

Don't Set Sail in a Leaky Ship —

D&O Insurance: How to Negotiate Your Policy to Plug the Holes in Coverage

By Rob Kibby

This article offers insight to directors, officers and their companies when a directors and officers (“D&O”) insurance policy is being purchased or renewed.

Executive Summary:

There's a crisis in the D&O insurance industry. The recent corporate scandals at Enron, WorldCom and others have triggered giant settlements, and the resulting corporate governance reforms have placed a greater oversight burden on boards of directors. Now, it is much more likely that directors will be held personally liable for corporate miscues. As just one example, WorldCom's directors recently paid \$20,000,000 out of their own pockets to settle D&O claims.

D&O insurance carriers have dramatically raised premiums to compensate for their increased risk, but there's only so much that rate increases can do. One of my law school professors was fond of saying that insurance companies don't make money by paying claims. True to form, insurance companies are now fighting coverage whenever possible, often using language in their D&O policies that is highly favorable to them.

Directors and officers are now understandably concerned about whether their companies will indemnify them for D&O claims or whether they'll be standing in line in bankruptcy court with the company's other creditors. Companies are having to go to greater lengths to satisfy directors and officers that they'll be protected against personal liability so that they don't shy away from serving as directors and officers.

What's a concerned director or officer to do? Make sure that the company negotiates the D&O insurance policy language like it's one of the most important contracts it will enter into. A checklist follows that will guide you through the major issues you'll encounter as you negotiate D&O coverage. Review the checklist and make sure to plug the holes before you set sail.

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Checklist for Review of D&O Insurance Policies

1. **Types of Coverage.**
 - a. **Side A** – “last resort” coverage that runs to Ds&Os. Side A coverage applies when the company cannot or will not indemnify Ds&Os, as is the case when the Company is insolvent or applicable law, charter, bylaws or indemnification agreement doesn’t allow indemnification.
 - b. **Side B** – corporate reimbursement coverage that runs to the company. The D&O carrier either reimburses the company for indemnification payments made to Ds&Os or pays the Ds&Os on behalf of the company.
 - c. **Side C** – “entity” coverage that protects the company when a securities or employment practices claim is made but Ds&Os aren’t named or are subsequently dismissed from the lawsuit.
2. **D&O Policy Application.** Because D&O carriers may attempt to avoid coverage by alleging that the D&O application contained material misrepresentations, the insurance application should be carefully considered and completed.
 - a. SEC filings or Sarbanes-Oxley Act certifications may be incorporated into the application. The application should therefore be modified to narrow what is included in it.
 - b. You should also check the application and D&O policy for severability provisions, which effectively provide that one person’s knowledge won’t be imputed to the entire group. Without a severability provision, the D&O carrier might be able to void coverage to Ds&Os as a group if one D or O has knowledge of a misrepresentation. There are several varieties of severability provisions, and the version used by your D&O carrier may need to be revised.
 - c. Applications will invariably ask for knowledge of potential claims. You should consult with counsel if you are aware of a situation, however remote, that could result in a claim.
 - d. Many applications ask about short term plans to merge/acquire/sell businesses. If you have confidential M&A plans that you don’t want to disclose to the D&O carrier, you will need to put the D&O carrier on notice that you may engage in an M&A transaction in the near future.
3. **Definitions.** Generally speaking, a D&O policy covers “losses” arising from “claims” made against “insured persons” for “wrongful acts”.
 - a. **“Loss”**
 - i. Many D&O policies don’t cover punitive damages, penalties, fines, and taxes. You should discuss this with the D&O carrier or broker to determine whether this definition can be modified to cover these types of damages so long as it is not against public policy.

