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Directors and Officers Liability and Insurance Update 2011

SUSANNE MAST MURRAY AND FRED T. PODOLSKY

State of the D&O Insurance Marketplace

There have been unprecedented changes in the directors and officers (D&O) insurance marketplace over the last year. Several insurers have introduced new insurance policies, both for public and private companies. These new policies include extraordinary grants of coverage and significantly increase the risks being underwritten by the insurers. We discuss some of these coverage provisions below, though we would point out that each insurer has its own risk concerns and risk appetite, so no one insurer generally would offer all of these new coverage provisions at the same time.

One of the biggest issues in the insurance marketplace today is the uncertain impact that the newly created Federal Insurance Office (FIO) will have on the business of insurance. Although the right of the states to regulate insurance has not been overturned, the FIO will have oversight rights and responsibilities over the state insurance regulatory activities and a more definite federal regulatory role in the purchase and sale of insurance. The FIO has also been charged with the task of working with other insurance agencies and instrumentalities outside of the U.S. to work toward a more consistent international insurance scheme. The potential impact of the FIO on the business of insurance remains unclear for now.
D&O Liability Exposures and D&O Insurance Implications

Directors and officers run the risk of liability for their actions or omissions. There are standard types of allegations of wrongdoing that are asserted by standard types of claimants. In many ways, the typical exposures are substantially similar for both public and private companies, with the most significant difference being the exposure to risk arising from securities claims against public companies and their directors and officers. These typical exposures are also substantially similar regardless of industry sector, other than the differing exposures arising from regulatory or governmental activity.

Although the claims and the claimants may remain somewhat constant over time, changes in the legal or regulatory climate do effect changes in exposure. In this article, we will touch on some of the most recent activities that can have an impact on D&O exposures, including both regulatory and legal activity. In addition to D&O liability from external sources, we will also touch on recent litigation that interprets specific coverage provisions or has a substantial impact on coverage.

It is likely that there will be a significant increase in whistleblower activity in 2011.

Dodd-Frank Act

The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Act) is a sweeping statute with a potentially significant impact on the liability exposures of directors and officers. The Act created numerous councils, offices, committees, and study groups focused on regulation of securities and securities liability and banks and nonbank financial institutions, among others. The Act encourages increased whistleblower activity, clarifies the Securities and Exchange Commission’s (SEC) right to bring actions based on controlling person liability under Section 20 of the Securities and Exchange Act of 1934, and focuses on executive compensation, including more stringent compensation clawback provisions in the event of financial restatements. One important comment worth making about the Act is the necessity for increased and continued funding for the SEC and other governmental agencies in order to be able to conduct the oversight and enforcement activities mandated by the Act.

Whistleblowing for Profit

Monetary awards will be given to whistleblowers who provide information leading to the successful enforcement of a judicial or administrative action by the SEC that results in monetary sanctions exceeding $1 million. The amount of the award to whistleblowers will range from 10 percent to 30 percent of what is collected from the monetary sanctions imposed in the action. Individuals who may be involved in internal audits or investigations can bring any potential financial improprieties to the SEC even before reporting such improprieties to the company itself. Whistleblowers can remain anonymous as long as they are represented by counsel, and they can even be individuals who have or may have engaged in wrongful misconduct, as long as they were not convicted of a related crime. It is likely that the plaintiffs bar is actively soliciting whistleblowers at this time. With the new “whistleblowing for profit” provisions from the Act, it is likely that there will be a significant increase in whistleblower activity in 2011.

Controlling Person Liability

The Act clarifies the SEC’s right to bring actions based on controlling person liability under Section 20 of the Securities and Exchange Act of 1934. A company’s directors and officers who directly or indirectly control another person (such as an employee or a subordinate officer) who commits a securities violation are responsible for that violation unless the directors or officers can show that they personally were acting in good faith and can demonstrate that they did not directly or indirectly cause or encourage the violation.

International Corporate Governance for Banks

In October 2010, the Basel Committee issued its final set of Principles for Enhancing Corporate Governance for the banking sector. The revised principles on corporate governance focus on board practices,
senior management, risk management and internal controls, compensation, corporate structures, disclosure, and transparency. In regard to risk management, banks are to establish and maintain effective internal controls and create an independent risk management function, including a Chief Risk Officer who has independence, resources, and direct access to the board of directors.

