# DIRECTORS & OFFICERS LIABILITY INSURANCE COVERAGE

IRMI®

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# Directors & Officers Liability Coverage
## Contents

# Chapter 1
# Introduction and Overview

IRMI has teamed up with WebCE to bring you this quality continuing education course.

This WebCE course is designed to give a moderately experienced insurance person a detailed look at the key provisions contained within a corporate D&O liability insurance policy and how they function within various claims scenarios. The course begins by describing the policy's three key insuring agreements and then examines the covered persons, covered organizations, and covered acts provisions. Next, it analyzes two of the policy's most important defined terms: "covered damages" and "covered losses." It continues with an analysis of the extent to which the policies cover employment practices liability exposures and describes the policy's defense coverage provisions and defense procedures. The manner in which a D&O policy's limits, retentions, and coinsurance provisions apply is considered next, followed by a look at the policy's most important conditions. The course reviews the exclusions section of the policy and the claims-made coverage trigger provisions. The final chapters analyze excess D&O liability policies and provide an overview of the specialized policy forms written to cover privately-held companies.

Upon successful completion of this course, you will be able to:

1. Identify and distinguish between a corporate D&O liability policy's three major insuring agreements.
2. Explain how the covered persons, covered organizations, and covered acts provisions coordinate within these three insuring agreements.
3. Interpret the "covered damages" and "covered losses" definitions and describe how they first define, and then limit the scope of coverage the policy provides.
4. State the extent to which D&O policies provide employment practices liability coverage and explain how endorsements to the forms can further expand upon the extent of such coverage.
5. Explain the scope of defense coverage provided by the D&O policies, distinguish between duty to defend and non-duty to defend policies, and describe how these two provisions function in a claim situation.
6. Analyze the manner in which a D&O policy's limits, retentions, and coinsurance provisions coordinate with the policy's three key insuring agreements.
7. Describe the critical policy conditions found within D&O forms, including: severability, cancellation, subrogation, other insurance, arbitration, presumptive indemnification provisions, and priority of payments provisions. Distinguish between "limited" and "full" severability provisions.

8. List and discuss the major exclusions found within D&O policies, distinguishing between the different versions of the same exclusion, and explaining the rationale for each of these exclusions.
9. Give details concerning the operation of a claims-made coverage trigger. Understand how the terms claims first made, post-policy reporting window, retroactive date, discovery provision, extended reporting and runoff provisions relate to such triggers and apply in claim situations.
10. Analyze the way in which excess D&O liability policies are structured to interact with primary D&O coverage and explain how the major policy provisions function in a claim situation.
11. Identify the unique exposures of privately held organizations and describe the how the coverage features within the policies differ from those contained in the forms designed to cover corporate/for-profit firms.

# Chapter 2
# The D&O Policy: Insuring Agreements

This chapter analyzes the three distinct insuring agreements found within corporate D&O policy forms. The first—known as "Side A" coverage, also termed "directors and officers liability insurance"—provides liability coverage for individual directors and officers of the parent corporation. The second insuring agreement—known as "Side B" coverage, also termed "corporate reimbursement insurance"—reimburses the corporation for payments it is legally obligated (or permitted) to make in indemnifying its directors and officers for liability claims made against them. The third—known as "Side C" coverage, also termed "entity coverage" —covers the corporation for claims made against it relating to the corporation's securities (i.e., shares of publicly-traded stock). The coverage provided by D&O policy forms is illustrated in Exhibit 2.1.

| Exhibit 2.1<br>D&O Insuring Agreements | | |
|---|---|---|
| **Side A Coverage<br>Directors & Officers<br>Liability Coverage** | **Side B Coverage<br>Corporate Reimbursement<br>Coverage** | **Side C Coverage<br>Entity Securities<br>Coverage** |
| Covers directors and officers when the corporation does not indemnify | Covers the corporation's obligation to indemnify directors and officers | Covers the corporation as a defendant in litigation involving securities issued by the corporation |
| No retention | Large retention | Large retention |
| Combined single limit for all three coverages. | | |

## Directors and Officers Liability Coverage ("Side A")

The first insuring agreement of a D&O policy covers what is known as the "direct" or "non-indemnifiable" liability of an organization's directors and officers. If such persons are found liable to third parties—and the corporation is not legally liable and\or is financially unable to indemnify the directors and officers—this portion of the policy promises to indemnify them for claim payments and defense costs they incur as a result of such liability.

Side A coverage applies in three situations: (1) when the parent organization is not legally required to indemnify directors and officers for a specific claim, (2) when the defendant directors and officers must pay a settlement or judgment in a shareholder derivative lawsuit (derivative claims are actions brought on behalf of a corporation against its own directors and officers, as opposed to claims brought on behalf of an individual), or (3) when the corporation lacks the financial capacity to indemnify the directors and officers, which usually occurs when it is insolvent. In each of these situations, Side A of the policy provides indemnification of the corporation's directors and officers on a "direct" basis.

### *Side A-Only D&O Policies*

Recognizing the importance of these exposures, beginning in the early part of the 2000s insurers began to offer what are known as "Side A-only" policies. Such policies are written in conjunction with "primary" D&O policies (which contain both Side A and Side B coverage and usually Side C coverage), provide coverage on an excess basis (excess of the corporation's primary D&O policy), and usually (but not always) cover only independent/outside directors (i.e., directors who are not employees of the company).

The intent of Side A-only policies is twofold.

- To provide excess limits in the event the limits under the primary form are exhausted by claim payments and defense costs.
- To "drop down" over primary forms, in the event that an exclusion or other coverage restriction under the primary form applies, that would otherwise defeat coverage.

#### Corporate Entity Is Not an Insured under Side-A Policies

Another key point to recognize is that the parent organization is not an insured under Side A-only policies. Rather, the forms only provide coverage for the directors and officers—not for the corporate organization's obligation to indemnify such persons. In effect, Side A policies operate like D&O umbrella policies but only as respects the coverage provided by Side A of the primary D&O policy.

Exhibit 2.2 provides a description of the advantages provided by Side A-only coverage forms.

| Exhibit 2.2<br>Advantages Of Side A-Only Coverage Forms |
|---|
| **Coverage Assured in Bankruptcy Situations**<br>One of the most important advantages of a Side A-only policy is that under a standard D&O form, there is sometimes uncertainty as to whether directors and officers have access to the proceeds of such policies in the event a company declares bankruptcy. More specifically, there have been a number of conflicting court decisions on this issue. Some decisions indicate that the proceeds of a D&O policy belong to the directors and officers. Conversely, other decisions have held that such proceeds are the property of the bankruptcy trustee (because it "stands in the shoes" of the corporate entity), a holding that usually precludes reimbursement of insured directors and officers. However, since the corporate organization is not an insured under Side A-only forms, coverage for the directors is not in doubt, even when a company is insolvent and a bankruptcy trustee seeks access to policy proceeds. |

**Exhibit 2.2 (cont.)**
**Advantages Of Side A-Only Coverage Forms**

**Inapplicability of Severable Warranties**

Another obstacle to a director's obtaining access to D&O policy proceeds is the application of nonseverable warranties. This refers to a situation in which coverage for a director is barred because of fraud or concealment by a corporation's CEO or CFO in providing information within the application for coverage. For example, assume a CEO knows of a situation that is likely to produce a claim. The CEO intentionally conceals such circumstances in the application for D&O coverage. Coverage for the claim will be barred as to all directors and officers under the policy. This is because such warranties are nonseverable, meaning that even directors who had no knowledge of these circumstances will be bound by the CEO's fraudulent statements in the application. However, under Side A-only policy forms, this otherwise nonseverable warranty, which ordinarily defeats coverage for nonculpable directors and officers, does not apply, so that coverage would be available under such circumstances.

**Exclusions for Financial Restatements**

Yet another coverage gap is created by exclusions for coverage of claims produced by financial restatements. (A financial restatement occurs when a publicly traded corporation must make a material revision to one of its recently-released earnings statements, almost always in a manner indicating that profits were lower or losses were larger than originally reported.) Again, such exclusions do not appear in Side A-only policy forms. Therefore, despite the presence of such an exclusion in a primary D&O form, coverage would nonetheless apply to directors insured by a Side A-only policy, because most types of Side A-only forms would "drop down" over the coverage gap caused by the financial restatement exclusion in the primary policy.

**Nonrescindable Policy**

Side A-only forms cannot be rescinded based on fraud committed by any insureds under the policy. In contrast, under traditional ABC D&O policies, an insurer can rescind an insurance policy when it finds that the insured has misrepresented a material fact when applying for coverage, such as providing a fraudulent financial statement with its application. (The rescission of a policy means that the policy never went into effect. Under such circumstances, an insurer must return the entire premium to the insured.)

Although coverage under a Side A policy would be denied as to an insured(s) who intentionally provided false information on an application, such coverage would still apply to other, nonculpable insureds under the policy, which is not always the case under traditional ABC policy forms.

**Additional Policy Limits Available for Mega-Claim Situations**

Since D&O policies are written with a combined single limit for all three insuring agreements (see Exhibit 2.1), when the corporate entity is named in mega-securities litigation (e.g., $100+ million), policy limits are usually depleted by the claim applicable to Coverage C (entity securities coverage), leaving little or no monies available for claims that also name directors and officers. However, the presence of a Side A-only policy, which contains a "dedicated" limit for directors and officers—and is not accessible by the corporate entity—solves this problem.

## The Two Types of Side A-Only Coverage

There are two types of Side A-only policies: (1) those written on a pure excess basis and (2) those providing "true" umbrella coverage (also called difference in conditions (DIC) coverage).

- **Pure Excess Side A-Only Policies**—Such forms afford coverage on the same basis as the primary D&O policy. That is, coverage is subject to the same terms and conditions of the underlying policy(ies). The only additional coverage that "pure excess Side A-only" forms provide is limits excess of primary coverage.

- **Umbrella (DIC) Side A-Only Policies**—"Umbrella (DIC) Side A-only" policies provide "true" umbrella coverage over a primary D&O policy and are therefore subject to their own terms and conditions. Accordingly, they will "drop down" over the Side A coverage provided within the primary D&O policy, in situations where the primary policy contains an exclusion or other provision that precludes coverage.

## Variations within Side A-Only Coverage

There are two key variations of Side A-only coverage. First, some corporations purchase an "all Side A" program and, second, a number of corporations purchase a Side A policy applying only to their independent/outside (i.e., nonemployee) directors.

- **"All Side A" Program**—A minority of corporations choose to purchase only Side A coverage, leaving their Side B (corporate reimbursement) and Side C (entity securities) exposures self-insured. The rationale behind this approach is that, first, such companies foresee a low probability of (1) claims against their directors and officers and (2) securities claims against the corporate entity. In addition, even in the event of a claim, these organizations feel their balance sheets are strong enough to withstand whatever defense costs and claim payments may be required to respond to such claims. Accordingly, they believe the only type of coverage that is really necessary is Side A, because it applies in situations where the directors and officers cannot legally be indemnified by the corporation or when the corporation cannot indemnify the directors due to its insolvency.
- **Coverage for Outside/Independent Directors Only ("IDL" Coverage)**—A second variation of Side A-only policies are those covering *only* outside/ independent directors while not covering "inside" directors (i.e., directors who are also employees of the company). An argument can be made, and a number of actual claim situations have proven, that outside directors, given their lack of day-to-day contact with and control over the inner workings of the corporate organization, require a greater level of protection compared to "inside" directors and officers. Accordingly, so-called IDL (independent directors liability) policies fill this need. Such forms also serve as a recruitment tool for independent directors who want to serve on a corporate board but seek additional protection of their personal assets.

The need for IDL coverage was illustrated when a number of outside/independent directors at Enron and WorldCom were forced to contribute personal funds to securities liability settlements with shareholders, because coverage limits of the Enron's corporate policies had been exhausted by claims against the company's inside directors. If IDL policies had been in effect, such coverage would have provided additional limits that could have covered the settlements and prevented the independent directors from having to resolve claims using their personal funds.

## A Word about Side-A Only Coverage Limits

Despite the value of such policies, a number of experts recommend that companies exercise a certain amount of caution when purchasing Side A coverage limits, especially for outside directors. Specifically, it has been suggested that a company purchase a maximum of 10 percent of its "regular" D&O policy limit for Side A-Only coverage for its independent/outside directors and no more than an additional 10 percent of its "regular" D&O policy limit for its inside directors and officers.

Using this formula, if a company had a "regular," "ABC" D&O limit of $25 million, it should buy:

- $2.5 million in coverage under a Side A-only policy for the company's outside/independent directors, and
- $2.5 million in coverage under a Side A-only policy covering the company's inside directors.

Thus, in this example, the company would have a $25 million "ABC" D&O policy *and* two $2.5 million Side A-only policies; one covering the company's outside directors and the other covering the company's inside directors.

The 10 percent figure is recommended for outside directors because their exposure is usually small (even in the most egregious cases of corporate wrongdoing, like Enron and Worldcom), compared to inside directors. Accordingly, the 10 percent figure is still generally sufficient to guarantee that the outside directors will have enough "dedicated" protection in the event that (a) the limits of the corporate policy are exhausted and (b) a bankruptcy court rules that the corporate policy proceeds are the property of the bankruptcy trustee, rather than those of the individual directors and officers. Similarly, the 10 percent figure is appropriate for the inside directors because although their exposure is greater than that of outside directors, there are normally only half as many inside directors as outside directors. Thus, if both outside and inside directors have an equal limit of coverage (as in the example above), on the typical board, the inside directors will actually have twice as much coverage on a *per director* basis. For example, in the case of a board with 12 members, 8 of whom are outside directors and 4 of whom are inside directors, if each group had an equal limit of coverage, the inside directors would actually have twice as much coverage on a per person basis.

## Corporate Reimbursement Coverage ("Side B")

The second insuring agreement in a D&O policy is called "Side B" or corporate reimbursement coverage. This part of the policy covers the parent company's obligation to indemnify the insured directors or officers for claim payments and defense costs associated with wrongful acts the directors or officers committed while serving the organization. The following documents typically require corporations to indemnify their directors and officers for wrongful acts.

- The organization's charter or bylaws
- Individual agreements with a director or officer as a condition of employment
- State indemnification statutes
- Common law requirements in the state of incorporation

### *The Corporation is Required To Indemnify Retention Amounts*

In situations where corporations are required to indemnify directors and officers against claims from wrongful acts, such requirements also usually include the requirement to reimburse any retention amounts that may not apply to the limits of liability under a D&O policy. For instance, if a D&O claim requires a director to expend $5 million in settlement and defense costs, the organization is required to reimburse the full $5 million, even if a $1 million policy retention applies to the corporate indemnification portion of the policy. This is important because with the exception of a situation involving corporate insolvency, practically all D&O claims (against the directors and officers) are paid under the corporate reimbursement ("Side B" coverage) provision of the policy, rather than under Side A (directors and officers coverage). Thus, in the event of a claim, the corporation must ultimately absorb the (normally substantial) cost of the retention stated in the D&O policy—not the individual directors and officers.

### *Complementary Nature of the Two Insuring Agreements*

The two insuring agreements, A and B, of a D&O policy are complementary. That is, if a director or officer incurs liability of a type for which the company is required to indemnify that director or officer, the D&O insurer will make the required indemnification on behalf of the company under Side B of the policy. On the other hand, when the company provides no indemnification, the D&O policy will afford direct coverage for the director(s) or officer(s) under Side A of the policy.

One confusing factor relating to indemnification is that state law defines the types of liabilities for which a company may or may not indemnify its directors and officers. However, if the amounts a director or officer is required to pay (because of a particular wrongful act) are not indemnifiable by the company under the applicable state law, coverage may still exist under the D&O policy's other insuring agreement—the one providing *direct* coverage for the directors and officers themselves (i.e., Side A coverage).

## Entity Securities Coverage ("Side C")

One of the common misconceptions about directors and officers liability insurance is that it automatically covers the parent organization if the company is sued directly. However, unless endorsed accordingly (by means of having purchased "Side C" Coverage), corporate D&O forms only cover the parent organization's loss when indemnifying a director or officer for a wrongful act. In effect, coverage under Sides A and B of a D&O policy is limited to situations when a lawsuit specifically names the organization's directors and officers (either individually or collectively). On the other hand, coverage under Sides A and B will be denied if the lawsuit names only the parent organization.

### *Side C Coverage Is Only for Securities-Related Claims*

To address this "gap" in coverage when the corporate organization is named in a lawsuit (either alone, or in conjunction with directors and officers), in the mid-1990s insurers introduced what is known as "entity coverage." Given the fact that a publicly traded corporate organization's single largest exposure relates to its potential liability as an issuer of securities, the corporate D&O policies that provide entity coverage do so *only as respects securities claims*. Such coverage is afforded under a separate section of a D&O policy, also known as "Side C" coverage. More specifically, this section of the policy covers the corporate entity in situations where a claimant names the corporate entity alone or names both the entity and individual directors and officers in a claim associated with securities.

#### An Example: A Covered versus a Non-Covered Claim under Side C

Assume that a claimant sues an insured corporation, alleging that the corporation had breached a contract to deliver $2 million of its product. The claimant's lawsuit cites damages incurred resulting from the company's failure to deliver their product. There would be no coverage under Side C (or under any other portion of a corporate D&O policy form) for this type of claim. This is because Side C applies only to claims involving the securities (i.e., shares of stock) issued by the insured corporation. On the other hand, a claimant brings a lawsuit alleging that poor management decisions caused the corporation to suffer a quarterly loss. Within 2 days of the announcement of this loss, publicly traded shares of the company have dropped in value by 50 percent. Side C of the policy would cover such a claim since it involves securities issued by the insured company.

### *Purchase Is Always Optional*

It should be noted that most D&O insurers allow insureds the option to either purchase or not purchase entity coverage for securities claims (while still buying "traditional" Side A and Side B D&O coverages). The insured's choice is reflected on the declarations page of the policy, although the vast majority (i.e., around 95 percent) of all publicly traded firms purchase entity securities coverage. (As will be explained in Chapter 12 of this course, privately held companies do not need to purchase entity securities coverage separately, because such coverage is automatically built into D&O policy forms designed to cover privately held companies.)

### *Limits for Entity Coverage of Securities Claims*

As is the case with Coverage A (directors and officers liability) and Coverage B (corporate reimbursement), Entity Securities coverage is also subject to the policy's aggregate limit. Again, it should be emphasized that claims *in any combination* under any of these three coverages (A, B, C) can exhaust the policy's aggregate limit.

### *Retentions for Entity Coverage*

Typically, however, coverage for securities claims is generally subject to a separate, and at times larger, retention than that applicable to Coverage B (corporate reimbursement) and Coverage A (direct coverage for directors and officers, which is not subject to a retention). Coverage under Side C of a D&O policy is subject to a higher retention because securities claims against corporate entities are usually much larger than other types of claims made under Coverage B.

### *Allocation Issues under Entity Securities ("Side C") Coverage*

One unique aspect of entity securities liability coverage is that in a number of instances, claims will be made against the entity that:

- Are also made against *other parties* not covered by the policy (i.e., nondirectors and nonofficers), known as "covered versus uncovered party" allocation, and
- Sometimes involve *individual allegations* that are not covered by the policy (i.e., claims not involving securities) along with those that do involve securities, which is known as "covered versus uncovered claim" allocation.

In each of these two instances, an "allocation" or apportionment must be made in which the insured and the insurer determine the extent to which *each of the parties* named in a lawsuit is entitled to indemnification from the D&O policy, and the extent to which each specific type of allegation comprising the claim is or is not covered by the D&O policy.

#### Covered versus Uncovered Party Allocation

Typically, a lawsuit names both individual directors and officers and the corporate entity. In cases where entity coverage is not purchased, the insurer must "allocate" or apportion coverage between the corporate entity on one hand and the directors and officers on the other. It must, according to the facts surrounding the claim, determine which specific allegations pertain to individual directors and officers and which result from the acts of persons who are not insured by the policy (i.e., nondirectors/nonofficers).

It should be recognized that in recent years, especially with the passage of the Sarbanes-Oxley Act in 2002 (SOx), insurers have added nondirectors/nonofficers as insureds with high level responsibilities (e.g., corporate comptrollers, senior staff attorneys) under Coverage C. This is because SOx expanded the personal liability of such individuals and for which coverage is now typically required in a large, publicly traded corporation. Such a coverage extension has significantly reduced the number of covered versus uncovered party allocation disputes.

### Covered versus Uncovered Claim Allocation

Another type of allocation issue arises when some, but not all, of the allegations comprising a D&O claim are covered under a given policy form. For example, a single lawsuit might involve allegations of both wrongful financial reporting that caused the share price of an insured's stock to nosedive, combined with allegations of damages caused by pollution. In this situation, an allocation would have to be made between the damages resulting from the former claim, which would be covered under Side C, and the latter claim, for which virtually all D&O forms exclude coverage.

## *Allocation Provisions in D&O Policies*

Apportionment of an insurer's payment is extremely complex in both covered person/uncovered person and covered claim/uncovered claim situations. Usually, the extent (i.e., the percentage) to which a claim is covered, becomes a matter of contentious negotiation between the parent organization and the insurer, rather than a function of straightforward application of policy terms.

Nevertheless, since disputes frequently result from the allocation process, D&O forms contain allocation provisions that are aimed at providing guidance as to how the allocation process will be conducted, in an effort to reduce, if not avert, such controversies.

### Best Efforts Allocation Provisions

By far, the most common type of allocation provision in D&O policies is known as the "best efforts" provision, whereby both insurer and insured promise to use their "best efforts" in apportioning covered claim amounts, based on the relative legal exposures of the parties and based on the type(s) of claims made. In the event they are unable to do so, the insurer promises to advance what it considers to be "fair and proper" amounts, on the insured's behalf, prior to resolving the dispute. In some instances, an arbitrator is hired to make an allocation determination, although in most cases, the insured and insurer are able to negotiate allocations between themselves. (Judges, on the other hand, do not participate in allocation proceedings.)

## Chapter 2 Review Questions

1. Chi Corporation's D&O policy has three insuring agreements. Which, if any, of these insuring agreements provides liability coverage for Chi's obligation to indemnify individual directors and officers?
   a. Side A coverage
   b. Side B coverage
   c. Side C coverage
   d. Chi's D&O does not cover a corporation's obligation to indemnify individual directors and officers.
2. A liability claim has been made against Tau Tea Company's directors and officers. Unless otherwise excluded, the coverage provided under Side A of Tau's D&O policy will directly indemnify the directors and officers for resulting claim payments under which of the following conditions?
   a. The directors and officers are found liable to third parties and Tau is financially unable to indemnify them.
   b. The directors and officers are found liable to third parties and Tau is legally required and able to indemnify them.
   c. The directors and officers are not found liable to third parties and Tau is financially unable to indemnify them.
   d. The directors and officers are not found liable to third parties and Tau is not legally liable to indemnify them.
3. Rho Boat Corporation purchases a standard D&O policy that includes Side A, B, and C coverages. Now that Rho declares bankruptcy:
   a. Courts agree that the proceeds of this policy clearly belong to directors and officers.
   b. Courts agree that the proceeds of this policy are the property of the bankruptcy trustee.
   c. It is uncertain whether directors and officers now have access to policy proceeds.
   d. Rho Boat Corporation fails to qualify as an insured for any of the policy's coverages.
4. Because she committed a particular wrongful act in her role as an officer of Theta Co., Amy is required to pay damages to a third party. Theta's D&O includes coverage under Sides A, B, and C. However, under applicable state law, Theta Co. cannot indemnify Amy for her loss. Under these circumstances, Amy might:
   a. need to absorb a large retention.
   b. receive direct coverage under Side A of Theta's D&O policy.
   c. receive direct coverage under Side B of Theta's D&O policy.
   d. receive indirect coverage under Side B of Theta's D&O policy.

