IS YOUR D&O POLICY WHAT IT SHOULD BE?

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Companies and their directors and officers should be aware that significant variations exist among directors and officers liability insurance policies ("D&O policies"). Whether or not a policy includes a particular provision or endorsement can greatly expand - or narrow - the scope of coverage. Policy terms and conditions that are presented as "standard clauses" are often open to negotiation. Among the policy provisions to be considered are the following:

Rescission/Severability: The principal concern with a D&O policy is that the coverage should be available when needed. Policyholders are increasingly concerned with the dynamic of insurers rescinding coverage against all Insureds on the theory that the policy was procured through material misrepresentations in the policy application.[1] At least with respect to the coverage provided directly to the directors and officers (*i.e.*, the Side A coverage -- as opposed to the Side B coverage for the corporation itself), policyholders may want to consider bargaining for an affirmative statement that such coverage is non-rescindable. In the absence of such a provision, policyholders should consider whether there is adequate "severability" language in the policy, *i.e.,* language that precludes the insurer from relying on a single Insured's misrepresentation to void coverage for all Insureds. The most policyholder-favorable severability endorsement would provide that no statement in the application, or knowledge possessed by any Insured, would be imputed to any other Insured.

"Capacity" Issues/Coverage for In-House Lawyers: D&O policies cover directors and officers for actions taken in their "capacity" as such. D&O carriers have taken the position that in-house lawyers, although they may be "officers" of the company, would not be covered under traditional D&O policies against claims related to their rendering of legal advice. We note that several current D&O policy forms specifically cover the general counsel for actions performed as general counsel. Coverage for other in-house lawyers is available through special endorsements.

Entity Coverage/Shared Limits: In addition to the traditional coverage for claims brought against the directors and officers, many D&O policies provide "entity coverage," *i.e.*, coverage for claims brought directly against the insured corporation. Entity coverage often is limited to securities claims, in which the company itself is targeted together with its directors and officers. If the entity coverage and the traditional D&O coverage share a single policy limit, directors and officers could be financially exposed if the entity claims exhaust the policy limit. This problem may be alleviated if the policy provides a mechanism for prioritizing payments,

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1 With public companies, the "application" is typically defined to include the corporation's SEC filings.

such that when claims are brought against the entity and the individual directors and officers, the individual Insureds are paid first. Another approach would be to have separate policy limits for the entity and the directors and officers. This approach might also be beneficial in the bankruptcy context as a way to protect the directors' and officers' share of the policy from becoming tied up in protracted bankruptcy proceedings of the company.

<u>"Hammer Clause":</u> Certain D&O policies provide that if the insured does not consent to a settlement of a third-party claim proposed by the insurer, then the insurer will not be responsible for any damages that would exceed the amount of the proposed settlement. This provision may enable the insurer to require a settlement that a director or officer may find objectionable (*e.g.*, one that requires an admission of wrongdoing). Policyholders may want to bargain for a provision indicating that the insured may reasonably withhold consent to a settlement (or may not unreasonably withhold such consent).

<u>Insured vs. Insured Exclusion:</u> A D&O policy typically excludes from coverage claims brought by one insured against another insured. The corporation itself, as well as its directors and officers, are "insureds" under the policy for purposes of this exclusion. In the bankruptcy context -- where many of the difficult D&O issues arise[2] -- some insurers have taken the position that claims brought by a bankruptcy trustee against the corporation's directors and officers should be excluded from coverage on the theory that the trustee is acting on behalf of the insured corporation. Thus, policyholders may want to procure a provision that specifically carves out bankruptcy trustees (and similar entities) from the definition of "insured" for the purposes of the "insured vs. insured" exclusion.

<u>Coverage for Investigations:</u> D&O policies typically will provide coverage for damages, judgments, settlements and defense costs arising out of a "Claim." To ensure the greatest possible coverage, policyholders will want the definition of "Claim" to be as expansive as possible. For example, a broad definition of "Claim" would not be limited to formal legal proceedings, but would also include investigations (such as by the SEC or other regulatory bodies).[3]

<u>Tail Coverage:</u> D&O policies are "claims-made" policies, meaning that they provide coverage only for claims that are both made against an insured during the policy period <u>and</u> reported to the insurer during the policy period. However, most D&O policies provide the insured corporation with an option to purchase an extended reporting period (known as a "tail" period) in which to report claims that are made against an insured during such period, but that relate to wrongful acts committed during the policy period. A typical tail period is one or two

[2] Obviously, in a bankruptcy proceeding, any indemnification that the corporation is otherwise obligated to provide to its directors and officers is of limited value; the directors and officers must look directly to the D&O policy for protection against liability.

[3] Note, however, that when "Claim" is used in exclusions to coverage in the D&O policy, it may be advisable to seek to limit the breadth of the term to narrow the liability for which coverage is barred.

years. The cost is usually a fixed percentage of the original policy premium. Importantly, policies vary as to when the option is triggered. In some policies, the option is triggered only if the insurer cancels or refuses to renew the policy. Policyholders may prefer an approach where the option is triggered if either the insurer or the insured cancels or chooses not to renew the policy.

Punitive Damages: The typical D&O policy does not provide coverage for punitive damages, although an endorsement to the policy may be obtained to add such coverage. It should be understood, however, that regardless of whether the policy purports to cover punitive damages, the proceeds of the policy could be unavailable to pay punitive damages as a matter of law. The law regarding whether punitive damages are insurable varies from state to state. Thus, policyholders may want a punitive damages endorsement stating that its enforceability is to be governed by the applicable law that most favors coverage for punitive damages.

Fraud Exclusion: D&O policies contain a standard exclusion for claims arising out of criminal or deliberate fraudulent acts. The policy should not be ambiguous as to when the exclusion applies or against whom. Many policyholders prefer that the exclusion apply only if a judgment or other final adjudication adverse to the insured establishes that such criminal or deliberate fraudulent act occurred and that the insurer be required to advance defense costs until there has been such a final adjudication. Policyholders may also bargain for a provision that the wrongful acts of one Insured will not be imputed to any other Insured for the purpose of applying this or other conduct-type exclusions.

Other exclusions that appear from time to time in D&O policies include those relating to restatements of financial results, financial impairment, acts of war or terrorism, commissions and payments to customers, political contributions, and the failure to maintain other insurance. Policyholders may want to examine the scope of these exclusions to ensure that they comport with the policyholder's specific needs and expectations.

We suggest that directors and officers consult with their corporate risk managers and/or insurance brokers to consider how the issues discussed above are addressed in their particular D&O policies. We would be happy to assist in any review.

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