Foreign Corrupt Practices Act (FCPA) Claims

The SEC and the Department of Justice (DOJ) have initiated an unprecedented number of enforcement actions during 2009 and 2010, and the price to resolve these actions has escalated dramatically. The FCPA Web log lists the top 10 FCPA settlements, amounting to about $2.8 billion in financial penalties. At the top of the list is an $800 million settlement by Siemens in 2008. While the great majority of big dollar settlements were reached with companies, there have been several settlements with individuals for over $1 million. What was possibly the largest settlement with an individual was announced by the SEC on November 22, 2010; it included jail time and $55 million in restitution after a conviction for securities fraud, conspiracy, and wire fraud.

FCPA settlements typically include money portions that are denominated as criminal fines, civil fines, restitution, or disgorgement of ill-gotten gains, and many include both fines and restitution as separate line items. FCPA claims are being brought as administrative or regulatory proceedings, parallel civil or criminal regulatory proceedings, and independent securities class or derivative actions. Claims brought by securities holders often follow announced settlements with the SEC or the DOJ.

D&O policies often now include express coverage for certain FCPA fines and penalties, and some include blanket coverage.

Coverage Issue: Right to Indemnification

D&O policies provide coverage for indemnifiable claims excess of a deductible. Whether a claim is indemnifiable is based on state statute and case law. In a recent case decided by the Second Circuit Court of Appeals, In Re DHB Industries Inc. Derivative Litigation, the court considered whether the parties in a derivative securities action had the right to settle a derivative claim that included a release of the company’s CEO and CFO from liability under Section 304 of the Sarbanes-Oxley Act of 2002 (SOX). Section 304 of SOX provides for disgorgement or return of incentive compensation or proceeds from certain stock sales by the CEO and the CFO. The court found that only the SEC had the right to bring an action under Section 304 or to agree to exempt someone from liability under that section. This decision raises several issues in connection with D&O insurance.

First, does the prohibition against indemnification also preclude insurance coverage? In that regard, the court noted that it considered the release of the CEO and CFO from liability under Section 304 to be “flying in the face of Congress’s efforts to make high ranking corporate officers directly responsible for their actions that have caused material noncompliance with financial reporting requirements.” In light of that language, it appears likely that any indemnity payments for a settlement

Coverage Litigation

Like all litigation, coverage litigation is fact specific, so the extent to which a decision in one case impacts the interpretation of coverage in another case varies. Having said that, coverage cases shine a light on problem areas so that the issues can be addressed, or at least understood. In addition to coverage disputes between insurers and insureds, other litigation outside of the insurance context can have an impact on D&O coverage. One such case mentioned below involves the ability of a company to indemnify its directors and officers. The case does not address insurance at all, but clearly the issue of indemnification does. Following are some examples of coverage provisions at issue in recent cases and the potential impact on D&O coverage.
or judgment of a Section 304 claim may be considered uninsurable. As some insurers have recently provided express coverage for fines and penalties if insurable by law, this may be an award that is uninsurable.

Second, does the prohibition against indemnification imposed by the court extend to defense costs or only to any disgorgement, return of proceeds of stock sales, or other monetary payment to resolve a Section 304 action? In this regard, several of the new D&O policy forms expressly provide for payment of defense costs in Section 304 claims, so at least in those policy forms, it is likely that insurers will continue to pay defense costs until a court decision instructs otherwise.

**Coverage Provision: Prior Notice Exclusion**

D&O policies are generally "claims made" policies and cover only claims that are first "made" during the policy period. A prior notice exclusion eliminates coverage for claims made during the policy period if they can be related back to an earlier claim that was noticed under an earlier policy. In that instance, the claim may have actually been asserted today, but it will be "deemed" to have been asserted under the prior policy and perhaps (but not always) covered under that prior policy.

In *Cox Communications Inc. v. National Union Fire Ins. Co. of Pittsburgh, PA.*, a federal district court held that the prior notice exclusion in the policy did not date back a proceeding newly brought during the policy period (in 2002) to claims noticed under a prior policy by a different insured (in 2000). The exclusion at issue eliminated coverage for claims noticed under any policy for which the current policy was a renewal or replacement or which it succeeded in time. The insurer argued that the exclusion applied because the lawsuit arose out of the same facts as two 2000 lawsuits and because the 2002 policy period succeeded in time the 2000 policy. The court ruled that the phrase "succeed in time" includes only prior policies issued to the insured.

