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D&O POLICY TERMS: KNOW WHAT TO ASK FOR

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In the past, directors and officers generally recognized that their company should purchase D&O insurance, but they had little interest in the details. Besides the total amount of coverage purchased and the size of the deductible, little else was disclosed to the Board and few questions were asked. Instead, the risk manager was given wide discretion to evaluate and negotiate coverage terms that he deemed acceptable.

Those days of passive indifference to the details of their own insurance protection are long gone. In the aftermath of huge recent settlements, the highly-publicized personal settlement contributions by directors of Enron and WorldCom and the increasingly aggressive vigilance of institutional investors and regulators, directors today are demanding unprecedented information about the terms of their D&O insurance coverage and are becoming much more involved in both understanding the terms of coverage and demanding certain coverage enhancements. Frequently, boards now retain advisors independent from the company's insurance broker to critique their D&O insurance program and to assist in improving the protection afforded by that program.

In this environment, being an informed buyer of D&O insurance is critical. Most terms and conditions are negotiable at least to some extent. Knowing what to ask for and why is essential to obtain the highest quality coverage available. Although some insurance brokers have sufficient D&O insurance expertise to properly evaluate and negotiate important coverage terms, others do not. In any event, directors and officers should possess a basic understanding of key coverage variables so they can perform at least a rudimentary assessment of their own insurance protection.

The following discussion briefly summarizes some of the more important D&O insurance policy terms which may under certain circumstances be enhanced through negotiation with the insurer. Obviously, an insurer's willingness to grant any of these enhancements depends on a number of factors, including the insureds' risk profile, the insurer's appetite for risk and the availability of additional premium. Ultimately, though, one will never know if the enhancement is available unless one asks for it.

A. Primary Policies

1. Retention/Presumptive Indemnification. Most companies purchase D&O insurance with rather large retentions applicable to Insuring Clause B (coverage for the company's indemnification of directors and officers) and Insuring Clause C (securities entity coverage). Often, this company retention is seven figures or more. Although this large retention does not apply to Insuring Clause A (coverage for D&O loss not indemnified by the company), policies typically contain a "presumptive indemnification" provision which states that if a company is permitted to indemnify a director or officer but fails to do so for any reason other than financial insolvency, then the large company retention applies to the directors' and officers' personal coverage under Insuring Clause A. Thus, if the company wrongfully refuses to indemnify a director or officer, that director and officer must personally pay the large company retention before he or she can access coverage under the policy. In many instances, this may effectively prevent

most directors and officers from ever accessing the policy since they will be unable to satisfy the large retention.

It is highly doubtful an insurer of a standard “A/B” policy (i.e., a policy containing both Insuring Clauses A and B) will agree to delete this presumptive indemnification provision since insurers do not want to incentivize a company to wrongfully refuse indemnification to its directors and officers. However, the risk that a director or officer must personally pay the large company retention can be eliminated if the company purchases a broad excess Side-A DIC policy, which frequently does not contain a presumptive indemnification provision and thus would drop down and pay the large retention under the primary policy where necessary. These types of policies are discussed below.

2. Application Severability. D&O policies vary widely today regarding the extent to which knowledge of any Insured Person is imputed to other Insured Persons for purposes of determining whether coverage is rescinded based upon misrepresentations in the Application. Most policies contain some form of “severability” provision, which limits the imputation of one Insured’s knowledge to other Insureds. However, many of those provisions afford only partial severability. For example, the knowledge of the person signing the Application or the knowledge of certain senior executive officers may be imputed to all Insureds. Under that type of provision, coverage for all of the Insureds could potentially be rescinded if the signer of the Application or the designated senior executive officers knew facts that were not truthfully disclosed in the Application

Preferably, the policy should contain a full severability provision, pursuant to which no knowledge of any Insured Person is imputed to any other Insured Person. Even better, the policy could state that coverage under Insuring Clause A is not rescindable for any reason. With respect to Insuring Clauses B and C, the most protective severability provision states that only the knowledge of a few designated senior executives of a company is imputed to that company but not to its subsidiaries or other insured companies under the policy.

