty that D&O insurers will reserve their rights to deny coverage, or even deny coverage outright, for all claims made against officers

and directors in any significant securities fraud case. That is the reality of it. Accordingly, an atmosphere of uncertainty will surround the resolution of the 'worst case' scenario until the end, even in the most probable situation where officers and directors ultimately make no financial contributions of their own. Uncertainty is never a good thing.

Secondly, the usual first line of financial defence for officers and directors is their right to indemnity from the company itself. Regardless of legal entitlement to this right of indemnity, it provides little benefit to officers and directors when the company is bankrupt and is being operated by new management which likely will fiercely resist paying anything out of the company's treasury to defend or indemnify old management.

Although there is no bullet-proof method for assuring the adequacy of D&O policy limits to cover foreseeable claims, there are methods to assist in determining the prudent limits of coverage to obtain for companies of varying market capitalisation and in various industry segments. Additionally, the following checklist contains important objectives to consider when approaching upcoming D&O insurance renewals:

1) Protect 'innocent' directors and officers

Ideally, D&O policies should not be rescindable, except in the most extraordinary circumstances wholly unrelated to 'securities fraud' type allegations. Alternatively, D&O insurance policies should guarantee severability of representations in both the application and the insurance policy to protect and preserve coverage for 'innocent' directors and officers.

Policyholders should avoid representations or warranties in either the written application process or the policy text which incorporate by reference previously filed public financial statements. Similarly, policyholders should avoid endorsing these financial statements as being material to the issuance of the D&O insurance policy. Insurers will almost certainly demand rescission if previously filed public financial statements, which have been incorporated by reference into the application, or the policy are subsequently restated. Remember also, securities fraud lawsuits are always based upon a contention that publicly filed financial statements were intentionally or recklessly misleading.

Always seek the broadest severability provision you can obtain limiting or prohibiting the imputation of knowledge or conduct from one director or officer to another in both the policy itself and in the application process. In this respect, pay particular attention to policy provisions which impute the knowledge of key executive suite occupants (eg the CEO, the CFO, etc) to other innocent directors and officers. Try to remove such imputation elements from any severability clause.

2) Maximise coverage for defence costs

Attorneys' fees and other defence costs in big damages securities cases can be astronomical, especially if related agency or law enforcement investigations proceed simultaneously. It would not be uncommon to experience combined gross defence expenses of several million dollars a month for the company and individual officer and director defendants. Accordingly, the importance of procuring the broadest commercially available coverage for attorneys' fees and costs cannot be overstated.

Equally as important to policyholders can be the right to retain defence counsel of their own choosing. This is especially important where, as almost always happens, insurers issue written reservations of rights to deny coverage at some future point depending upon how the case develops. In this regard, policyholders should carefully review an insurer's list of mandatory 'panel counsel' and wherever possible negotiate more acceptable alternatives.

- Avoid whenever possible provisions granting the insurer a right to recover payment of defence costs.
- Carefully review 'consent to settle' clauses to assure they will neither frustrate legitimate company or individual decisions to settle nor give the insurer bargaining leverage to reduce the amount owed in coverage.
- Ask to review the insurer's billing guidelines and negotiate appropriate amendments to avoid disputes when claims arise.
- Carefully review any provisions governing advancement or allocation of defence costs. Particularly with respect to agreed upon allocation formulas, policyholders should make sure they understand the full implications of what they are accepting.

3) Seek an alternative to entity coverage

Entity coverage has caused more problems than it was ever worth, particularly in situations involving:

- insolvency or bankruptcy; and
- changes in management resulting in hostility towards former directors and officers.

Although court rulings have helped to establish that D&O policy proceeds are not assets of a bankrupt estate subject to Chapter 11 injunctions and freezes,

this has not entirely stopped trustees or administrators from raising this issue. Additionally, erosion of policy limits by even a solvent corporate entity often has left individual directors and officers with little or no residual coverage for their own defence and settlement. 'First come, first served' rulings from courts promote fierce competition for policy proceeds between corporate entities and directors and officers 'on the outs'.

