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Securing the Director and Officers Liability Insurance Lifelines! What Every Director Needs to Know—Before Entering Troubled Waters [¶13.1] ©

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We often get called into corporate calamities where ''heavy water'' is starting to overwhelm the bilge pump of the corporate yacht. Often in those situations good people like directors and officers, who are tasked with figuring out what to do to ''save the ship,'' must at the very same time try to figure out if they have enough directors and officers (''D&O'') liability insurance to weather the storm and protect them from the sharks.

Nautical allusions aside, trying to figure out if your D&O insurance is good enough when you are about to enter rough waters is not ideal for many reasons. First, it takes time to do so (and depending upon circumstances, there may be no time to tinker with the D&O coverage). Second, and more importantly, if there is a problem with your coverage, many carriers are reluctant to modify policy wording (to potentially ''enhance'' coverage) when a company is having financial difficulty because the carrier itself is worried about its own potential exposure to directors and officers claims (whether they might be lawsuits or regulatory investigations). To many less-forward thinking carriers, doubling down (in some respect, even if it serves to protect their insureds) sometimes makes no sense.

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Finally, despite years of heavy claim activity and many large bankruptcies spurred by the financial crisis, we often still see the same problems with policies and towers of insurance. Why is that? We honestly cannot say. Sometimes corporations (and their boards) do not focus enough on D&O insurance issues because they are frankly too busy with other issues. Sometimes D&O insurance decisions are based not on ''substance'' issues, but on cost issues, which is generally not the right answer for many reasons. Furthermore, much of the literature dealing with D&O insurance tends not to be broadly disseminated to the folks who need the information most (like corporate directors and officers), and instead is left to the devices of risk managers and brokers who do not have much experience dealing with troubled company D&O issues.

Our goal in this piece is to place front and center the most important issues relating to ''troubled company'' D&O issues, so that directors and officers will understand what they need to know, and what to ask when questioning management on D&O coverage. These are not the only issues that should be addressed when considering the scope and breadth of D&O coverage, but certainly ones that should be at the top of any director's and officer's list. And truth be told, this advice should hold true for all companies and boards (not just troubled ones) because, as noted above, the best time to fix D&O issues is when the sailing is smooth, and not when the corporate yacht is about to sink.

Know Your Primary Carrier—Really Well

D&O insurance is frequently purchased in a ''stack'' or a ''tower'' of insurance, led by a primary carrier and multiple excess carriers. The excess policies are usually written in ''follow form'' nature, meaning they, in most cases, follow the terms and conditions of the primary carrier.

However, because neither insurance policy forms nor D&O carriers are fungible commodities, it is very important to understand who is the company's primary D&O carrier, what coverage such carrier offers (either in its base form or by endorsement), and whether or not they ''pay claims.'' In many ways, the primary D&O carrier is like a critical vendor or business partner with whom the company cannot do without. In fact, the primary D&O carrier can sometimes be *the* most important business partner (and friend) a company and a director or officer can have. The hope is that when the seas are rough (like in an insolvency or restructuring scenario), the primary carrier will be there to respond to claims and ultimately protect the personal assets of the directors and officers involved – even in times where indemnification or advancement is unavailable or refused by the corporation.

A couple of points to consider:

1. What is the carrier's claims handling and claims paying reputation? Is it business-friendly and coverage-neutral, or is the carrier known to try to find ''outs'' to coverage? Does the carrier have a free-standing claims department or does it farm out claims to coverage counsel? And if the company has multiple offices overseas, how does the D&O carrier handle cross-border claims or investigations? Through a bit of investigation, one can often learn from others (such as defense counsel or experienced D&O brokers) information that might indicate which way a carrier leans on these important questions. Obviously, the best carrier is one that will hang with the directors and officers even in the worst of times, and will not ''run and

hide'' behind coverage defenses so it does not have to pay.

2. What is the carrier's underwriting response to questions and potential modifications? What is the carrier's responsiveness to requests to enhance coverage for the insured? These questions relate to the prior question. Directors, officers, and companies want a business partner in their primary carrier, not a ''silent partner.'' Many of the better carriers often will consider (and implement) policy changes even days or weeks before a bankruptcy filing to clarify policy language for the potential benefit of the insureds. Those are the types of carriers that a director or officer wants on his or her side.

Do You Have Enough Coverage?

This can be the most worrisome aspect to any director or officer caught up in a corporate storm. Unfortunately, this is also an area that is confusing because there are often no clear or ''right'' answers as to what limits should be purchased.

