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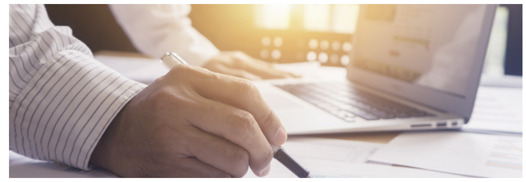

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D&O Liability Insurance: An Overview[1]

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Directors and officers of companies face the possibility that—even if they diligently discharge their duties to their stockholders—their stockholders may still sue them. Other parties, including government agencies, can sue directors and officers as well. Recognizing that the risk of personal liability makes being a director or officer of a public company unattractive, most companies purchase director and officer liability insurance, or "D&O Insurance," to protect their directors and officers. This insurance can in turn help companies recruit and retain good directors and officers.

The Need For D&O Liability Insurance

D&O Insurance is best understood as a type of professional liability insurance for errors and omissions that a company carries to protect its directors and officers if they are sued. It is D&O Insurance that responds when directors and officers are accused in civil or criminal court of acting in a way that violates their duties to the stockholders or the law, especially federal securities law. From a dollars perspective, the largest threat that public company directors and officers usually face is the threat of a federal securities class action suit that alleges violations of the federal securities laws. This type of suit is most likely to occur when there is a precipitous decline in a company's stock price.

These lawsuits are of great concern for directors and officers because average cash settlements are significant. The average cash settlement in 2017 was $17.4 million.[3] Moreover, the directors and officers of companies that are sued shortly after a company goes public are at particular risk because these lawsuits generally include allegations of having violated Section 11 of the Securities Act. Such cases are relatively easier for plaintiffs to pursue because the pleading standards under Section 11 are easier for plaintiffs to satisfy compared to other civil liability provisions of the federal securities laws. Another reason these lawsuits are of great concern to directors and officers is that they often take years to settle, resulting in legal defense fees in the millions of dollars.

Beyond securities class action lawsuits, directors and officers should be concerned about suits that allege that they breached their fiduciary duties to a corporation. These suits can either be brought directly or derivatively. Derivative suits are of particular concern because, in some circumstances, a company cannot indemnify its directors and officers to settle these suits, leaving insurance as the only payment source available to a director

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3 Excluding cash settlements over $1 billion. D&O DataBox, Woodruff-Sawyer's Proprietary D&O Litigation Database.

and officer other than his or her own checkbook. In these types of suits, the stockholder alleges that the officers and directors who are the subject of the suit have breached a fiduciary duty owed to the company and its stockholders and must pay damages or make restitution to the company. Note that many securities class action law suits are accompanied by "tag along" derivative suits that are premised on the same alleged wrongdoings recited in the securities class action complaint.[4] Directors and officers are rightly more concerned today about derivative suits than ever before because in recent years the plaintiffs' bar has increasingly used derivative suits as a vehicle for bringing claims. For example, in 2006 derivative suits—and not securities class action suits—were the primary vehicle stockholders and plaintiffs' firms chose for pursuing claims related to stock-option backdating.[5] Like federal securities class action lawsuits, these suits can be extremely expensive for a company to defend. Unlike federal securities class action lawsuits, a company may well be prohibited from paying to settle a derivative suit,[6] leaving D&O insurance and or the personal assets of directors and officers the sole source of available funds.

Notwithstanding the situation with derivative suits, companies can usually indemnify their directors and officers at least for their legal fees and also for the settlement of the claim brought against them. This obligation can arise pursuant to personal indemnification agreements as well as provisions found in a company's charter documents, and sometimes pursuant to state law. Nevertheless, directors and officers usually require the company to purchase D&O Insurance. The insurance can be seen as a form of balance sheet protection for a corporation's indemnification obligations to its directors and officers. In addition, directors and officers will ask for D&O insurance to protect them if, during the midst of a long-running lawsuit, their company becomes financially or legally unable to indemnify them.

