Directors and officers liability insurance: Tensions between corporate and individual insureds
McCutcheon, Mary E
International Journal of Disclosure and Governance; Jun 2006; 3, 2; ProQuest Central
pg. 148

D & O Policy Contracts

Directors and officers liability insurance: Tensions between corporate and individual insureds

Mary E. McCutcheon
Received: 15th March, 2006

Farella Braun + Martel LLP, 235 Montgomery Street, 17th Floor, San Francisco, CA, USA;
Tel: +1 (415) 954 4400; Fax: +1 (415) 954 4480; E-mail: MMcCutcheon@fbm.com

Mary E. McCutcheon is a partner at Farella Braun + Martel LLP, San Francisco, CA.

ABSTRACT
KEYWORDS: directors and officers insurance, Side A coverage, fraud exclusion, final adjudication, interim funding agreements, indemnification

D&O liability insurance has evolved from a policy designed to protect only individual directors and officers to a risk transfer mechanism used to protect a corporations balance sheet. The policy provisions implementing this evolution may dilute the coverage available to the individuals. Policy changes designed to mitigate against this dilution, however, may lead to unanticipated impairments of coverage for both individuals and the corporation.

International Journal of Disclosure and Governance, Vol. 3, No. 2, 2006, pp. 148–155
© Palgrave Macmillan Ltd, 1741–3591/06 $30.00

INTRODUCTION

Directors and officers (D&O) liability insurance forms are constantly evolving to respond to new litigation risks, developments in case law and marketplace demands. Many of the changes seek to address the tensions arising out of competing claims for policy proceeds by the company and individual insureds. These tensions, and the changes in D&O products and policy provisions which attempt to resolve them, cannot be ignored either when purchasing D&O insurance, or when a lawsuit or regulatory proceeding triggers claims against the policy.

D&O insurance originally was designed primarily as a risk transfer mechanism to protect the personal assets of directors and officers facing liability for errors or omissions committed in the course of discharging the duties owed to the company they served. Its secondary purpose was to guarantee the corporation's indemnification obligations to those individuals which were imposed by law or created by an indemnification agreement. But as companies became more concerned about the potentially catastrophic costs of the defence and settlement of securities and other high stakes litigation and the costs of responding to investigations by the Securities and Exchange Commission (SEC) and other governmental entities, they began to rely on D&O insurance as a mechanism to insure their own liabilities as well as those of their directors and officers. Today, D&O insurance is a fundamental component of corporate risk transfer.

The transformation of D&O insurance from a programme providing primarily individual protection to one providing

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

protection for the individual directors and officers and the corporation they serve means that the same sum of insurance limits may be drawn upon by more insureds. Competing rights to the policy obviously create conflicts among those looking to D&O proceeds to pay their attorneys' fees and indemnification costs, particularly if the company is unable to withstand the financial impact of litigation. Conflicts also arise when new management perceives that old management did not act in the best interests of the company, and, out of spite or necessity, attempts to conserve D&O proceeds for the company and new management. These concerns caused independent directors, already concerned about the pressures of Sarbanes–Oxley and increased SEC scrutiny, to scrutinise the D&O insurance purchased by the company and to focus on protection for their individual exposures.

Accordingly, when a lawsuit or governmental investigation involves allegations of severe malfeasance, counsel for both the individuals and the company must take into account, in addition to concerns about civil liability and criminal exposure, the interplay between litigation tactics and insurance concerns. They must make sure that policy proceeds are expended in the best interests of their client, as opposed to the other insureds, and that strategic decisions made in responding to the litigation or investigation do not negatively impact their client's ability to access D&O insurance when needed.