5. Gamma Corporation's D&O policy provides Side A and Side B coverage, but not Side C coverage. Allegations clearly covered by the policy are involved in a claim that names individual board members and Gamma Corporation itself as defendants. Under these circumstances:
    a. Coverage will be available for the corporation, but not for the individual board members.
    b. The insurer will deny the claim.
    c. The insurer will pay the claim in full.
    d. Coverage will be available for the individual board members but not for the corporation.

### *Answers to Chapter 2 Review Questions*

1. b. Side B provides corporate reimbursement coverage.
2. a. The situation which is covered is when directors and officers are found liable to third parties and Tau is financially unable to indemnify them. These circumstances are covered under Side A.
3. c. There is sometimes uncertainty as to whether directors and officers have access to policy proceeds in the event a company declares bankruptcy.
4. b. If the amounts a director or officer is required to pay (because of a particular wrongful act) are not indemnifiable by the company under the applicable state law, coverage may still exist under the D&O policy's Side A coverage.
5. d. Coverage will be available for the individual board members because Sides A&B, which have been purchased, will cover the individual board members. However, Side C which would cover the corporation, has not been purchased.

# Chapter 3
# Covered Persons, Organizations, and Acts under D&O Policies

This chapter examines the covered persons, covered organizations, and covered acts provisions found within corporate D&O policy forms.

## Covered Persons under D&O Policies

D&O policies are designed to automatically cover any person occupying the position of director or officer, without requiring that such individuals be specifically named in the policy declarations. (Note: the corporate charter is usually the source that determines which specific positions are designated as "officers" within a corporation. A person's official title can actually be misleading as to whether or not they are an officer of a corporation. For example, the "Chief Administrator" of a hospital is virtually always an officer—despite not having the title of "Vice President" or "Chief Executive Officer." On the other hand, the literally hundreds of Assistant Vice Presidents at large, national banks are generally not officers of the corporation, despite having the title of "Vice President.")

### *Coverage Only for Acts as a Director/Officer*

It should be recognized, however, that directors and officers are covered only for claims that allege wrongdoing while acting in the capacity of a director or officer. Where such acts of misconduct were not performed in such a capacity, claims under a D&O policy are not covered. For instance, often the chief counsel or senior legal person in an organization is also a corporate officer and, in some instances, this individual sits on the corporation's board of directors. In these situations, D&O policies do not cover such persons for their acts as attorneys (e.g., for liability incurred when drafting a contract or when making a court appearance on the organization's behalf). Rather, such exposures are addressed by specialized policies designed to cover their liabilities incurred as employed lawyers, known as "Employed Lawyers Professional Liability Insurance." In effect, a D&O policy would only cover the organization's chief counsel for acts that would subject nonattorneys to liability (e.g., voting to approve a merger or acquisition at a board meeting).

### *"Automatic" Coverage for Newly-Created Directors/Officers*

Few insurers mandate that the parent report newly-created director or officer positions. This is because D&O premiums are not based upon the number of covered individuals. (D&O premiums are more closely correlated with an organization's total assets.) Where reporting requirements do exist, they can usually be deleted upon request. In fact, most underwriters prefer not to deal with numerous name and position changes that may take place during the policy term. Accordingly, coverage under D&O forms is said to be "automatic."

### *Coverage for Nondirectors/Nonofficers*

When requested, underwriters will normally agree to broaden the policy to cover corporate managers with high-level responsibilities despite the fact that they are not technically officers (e.g., the corporate assistant treasurer or human resources manager). Addition of such persons as insureds can usually be accomplished for a nominal additional premium, if any. Such coverage extensions require that these nonofficers be reported to the underwriter. In some organizations, such as hospitals, officer positions are not always denoted by the term "vice president." Thus, a person who is, in effect, the chief executive officer of a hospital may have the title "chief administrator." Under these circumstances, it may be worthwhile to specifically list, in the policy declarations, the person or persons for whom coverage is intended to apply.

### *Removal of Officers for Premium Credits*

Although some underwriters will grant premium reductions in return for removing coverage of individuals who are technically officers but who do not have true management responsibilities (such as the many assistant vice presidents in banks), such reductions may be negligible unless numerous individuals are involved (e.g., more than 100).

### *Coverage of Nondirectors/Nonofficers for Securities Claims*

In recent years, and as noted earlier, a number of insurers have added nondirectors/nonofficers as insureds, although only for securities claims. The need to add such persons as insureds stems from the fact that under SOx, in addition to directors and officers, in-house accounting and legal personnel (e.g., auditors, staff attorneys) also can be held liable for a number of wrongful acts, the nature of which are sometimes asserted in lawsuits, most often in those involving securities. For this reason, an increasing number of insurers are adding this coverage extension.

### *Coverage of Past, Present, and Future Directors and Officers*

The policies intend to cover persons who:

- served as directors and officers in the past,
- currently serve, or
- those who will serve in the future.

#### Coverage of Past/Retired Directors

Coverage of past personnel is important because claims are routinely made against individuals after they have left the company but were directors and officers at the time of an alleged wrongful act. Such coverage also ensures the full cooperation of these individuals in defending a claim, which might not be the case if they were not insureds under the policy.

#### Coverage of Future Directors

By covering future directors and officers, it is made clear that the insurance is not limited only to those holding director and officer positions at the inception of the policy period. This is significant because a claim may be made against an individual director or officer after he or she assumes such a position but before the parent organization has had an opportunity to notify the underwriter to this effect. One final important point: coverage of new directors requires no notification to the insurer within any specific time frame during the policy (other than notification by means of their inclusion within a renewal application).

### *Specialized Policies for Past/Retired Directors*

Directors of public companies are exposed to claims long after their tenure on a board has ended. (In fact, the statute of limitations under SOx is 5 years.) As already noted, directors who sat on the boards at Enron and WorldCom were required to use their personal assets to settle lawsuits filed against them because the corporations they served were financially unable to provide indemnification due to insolvency. More recently, in 2007, five former directors of Just for Feet paid a total of $41.5 million in conjunction with their service at the company, an amount that exceeded the combined Enron and WorldCom director-funded settlements.

#### The Liability Exposure of Retired Directors: An Example

Persons who serve on a board of directors are exposed to liability claims long after their tenure has concluded. Consider a director who sat on a board for 10 years, from January 1, 1995 to January 1, 2005. On January 1, 2006, 1 year after retiring, the director is sued for alleged wrongful acts he committed during this 10-year period. The fact that the director is no longer a board member at the time the claim is made does not absolve him from liability. Now, in response to the claim, the retired director must provide a defense to these allegations and perhaps pay a settlement or judgment in conjunction with the lawsuit.

#### Gaps in Coverage for Retired Directors in Standard D&O Programs

As already noted, coverage under a corporation's D&O program would normally be available to defend and indemnify the retired director in the above example. This is because the "insured persons" definitions under virtually all standard D&O policy forms state that "... coverage applies to past, present, and future directors, for claims made against them during the term of the policy." Coverage applies to retired directors with no time limit, although functionally, such coverage does not extend much beyond the policy term, given the claims-made basis upon which D&O policies are written. (Claims-made coverage triggers are discussed at length in Chapter 10.)

Given the claims-made nature of D&O forms, coverage is triggered by the making of a claim against an insured. As long as a D&O policy is in force on the date the claim is made (January 1, 2006, in the above example), coverage should, in theory, be available to the retired director under the corporation's current D&O policy. There are, however, a number of reasons why this may not be the case.

- **A policy is no longer in force.** The company may not have a policy in place on January 1, 2006. If the organization is in poor financial condition, it may not have had the funds to buy coverage or it may have been forced to reduce limits. Or, even if the firm attempted to purchase a policy, the premium, given the organization's difficulties, might have been unaffordable. Since, as already noted, coverage under a claims-made policy is triggered by the date on which claim is made—rather than the date on which the wrongful act was committed—the fact that coverage was in place during the time the alleged wrongful acts took place (i.e., from January 1, 1995 through January 1, 2005), does not trigger coverage for a claim made on January 1, 2006.

- **No limits remain.** But even if a policy was in place at the time a claim is made against the retired director, other directors and officers, as well as the organization, are also likely to have been named in the lawsuit (or in other lawsuits). Consequently, the policy's limits may already have been exhausted by indemnity payments and/or defense costs in conjunction with such claims.
- **Various restrictions preclude coverage.** A number of restrictions within the policy, most likely exclusions, may allow the insurer to deny coverage for a claim against the retired director. The fact that these restrictions or exclusions were not contained within the policy that covered the retired director at the time he/she left the organization is of no consequence in determining whether coverage is currently available. Rather, the policy in effect at the time a claim is made is what controls the trigger of coverage. The key point to recognize is that policies renewed subsequent to a director's retirement may contain much more restrictive terms and conditions compared to the coverage that was in place during the director's tenure with the company.
- **A bankruptcy trustee claims ownership of policy proceeds.** In recent years, bankruptcy trustees have frequently claimed primary ownership of D&O policy proceeds, asserting that their interests supersede those of the insured directors, officers, and the corporate organization. In some instances courts have upheld this contention.
- **The policy has been rescinded.** The policy may have been rescinded by the insurer, most often, based upon a material representation contained within the application for coverage.

## The Need for Separate, Retired Directors Coverage

Many of the coverage gaps noted above stem from three major sources: lack of control over the D&O program, conflicting legal interests, and sharing of limits with incumbent directors. These sources provide the rationale as to why directors require separate coverage after they leave a corporate board.

- **No Control over D&O Program.** After a director has retired from a board, he or she has no control over the nature of the D&O coverage the organization buys. This is especially true if a company is taken over by a leveraged buy-out firm or even if one company is purchased by another. In these situations, the new organization's management has no loyalty to retired directors.
- **Conflicting Legal Interests.** When a director retires from a board, he or she may have different, if not conflicting, legal interests, compared to current directors or to the organization's operating executives. The Enron case provides a good example of this concept. Here, the outside directors were merely negligent in fulfilling their duties. Conversely, a number of the company's operating officers were either convicted of, or pleaded guilty to, criminal wrongdoing.
- **Shared Policy Limits.** Even when legal interests of the various insureds under a D&O policy are not in conflict, there remains the problem of shared policy limits, whereby multiple individual insureds, including the corporation itself (for securities claims), must "compete" for coverage limits under a D&O policy. Adding to this problem is the fact that in recent years, as discussed above, the trend is toward expanding the number of insured persons within D&O coverage forms. Since SOx imposed substantial legal liabilities on corporate auditors and in-house legal staff, as already mentioned, underwriters responded by adding

these and other non-directors/non-officers as insureds under D&O policies; the effect of which is to heighten the competition for policy limits.

### Coverage Aspects of Retired Directors Policies

Following are the key features of policies written to cover retired directors.

- Coverage applies for a 6-year term, following retirement.
- Premium is a flat, prepaid amount affording coverage for 6 years.
- The retired director is the only insured.
- The insured director—not the insurer—selects defense counsel.
- There is no requirement to maintain underlying insurance.
- The policy is written without a deductible/self-insured retention.
- The policy is noncancelable and nonrescindable

## *Coverage of Subsidiary Directors and Officers*

Directors and officers liability policies cover individual directors and officers at a number of corporate levels. Accordingly, coverage automatically applies to directors and officers of:

- the parent company,
- existing, majority-owned subsidiaries of the parent company, and
- newly-created/acquired subsidiaries of the parent.

Directors and officers of the parent company and existing subsidiaries are automatically covered at the inception of the policy. This is because the application normally includes underwriting data pertinent to these individuals, and the premium quoted reflects the exposure they generate.

Typically, policies define the term “subsidiary” as an entity in which the parent company owns more than 50 percent of the voting stock. However, a few policies contain somewhat more liberal definitions of “subsidiary” and broaden the term to include corporations in which a subsidiary or any entity of the parent company owns 100 percent of the voting stock (even if the parent corporation does not hold a majority interest in the subsidiary).

### Coverage of Directors and Officers of Foreign Subsidiaries

The directors and officers of a corporation’s foreign subsidiaries do not always have the title of “director” or “officer,” despite the fact that their duties, responsibilities, and legal liability exposures are similar, if not identical, to their United States counterparts. Accordingly, D&O policy “insured persons” definitions sometimes provide coverage of such individuals who function as directors and officers but whose official titles may not be “director” or “officer.” Organizations with foreign personnel who fall within this category should have their D&O policies endorsed accordingly, if the policy's definition of “insured persons” does not afford such coverage, under what is known as a “foreign functional equivalents” provision.

### *Coverage of Estates, Heirs, and Legal Representatives*

Most of the policies also cover the estates, heirs, and legal representatives of insureds. A D&O claim is a claim against the personal assets of the individual directors and officers; therefore, such protection will be transferred to the insured's heirs, estates, or trustees if he or she dies, is declared incompetent, or files for bankruptcy.

### *Spousal Coverage*

Insured directors and officers sometimes attempt to shield assets from potential D&O claim judgments by transferring those assets to their spouses. To counter this tactic, plaintiffs' attorneys name spouses in suit papers. Therefore, spouses also require protection under the D&O form, and insurers have responded to this need by extending insured status to the spouses of insured directors and officers.

#### Coverage Applies to Spousal Status, Not to Spousal Acts

It is important to note, however, that spousal coverage does not extend protection for the wrongful act of a spouse of an insured director/officer; rather, such provisions only cover that spouse's liability as a spouse of an insured or because the spouse shares interest in property of an insured director/officer. Thus, there would be no coverage of a spouse who is not a director or officer if he/she were accused of fraud. Coverage would only apply to the nondirector/nonofficer spouse if such an allegation were also made against the spouse (for his or her corporate wrongdoing) who is a director or officer.

#### Spousal Coverage Definition That Includes "Domestic Partners"

An increasing percentage of insurers' forms contain a spousal coverage definition that covers "... spouses, including 'domestic partners.'" (A domestic partnership is a legal or personal relationship between two individuals who live together and share a common domestic life but are neither joined by a traditional marriage nor a civil union.) Given the increasing incidence of such living arrangements, the need to provide this coverage extension will grow. Preferred wording, which provides the broadest possible scope of coverage, defines a domestic partner as a person qualifying as such "... under any applicable law of any jurisdiction in the world, or by common or statutory law ."

Many insurers cover spouses within their regular definition of "insured persons." However, spousal coverage is more often available by endorsement (generally for no additional premium) or is provided by a separate provision, elsewhere in the policy.

### *Coverage of Directors & Officers for Outside Activities*

Recognizing that corporate directors and officers also sometimes serve on the boards of other organizations, D&O policy forms usually contain provisions designed to provide coverage for these situations, typically in provisions termed "outside position management liability" coverage. It is important to mention that this provision applies only when service on such boards is at the direction of the parent organization. So, for example, there would be no coverage for a director who sits on the board of his condominium association. Rather, the intent of such provisions is to cover directors and officers who serve on nonprofit boards, usually as "representatives" of the for-profit corporation on whose board they also serve.

Accordingly, most D&O forms contain "built-in" policy provisions that provide outside directorship coverage for the kinds of situations noted in the previous paragraph. Under the minority of forms that do not cover this exposure automatically, such coverage can usually be obtained by endorsement.

### No Coverage for For-Profit Board Service

Coverage for service on outside boards only applies to nonprofit boards of directors. Coverage for an insured's service on for-profit boards is never provided under D&O policies. This is because service on for-profit boards generates significantly greater exposure to claim frequency and severity compared to service on nonprofit boards.

### Excess Coverage Application

When it applies, outside directorship liability coverage does so only on an excess basis. Specifically, such coverage is afforded excess of:

1. Any insurance coverage proceeds afforded to the director from the outside entity's D&O policy.
2. Any indemnification the outside entity provides to the director.
3. Any indemnification provided by the parent organization (i.e., the organization covered by the D&O policy that affords outside position coverage).

#### *"Double" versus "Triple" Excess Coverage*

About half of all D&O forms provide outside directorship coverage only after conditions 1 and 2 above have been satisfied, known as "double excess" coverage. The other half provide such coverage only after all three conditions above have been satisfied, known as "triple excess" coverage.

From a practical standpoint, the outside position coverage described above is of relatively little value. This is especially true when provided on a "triple excess basis." Consider the following scenario. The CEO of Company A serves on the board of Company B. Company A's policy provides outside directorship liability coverage on a triple excess basis. Before the CEO can receive any proceeds under A's policy, the following three events would first have to transpire.

- Company B's policy limits would have to be exhausted (or coverage not apply);
- Company B would be unable to indemnify the CEO (most likely, due to insolvency); and
- Company A would be unable to indemnify the CEO, again, most likely due to its own insolvency.

Even if coverage were written on a double excess basis, the first two conditions (above) would have to occur. Accordingly, outside directorship liability coverage is usually of little practical value.

## Covered Organizations under D&O Policies

D&O policies cover a corporation's individual directors and officers (Side A), as well as the organization's obligation to indemnify these individuals (Side B). The organization is usually termed the "parent company" under the policy, although, technically, it is not an insured under a D&O form, unless the policy also provides entity securities liability coverage (Side C).

### ***Coverage of Newly Created/Acquired Entities***

The scope of coverage for the directors and officers of newly created or acquired entities has liberalized significantly in recent years. Previously, most insurers required notification within 30 to 60 days of acquisition/creation and submission of underwriting data, sometimes imposed coverage restrictions, and frequently charged additional premium. Currently, many insurers afford automatic coverage (i.e., notification not required), provided the subsidiary's assets do not exceed 10 to 25 percent (depending on the individual insurer) of the parent company's assets. When an entity is acquired with assets exceeding 25 percent of the parent organization, underwriters generally require notification within 60 days, as well as additional premium, to reflect the increased exposure created by the acquisition. (Absent notification in such instances, no coverage will apply to the new entity.) In contrast, when a new entity falls below the policy's stated asset threshold, no notice is required, other than including the new entity in details provided with the corporation's next renewal application.

#### Coverage Only Applies to Post-Acquisition/Creation Acts

An important aspect of this provision is that coverage only applies to wrongful acts that took place after acquisition or creation of the new entity. For the policy to cover acts that took place before the acquisition/creation, additional premium is always required. In effect, the automatic nature of the coverage provided by this provision does not apply to "prior acts."

### ***Automatic Coverage Termination Provisions in Large-Scale Mergers/Consolidations***

Virtually all D&O policies include provisions that immediately cancel coverage in the event another company acquires the majority of the insured organization's assets. Automatic cancellation provisions of this kind override the normal cancellation notice requirements discussed later in this section of the course.

#### Coverage Excluded for Wrongful Acts after the Acquisition

These provisions preclude coverage for wrongful acts taking place after the date of acquisition, which, in theory, is not a problem. This is because coverage should only be required in conjunction with the wrongful acts that took place before the organization ceased to exist. For example, Organization A, whose D&O policy term is 1/1/2010–11, is acquired by Organization B on October 1, 2010. Organization A's D&O coverage under the policy automatically terminates as respect to claims from any wrongful that take place *after* that date. Accordingly, however, A will still have coverage for wrongful acts that took place *prior* to that date, as long as they are made against the insured and reported to the insurer prior to the end of its current policy period (1/1/2010–11). Thus, cancellation of coverage applies only to acts that take place after the acquisition, but not as to claims made against the insured and reported to the insurer prior to 1/1/11. In effect, the insured will have extended reporting coverage (a concept discussed in Chapter 10 of this course) as to any acts that took place prior to October 1, 2010 *and* are reported to the insurer prior to January 1, 2011.

As to acts taking place after the acquisition, Organization A will presumably have coverage under Organization B's D&O policy.

#### Activating a Discovery Provision

Another means to obtain coverage of acts prior to the acquisition would be for Corporation A to activate its D&O policy's discovery provision (also known as an "awareness clause" or "notice of potential claim provision," discussed in more detail in Chapter 10 of this course). Under a discovery provision, coverage will be afforded for any incidents or circumstances that could give rise to a claim (regardless of how far in the future such claims are actually made against the insured), provided the insurer is notified of such incidents prior to policy termination.

### *Coverage of Foreign/Non-U.S. Organizations and Operations*

Increasingly, American businesses are expanding their operations outside of the United States. Accompanying such expansion is the need to evaluate the resulting D&O exposures and to structure coverage that will respond appropriately. There are three methods of securing coverage for foreign D&O organizations and operations.

#### Securing Coverage under the Company's Domestic D&O Policy

First, coverage can sometimes be secured within the corporation's domestically issued D&O policy. The initial step is to make sure that the policy contains a "worldwide" territorial provision, so that coverage will apply to wrongful acts taking place and claims made, anywhere in the world. In addition, "foreign functional equivalent directors and officers" should be included within the policy's "insured" definition. And for such coverage to apply, the underwriter must normally be provided with full details of foreign operations, as well as information about persons serving on local boards in such countries.

#### Securing Coverage under DIL/DIC Policies

Second, a so-called difference-in-limits (DIL)/difference-in-conditions (DIC) policy can be purchased. Such policies function as both excess (as to limits) and umbrella (as to coverage) policies, over locally purchased insurance and as primary coverage within a domestic policy.

For example, assume that a U.S. corporation conducts operations in Brazil where it has purchased a local policy that only covers Brazilian operations. The policy contains a $3 million limit. Also assume that the corporation's primary U.S. policy is written with a $10 million limit.

A DIL/DIC policy containing a $10 million limit will fill the $7 million "gap" between the corporation's $10 million primary U.S. policy and the $3 million Brazilian policy. Thus, if the Brazilian policy's $3 million limit were exhausted by claims, the DIL/DIC policy would provide an additional $7 million in limits, thereby affording the same $10 million coverage limit for Brazilian as for domestic exposures.

In addition, the DIL/DIC policy affords DIC coverage breadth in the event that the Brazilian policy does not provide coverage for, or contains an exclusion for, a specific type of claim that is otherwise covered by the primary U.S. policy.

#### Securing Coverage under Locally-Admitted Policies

Third, coverage can be secured by purchasing locally admitted policies in countries where the corporation has assets, operations, and local boards of directors. There are situations in which foreign, locally admitted coverage must be purchased, according to law. These include the following.

- When admitted coverage is required by the law in a particular foreign jurisdiction.
- When a foreign subsidiary has both tangible assets and a local board of directors in a foreign jurisdiction.

### Problems in Securing Local Coverage

One problem with buying a foreign/local D&O policy is that the scope of the coverage it provides may be much narrower than the typical U.S.-issued policy, although such deficiencies can be remedied by buying a DIL/DIC policy, described above. Another drawback of buying locally issued policies is that when a firm is doing business in a number of countries, the administrative process of purchasing and maintaining numerous individual policies becomes unwieldy. Nevertheless, given the requirements that locally admitted coverage must be purchased in certain countries, such arrangements are necessary even if they are cumbersome. It is generally best if U.S. companies buying international D&O coverage work with brokers that have both international experience, as well as overseas offices, so that the corporation does not have to deal with multiple brokerage firms in arranging coverage.

