CHECK YOUR D&O INSURANCE

directors' and officers'

Make sure you've read the fine print as well as the exclusion clauses so you won't be hit with any surprises.

BY R. MARK KEENAN, ESQ.

Does it come as a surprise to you that over 40% of all outside directors of *Fortune* 1,000 companies have been sued in connection with their board service? Does it surprise you that claims against directors of small, closely held corporations are also a common problem? Or that directors of charitable organizations aren't immune from suit?

In the aftermath of Enron, WorldCom, and the other miscreant corporations, hundreds of class action securities claims have been filed along with numerous indictments—both state and federal. Meanwhile, the rules have literally changed. The federal government enacted the Sarbanes-Oxley Act to clean up corporate management, and numerous rule changes have since been endorsed by the New York Stock Exchange, the American Stock Exchange, NASDAQ, and others.

While significantly increasing the corporate governance responsibilities of officers and directors—particularly independent directors—these regulations have added new criminal provisions, increased the penalties for violations of existing securities laws, and dramatically increased directors' and officers' exposures to civil sanctions.

New corporate responsibilities include (among others):

- The CEO and CFO are required to personally certify financial reports filed with the Securities & Exchange Commission (Sarbanes-Oxley §302(a)).
- An audit committee of independent directors must be established and will be directly responsible for the appointment, compensation, and oversight of that company's auditors.
- Executives will be required under certain circumstances to reimburse any equity-based compensation or other bonuses or stock profits they receive if the company is required to restate its financial statements.
- Audit committees must approve all related-party transactions.
- Shareholder approval is required for all stock option plans involving officers or directors.
- Going-concern opinions, board changes and vacancies, and any warnings received for corporate governance violations must be disclosed.
- New board committees of independent directors are responsible for, among other things, director nomination and compensation.
- Codes of conduct are required to be established addressing conflicts of interest, compliance with applicable laws, and enforcement mechanisms.
- Accelerated disclosure of insider transactions is mandated.
- Director "continuing education" is mandated.
- A new crime called "securities fraud" has been enacted (Sarbanes-Oxley §807).
- A new obstruction-of-justice offense was established for the destruction of, among other things, corporate audit records (Sarbanes-Oxley §802).
- New criminal penalties for retaliation against any whistle-blower in a federal criminal proceeding were enacted (Sarbanes-Oxley §1107).

With these new responsibilities and sanctions, there's an even greater likelihood that an officer and director will be sued no matter how spotless his or her performance. Will insurance cover your potential liabilities?

DIRECTORS' AND OFFICERS' INSURANCE

The primary vehicle for protecting a director or officer is the specialized insurance policy known as Directors' and Officers' (D&O) Liability insurance. The D&O policy protects directors and officers against claims alleging wrongful acts, i.e., any negligent act, error or omission, or breach of duty committed by the director or officer in the discharge of his or her duties and solely in his or her capacity as a director or officer.

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A D&O policy is designed to have a limited scope. As a result, assertions of claims under D&O policies frequently lead to coverage disputes. While insurance companies are familiar with the types of insurance issues that will arise when a D&O claim is submitted, policyholders aren't.

There are numerous pitfalls and gaps in D&O policies that you should be aware of. Let's look at some of the important traps:

The Insurance Application

D&O insurance companies often require corporate policyholders to fill out a lengthy written application.

Some insurance companies then attempt to defeat insurance coverage on the grounds that certain facts weren't fully disclosed on the application. For instance, in *Harristown Development Corp. v. International Insurance Co.*, 1988 U.S. Dist. LEXIS 12991 (Pa. D.C.), the insurance

company denied the policyholder's claim, arguing that coverage for the lawsuit was void because there were misstatements made on the D&O policy application. The denial came years after the claim was initially filed with the insurance company. In the interim, the policyholder continued to renew its D&O policy and pay premiums to the insurance company.

The court found in favor of insurance coverage for the policyholder, concluding that there were no misrepresentations on the application that would nullify insurance coverage under the D&O policy. Nevertheless, the Harristown Development litigation is indicative of the practice of some insurance companies to comb through insurance applications for either misstatements or "incomplete" answers to insurance application questions in an effort to defeat insurance coverage for covered claims. This practice is typically employed after the policyholder files a claim for coverage.

"Postclaim underwriting" is the name of this game. Novelist John Grisham described this unseemly practice in his 1995 book, *The Rainmaker*, as follows:

Everett Lufkin, Vice President of Claims…finally admits it's company policy to do what is known as "postclaim underwriting," an odious but not illegal practice. When a claim is filed by an insured, the initial handler orders all medical records for the preceding five years. In our case, Great Benefit obtained records from the Black family physician who had treated Donny Ray for a nasty flu five years earlier. Dot did not list the flu on the application. The flu had nothing to do with the leukemia, but Great Benefit based one of its early denials on the fact that the flu was a preexisting condition.