The conflicts between corporate and individual director and officer objectives can also arise when the programme is placed, as companies decide how their budget for D&O insurance premium dollars is spent in relation to corporate versus individual risks. Because of the increased reliance on D&O insurance to protect corporate as well as individual interests, companies are asking outside counsel, in addition to brokers, risk managers and inside counsel, to advise them on the selection of insurance and negotiation of policy provisions. Cautious independent directors may even retain their own counsel to make sure that the policy is negotiated to protect the individual over the corporate insured. When advising their clients on insurance issues, counsel must not only advise their clients on how certain policy products and provisions might expand or restrict coverage for a claim, but also how the D&O insurance will most effectively serve their client if there eventually are competing claims on the policy. Assuming no serious coverage defences that jeopardise the availability of the proceeds to all concerned, when reviewing the policy when purchased or advancing positions once a claim is made, counsel's fundamental concern may well be (1) Is there enough insurance? (2) If not, what must I do to make sure my client gets their fair (or more than fair) share of the policy proceeds?

As discussed below, the D&O insurance issues most likely to give rise to such conflicts are: (1) entity coverage, which extends coverage to the company at the risk of diluting coverage for the individuals; (2) conduct exclusions, which may be used by the company or by presumably 'innocent' individual insureds to deprive disfavoured (arguably 'guilty') insureds in an effort to preserve limited policy assets for a subclass of insureds; and (3) insurer requirements for 'interim funding agreements', which may improperly shift corporate obligations to the individuals.

ENTITY COVERAGE

Twenty years ago, D&O insurance policies contained two components: 'Side A' and 'Side B'. Side A provides coverage directly to the directors and officers. It is triggered if the company is unable to indemnify its directors or officers by reason of financial insolvency or by operation of law (eg, a judgment in a derivative action).[1] Side B provides coverage for a company's contractual or statutory indemnification obligations to its officers and

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

directors. The corporation, rather than the individual officer or director, is considered the insured under Side B coverage, although the insurance is not available for the corporation's own defence costs and liabilities.

When issuing a standard Side A and B D&O policy, insurers presumed that in a lawsuit involving both individuals and the company, defence and indemnity costs would be allocated between the company and the individuals, that is, between the company and the D&O insurer. In other words, the insurer assessed its risk and based its premium on the assumption that, if solvent, the company would be a significant contributor to defence and indemnity costs for the litigation and, correspondingly, expenses to be paid by the insurer on behalf of the directors and officers would be relatively small.

As the expenses and exposures of securities litigation and governmental proceedings escalated, companies successfully argued that the D&O insurer should bear the full costs of defence or settlement where the exposure was based on the joint liability of the individuals and the company, where the company's liability was based on its vicarious liability for the acts of its insured directors or officers, or where the presence of the company in the litigation in addition to the directors and officers did not as a practical matter increase the total exposure for the litigation.[2] As a result, D&O insurers found to their surprise that instead of paying a relatively small percentage of fees and costs of shareholder litigation or SEC proceedings, they now were responsible for 100 per cent of millions of dollars of defence and indemnification expenses.

The ever-resilient D&O insurance industry responded to this initially negative development by creating a financial opportunity, revising policies (and charging a higher premium) to add 'Side C' or 'Entity' coverage as an additional insuring agreement. Side C coverage provides direct coverage for the company's liabilities (in the case of public companies, usually limited to securities claims), often providing that coverage whether or not an individual director or officer is named in the lawsuit. As a result, protection for individuals has been transformed into protection for the company as well.

While originally seen as a solution to the uncertainties of allocation disputes and the expanded risk undertaken by the insurer, Side C coverage began to present its own problems. Bankrupt companies and their creditors claimed that by virtue of the Side C coverage the D&O coverage was an asset of the estate. Thus, the individual insured's ability to access the policy proceeds for defence and indemnity would be held hostage to the demands of the creditors' committee and the rulings of the bankruptcy courts.[3] This situation was particularly burdensome where ongoing shareholder litigation was stayed against the company but maintained against the individuals, and the individuals' indemnification rights against the company were frozen or eliminated by the bankruptcy proceedings. As a result, the insurance was unavailable for the very purpose for which it was purchased: to protect the individual when the company could not.

