Competing Interests in D&O

by Joshua Gold

Directors and officers liability insurance is one of the few types of insurance that interests a company's senior management. This is because D&O is one of the few insurance products left that still provides reasonably broad protection against serious losses and defense costs—a protection that is especially valuable in a time where many corporations are on life support. Ironically, the broad scope of D&O coverage gives rise to its own set of problems—namely, a fight between various insured interests for the policy proceeds.

D&O policies protect against a wide range of liablilities including regulatory actions, class actions, derivative suits, federal and state securities suits and state breach of duty suits. These suits may be brought by investors, customers, creditors, government agencies, law enforcement officials, former insureds, employees and sometimes trustees in bankruptcy. Equally varied is the number of potential insureds, which typically include past, present and future directors and officers, in-house attorneys, the company itself and sometimes specific employees or even outside parties.

Competition for D&O insurance proceeds is fierce when corporate management changes, whether through a transaction, crisis-induced management shake-up or a condition of government settlements. Not surprisingly, these circumstances create competing and conflicting interests in the company's D&O insurance. The departing company management, even if still indemnified, may want to preserve coverage for lingering civil litigation or potential regulatory actions. The new management team will have an interest in preserving the D&O insurance for itself, and for the entity that they now manage, against pending and future claims. These dynamics lead to fights between groups of "insureds" vying for limited amounts under the policy before the well runs dry.

The situation is even more challenging in cases of bankruptcy. Some have argued that a D&O insurance policy that promises "entity" coverage transforms the policy into an asset of the bankruptcy estate, potentially leaving officers and directors "bare" in the event of litigation. The bulk of the cases rendered thus far do not necessarily support this conclusion, but it is an issue that recurs when creditors and trustees try to soak up every remaining viable asset. Even insurance companies have seized on this debate as a marketing point for the sale of non-entity D&O coverage and so-called Side A policies.

One of the critical points in these situations is whether a priority of payments clause is contained in the primary or excess policies. These clauses typically provide a strict formula for divvying up policy proceeds. Generally, they first afford coverage preference to non-indemnifiable claims, followed by claims indemnified by the corporation, before then furnishing entity coverage.

Priority of payment clauses bear their own set of ambiguities, however. Most importantly, such clauses purport to have no application until a "loss" exceeds the remaining limits of the policy. As such, timing of loss payments claimed under the policy becomes a key issue. To determine whether the clause is triggered, can one extrapolate from a monthly or quarterly burn rate to figure out when something such as defense costs will exhaust the policy? If so, can the priority of payments provision be triggered at that moment and require the application of the formula months before the policy limit is actually exhausted? Depending upon the competing interests in the policy, one side will argue yes and the other no. Very little guidance as to which side is correct is provided under the express terms of these clauses.

Also, a question may arise as to whether the clause is discretionary or automatic in its application. Both forms exist. If discretionary, which insured has the discretion to invoke it? Typically, the corporation as "named insured" will have that right. But it may be charged that there is a conflict of interest even in that scenario, as current management might want to invoke it even if it would be in the entity's coverage interest not to do so.

Competition for the policy proceeds may also have a chilling effect on global settlement prospects. Should the insurance company's contribution to a settlement be pivotal to resolving the underlying liability, a fight over the preservation of the policy to fund a different or future D&O claim may prove the settlement's undoing.

Most of these issues must be assessed on a case-by-case basis. If there is no uniformity of interest in covering the underlying claim, a three-way negotiation of these issues will ensue with an insurance company looking for concessions from the competing insureds as a condition of coverage. ■