Is Your D&O Coverage Ready For Individual Liability?

by Andrew M. Reidy and Joseph M. Saka

The U.S. Department of Justice's Yates Memo is shaking up corporate criminal investigations. Now, the DOJ will seek to target *individual* executives and board members in corporate prosecutions as never before. Has your D&O liability insurance coverage kept up with this major change—or will you find out too late?

In September 2015, the Department of Justice (DOJ), in a memorandum by Deputy Attorney General Sally Yates, announced that it was going to vigorously target *individuals* for corporate wrongdoing. In the memo, Yates highlighted six steps to strengthen the DOJ's pursuit of criminal wrongdoing:

- "In order to qualify for any cooperation credit, corporations must provide to the [DOJ] all relevant facts relating to the individuals responsible for the misconduct;
- Criminal and civil corporate investigations should focus on individuals from the inception of the investigation;
- Criminal and civil attorneys handling corporate investigations should be in routine communication with one another;
- Absent extraordinary circumstances or approved departmental policy, the [DOJ] will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation;
- [DOJ] attorneys should not resolve matters with a corporation without a clear plan to resolve related individual cases, and should memorialize any declinations as to individuals in such cases;
- Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay."

The effects of this new stated policy have yet to be fully realized, but already the Yates Memo, as it has become known, is having a huge impact. In November 2015, the DOJ revised its U.S. Attorneys' manual to reflect a number of these policy shifts.

Among other things, the DOJ added a new section, entitled "Focus on Individual Wrongdoers," that directs U.S. attorneys to investigate individual wrongdoers from the outset of a case. In May 2016, Deputy Attorney General Yates gave a speech in which she touted the results of these policy changes both in civil and criminal cases. She emphasized that companies are continuing to cooperate with the DOJ and "making real and tangible efforts to adhere to [the DOJ's] requirement that they identify facts about individual conduct."

Corporate directors and officers (and their personal assets) are in the DOJ's cross-hairs. Your liability insurance needs to prepare for this seismic shift in DOJ practices.

Yates also noted that, in civil matters, although the DOJ's civil lawyers previously focused on "recovering the most money possible," their focus has shifted to "deterrence, about stopping fraud from happening in the first place and about redressing misconduct of those responsible." Although the DOJ continues to look at individuals' ability to pay, she also stated that is "no longer the determinative factor in deciding whether to bring an action in the first instance."

In short, corporate directors and officers, along with their personal assets, are in the DOJ's cross-hairs. Corporations and their directors and officers need to prepare for this seismic shift in DOJ practices. Part of these preparation efforts entails improving compliance programs. To protect their assets, however, directors need to assess their directors and officers (D&O) liability insurance policies to determine

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whether they are adequately protected. Corporate boards are well-advised both to review their D&O policies and understand the steps they need to take under their policies in the event a claim is made.

☐ ***Avoid landmines in completing the application.*** After selecting an insurance broker, the first step in purchasing insurance usually involves completing sometimes burdensome applications. Companies usually must fill these out both the first time they purchase a policy and then again during every annual renewal.

Review these applications closely to ensure all questions are answered truthfully. Even where a claim is clearly covered, insurance companies sometimes seek to avoid their coverage obligations by claiming that there was a misrepresentation in the application for the policy.

Importantly, there is language that businesses can include in their insurance policies to reduce the likelihood of a denial of coverage based on a misrepresentation. First, the definition of "application" in the policy may include not only the formal application that the business is required to fill out to obtain the policy, but also other materials, such as filings with the SEC or other regulators. The narrower the definition of "application," the better it is for the policyholder.

Second, policyholders can request non-imputation or severability clauses. These provisions limit the impact of any misrepresentation to the person with knowledge, while allowing coverage for those that did not know of the misrepresentation. Also, keep in mind that even where there is a misrepresentation, the insurer usually has the obligation to prove that the misrepresentation was material and that the insurer relied on the misrepresentation in selling the policy.

D&O policies generally are written on a "claims made" basis. This covers claims made during the policy period, but usually not those made before or after the policy period.

☐ ***Understand what D&O insurance covers.*** D&O insurance is a form of liability insurance, intended to provide coverage for defense costs and any judgments or settlements for claims alleging wrongful acts by corporate directors and officers.

D&O insurance policies contain three primary insuring agreements:

- Side A, which covers directors and officers when the company does not indemnify them for the loss.
- Side B, which reimburses the company for costs of indemnifying directors or officers.
- Side C, which covers the company when claims are asserted against the company.

Perhaps most critically, D&O insurance protects the personal assets of the individual directors and officers. This allows them to serve their companies without fear that they will be personally at risk.

One important feature of D&O policies is that they generally are written on a "claims made" basis. This means that the policy covers claims made during the policy period, but usually not claims made before or after the policy period.

Beyond that, insurance policy forms vary dramatically. Some policies, for example, may require that the claim be reported to the insurer during the policy period. Other policies may provide a grace period (sometimes known as an extended reporting period) to report a claim after the end of the policy period. Policyholders need to understand these differences and how to respond in the event of a claim or potential claim.

