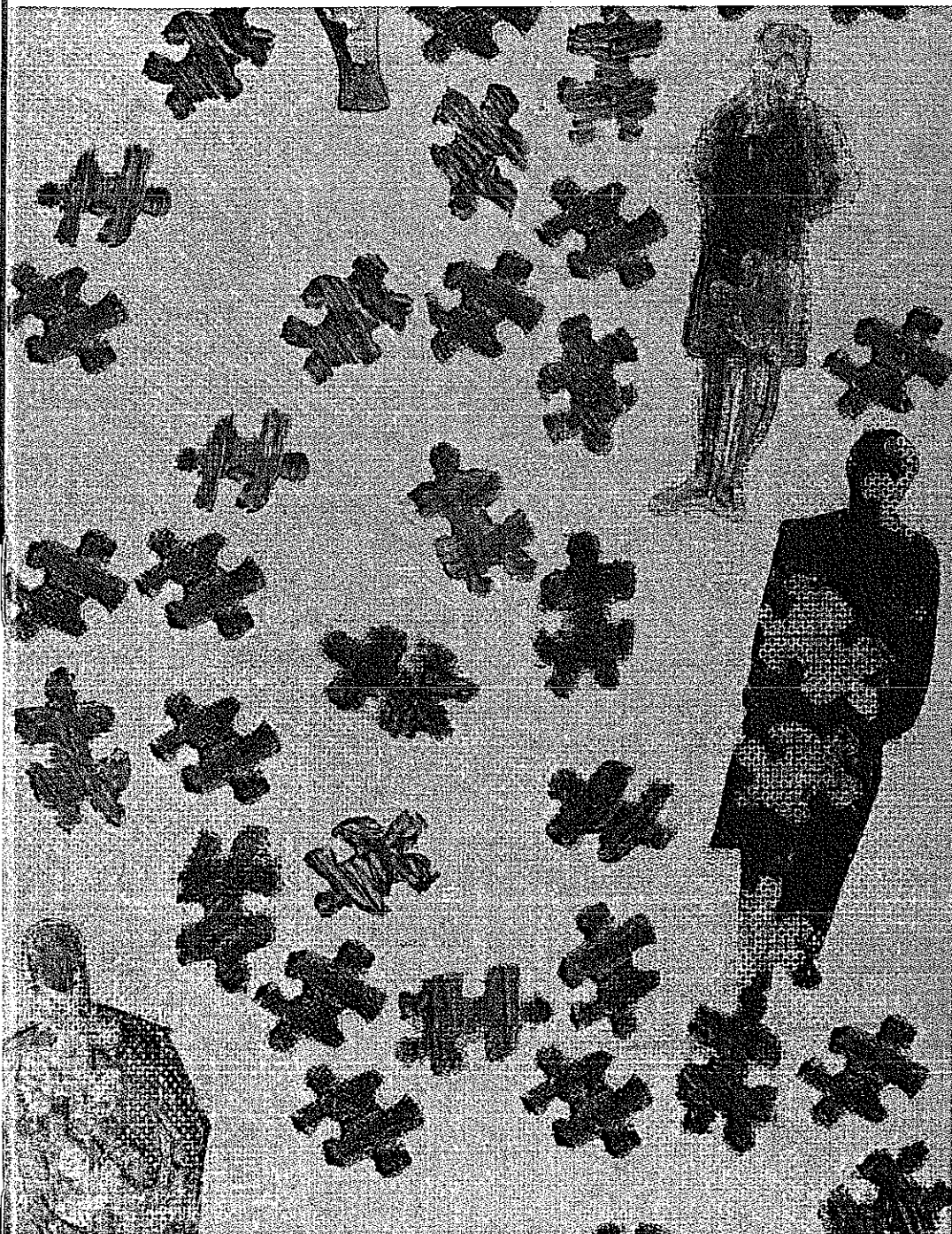


know  
the  
rules  
of the  
game

# EXECUTIVE

May 2005 • [www.executivelegaladviser.com](http://www.executivelegaladviser.com)

## LEGAL ADVISER



UNDERSTANDING THE  
LANGUAGE LAWYERS  
USE ON THEIR BILLS

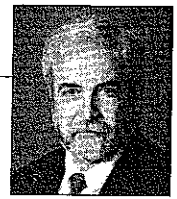
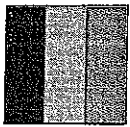
INDEPENDENT AUDIT  
COMMITTEES AND  
RISKS TO EXECUTIVES

D&O COVERAGE DIFFERS  
FROM OTHER COMMON  
TYPES OF INSURANCE

COURT APPROVES  
NEW THEORY FOR AGE  
DISCRIMINATION CLAIMS

ESTABLISH A REPUTATION  
AS A COMPANY THAT  
DOES NOT SETTLE

ACQUISITIONS AND  
DIVESTITURES —  
THE LEGAL ISSUES



# The Ins and Outs of D&O Coverage

THE SALARIES OF SUCCESSFUL DIRECTORS AND officers (D&Os) have increased recently and so have their assets. Plaintiffs are filing more suits against D&Os than ever before, and that number is not likely to decline any time soon.

Those investing in businesses need protection from improper conduct. Those running businesses need to protect their wealth from their own errors and those of others. Substantial D&O insurance is the best way to do this, but execs need to know that D&O coverage differs significantly from other common types of insurance.

