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Protecting D&O Insurance During Difficult Economic Times

By William G. Passannante and Raymond A. Mascia Jr.*


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This year's economic turmoil and corporate dislocation underscore the need for directors and officers to obtain effective directors and officers (D&O) 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 interpreting 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.

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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

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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% in the year ending September 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% 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 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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Resolutions

By Mark Garbowski

The most frustrating insurance problems are those that could be easily avoided. Policyholders would have a greater chance of prevailing in many insurance cases if they had followed some simple steps before consulting outside counsel. In many cases, following these steps might have avoided the need to consult outside insurance counsel altogether.

As we approach 2010, here are some suggested New Year resolutions for policyholders to keep in the coming year.

Give Notice of Every Claim or Potential Claim to All Possible Responsive Insurance Companies

The advice to provide your insurance company with notice of a claim or, in some instances, potential claims, is present in almost every speech, article, or any other form of presentation given by any insurance coverage lawyers who work for policyholders. Yet clients routinely present us with situations in which notice was delayed and the insurance company is using that delay as an excuse to deny coverage.

Yes, there are circumstances that legally excuse late notice. Yes, the insurance company might have to prove that the delay caused it prejudice in many jurisdictions. Yes, you might be able to argue that the insurance waived the right to require notice for various reasons.

But there is no reason to put yourself in a position to have to make these arguments. If you are presented with a claim or a potential claim, give notice to any and all insurance companies that might have a responsive policy.

Do Not Settle an Underlying Claim Without Consulting your Insurance Company

Do not let your worry that your insurance company might not approve a potential settlement keep you from asking for that approval. The insurance company might very well might refuse to grant its approval, but you are almost always in a better position if you settle after the insurance company refused its approval than if you settle without having given the insurance company the opportunity to say no, or yes.

Most policies and most states will require that an insurance company justify its refusal to approve a settlement, on the grounds that such consent cannot be unreasonably withheld.

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In some circumstances, particularly where the insurance company believes it has a strong defense to coverage, you might be able to get it to state that although it does not approve of the settlement and refuses to contribute, it nevertheless will agree not to raise the defense of non-approval during any future coverage dispute.

It is particularly damaging to make both of the mistakes discussed above in conjunction: never settle an underlying claim before giving notice to all potentially responsive insurance policies.

Read Your Policies

When you buy a new policy from a new insurance company – read the policy it sends you. When you renew a policy with the same insurance company – read the policy it sends you. A new or renewed policy will not always contain either the coverage that you were promised, that you expected, or that you had the year before.

Yes, you might have a claim against your brokers if they did not obtain the coverage you requested. Yes, some states will excuse the failure to read a renewal policy and hold the insurance company to the coverage in the original policy if reductions in coverage are not prominently disclosed. But again, there is no reason to put yourself in a position where you have to rely on these arguments. Rarely are judges impressed by policyholder complaints about why they were surprised, upon submitting a claim, to discover what is in, or not in, their policy.

Further, if your insurance company takes an extreme position about the meaning of certain policy language, you are also in a better position to argue that the policy is ambiguous or even incomprehensible if you can credibly testify that you reviewed the policy when it arrived, and you had no reason to expect that the policy would be applied in the way that the insurance company is advocating.

Conclusion

These unforced errors arise repeatedly. Indeed, if these rules were followed much more than they are now, then there would be less work available for coverage. attorneys. Want to reduce your legal bills? Read every policy you buy, and follow the procedures it requires.

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