Even if the company were solvent, in cases of allegedly severe securities fraud the policy proceeds could be quickly eroded by company defence and indemnification costs, and thus unavailable to settle non-indemnifiable claims against individual defendants which might not be resolved until after resolution of the shareholder litigation. This risk was increased by the practice of settling shareholder litigation first, and then resolving the usual companion derivative litigation almost as an afterthought. Companies who had exhausted the policy limits in settlement of the main shareholder litigation then realised that, even if they wished to, they might be forbidden by

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

law to indemnify directors and officers for settlement of the derivative litigation. These risks forced corporate and individual insureds to rethink the focus on entity coverage when purchasing D&O liability protection.

Non-entity coverage: 'Pure' Side A

In an effort to satisfy the concerns of independent directors, D&O insurers began to aggressively market 'pure' Side A coverage in various forms. This Side A coverage generally is designed so that it 'drops down' as primary coverage if the underlying coverage is no longer available. It can be triggered by a number of events, including the insolvency of the underlying insurer or the company, exhaustion of underlying limits, an improper denial of coverage by the underlying insurer or a refusal to indemnify by the company, rescission of the underlying policy or the application of an exclusion in the underlying policy. It may cover all individuals employed by the corporation, or only the outside independent directors. To placate nervous boards yet still maintain a reasonable premium for D&O insurance, many companies began to shift insurance premium dollars from traditional to 'pure' Side A coverage. As a result of director anxiety and insurer marketing, Side A coverage has become a larger share of many companies' D&O programmes.

THE SOLUTIONS MAY GENERATE THEIR OWN PROBLEMS

Adding generous amounts of 'pure' Side A coverage to a D&O programme, however, may not always be a prudent use of corporate funds. Because Side A coverage cannot be accessed as long as the company is able to indemnify the insured, purchasing the coverage essentially means that a company is spending a significant amount of its insurance budget for coverage that will only be used in rare instances, that is, where the company is financially or legally unable to indemnify the individual. For a financially stable company, insurance premiums may be better spent protecting the company's own balance sheet. While excessive Side A coverage may attract a talented, experienced and independent board, the board also has a responsibility to avoid spending excessive amounts of money on an asset that does not directly benefit the corporation. Thus, careful consideration should be given to not only the amount of D&O coverage purchased, but the balance between traditional coverage and Side A coverage. This is especially true for a solvent public company, which may be more vulnerable to catastrophic securities claims, which could impact the corporate bottom line and will not be insured by Side A coverage.

Even a healthy amount of Side A coverage may not be sufficient to protect the individual insureds, however, in the event of a catastrophic claim against a financially shaky company. If enough individuals potentially can claim status as an insured under a Side A policy, for example independent directors, officers, managers and (in some instances) employees, the value of the coverage is severely diluted. Individual defendants, each with their own high-powered legal counsel, can burn through a staggering amount of policy proceeds in an effort to make sure they get as big a piece of the pie as possible before the policy limits are exhausted. Thus, when Side A coverage is purchased, counsel for independent directors should take care that the definition of insured is properly restricted so that their client is not sharing policy proceeds with a wide array of company employees.

Another new D&O insurance product which seeks to maximise coverage while controlling premiums is a policy which provides Side A and B coverage only, but also effectively provides limited entity coverage by including a 'preset allocation' (typically 70 or 80 per cent) of defence and indemnity costs 'jointly incurred on behalf of' the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

company and the insured individuals in the defence of a securities claim. While this type of policy offers premium savings which can be used to purchase additional Side A coverage, it is a relatively new product, and the practical implications of the structure of the coverage have not been fully realised as claims are brought and adjusted under these policies.

