What You Need to Know About D&O Insurance: Top Ten List

By Mark E. Miller, Esq.

The last several years have been difficult for companies purchasing D&O insurance. Large year-to-year increases in premiums, few bidders, and hard-line negotiating by insurance carriers has prevailed. Fortunately, all of this may be changing for the better. It is not uncommon for companies that had only one D&O insurer bid on an account last year to find themselves with multiple carriers competing for their business this year. With multiple bids, companies, directors, and officers find themselves in a difficult predicament — how to evaluate the strengths and weaknesses of various quotes, and how to use that knowledge to negotiate the best possible coverage.

As many former officers and directors know only too well, a failure to procure adequate D&O insurance coverage can result in significant personal loss. Corporate indemnity, which directors and officers rely upon to pay their defense lawyers in the event they are investigated by a federal agency or sued personally, disappears with insolvency or bankruptcy of the corporation. This may leave directors and officers with only one line of defense between their personal assets and plaintiffs’ lawyers — their D&O insurance coverage. In these situations, personal estates and livelihoods often hinge on insurance policy language, and sometimes, on a single sentence or phrase buried within a D&O insurance contract or endorsement.

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Although properly negotiated traditional D&O coverage is the building block of any D&O insurance program, such coverage presents certain unavoidable risks, even when properly negotiated. First, coverage for the corporation can exhaust available limits, leaving directors and officers without coverage. Second, a bankruptcy court could determine that policy proceeds are assets of the estate, and prohibit payment to the directors and officers under the policies. And third, innocent directors could lose coverage because of misrepresentations, illegality, or deliberate fraudulent conduct of corporate insiders.
New D&O insurance products address some of these issues. Side A-only excess coverage cannot be exhausted by payments to the corporation and is beyond the grasp of bankruptcy courts, since none of its proceeds are paid to the corporation. Independent Director Liability (IDL) coverage is designed to cover independent directors in situations where other coverage is unavailable due to the adverse conduct of corporate insiders.

Unfortunately, unlike other types of business insurance, there is no standard D&O insurance policy form for any of these D&O insurance products, and there is significant variability in language contained in various D&O insurance products. The immense impact that this variability can have on the personal wealth of directors and officers is illustrated in the following “top ten” list of D&O insurance issues.

1. **Severability of the Application**

Most directors and officers never see the D&O insurance policy application, but it can, nonetheless, act in a manner more potent than any policy provision or exclusion. If an application is filled out incorrectly, even if the mistake was innocent, an insurance carrier may seek to rescind the policy, defeating coverage for all officers and directors. The impact of rescission is quite severe. If a policy has been rescinded, it no longer legally exists, and, as such, cannot provide coverage to any directors or officers seeking coverage under the policy. One way to address this rescission issue is with express language outlining that fraud or inaccuracies in the application cannot be imputed to innocent directors and officers who had no knowledge of the erroneous or untrue facts contained therein.

2. **Non-Rescindable Coverage**

Securities lawsuits commonly name a number of different parties and allege a number of different causes of action. When some of the parties are covered under the policy and others are not, or when some of the causes of action are covered, and others are not, an insurance carrier may assert that it does not have an obligation to pay for all of the defense costs incurred. To address this issue, many policies contain defense allocation provisions, but these provisions generally do not deal with the issue favorably. Some specify a predetermined percent of defense costs that will be deemed covered, and others specify that an insurance carrier may withhold payment of defense costs until an agreement is reached regarding how much of any given claim is covered. The problem with either of these two approaches is that both presume that less than one hundred percent of defense costs will be paid by the insurance carrier. It is often advisable to avoid such provisions, especially where they conflict with legal principles requiring an insurance carrier to provide full defense in the absence of such a provision.

3. **Duty to Advance Defense Costs**

Another common problem with defense coverage contained in some D&O insurance policies is that it does not specify when an insurance carrier must reimburse the directors and officers for defense costs incurred. Without such a provision, directors or officers may have to wait until the end of the underlying lawsuit for their insurance carrier to reimburse them for any of the defense costs previously incurred. Such a scenario could cause the director or officer to have to pay for their own defense costs with the hope that their insurer will eventually reimburse them for all of the costs incurred. Naturally, the better practice is not to leave the timing of defense cost
reimbursement to chance, and to negotiate coverage that requires reimbursement within a specific number of days.

5. Co-Insurance

In the very recent past, it was common for D&O insurance policies to contain a co-insurance provision requiring the policyholder to pay, or co-insure, some specific percent of defense costs and other losses incurred. The presence of these provisions has proved devastating to some unsuspecting directors and officers, and should not be accepted with respect to coverage provided under Side A of the policy, which pays the directors and officers directly in the event of insolvency of the company.