Depending on the individual country, special rules—unlike those in the United States—may apply to (1) claim settlements and defense proceeds paid on behalf of directors and officers and (2) premium payments. First, in a number of countries, taxes are owed when an insurer pays a claim on behalf of an insured director/officer. Thus, arrangements for paying such a tax would have to be made if, for example, an insurer paid $2 million to defend or pay a claim settlement on an insured director's/officer's behalf. Second, in some countries, the insured directors and officers are required to pay a portion of the D&O policy premiums out of their own pockets.

### Country-Specific Limits and Restrictions on Indemnification

A final roadblock to insuring foreign directors and officers pertains to country-specific limits and restrictions on indemnification. Outside of the United States, the right to indemnify directors and officers is often constrained, so much so that in some jurisdictions it is against the law. For example, until recently, indemnification was illegal in England and remains so in France. In other countries, indemnification may only be permitted for certain acts but not for others (acts for which indemnification would be permitted in the United States). For example, in some foreign jurisdictions, indemnification may be allowed for claims involving good-faith errors in business judgment but not in cases where the director or officer has been charged with illegal conduct or even gross negligence.

The subject of international D&O coverage is complex. Nevertheless, as companies expand the scope of their operations outside the United States, such coverage is a necessity.

## Covered Acts under D&O Policies

D&O policies contain a two-part wrongful act definition. The first part pertains to conduct and the second to status. Customarily, the definition encompasses the following.

1. Any actual or alleged error or misstatement or misleading statement or act or omission or breach of duty by directors or officers while acting in their individual or collective capacities
2. Any matter claimed against them solely by reason of their being directors or officers of the company

### ***No Coverage for Bodily Injury and Property Damage***

Like most other forms of professional liability insurance (although architects and engineers, medical malpractice, and police professional liability coverages are notable exceptions), D&O coverage is not designed to treat exposures related to bodily injury or property damage, an intent reflected in the "wrongful act" definition in the policies. In fact, separate exclusions apply to bodily injury and property damage claims in virtually all D&O policies. Rather, the typical covered claims that are made against corporate directors and officers are normally based on allegations that decisions, acts, errors, or omissions of the directors and officers have lowered the value of the company's stock, compromised the company's competitive position in the industry, wasted corporate assets, caused the company to forego a significant opportunity, or have otherwise injured stockholders (or others) in an economic or financial sense.

## Chapter 3 Review Questions

1. Alice Blue is a officer of Aqua Marine Corporation, but her name is not listed in Aqua's D&O policy declarations. Therefore,
    a. Alice is covered for any claims alleging wrongful acts.
    b. Alice is covered for all claims related to her association with Aqua Marine but not for personal activities.
    c. Alice is covered for claims that allege wrongdoing in her capacity as a corporate officer.
    d. Alice is not covered.
2. D&O policies are intended to cover all the following persons, except:
    a. current directors and officers.
    b. deceased directors and officers.
    c. past directors and officers.
    d. directors and officers added after the policy period begins.
3. Rainbow International, Inc. has offices around the world, many of which are staffed by a corporate officer who might or might not have an official title that reflects his or her actual status. To provide appropriate coverage for these officers, Rainbow's D&O policy should be endorsed accordingly unless the policy's definition of insured persons includes a(n):
    a. exclusion for officers outside the continental United States.
    b. extraterritorial provision.
    c. foreign functional equivalents provision.
    d. foreign flag waiver.
4. Grownup Toy Company creates a subsidiary known as Child Toy Company. Child's assets equal approximately 40 percent of Grownup's assets. Under the terms of a typical D&O policy, Grownup, the parent company,
    a. receives automatic coverage for the new entity with no additional premium.
    b. receives automatic coverage subject to additional premium following a year-end audit.
    c. should notify the underwriter only when completing a renewal application.
    d. should notify the underwriter within 60 days and pay an additional premium.

5. A U.S. corporation might face all of the following problems in purchasing a foreign/local D&O policy, *except*:
    a. Brokers with international experience and overseas offices are unequipped to handle these needs, which are more efficiently handled by multiple brokerage forms.
    b. The administrative process might be unwieldy.
    c. The country may limit or restrict a corporation's right to indemnify directors and officers.
    d. The scope of foreign/local coverage might be much narrower than that of a U.S.-issued policy.

### *Answers to Chapter 3 Review Questions*

1. c. Directors and officers are automatically covered for claims that allege wrongdoing while acting in the capacity of a director or officer.
2. b. Deceased directors and officers are no longer subject to D&O claims. Many policies do, however, cover the estates, heirs, and legal representatives of insureds.
3. c. A foreign functional equivalents provision provides coverage to foreign personnel who have officers' duties and exposures, if not officer titles.
4. d. When an entity is acquired with assets exceeding 25 percent of the parent organization, underwriters generally require notification within 60 days, as well as additional premium, to reflect the increased exposure created by the acquisition.
5. a. It is generally best if U.S. companies buying international D&O coverage work with brokers that have both international experience, as well as overseas offices, so that the corporation does not have to deal with multiple brokerage firms.

# Chapter 4
# Two Key Definitions: “Claim” and “Damages”

This chapter analyzes two key definitions included within corporate D&O policies: “claim” and “damages.”

## Definition of “Claim”

The manner in which the policies define the term “claim” is an important coverage issue. The broadest possible definition is ideal because such a definition tends to accelerate the trigger of coverage under a D&O policy form, which is usually advantageous from the insured's standpoint. Although the exact definitions of “claim” vary from policy to policy, the following are events that trigger a “claim” under the typical D&O policy.

### *Written Demand for Monetary or Nonmonetary Relief*

Under nearly all D&O policies, a written, rather than an oral, demand is required to trigger coverage. Such demands can seek either money damages or nonmonetary relief (e.g., a cease and desist order).

### *Civil Proceeding Commenced by the Service of a Complaint*

A civil proceeding commenced by the service of a complaint is actually a type of written demand for monetary or nonmonetary relief.

### *Criminal Proceeding Commenced by an Indictment*

Coverage is also triggered under a D&O policy by a criminal indictment. This is important because at times, corporate directors and officers are indicted for criminal offenses, prior to the time in which civil complaints are filed against them. (Note: the policies exclude coverage for damages alleged in conjunction with criminal acts. However, the policies state that defense coverage is provided when an insured is criminally charged, and that defense coverage continues until “final adjudication,” meaning the point at which the insured director/officer is acquitted, convicted, or the claim is settled.)

### *Administrative or Arbitration Proceeding Against any Insured Person*

Administrative or regulatory agencies frequently file complaints against directors and officers; thus it is important for coverage to be triggered by such actions. In addition, requests for arbitration are also brought against them, often under the terms of a D&O policy, usually in the event of a coverage dispute. (This issue will be addressed in more detail under the heading of “Arbitration Provisions,” discussed in Chapter 8 of this course.)

### *Civil, Criminal, Administrative, or Regulatory Investigations*

Corporate directors and officers frequently find themselves the target of investigations, in addition to having actual claims made against them. Accordingly, it is important that such actions also fall within a D&O policy's definition of “claim.” For example, during the summer of 2007, more than 100 companies were under investigation by the Justice Department and the Securities and Exchange Commission (SEC), regarding stock option granting practices.

### *Request for Extradition or Arrest Warrant for any Insured Person*

Occasionally, the extradition of a corporate director or officer, from a foreign country, is sought by legal authorities. Under some, but not all, policy forms, such actions fall within their definitions of “claim.”

Not all of the foregoing elements are contained in all D&O policy definitions of the term “claim,” especially the last element, that for extradition requests. However, the broader the scope of the definition of “claim,” the more advantageous for the insured.

## Covered Damages/Covered Losses under D&O Policies

D&O policies cover amounts paid as: (1) judgments or settlements and (2) expenses incurred in defending or settling an action against the insured directors and officers or covered entity. (The coverage provided by a D&O policy in connection with the defense of suits will be analyzed in Chapter 6 of this course.)

### *Items Excluded from “Covered Damages” Definition*

The following items generally do not fall within the typical D&O policy's definition of “covered damages” or “covered losses”: (1) sanctions, (2) taxes, (3) fines, (4) penalties, and (5) matters deemed uninsurable under the law where a D&O claim is made (which usually refers to coverage of punitive damages in jurisdictions where payment of punitive damages by insurance policies is not permitted). This means that even though a company's indemnification agreement permits it to reimburse directors and officers for certain types of damages awarded in conjunction with claims against them (such as punitive damages), the “items excluded” portion of the company's indemnification obligation is not covered by the policy.

#### “Covered Damages” Limited to Payment of Money Damages

Standard definitions of “covered damages” and “covered loss” also preclude coverage for injunctive relief, which refers to court orders to perform certain actions or to desist from certain actions (e.g., a corporation may be ordered by a court to surrender a piece of land to another corporation or individual, to whom the court has ruled the land rightfully belongs). In effect, the definitions of “covered damages” or “covered loss” are limited to the payment of money damages.

### *Coverage of Punitive Damages*

Until the mid-1990s, punitive damages were almost universally excluded from coverage under D&O policy forms. There were a number of reasons for this exclusion, one being that reinsurers would not cover punitive damages. In addition, some insurers felt that affording punitive damages coverage defeated their purpose. Since punitive damages were intended to punish an insured for uncommonly egregious conduct, offering insurance coverage allowed an insured to “escape” such punishment. (Although coverage for punitive damages could, in some instances, be obtained by endorsement and usually required payment of significant additional premium.)

However, In January 1995, Executive Re Indemnity introduced a policy containing a definition of the term “loss” that afforded an affirmative grant of coverage for punitive damages and, shortly thereafter, a number of other insurers began to do likewise. Since that time, the vast majority of D&O policy forms either provide affirmative coverage of punitive damages by means of inclusion within their “covered damages” definitions or, while not affirmatively covering them, do not specifically exclude them.

### State-Specific Prohibitions of Punitive Damages Coverage

Despite such provisions, a number of states, including California, New York, Florida, Pennsylvania, Ohio, and others, prohibit insurance coverage of punitive damages. Accordingly, even if a D&O policy does not exclude, or even affirmatively covers, punitive damages, these state-specific prohibitions can bar payment of punitive damages. (Note: policies written in these states do not contain endorsements barring coverage of punitive damages. However, given the laws in these jurisdictions, if the insured were to insist upon payment of punitive damages, the insurer would likely refuse to cover such damages and the insurer’s coverage denial would be sustained in the applicable state court.)

## *Most Favorable Jurisdiction Provisions*

In recent years, insurers have attempted to circumvent these state-specific prohibitions against coverage of punitive damages by means of what are known as “most favorable jurisdiction” provisions. About half of all D&O policy forms are written with such a provision. To a great extent, insurers’ willingness to cover punitive damages, despite state-specific prohibitions, arose from intense competition in the D&O market beginning in the late 1990s.

Most favorable jurisdiction wording states that with respect to the insurability of punitive damages, the law of the jurisdiction most favorable to the insurability of punitive damages will apply, provided the jurisdiction has a “substantial relationship” with either the insured, the insurer, or to the location where the claim is made or occurs. The “substantial relationship” criterion is considered to be met by one of the following: (1) the jurisdiction where the claim for punitive damages was made; (2) the jurisdiction where the act giving rise to the punitive damages award occurred; (3) the jurisdiction where the insured is incorporated or maintains its principal place of business; or (4) the jurisdiction where the insurer is incorporated or maintains its principal place of business.

### Two Critical Caveats

First, it is important to recognize that most favorable venue wording merely modifies the existing level of coverage for punitive damages already provided by a D&O policy; it does not provide such coverage if punitive damages are otherwise excluded by a policy form. Nevertheless, if a D&O policy is written with punitive damages coverage, an endorsement providing most favored venue wording should, of course, be requested.

Second, the enforceability of most favorable jurisdiction wording has never been tested in court. Therefore, if an insured requests such an endorsement, no additional premium should be charged, because the actual value of the endorsement may be nil, until its legality is tested in court.

### When the Endorsement Is Important

Most favorable jurisdiction wording is essential if, for example, a D&O claim is brought in a state where payment of punitive damages is prohibited by law despite the fact that the applicable D&O policy provides such coverage. (As already noted, a significant minority of states, including California, Florida, Illinois, New York, and Pennsylvania, bar or restrict the extent to which punitive damages may be paid by an insurance policy.) Under these circumstances, coverage may not be available, even if the claim was made under a policy that covered punitive damages.

Most favorable jurisdiction wording is therefore imperative for the insured when purchasing a D&O policy:

- In a state where punitive damages are not insurable and/or
- For insureds that have multistate operations and who therefore cannot predict where the claims seeking punitive damages will be brought against the insured.

## Chapter 4 Review Questions

1. On reviewing his corporation's D&O policy, Bert Dill is alarmed by the wide range of potential incidents that appear to qualify as claims. In discussing this concern with Ted, the firm's insurance agent, Bert learns that:
    a. A broad definition of "claim" creates problems, because minor incidents that fit the definition often go unreported.
    b. A broad definition of "claim" is desirable, from the firm's standpoint, because it means the policy covers a broad range of incidents.
    c. The narrower the definition of claim, the broader the coverage.
    d. The narrower the definition of "claim," the more expensive the coverage.
2. A claim against the directors and officers of Worst National Bank (WNB), who were accused of abusive lending practices, is settled when the bank agrees to take the following actions. Which of these actions is most likely to be covered by WNB's D&O insurance:
    a. WNB will cease to overcharge future borrowers.
    b. WNB will issue a public apology.
    c. WNB will pay damages to borrowers who were overcharged.
    d. WNB will return property that was wrongfully seized in settlement of a debt.

3. “Our Business is Picking Up” Waste Disposal Company (OBPU) is based in Pennsylvania, one of the states that prohibits insurance coverage of punitive damages, and operates in a neighboring state that has no such prohibition. To improve the probability that any D&O claim for punitive damages will be paid, the insurer agrees to add a most favorable jurisdiction endorsement to OBPU’s policy. The most appropriate charge for this endorsement is:
   a. $0.
   b. 10 percent of the normal D&O premium.
   c. twice the normal D&O premium.
   d. set by the states.

## *Answers to Chapter 4 Review Questions*

1. b. A broad definition results in fewer uncovered incidents.
2. c. WNB will pay damages to borrowers who were overcharged. Covered damages or covered loss refers to the payment of monetary damages.
3. a. The actual value of the endorsement may be nil until its legality is tested in court.

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# Chapter 5
# Employment Practices Liability Coverage under D&O Policies

This chapter explains the extent to which corporate D&O policy forms afford coverage for employment practices liability (EPL) claims, both within standard D&O policy forms as well as by means of EPL coverage endorsements that can be added to D&O policies. It also describes what are known as "stand-alone" EPL policies that are written to cover EPL claims, independent of D&O policies.

## EPL Coverage within D&O Policy Forms

An explosion in employment-related claims occurred in the early 1990s, soon after the Clarence Thomas Supreme Court confirmation hearings. As a result, a need arose for coverage of claims alleging sexual harassment, wrongful termination, employment-related discrimination, and a host of other workplace torts. Although D&O policies were not originally designed to cover such perils, many corporations, when faced with employment-related lawsuits, sought coverage for the claims under their D&O policies.

### *D&O Forms Do Not Exclude Employment-Related Claims*

It is important to recognize that while D&O policy forms do not affirmatively cover employment practices liability lawsuits, neither do they explicitly exclude them. In fact, to a limited extent, the policies actually cover them.

## EPLI Endorsements to D&O Policies

As an alternative to purchasing EPL insurance on a stand-alone basis, insurers sometimes offer EPLI coverage as an endorsement to D&O forms. Typically, the coverage costs an additional 10 percent of the D&O premium. Lately, however, EPLI endorsements to D&O policies have actually become more popular, largely because of their cost-effectiveness, compared to stand-alone EPLI policies.

Nevertheless, these endorsements suffer from many of the same coverage shortcomings as do unendorsed D&O policy forms, when it comes to providing coverage for employment-related claims. These shortcomings are discussed below.

#### Pitfalls of D&O Coverage Endorsements

The drawbacks associated with EPLI endorsements to D&O policies are noted in Exhibit 5.1.

**Exhibit 5.1**
**Coverage Shortcomings of EPLI Coverage Endorsements to D&O Policies**

**Limits Dilution**

EPLI endorsements do not create a separate limit of insurance. Rather, the coverage is subject to the existing aggregate limits available to cover claims against directors and officers, as well as securities claims against the corporate entity. Accordingly, these limits can be diluted by EPL claims, something that directors and officers do not favor.

**Higher Retentions**

EPLI endorsements are subject to the same retentions as are applicable to D&O claims under Side B coverage, which are typically much higher than those applicable under a stand-alone EPLI form (to be discussed below). Therefore, all but the most serious EPL claims will fall below this figure, thereby precluding insurer reimbursement.

**Lack of Coverage for the Entity**

Although entity coverage for securities claims is available under D&O policies, allegations naming the corporate entity when it is a plaintiff in an EPL suit are not covered by most EPL endorsements to D&O policy forms. In contrast, virtually all stand-alone EPLI forms routinely cover the corporate entity as a named insured. This is yet another important disadvantage of EPLI endorsements and many commentators suggest that it renders the coverage offered relatively incomplete and therefore of little value because the corporate entity is almost always named in employment-related suits (along with individuals who were specifically responsible for causing the claim).

**Lack of Coverage for Non-directors and Non-officers**

EPLI endorsements to D&O policies create yet another critical coverage gap since only directors and officers are insureds under these endorsements. Accordingly, employees, who are frequently named in EPL lawsuits, are left uncovered by these endorsements.

**Fewer Covered Perils Compared to Stand-Alone Forms**

Virtually all EPLI endorsements to D&O policy forms cover four key employment-related perils: wrongful termination, sexual harassment, discrimination, and retaliation. However, EPLI endorsements to D&O policies generally cover only a limited number of what are referred to as “workplace torts.” These “workplace torts” include (but are not limited to): breach of an oral or written employment contract, employment-related misrepresentation, wrongful failure to employ, wrongful failure to promote, wrongful discipline, wrongful deprivation of a career opportunity, failure to grant tenure, constructive discharge, negligent evaluation, invasion of privacy, employment-related defamation, whistle blower claims, and employment-related emotional distress. Usually, an EPL endorsement to a D&O policy will only cover three to five of these workplace torts, compared to an average of about a dozen under stand-alone forms.

## Stand-Alone Policies Covering Employment Claims

Given the fact that coverage of EPL claims was never really intended under D&O policy forms, insurance for such claims is available on a stand-alone basis under what are known as employment practices liability insurance (EPLI) policies. Although such forms do a good job of filling the coverage gaps found within D&O policies, these stand-alone forms pose two major drawbacks: (1) high premiums and (2) a rigorous underwriting process requiring firms to undergo a thorough evaluation of their human resources administration practices. As a result, many organizations have opted not to purchase EPLI coverage or do so in conjunction with a D&O policy, under what is known as an EPLI endorsement.

## EPLI Coverage within a D&O Policy: The Package Policy Approach

Increasingly, insurers are weaving EPLI coverage into the actual D&O policy, rather than covering the employment practices liability exposure by endorsement. They are doing this by means of a package policy approach in which EPL, fiduciary liability, and kidnap/ransom insurance are also provided along with D&O coverage. In many, although not all, such policies, each of these coverages is subject to a separate coverage limit. This is desirable for the insured because it avoids the problem of "limits dilution" when a D&O policy is written with an EPL endorsement; this situation is problematic for corporate insurers because employment-related claims have the potential for diluting the limits available to cover D&O claims, something that is disfavored by corporate directors and officers.

When assessing the scope of coverage afforded by these so-called management liability "package policies," it is advisable for the insured to review the items noted above in Exhibit 5.1. The key is to make sure that the EPL coverage is subject to its own set of policy provisions. If this is, in fact, the case, the coverage is often comparable to what is available under a stand-alone EPL form. More specifically, the EPL coverage should (1) be subject to a separate policy limit (to avoid diluting D&O limits with EPL claims); (2) be subject to separate retentions, since D&O retentions are generally much higher than those under EPL forms; (3) provide entity coverage, since virtually all EPL claims name the corporate entity; (4) cover nondirectors/nonofficers in addition to directors and officers; and (5) cover a broad range of workplace torts in addition to discrimination, sexual harassment, retaliation, and wrongful termination.

## Chapter 5 Review Questions

1. In reviewing its D&O policy to see whether it covers an employment practices liability lawsuit, Dental Plaque Co. is most likely to discover that employment practices liability is:
    a. affirmatively covered.
    b. covered to a limited extent.
    c. excluded by endorsement.
    d. explicitly excluded.
2. In deciding between a stand-alone EPLI policy and an EPLI endorsement to its D&O policy, Cardinal Co. is likely to recognize which of the following advantages of a stand-alone policy?
    a. low premium.
    b. simplified underwriting.
    c. broader coverage.
    d. need to thoroughly evaluate human resources administration practices.

3. Rather than using a separate endorsement, weaving EPLI coverage into a D&O policy:
   a. avoids the problem of limits dilution.
   b. creates the problem of limits dilution.
   c. is less common now than it was in the past.
   d. is prohibited by severability of interests provisions.

### Answers to Chapter 5 Review Questions

1. b. D&O policies cover employment practices liability claims to a limited extent.
2. c. Broader coverage is one of the advantages of a stand-alone policy as compared to an EPLI endorsement in its D&O policy.
3. a. Weaving EPLI coverage into a D&O policy avoids the problem of limits dilution because separate coverage limits apply to EPL claims.

# Chapter 6
# Defense Coverage within D&O Policies

This chapter examines the distinct nature and operation of defense coverage provisions and procedures contained within corporate D&O policies.

## Covered Defense Cost Items

D&O policies are very similar regarding the types of items included within the definition of "covered defense costs." Essentially, the policies cover attorney fees and investigation expenses required to defend and settle claims, as well as the costs of bonds (e.g., appeal and attachment bonds) associated with the litigation process.

### *Salaries of Insureds Are Not Considered "Covered Defense Costs"*

The most notable component that the policies specifically exclude from the definition of "covered defense costs," however, is the salaries of directors, officers, and employees of the parent organization. In other words, the policy does not reimburse the parent corporation for the salaries of the directors and officers who are required to spend time working with defense counsel to adjudicate or settle claims. Given the high compensation levels characteristic of insureds under D&O policies, uninsured compensation losses can be substantial. This is especially true considering the complex and time-consuming nature of D&O claims.

## Duty To Advance Defense Costs

Historically, D&O policies did not contain language requiring the insurer to reimburse the parent organization for defense costs until a claim had been completely resolved. However, given the substantial expense entailed in defending claims, even large, well-capitalized organizations would prefer to finance the defense of a D&O claim with some degree of insurer assistance. Consequently, the majority of D&O forms contain language making it a duty for the insurer to advance or at least reimburse defense costs as they are incurred.