☐ ***Review key definitions in your insurance policies.*** Typically, D&O insurance policies provide coverage for "loss" resulting from "claims" made against an "insured" alleging "wrongful acts," as these terms are defined in the policy. Each of these definitions can vary significantly from policy to policy. For example, the definition of "claim," undoubtedly, will include civil lawsuits, but it also may include civil investigation demands and subpoenas.

The expanded definition of "claim" can be very beneficial when responding to governmental investigations. Companies, however, must note that, with an expanded definition of "claim," there correspondingly is an expanded obligation to provide notice to their insurer(s).

As another example, the term "wrongful act" commonly is defined as any act, error, or omission in the officer or director's professional capacity, making clear the policy is designed to cover a wide range of intentional and negligent conduct. By contrast, other policies define "wrongful act" much more narrowly to cover only negligent acts or errors. These distinctions have dramatic ramifications on the scope of coverage that will be available.

The language of the policy is critical. For dishonesty or fraudulent acts exclusions, insist on a narrow exclusion.

☐ ***Seek to limit or eliminate problematic exclusions.*** All insurance policies contain a section that sets forth exclusions that limit coverage for certain types of claims or losses. These exclusions also vary from policy to policy.

In the context of claims by the DOJ, some of the exclusions that may be most critical to review are regulatory exclusions and dishonesty or fraudulent acts exclusions. As the name suggests, regulatory exclusions expressly bar coverage for claims by federal or state regulators.

Depending on the circumstances, these exclusions have been held to clearly bar coverage for claims by the DOJ. Given the Yates Memo, these regulatory exclusions should be removed from your D&O policy if at all possible.

Depending on the wording, dishonesty or fraudulent acts exclusions bar coverage for the dishonest or fraudulent acts of the company's directors or officers. It is a common misconception that insurance does not provide coverage for intentional misconduct. In truth, D&O insurance policies commonly provide coverage for (and insurance companies advertise their policies as covering) claims of intentional activity, such as breach of fiduciary duty and securities violations.

However, the language of the policy is critical. For dishonesty or fraudulent acts exclusions, insist on a narrow exclusion. For example, seek a narrow dishonesty or fraud exclusion that limits the exclusion to instances where there has been a final adjudication of the dishonesty or fraud. Also seek a severability clause so that the exclusion only applies to the alleged wrongful actor.

Policyholders can ask that their insurance companies eliminate, or narrow the scope of, certain exclusions. Oftentimes, the insurer will make the requested change without even adjusting the premiums for the policy—but policyholders need to know

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D&O Policy Definitions To Know

☐ *Tolling agreement.* An agreement to "toll" the statute of limitations to file a lawsuit, allowing the parties to negotiate a resolution or fact-find.

☐ *Order of payment provisions.* Provisions in insurance policies that sets forth the order in which policy limits will be paid in the event multiple claims are made against the policy.

☐ *Sub-limits.* Limits in insurance policies for a specified type of risk.

☐ *Non-imputation clauses.* Policy clauses that provide the acts of certain individuals will not be imputed to other insureds, or only will be imputed to specified insureds.

☐ *Cooperation clause provisions.* Policy clauses that require insureds to reasonably cooperate with insurers by, for example, providing information regarding claims that are made.

☐ *Claims made policies.* Policies that provide coverage for claims made during the policy period, regardless of when the conduct giving rise to the claim occurred.

☐ *Disgorgement.* A type of loss where the insured is required to return or give up ill-gotten gains.

☐ *Insured v. insured exclusions.* Exclusions in professional liability policies that bar coverage for claims by one insured against another insured.

☐ *Notice of circumstances provision.* A term in policies that permits coverage for circumstances reported during a claims-made policy period even if the claim is made after the policy period.

☐ *Consent to settle provision.* A policy clause that requires the policyholder to obtain the insurance company's consent before entering into a settlement.

what to request. Consider working with your broker or experienced coverage counsel to obtain the most favorable language.

☐ ***Beware of hidden limitations on coverage.*** Policyholders may assume that the major limitations on coverage are spelled out in the exclusions section. Increasingly, though, insurance companies are hiding limitations on coverage in definitions and elsewhere in the policy.

For example, the term "loss" generally is defined to include settlements, verdicts, and judgments, as most policyholders would expect. However, the definition of "loss" may "carve out" not only punitive damages, but also disgorgement and the depreciation of investments. In most states, exclusions must be clear and unambiguous, so these limitations may not pass the test.

To avoid these issues altogether, review the definitions section to assure that there are no hidden limitations on coverage. In purchasing coverage, also be mindful of "sub-limits." In some instances, sub-limits may result in an expansion of coverage, but in other instances, sub-limits are stealthily used by insurance companies to reduce the limit of already available coverage.

A separate payment limit dedicated solely to claims made against individuals means executives and directors need not compete with claims against the company.

☐ ***Anticipate the risk of insolvency.*** One of the purposes of insurance is to address worst case scenarios, regardless of how unlikely they may appear to be. For corporate directors and officers, one of the most serious risks is the insolvency of their company. There are a few provisions that your board should review to protect themselves in the event of this worst case scenario, including the insured v. insured exclusion and the "order of payments" provisions.