With 'pre-set allocation' coverage, decisions made during the course of the litigation can severely restrict funds available to the company. The company would have no coverage for defence costs incurred by a law firm representing only the company, or for defence and indemnity costs incurred after the individual insureds are dismissed from the case. Accordingly, the desire to utilise insurance proceeds can affect strategic decisions such as: whether to employ separate counsel for individual insureds (meaning that fees billed by the law firm representing the company, which is probably incurring the most significant legal fees as lead defence counsel, are not paid for by insurance); whether to settle on behalf of individual insureds early in the course of the litigation (meaning that the company has no more coverage for defence or liability); or whether to file dispositive motions that may result in a dismissal of the individual insureds only (again, depriving the company of coverage for the reminder of the litigation).

These strategic decisions may give rise to conflicts between the individuals and the company, requiring independent counsel not only to represent the individual in the liability action, but to provide coverage advice as well. If there is a concern that the policy proceeds will not be sufficient to protect the individuals in the underlying securities litigation, and the company's ultimate ability to indemnify the individuals is also in question, counsel for individual insureds may resist any litigation tactics which benefit the company at the expense of preserving limits for individuals.

CONDUCT EXCLUSIONS: AN ADVANTAGE FOR THE INNOCENT, A HAZARD FOR THOSE LESS SO

D&O insurance policies have always included what are known as 'conduct' exclusions, that is, exclusions for liabilities arising out of deliberately fraudulent or criminal acts, or for liabilities arising out of an insured having gained a 'profit or advantage' to which he or she is not legally entitled. Originally, those exclusions were worded to apply if the insured 'in fact' committed fraud or gained an improper personal advantage in connection with the underlying claim. It never was clear what 'in fact' meant: was the existence of admissible evidence of fraud sufficient to deny coverage? What about an admission by an insured? Did this language require a judicial determination of fraud? To provide greater protection to insureds that faced allegations of fraudulent conduct, the exclusions eventually were modified to provide coverage until there was a 'final adjudication' of improper conduct. Not only did this clarification make it harder for insurers to refuse to indemnify alleged malefactors, it also guaranteed that wrongdoers had access to policy proceeds for their defence of civil and regulatory claims, no matter how clear their guilt, throughout the proceedings in the underlying claims.

This modification, designed to protect individual insureds, often benefited a wrongdoer at the expense of an 'innocent' individual or corporate insured. While a guilty insured might take comfort in the assurance that it would be very hard for an insurer to halt the funding of his or her defence costs, companies who felt that they had been injured by the malfeasance of those individuals resented the fact that policy proceeds were diverted to protect people who did not, in the corporation's view, deserve protection. Or if a company was insolvent, 'innocent' insureds did not want scarce policy resources wasted by the malefactors at the expense of the innocent insureds' ability to fund their

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

defence and to use policy proceeds to settle the claims against them.

To allow greater flexibility to preserve policy proceeds for 'innocent' insureds, many companies are asking for, and insurers are agreeing to, a return to 'in fact' language, hoping that this more flexible standard will enable companies or innocent insureds to demand that the insurer refuse coverage for a guilty insured when there is strong evidence of criminal or fraudulent conduct. Insurers are also offering, and companies are buying, fraud and personal profit exclusions which preclude coverage when the improper conduct can be established by 'written evidence', or a plea in a regulatory or criminal proceeding.

It is not clear, however, what type of 'written evidence' will suffice to deny an insured coverage short of a judicial decree: an ambiguous memo or e-mail by the alleged wrongdoer uncovered during discovery? A declaration by a fellow insured with his or her own axe to grind? Recitations in a settlement agreement with the SEC?

The broadening of these exclusions undeniably benefits innocent insureds, as it gives them a basis to demand that insurers cease funding the defence of complicit insureds, preserving limits for the liability of those who were unaware of the wrongdoing but nevertheless may have to pay for it. These exclusions may be used, however, to deny coverage to former officers or directors whose conduct, while less than stellar, may not in fact be truly criminal or fraudulent, if the company has decided to scapegoat certain officers or directors as the source of the company's troubles. These exclusions can also deter individuals from agreeing to settle in SEC or Justice Department proceedings, if admissions in the settlement or plea documents may be used to deny coverage for ongoing civil litigation.