### *Recoupment of Uncovered Defense Costs*

Where the insurer has advanced defense costs, and where the insurer has provided a defense, the issue that often arises is whether the insurer is entitled to partially or completely recoup its defense costs from the insureds—if it turns out that one or all of the claims were not, in fact, covered by the policy. An example of this would be a situation where an insured director or officer is found guilty of having committed fraud in a criminal trial (acts typically excluded under D&O policies) and the insurer then seeks a return of the monies expended to defend the insured.

The majority of policies are silent as to whether an insurer is allowed to recoup uncovered defense costs that it has already paid on an insured's behalf. Accordingly, any provisions allowing the insurer to recoup such costs from the insured should be vigorously resisted. Not only are they obviously detrimental for an insured, but are also unusual, and should be objected to on that basis, as well.

### Barring the Insurer from Enforcing Recoupment

Ideally, wording in a D&O policy would state that the insurer is *barred* from seeking such reimbursement. Of course, this is a favorable approach for the insured. Although it is difficult to negotiate a provision barring an insurer from seeking recoupment of noncovered defense costs, attempts should be made to do so nonetheless.

### Common Law Right of Recoupment: The Majority Rule

It appears that a majority of jurisdictions allow insurers to recoup uncovered defense costs even in the absence of language to that effect in the policy, especially where the insurer expressly reserves its right to seek such recoupment in an agreement made prior to advancing the defense costs. They reason that, if the insured does not object to the insurer's reservation of rights in that regard, the insured must have consented to the insurer's right to be repaid if the claims turn out to be not covered.

Some D&O policies now contain express provisions requiring the insureds to repay defense costs if a court decides that any part of them were not covered. The D&O policy at issue in *Commercial Capital Bankcorp, Inc. v. St. Paul Mercury Ins. Co*. provides an example of such a reimbursement provision.

> [I]t shall be the duty of the Insureds and not the duty of the Insurer to defend any Claim.
> ...
>
> Subject to [the allocation provision] of this Policy, the Insurer shall advance on behalf of the Insureds Defense Costs which the Insured Persons ... have incurred in connection with Claims made against them, prior to disposition of such Claims, provided that to the extent it is finally established that any such Defense Costs are not covered under this Policy, *the Insureds ... agree to repay the Insurer such Defense Costs*. [Emphasis added.]

### No Common Law Right of Recoupment: The Minority Rule

A growing number of jurisdictions disagree with the majority rule. They read the insurer's duty to provide a defense to be more absolute. They hold that, absent language *in the policy itself* explicitly granting the insurer a right of recoupment, the insured is not required to repay defense costs even where the insurer provides a defense to the claim under a reservation of rights letter.

## Duty To Defend versus Non-Duty To Defend Language

D&O policies for larger, more legalistically sophisticated insured organizations are most often written on a "non-duty to defend" (also sometimes called a "duty to pay") basis. In contrast, smaller insureds who do not have the experience or time to become closely involved in the complexities of D&O litigation generally opt for what are known as "duty to defend" policies. In today's D&O market, insureds can usually choose between a "duty to defend" and a "non-duty to defend"/"duty to pay" form.

The phrase "duty to defend" in a D&O policy expressly states that the insurer has the duty to defend any claim alleging a covered act under the policy. In contrast, other policies state that the insurer has "no duty to defend" the insured; rather, such forms indicate that "it is the duty of the insured to defend claims." Such forms only compel the insurer to pay the defense costs in connection with the insured's executing the defense of the claims.

### *Who Controls Defense and Settlement?*

Two of the important differences between a "non-duty to defend" and a "duty to defend" policy involve (1) the right to choose defense counsel and (2) the right to control the defense of the claim. Under a "duty to defend" policy, unless specifically negotiated otherwise in the policy, the insurer has the right to choose defense counsel. In addition, under a "duty to defend" policy, the insurer typically has the absolute, unfettered right to control the defense strategy of the claim, including settlement.

Conversely, under a "non-duty to defend" policy, the insured is able to use any lawyer of its choice, subject to insurer approval (although such policies state that approval will not be "unreasonably withheld"). In addition, the policyholder has the right to control the defense strategy and settlement of the claim. Accordingly, the policyholder would, for example, have the option of settling a claim (although it typically may not settle without first obtaining the insurer's consent; again, the policies state that such consent will not be "unreasonably withheld") or, on the other hand, taking it to trial.

### *Pros and Cons of Duty To Defend versus Duty To Pay Policies*

In many instances, a duty to defend provision may benefit an insured, despite the fact that the provision reduces the extent to which the insured can exert control over the claims handling process. This is especially true if the company is inexperienced in managing the complexities of D&O litigation. On the other hand, firms that are more familiar with the details of the D&O claims handling process may prefer a D&O policy containing duty to pay/non-duty to defend language. (This is also true because there is typically no difference in cost between these two kinds of policies.) In short, the selection of duty to defend/non-duty to defend language is an organization-specific issue.

### *Defense Procedures under Non-Duty To Defend Forms*

Despite the fact that a policy is written on a non-duty to defend basis, a D&O insurer does, however, retain a certain amount of control over the handling of suits brought against its insureds. For instance, almost all of the policies give the insurer the right to associate with the parent company and insured directors and officers in defending and negotiating the settlement of claims, even when those policies are written on a non-duty to defend basis.

However, under non-duty to defend policies, if the insured is able to settle a claim within the policy's retention, no insurer consent is generally required. In addition, the policies require insureds to provide the insurer with ongoing information concerning the details of the settlement process.

## Chapter 6 Review Questions

1. Robert is concerned what might happen if an insurer unsuccessfully defends claims against a director that ultimately turn out to involve criminal acts or some other activity not covered by the D&O policy. Robert is afraid the insurer would then seek to recover its defense costs from the corporation. In such a situation, the most favorable wording in a D&O policy would:
    a. allow the insurer to recoup uncovered defense costs.
    b. bar the insurer from seeking reimbursement.
    c. be silent as to whether the insurer can seek reimbursement.
    d. require the insurer to seek reimbursement.
2. Under non-duty to defend D&O policies, an insured:
    a. may settle a claim within the retention without the insurer’s consent.
    b. may settle a claim within limits without involving the insurer.
    c. avoids any need to keep the insurer performed of the details of the settlement process.
    d. must use the insurer’s defense attorneys.

### *Answers to Chapter 6 Review Questions*

1. b. Ideal wording in a D&O policy would state that the insurer is barred from seeking such reimbursement.
2. a. No insurer consent is generally required if the insured is able to settle a claim within the policy’s retention.

# Chapter 7
# Limits, Retentions, and Coinsurance under D&O Policies

Chapter 7 explains the manner in which limits, retention/deductible, and coinsurance provisions apply within corporate D&O policies.

## Policy Limits

D&O policies are customarily written subject to an aggregate limit applying to losses paid under any one of the policy's three insuring agreements: (1) coverage for directors/officers (Side A), (2) corporate reimbursement coverage (Side B), and (3) coverage for entity securities claims (Side C). In effect, the policy limit will be applied in any combination to one or more claims that are covered by one or more of these three insuring agreements.

### *Limits under "Packaged" or "Management Liability" Policies*

A number of D&O policies (especially those written to cover privately held and nonprofit firms) are written in a "packaged" format (and are also known as "management liability policies"). Such policies also cover employment practices liability and fiduciary liability claims. About half of all "package policies" afford a separate limit for each of these three exposures, while the other half are written with an aggregate limit for D&O, employment practices liability, and fiduciary liability claims (as is the case with for-profit D&O forms.)

### *Defense Costs within Limits*

D&O insurance policies include defense costs within the policy limits, meaning that the expenditure of defense costs reduces the policy's limit of liability. (This approach contrasts with that used under commercial general liability (CGL) policies, under which defense costs do not reduce available policy limits, so that in effect, under CGL policies, defense expenses are covered to an unlimited extent.) Since many D&O suits involve highly complex areas of commercial and civil law, they are among the most expensive legal actions to defend. Consequently, limits should be selected not only to cover potential judgments and settlements, but also in consideration of high, anticipated defense costs, as well.

### Lack of Coverage for First-Dollar Defense

It should also be noted that D&O policies do not afford first-dollar defense coverage. For example, even if a claim were to involve only defense costs (and no judgment or settlement amount were payable), the insured would nevertheless be required to absorb the amount of the policy's retention before the insurer would indemnify or pay defense costs on the insured's behalf.

### Potential Bad Faith and Policy Limits Issues under Duty To Defend Policies

Whenever a policy is written with defense costs included in the limit of liability, there are potential bad faith issues for insurers to consider. For example, assume that a D&O policy is written with a $2 million limit. A corporation receives a $1 million demand. Three years later, if the insurer has already expended $1.5 million in defending the claim, the insurer would be unable to settle the claim within the policy's limits, despite the fact that the claimant's initial demand was only $1 million (i.e., the $1 million demand plus the $1.5 million already expended on defense equals $2.5 million, which exceeds the $2 million policy limit).

Note: in the above example, the insurer might, in theory, still be able to settle the claim for, say, $500,000 or prevail with no damages award at all—thus remaining within policy limits. Such outcomes are unlikely, however.

These kinds of "shrinking limit" situations (where defense costs reduce policy limits) place a duty on insurers covering insureds on a duty to defend basis, to keep insureds continually advised of current defense expenditure amounts so that strategic settlement decisions can be effectively made and potential bad faith claims avoided. (Normally, insurers provide insureds with quarterly statements as to defense monies expended on any given claim. In the event that insureds are not furnished with such information, they should request it from their insurer.)

Of course, under non-duty to defend policies, in which insureds control the defense process (and are therefore aware of all billings submitted to the insurer), the argument could be made that insureds are already cognizant of the extent to which policy limits have been reduced. Therefore, shrinking limits issues are less problematic under non-duty to defend policies, compared to situations in which coverage is written on a duty to defend basis.

## Retentions

The corporate reimbursement coverage (Side B) and the entity securities coverage (Side C) provided by a D&O policy is subject to a retention. Direct coverage for directors and officers (Side A) is not subject to a retention. This is to the insurer's advantage because the vast majority of claims are paid under the corporate reimbursement section (Side B) of the policy. It is, of course, also advantageous for the individual directors and officers.

### Retentions in Multiple Claim Situations

It is common for a single wrongful act to produce a number of claims (i.e., by different claimants). Without a policy provision to the contrary, this may cause retentions to "stack" on each other. To illustrate, if Side B of a D&O liability policy has a $500,000 per claim retention, and a single wrongful act leads to claims filed by three different persons against the insureds, the parent company could retain as much as $1.5 million of the loss payments and defense costs. To prevent such situations, anti-stacking clauses indicating that only one retention applies per wrongful act, are included in virtually all D&O policies.

Even in the absence of an anti-stacking provision, nearly all courts have held that if one or more interrelated causes are found to have resulted in all of the injuries or damages claimed, there is but one loss for the purpose of determining the applicability of retentions. Accordingly, even if a policy did not contain an anti-stacking provision, as a matter of common practice, a single retention would be applied if one wrongful act produced multiple claims (as in the example in the preceding paragraph).

## Coinsurance

In addition to the retention provision explained above, a handful of directors and officers liability insurance policies impose a coinsurance percentage or participation obligation on the insured. Coinsurance is normally only imposed on the most loss-prone risks and is also more common during hard market periods. This provision is similar to the copayment provisions found in medical insurance coverage, in which the policy will pay only a specified portion (typically 80 to 95 percent) of each loss in excess of the dollar amount deductible.

## Chapter 7 Review Questions

1. Klutz Company has a D&O policy with a $1 million limit and a $100,000 retention. $60,000 in legal expenses was incurred in successfully defending its first D&O claim, and no damages were awarded to the claimant. The insurer will pay:
   a. nothing.
   b. $30,000.
   c. $60,000.
   d. $100,000.
2. Footloose Company has a D&O policy with a $10 million limit and an 80 percent coinsurance clause. A claim for damages resulted in a settlement of $1 million, including defense costs. Ignoring any applicable deductible, the insurer will pay:
   a. $80,000.
   b. $640,000.
   c. $800,000.
   d. $1 million.

### *Answers to Chapter 7 Review Questions*

1. a. The insured is required to absorb the amount of the policy's retention before the insurer would indemnify of pay defense costs on the insured's behalf.
2. c. An 80 percent coinsurance clause in a D&O policy means the insurer pays 80 percent of the loss and the insured retains 20 percent; in this scenario, 80 percent of $1,000,000 is $800,000.

# Chapter 8
# Conditions in D&O Policies

Chapter 8 addresses the conditions provisions found in D&O forms, which include severability, cancellation, subrogation, other insurance, arbitration, priority of payments provisions, and presumptive indemnification provisions.

## Severability

In a D&O policy, the term "severability" means that either (1) the application for D&O coverage or (2) the exclusions within a policy apply individually to each insured, as if a separate contract of insurance were in place.

Typically, a D&O policy contains two separate severability provisions: one applying to the application and the other pertaining to the policy's exclusions.

### *Application Severability versus Severability of Exclusions*

If, in a claim situation, an exclusion applies to one insured due to some action on the part of that insured, severability operates so that coverage is not barred as respects other insureds. For example, if an officer commits fraud and, along with him, the firm's other directors and officers are also sued, the policy's fraud/dishonesty exclusion would not apply—but coverage would be available—to the so-called "innocent insureds." (Note: severability provisions usually apply only to a D&O policy's conduct-related exclusions such as illegal personal profit and fraud/dishonesty and are discussed in more detail in Chapter 9.)

Similarly, assume that one director knew the application for coverage contained a material misstatement (e.g., the director knew that the company's financial statements contained intentionally inflated earnings data). This knowledge would negate coverage for that particular director. However, a severability provision stating that such knowledge was not imputable to other directors or officers would preserve coverage for these nonculpable insured persons.

In effect, severability, as to the exclusions or the application, creates a separate policy and a separate application, respectively, so that the actions of one insured do not defeat coverage for another, innocent insured.

### *Why Has Severability Become Important?*

Severability provisions have become increasingly important in recent years because a significant percentage of claims against insured directors and officers have involved both so-called "white hat" (i.e., nonculpable insureds who did not commit fraud) and "black hat" insureds (i.e., culpable insureds who did commit fraud).

It has become commonplace for claims to be made against persons who were guilty of willful conduct in causing claims—along with those who were innocent of any intentional wrongdoing. Usually, it is outside directors who are unaware of the fraud committed by the officers who run the company's day-to-day operations. (The Enron situation provides a good example of this situation.) However, absent severability of both the application for coverage and as respects policy exclusions, coverage could otherwise be denied as to these innocent insureds, since the wrongful knowledge/conduct of culpable insureds could be imputed to the innocent insureds.

### Directors and Officers Should Review Applications

Although the Enron case presents the most notable example of the black hat/white hat dichotomy, many other less publicized cases in recent years have also involved intentional, wrongful conduct by some insureds occurring on a parallel basis with that of other nonculpable insureds. Even where severability provisions appear in both D&O policy forms and applications (which is usually the case), it should be an established procedure within all organizations that every insured director or officer be given a copy of the application, with instructions to review it carefully.

## ***The Two Types of Application Severability***

There are two types of severability provisions found within D&O application forms: limited severability and full severability.

### Limited Severability

Under a “limited” severability provision, severability will apply and coverage will be available to the other, “innocent” insureds, unless: (1) the person who signed the application had knowledge of the false application statement or (2) one of certain designated executive officers (typically the CEO or CFO) had knowledge of the false statement. Accordingly, knowledge of the false statement by either the signer of the application and/or the CEO or CFO will be imputed to all insureds and they will have no coverage. Although a minority of insurers' applications contain limited severability provisions, such provisions are not unusual.

### Full Severability

Under a “full” severability provision, which is the majority approach, knowledge of either the signer of the application or certain executive officers, such as the CEO or CFO, is not imputed to any other insureds and thus, such innocent persons will have coverage despite the false statement, or knowledge about the false statement.

It should be recognized, however, that a “fully severable” policy is not the same as a “nonrescindable” policy. “Full severability” should not be confused with provisions barring an insurer from rescinding a policy based upon material, fraudulent statements in an application  As noted earlier in this course, the availability of nonrescindable provisions is generally restricted to Side A-only policy forms. The lesson: simply because a policy is fully severable does not mean that it is nonrescindable.

### An Instructive Case

*Cutter & Buck, Inc. v. Genesis Ins. Co.,* demonstrates the importance of the severability provision within a D&O application. For fiscal year 2000, Cutter & Buck's chief financial officer accounted for a number of product “shipments” as “sales,” despite the fact that distributors returned the goods in 2001. This, of course, materially overstated the company's actual revenues. In 2002, when the firm's new CFO discovered these fraudulent accounting practices, she ordered an investigation that ultimately required the company to restate its financials. A number of shareholder lawsuits against the company's directors and officers followed. Genesis Insurance Company responded by rescinding coverage, asserting that the insured CFO, who was also the signer of the D&O application and eventually pled guilty to fraud, had misrepresented material facts on the application.

The application's severability provision stated that knowledge possessed by one insured was not imputable to other insureds. *But there was one critical exception*: knowledge possessed by a signer of the application was imputable to innocent insureds, which was exactly what transpired in this situation.

The judge found that Genesis was correct in rescinding coverage on this basis. Here, the wording of the application's severability provision did not bar Genesis from rescinding coverage for all of Cutter & Buck's directors and officers because the knowledge of the CFO—who signed the application—could be imputed to others, including innocent directors and officers.

Unfortunately, insureds will not always be offered a policy containing full application severability. In general, insurers are reluctant to grant it if such wording is not already contained within their standard application wording. Under these circumstances, insureds should take even greater care when completing applications to assure that all information contained within them is absolutely correct and complete.

The bottom line is that severability is not just an issue for the Enrons of the business world. Rather, it is important for firms of all sizes to carefully address severability provisions when arranging their D&O coverage.

## Cancellation

D&O policies have similar cancellation provisions, normally permitting immediate cancellation by the named insured with no advance notice. Under these circumstances, premium is returned on a short-rate basis (i.e., pro-rata unearned premium, less 10 percent). In a complimentary fashion, if the insurer cancels, unearned premium is returned to the insured on a pro-rata basis.

Conversely, if the insurer cancels, 30 days is usually the minimum notice period that most policies require insurers to provide insureds. Note that 10 days' notice by the insurer is the minimum notice period in two situations:

- nonpayment of premium or
- failure to reimburse deductible amounts

Although a majority of forms include cancellation notice provisions of 30 days, some insurers (i.e., most of the insurers providing coverage on admitted forms) have state amendatory endorsements attached to their policies that extend cancellation notice periods to 60 days. However, a few insurers' policies include “regular” cancellation notice provisions as long as 60 days.

### *Noncancelable Policies with Nonrenewal Notice Requirements*

Newer D&O policies provide more liberalized cancellation provisions. That is, a number of forms are written on a noncancelable basis (except that cancellation is permitted for nonpayment of premium) and with provisions requiring the insurer to provide up to 60 days' prior notice of its intention not to renew the policy.

## Subrogation

Virtually all directors and officers liability policies contain similarly worded subrogation provisions. The policies mandate the insureds' cooperation in recovering from third parties who were responsible for causing a claim to be made against the insureds. Such provisions reinforce the fact that the insureds are not permitted to prejudice the insurer's potential rights of recovery against parties responsible for causing a loss.

## Other Insurance

“Other insurance” clauses in D&O forms state that if other insurance is available, the directors and officers liability policy shall serve as excess insurance. The one exception is when the other directors and officers liability policy is specifically scheduled as excess of the policy in question.

The purpose of an “other insurance” clause is to prevent an insured from profiting as a result of a loss by collecting payment from more than one insurer. “Other insurance” clauses also preclude an insurer from profiting by escaping payment of a claim it rightfully insured.

## Arbitration Provisions

A significant number of D&O forms contain provisions requiring coverage disputes between the insured and the insurer be submitted to binding arbitration, rather than allowing either party to resort to the legal system to redress the dispute. (This is known as a “mandatory” arbitration provision, although a minority of forms afford insureds the option, but not the obligation, to submit coverage disputes to arbitration.) The effect of this provision is to expedite resolution of coverage-related controversies, given the long delays inherent in the conventional U.S. judicial process. Also important is the fact that arbitration typically reduces the cost of settling such disputes compared to utilizing the traditional court system.

### *Why Arbitration Favors the Insurer*

Although the mandatory arbitration provision benefits both the insurer and the insured for these reasons, arbitration probably affords greater benefit to the insurer. This is because it is generally believed that arbitrators are less biased against insurance companies than are judges and juries, as evidenced by the rare incidence of astronomical arbitration awards against insurers, compared to the occasional “runaway verdict” rendered by juries.

Yet another criticism of arbitration stems from the fact that insurers regularly hire arbitrators because insurers are repeatedly involved in coverage disputes. Given their continuing need for the services of arbitrators, over time, insurers are in a position to hire arbitrators “more selectively,” so that eventually they begin hiring arbitrators whose previous decisions have tended to favor them. Conversely, insureds, given the rarity of their participation in the arbitration process, are not in a position to select arbitrators whose prior decisions have appeared to favor their interests. This is yet another reason why arbitration tends to favor insurers.

### *Check Arbitration Provisions Carefully*

Although insureds should not anticipate becoming embroiled in a claim dispute with their D&O insurer, the possibility is far from remote. In fact, the 2006 Towers Perrin D&O Survey revealed that 6 percent of open claims were being contested by participants in the survey. As expected, 47 percent of such disputes involved the insurer's denial of coverage for a claim.

Given the reality of potential coverage disputes with a D&O insurer, it is wise for insureds to carefully check the dispute resolution provisions in D&O policies. Following are the points that demand particular scrutiny in any arbitration provision.

### Mandatory or Optional?

Is arbitration mandatory in all instances, subject to demand by either party? Or, can it be entered into only at the election of the policyholder? The latter is the more favorable version for an insured, since there may be situations in which counsel for the insured does not feel that arbitration is the ideal forum for resolving a dispute. In other words, the best provisions from the insured's standpoint are those giving the insured the option but not the obligation to submit a coverage dispute to arbitration.

### Pre-Conditions to Arbitration

Do the provisions require that the insured first submit disputes to nonbinding mediation in an attempt to reach an agreement? Most do not, but a handful of forms contain such a requirement. The problem with this approach is that assuming each party pays its own costs, the (usually) stronger financial position of the insurer may have the effect of "wearing down" the insured, thus compelling a settlement, prior to arbitration, which is not in the insured's best interests.

### Binding or Not?

Are the results of the arbitration binding? Under most, but not all, policies, arbitration is binding. Whether this is to the insured's or the insurer's advantage depends on the outcome of the arbitration and the facts underlying the dispute.

### Venue

Does the provision state the venue in which the arbitration must take place? If so, does it favor the insurer or does it make arbitration burdensome to the policyholder? Under some policy forms, for example, an insured may be required to appear at an arbitration in the United Kingdom, a situation that would clearly put a U.S. insured at a disadvantage.

### Controlling Law

Is the controlling law stipulated? Again, assuming the insured is an American corporation, U.S. law in a specifically enumerated state, should control the arbitration proceedings rather than the law of a country outside the United States.

