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Directors' and Officers' Insurance

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This post was written together with my colleagues Warren R. Stern and Martin J.E. Arms.

At a time of historically significant dislocation in the corporate world, directors and officers now more than ever need to focus their attention on directors' and officers' ("D&O") insurance, as part of their overall strategy involving effective corporate governance and risk management. Although the best protection should continue to come from conscientious attention to directorial and management responsibilities, an effective D&O insurance program, in combination with well-drafted indemnification and exculpation provisions in corporate charters and by-laws, is a critical component of protection for directors and officers at a time of increased scrutiny by shareholders, courts and regulators. Recent judicial developments further highlight the need for careful attention to policy terms, which can be outcome-determinative in significant litigation. Below are some thoughts on D&O insurance in these troubled times.

1. Side A excess coverage:

The main types of coverage provided by many D&O insurance policies are known as A, B and C coverage. The "A" coverage directly indemnifies a director or officer with respect to claims for which the company is not able to indemnify that director or officer, either by reason of law or financial insolvency. (Some companies purchase only A coverage.) The "B" coverage reimburses the company for amounts that it pays to a director or officer through indemnification. The "C" coverage is for claims directly against the company, but, for public companies, that coverage is almost always limited to securities claims. These types of coverage work together to provide broad protection for individuals and the company. But be wary: coverage can be exhausted by claims made on the B and C coverage, i.e., coverage that, in the end, insures the company and not the directors and officers themselves. This may leave directors and officers exposed when they need coverage most — when there is a claim for which the company cannot indemnify them. To avoid this problem, to the extent they do not do so already, companies that purchase A, B, C coverage should consider purchasing additional A-only coverage in excess of the A, B, C coverage. This A-only excess coverage will protect directors and officers if nonindemnifiable claims or obligations arise after the underlying A, B, C coverage has been exhausted. There is also a more comprehensive (and thus more expensive) version of A-only excess coverage known as A-only Difference-in-Conditions ("DIC") excess coverage. Under DIC coverage, the excess policy will "drop down" to provide coverage when another insurer fails to pay a claim (including as a result of insurer insolvency) or when a company fails to indemnify. DIC policies generally provide broader coverage terms than traditional A-only excess coverage. A DIC policy should also provide coverage if a bankrupt estate successfully argues that the underlying A, B, C policy is the property of the estate. In order to provide the greatest protection against insurer insolvency, companies that purchase DIC excess coverage should consider purchasing it from an insurer that is not on the underlying A, B, C insurance program.

2. Financial condition of insurers:

A common question these days is whether an insurer will be solvent years from now when the coverage is actually needed. There is no easy solution to this concern. As the past year has shown, even strong companies can see their financial state deteriorate with remarkable speed. That said, there are protections. Rating agencies and insurance brokers analyze the finances of insurers and their conclusions can be helpful in selecting an insurer (although recent experience shows that reliance on third party views alone can be dangerous). It may make sense to spend more for coverage from insurers that appear well-capitalized and financially strong. Buying excess insurance in smaller layers, with different insurers responsible for different tranches, diversifies risk. Finally, DIC coverage — discussed above— can protect insureds when an insurer does run into financial difficulties. At the same time, insureds need not run from an insurer simply because of financial problems suffered by a parent company. (Indeed, insurance companies are regulated separately from their parent holding companies, and the creditors of the parent companies cannot easily access the assets of the insurance subsidiaries.) Rather, insureds should make considered decisions taking into account a wide variety of factors, including ratings, broker input, policyholder surplus, level of regulatory oversight, policy language, claims payment history and cost.

3. Bankruptcy:

D&O policies should be reviewed with an eye on how the coverage provided would be affected by the bankruptcy of the insured company. The best time for such a review is when the company is financially stable. Certain policy provisions may help insureds respond to an argument by a bankruptcy trustee or creditors committee that a D&O insurance policy is an asset of the bankrupt estate and is subject to the automatic bankruptcy stay. These provisions include, for example, ones that provide (a) that insured individuals seeking payments from the insurer have priority over claims for coverage by the insured company, and (b) that it is the intention of the insurer and the insureds that insurance payments to individuals are not to be subject to a bankruptcy stay. Other beneficial bankruptcy-related terms provide (y) that, if the company is legally permitted to indemnify an individual but cannot do so because of financial insolvency, the insurer will provide coverage to that individual without the deductible that would usually apply to an indemnifiable claim, and (z) that a claim brought by a bankruptcy trustee or creditors committee on behalf of the estate is carved-out from the “insured versus insured” exclusion.

4. Policy wording:

Even in a straightforward renewal cycle, policy wording and terms should not be viewed as static and non-negotiable. Policies should be reviewed each year with a focus on improving the scope of coverage and clarifying ambiguities. Among many other items, insureds should consider the definitions of claim, loss and defense costs, ways to minimize the risks of allocation between insured and non-insured individuals or insured and non-insured claims, the mechanisms for dispute resolution, and policy language on severability and rescission. Just because a provision has been worded a certain way for years does not mean that insureds should not consider seeking a modification. Insureds should also ask their insurance companies to describe improvements reflected in terms offered to other insureds.

5. Excess insurance:

In purchasing insurance, attention rightfully tends to focus on the primary insurer and the primary policy. But excess insurers and excess policies should not be ignored. Care should be taken to make sure that the primary and excess terms and conditions are consistent and mutually reinforcing, and that excess coverage is available even in the case of the financial difficulty of an underlying insurer. Recent case law is also a reminder that companies need to carefully scrutinize the language of excess policies to make sure that the coverage obligation of an excess insurer can still be triggered if the primary (or a lower excess) insurer has paid less than the full amount of its policy limits due to a compromise with the policyholder.

6. Worldwide coverage:

For companies that operate internationally or that have securities listed on overseas exchanges, it is important to consider whether the company's D&O coverage will cover claims brought overseas, and if so, to what extent. More countries are allowing shareholder suits similar to U.S.-style class action or derivative suits. While the risks and exposures overseas are still not as great as in the U.S., the risks should nevertheless be considered when purchasing and renewing D&O coverage.