



Protecting Yourself Using Directors' and Officers' Insurance: Part 1

Our last column looked at the ways corporate indemnification might protect directors and officers (D&O). The next two consider directors' and officers' insurance as the ultimate backstop.

If you are a director or officer, D&O insurance merits your attention and involvement. Until recently, directors and officers were not much interested in D&O insurance. It tended to be purchased by a risk officer (in a large organization), or by someone in the finance group (in a smaller one). The buyer reported to directors and officers that the company had D&O insurance, what the maximum limit of coverage was and what the deductible might be. The sense was that D&O insurance was a commodity and that only these variables, and the premium cost, mattered.

THE NEW FOCUS ON D&O INSURANCE

But D&O insurance has received new attention following the recent spate of corporate scandals that began with Enron, Worldcom, Tyco and Nortel. While the fairly limited number of D&O issues that might have arisen previously tended to be settled in quiet discussions between insurers and insureds, these scandals produced highly public conflicts that exposed significant issues in D&O coverage.

For instance, in Nortel, the primary insurer has sued to "rescind" its coverage of some of the directors and executives otherwise protected by the policy. Rescission is claimed on the basis that these individuals participated in the creation of financial statements that were made a part of the insurance application and were required to be subsequently restated.

At one point in the Nortel situation, the prospect of rescission of the policy as against all of the insured persons seemed to exist. That result actually occurred in a US case, *Cutter & Buck, Inc. v. Genesis Ins. Co.*, (9th Cir., Wash., 2005). There, the company had tried to address the Nortel issue by obtaining a "severability" endorsement. This amendment to the

policy was intended to mean that, if some of the insureds under the policy made misstatements that would allow the insurer to void the policy as against them, those misstatements would not be asserted against innocent insureds. Unfortunately, the court construed the language of the severability endorsement narrowly and allowed the insurer to rescind against innocent as well as misbehaving insureds.

CONFLICT BETWEEN INSURED

Adelphia, the family-run, now bankrupt cable provider that was recently engulfed in charges of massive fraud, illustrated a quite different issue. The insurance coverage there applied to a wide range of insured persons and entities. Some of the insured persons ultimately pleaded guilty to charges of criminal misconduct. However, those individuals were, by virtue of the insurance policies, entitled to have their defence costs paid by the insurer. Accordingly, by the time innocent directors and officers came to access the insurance coverage, much of it had already been expended in defence of the perpetrators.

New insurance products, and the careful attention that is now brought to the D&O insurance purchase process, have highlighted the potential for conflict (of which Adelphia is one example) amongst various insureds. The procurement of D&O insurance therefore requires familiarity with the various substantive provisions of the policy and necessitates the design of an appropriate procurement process.

Let us begin with a short glossary of important D&O insurance terms. D&O insurance is usually sold as one or more of side A, side B or side C coverage. Side A coverage refers to an insuring agreement under which the insurer agrees to indemnify the directors and officers in respect of specified losses.

Side B coverage reimburses a company (subject to any deductible amount) that indemnifies its directors and

officers under a corporate indemnity. Side C coverage indemnifies the company itself in respect of securities claims. (While side C coverage would appear not to be D&O insurance at all, it is often bundled in with side A and side B as part of a D&O coverage package.)

HOW POLICIES STACK UP

Insurance is typically sold as a layered stack. The insurer at the bottom of the stack, the first to be accessed in a claim, is

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referred to as the “primary insurer.” Insurers who are stacked above the primary insurer are referred to as “excess insurers.” Excess insurance may “follow form,” meaning that the insurance will pay on the same basis as the primary insurance once the primary insurance limit is exhausted, or may have a different set of payment conditions. Insurance of this sort is often referred to as “difference-in-conditions” or DIC insurance.

An increasingly popular form of D&O insurance is side A DIC insurance, under which directors and officers are insured directly by the insurer under a less restrictive set of conditions than might apply to combined side A-B-C coverage of a comparable amount.

Further, side A DIC coverage can respond when the side A-B-C coverage has been exhausted through payment of loss, or has been rescinded or is otherwise unavailable: for instance, when the policy is seized as a corporate asset by a trustee in bankruptcy.

D&O insurance is typically sold for one-year policy periods, on a “claims-made” basis. The claims-made basis means that an insurer will respond only to claims made against the insured in the period during which its policy was in force. Thus, if a policy is in force in year one and a claim is made in year two in respect of directors’ and officers’ activities in year one, the year one insurer would typically not be responsible.

This claims-made basis is subject to qualifications when, for instance, an “extended reporting period” (or ERP) is available under the insurance. An ERP provides additional time after the expiration of a policy for claims to be reported in respect of the policy period and to be covered under that

policy. An ERP can be important if a policy is not renewed or when directors and officers resign from the company.

AVOIDING RESCISSION

“Rescission” is the right of the insurer to revoke the policy on the basis of a misrepresentation in the insurance application (and, in the absence of fraud, typically requires that the premium be returned to the insured). “Severability” limits the ability of the insurer to rescind as against innocent parties.


A well-drafted severability agreement can protect an innocent director or officer who has not reviewed the insurance application and does not actually know of a misrepresentation in it, even if the insurer is otherwise able to void coverage as against the company or other officers and directors. D&O policies can typically be cancelled on notice by the insurer during the one-year term. The right of the insurer to cancel can often be negotiated out.

THE EXCLUSIONS

Insurance policies usually contain a number of important exclusions. The policy will often not cover claims made by one insured person against another, or claims made by the company itself or a “major shareholder” (for instance, a 10 per cent shareholder) against others. D&O policies contain important definitions, including “claim” and “loss.” These terms define the types of matters that require the insurer to advance defence costs or reimburse substantive liability, and establish the trigger points when the insurer must respond.

The final important concept, for present purposes, is “priority of payment.” Recent D&O cases have demonstrated issues that can arise when different insured parties are covered by the same policy. For instance, priority of payment issues can arise as between independent directors and officers or as between a trustee in bankruptcy (who might claim a right to insurance proceeds pursuant to side C or side B entitlements) and the other parties covered by the policy.



Our next article will explore the workings of D&O policies and consider appropriate processes that might be employed to ensure that you get the best coverage you can. 

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