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GETTING MAXIMUM PROTECTION FROM YOUR D&O INSURANCE

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If you serve as a director or officer of a public or privately held company, you should be aware of certain terms and conditions (some long-standing, others recently imposed) found in directors and officers ("D&O") liability insurance policies that may limit the coverage provided to you under such policies.[1]

Insured vs. Insured Exclusion: A D&O policy typically excludes coverage for 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 – insurers have argued that claims brought by a trustee in bankruptcy against the debtor's directors and officers should be excluded from D&O coverage on the theory that the trustee is acting on behalf of the Insured corporation.[2] Uncertainty over how this exclusion might apply could be eliminated through an endorsement to the policy that would specifically exclude a bankruptcy trustee (or similar entity) from the definition of "Insured" for the purposes of the Insured vs. Insured exclusion.

Entity Coverage/Shared Limits: Many D&O policies provide "entity coverage" (*i.e.*, for claims brought directly against the Insured corporation, typically for securities claims) in addition to the traditional coverage for claims brought against the 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 aggregate claims exceed the limit. As discussed in our April memorandum, this problem may be alleviated if the policy provides a mechanism for prioritizing payments such that directors and officers are paid first, irrespective of the insolvency of the Insured corporation. (The efficacy of this approach has not yet been tested in

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[1] This memorandum updates and expands upon the memorandum dated April 23, 2002, entitled "A Look at Directors & Officers Insurance Post-Enron," available on our firm's website (simpsonthacher.com).

[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 to the D&O insurance policy for protection against liability.

the courts.) Another approach would be to have separate sublimits of coverage for the entity and the directors and officers.

Fraud Exclusion: D&O policies contain a standard exclusion against claims arising out of criminal or deliberate fraudulent acts. The policy should not be ambiguous as to when the exclusion applies or against whom. The policy should clearly provide that the exclusion will only apply if a judgment or other final adjudication adverse to the Insured establishes that such criminal or deliberate fraudulent act occurred. The insurer should be required to advance defense costs until there has been such a final adjudication. The policy should further provide that the Wrongful Acts of one Insured will not be imputed to any other Insured for the purpose of applying this (or other) exclusions.

Material Misrepresentations in the Application for D&O Insurance: Obviously, the D&O insurer should be unable to declare the policy to be null and void as to all Insureds on the theory that it was procured through material misrepresentations in the policy application. Therefore, unless the policy is otherwise unambiguous on this point, it is important that there be a severability endorsement. The endorsement should provide that no statement in the application, or knowledge possessed by any Insured, would be imputed to any other Insured.

Coverage for Investigations: D&O policies typically will provide coverage for damages, judgments, settlements and defense costs arising out of a "Claim." The definition of "Claim" should be as expansive as possible to afford the broadest possible coverage. For example, "Claims" should not be limited to formal legal proceedings, but should also include investigations (such as by the SEC or a Congressional panel).

Punitive Damages: The typical D&O policy does not provide coverage for punitive damages. An endorsement to the policy may be obtained, however, to provide coverage for punitive damages subject to other exclusions of the policy (*e.g.*, deliberate fraud or criminal acts). It should be understood 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. To address this concern, the endorsement should state that its enforceability is to be governed by the applicable law that most favors coverage for punitive damages.

Recent Developments

In addition to the foregoing, D&O insurance carriers recently have introduced (or reintroduced) other terms and conditions of which directors and officers should be mindful:

- Exclusions for Claims arising out of or related to the insolvency or financial impairment of the Company.

- Exclusions for Claims related to the restatement of financial statements.

- Exclusions for Claims related to the failure to maintain other insurance.
- Exclusions related to acts of terrorism.
- Exclusions for claims related to secondary public offerings.
- Limits on coverage for after-acquired or created subsidiaries.
- Limits on extended discovery periods.
- Limits on coverage for outside directorships.
- "Hammer" clause (*i.e.*, if Insured does not consent to settlement of a Claim on terms proposed by Insurer, Insurer is not responsible for any liability or defense costs to the extent they ultimately exceed the proposed settlement).

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

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