3. Conduct Exclusions. Standard D&O policies invariably contain exclusions for fraud, intentional violations of law, and illegal personal profit or remuneration. Three aspects of these “conduct” exclusions should be evaluated. First, what conduct is referenced in the exclusions? For example, the fraud exclusion should refer to “deliberate fraud” rather than “fraud” so that the exclusion does not apply to a securities fraud claim based on recklessness. Also, the personal profit exclusion should refer to illegal “financial advantage” rather than illegal “advantage” so that the exclusion does not apply to non-monetary benefits received by the Insured Persons.

Second, what must occur in order for the exclusions to apply? Some policies state that the exclusions apply if the referenced conduct “in fact” occurred. This is a potentially dangerous trigger for Insureds since it is unclear who determines

whether the conduct in fact occurred. Presumably, the insurer can make that determination and unilaterally deny coverage. Other policies contain a more protective trigger for Insureds by stating that the exclusions apply only if the referenced conduct is found to have occurred pursuant to a “final adjudication,” which has generally been interpreted by courts to require the adjudication in the underlying claim. Such a provision greatly minimizes the risk that the exclusions would be invoked by the insurer since virtually all D&O claims are settled rather than tried to a final adjudication. However, some may view such a trigger to be too protective for Insureds since it could allow Insured Persons who have committed particularly egregious wrongdoing to deplete the policy’s proceeds to the detriment of other “white hat” Insured Persons. Some policies address that concern by using trigger language that is a compromise between the pro-insurer “in fact” language and the pro-Insured “final adjudication” language. For example, the exclusions may apply if a ruling in any proceeding establishes the existence of the referenced conduct or if the Insured admits under oath to having committed the conduct.

Third, do the exclusions apply only to the Insured Person who actually committed the referenced conduct or received the illegal profit or remuneration, or to all Insured Persons if any one Insured Person committed the conduct or received the profit or remuneration? For example, if a CEO is sued for receiving excessive compensation and the board is also sued for approving the excessive compensation, does the exclusion apply only to the CEO or also to the director defendants as well? Even if the policy contains an exclusion severability provision, the exclusion may apply to all defendant Insureds if the exclusion eliminates coverage for claims arising out of “an” or “any” Insured committing the referenced conduct or receiving the illegal profit or remuneration. Consistent with the primary purpose of these exclusions, the policy can be clarified to eliminate coverage only for the Insured Person who actually commits the referenced conduct or receives the illegal profit or remuneration.

4. Entity Coverage. Many D&O policies afford coverage not only for claims against directors and officers, but also for securities claims against the company. Although that entity coverage for securities claims became popular in the mid- to late 1990s, some companies are now deleting entity coverage from their D&O policies primarily for two reasons. First, such coverage potentially dilutes the available coverage for directors and officers, who should be the primary beneficiary of the D&O insurance program. Second, if any insured company (including any subsidiary of the Parent Company) files bankruptcy, the existence of this entity coverage will likely result in the D&O insurance policy and its proceeds being treated as assets of the bankruptcy estate. In that event, the insurance proceeds will be subject to the automatic stay under the U.S. Bankruptcy Code, thus precluding any director or officer from accessing those insurance proceeds unless and until the bankruptcy judge lifts the automatic stay. At best, this will result in insured directors and officers being delayed in accessing the policy proceeds, and at worst this may result in the insured directors and

officers effectively losing their insurance protection for an extended period of time.

