

D&O FAQ

Directors & Officers (D&O) Liability and Insurance Frequently Asked Questions

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DAO FAQ

1. What is a D&O policy intended to do?

The policy is intended to protect directors and officers against allegations of wrongful conduct when they are acting as company executives.

2. When does wrongful conduct have to occur to be covered by a D&O policy?

Typically, most policies cover alleged wrongful acts that have taken place prior to or during the policy period. However, some policies are negotiated to expressly exclude "past acts" coverage, so the actual language of the policy must be closely reviewed.

D&O insurance is not intended to be "burning building" insurance. If a potential insured is aware of an impending claim, it may be too late to go out and get insurance to cover it, unless the potential claim is disclosed and the carrier expressly agrees to take it on. First time D&O purchasers must reveal any information they have regarding known claims or related circumstances in the application process itself. Matters disclosed in the application process will usually be excluded from coverage.

3. Who is insured under a D&O policy?

The simple answer is that directors and officers are covered under a Directors & Officers Liability policy, but this is not a complete answer.

While traditionally only the directors and officers themselves were covered under a D&O policy, today this may be expanded to include managers and other non-executive directors, employees and the company itself.

What about the company itself, since it may be a defendant in many claims that could be asserted against directors and officers? Today, most D&O policies for publicly traded companies also insure the company itself but only for securities claims. Most D&O policies for privately held or not-for-profit organizations include coverage for the company for an array of claims (not limited to securities claims).

4. Who can bring the types of claims typically covered by a D&O policy?

Claims can be brought by the company's stakeholders (owners, investors, lenders, employees and securities holders, including bondholders). Claims can also be brought by customers, consumer groups, competitors, business partners (vendors and suppliers) and government enforcement/regulatory groups.

5. Why don't companies simply indemnify their directors and officers?

Companies generally do indemnify their directors and officers. However, sometimes companies are financially unable to provide this monetary protection or are unwilling to do so for economic or political reasons. Without corporate indemnity or insurance, directors and officers would be reduced to relying on their own personal assets to pay for the costs of defense and any resulting settlement or judgment against them. Outside directors (those that are not also employed by the company) are usually very vocal about requiring D&O coverage before agreeing to sit on a corporate board.

6. How does the policy's limit of liability apply?

Usually, there is a single aggregate limit of liability that applies for all claims that fall within the terms of the policy. This means that the aggregate limit is the entire amount that the carrier is willing to pay under the policy, and is not changed because of the number of claims, the number of insureds, or the accumulation of defense costs. Once this limit is exhausted, there is no more coverage available under the policy for any current or future claims. To the extent that the limit is exhausted (the carrier has made payments totaling the limit of liability) prior to resolution of one or more claims, the carrier has no further obligation with respect to those pending claims. This also means that the carrier has no further obligation in connection with defense costs that may continue to be incurred.

Defense costs apply first to the deductible or retention of the policy, and then serve to exhaust the available limit of coverage. It is possible that the entire policy could be spent in the defense of a claim, with no coverage remaining for any possible settlement or court award.

7. When does the dreaded issue of allocation arise?

Whenever there is a claim that is made against both insured directors and officers and uninsured parties, allocation will arise. (Uninsured parties can include: the firm's accountants, attorneys, underwriters, etc.). In this situation, the insurance carrier will look to allocate the costs associated with the defense, settlement and investigation of the claim made against the insureds from those same expenses generated on behalf of the non-insureds. Allocation most commonly occurs when the corporation itself is named as a defendant, but is not insured under the policy. As mentioned above, the public company corporate entity may be insured under a D&O policy, but usually only for securities claims. If a claim is brought against directors, officers and the company by someone other than a securities holder (such as a competitor), then the carrier will not provide coverage for that portion of any defense costs incurred by the uninsured entity or any settlement or judgment allocated to the entity.

Allocation may also arise when everyone is an insured under the policy, but not insured for all of the allegations that are included in the claim. This happens if either part of the claim is specifically excluded under the D&O policy or it simply falls outside the terms of the policy, for example, when a director or officer is sued in a professional rather than managerial capacity (outside the terms of a D&O policy) or part of the claim arises under the Employee Retirement Income Security Act (specifically excluded).