These exclusions present dangers to the corporation as well. Before a company elects to include the broader conduct exclusions in its D&O policy, it should review the indemnification agreement it has entered into with its directors and officers. Many corporate indemnification agreements are extremely broad, requiring companies to advance defence costs on behalf of directors and officers no matter how serious the allegations against them, and also make it difficult to avoid indemnification responsibility for a settlement or judgment. A corporation certainly does not want to purchase insurance which makes it easy for the insurer to deny coverage for a claim for which the company cannot escape its indemnification obligations.

A broad conduct exclusion may have other negative implications for a company. The fraudulent or criminal conduct of certain individuals, particularly senior management, usually is imputed to the company by the policy terms, depriving the company of Side C coverage for its own liabilities. So, the same exclusion used to eliminate coverage for the guilty individual can void coverage for the company as well. A corporation eager to charge a director or officer with corporate malfeasance, or to pursue a litigation strategy which lays blame at the feet of the individuals, should take care so that the strategy does not ultimately backfire and cost the company more in insurance proceeds than it gains in strategic advantage.

UNDERTAKINGS: INTERIM FUNDING AGREEMENTS

Insurance companies are becoming increasingly aggressive in demanding that the company and individuals execute 'undertakings' or 'interim funding agreements' (IFAs) in which the insureds expressly agree to repay defence costs if it ultimately is determined that the claims are not covered by the D&O policy. These agreements may not be required by the language of the D&O policy, but a corporation may accede to this demand simply to avoid a fight with its insurer and to facilitate the immediate flow of defence

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

reimbursement funds. A company often does not have an interest in ensuring that current or (more likely) former directors and officers receive the full protection required by the corporate and insurance indemnification provisions. So, it may pressure its directors and officers to sign an IFA with the insurer, even if not required under the policy or in the indemnification agreement, as a condition of advancement of defence costs under the indemnification agreement between the individual and the company.

When civil or regulatory securities suits are filed against a company, all defendants simply want to make sure that someone else pays for their defence. A company may not care that the IFA demanded by the insurer is not required by the D&O policy. It may not care that the IFA imposes liability for a corporate obligation upon the individual insureds; it simply wants to protect its cash flow by obtaining coverage for defence costs as soon as possible. Officers and directors who may have executed undertakings for the company to obtain advancement of defence costs pursuant to the company indemnification agreement may see the IFA demanded by the insurance company as simply another necessary evil.

Counsel for individual insureds, however, should not quickly acquiesce to their client's execution of an IFA not otherwise required by the policy terms. They should also resist any attempts by the company to pass off to the individuals the responsibility for seeking reimbursement from and working out payment disputes with the insurer. If a company is financially and legally able to advance defence costs, then the *company*, not the individual, is the insured under the Side B coverage of the D&O policy. Accordingly, it is the company, not the individual, who should sign any IFA required by the insurer, pay the individual insureds' defence fees under the terms of the company's indemnification agreement with the individuals, submit those bills to the insurer for reimbursement and argue with the insurance company when it refuses to pay some or part of the defence fees.

Why does it matter whether the director or officer is paid by the company as opposed to the insurer? While it may appear easier to eliminate the company as the middleman between the individual and the insurer, the company's presence in the payment process may protect the individual from unforeseen exposures. If the company were to become insolvent, the individual signing the IFA may have essentially assumed liability for a corporate obligation, with no recourse to the company if it is unable to fulfil its indemnification obligations. Indeed, if the company and the individual have undertaken a joint defence, depending on the scope of the IFA, the individual insured may be responsible for reimbursing the insurer for defence and indemnity costs incurred primarily on behalf of the corporation.