6. Conduct Exclusion Language

D&O policies routinely contain exclusions for criminal conduct, fraud, and illegal profit or advantage taken by the directors or officers. These exclusions can often be narrowed. One way to narrow the scope is to require “final adjudication” language, which should obligate an insurance carrier to reimburse defense costs until a judicial decree in the underlying lawsuit establishes wrongful excluded conduct. Another way is to require that the exclusions will not apply unless there was “in fact” wrongful conduct, which minimizes the chance of an insurance carrier denying coverage based on unfounded allegations contained in the underlying lawsuit. Finally, some insurers have been willing to narrow the fraud exclusion by inserting the word “deliberate” in front of the word fraud, which may provide broader coverage in the problematic area of securities fraud litigation, which by its very nature, alleges some level of fraud.

7. Severability of Conduct Exclusions

Another issue that arises with conduct exclusions is how the exclusions apply to innocent directors and officers. If one officer, for example, is convicted of a crime, or is guilty of self-dealing, an insurance carrier could argue that coverage is defeated for all officers and directors covered under the policy, regardless of their own personal conduct. To prevent this scenario, conduct exclusions should contain appropriate severability language stating that conduct of any officer or director will not be imputed to any other officer or director.

8. Bankruptcy and the Insured vs. Insured Exclusion

No single D&O exclusion has generated more case law than the so-called Insured vs. Insured exclusion. The reasons for the exclusion are based on two common concepts: first, there should be no coverage where an insured sues itself, and second, D&O insurance should not insure the financial results of a company. Common Insured vs. Insured language, however, may do more than protect against these two perceived inequities. It may bar coverage for lawsuits brought by trustees and creditors in bankruptcy. The right to coverage for a lawsuit brought by a trustee in bankruptcy against a director or officer may hinge on four words - whether the policy states that coverage is barred for any claim “brought by or on behalf of an Insured Organization” or just for any claim “brought by an Insured Organization.” Where possible, the policyholder should not agree to the “or on behalf of” language. Another option is to seek language that specifically excepts trustee claims from the exclusion, or that expressly covers such claims so long as they are brought independently and without the help of the Insured Organization.

9. Side A-Only Excess Insurance Drop-Down

Directors and officers considering the purchase Side A-only coverage should also recognize that not all Side A-only coverage is alike. Two general types of Side A excess coverage exist: standard follow-form excess Side A coverage, and excess umbrella Side A coverage, sometimes called Difference in Condition (“DIC”) coverage. Under the former type of Side A coverage, if the primary policy contains problematic language related to severability of the application, severability of the exclusions, or adverse exclusions, the excess follow-form Side A-only policies may not drop-down and pick up coverage when the primary policies have failed. Excess umbrella Side A-only DIC coverage, in contrast, is designed to be broader than
primary coverage, and should “drop-down” and function as primary insurance in situations where the primary carrier has canceled or rescinded coverage, or where the corporation has refused to indemnify the director or officer in question.

10. Warranties

Like the D&O insurance application, most directors and officers never see warranties executed by the company as part of the D&O insurance procurement process. Nonetheless, these warranties, which are commonly used in D&O insurance underwriting, especially where limits have been increased, have been upheld by some courts as a way for insurance carriers to defeat coverage. For this reason, warranties should not be signed until they have been thoroughly evaluated for impact on coverage.

CONCLUSION

At a minimum, these “top ten” issues illustrate the severity of issues presented, and the level of review that should be conducted prior to binding D&O insurance coverage. A thorough understanding of issues faced and potential solutions requires, at a minimum, sufficient knowledge of applicable D&O insurance law, and an understanding of insurance products currently available. As a starting point, a D&O coverage review should include a side-by-side comparison of coverages offered by the various competing insurers. This review should be followed by the negotiation of enhancements to coverage to minimize risk associated with unfavorable provisions contained in the strongest competing bids.

Considering the risks at stake, and the difficulty of legal issues implicated with D&O insurance coverage, it is not uncommon for directors and officers to require that the corporation retain independent outside legal counsel to conduct a thorough D&O insurance policy review, and assist with negotiating ongoing D&O coverage. In these situations, it is important to prepare early, insist on skilled D&O insurance brokers, and involve independent outside counsel long before coverage is bound. The below “D&O Insurance Renewal Timetable” provides some key deadlines that should be met, and action items that should be performed, starting 120 days prior to the expiration of current D&O insurance policies.

Footnote

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