The most important thing a director or officer can do in this regard is ask many questions of management. Common sense suggests that for a $1 billion public company, $20 million of D&O insurance likely does not make sense. Similarly, for companies with substantial debt and perhaps not a lot of cash on hand, a low D&O limit also would not make sense. In addition to common sense, there are other available metrics directors and officers can consider. Very often, an experienced D&O broker can perform an exercise called benchmarking, which is designed to create an apples-to-apples comparison of the D&O insurance purchased by similarly situated companies. Thus, a company can look to a competitor in its space, or at its size, to determine what type and level of D&O insurance comparable companies have purchased. Finally, many larger companies with public debt or equity exposure can perform ''mock'' damages analyses to understand what a potential securities claim against them might look like from a damages and defense cost perspective. The variable here is that the cost of a simultaneous regulatory or criminal investigation, as discussed below, can vastly skew those amounts.

Can a company increase the limits of its D&O coverage midterm, or even after bad news surfaces? This is a question we often get. The answer is that it depends on the facts and the circumstances of the particular situation. Sometimes the circumstances a company faces are not so dire, and carriers will cooperate with the company's desire to protect its directors and officers by agreeing to increase the limits of its tower (for a price, of course). Other times, the situation may be so severe that a request to increase limits will be politely declined. The later polite declination really proves our point. Directors and officers should ask questions up front regarding coverage amounts, and not wait until the corporate ship starts to keel over to request higher amounts. By then it might be too late.

Coverage for Regulatory and Criminal Investigations

Troubled companies often encounter a simultaneous regulatory (SEC/DOJ) or criminal investigation at the same time they are facing civil litigation. This is the potential ''double whammy'' of defense costs, which often can run into the millions depending on the situation. Thus, directors and officers need to know what sort of coverage their D&O insurance provides for such investigations because, to the extent such investigation constitutes covered loss under the D&O policy, every dollar spent on investigations will generally

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reduce the overall limits available to ultimately settle the underlying litigation.

The rules of the road are well established in this area. Directors and officers are generally covered under the company's directors and officers insurance for regulatory and criminal investigations and inquiries. Corporations are generally not covered for their involvement in such situations, unless individual directors or officers are also simultaneously named in the investigation (these rules of the road are often different in the private equity space, which is beyond the scope of this article). Specialized policies in the D&O marketplace exist to cover regulatory and criminal investigation in those situations where only the company is named, though those policies are reported to be expensive. All other things being equal, a director or officer should ensure that he or she is covered for regulatory and criminal investigations and inquiries.

Why Does the Insured Versus Insured Clause (and Its Carve-outs) Really Matter?

The insured versus insured clause has been included in D&O policies for a long time. It finds its genesis in a carrier's need to guard against collusive lawsuits brought by one insured (say, for instance, the company) against another insured (like a director or officer), solely designed to get to the proceeds of the company's D&O policy.

Indeed, carriers may have valid reasons for not wanting to cover these types of lawsuits. But there are other types of potential "insured versus insured" lawsuits that should be covered (and thus "carved-out" of the insured versus insured exclusion) because they generally would not be collusive (and normally are just as hotly contested as suits brought by traditional third parties). Here is a list of certain types of lawsuits which we believe should be explicitly covered under the D&O policy (i.e., carved-out) to protect the interests of the directors and officers.

1. Shareholder derivative actions.

2. Suits that generally arise in bankruptcy when bankruptcy-formed constituencies, such as creditors' committees, bondholder committees, or equity committees bring an action derivatively on behalf of a bankrupt company for alleged breaches of fiduciary duty by the company's directors and officers. Similarly, suits by trustees, liquidators and receivers against directors and officers should also be covered. As we have seen from very high-profile suits involving companies like The Tribune Company, Extended Stay, and BearingPoint, bankruptcy-formed constituencies and trustees have become much more aggressive and litigious over the years, and the threat of such suits simply cannot be ignored.

3. Whistleblower suits brought under the provisions of either Sarbanes-Oxley or Dodd-Frank.

What is Non-Rescindable Side A Coverage?

There are two general coverage sides to a D&O policy (leaving for another day the concept of outside director coverage). Coverage "Side A" is for non-indemnifiable loss, meaning loss for which a company cannot indemnify or is financially unable to indemnify. Under this side, the directors and officers are the insureds. Coverage "Side B," on the other hand, is for indemnifiable loss. Under this side, the company is insured for securities claims.

Coverage Side A covers a range of different scenarios. For example, under Delaware law (where many corporations are incorporated), a company cannot indemnify its directors and officers for the settlement of a shareholder derivative action. And in bankruptcy, a company often will be unable to advance defense costs and to indemnify its directors and

officers for claims. Indemnification claims by directors and officers against the company may be treated as unsecured claims that get pennies on the dollar, or may even be subordinated in certain circumstances.

As several of the noteworthy ''financial fraud''-related bankruptcies have taught us, having ''non-rescindable'' Side A coverage is very important. ''Non-rescindable'' Side A coverage means what it says. Even in cases where a carrier may challenge as false statements made by a potentially complicit CEO or CFO in the company's insurance application for D&O coverage (attaching to such application, for example, financial statements that later need to be restated), non-rescindable Side A coverage generally cannot be rescinded for any reason, which should allow the directors and officers to sleep better at night. Directors and officers should know that non-rescindable Side A coverage is generally standard in today's D&O marketplace, and thus primary policies that do not have such coverage should be immediately updated.

