

DIRECTORS AND OFFICERS INSURANCE ISSUES

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In an ever changing business and social environment it has become increasingly important to have appropriate and adequate insurance coverage. With the volume of litigation on the rise, and the costs of defending even a baseless claim often reaching sums that challenge the most financially secure individuals, it is vital that individuals serving as directors and/or officers of corporations have adequate and appropriate insurance.

Contrary to common belief, Directors and Officers insurance is not simply a form of insurance that has relevance to board members or officers of large publicly traded corporations. On the contrary, smaller publicly traded corporations, as well as private and non-profit corporations, all have individuals serving as board members and officers. In fact, the reach of Directors and Officers insurance extends into entities as common as condominium associations which have boards of directors and officers who are charged with fiduciary duties in connection with the operation of the condominium association and who are potentially subject to suit given their duties and responsibilities as board members and officers of the condominium association. Thus while Directors and Officers insurance may commonly be perceived as a “niche” type of insurance, having

the correct D&O insurance can be critical to the financial health of an individual serving on a board of directors or in the capacity of an officer of a corporation.

While it is always important to discuss the various options available in the insurance market with an experienced broker, it is also important to have a basic degree of knowledge regarding the types of Directors and Officers insurance available, as well as the pitfalls that have commonly been observed in connection with Directors and Officers policy language. We will discuss below the general nature and types of Directors and Officers insurance products currently available, as well as the common issues that often arise between insurance carriers issuing Directors and Officers coverage and the insureds who have made claims under those policies.

A. WHAT IS ENCOMPASSED WITHIN DIRECTORS AND OFFICERS INSURANCE COVERAGE?

While there is no “form” Directors and Officers insurance policy, there are several elements that are typically found in D&O policies:

1. Directors and Officers policies commonly are referred to as providing side A, side B, and side C coverage. The side A coverage is designed to provide insurance to the individual Directors and Officers of a corporation in an effort to protect the assets of the individual Directors and Officers. Side A coverage comes into play where a Director or Officer is unable to receive indemnification from the corporation, either as a result of a prohibition under law

against a corporation indemnifying an Officer or Director (such as in the case of a derivative suit) or where the corporation itself is either unwilling or unable (such as in the case of bankruptcy) to provide indemnity to an Officer or Director as the result of a claim. Side B coverage is directed to the corporation that is insured under the policy and is designed to protect the corporation's assets. Side B coverage provides for the insurance carrier to reimburse the corporation for those sums that the corporation has provided by way of indemnity to an individual Director or Officer as part of the defense or payment of a claim made against that Director or Officer. Finally, the side C coverage is designed to provide insurance for the corporation as a result of claims made directly against the corporation itself.

2. The Directors and Officers policies are commonly "claims made" policies which provide coverage for claims first made against a Director or Officer, as well as the corporation itself, during the period of time that the policy is in effect. Furthermore, the Directors and Officers policies typically provide for the defense of Directors and Officers, as well as the corporate insured, and also provide for the payment of settlements or judgments which may be entered against the Directors/Officers and corporation. As will be discussed below, the Directors and Officers insurance policy usually is no different than other insurance policies to the extent that it contains various exclusions and limitations on the scope of the insurance coverage provided. The exclusions commonly found in such insurance policies are discussed at length below in Section "E".

i. As a general rule Directors and Officers policies have “eroding limits”. In these circumstances, the total insurance policy limits available to pay any individual claim are reduced by the costs and expenses incurred by the insurance company in defending the claim. Thus although a policy’s coverage limit may be \$1,000,000.00 or more at the time a claim is made, after potentially years of litigation the available limits to settle or pay a claim may be substantially less because of defense costs and expenses incurred by the insurance carrier in defending the claim.

3. As with any insurance policy the first step in obtaining Directors and Officers coverage is completing a policy application. Often insurance companies will require that various financial records be attached to an application for Directors and Officers insurance. The statements contained within the policy application will be reviewed very carefully by the underwriting department of the insurance carrier and thus great care must be taken to ensure that the statements contained in the application are accurate and not misleading. As will be discussed further below in Section “D”, regarding rescission, insurance carriers on occasion have attempted to rescind an insurance policy on the grounds that a material misrepresentation was contained in the policy application or documents attached to the policy application. Thus where financial statements attached to an application are subsequently revised or amended, a failure to so advise the insurance carrier can lead to a coverage dispute wherein the insurance carrier

seeks to have the coverage rescinded based on a claimed material misrepresentation of fact in the application.