**Coverage Provision: Insured Versus Insured Exclusion**

The insured versus insured exclusion found in a D&O policy eliminates coverage for claims brought by one insured under the policy against another insured under the policy. Two cases were recently litigated over this exclusion and are referenced below.

In *M. William Macey, Jr., et al. v. Carolina Casualty Ins. Co.*, the Second Circuit Court of Appeals found the insured versus insured exclusion was ambiguous as to whom it was intended to exclude and noted ambiguous provisions cannot be enforced. The insurer argued that directors and officers of the predecessor company were past insureds. The current insured, on the other hand, argued that the directors and officers at issue were not former directors or officers of the newly incorporated entity and therefore were not insureds under the policy in question such that the exclusion would be triggered. The court ruled that because there was a question of fact as to when in time the newly incorporated entity came into existence, the case would have to be remanded to discover facts outside of the policy.

In *Ideal Dev. Corp. v. U.S. Liability Ins. Co.*, a federal district court held that the insured versus insured exclusion in an insured corporation's D&O policy precluded coverage for lawsuits involving one of the corporation's board members as an adverse party. In doing so, the court rejected the insured's argument that the exclusion applied only when the director was suing in his capacity as a director. The plain language of the policy excluded coverage for any claim by, at the behest of, or on behalf of the organization or any individual insured.

**Coverage Provision: Right to Advancement of Defense Costs**

Most state corporation statutes permit advancement by the company of defense costs incurred by its directors and officers for claims brought against them in their capacity as such.

In *Baker v. Impact Holdings Inc.*, the Delaware Chancery Court found that costs incurred in an affirmative action brought by the plaintiff, who was a former director, were not "in defense of a claim" and therefore not subject to indemnification and advancement by the company, even though the plaintiff asserted that such costs and expenses were in anticipation of a claim. While the defendant did have articles of incorporation requiring indemnification and advancement for claims or threatened claims, in this instance, the former director brought suit before any claims were affirmatively initiated against him, and the litigation was not therefore initiated “in defense” of an investigation.

From an insurance perspective, D&O limits are a
wasting asset, as you can only spend the limits once, and they are intended to protect insureds from liability to third parties. Many policies will actually state that costs incurred pre-claim, such as costs incurred to preempt a claim about to be made against an insured, are not covered by the policy, even if the result of such costs will ultimately benefit the defense of a claim. However, this is one of the issues that has been addressed in recent policy form modifications as more fully discussed below.

Coverage Provision: Conduct Exclusions

Most D&O policies include conduct exclusions that eliminate coverage for claims arising from specifically prohibited activity. The actual conduct being precluded differs among policies, but generally it can include fraud, dishonesty, criminal or malicious acts, willful violation of statute, improper personal profit or advantage, or any combination of the above. Mere allegations of the excluded conduct will generally not trigger the exclusion, however. What is necessary

Exhibit A

Looking Back: 2010 D&O Market Highlights

- 2010 was generally a year of premium decreases, with notable exceptions in some financial services segments.
- Large publicly traded companies saw average rate reductions of 5 percent to 15 percent.
- Small to middle market public and private company insureds saw more aggressive reductions in the 10 percent to 20 percent range.
- Excess insurers added to downward pricing trends in 2010 by adjusting their excess pricing modifiers from 2009 levels of 70 percent to 80 percent to more realistic levels of 60 percent to 65 percent and, in some cases, lower.
- More insurers competed for primary layer positions as their excess rates and positions were placed under pricing pressure.
- There was continued growth in Side A insurance programs being purchased.
- More insurers introduced simplified excess forms.

Exhibit B

2011 D&O Market Trends

- Heavy competition in selected market segments will continue, especially for private company business. Industry segments that continue to be less favored by the market are financial institutions, health care, and certain technology companies.
- Insurers may be more willing to walk away from renewal and new business opportunities if pricing levels remain under heavy pressure. Already, some insurers have been vocal about not following downward pressures, as doing so adversely affects their ability to actually underwrite the risk. This could be an early sign of a market shift. New entrants to the market in 2010 should benefit from an overall stabilizing market this year.
- We continue to see certain Bermuda- and London-based insurers open up underwriting facilities in the U.S. targeted at specific market segments.
- An increasing number of insurers will compete for primary business, as their excess rates have come under downward pressure, creating opportunity for some companies to benefit from further rate reductions of 3 percent to 10 percent.
- Insureds will continue to evaluate program structure and total limits purchased for appropriateness.
- Breadth of contract severability, rescission, and fraud language will be key negotiation points.
to trigger a conduct exclusion is heavily negotiated and usually requires some establishment that the prohibited conduct occurred.