### Panel Composition

Is the approach for selecting the arbitration panel reasonable? Usually, the provisions call for each participant to appoint one arbitrator, both of whom choose an umpire. Sometimes there is a change from this, whereby restrictions are placed on the background and experience of the arbitrators, and these could work to the advantage of one of the parties, usually the insurer that drafted it.

### Costs

How are the costs of arbitration allocated between the parties? Usually, each side must pay its own costs. To be avoided are provisions requiring the insureds to pay the insurers' costs, in addition to their own.

Given the chance that an insured will, at some time, be engaged in a claim dispute with its D&O insurer, insureds (or their representatives) should carefully analyze these points and, if any appear onerous, attempt to negotiate more favorable wording.

## Priority of Payments Provision

When a corporation files a bankruptcy petition, it creates an "estate," which includes all of the property interests of the debtor corporation at the time the bankruptcy proceeding commences. During the past several years, one of the critical questions that has arisen in such situations is whether the proceeds of a D&O policy should be treated as a part of the bankruptcy estate, or, whether those proceeds are the property of the individual insured directors and officers. If such proceeds are considered property of the estate, they will be subject to the bankruptcy court's jurisdiction and may not be available to pay the defense costs of the directors and officers.

### *Why the Provision Is Important*

This issue, which arose during the Enron bankruptcy, remains legally unsettled to this day. Accordingly, it is advantageous for a D&O policy to include a priority of payments provision which specifically states that such proceeds are the property of the directors and officers. A typical priority of payments provision states that payment will first be made under Coverage A, (directors & officers liability), then, under Coverage B (corporate reimbursement), and lastly, under Coverage C (entity securities). This is in keeping with the concept that the primary purpose of D&O coverage is protection for individual directors and officers, then for the corporate entity, and finally, for "other interests" such as a bankruptcy trustee.

### *Limitations of Priority of Payments Provisions*

Priority of payments provisions are helpful but far from ironclad. Although insureds should insist that they be included in a D&O policy, such endorsements cannot be completely relied on for two reasons. First, bankruptcy law is governed by federal statute whereas state law is used to interpret insurance policies. And since federal law takes precedence over state law, a bankruptcy court could decide to ignore a priority of payments endorsement. Second, the validity of such endorsements has not yet been examined by a court. Accordingly, if an insured requests that this provision be added by endorsement, no additional premium should be charged.

## Presumptive Indemnification Provision

As noted earlier under the "retentions" heading earlier in this course, the typical D&O policy includes a substantial self-insured retention for corporate reimbursement (Side B) coverage and Entity Securities (Side C) and no retention for direct (Side A) D&O coverage.

### *Why the Presumptive Indemnification Provision Was Introduced*

At one time, corporations attempted to avoid paying the Side B retention by simply electing not to indemnify the insured directors and officers, thereby forcing the insurer to provide first-dollar coverage for the directors and officers under Side A of the policy.

In response, insurers placed "presumptive indemnification" provisions in D&O policies, stating that for the purpose of determining whether a claim is subject to the retention, the corporation will be deemed to have indemnified its directors and officers to the fullest extent permitted by law, regardless of whether the corporation does, in fact, indemnify the directors and officers.

### *When the Provision Does Not Apply*

It is important to recognize, however, that presumptive indemnification clauses typically do not apply when insolvency prevents the corporation from meeting its indemnity obligations. Accordingly, one might think that directors and officers will also enjoy virtual first-dollar coverage when the corporation has filed for bankruptcy, which, in fact, may not necessarily be the case. Rather, there are times when a currently solvent company will file for bankruptcy to forestall a potential risk of future insolvency. As a result, if a corporation files for bankruptcy, but is not actually insolvent, an insurer could argue that the presumptive indemnification clause requires the insureds to assume liability for the self-insured retention.

Given this possibility, when negotiating the wording of a D&O policy (especially if there is a possibility of a future bankruptcy filing), the corporation should ask the insurer to use language that eliminates the presumption of indemnification on filing of bankruptcy, as well as when the corporation is insolvent.

## Chapter 8 Review Questions

1. Careful reading of J-Fly Company's D&O policy suggests that, no matter how innocent he or she might be, no director or officer of the company is entitled to protection under the policy if the CEO or CFO knows that the insurance application contains false statements. Based on this information, it appears that J-Fly's D&O policy has:
   a. a broad severability provision.
   b. a full severability provision.
   c. a limited severability provision.
   d. no severability provision.
2. A typical D&O policy includes provisions that:
   a. clarify the policy's relationship with other insurance and require cooperation with the insurer's subrogation efforts.
   b. permit other D&O insurance but prohibit subrogation.
   c. permit subrogation but prohibit other D&O insurance.
   d. prohibit subrogation by the insurer and prohibit other insurance covering the same exposures.
3. When comparing arbitration provisions in D&O policies from the standpoint of the insured,
   a. all arbitration costs should preferably be paid by the insured.
   b. mandatory arbitration is preferable to optional arbitration.
   c. restrictions on the composition of the arbitration panel usually favor the insurer.
   d. the venue in which the arbitration must take place is not a relevant factor.

### *Answers to Chapter 8 Review Questions*

1. c. Under a “limited” severability provision, severability will apply and coverage will be available to the other, “innocent” insureds, unless: (1) the person who signed the application had knowledge of the false application statement or (2) one of certain designated executive officers (typically the CEO or CFO) had knowledge of the false statement.
2. a. Other insurance clauses state that the policy provides excess coverage (subject to one exception) and requires the insured to cooperate with the insurer’s third-party recovery attempts.
3. c. Restrictions on the background and experience of the arbitrators usually work to the advantage of the insurer that drafted the restrictions in the policy.

# Chapter 9
# Exclusions in D&O Policies

Chapter 9 examines the exclusions found within corporate D&O policies.

Exclusions are incorporated into directors and officers liability policies in one of two ways: (1) they are contained within the policy form or (2) they are added to the policy by endorsement. Both types of exclusions can have a significant effect on the scope of coverage the policies provide. Since D&O policies vary more in their exclusionary language than in any other coverage aspect, it is necessary to examine the exclusions carefully.

It is also important to note that the exclusions in a D&O form are not always contained in the policy section titled "Exclusions." They may also be contained within definitions (e.g., "loss" defined to exclude fines and penalties) as well as in the conditions section.

## D&O Forms Containing Multiple Sets of Exclusions

A number of D&O policies incorporate as many as three sets of exclusions: one set applicable to the corporate reimbursement section of the policy, a second set applicable to the coverage for directors and officers, and a third set applicable to the policy's entity securities coverage section.

It should be recognized that a corporation's bylaws and state statutes governing corporate reimbursement plans impose many of the same restrictions found in the directors and officers coverage exclusions. For this reason, these exclusions do not always need to be included in the set of exclusions that pertain to the corporate reimbursement coverage section. As a result, a number of D&O policies contain only a single set of exclusions that apply to the corporate reimbursement, the directors and officers, and the entity securities coverage sections (i.e., Coverages A, B, and C).

## Severability Provisions in Policy Exclusions

As discussed earlier, by virtue of what are known as severability provisions, for the purpose of applying D&O policy exclusions, the actions of one director or officer are not normally imputed to any other directors or officers. For example, assume that a claim alleges dishonest acts were committed by a group of directors and officers. If only one of these individuals was, in fact, proven guilty of the dishonesty, based upon the severability provision applying to the policy's exclusions, the innocent directors/officers would not be barred from having defense coverage available for the claim. This is because the provision states that the dishonest acts of the guilty director/officer will not be imputed to the innocent director(s), so as to bar coverage for these individuals.

Severability provisions are also sometimes referred to as "innocent director" or "nonimputation" clauses. (The concept of severability regarding statements made in connection with the application for a D&O policy was examined earlier in this course.)

### *Exclusions for Which Severability Provisions Usually Apply*

Insurers typically include severability provisions with respect to the following exclusions.

- Fraud/Dishonesty
- Personal profit
- Illegal payments and gratuities
- "Short Swing" profits
- Return of remuneration

Care should be taken to verify that severability provisions also apply to any similar kinds of exclusions that may be added to the D&O policy by endorsement.

The following pages will discuss these specific exclusions:

- Claims caused by director/officer fraud/dishonesty
- Personal profit exclusion
- Illegal payments and gratuities exclusion
- Exclusion of claims under Section 16(b) of the 1934 SEC Act ("Short Swing" Profits)
- Exclusions relating to various corporate activities
- Return of remuneration exclusion
- Prior and pending litigation exclusion
- Exclusion of losses covered by a prior policy
- Insured versus insured exclusion
- Failure to maintain insurance exclusion
- Wage and hour claim exclusion
- ERISA liability exclusion
- Bodily injury/property damage/personal injury exclusion
- Pollution exclusion

## Exclusion of Claims Caused by Dishonesty of Directors and Officers

Insuring people for their individual liability arising out of intentionally committed illegal acts is not permitted as a matter of public policy. Accordingly, D&O policies exclude coverage for dishonest, fraudulent, malicious, and criminal acts committed by insured directors and officers.

### *"Final Adjudication" versus "In Fact" Wording*

There are two versions of the dishonesty exclusion in D&O policies. The first requires a "final adjudication" before it can be applied. This version is viewed as being more favorable to the insured because it implies that the claim has reached a definite conclusion (i.e., a settlement or a judgment).

The second version requires that the dishonesty be established "in fact," which sets up a lower standard of proof compared to the first version. This is because it does not specify that the claim has reached a final outcome.

In addition, there is a certain degree of ambiguity associated with "in fact" language compared to the "final adjudication" version of this exclusion. More specifically, if "in fact" means something less than a "final adjudication," how and when does the insurer establish the misconduct precluded by the exclusions occurred "in fact"?

- Upon testimony or document production during the discovery phase of litigation?
- Through facts uncovered by the insurer during its own investigation?
- At trial, where, arguably, facts are established for the first time through admitted evidence?

A final problem associated with "in fact" language is the question of who determines when dishonest conduct has "in fact" occurred? Although not specified in the policy language, one insurer that has used "in fact" wording for many years has in the past advised its policyholders that it would not unilaterally apply these exclusions. Rather, it would seek the intervention of a third party, such as an arbitrator, to decide whether the misconduct had "in fact" taken place.

In short, given these ambiguities, "final adjudication" wording is more favorable for the insured, compared to "in fact" wording, and should always be preferred when comparing the wording of the dishonesty exclusion. And for this reason, "in fact" wording is rarely found in policies that have been issued within the past 5 years.

### *Coverage for Defense*

By inference, the wording of the dishonesty exclusion indicates that the D&O policy covers the cost of a successful defense against charges of dishonest conduct on the part of a director or officer. In addition, defense coverage is available if a settlement is made without admission of liability (which is typically the case in settlement agreement language). The availability of defense coverage in these instances is critical because the majority of claim allegations made against insured directors and officers contain specific charges that dishonest conduct was responsible for causing a loss.

### *"Final Adjudication" Wording in Conduct Exclusions May Not Always Be Advantageous*

Traditionally, and as already discussed, "final adjudication" wording is considered preferable for the insured. But in recent years, the supposedly insured-friendly "final adjudication" wording has, in some cases, had the opposite effect. Former Enron CFO Andrew Fastow pleaded guilty in criminal proceedings associated with Enron's bankruptcy. Yet since the Enron D&O policy forms were written on a "final adjudication" basis, the insurer continued to defend Mr. Fastow against civil lawsuits because his conduct still had not been subject to "final adjudication." This was because although Mr. Fastow had pleaded guilty to criminal charges, he had not yet been sentenced and, until that time, could still change his plea. But by continuing to defend Mr. Fastow, other far less culpable directors and officers had their remaining policy limits depleted.

The solution? Consider negotiating to have the conduct exclusions worded so that defense coverage continues until "final determination" rather than "final adjudication." "Final determination" still solves the problems associated with the finding "in fact" approach but also avoids the problem of having to wait until an actual criminal sentence is handed down before defense can be terminated.

Such a provision would have cut off defense funds for Mr. Fastow, while maintaining their availability for other, far-less-culpable insureds under Enron's policy.

## Personal Profit Exclusion

Another exposure considered to be uninsurable involves claims that directors or officers have gained illegal personal profit or advantage to which they were not legally entitled. For example, an outside director may also be the owner or major stockholder of a firm that is bidding on a contract proposal offered by the parent organization. If the director's company wins the bid because it was proven that the director was privy to the bids submitted by competitor firms, a claim of illegal personal profit could be made and if a lawsuit were filed as a result, the director would not have coverage.

### *"In Fact" Wording Is Preferable*

The most favorable versions of this exclusion state that coverage for illegal personal profit is excluded, but only if such profit was gained "in fact" by an insured. The implication is that defense coverage to allegations of personal profit is covered by the policy until it is factually established that the insured gained illegal personal profit.

#### Full Severability Usually—But Not Always—Applies to the Personal Profit Exclusion

In *TIG Specialty Ins. Co. v. Pinkmonkey.com, Inc.,* 375 F.3d 365 (5th Cir. 2004), the CEO personally profited from the wrongful sale of stock. However, the personal profit exclusion applied whenever "an insured" personally profited from the alleged wrongful conduct. The court held that, under such wording, coverage was precluded for all insureds, not just the culpable CEO. (It should be recognized that such severability language is unusual, although insurers do occasionally use it.)

On the other hand, had the exclusion been worded so that it applied only when "the insured" personally profited from wrongful conduct, it is likely that the court would have ruled differently, that except for the culpable CEO, coverage would apply to the other, "innocent" insureds. The lesson for insureds is that they should avoid severability language in conduct exclusions that precludes coverage when "an insured" is guilty of wrongful conduct. Instead, they should request language precluding coverage only when "the insured" has committed such acts. Language of this kind will then allow the severability provision to function as intended, whereby "innocent insureds" will not lose coverage.

## Illegal Payments and Gratuities Exclusion

This exclusion is sometimes called the "payments and commissions" exclusion. It excludes claims relating to the insured's receiving or making payments that are prohibited by law.

The exclusion originated as a result of the Foreign Corrupt Practices Act of 1977, which prohibits bribes, political contributions, gratuities, and other payments to foreign or domestic officials. The Act was passed as a result of SEC investigations in the mid-1970s. Ultimately, these investigations revealed that more than 400 U.S. corporations admitted making questionable or illegal payments in excess of $300 million to foreign government officials, politicians, and political parties. The abuses were widespread and included such acts as: bribery of high foreign officials to obtain various forms of favorable action or consideration by a foreign government, as well as so-called "facilitating payments," made to ensure that government officials performed certain accounting and bookkeeping duties that were essential to the completion of various business deals.

However, it should be emphasized that the exclusion prohibits coverage not only for illegal payments in conjunction with the Foreign Corrupt Practices Act of 1977, but as respects any other applicable laws.

The exclusion is not usually incorporated into the text of policy forms but appears with sufficient regularity as an endorsement to be deserving of special mention and is also normally subject to severability provisions. Thus, if a claim of having arranged illegal payments were made against five directors and officers, but only one had actually done so, defense coverage would apply to the four innocent insureds.

## Exclusion of Claims under Section 16(b) of the 1934 SEC Act ("Short Swing" Profits)

Profits made from the director or officer's personal sale of stock in his or her own company, if the stock has been held for less than 6 months (referred to as "short swing" profits), are prohibited by the Securities Exchange Act of 1934. Virtually all D&O policies exclude coverage of claims alleging violation of this rule. However, insurers usually provide coverage of defense costs when allegations of Securities Exchange Act of 1934 violations are successfully defended.

## Exclusions Relating to Certain Corporate Activities

Related to exclusions pertaining to "short swing" profits, are those sometimes imposed for other, specified corporate activities. In most instances, such exclusions find their way into policies by means of standard or manuscript endorsements, rather than via standard policy wording. However, in some unusual instances, these restrictions are also included within regular policy forms. Either way, they can eliminate coverage for significant D&O exposures. Following are several of the most important types of such exclusions.

### *Claims from Going Private/Leveraged Buyouts*

During periods of high private equity activity, such restrictions can easily find their way into D&O policies. This is especially true, since stockholders frequently allege conflicts of interest and self-dealing in claims associated with private buyouts. (Private equity firms purchase the shares and ultimately gain control of publicly held companies. The private equity group eventually resells the company at a later date, hopefully for a higher price per share than the one for which it was originally acquired on the public market.)

### *Claims from Mergers & Acquisitions*

Although these transactions do not involve a private buyout, they nevertheless create the distinct possibility that stockholders of the acquired firm will allege that they were insufficiently compensated for their shares by the acquiring firm as a part of the merger or acquisition.

### *Claims from Initial Public Offerings (IPOs)*

Claims associated with IPOs are most often made by purchasers of the newly-public shares who assert that the offering prospectus did not present a true picture of the company. Accordingly, D&O forms written for private companies (which are discussed later in this course) should be checked carefully for any restrictions or exclusions relating to claims from IPOs, since, during a policy period but well after having signed an application for coverage indicating no plan to do so, the company could decide to float a public offering of its shares.

### *Claims from Joint Ventures or Partnerships*

At times, corporations will operate a joint venture or partnership with another organization for a short-term, time-limited business purpose. Underwriters sometimes preclude coverage for joint ventures by means of "insured" definitions within their policy form. Accordingly, such definitions should be checked and consideration given to negotiating to include the joint venture or partnership as an insured under the policy.

Although additional premium may be required to remove these types of restrictions and exclusions, it may be well worth the cost, given the high claim potential inherent in such circumstances.

## Return of Remuneration Exclusion

Most D&O policy forms exclude coverage for monies paid to a director or officer without stockholders' approval. However, some D&O policies incorporate an important exception to this exclusion by making it apply only when remuneration has been held by a court to be illegal. If possible, the exclusion should contain wording to this effect, which would make defense coverage available until an allegation of illegal remuneration is actually proven.

### *Origins of the Return of Remuneration Exclusion*

Originally, the exclusion of illegal remuneration was not commonly found in D&O forms since, under SEC rules, the compensation paid to directors or officers was not subject to shareholder approval. However, concern about excessive compensation of management commencing in the early 1990s has prompted a change in SEC rules, which now permit greater shareholder involvement in the setting of compensation for top executives. Given the degree of controversy surrounding this topic, more claims alleging illegal remuneration can be expected in the coming years.

This, again, is an exclusion to which severability applies in almost all policies.

## Prior and Pending Litigation

Nearly all D&O policy forms exclude claims arising from litigation that was pending prior to the inception of the policy or was pending prior to the policy's "prior and pending litigation date" (a date which is normally included on the declarations page of the policy or added by endorsement). The intent of this exclusion is to avoid insuring the so-called "burning building," whereby the insurer must cover claims from events that were lacking in fortuity and that sometimes provide the incentive for an insured to obtain coverage.

### *How the Prior and Pending Litigation Exclusion Applies*

A prior and pending litigation exclusion would apply if litigation against a corporation—rather than individual directors and officers—was pending prior to the inception of a D&O policy. If the lawsuit is amended after inception of the policy, so that it now names the organization's directors and officers, the prior and pending litigation exclusion would preclude coverage for the amended version of the claim.

#### An Example

On July 1, 2008, a borrower whose home has been foreclosed on by XYZ Bank files a lawsuit alleging breach of contract against the bank. The suit alleges that the bank misrepresented the actual terms of the loan when the closing papers were signed, because the papers failed to state explicitly that after 2 years, the monthly payment would double. (Note that a breach of contract lawsuit against the bank would not be covered by a D&O policy because Coverage C, Entity Coverage, applies only to claims involving the securities of the insured corporation, in this example, shares of the bank’s stock.) On January 1, 2009, the borrower amends the lawsuit to also name the bank's directors and officers. (In contrast, this claim would be covered, because coverage applies under Coverages A or B, for any cause of action.) A week after receiving the suit papers, the directors and officers file the claim with their D&O insurer under their January 1, 2009–January 1, 2010 policy. However, if the bank's January 1, 2009–January 1, 2010 policy contained a prior and pending litigation exclusion, coverage will be denied since the claim arose out of a lawsuit that was pending prior to the inception of that policy (i.e., the “original” breach of contract lawsuit was filed on July 1, 2008.)

### Modifying the Prior and Pending Litigation Exclusion

Often, insurers will agree to modify the prior and pending litigation exclusion so that it only applies to litigation pending prior to the inception date of the present insurer's first D&O policy. Given this modification, any litigation originally initiated during the present insurer's stream of protection will not be excluded. This is a reasonably negotiable item and can usually be achieved without additional premium. This modification can be accomplished by having the policy's “prior and pending litigation date” be the same as the inception date of the current insurer's first D&O policy. Using the example in the above paragraph, if the insurer first began writing coverage for the insured on January 1, 2008 and the prior and pending litigation date on the policy was also January 1, 2008, the prior and pending litigation exclusion would not bar coverage for the claim, since the original litigation was not pending prior to January 1, 2008. On the other hand, if the prior and pending litigation date on the 1/1/09–10 policy described above was January 1, 2009, no coverage would have applied since the litigation actually began on July 1, 2008—a date preceding the January 1, 2009, prior and pending litigation date. As a general rule, from the insured’s standpoint, the prior and pending litigation date should be as early in time as possible.

### Removing the Exclusion in Renewal Policies

Insureds should also attempt to have the prior and pending litigation exclusion removed in renewal policies. The purpose of the exclusion is to avoid having the insurer cover situations that the insured knew or suspected would eventually result in a claim against the corporation's directors and officers. Accordingly, after the policy has been in force for a year, this possibility is greatly reduced, if such a claim has not yet been made. Thus, at the first renewal, the insured should request that the prior and pending litigation exclusion be removed.

## Exclusion of Losses Insured by a Prior Policy

Most D&O forms contain exclusions precluding coverage for claims that have already been reported under prior policies, written either by the current insurer or by a previous insurer. Such exclusions are necessary to prevent insureds from reporting a claim—for the second time—under current policies with higher limits or broader coverage provisions, than those in prior years, when claims were previously reported.

For example, an insured reported a claim during the term of Insurer A’s policy (1/1/10–11). The policy’s limit was $5 million. For the 1/1/11–12 term, the insured purchased a policy containing a $10 million limit, from Insurer B. This exclusion prevents the insured from obtaining coverage under a policy with a higher limit (i.e., $10 million), by reporting the same claim to Insurer B, if, for instance, the claim turned out to require more than Insurer A’s $5 million limit.

## Insured versus Insured Exclusion

Insured versus insured exclusions preclude coverage for claims made by one insured under a D&O policy, against another. An example of an insured versus insured claim (that would be excluded) is one in which corporate director "A" sues corporate director "B" because of a bad business proposition that "B" advised the company to pursue, such as urging the acquisition of a subsidiary that eventually produced a significant loss for the company.

### *Rationales for the Exclusion*

There are several rationales for the insured versus insured exclusion in D&O policy forms.

#### No Intent To Cover Recoupment for Bad Business Decisions

The insured versus insured exclusion was originally introduced in the 1980s, when Bank of America began suing a number of its loan officers for losses caused by imprudent extensions of credit. In response to these lawsuits, the officers then sought coverage under Bank of America's D&O liability policy. However, the bank's insurer did not intend for the policy to function as an indemnification vehicle for bad business decisions. (Insurers viewed such claims as affording coverage for "business risk," rather than for professional negligence). So in response, D&O insurers began inserting insured versus insured exclusions within their policy forms (a practice which was later extended to other kinds of professional and management liability policy forms).