8. What is typically excluded under a D&O policy?

Standard exclusions include fraud, personal profiting, accounting of profits, and other illegal compensation exclusions, pending and prior litigation, prior (late) claim notice, bodily injury/property damage, pollution, insured versus insured claims and ERISA (the Employee Retirement Income Security Act of 1974). Insurers may also include other exclusions based on their own claims payment experience, such as hostile takeover or captive insurance company exclusions.

Some exclusions pertain to areas usually covered under some other type of insurance. ERISA violations are usually covered under a Fiduciary Liability policy, property damage may be covered under a General Liability policy, etc.

9. Wouldn't an exclusion for fraud or personal profiting eliminate coverage for most claims?

While a large percentage of D&O claims include allegations of fraud or illegal personal profiting (or both), the simple allegation is not enough to trigger the exclusion. Most, if not all, such exclusions require something like a court determination of guilt or an admission of guilt before the exclusion can apply. Either the words "final adjudication" or "in fact" will be used in the exclusion to indicate how high the hurdle is for the carrier to apply these exclusions.

Defense costs incurred for such a claim are typically covered by the policy until such time as the wrongful conduct is determined to have "in fact" occurred, or until there is a final adjudication. This means that a settlement without an admission of wrongdoing usually does not trigger the exclusions. In the event there actually is a finding of fraud or personal profiting, those directors and officers who are not found guilty continue to be covered even after others may have confessed or been adjudged guilty.

10. What's an "insured versus insured" exclusion?

A D&O policy is intended to function as third-party coverage or to insure claims made against the directors and officers by outsiders or third parties. It is not intended to respond to claims by the insureds themselves. (These are viewed as either insider fighting or collusive suits – things that the insurance carriers want to avoid).

There are some exceptions to the application of this exclusion. The first makes an exception for shareholder derivative suits as long as no insured (including the company) assisted in bringing the suit in any way. The second typical exception is for wrongful termination suits by officers. More recent exceptions may apply to cross-claims or claims for indemnity. Each of these exceptions means that the exclusion does not apply in those circumstances – so there is coverage.

11. When does a claim have to be reported to the D&O carrier?

It varies, but typically, the claim has to be first asserted or "made" against the insured during the policy period. This is why D&O insurance is generally referred to as "claims made" coverage. Some D&O policies also require that the claim be reported to the carrier during the same policy period. This is referred to as "claims made and reported" coverage. Many carriers provide some degree of a reporting "tail" to allow a short period of time after the policy expiration in which to provide notice of claims that came in during the policy period.

12. What happens if a claim is not reported in a timely fashion?

Courts have upheld the claims-reporting requirements of D&O policies, finding such requirements to be a condition of coverage. Since the reporting of claims is solely within the control of the insured, it is an obligation of the insured to act in a timely manner. Exactly what is “timely” may vary slightly among carriers, however. Many policies require notice as soon as practicable, as long as it is still within the policy period. Carriers and courts differ on what length of time is practicable. In any event, failure to provide timely notice can and will result in loss of coverage. What would be a covered claim can become uncovered if the reporting provisions of the policy are not strictly adhered to.

13. What precisely is a “claim” under a D&O policy?

The definition of a claim varies from policy to policy, and some do not define it at all. Generally, a claim includes any written demand alleging a wrongful act by a director or officer in his or her capacity as a director or officer, seeking monetary or non-monetary damages. This may be expanded to include investigative orders, grand jury subpoenas in actions that seek to hold the individual liable and other more esoteric events.

