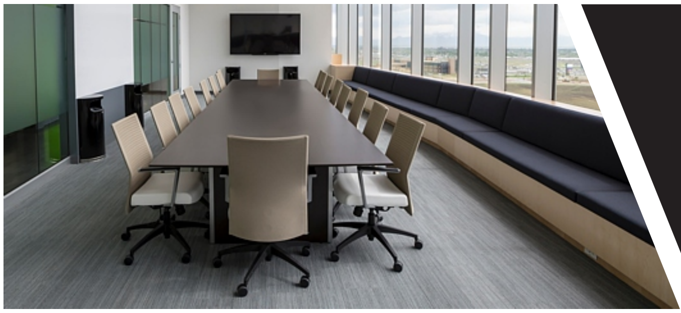
DIRECTORS & OFFICERS
LIABILITY INSURANCE

PRFC
LIMITED
INSURANCE BROKING
+ RISK MANAGEMENT

With Corporate governance concerns, increasingly stringent laws, and enhanced fiduciary duties owed to stakeholders, Directors & Officers (D&O) of a company may be heavily exposed to the legal costs for defense and possible subsequent damages due to wrongful acts in their capacity as the decision makers within a company.



Protection for these exposures is available in the form of D&O Liability Insurance, many details of which are explained herein.

What is a D&O policy designed to do?

A D&O policy is designed to protect the Directors & Officers of a company against allegations of wrongful conduct in their role as company executives. It can also be expanded to include managers and other non-executive directors, employees, and the company itself (for example in the case of publicly-traded companies who may be exposed to securities claims only, or for all claims in the case of private firms and non-profit organisations).

Where does the cover attach to wrongful acts under the policy?

Most D&O policies "attach", or offer cover for, wrongful acts that have taken place during the period of the policy, however some policies can be extended to include coverage for past acts, within defined parameters. What must be kept in mind is that the cover is not intended to be given where there is a potential pending claim, but rather is intended to cover future acts. It is for this reason that first-time purchasers of D&O Insurance are obligated when applying for cover to disclose any information they have regarding known claims or circumstances that might give rise to a claim. Matters such as these will usually be excluded from the cover.

Who can bring these claims typically covered under a D&O policy?

Claims can be brought against directors and officers by a number of people, in a number of different ways: The company's owners, investors, lenders, employees, and security holders, as well as by customers, consumer groups, competitors, vendors, suppliers and government enforcement/regulatory groups can all bring an action against the directors and officers of a firm, and even if the claim proves to be without merit, a full legal defense will need to be presented, which is likely to come at great cost.

Why don't companies indemnify their directors and officers?

The fact is companies generally do indemnify their directors and officers, however sometimes companies might be **financially unable** to do so, or alternatively might be unwilling to do so for political or economic reasons. In the absence of corporate indemnity or insurance, directors and officers would be reduced to relying on their own personal assets to pay for the costs of legal defense and for any resulting settlement or judgement against them. Outside directors (ones not also employed by the company) are usually very vocal about requiring D&O coverage before agreeing to sit on a corporate board.

How does the policy's limit of liability apply?

Usually, there is a single aggregate limit of liability that applies for all claims that fall within the terms of the policy, and the limit is chosen by the insured at inception, based on the nature and scale of their business, and the types of exposures they face. This aggregate limit is the total amount that the Insurer is willing to pay in the event of a claim, regardless of the number of claims incurred, the number of directors and officers, and the accumulated defense costs. Once this limit is exhausted, there is no more coverage available for the current or future claims, and the Insurer has no further obligation in respect of the current or future claims, nor for any ongoing defense costs that may be incurred. Defense costs apply first to the deductible under the policy (or if applicable, a pre-agreed retention), and then serve to satisfy the agreed limits under the policy. For this reason it is possible that the entire Sun Insured could be spent in defense costs, with no remaining coverage available for any possible settlement or court award, and as such it is important that careful consideration is given when deciding upon a suitable Sum Insured.

What is "Allocation", and how is it treated under the policy?

In certain circumstances, a claim can be made against both the directors and officers of a company and uninsured parties, such as the firm's service providers in the form of accountants and attorneys. If a claim is made jointly against your firm and the service provider(s), the Insurance carrier will seek to allocate the costs associated with the defense, settlement and investigation of the claim made against the insureds from those same expenses generated on behalf of the non-insureds. Allocation most often occurs when the corporation itself is named as a defendant, but is not a named insured under the policy. As mentioned above, the public company corporate entity may be insured under a D&O policy, but usually only for securities claims. If a claim is brought against directors, officers and the company by someone other than a securities holder (such as a competitor), then the carrier will not provide coverage for that portion of any defense costs incurred by the uninsured entity or any settlement or judgment allocated to the entity.

Allocation may also arise when everyone is an insured under the policy, but not insured for all of the allegations that are included in the claim. This happens if either part of the claim is specifically excluded under the D&O policy or it simply falls outside the terms of the policy, for example, when a director or officer is sued in a professional rather than managerial capacity (outside the terms of a D&O policy) or part of the claim arises under something that is specifically excluded under the terms of the D&O policy.