4) Obtain protection against insolvency

Provide that deductibles or self-insured retentions (SIRs), which may be substantial, do not apply if the company is insolvent. Negotiate 'priority of payment' provisions to specify which insureds (typically directors and officers) are entitled to access policy proceeds first.

5) Review important policy definitions

Analyse the definition of 'Insured' to make sure it covers all of those for whom protection is sought. At the same time, be wary of inadvertently increasing the reach of the 'insured v insured' exclusion by defining 'Insured' too broadly.

Analyse and negotiate suitable definitions of all key policy terms. For example, policyholders should consider the following points with regard to the definition of 'Claim':

- A broadened definition helps to ensure the availability of D&O insurance coverage for administrative, regulatory, civil and criminal proceedings.
- A broadened definition helps to ensure coverage not only for litigation but also for alternative dispute resolution proceedings and even investigations, which are occurring in increasingly large numbers in recent years by state attorneys general and federal agencies like the SEC.
- A broadened definition, however, may affect the issue of when notice must be given and when it will be deemed late.

Policyholders also should review the definition of 'Loss' in light of cases like *Level 3 Communications v Federal Insurance Co*, 272 F.3d 900 (7th Cir 2001), and *Vigilant Insurance Co v Credit Suisse First Boston Corp*, 800 N.Y.S.2d 358 (Sup Ct 2003), which have held that under certain limited circumstances money paid in settlements may constitute 'disgorgement of ill-gotten gains' and thus be excluded from coverage under D&O insurance policies. Although both *Level 3* and *Vigilant* were highly fact-sensitive and should not be interpreted as precluding coverage for the vast majority of payments made to settle securities fraud and other types of actions, this has not stopped D&O insurers from constantly citing these decisions as a pretext for holding up indemnity payments for securities fraud and similar case settlements.

A broad definition of 'Loss', including coverage for various kinds of claims (for example, damages under section 11 of the Securities Exchange Act) may help preserve intended coverage. The extent of coverage for 'fines' and 'penalties' and attorneys' fees should also be considered carefully to ensure the availability of coverage and minimise disputes should a claim arise.

6) Ensure coverage for all international risks and global exposures

Policyholders should review their D&O policies to make sure that they cover all operations and individuals regardless of location or jurisdiction. Policyholders should make certain that their D&O policies explicitly cover liabilities that may arise under foreign law.

7) Pay close attention to 'bad conduct' and all other policy exclusions

D&O policies typically have a variety of exclusions for certain types of 'bad conduct' (eg, the 'deliberate fraud', 'criminal acts', 'dishonesty' and 'personal profit' exclusions). These 'bad conduct' exclusions should explicitly require a final judicial adjudication of the facts relating to the alleged 'bad conduct' to adequately protect policyholders who settle claims. Otherwise, insurers will invariably contend that if the case had not been settled, the policyholder would have been found to have engaged in uncovered 'bad conduct' for which some deduction should be made from the indemnity they otherwise owe under the policy.

Policyholders should also insist upon severability provisions assuring that 'bad conduct' exclusions are strictly limited to the 'bad actors'.

Similarly, policy exclusions for 'prior acts', 'prior notice' and 'insured v insured claims' should be carefully examined and limited. The 'insured v insured' exclusion can be especially problematic and should be written so as not to preclude coverage for actions brought by a trustee in bankruptcy or by any subsequent litigation trusts created for the benefit of creditors. Nor should the language of the 'insured v insured' exclusion arguably extend to actions assisted by 'whistleblowers'.

Conclusion

Insurance policies are contracts. Accordingly, in the procurement process insurance policies should be carefully reviewed not only by risk managers and brokers but also by the company legal department or even outside counsel to assure conformity with the needs and expectations of the insureds. For D&O insurance policies, company directors and officers have the biggest stake in being assured of the maximum suitable coverage available in today's commercial marketplace, consistent with company culture and

values. They care a lot about the scope of coverage being procured to protect their interests, and they deserve answers to their tough questions.

Note

- 1 See, eg, Table 2, 'Out-of-Pocket Payments by Outside Directors, 1980-2005', in Bernard Black, Brian Cheffins, & Michael Klausner, *Outside Director Liability*, 58 Stanford L Rev 1055,1070 (Feb 2006).