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D&O Liability Insurance — Peace of Mind, or Piece of Dross?

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A Mythical D&O Colloquy: ***Ms. Big:*** *"I'm very pleased that you've asked me to serve on Acme Co's board of directors. I'm a cautious person. Can you tell me if you have adequate D&O insurance?"*

Mr. Acme: *"Darn right we do. $50 million in limits from BigInsCo — a quadruple A-rated insurance company. In fact, the premium was so low on account of the soft market that we increased our limits. You don't have a worry in the world about your service on our board."*

Ms. Big: *"Yes, but what about BigInsCo's claims handling philosophy? Given the soft market, might that philosophy determine if my claim gets paid?"*

Mr. Acme: *"Uh, I'd never thought of that...."*

Directors' and Officers' liability insurance is sold to protect senior management against claims alleging wrongful acts. Many claims involve shareholders' derivative or class-action lawsuits. Policyholders who bring claims under D&O policies frequently find themselves in coverage disputes because claims handling philosophy often is not as fair and generous as the premium-collecting underwriting approach. Many insurance companies have an unfair advantage because they are familiar with the types of issues that arise when a D&O claim is made, but policyholders generally are not. An experienced broker and legal counsel knowledgeable in the D&O area can help policyholders navigate those treacherous waters.

Why Does Ms. Big Care?

Many policyholders face D&O claims. According to the most recent Tillinghast-Towers Perrin D&O study (1998), 28% of United States D&O survey participants experienced one or more claims against their officers and directors over a ten-year period. D&O claims often are significant. For 1997, the average defense costs was $1.2 million, and for those claims in which an indemnity payment was made, the average indemnity payment was $7.5 million, and research by National Economic Research Associates indicates that the average cost to settle a federal securities case rose 40% in 1998, to almost $11 million.

The source of over one-third (35%) of 1998 D&O claims was shareholders bringing derivative or class actions against directors and officers. These claims are a serious threat facing officers and directors, because of the amount of damages alleged, and the cost of a defense. These claims arise from adverse corporate financial performance and merger, acquisition and divestiture activities. Recent M&A or divestiture activity nearly doubled the frequency of D&O claims. Claims based upon improper disclosure and financial reporting are the most frequent. Public and private companies face very different risks; shareholder suits account for 49% of 1998 D&O claims at public companies, but only 9% of claims at private companies.

Look this Gift Horse in the Mouth

The current soft insurance market is favorable to insurance buyers, but beware of which product you purchase. The 1998 Tillinghast-Towers Perrin study showed a 13% average *reduction* in premiums for the typical D&O insurance purchaser, following an average 15% premium reduction in 1997. There are some exceptions; for example, premiums for D&O liability coverage in connection with hot Internet IPOs are reportedly "soar-

ing" to levels "three or four times what they would have paid only a few years ago."

Claims Handling Philosophy is Crucial

Policyholders should be concerned with the handling and payment of claims, not just lower premiums. With increasing dependence on technology, and uncertainty concerning potential liabilities arising from Year 2000 ("Y2K")-related computer malfunctions, policyholders are immediately concerned with the scope and availability of Y2K liability protection under their D&O insurance policies. Again, an experienced insurance consultant or legal professional can help in this area.

Given the declining trend in premiums and the possibility of continued increases in claims exposure, industry analysts now warn of "tougher times . . . ahead for the D&O insurance industry" and caution that "[i]f current trends continue, or perhaps worsen as Year 2000-related computer claims materialize, we could be only a few years away from some fairly adverse loss ratios and shrinking insurer profit margins." The current soft market has featured not just lower premiums, but also expanded policy language (*e.g.*, removal of certain exclusions, increased "entity" coverage). Insurance industry sources acknowledge that "overly liberal expansion of D&O policies may come back to haunt insurers when claims come in." Claims handling philosophy will be crucial.