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- ii. Most D&O policies will exclude “uninsurable losses”, such as those where a D or O obtained an improper personal benefit or where a law prohibits indemnification. You should consider whether to negotiate for a “most-favorable-law” test that requires indemnification if the law most favorable to the insured would allow coverage under the policy.
 - iii. Review the definition carefully to ensure that costs of investigation are included, as well as costs of appeal. Some D&O policies exclude special committee expenses but will cover those expenses if you purchase an endorsement.
- b. **“Claims”** – the claims below may or may not be covered, depending on the policy’s language. Some claims may not be covered if only the company is the subject of the proceeding. Other claims may be covered only if formal court proceedings have been initiated. Therefore, you should carefully review and consider the definition of “claim” in the policy and negotiate for a broader definition if necessary. If “claim” is broadly defined, note that you may be required to report many more claims to the D&O carrier.
- i. Administrative proceedings
 - ii. Arbitrations
 - iii. Threatened actions
 - iv. Investigations (internal and government)
 - v. Informal governmental inquiries, orders and subpoenas
 - vi. Criminal proceedings
 - vii. Securities claims
 - viii. Employment-related claims such as discrimination or sexual harassment
- c. **“Wrongful Acts”** – Some policies define this term to include only those actions or omissions of a D or O solely by reason of the person’s status as a D or O. Negotiate to remove the “solely” limitation since the insurance company may claim that the person seeking indemnification was not acting as a D or O and thereby seek to avoid coverage.
- d. **“Insured Persons”**
- i. Because the definition may include only those individuals considered to be Ds&Os under the company’s bylaws, consider whether the individuals you seek to cover fall within the definition and have the definition modified if necessary.
 - ii. Determine whether former Ds&Os may be covered, and negotiate for them to be covered if appropriate.
 - iii. Consider whether to negotiate to include employees who may not be Ds or Os as strictly defined by the bylaws, such as in-house legal counsel and non-officer accounting and finance personnel.
 - iv. If the D&O policy contains language that indemnifies Ds&Os of subsidiaries existing only at the time the policy is purchased, consider negotiating for automatic coverage of newly formed or acquired subsidiaries.

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4. **Claims Reporting Provisions.**

- a. Most policies are “claims made” policies, which means that a claim must be made during the policy period. Negotiate for a “tail” period after the policy expires during which you may make claims based on events that occurred during the policy period.
- b. Develop a stringent claims reporting procedure to ensure that claims are timely reported to the D&O carrier.
- c. Some policies require that claims be reported within a specified time period after the claim is made. Consider requesting that the clock begin to run from the time that individuals who are aware of the company’s claims reporting procedure, such as the general counsel or head of risk management, have knowledge of the claim. Or, negotiate language that allows the D&O carrier to deny coverage only if the failure to provide notice within the reporting period prejudiced the D&O carrier.
- d. Because some policies limit your ability to report potential claims, you should seek to negotiate for the right to report a potential claim at any time during the policy period, regardless of whether the policy is being renewed.
- e. Some claims made after a policy has expired may relate back to an earlier claim made while the policy was effective. Other policy language may exclude claims that relate to a claim made against another D&O carrier or that arose before the policy was issued. Therefore, you should check the related claims language to see whether it should be broadened or narrowed based on your particular situation.

5. **Coverage of Defense Costs.**

- a. Most D&O policies are “wasting policies”, which means that defense costs will eat away at the policy limits.
- b. Most policies allow insureds to choose counsel with the D&O carrier’s consent.
 - i. Confirm that the D&O carrier may not unreasonably withhold its consent to the choice of counsel.
 - ii. Because some policies do not allow reimbursement of legal expenses until the D&O carrier has consented to your choice of counsel, consider requesting that this provision be removed or that a grace period be inserted to allow you to quickly hire counsel.
 - iii. If the policy refers to an “approved counsel” list, consider requesting the D&O carrier to add your outside counsel to the list or having this provision removed. Consider negotiating for language that allows the Ds&Os to retain separate counsel.
- c. Make sure that the policy requires the D&O carrier to reimburse defense costs as they are incurred, rather than after the matter has concluded or only after the insureds have paid counsel. Because Side B coverage normally has a higher retention amount, or deductible, than does Side A coverage, consider whether to request the D&O carrier to agree to advance defense costs to Ds&Os without regard to the retention on the condition that the company agrees to reimburse the insurer for defense costs up to the retention amount if the company is found to have an obligation to advance defense costs.