Outline of a D&O Insurance Policy

Although a D&O policy can be described in broad terms for heuristic purposes, it bears mentioning that a particular company's overall D&O Insurance program is typically comprised of several highly negotiated financial instruments. Most public companies purchase their overall limits of insurance from multiple insurance carriers in layers. Each of these layers represents coverage provided by a particular insurance carrier for typically at least $5 million in limits and often much more. The terms of each of these layers of insurance is set by the insurance policy issued by the insurance carrier providing that particular layer of insurance. Each of these layers must be separately negotiated by a company's insurance broker. This process generally includes negotiating multiple endorsements, i.e. amendments, to an insurance carriers' basic policy form.

Typical D&O Insurance Policy

A typical D&O Insurance policy is divided into three parts, all of which share the same single policy limit. "Side A" is the part of a D&O Insurance policy that responds when a company is unable to indemnify its directors and officers. The most common example of such a situation is when a company becomes insolvent. Properly constructed, this part of the insurance policy should pay on a first-dollar basis, i.e. there should be no self-insured retention or deductible. Side A coverage is often referred to as the "personal protection" part of a D&O Insurance contract.

"Side B" is the part of a D&O policy that reimburses a company for its indemnification obligation to its directors and officers. This is typically the case with the vast majority of civil claims brought against directors and officers. This part of the insurance policy is generally subject to a self-insured retention or deductible.

4 Ibid.

5 Ibid.

6 Delaware General Corporation Law Section 145(b).

"Side C"—also known as "Entity Coverage"—is the part of a public company D&O policy that responds to securities claims made against the company. Side C exists because, in a typical federal securities class action lawsuit, the company is a named defendant along with its directors and officers. If an insurance policy does not have Side C coverage, the insurance carrier and the company must negotiate the portion of the total defense costs and the settlement of a securities claim that is to be allocated to the uninsured company and the portion that is to be allocated to the insured directors and officers. This will be a contentious negotiation because any portion of the suit that is allocated to a company without Side C coverage is a portion the insurance carrier does not have to pay. Purchasing Side C coverage eliminates this area of dispute. Like Side B, Side C is typically subject to a self-insured retention or deductible. Side B and Side C coverage together are often referred to as "balance sheet protection" for a company.

Side A Difference in Condition D&O Policy

A Side A "Difference-in-Condition" or "DIC" policy is a D&O policy that only provides Side A coverage. Such a policy does not include Side B and Side C coverage. Many companies will structure their insurance program to include a combination of regular ABC insurance policies and Side A-only insurance policies. One of the main drivers of this type of insurance program structure is the concern that directors and officers with only a full BC policy may find themselves without any insurance coverage if their company ends up in bankruptcy, which is, of course, precisely the moment that the company can no longer indemnify its directors and officers. This concern arises because there is some risk that if a company goes into bankruptcy with a D&O policy that includes Side C coverage and perhaps Side B coverage, a bankruptcy trustee may attempt to seize the insurance policy proceeds for the bankruptcy estate. Such a seizure would leave the directors and officers without coverage unless they had a separate, Side A policy on which they could rely. While many courts have declined the invitation to appropriate D&O policy proceeds to the bankruptcy estate, legal experts agree that there is a higher probability that a bankruptcy judge would allow a bankruptcy trustee to seize all the proceeds of an insurance policy if the policy includes balance sheet protection. The bankruptcy trustee's argument is that the now-bankrupt company paid for the insurance policy and is the intended beneficiary of the policy by virtue of being an insured party under the policy. Therefore, the insurance policy may be viewed by the bankruptcy court as an asset of the now-bankrupt company and not exclusively as an asset of the directors and officers. A bankruptcy trustee would not have this same argument to seize the proceeds of a Side A policy since the company is not an intended beneficiary of a Side A policy; the only intended beneficiaries of a Side A policy are the company's individual directors and officers.