What should Mr. Acme do? When obtaining or renewing coverage, all policyholders should seek available expansions and increased limits. Policyholders should resist onerous exclusions, including any Y2K exclusion, and might find more favorable terms elsewhere if a particular insurance company insists on an exclusion. Policyholders should seek multi-year policies to lock in favorable terms. Consider the financial strength and stability of the insurance company. Evaluate the claims-paying philosophy and reputation of the insurance company, before buying the policies. Risk managers should seek information and advice from their peers and from their D&O expert insurance brokers, attorneys and insurance consultants.

Small-Print Exclusions Should Not Be Magnified

Exclusions when magnified become a vehicle for improper post-loss underwriting. When future claims come back to "haunt" D&O policyholders, they should resist attempts by insurance companies to compensate in the claims process for what might be seen as imprudent underwriting. Post-loss underwriting should not be an accepted practice. Policyholders should inform their brokers and insurance companies that they expect prompt and fair investigation and payment of their claims with the insurance policy interpreted expansively. Unfortunately, as litigation shows, insurance companies will improperly assert policy exclusions.

"A Truly Wacky Result"

In a recent case, Chief Judge Posner of the United States Court of Appeals for the Seventh Circuit rejected an insurance company's overreaching application of the "insured versus insured" exclusion in a D&O policy. In *Level 3 Communications, Inc. v. Federal Ins. Co.*, a former director of a subsidiary of the corporate policyholder joined a securities fraud action against the corporation six months after the suit had been filed, as one of eight plaintiffs. The former director owned 16% of the corporations' shares. Based on the "insured versus insured" exclusion, and based on broad definitions which included a former director of a subsidiary as an "insured," the lower court granted summary judgment for the insurance company as to the entire claim, not just the part of the claim brought by the former director.

The Seventh Circuit reversed, finding that the insurance company's argument "has no basis in the language of the contract" and "would produce the odd result that a claim fully covered when made could become fully uncovered when another plaintiff was permitted to join it." Judge Posner suggested that even if this found support in the literal language of the policy, it was "a truly wacky result." In fact, outside the narrow terms of the exclusion, the D&O policy expressly required allocation of covered and uncovered losses, which supported the Seventh Circuit's reversal and remand to the district court. Rather than defeating coverage entirely, as the insurance company had asserted, the "insured versus insured" exclusion required allocation of covered and uncovered losses, with the policyholder "entitled to insurance proceeds equal to the amount of the settlement in the fraud case minus the amount that went to the [insured claimant]."

Another case rejecting an insurance company's improper assertion of a policy exclusion is *Owens Corning v. National Union Fire Ins. Co.* In that case, the United States Court of Appeals for the Sixth Circuit held that an asbestos claims exclusion in a D&O policy did not bar coverage for a shareholders' securities fraud claim based on the company's alleged misrepresentation of future financial exposure to asbestos claims. The court found the asbestos claims exclusion inapplicable because "the use of asbestos is not causally related to the harm alleged in the [shareholders'] complaint." The court continued:

> The complaint alleges that the named directors and officers were responsible for filing misleading financial-disclosure statements, resulting in an artificially inflated stock price. Only the alleged misrepresentations can be considered the cause of the artificially inflated prices. This is unchanged by the possibility that the motive behind the alleged misrepresentations was to hide the fact that the company was suffering financially from asbestos. Thus, any negligence or wrongful act by the directors and officers with regard to the use of asbestos is irrelevant here.

Noting that the policyholder's business "largely concerns the sale of asbestos and asbestos-containing products," the court found that the insurance companies' broad reading of the asbestos claims exclusion "would swallow up all of the coverage's."

These cases show that policyholders should be prepared to challenge their insurance companies' assertions of policy exclusions. Such assertions could swallow up all of the coverage, contrary to the limited construction which properly should be given to policy exclusions. Consultations with insurance brokers and other professionals can help ensure that a more appropriate interpretation is given in the D&O policy. Ms. Big should get the coverage she needs, and which Mr. Acme thought he bought. ■

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