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6. **Claims Settlement Process.** Some D&O policies have claims settlement provisions that can effectively force an insured to settle a claim that is within the policy's limits. These provisions limit the D&O carrier's liability to the amount the carrier offered to settle the claims if the settlement offer is within the policy limit. If this provision cannot be deleted, it should be modified to limit the D&O carrier's liability to the settlement amount only if the insured unreasonably withholds consent to the settlement.
7. **Allocation.** Allocation issues arise when some claims in a lawsuit are covered and others aren't, or where some persons are covered, while others aren't. Claims by the company and covered Ds&Os can also trigger allocation disputes if the claims exceed the policy limits or if the company and Ds&Os are sued but entity coverage is not implicated. In short, the D&O carrier may attempt to allocate as much of the losses as possible to claims and parties that aren't covered by the D&O policy. Some policies have pre-determined allocations for certain types of claims such as securities claims. Therefore, you should pay close attention to the policy allocation provisions.
 - a. D&O policies that allocate on the basis of the relative liability and benefits of covered parties should be reviewed to determine whether to delete this allocation language since D&O carriers will likely use this language to allocate losses to parties that aren't covered or that are subject to a higher retention.
 - b. Allocation of defense costs and other losses may be treated the same in the D&O policy. You should consider whether different allocation standards should apply to the different types of losses an insured may suffer.
8. **Exclusions.** As you might imagine, the policy exclusions are often the most important provisions of the D&O policy. Therefore, you should carefully review the exclusions in the body of the D&O policy and in the endorsements to determine whether they limit coverage for the types of claims against which you're trying to insure. Here are some typical exclusions from coverage:
 - a. Claims relating to public securities offerings or violations of securities laws. An endorsement can often be purchased to insure against cover these types of claims.
 - b. Claims relating to earnings restatements.
 - c. Claims relating to an inadequate or excessive price in an M&A transaction.
 - d. Claims for return of remuneration paid to a D or O to which the D or O was not legally entitled.
 - e. Violations of ERISA.
 - f. Claims relating to short swing profits from insider trading in company stock.
 - g. Fraudulent or dishonest conduct or illegal conduct. Negotiate these exclusions to require a final judicial determination of wrongful conduct. Also, make sure that these exclusions are severable to protect against the D&O carrier's attempt to void all coverage based on the wrongful conduct of a few bad actors.

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- h. Claims by one insured party against another (the so-called “insured vs. insured exclusion”). You should review the insured vs. insured exclusion carefully to make sure that the typical carve-outs in the policy (including a carve-out for claims by a bankruptcy trustee against Ds&Os) are as broad as possible.
 - i. Claims based on acts that occurred before the D&O policy was purchased or that may be covered under another policy. These exclusions should be narrowed as much as possible.
9. **Retentions.** Because retentions may vary based on the type of claim, you must consider how the retention may affect the Ds&Os ability to recover against the D&O carrier. For example, there is normally no retention for claims against Ds&Os when the company isn’t indemnifying them (*i.e.*, Side A Coverage). The claims that are indemnifiable (*i.e.*, Side B Coverage) will typically be subject to the retention. Securities-related claims may also have different retentions, and some D&O carriers may waive retentions applicable to defense costs if Ds&Os are found to have no liability.
10. **Bankruptcy Issues.** Some courts treat D&O policy proceeds as part of the bankrupt debtor’s estate. If this occurs, then the Ds&Os may have to stand in line with the other creditors of the bankrupt company. Because of this bankruptcy risk, you should consider the following:
 - a. Obtaining separate policy limits for Ds&Os or “separate Side A coverage”.
 - b. Purchasing personal D&O policies for each director.
 - c. Specifying the order of payments from the policy such that the Ds&Os are paid first out of policy proceeds before the company receives proceeds.
 - d. Negotiating language in the policy to the effect that the D&O carrier, company and Ds&Os intend for the proceeds to benefit the Ds&Os.
11. **Alternative Dispute Resolution.** Some D&O policies require that mandatory alternative dispute resolution procedures, such as arbitration, be used to resolve claims. These provisions should be deleted if at all possible to give the insureds the flexibility to get the case in front of a jury. Additionally, mandatory venue selection clauses that pick a location for a lawsuit over coverage should be carefully considered.

While you may not be able to get all that you ask for and may not know how much more a stronger D&O policy will cost, you never know what you’ll get until you ask. By focusing on the greatest risks to your Ds&Os and negotiating with the D&O carrier to minimize those risks, you’ll maximize coverage against personal liability and give them comfort in knowing that you’ve obtained adequate coverage against those risks.

Contact Rob Kibby at rkibby@munsch.com with feedback, suggestions for future articles or inquiries.

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