4. A number of new products are being offered by insurance carriers relating to Directors and Officers insurance coverage. What follows is a partial list of certain of these new products:

(a) One of the most discussed and sought after options for Directors and Officers coverage is the “stand alone difference in condition side A policy.” As discussed above, the portion of a Directors and Officers insurance policy which provides defense and indemnification directly to an Officer or Director, as opposed to the corporation, is the side A coverage. However, situations have arisen in which the side A coverage of a standard Directors and Officers policy is either unavailable or insufficient and, consequently, a Director or Officer may be in jeopardy of losing coverage benefits thereby exposing his or her personal assets as a result of a claim. For example, in cases where the corporation, as well as the Directors and Officers, are covered by a single policy and the corporation becomes involved in a bankruptcy proceeding, there have been occasions when the bankruptcy trustee has claimed that the insurance policy is an asset of the bankrupt estate and, therefore, no funds can be paid out under the policy to defend and settle claims against individual Directors and Officers. In response to such situations, several insurance carriers have begun making available the stand alone side A

difference in condition policy. Such a policy can serve as either primary or excess insurance and in those cases where the policy serves as excess insurance, it will “drop down” and become primary coverage should the Directors and Officers policy maintained by a corporation become unavailable. The stand alone side A policy only insures the Directors and/or Officers, as opposed to the corporate entity. In such a situation it can be argued that the policy is not part of the corporation’s bankruptcy estate in the event such an eventuality arises. As an excess policy the stand alone side A policy may also provide additional insurance coverage limits should the corporation’s Directors and Officers policy limits be eroded by the payment of defense costs or settlements/judgments.

(b) Certain of the insurance companies writing Directors and Officers coverage have now begun to tailor policies for smaller public companies and include provisions such as no rescission of the policy in the case of innocent Directors and Officers, and a definition of “claim” which allows coverage to be triggered by an SEC or Department of Justice investigation. Other carriers have begun marketing D&O policies that contain no specific exclusion section in the policy, provide automatic coverage for outside director’s liability in the case of not-for-profit corporations, and a non-cancelable provision except in those situations where an insured has failed to pay the applicable premium.

B. THE IMPACT OF SARBANES-OXLEY

In July 2002 the Sarbanes-Oxley Act was signed into law with far reaching ramifications for Officers and Directors of both public and private/not-for-profit corporations. While the Sarbanes-Oxley Act by its terms applies to publicly traded companies of sufficient size that they are required to file 10-Q and 10-K statements under the Securities Act, the impact of Sarbanes-Oxley reaches far beyond those parameters to affect private companies and not-for-profit companies.

1. The most immediate affect of Sarbanes-Oxley is to require CEO's and CFO's to sign off on and certify the financial information of the corporation under penalties that can be as severe as 20 years imprisonment for willful/intentional misstatements of information. Both civil and criminal penalties are contemplated by violations of the Sarbanes-Oxley Act. Additionally, Sarbanes-Oxley requires corporations falling within its scope to create and maintain an audit committee, create a code of ethics and bars Officers and Directors from receiving loans from the company where they are serving as an Officer or Director.

2. The existence of Sarbanes-Oxley has an impact on small public corporations, private corporations and not-for-private corporations as well. Given the fact that various ethical and financial terms are included within the scope of Sarbanes-Oxley, that Act is likely to be deemed to be a benchmark by which Directors and Officers in small public corporations, private corporations and not-for-profit corporations will be judged when their conduct is called into question.

Thus an Officer or Director of a small public corporation or private corporation who receives loans from the corporation may have a difficult time justifying the appropriateness of such loans when the United States Government has decreed that such loans are not appropriate in the case of large public corporations pursuant to Sarbanes-Oxley. Most importantly, the presence of these various provisions in Sarbanes-Oxley also creates an increased potential for claims against Officers and Directors who do not voluntarily comply with certain of the financial or ethical portions of Sarbanes-Oxley.

