



Protecting Yourself Using Directors' and Officers' Insurance: Part 2

Our last article explained why directors and officers should pay careful attention to their D&O insurance coverage and explained important D&O insurance terms. This article looks at some key coverage and procurement issues.

It is important to get the substance of D&O coverage right. An initial question is whether a corporate D&O program should include all or only some of sides A, B and C coverage. A package that includes all of these coverages (which is quite common) offers direct insurance for directors and officers (side A), along with balance sheet protection for corporate indemnification (side B) and for securities claims liability (side C). Side A coverage has become more relevant because of an increased interest in pursuing directors and officers who are thought to have participated in wrongdoing or to have been negligent. Side C coverage has become more interesting since the passage of *Bill 198*, which is perceived to have extended the risk to corporations themselves.

While breadth of coverage may be desirable, it includes a number of risks. First, the number of covered individuals and entities is large and the total insurance pool is potentially shared among the group: a claim and the need to fund defence costs or substantive liability for any group member may (subject to sub-limit or priority of payment arrangements) deplete the insurance, so that it will not be available to others. A misrepresentation in the insurance application by, for example, a fraudulent or negligent officer could result in rescission of the policy as against all insureds.

Insurance applications tend to be prepared by individuals or small groups within management. The application may not be seen by the directors or by many of the officers who are covered by the insurance that is obtained subsequently. Those not directly involved in the application process need to ensure that suitable severability language is included in the policy, so that knowledge of an applying person is not

imputed to others and the misdeeds of particular officers will not allow rescission of the policy as against innocent insureds. Severability can usually be negotiated, but the cases to date have demonstrated that the actual wording of severability clauses can matter. It is important to carefully review any proposed severability provision.

D&O insurance must be in a suitable amount having regard to the perceived risk and the cost. An insurance broker will typically provide benchmarking of proposed limits against insurance that is known to be in force for other comparable companies. Benchmarking of this sort must be used with care. Benchmarking statistics are sometimes a year out of date, being based on surveys that are not published for many months and, in any event, do not necessarily consider the implications of changes in risk levels that may have occurred in the meantime: the proclamation of *Bill 198* as of December 31, 2005, is a recent example. Lawsuit and known settlement results can also be used.

There are a number of detailed D&O provisions that should be assessed, and may be negotiated. One of these relates to actions of insured persons that might void the insurance as against them or as against other insureds as well (conduct-based exclusions). The policy terms should require that there must be suitable level of proof that an exclusion applies before the insurer can deny coverage. The gold standard here is usually thought to be "final adjudication," pursuant to which a court or arbitration proceeding must determine that the conduct has occurred before the exclusion applies. On the other hand, it may be desirable to have an alternative standard available for the protection of innocent insureds. If an executive formally admits wrongdoing, innocent insureds may well want further coverage to be unavailable to that person so that the insurance limits are preserved for them.

Particular care must be taken with directors and officers who leave the board or company. D&O insurance is on a

claims made basis, with the result that, after the currency of this year's policy, claims made in the future are only insured if insurance is in place in the future. Retiring directors and officers can hope that their company will maintain suitable D&O insurance, or they can require (typically in contractual indemnities) the renewal of insurance at agreed levels and on specified terms. Retiring individuals might want to consider run-off insurance pursuant to which the retiring individual is covered for a suitable period (two, six or perhaps even 15 years) with respect to actions taken while the person was a director or officer. Run-off insurance is available in the market and should certainly be considered in the context of mass departures, for instance after a corporate takeover.

As should now be apparent, expert advice is needed to guide applicants to the best product for them. This begins by having a knowledgeable insurance broker who is able to guide you through the choices. Because of the range of alternatives, and the inherent conflicts that exist (between different insured groups and between cost and protection), it is important that the right people be involved. Today, this typically includes the management representative responsible for D&O insurance, a representative of the board and a legal representative (general counsel, if knowledgeable enough about D&O insurance matters, or otherwise outside counsel). Some boards see benefit in retaining their own

independent advisors (brokers and/or lawyers) in much the same way that compensation committees have done and that audit committees now consider more often. The D&O insurer matters. The underwriting and claims histories of the insurer, the presence of capital and claims personnel in the jurisdiction and other like matters need to be considered.

D&O insurance is important and represents a significant purchase. Strangely, a practice has developed pursuant to which the generalities of a policy and endorsements are provided to companies that buy D&O insurance, and the actual policy is made available only some time (often many months) later. The cases have demonstrated that the actual wording of policies and endorsements can affect results.

It is imperative that the D&O insurance procurement process be commenced early enough that policy and endorsement wordings can be negotiated and reviewed and the final terms settled before a policy is required or a renewal date occurs. ▀

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