When companies are doing well, bankruptcy feels like a remote concern. Companies for whom bankruptcy is a remote concern may decide to purchase an insurance policy with Side A Coverage, Side B Coverage and Side C Coverage. Having said that, an increasing number of well-capitalized companies are also purchasing at least a small amount of stand-alone Side A coverage in addition to their regular ABC insurance policies because (1) they are being cautious about bankruptcy concerns, (2) they find purchasing a Side A DIC policy is attractive because it is often subject to fewer exclusions than the Side A portion of a regular D&O policy, and (3) the Side A-only policy can drop-down and respond on a first dollar basis in some circumstances, including if a company refuses to indemnify a director or officer. This third reason is particularly attractive because, in most cases, if a company were to refuse to indemnify a director or officer for an indemnifiable claim, that director or officer would have to pay the Side B self-insured retention before the insurance would start to respond. This self-insured retention can be hundreds of thousands or even millions of dollars. As an aside, it is worth mentioning that some very large public companies elect to purchase only Side A coverage in order to save money on the overall cost of the insurance program by forgoing any balance sheet protection.

Limiting the Insureds Under a Policy

It is possible to limit the insureds under a D&O Insurance policy to a subset of all the directors and officers of a company. This is done when there is a desire to limit the number of insureds who are allowed to share the limits of a particular D&O policy. If a company is going to purchase a restricted-insured insurance policy, the insureds are generally limited to all the non-officer, independent directors. This type of policy is typically referred to as an "Independent Director Liability" or "IDL" policy. When the insureds under a policy are restricted to one individual, usually an independent director, the policy is typically referred to as a "Personal Director Liability" or "PDL" policy. PDL policies can also be modified so that they provide insurance coverage for one independent director who sits on the board of multiple companies. Only a very small minority of individuals ask their companies to purchase this type of D&O policy.

Wealth Security Policy

While an individual director's personal umbrella policy will almost always exclude coverage for service as a director for a for-profit company, it is possible for a director to purchase a personal director liability insurance policy for him or herself. Known as a "Wealth Security Policy," This type of policy would typically be purchased by directors with significant assets, but for whom having to defend or settle a lawsuit would be financially burdensome. A Wealth Security Policy is an extra means to safeguard personal wealth at a time when the director's company may be bankrupt and the company's D&O Insurance policy turns out to be inadequate or unavailable due to bankruptcy proceedings.

Policy Definitions

One of the key areas in play in a D&O policy is the policy's definitions. For example, whether informal SEC investigations are covered by the policy generally turns on the definition of a "claim," and the answer to this subtle question can mean the difference between being reimbursed for millions of dollars in legal expenses or not.

Another critical definition in a D&O policy is the definition of "loss." In particular, it is important that the D&O policy of any company that does public offerings—including an IPO—has a "Section 11 Endorsement." Such an endorsement can affirmatively clarify that the insurance carrier intends to include settlements of Section 11 cases in the definition of loss. Without this clarification to the definition of loss, recent case law suggests that a carrier might attempt to take the position that a settlement of a Section 11 claim falls outside the ambit of the policy because it does not meet the definition of covered loss under the policy. A sophisticated D&O Insurance broker will be able to provide guidance on the types of definition modifications that are available from each insurance carrier.

Policy Exclusions

Like all insurance policies, D&O policies will not pay for a claim if a relevant exclusion removes the claim from the scope of the policy's coverage. As is typical with most components of a D&O Insurance policy, the contours of these exclusions are negotiable. For example, one exclusion that will appear on all D&O Insurance policies is an exclusion for fraudulent or dishonest conduct. This exclusion exists as a matter of public policy, so no insurance carrier can insure for these items. The critical item that can be negotiated, however, is the point at which such conduct becomes excluded. For example, if the conduct can only be excluded after a final adjudication of fraudulent or dishonest conduct, then clearly all defense costs will be advanced by an insurance carrier until the final adjudication is made. Most companies and their directors and officers consider this to be a superior result, but a minority may instead prefer that an insurance carrier have the ability to stop spending policy limits on persons the carrier considers to be bad actors so as to preserve the limits for good actors. A skilled broker will identify issues of this type for a company, make a recommendation based on the particular company's risk profile, and then negotiate with the insurance carriers to obtain the desired result. Other typical exclusions found in D&O policies concern areas of exposure for which other types of insurance can be purchased. Examples of these are ERISA claims and many types of employment practices claims.