3. The presence of Sarbanes-Oxley simply reinforces the need for Directors and Officers insurance even in the context of small public, private or not-for-profit corporations as plaintiffs' attorneys are well aware of the provisions contained in Sarbanes-Oxley and are equally aware of the argument that the standards set by Sarbanes-Oxley for public corporations should be applicable to small public corporations, private corporations and not-for-profit corporations.

C. SEVERABILITY ISSUES

As a general rule, one individual is often charged with responsibility for preparing an insurance policy application and assembling the materials which will be attached to it. That individual may be the same person that signs the applications or may, in fact, be someone separate from the person who signs the policy application. In either case, when dealing with Directors and Officers insurance there are a number of other individuals who likely have not participated in the preparation of the application and are not aware of

all of the information set forth in the application. For a number of years after Directors and Officers insurance became available any statement contained in the policy application which was deemed to be untrue or a misrepresentation served as a basis for the insurance carrier to seek rescission of the entire policy as to all of the insureds. Naturally, such an approach had a devastating affect on “innocent insureds” who had no personal knowledge of the purported misrepresentation or omission of information from the policy application. Over time several insurance companies have been modifying policy language to provide for “severability”. In such cases, insurance carriers agree that knowledge of one insured regarding a misstatement, false statement or omission of fact will not be imputed to an “innocent” insured who had no such knowledge. Thus under the principle of severability, certain insureds may lose their insurance coverage while other “innocent” insureds are insulated from that situation by their lack of knowledge regarding the facts in question.

1. When considering the policy language in a Directors and Officers policy, it is critical to ensure that the “severability” language is present in the policy so that knowledge of one insured which could support a rescission claim by the insurance carrier is not imputed to one or more of the other insureds under the D&O policy who have no such knowledge.

D. RESCISSION

The doctrine of rescission has been applied by insurance carriers in the context of Directors and Officers coverage just as it has arisen in connection with other types of

insurance coverage. Under the doctrine of rescission, an insurance carrier files suit against the insureds seeking to have a court declare that the policy is rescinded and provides no duty to defend or indemnify as a result of a material misrepresentation or omission of fact in an insurance policy application. In essence, the insurance carrier is claiming that it was deceived by the insured into issuing the insurance coverage and that had it known facts at the time it was considering the application, that it now is aware of, it would never have issued the insurance policy.

1. In the context of Directors and Officers insurance, rescission remains a viable argument made by insurance carriers. Many carriers now require parties seeking Directors and Officers insurance to attach financial information to the policy application. Should it subsequently be learned that information contained in the financial statements attached to the application is incorrect and is being restated, an insurance carrier may argue that this represents a material misrepresentation of fact and seek to rescind coverage based on the restatement of that financial information. Of course, insurance carriers also seek rescission of Directors and Officers insurance based upon other arguments such as that a claim was known to exist at the time the application was completed but was not disclosed in the application. Thus the principles discussed previously regarding “severability” have application in the context of rescission. Where a corporate president is the party responsible for completing the application and fails to disclose in the application his knowledge regarding a potential claim, an insurance carrier will likely seek to rescind the policy should that potential claim ever

become a reality. However, those individuals who are insureds under the D&O policy who do not have the knowledge of the person who completed the policy application, have the ability to rely on severability principles in defense of a rescission claim and state that they are entitled to continued insurance coverage.

E. DIRECTORS AND OFFICERS' POLICY EXCLUSIONS

As is the case with most insurance policies, Directors and Officers' policies commonly contain a section that identifies multiple exclusions from coverage. While the items identified as exclusions under a Directors and Officers' policy are evolving and may, on occasion, be open to negotiation, there are certain exclusions that tend to regularly appear in Directors and Officers insurance policies. Thus you will normally find an "insured vs. insured" exclusion. This exclusion provides that no coverage is afforded for claims brought by one insured against another, and has become more prevalent with the rise in bankruptcy filings. Consequently where a bankruptcy trustee files a claim against Directors and/or Officers of a corporation alleging that they breached their fiduciary duty to the corporation, some insurance carriers have argued that the claim is being brought by the bankruptcy trustee as the representative of the corporation, and since the corporation is an insured under the Directors and Officers' policy this falls within the insured vs. insured exclusion. Some insurance carriers have begun carving out exceptions under this exclusion for claims brought by bankruptcy trustees. However, it is essential that during the process of evaluating whether to change carriers or renew an

insurance policy you pay special attention to the definition of “insured” under the policy and who is considered to be an insured.