Entity coverage in D&O policies became popular as a means to eliminate difficult allocation issues when a securities claim is made against both Insured Persons and the uninsured company. If entity coverage is deleted from the policy, a predetermined allocation provision could be added which determines what portion of defense costs and any settlement amount jointly incurred by Insured Persons and the uninsured company would be paid under the policy. Frequently, this predetermined allocation can be set at 100%. However, if the predetermined allocation is less than 100%, such allocation percentage should not apply to coverage under Insuring Clause A since such a lower allocation would mandate a personal contribution by the Insured Persons for non-indemnified loss.

5. Insured v. Insured Exclusion. All D&O policies contain an exclusion eliminating coverage for certain claims filed by or on behalf of the company or any Insured Person. Two aspects of this exclusion should be examined. First, although most versions of this exclusion apply only to claims by or on behalf of Insureds, some versions also apply to claims by any shareholder of the company unless the claim is instigated and continued totally independent of and totally without the solicitation or assistance of any Insured Person. In part because there is an increased frequency of employees (and occasionally officers) of a company being a whistleblower and/or providing assistance or information to plaintiffs in the prosecution of shareholder claims, the inclusion within the exclusion of claims by shareholders is potentially dangerous and should be deleted. Second, the exclusion typically contains a number of exceptions (i.e., affords coverage) for certain types of non-collusive claims by or on behalf of Insureds, such as independently prosecuted derivative claims and employment-related claims. Some policies contain additional exceptions to the exclusion and thus afford coverage for claims outside the United States, claims by the debtor-in-possession or receiver of the company and its assignees, claims by directors and officers who have not served in such capacity for at least four years, and claims by non-officer employees who are added as Insureds.
6. Pollution Exclusion. All standard D&O policy forms contain a very broad pollution exclusion. However, some policies contain an exception to the exclusion (i.e., affords coverage) for non-indemnifiable shareholder derivative suits or securities claims or for any type of pollution claim under Insuring Clause A.
7. Definition of “Claim”. Three aspects of this definition should be considered. First, the definition typically includes written demands for monetary damages, but may not include written demands for non-monetary relief. Preferably, the definition should include written demands for both monetary damages and other relief. Second, some definitions do not include criminal proceedings, although most policies include coverage for defense costs in a criminal proceeding. Third,

many definitions do not include formal investigations against Insured Persons prior to those investigations resulting in a formal proceeding. For example, an Insured Person who is a target of an SEC investigation may not have coverage for defense costs incurred prior to the SEC commencing a formal proceeding against the Insured Person unless the definition of Claim specifically includes investigations.

8. Definition of “Insured Persons”. This definition typically includes directors and officers and may include non-officer employees with respect to securities claims. Companies should consider whether certain management positions should be specifically included in the definition if those positions are not technically officers. For example, the company’s general counsel, comptroller and risk manager may not be “officers” and therefore may not be covered under the policy absent an amendment to this definition. Some companies have also amended this definition to include as Insured Persons all employees but only if the non-officer employee is a co-defendant in a claim against directors and officers. This enhancement eliminates the need to allocate loss jointly incurred by insured directors and officers and uninsured non-officer employees, while minimizing the risk that non-officer employees will significantly dilute the coverage for the directors and officers.
9. Foundations and PACs. If the company sponsors a Political Action Committee (“PAC”) or foundation, such organizations are typically not included as an insured company under the policy and therefore no coverage would exist for trustees or officers of those organizations. If coverage is desired for loss incurred by those trustees and officers to the extent the PAC or foundation does not indemnify them, outside positions coverage for those persons could be added to the policy. However, if coverage is desired not just for non-indemnified claims against those trustees and officers, but also for the PAC’s or foundation’s indemnification of its trustees and officers, then the PAC or foundation should be added as insured companies.
10. Notice of Claim. D&O policies typically require the Insureds to give notice to the insurer of a claim as soon as practicable. In order to eliminate the risk of inadvertent delays in reporting a claim (which can give rise to a coverage defense by the insurer), the policy could require notice of a claim only after either the company’s in-house general counsel or risk manager first learns of the claim.