Rescindablity and Severability

When a claim hits that has particularly egregious facts, insurance carriers may consider rescinding a policy. This would involve an insurance carrier's taking the position that the insureds misled the insurance carrier at the time the contract between the company and its insurance carrier was formed. As a result, the carrier would assert, it should be allowed to rescind the insurance policy. One way of handling this concern is to negotiate for a non-rescindable policy, at least in part. Side A is the part of the insurance policy that is most easily obtained on a non-rescindable basis. Another way to address the concern that the bad acts of one insured could result in the loss of insurance coverage for innocent parties is to put provisions in the insurance contract that sever bad actors out of a policy, leaving the policy proceeds available for good actors. Referred to as "severability provisions" these provisions can enhance a company's ability to preserve insurance coverage for good actors in the face of unfortunate fact patterns. Obtaining solid rescission and severability provisions is fundamental to the protective strength of a D&O policy.

Claims-Made Policy

One final note on the structure of a D&O Insurance policy: D&O Insurance policies are typically "claims-made" policies, as opposed to "occurrence" policies. When a policy is a claims-made policy, the policy that responds to a claim is the policy that is in effect at the time the claim is made. By contrast, with occurrence policies the policy that responds to a claim is the policy that was in effect at the time the alleged bad occurrence took place, even if that was many years before any claims are actually filed. A further complication, however, is that notwithstanding being claims-made policies, D&O Insurance policies may have a "past acts" date. When a D&O Insurance policy has a past acts date, the policy will not respond to a claim made during the policy period if that claim relates to a wrongful act (occurrence) that took place before the past acts date. It is critically important to a company's insurance coverage that this past acts date be completely eliminated or negotiated as far back in the past as possible.

Selecting the Right Broker

Securing a D&O Insurance policy is easy and can even be relatively inexpensive; securing D&O Insurance that will actually pay a claim that hits a company and its directors and officers is much more difficult. It is all too easy for a company to purchase a D&O policy that, by its contractual terms, is unlikely to pay for any claims. Counter-intuitively, even purchasing insurance from a reputable carrier is no guarantee that a good policy will be issued to the buyer. The pricing, and terms and conditions of an insurance policy are almost entirely driven by the knowledge and skill of the broker placing the insurance contract. For this reason, a company should hire a broker that specializes in this particular type of insurance and places it regularly. Indeed, it is common for companies to have their D&O Insurance placed by a specialist and to have a different brokerage place the company's other important but less complex lines of insurance.

Given the stakes, your choice of a D&O Insurance broker is a critical part of the D&O liability risk management process. You are looking for a broker who is able to

- Scope and calibrate your specific risk profile;
- Provide guidance on the important terms and conditions in a D&O Insurance policy contract;
- Give you company-specific recommendations for limits of liability that are based on historical data and not just peer data benchmarking and industry averages;
- Handle issues that arise from a company's having foreign subsidiaries;
- Appropriately integrate your personal indemnification agreement with the D&O Insurance program;
- Consult with you on loss control and risk management policies and activities that can drive down a company's overall D&O Insurance premium; and

- Effectively advocate on your behalf should a claim arise.

The D&O insurance broker you choose will be representing you in front of the very insurance carriers you expect to pay your claim should the need arise. As a consequence, your broker's experience and expertise are critical when it comes to your D&O liability risk management process.

Questions? Comments? Please contact Priya Cherian Huskins at 415.402.652s7 or phuskins@woodruffsawyer.com.

Practical Tip: Avoid Sending Multiple D&O Insurance Brokers Into the Insurance Market

A company will obtain the best possible terms, conditions and pricing for its D&O Insurance if it chooses one broker to speak to all insurance carriers. A less effective strategy that some companies attempt to employ is the strategy of asking multiple D&O Insurance brokers to place the D&O Insurance on the theory that the company will choose the broker that presents the best program. This is called "dividing the market."

The problem with the multiple broker approach is that insurance carriers will only give quotations for a specific company to a single broker. The greater the number of interested insurance carriers (that is, the more competition for the company's D&O risk), the more a skilled broker can use market competition to lower the premium and improve the terms and conditions of an insurance policy for a company. Dividing the market, on the other hand, has the net effect of limiting the number of insurance carriers that are competing against each other for the same D&O risk. Less competition almost always means a result that is suboptimal compared to the result that could have been obtained if the full insurance market were competing for the same D&O risk.