Lowenstein Sandler's Insurance Recovery Podcast: Don’t Take No For An Answer

Episode 88:
The ABCs of D&O Insurance

By [Eric Jesse]

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Eric Jesse: Welcome to, don't Take No For an Answer. I'm your host, Eric Jesse from Lowenstein Sandler's Insurance Recovery Group. And today I'm pleased to be joined by Mike Richmond, who is the executive vice president and shareholder at the Horton Group. So welcome to the program, Mike. Thanks for joining us.

Michael Richmond: Thanks, Eric. Good to be here. Thanks for having me.

Eric Jesse: Absolutely. So Mike is an insurance broker that we work with extensively on behalf of our mutual clients to place different types of policies ranging from reps and warranty insurance to cyber to directors and officers insurance. And that's what we're here to talk about today, D&O Insurance. As our listeners know we here on Don't Take No For An Answer, like to get back to basics sometimes and give our audience an overview of the different types of policies that are out there and provide some practical advice along the way. So today, Mike is going to help educate us on the ABCs of D&O insurance. Get it, Mike.

Michael Richmond: Got it.

Eric Jesse: Yeah. So with that, let's jump in. Mike, so D&O insurance, directors and offices insurance, it only covers directors and officers, right?

Michael Richmond: Actually, no, it extends beyond that. So certainly, directors and officers, board members of the company, owners, if it's an LLC, members of the LLC, but it also extends to employees, advisory board members, board observers, and importantly we'll talk about this later, I'm sure is the entity itself is covered as well. So I think of it as a catch-all for anybody associated with the business.

Eric Jesse: Yeah, that's right. D&O insurance it really is that little bit of a misnomer and obviously the words and the terms and conditions matter, but yes, it can be as broad as you said. And my joke that went flat a few moments ago, we hear the terminology about Side A, B and C coverage. Can you tell our audience what is that all about? Can you break it down?

Michael Richmond: Sure. So these are the fundamental parts of the policy, and I did get the joke, Eric. It was actually pretty good as insurance nodes of a nerds guys, all right. So yeah, there are three fundamental parts of the policy, A, B, and C. So let's start with A. That is traditionally what you think of as coverage for directors and officers. This is a situation where for whatever reason, whether contractually, regulatory, legally, what have you, the business can't indemnify individual directors and officers. So it's a part of the policy that's there. It's a bucket of coverage for these individual directors and officers in the event the company can't reimburse or indemnify. So that's Side A.

Side B actually covers the entity itself in situations where they do have to indemnify the officers for defense and expenses, settlements and judgments. So this is a situation where they have to indemnify them, the board members are named in a suit and there's this coverage for the company in the event of them having to indemnify as part of that suit. And then C, which conveniently C, company or entity, that's coverage for the company where the company's named and the board members may not be named for whatever reason or if they are named most of the company, the liability falls to the company or the actions of the individual directors and officers. So that's the portion of the policy that is strictly just for the company in that regard.

Eric Jesse: And that's helpful, Mike, and just say with side C, coverage for the entity itself, the scope of coverage for the entity can vary, right?

Michael Richmond: Correct. Yeah, it's going to cover anything that basically if the company's sued for tortious interference with contract based on the actions of the employees or the board and you name it, any reason that the company would be sued due to the actions of the board members, there will be coverage under C.

Eric Jesse: Yeah, and I think the one exception for the company is just if it's a publicly traded company, then there's only going to be coverage for security type claims.

Michael Richmond: Correct, right.

Eric Jesse: Any other coverages? So we talked about Side A, B, and C, any other coverages that can sometimes be part of a D&O policy.

Michael Richmond: These would be limited coverages that maybe are typically excluded under the policy, but just given that it's so tied to the actions of the directors and officers, they'll include some sublimates. So most common is derivative investigation coverage, and that range anywhere from as low as $10,000 in sub limits up to $500,000. And you certainly want to negotiate higher limits there. You could also see coverage for public relations and crisis management costs, employee lawyers’ coverage, executive officer replacement coverage, which is very nice coverage to have in the event that an executive officer passes. So there's all kinds of coverages that can be sub-limited onto the policy.

Eric Jesse: Yeah, I'm glad you mentioned employed lawyers' coverage for the in-house counsel and general counsel that are listening. That's a key coverage that in-house attorneys want to make sure that the company has. So that's a good point. Just real quick, so we're just going through the coverages, in terms of the scope of coverage at a high level, what can a D&O insurance cover, we talked about coverage for the directors, officers, the entity, maybe employees, what types of claims can be covered by a D&O policy?

Michael Richmond: So the actual claim itself would be referred to as a "wrongful act". Now wrongful acts typically alleged from some breach of fiduciary duty that a director or officer has for anyone associated with the company, certainly shareholders. So shareholders bring suits for anything ranging from breach of fiduciary duty of due diligence to conflict of interest and self-dealing, good faith, bad faith and so on. But there's also other types of suits that can come up as well. Any type of misrepresentation that could be misrepresentations to potential investors or shareholders throughout the courting process or after the courting process.