B. Excess DIC Side-A Policy

Excess DIC Side-A policies can provide valuable additional coverage to directors and officers by affording extremely broad coverage excess of a standard A/B/C underlying D&O insurance program. Such a policy can provide several important benefits for directors and officers. First, a Side-A policy, which only insures directors and officers for non-indemnified loss, can provide many extraordinary coverage enhancements not available in a standard D&O insurance policy. However, there is a wide variety of Side-A policies available in the market.

Only a few, such as the CODA Premier policy available through ACE, afford truly extraordinary coverage as opposed to simply deleting Insuring Clauses B and C from a standard D&O policy form. For example, the CODA Premier policy contains all of the coverage enhancements summarized above as well as many others, including the following:

- No ERISA exclusions
- No pollution exclusion and bodily injury/property damage exclusion does not apply to pollution claims
- Conduct exclusions do not apply to Defense Costs
- Very narrow insured vs. insured exclusion (exclusion applies only if the Claim is by or on behalf of the Company and at least 2 current senior executive officers approve or assist in prosecuting the Claim; exclusion does not apply to Defense Costs or to Claims by Insured Persons, or Claims outside U.S. or Canada, or Claims by bankruptcy or insolvency trustee or its assignee, or Claims made after Parent Company has a change of control)
- Consent by CODA to defense counsel not required.

Second, a Side-A policy dedicates its limit of liability exclusively for the benefit of directors and officers rather than the company. Third, a Side-A policy should not be subject to the bankruptcy automatic stay if any insured company files bankruptcy. Fourth, a Side-A policy affords greater flexibility in settling claims since the policy preserves its limits for subsequent non-indemnifiable settlements.

If extraordinary protection for only outside directors is desired, a company can purchase an Independent Director Liability (“IDL”) Policy, which is a Side-A policy insuring only the outside directors and not officers or other employees for non-indemnified loss. Such a policy frequently contains all of the extraordinary coverage enhancements of the standard Side-A policy plus a few additional coverage enhancements. For example, the CODA IDL policy eliminates the fraud and illegal remuneration exclusions in their entirety.

To afford maximum protection, these Side-A policies can be purchased with difference-in-conditions (“DIC”) coverage, thereby requiring the policy to drop down and fill any gaps in coverage for losses not covered under the underlying policies, but covered under the broader excess Side-A policies. Broad Excess DIC Side-A policies can not only provide high quality insurance protection for the directors and officers, but can also give important psychological comfort to the directors and officers that their risk from serving as a director or officer is being aggressively managed.

C. Excess Policies

1. Follow-Form Coverage. Although excess D&O liability policies generally state that coverage afforded by the policy is in accordance with the same terms, conditions and limitations as contained in the primary policy, the excess policy

usually contains numerous specific provisions which render the coverage far from pure “follow-form.” For example, excess policies frequently will not follow the primary policy, but will have their own unique provision with respect to when and how claims are reported under the policy; the availability and terms of a Discovery Period; what substantive law applies to the policy; how coverage disputes must be resolved (i.e., mediation, arbitration or litigation) and the terms of that dispute resolution process; who can cancel a policy for what reasons; and how related claims are treated.

These unique provisions in the excess policy can create inconsistency among the primary policy and the various excess policies. Those inconsistencies can be problematic for the insureds. For example, if different policies within the same D&O insurance program are governed by the laws of different jurisdictions, or if some policies are subject to mandatory arbitration and others are not, a single coverage issue may need to be resolved in multiple coverage proceedings in different forums subject to different laws, thereby causing enormous inefficiency and creating the potential for inconsistent rulings. Therefore, the excess policies should provide as close to pure follow-form coverage as possible.