In *Laura Pendergest-Holt, et al. v. Certain Underwriters at Lloyd’s of London and Arch Specialty Ins. Co.*, the Fifth Circuit Court of Appeals ruled that the insurers must advance defense costs until the excluded conduct is determined to have occurred “in fact.” The policy did not clarify who was making this determination or what “in fact” meant. As a result, the court rejected the insurer’s argument that it was in the position to make the determination, ruled that the policy required the decision to be made in some sort of judicial forum (though not in the underlying action), and remanded the case to federal district court to conduct this separate action and make the determination. Ultimately, the federal district court did find that the excluded conduct had occurred and therefore agreed that the insurers were no longer obligated to pay defense costs.

Unlike the policy at issue in the case above, the method of establishing whether the excluded conduct occurred is generally spelled out in the D&O policy. The preferred language is the requirement of a final adjudication in the underlying proceeding proving that the excluded conduct occurred before the exclusion will be triggered. This language means that no alternative or corollary claim or forum, such as an SEC investigation or a criminal proceeding, a separate court proceeding as in the above instance, or a separate proceeding initiated by the insurer, can be utilized to prove and adjudicate the conduct in question.

Exhibits A and B demonstrate 2010 market highlights and predict 2011 market trends.

### 2011 Rate Expectations

As shown in Exhibit C, we expect that most insureds will see moderate decreases to flat renewal pricing during 2011, though there will be many insureds that can do significantly better. Insureds that have gone through five or six rounds of price decreases are more likely to see flat pricing without a strong round of marketing forcing additional cost savings for better insureds. Those with higher profiles are likely to see greater pressure for a premium increase without substantial program marketing, even if recently marketed.

The issues affecting rate expectations are many, but we believe insurers will focus on the following during 2011:

- financial statement profile;
- board and audit quality;
- claims history;
- corporate governance profile;
- industry and company specific regulatory profile; and
- ownership profile.

### Excess Pricing

Filling out a large limit program is still a time-consuming exercise, but it was less so in 2010, and we expect that trend to continue into 2011. Whereas in recent years we saw demands from underwriters to know both pricing below and above their layer and individual demands as to terms and conditions, applications, and exclusions, 2010 was a year of excess capacity available for most programs. Excess layer pricing fell fairly dramatically in some cases, from upwards of 75 percent of the underlying limit rate to a rate of 55 percent to 65 percent and sometimes more, depending on the overall size of the program. We expect this trend to continue during 2011. However, for the larger limit programs, it is important to note that excess rates on line, or rates as a percentage of the layer below, do level off at some point to a minimum price per million.

<table>
<thead>
<tr>
<th>Exhibit C</th>
<th>2011 Rate Expectations</th>
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<tbody>
<tr>
<td><strong>Better Than Average Risk</strong></td>
<td>Flat to 7 Percent Decrease</td>
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<tr>
<td><strong>Average Risk Profile</strong></td>
<td>Flat to 5 Percent Decrease</td>
</tr>
<tr>
<td><strong>Higher Risk Profile</strong></td>
<td>Flat to 10 Percent Increase</td>
</tr>
<tr>
<td><strong>Extreme Risk Profile</strong></td>
<td>Flat to 25 Percent Increase</td>
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</table>
2011 Capacity

We believe that approximately 50 companies write D&O for public, private, or non-profit companies. Many insurers have exited or substantially altered their focus over the last few years as short-term profits disappeared with ever expanding litigation trends and settlement amounts. D&O is a “feast or famine” business, and the time period that D&O insurers get to feast has become short. Pricing levels declined dramatically while average settlement values of securities cases rose and coverage expanded. We have seen that it is difficult for any insurer to time the right moment to enter and exit the market, and companies typically look for long-term staying power from their D&O insurer.

Currently, less than 10 primary insurance markets compete in the large public company segment of this business. New capacity entering the market has tended to focus more on excess business and the private or nonprofit sectors. While it is expected that the industry will be profitable for 2010, there is widespread concern over the adequacy of reserves as a whole. Establishment of timely and appropriate claim reserves is a critical component of any insurance company. We worry about the ability and fortitude of newer and financially weaker insurers to appropriately reserve in the volatile D&O line where understanding complex legal matters can be difficult.

