Your D&O coverage: Do you have what you need … and expect?

Many directors and officers are vaguely familiar with the general nature of D&O insurance but they do not really understand how the coverage works. Here are five things you should know about your D&O insurance coverage.

By Lynda A. Bennett

Any person who serves as a director or officer knows that a D&O policy should be purchased to protect the individual assets of those who serve the company as board members or executive officers. However, other than asking whether a D&O policy exists, most directors and officers do not know how D&O insurance works, who has access to that coverage, and whether the policy really will serve as the last line of defense against their homes, personal assets, and life savings.

In fact, D&O insurance is one of the most complicated coverage lines available in the insurance market today, and there is wide variation in terms of the coverage provided, the ease with which the defense cost coverage may be accessed, and the ways in which corporate changes may impact coverage rights. This article identifies five important issues that every director and officer should know about their D&O coverage to determine whether they have the insurance protection they expect and need in the event of a claim. However, to secure real peace of mind, directors and officers are best served to consult with their insurance professionals and coverage counsel to review the precise terms of their policies to avoid unwelcome surprises after a claim has been made.

Who is covered by the D&O policy?

Most people assume that a D&O policy provides coverage only to the directors and officers of the company and all available limits are in place to protect only those individuals. Not so. In fact, most D&O policy forms on the market today define "Insured Individual" so broadly that all past, present and future employees of the company

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have access to the D&O policy. Not only that, the defined term "Insured Individual" can also include independent contractors, part-time employees, and seasonal workers. Importantly, the D&O policy does not differentiate between directors, officers, employees, independent contractors, or seasonal workers when it comes to providing access to the policy limits. In other words, *each and every one of those individuals has equal and immediate access to the limits of the policy when a claim is made.*

> It is important to know that many 'D&O policies' are not, in fact, just D&O policies.

While there may be good reason to include individuals other than directors or officers within the definition of "Insured Individual," companies and their boards must carefully consider the impact of this broad access vis-a-vis the policy limits that are secured. Consider a claim where several corporate representatives are named as defendants in a lawsuit and each one wants to have their own lawyer to defend the case. Defense costs erode the limits of D&O policies. Under this scenario, the board must be sure that it has sufficient overall policy limits to accommodate all of these defense obligations.

How and when is 'dollar one' coverage available?

Having a D&O policy does not mean that Insured Individuals have immediate and direct access to a D&O policy. Indeed, many directors and officers are vaguely familiar with the alphabet soup that is D&O coverage but they do not really understand how the coverage works. They have heard terms like "Side A" coverage, Entity Coverage, and DIC coverage. However, it is important to understand a few basic details about the alphabet soup as it can directly impact how and when a defense is provided.

Most D&O policies today provide three "basic" coverages:

• "Side A" coverage is available for "Insured Individuals" and is usually provided on "dollar one" basis, i.e., there is no deductible or self-insured retention (SIR). However, that Side A coverage is not available unless the Insured Individual is unable to secure indemnification from the company. Moreover, many D&O policies on the market today contain a provision that *presumes* the company will indemnify corporate representatives to the greatest extent permitted by law unless the company is financially insolvent. Thus, directors and officers are well served to understand whether their governing documents and indemnification agreements are "married" to their D&O insurance coverage.

• "Side B" coverage is available to the company and provides reimbursement for the indemnification that the company gives to the individual insureds. Side B coverage is provided subject to a SIR or deductible, which can be substantial. Once the SIR or deductible is satisfied, the company has equal access to the policy limits to satisfy its indemnification obligations. Thus, here again, there is a limits tension issue that should be considered and addressed when purchasing D&O coverage.

• "Side C" coverage, also known as Entity Coverage, provides coverage for claims asserted directly against the company. For public companies, Entity Coverage typically is limited to Securities Claims only. Entity Coverage also erodes the policy limit, once the SIR or deductible is satisfied, and therefore must be considered when total limits are evaluated.

Finally, a lesser understood, but vitally important, coverage is DIC, or difference in conditions coverage. Sometimes DIC policies are referred to as "Side A" policies, which is separate and apart from the Side A coverage provided under the "standard" D&O policy. It is important for directors and officers to understand the differences between DIC coverage and "standard" Side A coverage because DIC coverage is broader. It is subject to less exclusions. It is non-rescindable. It is usually "dollar one." Typically, it covers only directors and officers. And it may provide protection against the uncomfortable scenario where a director or officer expects to receive indemnification coverage from the company but it is not provided (for reasons other than insolvency). Sometimes this coverage is provided through a standalone DIC policy; other times it is added to the "standard" D&O policy by endorsement. While confusing, it is important for directors and officers to know whether they have DIC coverage given its highly favorable terms and the dedicated nature of its limits.

What is covered by the 'D&O Policy'?