The bottom line is that you don't want your insurance rescinded because the director who signed the application made certain alleged misrepresentations. You want to protect yourself from another director's bad acts of which you have no knowledge. To protect yourself in that regard, *make sure there is an endorsement providing that no statement in the application or knowledge of any insured will be imputed to any other insured—such as you.*

In addition, the company's financial statements are "incorporated" as a part of the application. This can create a catch-22 if your company's financials are restated. At the very time you need insurance coverage to defend against the inevitable claims resulting from the restatement, the insurance company seeks to declare the policy null and void because of a misstatement in the application (i.e., the lack of truthfulness of the financial statements). You can seek and obtain an endorsement that prevents such a result, both as a basis for rescission or as an exclusion, which simply states that the restatement of the company's financial statements won't be a cause for denying coverage.

Fraud Exclusion

A standard exclusion in D&O policies is the exclusion for claims arising out of deliberate criminal or fraudulent acts. The policy should provide that the exclusion will only apply if a judgment (or other final adjudication) adverse to the insured establishes that a criminal or deliberate criminal or fraudulent act occurred. Such a provision enables you to settle lawsuits without admitting liability and still obtain coverage. It also enables you to obtain advance payment of defense costs during the litigation process. Without such a provision, both of those benefits may be lost. There should also be a severability provision stating that the wrongful acts of one insured won't be imputed to any other insured for the purpose of applying the exclusion.

Illegal Profit Exclusion

The points raised with respect to the fraud exclusion apply equally here. The illegal profits exclusion should apply only if there's a judgment adverse to the insured

that expressly establishes that illegal profits were received. In addition, appropriate severability provisions should be in place to protect the innocent director from the isolated acts of the guilty director. For example, if one director induces his fellow board members to approve a self-dealing contract, awarding lucrative business to a company controlled by the director's spouse, his self-dealing shouldn't be used as a basis to deny coverage to directors who had no knowledge of the personal connection.

Shared Limits

Current D&O policies often provide coverage for parties other than the directors and officers (for example, the corporation itself) or for different types of claims, such as Employment Practices Liability insurance. When these coverages share the same policy limit, directors and officers could be exposed if the policy limits are exhausted by the other claims. Separate limits for each type of claim can be established with a priority given to D&O coverage, or the policy can be limited to pure D&O coverage.

Investigations

D&O policies will provide coverage for damages, judgments, settlement, and defense costs arising out of a "claim." The coverage should include not only formal legal proceedings but should also include investigations by the SEC or other regulatory authorities.

Defense Costs

Every director and officer wants defense costs advanced on a contemporaneous basis (i.e., monthly or quarterly, but well before the trial) rather than at the end of the litigation. The timing of the advance costs should be made explicit in the policy. Note: Defense costs are a part of the limits of the D&O policy, not in addition to the limits.

Bankruptcy

When a company has gone into bankruptcy, insurers have argued that claims brought by a trustee in bankruptcy against the debtor's directors and officers should be excluded from the D&O coverage they sold. Policyholders should close this loophole by insisting on an endorsement to the policy explicitly stating that coverage won't be terminated in the event of bankruptcy.

Punitive Damages

Most D&O policies expressly exclude coverage for punitive damages—fines or penalties. But you can obtain an endorsement to the policy to provide coverage for punitive damages subject to other exclusions of the policy (e.g., deliberate fraud or criminal acts). The endorsement should also state that its enforceability is to be governed by the applicable law that most favors coverage for punitive damages.

ASK QUESTIONS

There are many other questions that officers and directors should be asking their corporate general counsel or risk manager. For example:

- Given the increased liabilities established under the Sarbanes-Oxley Act and its progeny, has the company increased its D&O insurance limits?
- Is the coverage pure D&O insurance, or does it also cover other risks?
- Will the other risks covered by the policy "eat away" coverage protecting me as a director?
- What is the company's claims history insofar as D&O claims are concerned?
- If the company decides not to give notice to the insurance company of a claim or potential claim, may the director do so?
- If the D&O insurance won't cover a particular claim in whole or in part, will the company indemnify the directors and officers?
- Are there statutory or judicial limitations to such indemnification?
- As an independent director, do I need separate representation to review the policy and to become directly involved in the claims handling process?
- As an independent director, do I need separate coverage just for the independent directors?

The passage of these new enactments makes it imperative for officers and directors to check the fine print and the exclusion clauses of their D&O policies. ■

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