14. What exactly does a D&O policy cover in terms of expenses?

A D&O policy will generally either pay or reimburse the company the costs associated with the defense, investigation, negotiation and settlement (by way of a court determination or otherwise) of a covered claim. This includes attorneys’ fees, court costs and filing fees. It may also include expert or other specialist fees that are consented to in advance by the carrier. Most policies include the phrase “reasonable defense costs.” Therefore, some carriers may object to some element of expenses as being unreasonable (either because the amount charged is excessive, the work is duplicative, or the services rendered were unnecessary). In all events, the carrier only pays for or reimburses those expenses that are consented to in advance. In addition to expenses, D&O policies cover judgments/verdicts and settlements. Although the actual term used may differ (some carriers cover “loss” while others cover “damages”), all typically cover any court award or settlement, plus defense expenses.

15. What will a D&O policy usually not cover as loss or damages?

Covered loss will usually specifically exclude civil, criminal or punitive fines or penalties; exemplary or multiplied damages; amounts that are without legal recourse to an insured; or amounts that are uninsurable under the law. As with many other aspects on D&O policies, this can be modified by insurers. Many now agree to pick up certain fines and penalties and agree to provide coverage for punitive damages where insurable by law, especially for securities claims.

16. Who selects defense counsel for a covered D&O claim?

It depends: for securities claims involving public companies many D&O carrier have a pre-set list of law firms that they require the Insured to use (with pre-set, usually advantageous, rates). For non-securities claims for publicly traded companies, the insureds can usually select their own defense counsel. Carriers without pre-set lists still retain the right to consent to the counsel chosen by the insured and look for counsel that can demonstrate experience in the type of litigation at issue.

Under most D&O policies issued to privately held or nonprofit companies, the insurance carrier has both the right and duty to defend claims brought against the directors and officers in their official capacity. This usually means that the insurance carrier gets to select counsel.

17. What happens to coverage if the company is bought or merges into another?

Most D&O policies have what are generally referred to as “change in control” provisions. Most, but not all, policies state that in the event of a change in control, the policy will remain in force for the remainder of the policy period, but, and this is a big caveat: coverage will only be provided for claims involving wrongful acts occurring prior to the change in control.

Please note that some policies actually terminate coverage altogether at the time of the change in control. It is very important to know precisely how a specific policy would respond in such a situation.

Under the majority of policies, a change in voting control is the trigger for a change in control. Some also include sale of all or substantially all assets as a trigger. A filing for bankruptcy typically does not trigger the change in control clause, nor does a substantial change in the composition of the board.

18. Can a D&O policy be cancelled by the insurance carrier during the policy?

Historically, all D&O policies could be readily canceled by either the insurer or the insured. Many state insurance commissioners believed that this ability presented a significant hazard to the insured. As a result, many states limit the situations under which an insurance carrier can cancel a D&O policy and require these specific situations to be clearly identified and detailed in each policy. Today, D&O carriers are often willing to make their policies non-cancelable as long as premiums are paid. In these cases, the insured does not need to worry about being deserted when prospects are bleak.

19. If my D&O carrier cancels or non-renews my policy, do I have any rights?

In addition to setting out the specific circumstances and timeframes in which an insurance carrier can cancel or non-renew a D&O policy, most states provide the insureds with special protected rights in these situations. These rights can often be found in the D&O policy itself.

One such provision is the right to purchase an extended period in which to report claims that would have been covered by the policy before it was cancelled or non-renewed. When these claims are first asserted and reported during this extended period, they are then covered under the policy terms and limits in effect prior to the policy’s termination. This extended reporting period (ERP) is often referred to as a discovery period. Some D&O insurers make discovery available when either the insurer or the insured cancels or non-renews.

20. What's the "hammer clause"?

Most D&O policies have a provision stating that insureds are not permitted to settle a claim without the carrier's approval. This is particularly relevant if the insured expects the carrier to contribute to the settlement. On the flip side, the carrier is not going to settle without the insured's consent. However, if the carrier believes that a settlement is in the best interests of both it and the insured, and the insured refuses to consent, then the carrier can invoke a protective clause usually referred to as the hammer clause. Pursuant to this clause, if the plaintiff and the carrier are amenable to a settlement and the insured refuses, then the carrier limits its liability to the amount that the claim could have been settled for, plus defense costs incurred to the date of the proposed settlement. If the claim ends up costing more than it could have been settled for, the additional costs are not going to be covered by the insurance.