2. Attachment. Most excess D&O policies issued by domestic insurers state that liability attaches under those policies only after the insurers of the underlying insurance have exhausted their respective limit of liability by payment of loss under those underlying policies. In contrast, excess D&O policy forms issued by several Bermuda insurers state that liability attaches under those excess policies if either the insurers of the underlying insurance or the insureds pay the amount of the underlying limit(s). Under the more restrictive attachment language in the domestic policies, an excess insurer can refuse to pay loss under its policy if the underlying insurer fails or refuses to pay its full limit of liability due to its insolvency, a coverage issue or any other reason.

In many claims today, insurers raise potentially significant coverage issues and insist upon paying less than their full limit of liability in light of the coverage defenses. In those situations, the more restrictive attachment language can create a major obstacle to settling a large claim. The primary insurer will refuse to pay its full limit because of the significant coverage issue and the excess insurers will refuse to pay any amount because the primary insurer has not exhausted its limit. In order to allow the insureds to negotiate a compromise of those coverage issues with underlying insurers without jeopardizing coverage under the excess policies, the broader attachment language contained within the Bermuda excess policy forms is desirable for insureds. In other words, the insureds can settle the coverage dispute rather than be forced to submit the dispute to a winner-take-all lawsuit or ADR proceeding.

3. Consent. Some excess D&O policy forms state that the insureds cannot incur any loss without the excess insurer’s consent, even if the loss is below the excess policy’s attachment. Although excess insurers are potentially affected by the

payment of any loss under the underlying policies, insureds understandably want to avoid the administrative burden, time delay and risk of seeking consent from all the excess insurers for even a small loss payment. As a compromise to these two legitimate but competing concerns, the consent provision in the excess policy could require the excess insurer's consent only if loss exceeds, for example, 50% of the Underlying Limit or, alternatively, only if loss is reasonably likely to involve the excess policy.

4. Quota Share Programs. Most large D&O insurance programs are structured with layered excess policies. Each layer is issued by a different insurer and is subject to a separate policy form. Although very common, that type of insurance program structure can lead to enormous inefficiencies and unnecessary disputes in the claims context. For example, the insurers for each layer in the program have complete claim control over that layer of coverage. Thus, in a large claim, it is not unusual to have 10 to 20 insurer representatives involved since each layer frequently will have one or two internal claim representatives and an external law firm working on the claim for each layer in the program. As the number of insurance companies and individuals involved in claim issues increases, the likelihood of prompt, efficient and consistent coverage decisions decreases.

In contrast, a large D&O insurance program which is structured as one or more quota share arrangements reduces many of those risks and can provide a far more efficient claims handling structure if one or a small number of participating insurers are granted claims control for the entire program. Excess insurers historically have been very reluctant to participate in that type of quota share arrangement, primarily because of their lack of claim control. However, the benefits from that type of program structure arguably outweigh the claim control concern. For example, a quota share participant who does not have claims control is arguably similar to a reinsurer who is financially obligated to pay losses under a reinsurance treaty even though the reinsurer has no direct control over the management of the underlying claim by the insurers. In both the quota share and reinsurance context, the insurer possessing claims control has an obligation to adjust that claim in the best interests of both that insurer and its constituents (i.e., its reinsurers and the other insurers in the quota share program who do not have claim control).

Although relatively rare in the past, we believe the current market may be more receptive to this type of quota share arrangement.

D. Conclusions

The existence of high quality D&O insurance protection has become a necessity for companies to successfully recruit and retain quality directors. Companies can obtain the broadest scope of D&O insurance protection only through negotiating coverage enhancements which are not contained within an insurer's standard policy form. All of the coverage enhancements summarized above have been afforded by at least some insurers in some

circumstances, and therefore it is reasonable to at least request those enhancements if desired. Obviously, there are many other possible coverage enhancements or clarifications which may be appropriate and available depending upon a particular policy form and the unique facts or circumstances applicable to the Insureds. Therefore, if a company wishes to maximize the protection afforded by its D&O insurance program, it should retain advisors with true expertise regarding D&O insurance and devote significant time and resources to crafting policies tailored to the unique concerns, exposures and desires of the company.