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Client Alert

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BUSINESS AND FINANCE

D&O Insurance Alert: Are You Covered?

Over the last decade, the growth in venture capital investment, the adoption of new securities laws and regulations, the requirements of the stock exchanges and NASDAQ and the demands of institutional investors have combined to increase the size of corporate boards and the number of independent directors who sit on them. The mobility of executive level employees, particularly in technology related fields, and their addition to the boards of their new employers also has fueled this trend.

Often, the first question a potential candidate for a directorship asks is whether the company has a directors' and officers' liability insurance policy. Increasingly, the answer to this question is yes. Unfortunately, too often the questioning ends there or after the candidate learns of the dollar amount of the coverage. But just how much protection does the typical policy afford?

As is true with most other types of insurance, D&O policies have limits, deductibles and exclusions. These could leave officers and directors exposed to substantial uncovered liability. Moreover, many companies fall into the habit of renewing their coverage without evaluating whether it is still adequate or requesting important enhancements which may have become available.

Here are some questions each officer, director or potential director should consider when evaluating a company's D&O coverage.

What are the policy's limits? Due in large part to the dramatic increase over the past several years in the prices of securities, the number of securities class action lawsuits and the size of the claims brought in these suits have spiraled to alarming heights. Through July 2001, 223 federal securities class action lawsuits had been filed, compared to only 211 during all of last year. The cost of settling these cases is also increasing. The average settlement in 2000 was approximately $14 million, not including the $1 billion paid by Cendant to settle a suit brought against it, an increase of over 8.5% from approximately $12.9 million the previous year. Accordingly, what may have been sufficient coverage a few years ago may be inadequate today.

What constitutes sufficient coverage depends upon a variety of factors, including whether the Company is public or private and the nature and size of its business. The amount of coverage should be reviewed periodically in light of the relevant factors and adjusted as circumstances dictate.

Are there any gaps in the coverages provided by separate policies? Many companies obtain layers of D&O coverage — a primary policy with a stated limit and one or more additional policies which cover the excess over the limits of the policy or policies coming before them, each with its own stated limit. The insurers under the primary and secondary policies are different companies using their own contracts of insurance. Care must be taken to ensure that there are no gaps or inconsistencies between the coverages provided by these separate policies. Similarly, if the Company has recently changed carriers, care should be taken

to ensure that claims brought after the change relating to events occurring prior thereto are covered.

A related issue arises when a company is down-sizing, being sold or winding up and questions of continued coverage are presented. The officer or director should consider what the policy provides in these circumstances. If the policy does not provide extended coverage automatically (most don't), the officer or director might consider obtaining an advanced undertaking from the Company to purchase a policy "tail" or, in the case of a sale, requiring the acquiror to provide coverage on substantially similar terms.

What are the deductibles? Virtually all D&O policies have deductibles for some forms of coverage, and many have deductibles that vary depending upon the nature of the occurrence or whether the insured is entitled to indemnification from the Company. (Typically, the deductibles for securities claims are significantly higher than the deductibles for most other forms of coverage.) The officer or director should inquire about the amount of any deductibles and the circumstances in which they apply. He or she should also ask what happens if there is a deductible and the Company is financially incapable of paying it. The preferred policy is one which provides that the insurer will waive the deductible if the Company is insolvent.

Recently, several insurers have expressed their intentions to have insureds share more of the risk associated with losing an insured claim. Here again, if the Company's D&O policy contains a risk sharing provision and the Company is financially incapable of paying its share, officers and directors may be required to contribute to the claim.

What types of claims are covered? For public companies, securities claims continue to cause the greatest concern as they have the potential to result in the greatest exposure. Virtually all D&O policies provide coverage for officers and directors against securities claims; and, since the early 90's, most policies even provide coverage for the Company. (This coverage put an end to disputes between insurers and insureds concerning the allocation of costs and liabilities between the individuals who were covered by the policy and the Company which was not.) Not all policies, however, cover officers and directors from claims brought by securityholders of other companies. And many policies, especially those of a somewhat older vintage, do not provide coverage against expenses and liabilities emanating from administrative proceedings or regulatory investigations, or from fines, penalties and taxes for which officers and directors may find themselves personally liable. The need for coverage for matters of this nature has become increasingly important in light of the enactment of new laws and regulations — such as the SEC's Regulation FD — that expand government agencies' authority to commence investigations and enforcement actions. Many insurers have begun to offer enhancements covering these types of claims, proceedings and liabilities. Officers and directors should understand the limitations of the Company's D&O coverage and, if appropriate, suggest, or insist, that the coverage be expanded to cover these areas.

Many D&O policies have employment practices liability endorsements. Employment claims, which are more common than other D&O claims, could reduce the amount of coverage available for matters which generally carry greater exposure, such as securities claims. Management should carefully consider with their insurance professionals whether it makes sense and is cost efficient to insure employment liability risks with a stand alone policy or as an endorsement to the Company's general liability policy.

What is excluded under the policy? Like most other types of insurance policies, D&O policies exclude certain types of claims from coverage. The categories of exclusions vary from policy to policy. An in-depth analysis of policy exclusions is beyond the scope of this Alert. Most policies exclude coverage against fraud, bodily injury or damage to tangible property, breaches of contract, the ownership of intellectual property, or claims involving any act as a result of which the insured gained an advantage to which he or she is not legally entitled. The Company may have other insurance covering certain of these matters. Which exclusions may or may not be appropriate will depend in part upon the nature of the Company's business. Officers and directors should consider the policy's exclusions in this light.

Special attention should be paid to the provisions governing intentional or wrongful conduct and fraud. Officers and directors should make sure that the acts of one insured do not negate coverage for all insureds. Moreover, the policy exclusions concerning this conduct (and, perhaps other areas) should clearly state that they apply only after a finding that the insured is in fact guilty of such conduct. The defense obligation is crucial in this context since most cases settle. The policy should make it clear that the insurer may not disclaim coverage based solely on the allegations of the complaint, even if those allegations claim intentional wrongdoing or fraud.

Attention should also be paid to the so-called "insured vs. insured" exclusions. Designed to prevent collusive practices, some insurers have relied on such provisions to disclaim coverage where no threat of collusion is present.

Conclusion. The value of and coverage afforded by D&O insurance policies can vary widely in important areas, such as the limits of coverage, deductibles, the types of claims covered and policy exclusions. It is not enough that the Company has coverage. The policy should provide adequate protection to its beneficiaries under the circumstances. Officers, directors and potential directors would be well served to review the Company's D&O policy with experienced counsel and insurance professionals to determine its adequacy in light of the relevant facts, including the identity of the Company and the nature of its business. Moreover, they should be aware that D&O insurance constitutes only one element of a coordinated program of protection which also includes carefully drafted charter and by-law provisions, indemnification agreements and other measures. Here again, experienced counsel can be helpful in evaluating the total package and structuring appropriate protections.