Market-Changing Coverage Expansions

Notwithstanding the increasing risk of liability of directors and officers, the D&O insurance marketplace continues to provide broad coverage with few restrictions. In addition to refining coverage provisions already in existence, this last year has seen new primary D&O policy forms from several insurers. Coverage across the board has broadened — a more comprehensive definition of “claim” is an example — but in addition to tweaking coverage that already existed, entirely new provisions have been introduced, and old standards have gone by the wayside. Some of the most significant of these market-changing coverage expansions are discussed below.

Presumption of Indemnification

Traditional D&O policies include coverage for indemnifiable loss subject to a negotiated deductible and explicitly provide that if a claim is indemnifiable, then the insurer will presume that the claim is being indemnified. Therefore, coverage for indemnifiable loss is not triggered until the deductible is spent. For indemnifiable claims that are not being indemnified, insured persons are personally responsible for their defense costs in connection with a claim until they have satisfied the deductible. This personal liability exposure has been addressed over the last several years by purchasing additional Side A nonindemnifiable loss coverage with different terms from the traditional policy, which is referred to as a Side A difference in conditions (Side A DIC) policy and includes coverage for indemnified claims that are not being indemnified. Over the course of the past year, as mentioned earlier, several insurers have developed new policy forms for public companies, and generally these new forms have removed the presumption of indemnification. Instead, if a claim is indemnifiable, but for whatever reason the insured company is not indemnifying, then the D&O policy will step in and pay the bills before the deductible is satisfied. This means that the insured persons are protected from dollar one. In the event that the insurer has to pay for an indemnifiable loss before the deductible has been satisfied, the insurer has a direct contractual right to recoup such payments from the insured company.

Some policies state that the insurer will not subrogate against an insured unless a conduct exclusion has been triggered.

Waiver of Rights of Subrogation

Whenever payment is made under an insurance policy, the insurer retains the right to subrogate against other potentially responsible parties. While some insurers will say that they do not intend to subrogate back against any insured under the policy who may be the cause of the loss, most insurers will expressly limit their right of subrogation in the policy to some degree. Some policies state that the insurer will not subrogate against an insured unless a conduct exclusion has been triggered. Some will expressly waive all rights to subrogation against any insured or any insured person.
Coverage for Fines, Penalties, and Taxes

Some insurers will now include fines, penalties, and even taxes as an element of covered loss if such amounts are a personal obligation of an insured person and arise out of a covered wrongful act. This expansion is subject to the overriding requirement that such amounts are insurable. In some policies, the extent of fines and penalties coverage is limited to amounts imposed under the FCPA.

Prejudice Required to Deny for Late Notice

D&O policies have strict reporting provisions, and courts have routinely enforced those provisions. For that reason, late notice is the single largest area of contention between insurers and insureds. Over the last several years, different courts have considered whether the insurer can reasonably deny a claim based on late notice if the insurer has not been prejudiced by the delay. Some insurers now specifically provide that they will not deny for late notice unless they have been prejudiced.

Insured Versus Insured Exclusion Converted to Company Versus Insured Persons

The insured versus insured exclusion eliminates coverage for claims brought by one insured under the policy, which can include claims brought by an insured individual or by the insured company, against another insured under the policy, whether entity or individual. The genesis of this exclusion was to prevent insureds from colluding with each other to force payments under the policy for claims amongst themselves. Over time, numerous exceptions have been added to the effect that the exclusion does not apply under certain circumstances. One important exception has been to limit the applicability of the exclusion to only claims brought in the United States. Most recently, insurers have converted this insured versus insured exclusion to a company versus insured person exclusion, which limits the number of plaintiffs and provides coverage for claims by the board against management or vice versa.

Continued Narrowing of Conduct Exclusions

Conduct exclusions generally eliminate coverage for (1) fraudulent, criminal, dishonest, or malicious acts or willful violations of statute — and most exclusions include some but not all of those enumerated wrongful acts; (2) gaining a profit or advantage to which the insured was not legally entitled; and sometimes (3) illegal remuneration or an accounting of profits. Under most standard D&O policies, the exclusions are triggered only if there is some establishment of the excluded conduct. The degree to which the conduct must be established is what continues to evolve. At this point, the narrowest trigger is to require a final and nonappealable adjudication in the underlying proceeding before the exclusion will be triggered. Until that time, coverage exists, so the insured can receive defense costs and settlement costs for such claims. Some insurers will also provide additional coverage even after the exclusion has been triggered, such as an exception for defense costs or an exception where the exclusion does not apply to independent directors, or even an exception that the exclusion does not apply to indemnifiable loss.

