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Protecting D&O Insurance In Tough Economic Times

Law360, New York (January 05, 2010) -- This year's economic turmoil and corporate dislocation underscore the need for directors and officers to obtain effective directors and officers liability insurance.

In the wake of the collapse of the U.S. credit market, directors and officers are likely to face an increase in bankruptcy litigation, shareholder claims, securities class actions, regulatory investigations and suits, and even criminal investigations and prosecutions. Thus, an increase in covered D&O claims is likely.

Complicating matters further, the current economic climate has resulted in a "soft" D&O market characterized by lower premiums, which will consequently lead to stricter claims review and an increase in coverage denials by insurance companies.

Set forth below are some of the relevant issues for directors and officers and suggestions for protecting D&O insurance in light of the current economic climate.

Think D&O

When faced with a suit threatening substantial liability and legal expense, directors and officers should look to D&O insurance. Most D&O policies broadly insure against losses arising out of "wrongful acts" committed by a corporation, its directors and officers, and other high-ranking employees.

Typically, D&O policies broadly define "wrongful acts" as "any act, error, misstatement or omissions, neglect or breach of duty" committed by the directors or officers while serving in that capacity.

Moreover, D&O insurance policies function as "litigation insurance," in that they advance legal fees and costs for defending claims against directors and officers.

For these reasons, an effective D&O insurance program is a crucial component to effective risk management in the face of increased scrutiny from courts, shareholders and government regulators.

Do Not Accept Coverage Denials

All too frequently, insurance companies will attempt to deny D&O coverage by improperly asserting vague defenses and interpeting policy exclusions over-broadly.

In our experience, such assertions often have little basis in fact and are recited in an improper attempt to protect the financial self-interest of the insurance company. Policyholders should be prepared to resist such defenses. Below are some examples of coverage defenses that insurance companies often assert inappropriately.

The "Insured vs. Insured" Exclusion

The so-called insured vs. insured exclusion, which is commonly found in D&O insurance policies, purports to preclude D&O coverage for claims by an insured corporation against its directors and officers.

The exclusion originated in the early 1980s in response to attempts by several corporations to obtain D&O coverage for losses resulting from the acts of directors and officers. Thus, the exclusion is widely interpreted to prevent only collusive lawsuits by a corporation against its officials.

Policyholders should be aware of two instances where an insurance company will attempt to assert this exclusion:

First, many insurance companies improperly argue that the exclusion precludes coverage when a regulatory agency or statutory receiver, such as the FDIC, sues a former director or officer.

However, most courts have held that the exclusion does not apply in these situations because the exclusion is designed and intended to prevent collusive lawsuits between "insureds."

Regulatory agencies and receivers are sufficiently adverse parties to a corporation and its officials, not "insureds," and thus, lawsuits brought by them against directors and officers cannot be collusive in nature.

Second, many insurance companies will assert that the "insured vs. insured" exclusion precludes coverage for claims brought by a bankruptcy trustee or a creditors' committee against directors and officers on behalf of the corporation.

In today's business climate, policyholders should be particularly wary of this use of the exclusion. According to the Administrative Office for the U.S. Courts, business

bankruptcy filings were up 52 percent in the year ending Sept. 30, 2009, totaling 58,771 compared to 38,651 in the year prior.

Given the risks, policyholders should ensure that their D&O policies contain an exception (or a “carve-out”) to the “insured vs. insured” exclusion for suits brought by a bankruptcy trustee or creditor.

Regulatory Exclusions

The "regulatory" exclusion purports to deny coverage for suits brought by any governmental, quasi-governmental, or self-regulatory agency.

These exclusions proliferated in the wake of the Savings and Loan Crisis of the 1980s and were often found in D&O policies issued to financial institutions. According to a 1995 estimate, 50 to 75 percent of D&O policies sold to banks contained regulatory exclusions.

In recent years they have become much rarer as the D&O market softened and memory of the prior crisis faded. However, with the number of failed financial institutions rising daily, policyholders should expect a resurgence of the regulatory exclusion and be prepared to defend against it.

If your policy does contain this exclusion, closely examine its wording. In some cases, the policy will name specific regulatory agencies; in others, not. While some courts have upheld the applicability of regulatory exclusions, others have determined the language to be ambiguous and refused to preclude coverage.

Moreover, in cases in the wake of the S&L crisis, government regulators themselves successfully defended against the regulatory exclusion using a public policy argument to the effect that regulatory exclusions significantly constrain the ability of federal regulators to sue directors and officers that have committed wrongful acts.

Insured Capacity

Standard D&O policies generally provide coverage for claims alleging “breach of duty by an insured person in his or her capacity as such,” as well as coverage for “any matter asserted against an insured person solely by reason of his or her status” as a director or officer.

Some insurance companies may try to deny coverage by alleging that certain claims fall outside of the scope of the directors and officers’ duties as officials.

For example, in one case, an insurance company attempted (unsuccessfully) to argue that directors and officers accused of making misrepresentations about a company’s stock price were not acting in their capacity as members of the board because those alleged misrepresentations would have benefited them as stockholders.

Bad Acts Exclusion

Almost all D&O policies include exclusions that purport to deny coverage for liability arising from fraud, criminal acts, or intentional misconduct.

Claims against directors and officers often include allegations of fraud and self-dealing, and insurance companies sometimes improperly argue that, to the extent that the directors and officers were acting with a selfish or fraudulent intent, any resulting liability falls under this exclusion.

Policyholders should keep in mind that the law is clear: These exclusions apply only after a final adjudication of claims, and directors and officers are entitled to an advancement of legal costs to defend against any allegation of intentional misconduct or fraud.

Give Notice Early and Often

If there is any possibility of a claim under your D&O policy, consider giving notice now. Pay close attention to any and all notice provisions contained in your insurance policies and comply with them.

Insurance companies routinely deny insurance coverage by arguing that the policyholder did not furnish timely notice. Do not let them. While examining the nature of your claims and your liability insurance policies is necessary, the safest course is to give notice often and early.

Continue to Protect D&O Insurance

The exclusions and coverage denials discussed above are only a few examples of the roadblocks to insurance recovery that directors and officers will face in the coming months.

Thus, when confronted with liabilities arising out of the current financial crisis, continuing efforts to protect the availability of liability insurance are crucial.

In-house counsel and risk management personnel can provide valuable counsel in interpreting existing insurance policy exclusions and resolving insurance disputes.

Moreover, risk management teams should pay close attention to D&O policy language when renewing policies from year to year. As new trends in the D&O market emerge, policyholders should seek to improve the scope of their D&O policies and avoid ambiguities.

Take steps today to protect your D&O insurance. Those insurance policies can often be one of the most important bulwarks between directors and officers and financial ruin.

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