#### Other, More "Specific" Insurance Coverage Available

Since many insureds also purchase stand-alone employment practices liability (EPL) coverage, D&O liability insurers feel that employment-related claims by one insured against another (which, for example, would preclude coverage if a CEO who is terminated, sues the other directors and officers) are more appropriately covered by stand-alone EPL policy forms.

#### No Coverage Intended for "Infighting"

Yet another rationale for not covering claims made by one insured person against another is that, at times, such lawsuits are the result of "infighting" by one insured against another. For example, in an attempt to force a director to resign because of a personality conflict, the other directors sue him for negligence, alleging that he does not contribute adequately at board meetings.

### *Key Exception Wording*

Despite the rationales for excluding claims by one insured against another, the policies contain "exception wording," which has the effect of providing coverage for certain kinds of claims in which one insured sues another insured. Under the following circumstances noted below, most but not all D&O policies "except," and therefore cover, the following claim situations.

#### Derivative Actions

These actions are brought by one or more stockholders, on behalf of the corporation. Any recovery in a derivative suit inures to the benefit of the corporation itself as opposed to the individual shareholders who institute the action (i.e., the proceeds of a successful derivative suit are paid to the corporation). If, for example, a director or officer were to bring a derivative suit, the insured versus insured exclusion would not apply to the claim and coverage for the claim would be available.

### Employment-Related Claims

Claims by one director/officer against another are not excluded if they involve employment-related matters. For example, an officer of a corporation sues the other officers and directors, alleging that he was wrongfully terminated. When an insured purchases the employment practices liability coverage endorsement, discussed later in this chapter, this exception wording must be added to the policy—if it is not already included—to preserve the protection that is intended to be provided by the endorsement. On the other hand, if an insured has purchased a stand-alone employment practices liability policy, the lack of exception wording as it would pertain to lawsuits by one insured director/officer against another (and consequent lack of coverage for such suits under the D&O policy), is not a problem. This is because coverage for these claims would be available under the stand-alone employment practices liability policy.

### Claims for Contribution or Indemnity

This refers to a situation where one director or officer is sued and then, by means of another lawsuit, attempts to have other directors and officers contribute monies for his defense and/or payment of the claim. Coverage for these types of situations are excepted by most versions of the insured versus insured exclusion.

### Claims by Bankruptcy Trustees

In recent years, bankruptcy trustees have made numerous claims against directors and officers. Bankruptcy trustees should not be considered to be insureds under D&O policies and therefore, most policy forms cover such claims by “excepting” them from the insured versus insured exclusion.

### Claims by Past Insureds

This refers to claims made by persons who have not served as a director or officer for a period of at least 5 years (provided they are not bringing the claim with the assistance of, or at the urging of a person who is currently serving as a director or officer). Given the 5 year time lapse, such claims are rarely motivated by either collusion or by infighting and are therefore excepted from the insured versus insured exclusion.

### Claims Brought Outside the United States

The most frequent situation in which this exception applies, and coverage is afforded, would be a claim brought by a director or officer of a foreign subsidiary and filed outside the United States against the company's U.S. directors and officers.

## Failure to Maintain Insurance

A number of D&O policies contain an exclusion of claims alleging loss due to the failure of directors and officers to maintain property and liability insurance coverage. The following scenario illustrates the way in which a “failure to maintain insurance” exclusion could come into play in a claim situation. Assume that an organization with a large insured property schedule either has inadvertently omitted an individual property from the schedule or perhaps does not have the correct scope of property insurance coverage on this singular location (e.g., there is no coverage for flood on a given manufacturing plant). The property suffers damage and is not insured, resulting in financial loss to the organization. This loss leads to litigation alleging director/officer negligence in managing the corporation's insurance program. If the D&O policy contained a failure to maintain insurance exclusion, the D&O insurer would be likely to deny the claim. In fact, taken literally, the D&O

insurer could deny almost any claim for which there would be insurance available, somewhere, and at some price. (And are most exposures not at least somewhat insurable somewhere and for some price?) The vagueness of the language of the exclusion, accompanied by the eagerness of many D&O insurers to deny claims, are reasons for concern regarding this language.

### *Katrina Disaster Underscores the Dangers of Failure To Insure Exclusions*

If there were ever a time when an insured would not want a failure to maintain insurance exclusion in a D&O policy, it would be in the aftermath of a natural disaster such as Hurricane Katrina. Firms with substantial operations in the affected area were almost certain to suffer considerable property damage and business interruption losses—even if insurance coverage was in place—given deductibles/retentions, coinsurance provisions, and valuation clauses that produce less than full replacement cost recoveries.

But for any firms that lacked flood coverage or had inadequate or no property and/or business income policies at the time of the hurricane, lawsuits by investors could allege managerial negligence in failing to obtain appropriate coverage. Under these circumstances, a failure to maintain insurance exclusion in a D&O form could prove problematic.

### *Removing the Exclusion*

Given the problems this exclusion could generate, insureds should present the D&O insurer with a complete schedule of insurance coverage, along with a discussion of the corporation's risk management program. Based on this material, the insured will be in a better position to negotiate the removal of the exclusion.

### *Terrorism and the Failure To Maintain Insurance Exclusion*

Within the past several years, coverage for terrorism has become available under commercial general liability (CGL) and property insurance policies. Regrettably, many insureds have received premium quotations for such coverage that range from high to prohibitively high. Faced with this situation, corporate risk managers are making well-researched, carefully-reasoned decisions not to purchase terrorism coverage. But should such companies suffer an uninsured terrorism loss, lawsuits alleging that directors and officers were negligent in failing to purchase coverage may result.

In an effort to prevent these problems, if the failure to maintain insurance exclusion cannot be removed, the insured should request that it be modified so there is an exception for claims alleging negligent failure to buy coverage for terrorism. (However, such an exception would still not prevent an insurer from denying coverage for failure to buy any other types of insurance coverage.)

### *Exclusions for Insurance-Related Operations*

A few versions of the failure to maintain insurance exclusion also contain restrictions on claims involving the insured's involvement with risk-bearing operations such as captive insurance companies and risk retention groups. Both for-profit and nonprofit organizations sometimes band together with firms in similar industries and form such risk-bearing entities. Separate coverage is required to provide coverage for such operations.

## Wage and Hour Claims Exclusion

Some D&O policies exclude coverage for wage and hour claims. Such claims most commonly arise from an employer's alleged failure to pay overtime to what should have been treated as nonexempt employees. All employees are either "exempt" or "nonexempt." Although those terms have many implications, the most important is that exempt employees (e.g., professional staff employed on a salaried basis) need not be paid overtime. Wage and hour claims most often occur when an employee complains about not getting paid overtime to an attorney who then, after the interview, realizes that he may have a six-figure class action claim on his hands.

The exclusion of wage and hour claims first became an issue of urgent concern on July 10, 2001, when a California jury returned a $91 million verdict against a company (Farmers Insurance) that had improperly classified its claims adjusters as exempt. Numerous high-dollar settlements against a number of national companies, including Rite Aid ($25 million), U-Haul ($7.5 million), and Taco Bell ($13 million), have since followed. More recently, Staples paid $38 million—more than $22,000 to each "assistant manager" who allegedly was misclassified as an exempt employee under overtime laws.

There is an overtime exemption for executive, administrative, professional, and outside sales employees under the Fair Labor Standards Act (FLSA) and most state guidelines. To be exempt, these employees must meet certain tests regarding job duties and responsibilities and be compensated "on a salary basis" at not less than stated amounts. However, such tests are often confusing. Indeed, the issue of who is an "exempt" employee is not always clear-cut.

### *Modifying the Exclusion*

Although there is not much an insured can do about the standard wage and hour exclusion, wording should be requested that modifies the exclusion so that it does not apply to claims associated with the federal Equal Pay Act of 1963. This law, which prohibits sex-based discrimination in determining the wages of male and female employees, mandates equal pay for both sexes when work involves equal levels of skill, effort, and responsibility and does not involve the types of wage and hour claims already discussed. However, absent a clarifying endorsement to this effect, an insurer could stretch the intended scope of this exclusion so that it extends beyond prohibiting merely a garden-variety wage and hour claim.

### *Favorable Exception Wording*

One final point is that many versions of this exclusion "except" and therefore provide defense coverage for allegations that a corporation or its directors and officers have conspired to violate wage and hour laws, which is favorable for the insured.

The exception also applies to, and therefore covers, both defense and indemnity costs associated with wage and hour claims, if such claims fall within the purview of Side A (i.e., directors and officers liability) coverage.

## ERISA Liability Exclusion

Claims are excluded under a D&O policy if they are based on a director's or officer's responsibilities as a fiduciary as defined in the federal Employee Retirement Income Security Act (ERISA) of 1974 or similar laws. ERISA and other liability exposures associated with administration of corporate pension plans, profit sharing, and employee benefit programs are insurable under separate fiduciary liability policies (discussed in a separate course within this series). Certain variations of this exclusion also preclude coverage for benefits due under a number of federal, state, and local labor-related statutes such as the National Labor Relations Act, the Fair Labor Standards Act, the Worker Adjustment and Retraining Notification Act, and others.

## Bodily Injury/Property Damage/Personal Injury Exclusion

Claims alleging the following are excluded under almost all D&O policy forms.

- Bodily injury (including sickness, disease, and death)
- Damage to or loss of use of tangible property
- Libel or slander
- Emotional distress
- Other common personal injury perils (i.e., false arrest, assault)

The purpose of the bodily injury/property damage liability/personal injury exclusion in D&O forms is to avoid an overlap in coverage between an insured's D&O policy and its commercial general liability (CGL) policy.

### *Two Key Variations of the BI/PD/PI Exclusion*

There are, however, two distinct versions of this exclusion. Preferably, the exclusion should be worded so that it applies only to claims "for bodily injury and property damage" and not "to claims *based upon, arising out of, or in any way related to* bodily injury or property damage."

The latter, "based upon, arising out of, or in any way related to" version should be avoided. This is because such wording could eliminate coverage not only for claims by persons suffering bodily injury or property damage (a CGL exposure), but also with respect to secondary claims by stockholders who sustain financial loss resulting from the bodily injury or property damage of others (e.g., shareholders in an oil company suffer financial losses when a major refinery is blown up by terrorists). Such secondary claims are not covered under a commercial general liability policy, thus creating a gap in coverage if this wording is included.

### *BI/PD/PI Exclusionary Wording and Its Effect on Terrorism*

D&O insurers have not added terrorism exclusions to D&O forms. Nevertheless, a bodily injury/property damage exclusion using the "based upon, arising out of, or in any way related to" wording could also have the unintentional effect of precluding coverage for acts of terrorism that cause financial loss (e.g., terrorists destroy a manufacturing plant, causing loss of revenues and a consequent drop in a corporation's share price). This example provides yet another reason to avoid the "based upon, arising out of, or in any way related to" wording of the BI/PD exclusion, if possible.

### *Exception Wording When a D&O Policy Covers Employment Practices*

When a D&O policy contains an employment practices liability coverage endorsement, there should be "exception" wording within this exclusion, so that coverage will apply for libel, slander, emotional distress, and other common personal injury perils. Such an exception is necessary because these types of allegations are often made in conjunction with employment-related claims of wrongful termination, discrimination, retaliation, and sexual harassment.

### *Exclusion of "Intentional Torts" and/or "Personal Injury"*

Similar to the exclusion of bodily injury or property damage discussed above, this exclusion relates to "personal injury" or "intentional torts." At one time, D&O policies usually excluded only libel or slander, in this class of torts. But as more insureds have acquired broad personal injury protection in their basic insurance portfolios, via commercial general liability (CGL) and employment practices liability (EPL) policies, this exclusion has usually been expanded because these other policies will respond to such claims. In many D&O policies, the "intentional torts" exclusion is attached to the "bodily injury and property damage liability" exclusion, as a clause of that exclusion rather than having a separate identity, adding "invasion of privacy," "wrongful entry," "eviction," "false arrest," "false imprisonment," "malicious prosecution," "libel," and "slander," as excluded perils within the bodily injury/property damage exclusion. This exclusion should be removed if the policy is written with an EPLI coverage endorsement and the general D&O exclusions also apply to the endorsement, since the intention of the EPLI endorsement is to cover such claims.

## Pollution Exclusion

Most pollution exclusions in D&O forms are highly restrictive and exclude coverage for all forms of pollution. (A recent decision by the 11th U.S. Circuit Court of Appeals held that the pollution exclusion applied, and no coverage was available, even though the insured did not cause the pollution giving rise to a claim.) In addition to property damage and bodily injury caused by pollution, the policies also preclude coverage for cleanup costs involving a pollution loss. It also eliminates coverage for penalties that might be levied against directors and officers. Such penalties could be applied when their decisions result in either a violation of federal, state, or other environmental protection statutes. Or, these penalties might be levied in a common law action based on something other than bodily injury or property damage, such as tort actions alleging nuisance or trespass.

### *"Based Upon, Arising Out of, Related to" Wording versus "For" Wording*

It should also be pointed out that, like the BI/PD exclusion (discussed above), a number insurers use language that excludes coverage "for" pollution, rather than excluding claims "based upon, arising out of, directly or indirectly resulting from, or in consequence of" pollution. For the same reasons, "for" language is preferable for the insured and should be included, where possible.

## Chapter 9 Review Questions

1. As with other insurance policies, exclusions in a D&O insurance contract commonly appear in all the following places, *except:*
   a. the application.
   b. the conditions.
   c. the definitions.
   d. the endorsement.
2. Although Chopped Sewage Company's D&O policy excludes coverage for intentionally committed illegal acts, questions remained as to whether the acts of Sam, the officer accused of a wrongful act, were intentional. Because the D&O policy's dishonesty exclusion contains final adjudication wording, which of the following describes the earliest point at which the insurer can deny coverage for Sam based on the exclusion?
   a. A document produced during the discovery phase suggests Sam intended to commit fraud.
   b. An appeals court upholds the trial court's finding that Sam intentionally committed a crime.
   c. At Sam's trial, the plaintiff introduces evidence establishing the facts.
   d. The insurer's investigation uncovers a witness to a conversation in which Sam described his plans to commit the fraudulent act.
3. Missing Lynx Company's D&O policy excludes coverage whenever "an insured" personally profits from the alleged wrongful conduct. From the standpoint of an insured, the major problem with this wording is that:
   a. it conflicts with the severability provision and creates an ambiguity.
   b. it precludes coverage for all insureds, even those who are not culpable.
   c. the exclusion fails to clarify who is an insured.
   d. the party that profits from the alleged conduct is the party that needs the coverage.
4. Exceptions to the insured versus insured exclusion in a D&O policy normally provide coverage for all of the following situations, *except:*
   a. A bankruptcy trustee sues corporate directors and officers.
   b. A director seeks indemnification from another director for expenses resulting from a lawsuit against the first director.
   c. A former director, who left the board ten years ago but is still a major stockholder, sues current directors.
   d. A corporation sues its officers for making bad decisions.

5. Noah Sark Ferry Corporation stock became worthless when passengers' injury and death claims exceeded corporate assets after the ferry capsized during a storm. The ferry and vehicles aboard the ferry were also destroyed. Shareholders sued corporate president and boat captain Noah Sark for a wrongful act arising out of bad management, alleging that the boat should not have been sailing when a severe storm was predicted. The corporation's D&O policy precludes coverage for claims based upon, arising out of, or in any way related to bodily injury or property damage." In this case, the D&O claim:
   a. is covered because it alleges a wrongful act that is not related to bodily injury or property damage
   b. is covered because it is based on the stockholders' emotional distress.
   c. is not covered because it is related to the bodily injury to passengers and the property damage to their vehicles
   d. is not covered because devaluation of corporate stock is a form of property damage

## *Answers to Chapter 9 Review Questions*

1. a. Exclusions and/or other options may be selected in an application, but they become effective when they appear as part of the contract language.
2. b. The earliest point at which the insurer can deny coverage for Sam based on the exclusion is when the final adjudication verdict establishes Sam's intent as a legal fact.
3. b. Courts have held that such wording precludes coverage for all insureds, not just the culpable one
4. d. The D&O policy does not intend to protect a corporation against bad business decisions.
5. c. The D&O claim is not covered because this secondary claim is clearly related to the bodily injury/property damage claim.

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# Chapter 10
# Coverage Triggers in D&O Policies

Chapter 10 explains the nature of D&O policy coverage triggers. It begins by discussing how they function and also describes the key terms associated with claims-made coverage triggers (i.e., retroactive dates, discovery provisions, and extended reporting provisions).

## Operation of Claims-Made Coverage Triggers

Virtually all of the major insurers' policy forms are written on a claims-made basis. To be covered under a claims-made policy, a claim must be:

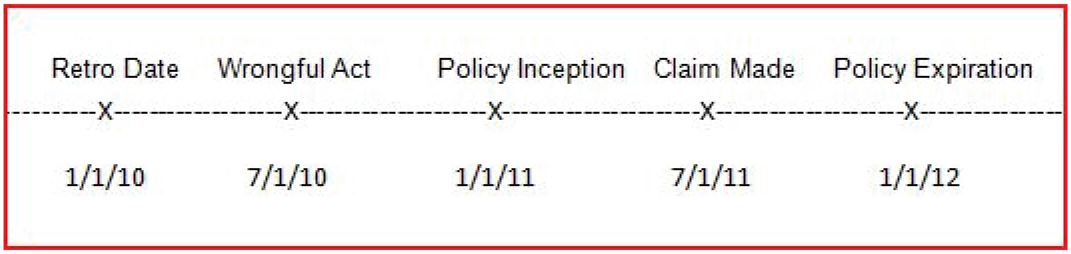
1. *first made* against an insured during the policy period,
2. result from a wrongful act that took place on or after the policy's *retroactive date*, and be
3. *reported to the insurer*, prior to the expiration of the policy (or within 30 to 60 days following expiration).

The italicized terms will be explained in the pages that follow.

Operation of a claims-made coverage trigger is illustrated in Exhibit 10.1

**Exhibit 10.1**
**How a Claims-Made Policy Functions**

**Policy Period: 1/1/11–1/1/12**
**Retro Date: 1/1/10**
**Wrongful Act: 7/1/10**
**Claim Made: 7/1/11**




In this example, coverage applies because: (1) the claim was first made against the insured during the 1/1/11–12 policy period, (2) the wrongful act took place after the policy's 1/1/10 retroactive date, and (3) the claim was reported to the insurer prior to policy expiration. Had the wrongful act taken place prior to the policy's 1/1/10 retroactive date, coverage would not have applied. Similarly, there would have been no coverage, had the claim been made against the insured prior to 1/1/11 or after 1/1/12.

### *The Significance of "First Made" Language*

Use of the term "first made" is significant because it indicates that coverage will apply only when the claim has not previously been made in conjunction with: (1) a policy prior in time written by the current insurer or (2) made under a policy written by a different insurer, covering the insured prior to the current insurer.

### *Claims-Made and Reported Policies*

Under a minority of D&O policies, coverage applies only if the claim is both first made against the insured and reported to the insurer during the policy period. This is known as a "claims-made and reported" policy. For example, under such a policy with a 1/1/10–11 term, no coverage would apply unless a claim was both made against the insured during the policy period and also reported to the insurer prior to 1/1/11.

### Claims-Made Policies and Reported Policies with Post-Policy Reporting "Windows"

In contrast, a majority of forms provide what are known as post-policy claim reporting "windows," under which claims made against the insured during the policy period can be reported to the insurer for either 30 or 60 days (depending upon the insurer) after expiration of the policy.

D&O forms containing post-policy reporting "windows" are preferable to claims-made and reported policies. This is because some circumstances could render it impossible for an insured to report a claim made late in a policy period. For example, if a summons is delivered to an insured CEO's office late in the day that a policy expires, the insured may be unable to notify the insurer within the policy period. This case may be especially true if he or she is not in the office that day or if the summons were served late in the day at the start of a long, holiday weekend, as a result of which the insurer's office had closed earlier than usual. Under such circumstances, a claims-made policy that contains a

30-day or, preferably for the insured, a 60-day post-policy reporting window is advantageous compared to a claims-made and reported policy because it allows an insured to report a claim to the insurer after the term of coverage has expired.

## Retroactive Dates

Retroactive dates in D&O liability policies state that for coverage to apply, the wrongful act giving rise to a claim must have taken place on or after the retroactive date. Thus, retroactive dates preclude coverage for claims stemming from acts that took place prior to a policy's retroactive date.

### *Purposes of Retroactive Dates*

Retroactive dates have the effect of excluding coverage for possible wrongful acts committed in conjunction with some known event (i.e., known to the insured) that took place prior to policy inception. They also preclude coverage for wrongful acts that transpired in the distant past—even if unknown to the insured.

Retroactive dates are generally included in D&O liability policies for organizations that are buying coverage for the first time. This is because underwriters are reluctant to offer "full prior acts coverage" (i.e., policies without retroactive dates) under such circumstances. Their concern is that the insured's sudden desire to obtain a policy may have been prompted by the need to obtain coverage for circumstances they suspect could produce a claim in the future. For example, if a lawyer began practicing on 1/1/00 but did not seek to buy professional liability coverage until 1/1/10, an underwriter could have the impression that the lawyer expects a claim to be made against him shortly, since he practiced for 10 years without purchasing professional liability coverage.

### *"Full Prior Acts": Coverage without a Retroactive Date*

However, for a firm that already has a D&O policy in place with another insurer, inclusion of a retroactive date should be resisted unless there is a specific underwriting reason, such as a complete change in the company's operating management and board of directors. By eliminating a retroactive date, a policy will provide what is known as "full prior acts coverage" for all acts, going back to when the organization was founded/incepted.

#### Retro Date Should Be No Earlier than the Insured's First D&O Policy Inception

Ideally, an insured will have a policy written with full prior acts (i.e., no retroactive date) coverage. But at very least, an insured should always require an insurer to offer a policy with a retroactive date that coincides with the date on which it first began buying D&O coverage (known as "prior acts" coverage) , even if that date precedes the date on which its current insurer first began writing coverage. If an insured's retroactive date does not coincide with the date on which it first began buying coverage, a coverage gap will result since there will be no coverage for wrongful acts that took place between the inception date of the insured's first D&O policy ever purchased and the retroactive date of the new insurer's policy.

### *Always Resist Retroactive Date Advancements When Replacing Coverage*

At times, underwriters seek an "advanced" retroactive date when writing coverage for a new account. This has the effect of limiting the coverage they are willing to provide, to the start of the period of time this new insurer will be on the account. This approach is detrimental for an insured because it provides no coverage for acts that took place from the inception date of its first policy and the inception date of the new insurer's policy. Accordingly, D&O insureds and their agents/brokers should always resist such advancements, even if additional premium is required to achieve “prior acts” coverage.

### *Options Backdating Claims Illustrate the Importance of Retroactive Dates*

The wave of option backdating claims that surfaced in the summer of 2006 illustrate the potential problems that can result from retroactive dates in D&O policies. (Option backdating occurs when a stock option exercise date is set prior to the date on which the option was granted and at a lower exercise price than the current market price of the company’s stock. Directors and officers are frequently compensated by means of option grants, in addition to salary.) Option backdating is not illegal, provided the backdating is clearly communicated to stockholders and as long as the effect of the backdating is properly reflected in both earnings reports and in tax payments. However, in recent years, there have been a number of lawsuits against corporate directors and officers alleging illegal option backdating in which these conditions were not met.