Deletion of Previously Standard Exclusions

Most D&O policies contain a standard set of exclusions, though each insurer crafts these exclusions to address its own particular risk concerns. Over time, these standard exclusions have been refined and narrowed, and now some have been deleted entirely by some insurers. For example, some insurers will now delete the pollution exclusion entirely. Deleting this exclusion is not intended to add coverage for environmental liability, and insurers can still look to a bodily injury exclusion and a property damage exclusion to exclude claims arising from the results of pollution. Some Side A DIC policies have deleted virtually all exclusions other than conduct exclusions.

Return of Retention/Deductible Waivers

In an effort to encourage insureds to actually litigate claims that are without merit, some insurers agree to waive the policy retention if the defense is ultimately successful. Although introduced several years ago, the right to a retention waiver was fairly quickly taken away. Over the course of the past year, a small number of insurers have again been willing to provide this policy enhancement, though generally this will only be available when retentions are under $1 million.

Deletion of Undertaking Clause

The undertaking clause in a D&O policy is essentially the payback provision. Costs will be advanced under the policy with the understanding that if it is
### Exhibit D

**Triggering Coverage Under a D&O Policy**

| Assertion of a Claim | Claim includes: written demand; civil, criminal, regulatory, administrative, or arbitration proceeding; investigations or inquiries involving insured persons (whether identified as a target or not); and request to waive or toll statute of limitations.

*This is an area of recent changes to standard coverage.* |
<table>
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<tr>
<td>Against an Insured</td>
<td>Insureds under a traditional D&amp;O policy include directors and officers and their functional equivalents outside the U.S. Some D&amp;O policies specifically reference other individual titles as well, such as trustee, governor, manager or members of the board of management, general counsel, and risk manager. Insureds may include employees for certain claims or on a codefendant basis when at least one other insured person is included in the claim. Insureds under a traditional D&amp;O policy also include the corporate entity and downstream subsidiaries as an insured.</td>
</tr>
<tr>
<td>Alleging Wrongdoing or Alleging Covered Capacity</td>
<td>“Wrongful act” basically includes any act, error, or omission. In addition, because some claims may include individuals as defendants simply because they are directors or officers or play other specific roles, most D&amp;O policies also extend coverage for claims asserted against insureds because of their role, even if the claim does not allege any specific wrongful act committed by the insured.</td>
</tr>
<tr>
<td>Made During the Policy Period</td>
<td>D&amp;O policies are generally “claims made” policies covering claims made during the term of the policy. Claims made prior to the policy inception date or after the policy and any extended reporting period expire are not covered under the policy.</td>
</tr>
</tbody>
</table>
| Not Otherwise Excluded | Most D&O policies include exclusions for certain conduct, for claims that can be insured elsewhere, or for claims that are uninsurable. Even when an exclusion can potentially mean that a claim is not covered, many exclusions have trigger hurdles that must be met before an exclusion can be relied on to deny coverage entirely.

*The number of exclusions, the breadth of the remaining exclusions, and the ability to trigger those exclusions have recently undergone significant change.* |
| Properly Noticed | The notice requirements under a D&O policy are generally considered to be “conditions precedent” to coverage, so they must be complied with and will generally be strictly construed. D&O policies differ on the timing of notice, with some having narrow windows (such as notice within 60 days of knowledge of a claim), while others have broad windows (such as anytime during the policy period or some specified tail period after expiration of the policy or the expiration of any extended reporting period).

*Recent coverage expansions include coverage for claims that are late noticed unless the insurer has been prejudiced by the late reporting.* |
later determined that the claim was not covered, the insured agrees to repay such amounts. While, practically speaking, insurers do not routinely seek recoupment of amounts paid out — for example, after triggering a conduct exclusion — virtually all D&O and other executive risk policies give the insurers that right. Some insurers have now agreed to delete the undertaking to repay clause entirely. While this obviously provides protection to individuals from having to personally repay amounts paid out in defense costs, it also means that individuals whose conduct has been sufficiently bad so as to trigger a conduct exclusion will have spent some or perhaps quite a bit of the D&O limits of coverage that would otherwise be available to other, more innocent, insureds.