Of course, lenders and creditors bringing the suit, claiming there's misrepresentation for anything from seeking a line of credit to a bank loan, what have you. But it can go even beyond that. So tortious interference with contracts, regulatory investigations, creditor claims that we talked about. I see directors and officers as sleep at night coverage for any of the owner's, officers, directors of a company because it is so broad in terms of what it covers.

Eric Jesse: That's a good segue. The next thing I wanted to ask you about was just the Side A coverage that you mentioned, the coverage for directors and officers when they're not indemnified, and that's what I always refer to when I'm talking to clients as really that's the sleep at night coverage. And there's something called a Side A difference in conditions policy, which I think is really important for directors and officers to have and see if their company has. So can you tell our audience what that is? What is a Side A DIC policy?

Michael Richmond: Of course. Yeah. So Side A we've talked about. That's coverage for individual directors and officers. And difference in conditions is just globally an insurance term or it was a policy that might follow another policy, but it's written slightly different. So it can do more than a typical excess policy, if you will. So in this case, what we're talking about is there are certain circumstances that for whatever reason, a primary directors and officers policy like we're talking about, would not provide Side A coverage. It could be due to regulation, state or federal law, what have you. The most common example, it will be bankruptcy. Now in a bankruptcy proceeding, most bankruptcy jurisdictions have found that the primary D&O policy, since it's in the name of the business and provides coverage for the business, it actually is an asset of the business, therefore gets dragged into the bankruptcy estate for the benefit of creditors.

So instead of there being that bucket of money to indemnify the individual directors and officers under Side A, that payment would essentially be dragged back into the bankruptcy estate to pay creditors leaving those individual directors and officers without coverage. And that's of course what everyone thinks about when they have a director's and officer's policy is that's a situation you want the policy for. So the way to prevent an issue here is you get a Side A difference in conditions policy that would both sit excess above the primary ABC D&O policy we're talking about. So that if you eroded those primary limits, that policy would still be there to provide additional coverage for the individual directors and officers.

But then also in the situation, this is where the difference in conditions comes in because the difference in conditions being it can do more than just sit excess and follow form of the primary policy, it will drop down in this situation where the bankruptcy court removes that primary coverage and it'll provide coverage on a first dollar basis for those individual directors and officers. So certainly in a bankruptcy situation, and you want to get the policy long before you saw a bankruptcy situation arising at the company, that's a critical policy to get in place for individual directors and officers.

Eric Jesse: Yeah, absolutely. And I think there's a few key points to these policies, because it will, as you mentioned, only ensure the directors and officers. So you don't have to worry about the company is staking a claim to it, particularly on bankruptcy proceeding, the drop-down. But also I like that these policies have very few exclusions. So you're not going to have the laundry list of policy exclusions. There might be you get a good Side A policy, it's only going to have one exclusion. I mean it's the conduct exclusion, which we'll talk about in a moment. So yeah, definitely a key and critical coverage that it is that sleep at night coverage for D's and O's.

Michael Richmond: Absolutely. Yeah.

Eric Jesse: So maybe that's a nice segue to talk about, you had outlined what the policies cover in terms of wrongful acts, but insurance companies they like to give it and then take it away through exclusions. So what are some of the key and common exclusions that are in traditional Side A, B, C D&O policy?

Michael Richmond: Sure, and these can range from policy to policy. There are some base exclusions, certainly. We talked about conduct, certainly fraud, intentional acts, particularly intentional criminal acts, uninsurable fines and penalties under certain government regulations. Again, that's one where it might be excluded under a base D&O policy, but covered under Side A DIC. Intellectual property claims, this is one where sometimes you can find a gray area where there could be some coverage, but if the company has true intellectual property exposure, typically have to get a base, a standalone monoline intellectual property policy, a legal remuneration and personal profit of board members. And another one too is just insured versus insured exclusions. And sometimes, well, we've seen this lately, board members or officers who have been let go and then suing the company for a range of causes of action and those being excluded because it's an insured versus insured situation. So those are just some of the base exclusions.

Eric Jesse: Yeah. And those are important ones to highlight on the conduct exclusion that you mentioned, right, for fraud or criminal conduct or illegal remuneration. One thing we always try to see, and this should be in the policy or in a base policy, but it's not always there and that's the key exception, that exclusion doesn't apply unless until there's a final non-appealable adjudication that establishes the conduct occurred. And that's critical. So our mutual clients can have coverage for defense costs along the way and any settlements and the IVI, it's important to get our negotiate exceptions, which can be common to these policies, but to make sure they're in there.

So you mentioned like a former board member bringing a claim, so you want to try and negotiate for language that says, well, it's the board member resigned over a year ago and then brings the claim, then an exception applies. Or since you mentioned the bankruptcy context, we also want to see an exception if a claim is brought on behalf of a creditors committee and as part of a bankruptcy proceeding so. Yeah, no, all good things to highlight. So Mike, I know you're on the front line to the D&O insurance market. So what's the current state of the market? I know a couple of years ago it was very tough, it was a hard market, premiums were going up, pretensions going up. What are you seeing these days?