Many of these claims related to option grants that were made during the mid-to-late 1990s, in some cases as many as 10 years earlier. So unless the retroactive date on an insured corporation's current D&O policy form—the one under which an options backdating claim was being made—is earlier in time than the alleged wrongful acts associated with these options grants, no coverage will be available.

For example, assume that improper options grants (i.e., the “wrongful acts”) were alleged to have been made in 1997. Unless the insured's current D&O policy contains a retroactive date of 1/1/97 (or earlier), no coverage would apply, despite the fact that the claim was made against the insured during the term of the policy presently in force.

As these circumstances illustrate, retroactive dates present potential coverage problems because D&O claims have a way of “popping up” despite the fact that the alleged wrongful conduct giving rise to the claim took place many years earlier, as was the case with these option backdating claims.

### *Retroactive Date Issues in Policies for IPOs*

One error is often made when structuring D&O coverage for companies making initial public offerings (IPOs) of its shares of stock to the public. Specifically, policies for such companies are sometimes written with a retroactive date coinciding with the date on which the company first began selling shares to the public. This is normally the date on which such firms are considered “public companies.” There are two coverage gaps created under this scenario.

#### No Coverage for Operations Prior to the IPO

First, by setting the retro date as the date on which the company begins selling shares to the public, it eliminates coverage for any claims that resulted from acts committed prior to that time. Few companies begin as publicly-traded firms. More typically, they first achieve success as privately-held companies and then, some years later, begin selling shares to the public, most often, given the firm’s need to raise capital so it can expand its already-successful operations.

#### No Coverage for Prospectus-Related Claims

Second, by setting a retroactive date coincident with the date on which it begins selling shares to the public, it will eliminate coverage for claims relating to the firm’s prospectus. (A prospectus provides details about the company’s history and operations, includes detailed financial data, and is intended to serve as an inducement for people to buy shares of stock in the company.) This is because an IPO offering prospectus is always prepared prior to the date on which shares are offered. Thus, any alleged wrongful act associated with the prospectus (i.e., allegations by investors that the prospectus misrepresented the company's financial condition), would have necessarily taken place prior to the retro date and, as a result, would not be covered. Admittedly, a retro date coincident with the date on which the firm went public will produce a lower premium compared, for example, to one coinciding with its inception. However, given the relatively high risk associated with IPOs, any premium savings achieved in this manner are probably not worth it.

Accordingly, if a company begins offering shares to the public, and as a result, seeks to buy D&O coverage for the first time, the policy's retroactive date should coincide with the date on which the firm initially "opened its doors," even if this was a number of years prior to becoming or beginning the process of becoming a public corporation.

## Discovery Provisions

Circumstances often arise under which it is probable that an act, error, or omission will eventually cause a claim to be made against insured directors/officers—despite the fact that litigation may not be initiated for some time. Accordingly, virtually all D&O policies provide, by means of what are called "discovery provisions" (also known as "incident reporting provisions" or "notice of potential claim provisions"), that if the insured advises the insurer of "incidents" or "potential claims" during the policy, any claims arising out of such "incidents" will be considered to have been "made" during that policy period. For example, a corporation announces that it did not meet its quarterly earnings target and as a result, receives negative commentary in the financial press. During the next week, the company's share price drops by 20 percent. This chain of events could be considered an "incident," reportable under a D&O policy's discovery provision. While no claims have yet been received, there is a strong possibility that shareholder class action lawsuits, will follow.

When such notice is provided to the insurer, coverage for these claims will apply regardless of how long after the policy under which they were reported has expired. Exhibit 10.2 illustrates the operation of a discovery provision.

**Exhibit 10.2**
**How a Discovery Provision Functions**

```
Policy Term: 1/1/10–11

Retro date    incident     8/1/10                          claim made
----------X-------------*-------------*--------------X----------------------*-------------------X-------
       1/1/10        7/1/10      insurer        1/1/11              7/1/11             1/1/12
                                 notified
```

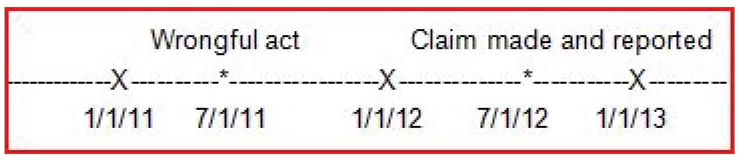
In this example, coverage applies because the insurer was notified by the insured of an "incident" on 8/1/10. Although the claim associated with the incident was not made against the insured until after the 1/1/10–11 policy had expired, coverage applies nonetheless because the insurer was notified of the incident under the policy's discovery provision.

## Extended Reporting Provisions

Extended reporting periods (ERPs), which are also known as extended discovery or "tail" provisions and are included in D&O policies, give an insured the right to present claims after a policy has expired or been canceled. Exhibit 10.3 illustrates how an ERP provision functions.

**Exhibit 10.3**
**How an Extended Reporting Period Functions**

**Insurer A's Policy Term: 1/1/11-12**
**Insured buys an ERP from Insurer A, with a term of 1/1/12-13**
**Wrongful Act: 7/1/11**
**Claim Made and Reported: 7/1/12**




Coverage applies under the ERP because the wrongful act took place during Insurer A's 1/1/11–12 policy term *and* a claim associated with the act was made and reported during the term of Insurer A's 1/1/12–13 ERP. One final, key point regarding ERPs: no coverage would have applied in this example if *both* the wrongful act took place *and* the claim were reported during the 1/1/12–13 ERP period. Rather, the wrongful act must take place during the expired\cancelled policy period for coverage to apply during the ERP.

### *ERPs Do Not Reinstate Remaining Policy Limits*

ERPs do not, however, increase or reinstate the policy's limit of liability. Thus, coverage during an extended reporting period is always subject to available remaining limits. In some instances, especially where one or more significant claims are pending under an expiring policy, insurers will, at times, make additional limits available under an ERP provision. However, reinstatement of this type will almost always require substantial additional premium, over and above the scale provided for in the policy, and as discussed below.

### *No Coverage for Wrongful Acts during the ERP*

Nor do ERPs cover claims from wrongful acts that took place during the ERP. In effect, they only extend the time period during which wrongful acts that took place during the expired (or in some instances, canceled policy), can be reported to the insurer. Rather, for coverage to apply under an extended reporting period, the alleged wrongful act giving rise to the claim must have taken place on or after the retroactive date, if any, of the policy and before the policy's termination date. Thus, ERPs do not afford coverage for an act or omission that took place during the extended reporting period itself, in spite of the fact that such a claim is reported during the extended reporting period.

### *Discovery Provisions versus ERPs*

Although these two provisions are often confused, the difference is straightforward. Discovery provisions allow insureds to obtain coverage for incidents that are reported during the policy period. In contrast, ERPs provide coverage for claims that are reported after a policy period has expired.

### *Key Variations between ERP Provisions*

There are several important variations between the key provisions associated with ERPs as they are written by the different D&O insurers. These differences are described in the following paragraphs.

#### Availability

The vast majority of D&O forms permit the insured to purchase an ERP if cancellation/nonrenewal is at the insured's or the insurer's election. This is known as a two-way or bilateral tail. A few provide this option only in the event that cancellation/nonrenewal is initiated by the insurer, termed a one-way tail. Clearly, D&O policy forms that contain bilateral ERPs are preferable to those offering only a one-way tail provision. The latter should be vigorously resisted when negotiating coverage with an insurer.

#### Coverage for "Notice of Circumstances" during ERP

A key variation between the ERPs in D&O forms is whether a report of circumstances that have the potential—but have not yet resulted in a formal claim against the insured—are covered by an ERP. In effect, under some insurers' ERP wording, the policy's discovery provision (discussed earlier in this section) is operative, whereas in others, it is not.

Case in point: A D&O policy expires on January 1, 2010, at which time the insured firm buys a 1-year ERP. On August 1, 2010, the insured firm becomes aware of circumstances (from a wrongful act that took place during the expired policy) that could potentially materialize into a formal claim, but have not yet. Under some insurers' policies, the report of such circumstances would trigger coverage. However, under other insurers' ERP wording, no coverage would apply until the insured has a formal claim made against it, even if these circumstances are reported to the insurer during the ERP.

Given the situation in the above scenario, the insured would be compelled to purchase (if available) another ERP at the expiration of the current ERP, if the potential claim had not yet been made against the firm, but was expected at some point. In this situation, the advantage of having a policy's discovery provision that is operative during the ERP provision, is apparent.

#### Duration

In most instances, D&O insurers offer ERPs of 1 year in duration, although in some cases, ERP durations of longer durations are offered, as well. Multiple duration options (e.g. 1 year, 2 years, 3 years) are often available under D&O policies written for privately held and nonprofit organizations. However, publicly traded companies are rarely allowed anything other than a 1-year option.

#### Premium Charge

In nearly all instances, the policies state the premium charge for the ERP option. This is typically done by indicating that the ERP will cost a fixed percentage of the expiring policy's premium; normally 100 to 200 percent, depending upon the individual policy, for a 1-year ERP.

#### Time in Which To Elect

The majority of D&O policies allow the insured up to 30 days following nonrenewal, expiration, or cancellation to purchase the ERP. A few allow as long as 60 days in which to make this election, which is, of course, preferable since it is beneficial to maximize the time period in which the insured can make this election.

### *Runoff Policies*

As an alternative to an ERP, there are certain circumstances under which insureds should consider purchasing a runoff policy.

#### Runoff Policies versus ERPs

Like ERPs, runoff policies also permit an insured to report claims (that resulted from wrongful acts taking place during prior policy periods) for a specified period of time in the future. In contrast, the use of runoff policies is typically restricted to situations in which an insured merges with or is acquired by another organization, rather than when the insured replaces coverage with another insurer, as is usually the case when an ERP is purchased. Like ERPs, runoff policies are usually offered on a 1-year basis. However, unlike, ERPs, they are usually offered on a renewable basis, with a decreasing premium for each subsequent 1-year renewal period.

## Chapter 10 Review Questions

1. To be covered by a claims-made D&O insurance policy, a claim must meet all of the following criteria, *except:*
    a. first made against an insured during the policy period.
    b. result from a wrongful act during the policy period.
    c. be reported to the insurer prior to the policy's expiration (or within 30 to 60 days following expiration.
    d. result from a wrongful act on or after the retroactive date.
2. Under a D&O policy with a post-policy reporting window, a claim first reported to the insurer after the policy period ends:
    a. is covered if it is reported while a 30- or 60-day post-policy reporting window is open.
    b. is covered if it is reported while a 30- or 60-day post-policy reporting window is closed.
    c. is covered if the wrongful act takes place within a 30 or 60 days of the policy period.
    d. is never covered.
3. The provisions in a D&O policy that give the insured a right to present claims after a policy has terminated are referred to in several ways. These include all of the following, *except:*
    a. extended discovery provisions.
    b. extended reporting periods.
    c. nose coverage.
    d. tail provisions.

4. Claims would be covered under a D&O policy with an extended reporting period (ERP) for an alleged wrongful act that occurred:
   a. after the policy's termination date but during the ERP.
   b. after the retroactive date and before the policy's termination date.
   c. after the retroactive date and during the ERP.
   d. before the retroactive date.
5. As regards the decision whether to purchase coverage for an optional extended reporting period (ERP), a typical D&O policy:
   a. permits the insured to activate ERP coverage during a 1-year period following the policy's termination.
   b. stipulates the premium that will be charged and requires the insured to declare during the policy period its intention to purchase or forgo ERP coverage.
   c. stipulates the premium that will be charged and the time period following nonrenewal, expiration, or cancellation during which the ERP may be elected.
   d. stipulates the time period following nonrenewal, expiration, or cancellation during which the insurer must quote the ERP premium and the insured may elect whether to purchase the ERP.

### *Answers to Chapter 10 Review Questions*

1. b. The alleged wrongful act need not take place during the policy period so long as other criteria are met.
2. a. Claims made against the insured during the policy period can be reported to the insurer for either 30 or 60 days (depending upon the insurer) after expiration of the policy.
3. c. Coverage attached to the back end of the policy term is sometimes referred to as tail coverage. As a metaphorical contrast, retroactive dates or other appendages at the front end of the policy period are occasionally referred to as nose provisions.
4. b. Coverage applies to wrongful acts that took place on or after the policy's retroactive date and before the policy's termination date.
5. c. Nearly all policies indicate the specific ERP option's premium charge as a fixed percentage of the expiring policy's premium and allow the insured 30 (sometimes 60) days to elect coverage.

# Chapter 11
# Excess D&O Insurance Policies

Chapter 11 explains the nature and function of excess D&O policies.

Excess D&O policies are used in situations when an insured requires higher limits than any single D&O insurer may be willing to provide. In such situations, insureds obtain a primary D&O policy and then proceed to build excess "layers" of coverage above the primary policy, until a sufficient limit has been obtained. A layered D&O program is illustrated in Exhibit 11.1.

**Exhibit 11.1**
**A Layered D&O Program**

| Layer | | Insurer |
|---|---|---|
| $10 | million primary policy | A |
| $25 | million 1st excess layer ($25 million excess of $10 million) | B |
| $25 | million 2nd excess layer ($25 million excess of $35 million) | C |
| $25 | million 3rd excess layer ($25 million excess of $60 million) | D |
| $15 | million 4th excess layer ($15 million excess of $85 million) | E |
| Total Limits: $100 million | | |

## Quota Share Excess D&O Programs

Quota share arrangements among excess D&O insurers are being used more frequently now than in the past few years. Unlike the example provided in Exhibit 11.1 above (where only one insurer provided all of the coverage within each excess layer), the quota share approach involves the assumption of a given layer of excess coverage by more than one insurer. Under such arrangements, participating insurers provide policies that afford a specific percentage of coverage within a particular layer. Exhibit 11.2 illustrates a quota share D&O program.

**Exhibit 11.2**
**Enron's Quota Share D&O Program**

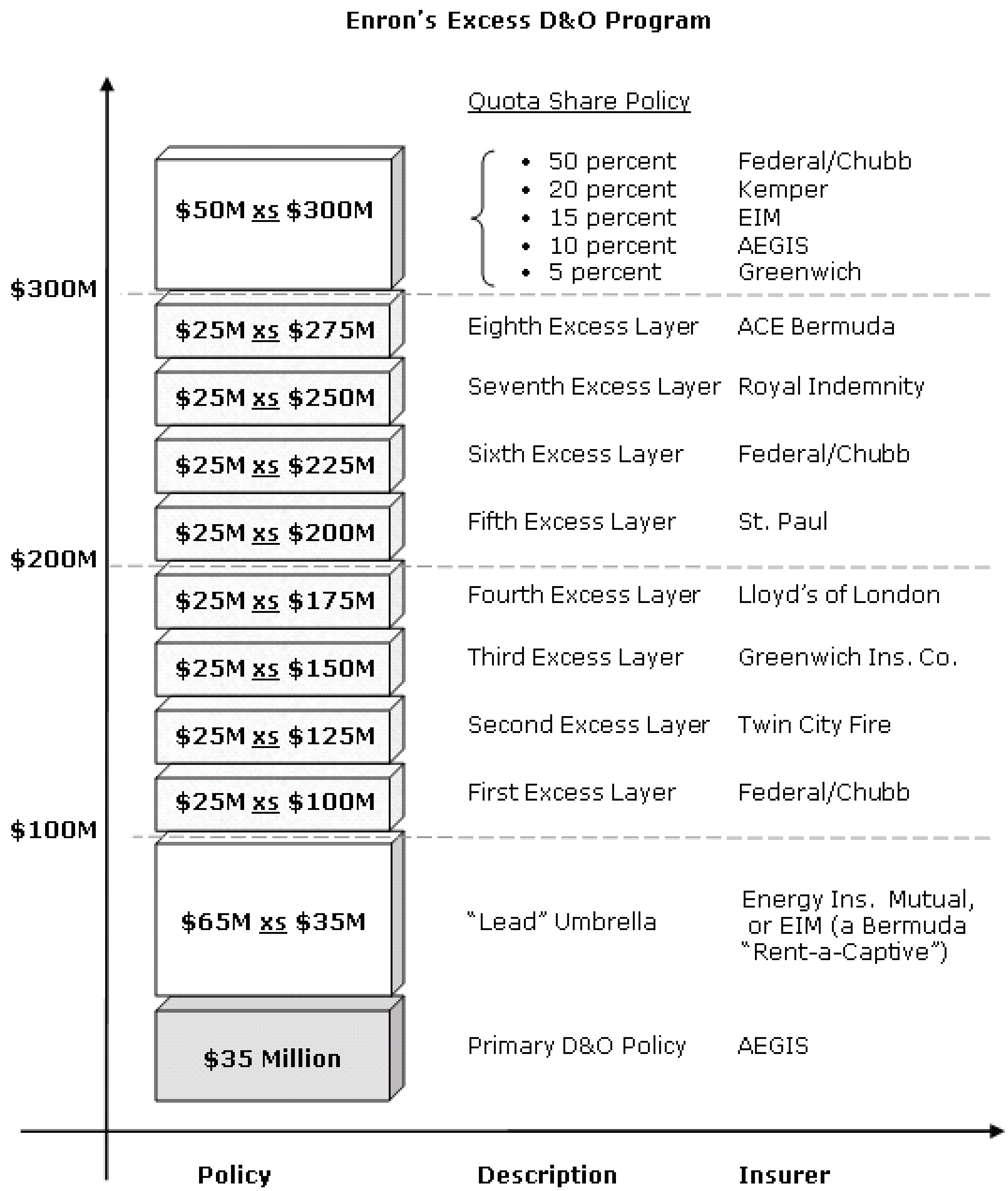


Exhibit 11.2 provides an example of a quota share excess D&O program. Specifically, it depicts Enron's D&O program that provided a total of $350 million of coverage at the time of its financial collapse in late 2001. Note that the $50 million layer of coverage, excess of $300 million, is afforded under a quota share arrangement, in which five different insurers are participating, in various percentages, to provide a total of $50 million of coverage. If, for example, there was a $25 million loss within this $50 million layer, each of the five insurers would contribute their respective percentages, as noted in Exhibit 11.2. So, for example, since Federal provided 50 percent of the coverage within this layer, in the event of a $25 million loss, it would pay 50 percent, or $12,500,000.

## Coverage under Excess D&O Policies: Two Basic Types

There are two basic types of excess D&O insurance policies.

- Follow form policies
- Independent or "stand-alone" excess policies

Follow form policies are much more common and, in recent years, "stand-alone" excess policies have generally not been available.

### *Follow Form Excess D&O Policies*

These policies adopt the coverage provisions of the underlying policy or policies. This usually includes such matters as insuring agreements, conditions, exclusions, and other key coverage provisions. The insuring agreements state that unless endorsed, the coverage provided by the excess D&O policy will not be broader than that afforded by the form immediately below it in the "tower" of coverage.

### *Independent or "Stand-Alone" D&O Policies*

These excess policies have their own complete sets of coverage agreements, definitions, and exclusions. However, as already noted, since the late 1990s, such policies are rarely written. Rather, following form excess policies are by far more common.

## Underlying Limits of Liability Definition

The manner in which an excess D&O policy defines "underlying limits of liability" is important in understanding how excess D&O policies function. Typically, the "underlying limits of liability" is defined as the sum of (1) the primary D&O policy limits, (2) any retention applicable under the primary D&O policy, and (3) all limits available under any underlying excess policies.

### *Applying the Underlying Limits of Liability Definition*

Assume an insured has a primary D&O policy with a $5 million limit. The policy is written with a $1 million retention. The insured also has a first excess policy with a $10 million limit and a second excess policy with a $10 million limit. In this situation:

- $6 million is the "underlying limit" as respects the first excess policy ($5 million primary policy + $1 million primary retention), and
- $16 million is the "underlying limit" as respects the second excess policy ($5 million primary limit + $1 million primary retention + $10 million first excess limit).

## Limit of Liability Provision

The manner in which D&O excess policies define the term "limit of liability" is also important in the functioning of excess D&O policies.

This provision states that the excess D&O insurer will pay losses that exceed the "underlying limit of liability." This means that the excess insurer is not liable until each of the underlying insurers have paid the full amount of the "underlying limits of liability" (as defined in their policies). Finally, the provision indicates that if underlying limits are reduced or exhausted, the policy will pay excess of these reduced or exhausted limits, but only after the retention applicable to the primary policy has been satisfied.

### *Applying the Limit of Liability Provision*

Referring to the example used in the underlying limit section (above), the limit of liability provision indicates that:

- the second excess D&O insurer must pay loss excess of the underlying limit, which in this case is $16 million ($5 million primary limit + $1 million primary retention + $10 million first excess limit) up to a maximum of an additional $10 million (the policy limit of the second excess D&O policy); however,
- no payment must be made by the second excess D&O insurer until the "underlying limit" of $16 million has been satisfied by payments from both the primary insurer and first excess insurer ($15 million) plus absorption of the $1 million retention by the insured under the primary policy.

## Exhaustion/Depletion of Underlying Limits Provision

All excess D&O policies contain a provision stating that the underlying policies must be exhausted before the excess insurer has any liability for payment of loss.

There are four rationales underlying this type of provision.

1. To assure that the excess insurer is not being requested to drop down to assume loss that it did not bargain to accept.
2. To be sure that the professional claims department and/or counsel of the primary insurer has evaluated the claim, analyzing such issues as coverage, allocation, and the application of exclusions. (Although these findings may not be binding on the excess insurer, excess insurers generally rely on the work done by the primary insurer.)
3. To be certain that its place in the queues of insurers is not violated, an insurer will not forced to pay a loss when there is an insurer having a greater obligation to pay the loss still available to the insureds.
4. In the case of "duty to defend" policies, to avoid a premature demand for defense of a claim. (However, this is not applicable to most D&O claim situations, since the majority of D&O policies written with excess coverage do not involve a duty to defend.)

### *Strict versus Liberal Exhaustion of Limits Provisions: A Case Study*

Excess insurers use different policy language to define "exhaustion"—some of which is worse for the insured than others.

### Facts of the Case

In *Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770 (Ct. App. 4th Dist. 2008), employees sued Qualcomm over issues related to their stock options. Qualcomm settled the stock option litigation, incurring $28.6 million in defense and indemnity costs.

Qualcomm had a $20 million primary D&O policy with AIG and an excess D&O policy with Lloyd’s. Qualcomm settled its coverage claim under the AIG policy for $16 million. This was the most AIG agreed to pay as respects the claim. Since Qualcomm was willing to absorb the next $4 million in costs between the $16 million AIG settlement and the $20 million attachment point of the excess coverage, it only sought excess coverage for about $8.6 million from Lloyd’s. (Note: according to what Qualcomm *thought* were the terms of the Lloyd’s excess policy, that policy would not afford coverage until $20 million had been paid out within the primary layer—whether by the primary insurer and/or by Qualcomm. In effect, Qualcomm needed to self-insure the $4 million settlement “gap” so it could access the Lloyd’s excess policy.)