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Some insurers have now agreed to delete the undertaking to repay clause entirely.

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Recoveries Reinstate the Limits

Unlike certain other executive risk policies, most notably fidelity policies, D&O policies have not historically addressed recoveries. While an insurer would not keep amounts recovered in excess of any insurance payout, the question is whether amounts paid out under the insurance policy that are later recovered will reinstate the D&O policy limits by the amount of the recovery. While some insurers have taken the position that it goes without saying that any recoveries would replenish the limits, some have recently agreed to add a recoveries clause to their D&O policy expressly providing that recoveries reinstate the limits.

Understanding How D&O Insurance Works

Exhibit D explains how coverage is triggered under a D&O policy.

Coverage for Nonindemnifiable Loss Incurred by Insured Persons — Referred to as Side A

Nonindemnifiable loss is loss incurred by individual directors and officers and other insured persons when the company is not required or permitted by law to indemnify them for the costs of responding to claims brought against them. Generally, the determination of whether a claim is indemnifiable is based on state statutes rather than on company inclination. Although these state statutes differ, they all generally provide that the company can indemnify directors and officers for most claims, and then they provide specific examples of when indemnification is not permitted. When indemnification is prohibited, that means the company is prohibited from paying costs incurred by the individuals in defending claims against them. If the company is not allowed to pay the bills, then the individuals can look to insurance or spend their own money.

Coverage for Indemnifiable Loss of Insured Persons — Referred to as Side B

Indemnifiable loss is loss that the company is permitted by statute to pay on behalf of the individual directors and officers in defending claims against them. In this instance, the insurance provides balance sheet protection by taking over the company's indemnification obligation after the deductible has been satisfied.

Coverage for the Entity for its Own Liability — Referred to as Side C Under Most Policies

Traditional D&O policies provide coverage to the corporate entity itself in certain instances. This is generally referred to as entity coverage, and the degree of entity coverage differs between public company D&O policies and private company policies. Under public company policies, the entity is generally covered for its own liability only in connection with securities claims. For all other claims, there is no coverage for the entity for its own liability. Under private company policies, the entity has coverage for all claims, rather than just for securities claims, subject to the exclusions on the policy. Because of this broad grant of coverage for the entity, a private company policy typically includes additional exclusions not found on public company forms, but the additional exclusions are only applicable to the company. Most insureds purchase policies that have some degree of entity coverage, but it is important to be aware that including coverage for the entity means that the individual directors and officers are sharing their D&O limits with the entity.
Side A Coverage on a Difference In Conditions Basis

Traditional D&O policies include Side A coverage that is shared with indemnifiable loss coverage and with entity coverage. Many insureds purchase additional Side A coverage that is not shared. This can be purchased simply as more Side A that follows the terms of the Side A coverage in the traditional policy, or it can be purchased on a DIC basis. Most insureds purchasing additional Side A protection do purchase Side A DIC coverage. The primary benefit of additional Side A coverage is the additional protection to individual insured persons when claims against them cannot be indemnified. In that instance, they cannot look to the entity to pay their bills, so they must rely on the insurance. There are different benefits to the Side A DIC policy, including coverage for indemnifiable loss (which would not normally fall under Side A of a policy) if the company fails or refuses or is unable to indemnify. Side A DIC policies vary, but all generally have fewer exclusions (or virtually no exclusions).

Conclusion

D&O insurers continue to compete with each other for business, making the price cheaper and the coverage more expansive. Although the regulatory and legal environment points to an increase in liability exposure for directors and officers, the insurance market is apparently willing to take on more of that exposure in an effort to win business. The extreme market-changing coverage provisions that have become available are a testament to this increased risk tolerance by insurers. For insureds, the message is clearly to get the broadest coverage possible while you can so that you have something with which to negotiate in the event that the tide turns.

Endnotes

3 The Basel Committee on Banking Supervision is an institution created by the central bank governors of the Group of Ten nations. It was created in 1974 and meets regularly four times a year.
4 Available at http://www.bis.org/publ/bcbs176.htm.
5 Available at http://www.fcpablog.com/.
8 In Re DHB Industries Inc. Derivative Litigation, No. 08-3860-cv (2d Cir. September 30, 2010).
9 Id. at *13.

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