Michael Richmond: At the moment, and it's been trending this way, it's a fairly soft market, meaning that underwriters are willing to provide better pricing and coverage and limits than were previously. I caveat the limits 'cause that's one area where, from a capacity perspective, we're seeing capacity come down somewhat. And this is more from legacy policies where let's say you had a $10 million limit with one carrier and they come back and they say, "Hey, this year we just want to cover $5 million." So then you have to go get another $5 million to meet the prior $10 million limit. And usually that would be very costly to do that because you've lost volume with one carrier.

But since the premiums have come down a bit, it actually ends up being a wash. So while we're losing capacity that the decrease in costs, it is making up the difference. So I say that with a little bit of hesitancy because obviously whenever there's economic conditions that could hurt a D&O policy because that's when claims would typically arise, we do see potentially a hardening of the market, but we're not there yet. So basically it's a good time to make sure you have the proper limits and your Side A DIC coverage in place.

Eric Jesse: Good. And it also sounds like it's a good time. A couple of years ago, certainly at the height of Covid, I feel like when it was a hard market, companies might've reduced their limits just because of pricing concerns or maybe even capacity concerns. But now it'd be a good time to revisit if those limits should be restored if they were reduced, so.

Michael Richmond: Absolutely.

Eric Jesse: Just real quick, we're talking insurance language, but when we talked about retentions briefly, can you just describe what the retention is for those in the audience that might not know?

Michael Richmond: Yeah, sure. The retention is basically, it's very similar to a deductible. The main difference being that under a retention, you would be expected to pay that retention before the insurance carrier drops down to pay the remainder or the actual loss. And those are different for A, B and C. Typically you'd see a policy start with a $0 deductible for A, but then for the company coverage it might be $25,000 or $50,000. And usually that A is lower, but that's the difference.

Eric Jesse: Yeah. All right, great. So just to bring things home and wrap it up, I was thinking, can you give a couple of pro-tips for our listeners, things they should be thinking about? And this is a two part question. So part one is just in terms of the underwriting process, what's a key tip for policyholders to keep in mind as they go through the underwriting process? And then from a claim perspective, if and when a claim is made, what do companies need to do?

Michael Richmond: Sure. First, for putting yourself in the best position, it comes down to providing as much detail as possible. So we're talking about audited financials if possible. If it's not audited financials, very clean internal financials that you can share for both the current term and prior term, cap table org charts. And it is what it is in some respect, but making sure you set yourself up so that all claims are covered and making sure any potential misrepresentations in the application are addressed. Thinking right now, just acquisitions, which certainly is always top of mind. If there's one on the horizon, making sure identifying that in the application process and the carriers will address that accordingly. But making sure that they don't have a right to essentially deny a claim in the future. And the other thing too is just making sure you have a really good D&O specialist you're working with.

We're very fortunate, the Horton Group, we have a management liability practice leader, and Aaron Turner, my colleague, he's a D&O specialist. And while many of us do work in D&O and all of my clients have D&O and I work with it on a daily basis, he's a thought leader in the industry and one of the top in the country. So it's good to have a partner like that. From a claim perspective, and this is probably even more critical, when you get a complaint on even internally versus an actual suit, just getting your broker involved in discussion right away and trying to determine whether or not whatever complaint you're receiving meets the status of notice and the policy so that we can make sure we get the carrier involved. And there isn't a question of delay or not getting them involved to mitigate when necessary.

The other thing is documentation, making sure you have all of your detailed records and correspondence, so things are nice and easy for the adjuster and counsel. And then finally, from a claim perspective, making sure you have counsel ready. So these carriers typically have panel counsel that they've worked with, but if you have a legal counsel that you would prefer to work with, you can negotiate that long before a suit ever comes. Go to the insurance carrier, your directors’ and officers’ insurance carrier and say, "This is the attorney we'd want to work with. They're a specialist in this space." They may already be panel counsel, but if not, you'd negotiate to have them approved. Often it comes down to rates and making sure that they have the expertise in the D&O space, but those are the three key items for claims.

Eric Jesse: That's great. And Mike, you touched upon a few themes that constantly come up here on Don't Take No For An Answer, right, that communication is key, whether it's on the underwriting side or on the claim side. And notice, notice, notice when a claim comes in, providing prompt notice of a claim is critical.

And I will echo your comment that it is also very important to work with a broker that specializes in these types of policies, in a D&O policy because they can be complicated with all the defined terms, and sometimes you need that secret decoder ring to decipher them. So all good pro-tips for the audience. So with that, I think we'll wrap it up. So thank you, Mike, for joining us. I think this was a very helpful and informative discussion, so we appreciate it.

Michael Richmond: Thanks Eric. Appreciate you and the Lowenstein team having me.

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