Does D&O insurance encourage managers to behave negligently?

No. D&O is not a blank check for bad behavior. This frequently made assertion is not specific to D&O but rather has to do with the basic issue of liability cover, and yet opinion leaders who demand that managers should "get what they deserve" eclipse the real facts: no amount of research can show that managers behave any less responsibly when insured by a D&O policy.

In fact, the opposite is true: The process of a public lawsuit and financial losses, the possibility of corporate and personal reputational losses and all the other pains that accompany a claim made against a manager are a major deterrent. A D&O policy does not automatically cover all these losses, as they are quite complex and largely outside its scope.

Furthermore, D&O insurance enables the insurance industry and regulators to collect objective data about acts that lead to claims and to better monitor these trends. Limits and personal deductibles allow insurers to adjust policies to individual persons or companies as well, leading to better corporate governance. In an environment of ever-tightening management liability regulations, D&O cover therefore provides an essential tool for both steering good business practice and handling the growing risks directors and officers face.

What are the typical exclusions on a D&O policy?

The standard exclusions under most D&O policies include personal profiteering, fraud, accounting of profits and other illegal compensation acts, pending and prior litigation, prior (late) claim notice, bodily injury/property damage, pollution, and "insured vs. insured" claims. Some exclusions pertain to areas usually specifically covered by other types of Insurance, such as when property damage is covered under a General Public Liability policy.

Wouldn’t the exclusion for fraud/personal profiting eliminate coverage for most claims?

Whilst a large proportion of D&O claims include allegations of fraud or illegal profiting (or both), the simple allegation is not enough to trigger the exclusion. Most, if not all, such exclusions require something like a court determination of guilt or the admission of guilt before the exclusion can apply. Within the D&O policy wording, the words “final adjudication” or “in fact” will be used in the exclusion to indicate how high the hurdle is for the Insurer to apply the exclusion.

Defense costs incurred for such a claim are typically covered by the policy until such time as the wrongful conduct is determined to have “in fact” occurred, or until there is a final adjudication. This means that a settlement without an admission of wrongdoing usually does not trigger the exclusions. In the event there actually is a finding of personal profiting or fraud, those directors and officers who are NOT found guilty continue to be covered. even after others may have confessed or been adjudged guilty.

What is the “Insured versus Insured” exclusion?

A D&O Policy is intended to function as a third-party coverage or to insure claims made against the directors and officers by outsiders or third parties. It is not intended to respond to claims from Insureds themselves, as such claims are viewed as either insider fighting or collusive suits, both of which Insurers want to avoid.

There are however some exceptions to the application of this exclusion. The first makes an exception for shareholder derivative suits as long as no insured (including the company) has assisted in bringing the suit in any way. The second typical exception is for wrongful termination suits by officers. More recent exceptions may apply to cross-claims or claims for indemnity. Each of these exceptions means that the exclusion does not apply in those circumstances – so there is coverage in certain cases.

What exactly is a “claim” under a D&O policy?

The definition of a claim varies from policy to policy, and some do not define it at all. Generally, a claim includes any written demand alleging a wrongful act by a director or officer in his or her capacity as a director or officer, seeking monetary or non-monetary damages. This may be expanded to include investigative orders, subpoenas in actions that seek to hold the individual liable and other more esoteric events.

What exactly does a D&O policy cover in terms of expenses?

A D&O policy will generally either pay or reimburse the company the costs associated with the defense, investigation, negotiation and settlement (by way of a court determination or otherwise) of a covered claim. This includes attorneys’ fees, court costs and filing fees. It may also include expert or other specialist fees that are consented to in advance by the carrier. Most policies include the phrase “reasonable defense costs.” Therefore, some carriers may object to some element of expenses as being unreasonable (either because the amount charged is excessive, the work is duplicative, or the services rendered were unnecessary). In all events, the carrier only pays for or reimburses those expenses that are consented to in advance. In addition to expenses, D&O policies cover judgments/verdicts and settlements. Although the actual term used may differ (some carriers cover “loss” while others cover “damages”), all typically cover any court award or settlement, plus defense expenses.

What will a D&O policy usually not cover as loss or damages?

Covered loss will usually specifically exclude civil, criminal or punitive fines or penalties; exemplary or multiplied damages; amounts that are without legal recourse to an insured; or amounts that are uninsurable under the law. As with many other aspects on D&O policies, this can be modified by insurers. Many now agree to pick up certain fines and penalties and agree to provide coverage for punitive damages where insurable by law, especially for securities claims.

When does a claim have to be reported to the D&O carrier?

Typically, the claim has to be first asserted or "made"against the Insured during he policy period. This is why D&O insurance is generally referred to as "claims made" coverage. Some D&O policies also require that the claim be reported to the carrier (insurer) during the same policy period, in which case the policy is offering "claims made and reported" coverage. Many insurers provide some degree of reporting allowance to facilitate a short period of time after the policy expiration in which to provide notice of claims that came in during the policy period.

What happens if the claim is not reported in a timely fashion?