Unfortunately for Qualcomm, the Lloyd’s excess policy had a very strict exhaustion provision that read “Underwriters shall be liable only after the insurers under each of the Underlying Policies [the AIG policy, in this instance] have paid or have been held liable to pay the full amount of the Underlying Limit of Liability.”

### The Court’s Ruling

The appellate court held that Qualcomm was not entitled to excess coverage. Nothing in the Lloyd’s exhaustion provision was ambiguous. It clearly required either that (1) AIG “has paid” the full amount of the $20 million primary limit, or (2) that AIG has been “held liable to pay” the full amount of the $20 million underlying limit. Neither of those events occurred. AIG actually paid only $16 million out of its $20 million underlying limit. AIG was not “held liable” by a judge or jury. Even reading the phrase “held liable to pay” as meaning being obligated to pay under a settlement, in this case, the settlement only required AIG to pay $16 million out of the $20 million underlying limit. Since the terms of the strict exhaustion provision were not fulfilled, the court held that Qualcomm forfeited around $8.6 million in excess coverage.

The real problem in the Qualcomm case was that the exhaustion provision restricted who was allowed to pay the underlying limit. The plain terms of the Lloyd’s policy said only *the underlying insurer* was allowed to pay. This language simply did not grant the insured a contractual right to absorb any portion of the settlement costs within the primary layer.

### A Better Alternative

There are other, more liberal, versions of policy language regarding exhaustion of primary coverage that would have better suited the insured in the Qualcomm case. Specifically, some excess D&O policies expressly permit the insured to pay a portion of the underlying limit. For example, ACE Bermuda‘s excess D&O policy contains an exhaustion provision condition that reads: “liability for any covered Loss with respect to Claims first made in each Policy Year shall attach to the Insurer only after [1] the insurers of the Underlying Policies, [2] *the Insured Company* and/or [3] the Insured Persons shall have paid, in the applicable legal currency, the full amount of the Underlying Limit for such Policy Year.” Under this language, the “Insured Company” has the right to contribute payment toward the underlying limit, which the excess insurer will deem to be satisfied as long as the full amount is paid by any combination of the three listed parties.

### The Lesson of the Case

If the language specifies that only the primary insurer can pay the underlying limit, it is wise to negotiate a more liberal exhaustion provision giving the insured the contractual right to absorb a portion of settlement costs without forfeiting excess coverage.

## Maintenance of Underlying Policies Provision

Of utmost importance to an excess insurer are (1) the existence of the underlying insurance and (2) the solvency of the underlying insurers. The purpose of this provision is to protect the excess insurer in the event that any of the underlying insurers' policies expire or are canceled yet not replaced with comparable coverage. In such instances, and in the absence of the maintenance of underlying insurance provision, an affected excess insurer would otherwise be liable for loss that these underlying policies would no longer cover. However, since the excess insurer's premium was predicated on the existence of a specific amount of underlying coverage, it would be inequitable for the excess insurer to bear such loss.

For example, let us return to the numbers used in the previous example (beginning under the heading of “Applying the Underlying Limits of Liability Definition”):

- an insured has a primary D&O policy with a $5 million limit. The policy is written with a $1 million retention. The insured also has a first excess policy with a $10 million limit and a second excess policy with a $10 million limit. In this situation:
    - $6 million is the “underlying limit” as respects the first excess policy ($5 million primary policy + $1 million primary retention), and
    - $16 million is the “underlying limit” as respects the second excess policy ($5 million primary limit + $1 million primary retention + $10 million first excess limit).

If the first excess insurer were to cancel coverage and the insured were unable to secure replacement coverage, the second excess insurer would not be liable for any payments until the primary insurer paid $5 million of loss, the insured absorbed the $1 million retention applicable under the primary policy, and the insured self-insured the $10 million policy limit of the first excess insurer whose coverage was not replaced. In effect, based on the maintenance of underlying insurance provision, the second excess insurer would not be liable until a total of $16 million had been paid or absorbed by the insured and the primary insurer.

### *Two Versions of the Maintenance of Underlying Policies Provision*

There are two versions of the maintenance of underlying insurance provision.

#### Restrictive Version

Under the restrictive version, if an underlying policy is canceled or its limits are otherwise impaired (e.g., by means of insurer insolvency), the excess policy above it automatically terminates. In the example being discussed above, assume the primary insurer writing the $5 million of coverage becomes insolvent and is no longer able to pay claims. The first excess policy above it provides an additional $10 million limit, but the form contains a restrictive version of the maintenance of underlying limits provision. In this situation, the $10 million excess policy would automatically terminate and the insured would have neither primary coverage nor the coverage under the first excess policy available.

### Favorable Version

In contrast, under the favorable version of the maintenance of underlying provision found within excess D&O policy forms, if an underlying policy is canceled or its limits become impaired (in this instance, by the primary insurer's insolvency), the excess policy above it will not automatically terminate. Rather, the excess policy applies as if the policyholder were self-insured for the underlying layer (i.e., the excess policy will not “drop down”). In the previous claim example, if the primary insurer became insolvent, the first excess insurer's policy would remain in force, subject to a $6 million self-insured retention ($5 million policy limit + $1 million retention).

### *Implications of the Maintenance of Underlying Insurance Provision*

Given the significant functional difference between the favorable and restrictive versions of the maintenance of underlying provisions, it is a critical point of differentiation between excess D&O policies. Accordingly, when putting together an excess D&O program, the restrictive version of the maintenance of underlying limits provision should be avoided. If it cannot, such policy(ies) should be placed as high as possible in the insured's “tower of coverage.”

A follow form excess policy adopts the exclusions in the immediately underlying policy. Accordingly, in the example that has been used throughout this section on excess D&O policies, the second excess D&O policy would adopt any additional exclusions found in the first excess D&O policy and the first excess policy would adopt any additional exclusions found in the primary policy.

If an excess D&O policy contains additional exclusions, this would be to the insured's disadvantage. Accordingly, such policies should be avoided whenever possible. If, however, this cannot be arranged, such policies should be placed on the top layer of an excess D&O program to minimize the probability of involving that policy in a claim situation. Otherwise, these added exclusions would probably be adopted automatically by insurers providing higher layers of excess coverage.

## Warranty Clause

Some excess D&O policies contain a warranty clause to either supplement the one found in the application or, in some cases, to function as the warranty for the policy when none is contained in the application. Warranty provisions are fairly standard except that some contain a grant of severability, which, of course, is favorable for the insured.

## Integrated Excess Policies

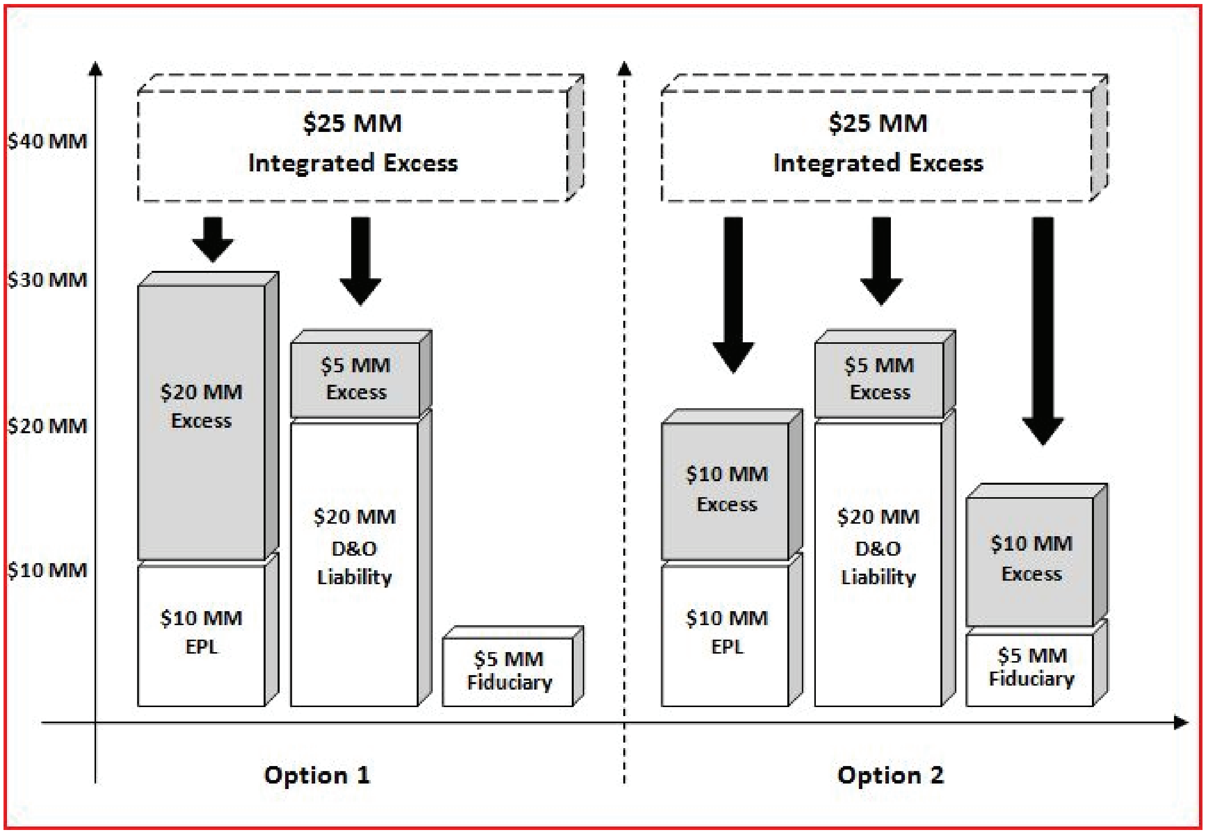
In addition to excess D&O policies, which apply to a single type of coverage, a number of insurers offer what are known as “integrated” or “flexible” excess policies that apply as excess coverage over a variety of claims-made policies. These policies include directors and officers (D&O) liability, employment practices liability, and fiduciary liability.

Integrated excess policies are written with a single aggregate policy limit for all coverages combined. The terms and conditions of such forms are generally similar to those found in excess D&O forms, except for those changes required to accommodate multiple coverages.

Under integrated excess policies, if losses other than D&O losses exhaust the aggregate policy limit, there will be no coverage left for D&O claims other than what is available in underlying policies. On the other hand, for the same amount of total premium dollars as might be paid for individual excess policies, a much higher aggregate limit for the entire group of coverages will probably be available under an integrated excess policy.

The question then becomes whether it is better to have a rigid wall around the D&O policy to protect only the directors and officers or to have the flexibility to apply the excess coverage where it is needed when other types of losses (i.e., employment practices, fiduciary, crime) occur. The manner in which integrated excess policies function is illustrated by Exhibit 11.3.

**Exhibit 11.3**
**Operation of an Integrated Excess Policy**




In this diagram, an aggregate limit of $25 million in coverage is provided under the integrated excess policy. The policy functions exactly like an umbrella policy, providing $25 million in excess coverage over the three underlying policies—in any combination—whenever any of the limits, of any of the underlying policies, are exhausted.

### *Two Examples*

In Option 1 shown on the left, the insured has allocated $20 million of the excess coverage to apply over the EPL policy to cover a very large EPL claim, which leaves only $5 million of the aggregate limit available which can be applied over the other policies, such as the D&O policy. In Option 2 shown on the right, the insured has allocated $10 million of the excess coverage to the EPL policy, $5 million of the excess coverage to the D&O policy, and $10 million of the excess coverage to the fiduciary liability policy.

In a like manner, the insured has the flexibility to use the $25 million aggregate limit in any fashion to respond to large claims filed under any of the three underlying policies.

## Chapter 11 Review Questions

1. Private companies tend to have a smaller D&O exposure than publicly held firms for of all the following reasons, *except:*
   a. Claims are less severe because privately held corporations are smaller.
   b. Ownership of most privately held corporations is highly concentrated.
   c. Privately held corporations have fewer shareholders.
   d. Privately held companies have no exposure to securities claims.
2. Wedding Cake Company has a quota share excess D&O program, a program in which:
   a. each insurer is entirely responsible for its own layer of coverage.
   b. gaps between the various layers require filling.
   c. more than one insurer shares a layer of coverage.
   d. only one layer of coverage applies.
3. Pancake Company is comparing the maintenance of underlying insurance provisions in excess D&O policies from two insurers. Policy A says that if an underlying policy is canceled, the excess policy applies as if the policyholder were self-insured for the underlying layer. Policy B says the excess policy terminates if an underlying policy is canceled. From the policyholder's standpoint:
   a. both policies are acceptable since both drop-down coverage.
   b. Policy A is preferable.
   c. Policy B is preferable.
   d. neither policy is acceptable.

### *Answers to Chapter 11 Review Questions*

1. d. Private companies have smaller D&O exposures than publicly held firms because claims are less severe, ownership is highly concentrated, and there are fewer shareholders.
2. c. A quote share excess D&O program is a program in which more than one insurer shares a layer of coverage.
3. b. The policyholder will still have excess coverage if an underlying policy is canceled.

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# Chapter 12
# D&O Insurance for Privately-Held Companies

Chapter 12 examines the unique nature of the D&O claim exposures to which privately-held companies are subject, as well as the distinct policy forms that are available to cover these exposures.

## Private Companies Do Have an Exposure to Securities Claims

One of the most pervasive myths surrounding D&O insurance is that privately held firms have no need for the coverage because they have no exposure to securities claims. As will be explained below, such firms do, in fact, have a securities claim exposure because they all have shareholders (despite the fact the corporation's shares are not traded on a public stock exchange). In addition, privately held companies are frequently sued by competitors, government agencies, regulators, and employees—in addition to stockholders.

Admittedly, private companies do not have securities exposures approaching the magnitude of publicly traded firms. Nevertheless, simply because a corporation is not publicly traded does not mean it has not issued a "security" that would subject it to U.S. securities laws. As a result, directors and officers of privately held corporations still have an exposure to claims involving securities that it has issued, albeit a smaller one compared to publicly-traded firms. This smaller exposure is the result of three factors.

- **Privately-held corporations are not as large as publicly held ones**. On average, the value of the outstanding stock of the typical privately-held company is smaller than that of the average publicly held firm. As a consequence, the size of the potential loss to shareholders is much smaller, a factor that significantly reduces possible claim severity.
- **Privately-held corporations have fewer shareholders than publicly held ones**. As a result, there are fewer plaintiffs that could potentially bring securities lawsuits against the typical privately-held corporation. This factor reduces potential securities claim frequency.
- **Privately-held corporations usually have highly concentrated ownership**. Given such concentration, coupled with the fact that many D&O policies covering privately held firms preclude coverage for claims brought by shareholders owning greater than a certain percentage of the corporation's stock (typically 10 percent), securities claim frequency is much lower for privately held companies compared to publicly held companies. In fact, the typical privately held company does not have a single shareholder whose holdings are less than 10 percent.

## Unique Exposures Associated with Privately-Held Companies

Although the legal duties of the directors and officers of privately held organizations are similar to those of their publicly held counterparts, the privately held sector's directors and officers often encounter special exposures that the directors and officers of publicly held companies do not face.

### *Exposure as Advisers to Management*

First, outside directors are more likely to become personal advisers to senior management of privately held companies since those companies generally do not have extensive depth in their levels of management.

### *Exposure from Domination by a Small Group of Shareholders*

Second, an outside director's liability exposure is heightened when the corporation is dominated by one or a small group of controlling shareholders. These dominant shareholders are more likely to operate the organization without full regard to the rights and interests of minority shareholders and other company constituents. In such an instance, the outside director must be particularly mindful of the duty to represent all shareholders, not just the faction that elected that director to office, and must be prepared to oppose the wishes of the dominant shareholders when appropriate.

### *Exposure from Limited Time Commitment by Directors*

Third, as with the directors of nonprofit organizations, the directors of privately held companies will often serve on the board in a limited, part-time capacity with relatively small compensation. Similarly, the resources of these corporations may be insufficient to provide the directors with effective support. Thus, the directors may not have access to all relevant information before making decisions.

### *Potential Claimants*

The directors and officers of privately held firms face exposure to claims from a number of parties, including minority shareholders, employees, and a variety of third parties.

#### Minority Shareholders as Potential Claimants

As already noted, many directors and officers of privately held corporations take false comfort in the fact that the corporation is not publicly traded and generally has fewer shareholders than larger publicly traded corporations. However, liability exposure to shareholders of privately held corporations does exist.

In particular, minority shareholders frequently assert D&O claims alleging that the business was conducted for the benefit of the controlling shareholders to the detriment of the minority shareholders. And even in a situation where the shareholders are viewed as colleagues or friendly business associates, the potential for shareholder liability exists. Events such as divorce, death, foreclosure on a stock pledge, or the insolvency of one of the shareholders may suddenly and dramatically thrust new shareholders with new perspectives and expectations into the picture.

#### Claims by Employees

Employees are frequent claimants in lawsuits against privately held firms and their directors and officers. For this reason, nearly all writers of such policies offer policies that are designed to provide broad EPL coverage, thereby precluding the need to purchase a stand-alone EPL policy.

### Claims by Third Parties

Additionally, third-party claims brought by "outsiders" against directors and officers of privately held corporations have been increasing in frequency and severity in recent years. Examples of claims by third parties against directors and officers of privately held corporations include the following.

- A company's directors and officers were held liable for damages when a competitor alleged that the firm's buyout discussions were merely a pretext to obtain information about the competitor.
- The president of a construction company was held liable for negligence in the construction of a building because he was at the construction site on a daily basis, supervised the construction process, and failed to act with reasonable care.
- A company's directors and officers were sued for misappropriation of trade secrets when they hired a seasoned employee away from a competitor firm in the same industry.
- A corporate president was held liable to the lessee of adjoining premises damaged by demolition of a building owned by his corporation, where he gave the contractor no instructions concerning the demolition. This occurred despite his knowledge that if the demolition was improperly performed, it would damage the adjoining property.
- A corporate president was held liable for breach of contract, where his corporation refused to deliver goods to a consumer and sold the goods to another party at the direction of the president.
- The president and vice president of a corporate waste disposal service were held liable for the corporation's illegal dumping and storage activities.

## Distinctive Aspects of Private Company D&O Coverage Forms

For the most part, the policies written to cover privately held companies are very similar to those available to publicly traded organizations. However, there are several key differences between the two kinds of forms. These differences are discussed below.

### *Packaged Approach*

The vast majority of D&O coverage written for privately held firms is made available on a so-called package basis. That is, in addition to offering standard D&O coverage, nearly all of the policies also provide coverage for employment practices liability and fiduciary liability exposures. In addition, some policies designed for private companies also afford the option to purchase kidnap/ransom coverage (also termed "special crime" coverage) and miscellaneous professional liability insurance (covering corporate accountants and attorneys).

### *Flexibility in Limits and Retentions*

Another advantage of the package format is that (in contrast to what is made available by insurers of publicly held companies) most writers of private company D&O offer a great deal of flexibility in the selection of limits and retentions for the various coverages. Insurers usually offer either separate or combined limits for each of these different types of coverage as well as either separate or combined retentions for each of them.

For example, under a typical package approach, an insured could elect a combined single limit applying to D&O, employment practices, and fiduciary liability coverage. Or, the insured could select a separate limit for each of these coverages. The same can usually be said for the selection of retentions for each of these coverages. That is, the insured could opt for a separate retention for each type of coverage or a single retention annual aggregate for all coverages.

### Broad “Insured Persons” Coverage

Unlike corporate D&O policies, whereby only directors and officers are “insured persons,” private company policies cover a much broader range of individuals. Specifically, employees (both full and part-time) are also insureds under the forms.

### Broad Entity Coverage

Unlike insurers of publicly held companies, insurers who write privately held firms provide entity coverage for all kinds of claims—not just those involving securities. Moreover, entity coverage is automatic under D&O policies for private companies, whereas, under corporate D&O forms, entity coverage always requires payment of additional premium (i.e., and purchase of Coverage C).

### Duty To Defend

Virtually all D&O policies for private companies are written on a duty to defend basis. In contrast, the vast majority of forms written for publicly traded firms state that the insurer has no duty to defend, only a duty to pay defense costs and make indemnity payments.

However, the duty to defend approach is usually better suited to privately held firms because they tend to be smaller and less familiar with the complexities of D&O litigation. It is usually best to allow the insurer to manage and control the litigation process when private companies are involved, compared with the larger, publicly traded companies that tend to have sizeable legal staffs and are more comfortable controlling the litigation process associated with D&O claims.

### Liberal Cancellation and Nonrenewal Provisions

The cancellation and nonrenewal provisions in private company D&O policies tend to be more liberal than those found in their for-profit counterparts. Specifically, a majority of such forms are written on a non-cancelable basis (except for nonpayment of premium). In contrast, the typical corporate D&O form requires only 30 to 60 days' notice prior to cancellation.

In addition, most private company forms require the insurer to provide 30 to 60 days' notice prior to non-renewing, compared to corporate D&O insurers whose forms generally do not require any prior notice of nonrenewal.

### Broad Extended Reporting Provisions

The extended reporting provisions found in private company D&O forms are usually somewhat broader than those made available by corporate D&O writers. For example, private company forms typically offer ERPs of 1 year, for a maximum of 125 percent of the expiring premium and in some cases as low as 50 percent of the expiring premium. Conversely, corporate D&O insurers' ERP premiums are usually a minimum of 100 percent of expiring premium and can be as high as 200 percent of the expiring premium. In addition, insurers of privately held companies frequently offer ERPs of more than 1 year and for as long a period as 5 years.

## Chapter 12 Review Questions

1. Privately held companies are frequently sued by all of the following, *except*:
   a. Competitors.
   b. Government agencies.
   c. Regulators.
   d. Stock brokers.
2. Private companies tend to have a smaller D&O exposure than publicly held firms for of all the following reasons, except:
   a. Claims are less severe because privately held corporations are smaller.
   b. Ownership of most privately held corporations is highly concentrated.
   c. Privately held corporations have fewer shareholders.
   d. Privately held companies have no exposure to securities claims.
3. Paper Clips, Inc., a privately-held office supplies store, wants to purchase a package policy that includes D&O, employment practices liability (EPL), and fiduciary liability coverage. Under a typical packaged approach, Paper Clips would have any of the following options, *except*:
   a. combined single limit for all coverages.
   b. separate limits for each coverage.
   c. separate retention for each coverage.
   d. waiver of underlying insurance.
4. The officers of Fox Hole, a private company, are reluctant to inform their insurer of a possible D&O claim for fear their policy will be canceled. If their policy is like most D&Os written on private companies, the insurer:
   a. cannot cancel the policy except for nonpayment of premium.
   b. may cancel the policy only if the policyholder gives notice of a potential claim.
   c. must provide 30 to 60 days' notice prior to cancellation.
   d. may cancel the policy for any reason.

### *Answers to Chapter 12 Review Questions*

1. d. Privately-held companies are frequently sued by competitors, government agencies, and regulators.
2. d. Private companies have smaller D&O exposures than publicly held firms because claims are less severe, ownership is highly concentrated, and there are fewer shareholders.
3. d. Under a typical packaged policy, Paper Clips would not have the option of a waiver of underlying insurance.
4. a. A majority of private-company D&O policies are written on a noncancelable basis, except that the insurer may cancel for nonpayment of premium.