What is Side A Excess Difference in Conditions Coverage (and Why Is It So Important)?

As noted above, having non-rescindable Side A D&O coverage is critically important. Having ''Side A Excess Difference in Conditions'' D&O coverage can be even more important. Why? This coverage reacts in two different, wonderful ways to protect directors and senior management.

First, it acts as ''excess'' Side A D&O insurance, meaning, in English, that it sits above the company's traditional tower of insurance, and will pay Side A non-indemnifiable claims when the traditional tower is exhausted by either traditional indemnifiable claims or non-indemnifiable claims. Take, for example, a Company that has $50 million in traditional D&O coverage and $25 million of Side A Excess Difference on Conditions coverage, where $45 million of that insurance has already been exhausted by the settlement of a simultaneously commenced securities class action and SEC investigation. In such a case, the directors and officers would still have $30 million of Side A insurance to deal with, for example, the settlement of shareholder derivative litigation.

Second, most Side A Excess Difference in Conditions D&O Insurance has something called a ''drop down'' feature, meaning that if, for example, an underlying excess carrier refused to pay its limit of insurance for some coverage-related reason, the Side A Excess Difference in Condition carrier might have the contractual obligation to ''drop down'' and fill that layer. Thus, it is a critically important feature that potentially will help fill potential gaps in coverage. Also, note that most Side A Excess Difference in Conditions policies have very few exclusions (e.g., most do not have an insured versus insured exclusion), so they can be particularly helpful to directors and officers in navigating difficult claims.

What is the Priority of Payments Clause (and Why Is It Important)?

A Priority of Payments clause specifies how a carrier should handle competing claims on a policy's proceeds. For example, most Priority of Payments Clauses (some carriers call them ''Order of Payments'' clauses) specify that Side A claims get paid first, and then traditional Side B company reimbursement and indemnity claims get paid thereafter. Obviously, this approach is tremendously important to directors and officers who may need to defend themselves in securities class actions or bankruptcy-related or inspired litigation.

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Some Priority of Payments clauses give the right to the company or a company officer (like a CEO or CFO) to "withhold" or "delay" payments made under Side B of a D&O policy until the time at which those payments are properly designated by the appropriate party. This type of discretion is potentially not a good thing. Why? Giving such potential discretion to the company or a company officer to withhold or direct payments under Side B of a D&O policy might be creatively viewed by some as giving the debtor in bankruptcy "a say" or "control" of the proceeds of the D&O policy, a situation that could be used by a creditor or other bankruptcy constituency to control or delay payments to the directors and officers under Side A of the Policy, again potentially leaving them without resources to pay their counsel. Years of experience counsels that carriers are very able to make policy reimbursement calls in bankruptcy settings, and the order of payments under a D&O policy should be left to them and not others.

Severability of the Application and Exclusions

The concept of "severability" is important in D&O policies for a simple reason: there are very often multiple insured persons under a D&O policy (often dozens), and it would be a bad thing if the wrongful, criminal, or even fraudulent conduct of one insured (say for instance a CFO who subsequently pleads guilty to "cooking the books") could vitiate, void, or adversely affect coverage for the rest of the insureds under the policy. For this reason, most applications for D&O policies are fully severable (meaning statements made in the application by one insured person are generally not attributable to other directors and officers for the purpose of potentially rescinding coverage under the policy), and most "conduct exclusions" contained in D&O policies (like the fraud and criminal acts exclusion) are also fully severable as between insured persons, meaning one bad egg will not affect the coverage for the directors and management team.

Making a Better D&O "Mousetrap"

Admittedly, some of the above items are a bit difficult to understand conceptually for the non-insurance professional, and admittedly, directors and officers often have more pressing issues to deal with when trying to help their companies navigate through troubled waters. But as we have seen time and time again in our practice, very often D&O insurance becomes the lifeline for directors and officers when companies face trouble.

How can a director or officer stay on top of these issues in the most efficient manner possible? Here are a couple of suggestions:

(1) Ask the right questions to the right people, like the company's risk manager, CFO, or general counsel, as to what is covered and what is not, and ask about the above issues to make sure you are comfortable that at least these points are properly covered. Again, common sense often prevails here, and if a director or officer does not like the answers he or she is getting, then corrective action should be demanded before it is too late to act.

(2) Make D&O insurance issues a board topic at least twice a year so that board members can stay abreast of coverage developments, options, and modifications.

(3) Make sure management sends out the company's D&O program and tower of insurance at least once a year for a "tune-up." In this area, coverage options often change, and better coverage can often be obtained so long as the right diagnosis is made by qualified persons such as an experienced D&O broker, or even sometimes, experienced outside counsel.