Courts have upheld the claims-reporting requirements of D&O policies, finding such requirements to be a condition of coverage. Since the reporting of claims is solely within the control of the insured, it is an obligation of the insured to act in a timely manner. Exactly what is "timely" may vary slightly among carriers, however. Many policies require notice as soon as practicable, as long as it is still within the policy period. Carriers and courts differ on what length of time is practicable. In any event, failure to provide timely notice can and will result in loss of coverage. What would be a covered claim can become uncovered if the reporting provisions of the policy are not strictly adhered to, and thus it is critical that your Broker is formally notified as soon as a potential claim arises.

Who selects defense counsel for a covered D&O claim?

It depends: for securities claims involving public companies many D&O carriers have a pre-set list of law firms that they require the Insured to use (with pre-set, usually advantageous, rates). For non-securities claims for publicly traded companies, the insureds can usually select their own defense counsel. Carriers without pre-set lists still retain the right to consent to the counsel chosen by the insured and look for counsel that can demonstrate experience in the type of litigation at issue.

Under most D&O policies issued to privately held or nonprofit companies, the insurance carrier has both the right and duty to defend claims brought against the directors and officers in their official capacity. This usually means that the insurance carrier gets to select counsel.

What happens to coverage if the company is bought or merges into another?

Most D&O policies have what are generally referred to as "change in control" provisions. Most policies state that in the event of a change in control, the policy will remain in force for the remainder of the policy period, but, and this is a big caveat: coverage will only be provided for claims involving wrongful acts occurring prior to the change in control. Please note that some policies actually terminate coverage altogether at the time of the change in control. It is thus very important to know precisely understand how a specific policy would respond in such a situation.

For directors and officers a takeover is a critical scenario. An acquiring company will often face huge liquidity problems due to the high costs of the acquisition. Germany, for instance, has seen this in some recent spectacular examples in which a smaller company has taken over a bigger company. The new owners of the acquired company may investigate the company's recent history and decide to sue the old management, looking for wrongful acts in the past to make D&O claims. Since the management team of an acquired company has usually changed, this means that managers who left the company have difficulty defending themselves against these claims without access to the complete data and internal information of the company.

Normally the merged or bought company will be integrated into the D&O program of the new parent company with cover for new wrongful acts. For claims due to wrongful acts in the past, a "run-off policy" can be agreed for an additional premium, granting cover for claims for up to six years after the date of the transaction.

Under the majority of policies, a change in voting control is the trigger for a change in control. Some also include sale of all or substantially all assets as a trigger. A filing for bankruptcy typically does not trigger the change in control clause, nor does a substantial change in the composition of the board.

Can my insurance carrier cancel the D&O policy during my policy period? What are my rights after cancellation or non-renewal?

Historically, all D&O policies could be readily canceled by either the insurer or the insured. Today, whilst certain circumstances policies may have cancellation provisions noted, D&O carriers are often willing to make their policies non-cancelable as long as premiums are paid. In these cases, the insured does not need to worry about being deserted when prospects are bleak.

In addition to setting out the specific circumstances and timeframes in which an insurance carrier can cancel or non-renew a D&O policy, the laws of many countries provide insureds with special protected rights in these situations. These rights can be found in the D&O policy itself. One such provision is the right to purchase an extended period in which to report claims that would have been covered by the policy before it was cancelled or non-renewed. When claims are first asserted and reported during this extended period, they are then covered under the policy terms and limits in effect prior to the policy's termination. This extended reporting period (ERP) is often referred to as a discovery period. Some D&O insurers make discovery available when either the insurer or the insured cancels or non-renews.

What is the "hammer clause?

Most D&O policies have a provision stating that insureds are not permitted to settle a claim without the carrier's approval. This is particularly relevant if the insured expects the carrier to contribute to the settlement. On the flip side, the carrier is not going to settle without the insured's consent. However, if the carrier believes that a settlement is in the best interests of both it and the insured, and the insured refuses to consent, then the carrier can invoke a protective clause usually referred to as the "hammer clause".

Pursuant to this clause, if the plaintiff and the carrier are amenable to a settlement and the insured refuses, then the carrier limits its liability to the amount that the claim could have been settled for, plus defense costs incurred to the date of the proposed settlement. If the claim ends up costing more than it could have been settled for, the additional costs are not going to be covered by the insurance.

In summary

D&O policies offer financial protection for managers against the consequences of their wrongful acts, along with defense costs and financial losses, which can arise from many different scenarios:

- Employment practices & HR issues
- Shareholder actions
- Reporting errors
- Inaccurate or inadequate disclosure (eg. in company accounts)
- Decisions exceeding the authority of a company officer
- Failure to comply with regulations or laws.

Even if a loss falls outside the policy and the Insurer might thus ultimately not cover a particular loss, D&O insurance will be incredibly useful because the (often significant) defense costs for the claim can also be covered.

With the completion of an application form, non-binding quotations for D&O cover can be obtained from both the local and overseas markets at no cost, for your Board's consideration.

PRFC LIMITED INSURANCE BROKING + RISK MANAGEMENT

We welcome any questions you might have on D&O cover, or indeed on any of your Insurance requirements. Please feel free to contact us to arrange a meeting.

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