1. As a general rule Directors and Officers’ policies exclude coverage for suits relating to property damage, claims by regulatory agencies, claims arising out of environmental damage, ERISA claims, and claims arising from fraud or self dealing. Although certain of the Directors and Officers’ policies now provide for the defense of fraud or self dealing claims it is important to thoroughly review the language of such policies as in some cases if an insured is ultimately found liable for fraud or self dealing the policy may contain an obligation to reimburse the insurance carrier for all defense costs and expenses incurred in connection with the unsuccessful defense of such claims.

2. As previously noted, many Directors and Officers’ policies exclude from coverage claims involving fines or penalties. Where a claim has been brought against a Director, Officer or corporation under Sarbanes-Oxley for knowing or willful misconduct, the potential exists that such a claim may be deemed excluded under Directors and Officers’ coverage based on the characterization of the relief sought against the Director/Officer or corporation as a “fine” or penalty. Once again, it is important to work with your insurance broker in an effort to negotiate policy language that may reduce the potential for such claims to be excluded.

F. DEFENSE COSTS

Directors and Officers' policies normally contain both a duty to defend and a duty to indemnify insureds in connection with claims brought against them. As a general rule insurance carriers have a number of attorneys/law firms that regularly handle cases of this type and when a claim arises they are inclined to assign one of those attorneys to represent an insured. However, certain of the Directors and Officers' policies now contain a provision that allows the insured to request a particular attorney who may not be on the regular panel of counsel that represents insureds for a given insurance carrier. Of course, irrespective of whether the insured or the insurer decides who will represent the insured, there will be costs incurred in connection with defending a claim. These costs typically include attorneys' fees, as well as expenses associated with a claim.

1. In most cases defense costs will reduce the available policy limits on a dollar for dollar basis after the deductible or self-insured retention has been satisfied by the insured. As a general rule, the insured has no obligation to repay defense costs if the outcome of a claim or litigation is not favorable to the insured. However, there are situations in which a Directors and Officers' policy may require reimbursement of defense costs. As previously noted, certain policies will provide a defense for fraud or self dealing claims, however if the outcome of the litigation or claim is not favorable to a Director/Officer or corporation, the policy may require that the defense costs be reimbursed to the insurance carrier. This can result in substantial financial hardship for a Director or Officer who has been involved in litigation for an extended period of time and significant defense costs have been incurred. Once again, it is important when negotiating the terms of a

D&O policy, to keep in mind such possible reimbursement issues in an effort to negotiate language which provides for an insurance carrier to defend fraud or self dealing claims without a reimbursement obligation.

G. PRIORITY OF PAYMENT

Many of the current Director and Officers' policies contain what is referred to as an "entity" clause which adds the corporation as an insured. While at first glance this may seem to be a positive development, there are also traps for the unwary which may arise as a result of the entity clause. One such trap relates to the concept of priority of payment. When the individual Directors and Officers are insured under a D&O policy, and the corporation is also insured under that same policy the potential exists that problems may arise in payment of claims where there is either a limited amount of insurance coverage remaining or the corporation is in bankruptcy. In such a situation, the question arises as to which claims are paid first, those directed against the corporation or those directed against individual Directors/Officers. The priority of payment endorsement was designed to remedy this issue. Typically, the priority of payment endorsement provides that funds will first be paid on behalf of the individual Directors and Officers in satisfaction of a claim, then remaining funds will be applied to pay the corporation for sums that it has paid to indemnify Directors and Officers for their defense and indemnity costs, and finally if any funds remain available they will be used to reimburse the corporation itself. While it cannot be said that every bankruptcy court has addressed this issue, it appears that the priority of payment endorsement should be enforceable despite a bankruptcy filing. However, as discussed previously the best

protection for Directors and Officers in such a situation would be a stand alone side A policy which is payable solely to the Directors and Officers and does not bring the “entity” issue into play as the corporation is not an insured under such a policy.

The discussion contained herein was not intended to be all encompassing on the topic of Directors and Officers Insurance, and should you have any questions regarding the points discussed in this presentation, or that were not addressed herein, please feel free to contact Howard L. Lieber at FISHER KANARIS, P.C.