Insured v. insured exclusions typically only bar coverage for claims "by, on behalf of, or at the behest of" the insured company or any insured person against another insured. However, some insurers incorrectly have relied on this exclusion to bar coverage for claims by bankruptcy trustees and others following a corporate insolvency.

"Order of payment" provisions address how the limits of the policy will be paid out in the event of a loss. To obtain the best protection, make sure that these provisions expressly state that the individual insureds are paid first and that the insurer will not pay any sums for claims against the corporate entity until claims against individuals have been resolved. Some insurers also offer a separate limit that is dedicated solely to claims made against individual insureds, so executives and directors need not compete with claims against the corporate entity.

☐ ***Be careful during renewal and in replacing insurers.*** Policyholders need to be most cautious when they renew their policies or decide to replace their insurance company. Here is the issue: existing policies may not cover claims reported after the policy period, and the replacement policies may exclude prior acts or prior litigation.

Additionally, some replacement policies may contain a retroactive date limiting coverage to claims arising from acts taking place after a specified date. Companies need to be aware of the implications of these provisions in view of existing claims and potential claims.

One potentially important clause is the "notice of circumstances" provision, which allows policyholders to provide notice of circumstances that may lead to a future claim. In the event that the anticipated future claim or a related claim is later made, it then is treated as having been made during the earlier policy period. Although there are clear advantages offered by these provisions, directors and officers need to thoroughly consider the requirements of the policy and the implications of sending a notice of circumstances.

As an example, some policies require detailed information regarding the potential claim, including the identity of potential claimants, the specific identity of the potential wrongful actors, and the specifics regarding the wrongful acts that could give rise to a claim. Even if the required information is provided, the insurer still may seek to avoid coverage in the

event of a claim by contending that the subsequent claim is not the claim that was described in the notice.

The insurer also is likely to attempt to add exclusions in subsequent policies to bar coverage broadly for claims arising out of the wrongful acts described in the notice of circumstances. That being said, in some instances, providing notice of circumstances is the best way to secure coverage for an expected claim, given the nature of claims made policies. Due to the various ramifications on your coverage, it is best to seek guidance from insurance brokers or coverage counsel before doing so.

☐ ***Provide notice.*** All D&O policies require the policyholder to provide notice of claims that are made. Your company will need to carefully consider when notice is required under D&O policies. Notice will be triggered by a "claim," but as noted above, the definition of "claim" is not the same in every policy. In some instances, a lawsuit will trigger the obligation to provide notice, whereas in others an oral demand on a telephone call will be sufficient to require notice.

Policies commonly provide specific information on how notice needs to be provided including, in some instances, a specified time period and a specific location. When possible, policyholders should comply strictly with these provisions. Compliance need not be difficult, but failure to comply can result in an insurer's asserting forfeiture by the insured. Even before a claim comes in, companies should have a thorough understanding of what is required and a plan in place to meet those requirements.

☐ ***Know that you still have options after a denial.*** Unfortunately, even with the best planning, the insurer may still deny coverage for the claim. In these situations, you need not simply accept the denial. Rather, you should take steps to try to convince the insurer to reconsider its decision.

There are strategies businesses can implement short of litigation to persuade insurers to reconsider their denial. These include providing additional information, meeting with the insurer and the broker to attempt to resolve the claim, requesting a tolling agreement, or engaging experienced coverage counsel.

Nevertheless, in some instances, litigation is necessary. Before filing, businesses should assess a number of factors to assure that litigation will meet the objectives for securing coverage. Specifically, consider:

- Whether initiation of coverage litigation will help to resolve the dispute.
- Whether the issue is forum sensitive.
- Which state's laws will apply to the dispute.
- What claims are available in the lawsuit.
- What the insurer's defenses will be.

The decision about whether to file a lawsuit is multifaceted. In some instances, filing a lawsuit will quickly resolve a dispute with an insurer. In other instances, litigation will not lead to immediate resolution, and will lead to some unanticipated litigation expenses. Experienced coverage counsel should be able to walk you through these issues.

☐ ***Consider insurance implications before entering into a settlement.*** If claims are brought by governmental entities, there may be an opportunity to enter into an early settlement and avoid the associated expenses or publicity. Before entering into a settlement, however, businesses need to consider carefully the implications on insurance.

For example, most policies require the insured to obtain the insurer's consent prior to settlement. Although some states will not enforce this requirement where an insurer has denied coverage or unreasonably refuses consent, companies need to review the applicable law on the "consent to settle" provision before settling.

Additionally, the underlying lawsuit may allege both covered and uncovered claims. In those instances, the policy and the applicable law should be evaluated as to whether the settlement will be allocated between the insurer and the policyholder.

With the DOJ's increased focus on claims against individuals, directors should not assume that their D&O insurance policies are adequately structured or that coverage is a given. By actively addressing these issues at the outset, corporate executives can put themselves in the best position to protect their personal assets in the unfortunate event that they do face a claim. ■