Many directors and officers use the generic term "my D&O policy" and believe that the limits purchased for that policy are dedicated to protecting them against "D&O" risks. However, it is important to know that many "D&O policies" are not, in fact, just D&O policies. Instead, many policies sold today are "Executive Liability Policies" that provide coverage for a host of risks, including D&O, Employment Practices, Fiduciary, Cyber, Crime, Kidnap & Ransom, and maybe even Employed Lawyers/Malpractice. Once again, this issue presents limits tension and management considerations. Directors and officers must understand whether there are dedicated limits for each of these risks and how the D&O coverage limit intersects with the policy aggregate limit.

What is the nature and scope of defense cost provided?

The main reason that directors and officers need a D&O policy is to secure a defense when they are named individually in a lawsuit in connection with their service on the board or management team for the company. Unfortunately, the ability to meaningfully and immediately access defense coverage under a D&O policy is becoming increasingly difficult. Directors and officers will be well served to learn about several key provisions that may be contained in their D&O policy and can directly impact the scope of defense coverage provided.

First, many D&O policies contain an allocation provision that is designed to address "mixed" claim scenarios, i.e., where a lawsuit includes both covered and "non-covered" claims or parties. The provision often allows the insurer *unilaterally* to determine how much defense cost coverage will be provided, and some also address how disputes about allocation will be resolved (and it is not uncommon that the dispute resolution method is highly unfavorable to the insured). In fact, there is wide and significant variation among D&O policy forms regarding allocation provisions. Negotiation is often required to improve the baseline terms so that future coverage litigation may be avoided.

Second, more and more D&O policies include provisions that require *repayment* of defense costs in the event it is later determined that coverage is unavailable under the policy. Sometimes the recoupment provisions are imbedded within the exclusions of the policy. In other instances, the recoupment provisions are found in the defense section of the policy or contained in a "stand alone" section. Wherever the recoupment provisions appear, directors and officers should be concerned as defense coverage may *retroactively* disappear. Most directors and officers expect that they will receive a defense unless and until the insurer establishes there is no coverage obligation. By including the recoupment provisions, insurers are reserving a contractual right to claw back defense costs that were paid while the facts remained "in dispute."

Finally, there is a recent trend to reduce defense cost coverage even further by including exclusionary language in unexpected places such as the definitions section of the policy. For example, some D&O policy forms exclude from the definition of "Defense Costs" costs that *should* be covered by another insurer because it has a duty to defend, *not* that those costs *actually are paid* by another insurer.

The point is that directors and officers should not assume they have full and complete defense costs coverage just because the D&O policy promises a defense. More than ever before, it is critically important to read the entire policy to understand the nature and scope of defense cost coverage secured. Many of the limitations now being placed on defense cost coverage can be negotiated and improved with skilled insurance professionals and coverage counsel.

What happens to the D&O coverage when the corporate structure changes?

Within the last 20 years, directors and officers have been forced to focus on D&O coverage in the context of bankruptcy proceedings. Many directors and officers know that D&O policies have become a hotly contested asset of the bankruptcy estate where creditors' committees have tried (with some success) to limit director and officer access to the policies with the goal of increasing the size of estate distribution. Most D&O policies now have a "priority of payment" provision that is designed to establish that the D&O policy should be available first to the Individual Insureds and then, only if limits remain, to the corporation. However, directors and officers should be aware that the precise terms of the "priority of payment" provision matter and vary from form to form. Creditors' committees continue to successfully challenge and limit individuals' access to D&O policies for immediate defense coverage.

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Directors and officers also should be aware that a bankruptcy petition is not the only corporate structure change that impacts D&O coverage. Most D&O policies today contain a "change in control" provision that may *automatically* and *immediately* curtail, or in extreme instances eliminate, coverage when the composition of the board, the voting control, or the majority stock ownership changes. To the extent that business operations continue, attention must be given to whether the current D&O policy should be modified or a new policy should be secured.

IT IS NOT UNCOMMON THAT THE DISPUTE RESOLUTION METHOD IS HIGHLY UNFAVORABLE TO THE INSURED.

Finally, when a company (or even a division) is going to be acquired, directors and officers must understand the terms and conditions under which "tail" coverage may be purchased. D&O policies are written on a claims made basis, meaning that coverage is available only if the claim is made and reported to the insurer during the policy period. When an acquisition occurs, directors and officers will want to be sure that they have additional time to report claims that may be made after the transaction occurs. This additional period of time to report claims is often referred to as a "tail." Most D&O policies offer tail coverage, though the terms, conditions, and pricing of such coverage varies. Understanding those terms before the board and management team are knee-deep in the transaction is highly advised given the importance of the protection provided.

Need for constant evaluation

D&O insurance offers critical protection to the thought leaders who are entrusted to make the most difficult decisions within their corporate organizations. As demonstrated above, however, the nature and extent of the coverage actually provided is complex and requires constant evaluation. Directors and officers who understand their D&O insurance before a claim is presented are far better served than those who learn about shortcomings and gaps while in the midst of defending themselves in a lawsuit. ■

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