In addition, company indemnification is usually broader than insurance policy provisions. Indeed, it may be easier to obtain reimbursement of defence fees from the company than from the insurer. Also, insurance companies will try to impose limitations on attorneys' fees (eg, rates and internal charges), which are not incorporated into the corporate indemnification agreements. Once the direct relationship is established with the insurer, however, the individual will be dragged into disputes over payment of defence fees.

OTHER POLICY PROVISIONS

Other D&O policy provisions may also come into play when addressing the conflict between individual and corporate interests. For example, that portion of the definition of 'Securities Claim' which addresses the scope of coverage for regulatory proceedings may or may not include coverage for regulatory proceedings against the company, or may provide coverage for the company only if an

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

individual is named as a target of the proceeding. The broader coverage benefits the company but means that policy proceeds are more easily exhausted by the exorbitant expense of a company response to an SEC investigation.

A policy's 'priority of payments' provision may address how competing claims are treated under the policy. Generally the language provides that Side A claims are paid 'first'. The provision often does not address, however, how payments are made when Side A, B and C claims accrue over a period of time; there often is no mechanism to insure that proceeds are conserved for anticipated but not yet incurred Side A claims.

CONCLUSION

Subtle distinctions in policy structure or wording may be crucial to maximising coverage for D&O insureds, corporate as well as individual, when policy proceeds may not be sufficient to satisfy the defence and indemnification demands of catastrophic claims. Choosing between policy provisions is akin to walking through a minefield. Even the basic decision of how much and what type of insurance to buy raises conflicts among the insureds. Invest in Side A coverage at the expense of coverage for the company? Provide Side A coverage to all eligible individuals at the risk of diluting coverage for independent directors? Purchase a 'pre-set' allocation policy which may influence strategic decisions in the underlying action? And while companies may decide that more restrictive 'conduct' exclusions are desirable because they increase the ability to deny coverage to a 'guilty' insured, the broader exclusions may in fact allow the insurer to deny coverage for the company, to which that insured's conduct is imputed. And finally, when a claim is made, the company may be more than happy to allow the individual insured, rather than the company itself, to take on the frustrations and perils of dealing directly with the insurer in the matter of IFAs and payment of defence bills. Counsel must carefully consider how choices among policy provisions, as well as strategic decisions made in the underlying litigation, impact their client's ability to realise the protection expected from a D&O policy.

REFERENCES

1. See *TLC Beatrice v. CIGNA*, 1999 WL 33454 (S.D.N.Y. 1999) (Delaware Section 145(b) permits indemnification only for defence, but not settlement, of derivative suits); see also Calif. Corp. Code § 317(c)(1), (2) (no indemnification where director/officer 'adjudged liable' to the corporation); but see also *Baker v. Health Management Systems*, 98 N.Y. 2d 80 (2002) (Section 722(c) [McKinney's Business Corporate Law (New York)] allows for indemnification of settlements and defence of derivative action if officer and director 'acted in good faith and in the best interests of the corporation'). There is no prohibition, however, against using insurance proceeds to satisfy a settlement or judgment in a derivative action.
2. See *Harbor Ins. Co. v. Continental Bank Corp.*, 922 F.2d 357, 368 (7th Cir. 1990) (applying Illinois law) (no allocation necessary where corporate liability is based on vicarious liability for conduct of insured officers/directors); *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1432 (9th Cir. 1995) (applying Washington law) (no allocation if separate corporate liability does not result in 'larger settlement'); *Safeway Stores, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 64 F.2d 1282, 1287 (9th Cir. 1995) (applying California law) (same).
3. The trend is in favour of finding that the corporation as debtor has no rights to the D&O policy proceeds unless it had made payments for which it was entitled to coverage under the policy. See *In re Adelphia Comm'ns Corp.*, 298 B.R. 49, 52-54 (S.D.N.Y. 2003); *In re First Central Fin. Corp.*, 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999), *aff'd*, 2000 U.S. Dist. LEXIS 22005 (E.D.N.Y. 2000).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com