• When execs are covered: D&O insurance often comes in the form of a claims-made policy, which differs from other business liability insurance policies (BLIPs) in important ways. A commercial general liability (CGL) policy provides coverage depending upon when the injurious event took place. In contrast, D&O coverage depends upon when claims are made against insureds (hence the name). For D&O policies to cover claims, the aggrieved party, such as a shareholder, must make them during the policy's (often annual) period, or during a paid-for, explicitly specified previous period of time. While this may seem unusual, many professional malpractice policies function like this.

• Duty to defend: Most BLIPs, such as CGLs, create for insurers not only a right to defend arguably covered suits brought against insureds, but also a duty to do so.

However, under most D&O policies, carriers have neither the right nor the duty to defend.

Failure to understand this can result in a nasty surprise for an exec who gets sued. But at the same time, D&O carriers do have a duty to pay reasonable attorneys' fees undertaken in the defense of covered claims.

• Policy limits: In most BLIPs, the policy does not limit the amount of attorneys' fees a carrier may have to pay to defend an insured. Further, the fact that the carrier pays the defense expenses does not erode the amount of money

available to pay claims. However, D&O policies are the opposite. Defense expenses fall within policy limits, so any expenses the insurer pays to attorneys cuts down on the total amount available to protect an exec. This gives execs a significant interest in holding down lawyers' fees.

• What's covered: Most BLIPs require an insurer to defend the entire suit, if the plaintiff's pleading makes any claim in the complaint that appears to be covered. However, in most D&O policies, carriers need only pay to defend those claims for which pleadings suggest coverage. For example, under a BLIP, the insurer must defend the whole suit if it has to defend any part of it. But under D&O coverage, the insurer only has to pay for the defense of the claims that, if true, will create covered liability.

• Multiple forms: For most BLIPs, insurers generally use only a few different forms, so most policies look pretty much alike, sometimes with a few added exceptions. This is not true for D&O policies, because states do not require that insurers restrict themselves to using a few predetermined forms for D&O policies. As a result, a multitude of different D&O forms are in use. Currently, I have 25-plus current policies in my desk drawer.

## COMMONALITIES

Despite all of these variations, D&O liability policies and other BLIPs do have some similarities, such as a tendency to contain an arbitration clause. Other areas that sometimes overlap include the following:

• External reinsurance: Organizations often purchase multiple BLIPs, so that they are covered by primary policies, first-layer excess policies, second-layer excess coverage and so on. Often, excess policies exactly follow the form of the primary policies, meaning they have all the same coverage, exclusions and conditions as the primary policy. This is less true for D&O coverage, although insurers use excess policies all the time that look like "follow form" excess policies. Virtually all substantial liability policies involve external reinsurance. Reinsurance is common in virtually all areas of insurance, and D&O insurance is no exception. Usually policyholders have no (or few) legal rights against reinsurers.

• Policy structure: D&O policies involve general insuring agreements, plus particularized (and narrower) specific exclusions. Like other insurance

## D&O DIFFERENCES

• D&O INSURANCE DIFFERS SIGNIFICANTLY FROM OTHER KINDS OF INSURANCE.

• SOME DIFFERENCES INCLUDE WHEN AN EXEC IS COVERED, THE DUTY TO DEFEND AND WHETHER ATTORNEYS' FEES REDUCE THE AMOUNT AVAILABLE FOR THE DEFENSE.

• THREE IMPORTANT CONDITIONS ALSO USUALLY ARE PRESENT IN D&O POLICIES: 1. INSURED'S MUST REPORT CLAIMS AS SOON AS POSSIBLE; 2. INSURED'S MUST COOPERATE WITH INSURERS IN WORKING ON CLAIMS; AND 3. INSURERS MUST COOPERATE WITH INSURED'S.

policies, D&O policies also are usually filled with definitions and conditions that become critically important during the claims process.

Three important defined terms are "officer," "ultimate net loss" and "wrongful act." Some policies include a reference to the corporate constitution or articles of incorporation to determine who qualifies as an "officer" for coverage purposes, whereas others will cover anyone the company treats as an officer.

The phrase "ultimate net loss" is a standard way of indicating what is covered. Usually, it refers to legal damages and defense expenses, including tort damages and statutorily prescribed damages, but excluding restitution the company or D&O must make to a victim of wrongdoing.

D&O policies generally define "wrongful act" to include negligence, negligence-like torts and misrepresentations; sometimes they cover fraud by implication. However, insurers will often change the definition of "wrongful act" when coverage is expanded by endorsement (supplemented by additional pages that can either add to or subtract from the coverage).

- **Insuring Agreements.** Almost all D&O policies insure directors and officers against liability for wrongful acts that they commit when the business does not provide indemnity. Similarly, virtually all D&O policies cover businesses for amounts paid under indemnity agreements for their directors and officers accused of liability for wrongful acts. Often, it's quicker and simpler for the insurer to simply make payments on behalf of the accused directors and officers, rather than make them file claims under the business' indemnity policy, then have the business turn around and file a claim under its policy.

When the insured company cannot pay a promised indemnity or no enforceable commitment to do so exists, insurers pay when there is coverage. Sometimes they do so under a reservation of rights. (When an insurer issues a reservation in the context of a D&O policy, it sometimes can get its money back.)

- **Exclusions:** D&O policies differ substantially with respect to what is excluded. Examples of general exclusions include injuries insured by other types of policies; insureds under the policy suing each other; criminal conduct; ERISA foul-ups; pollution; nuclear accidents; slander or libel; antitrust; intellectual property; and SEC accusations.

Exclusions usually fall into one of three categories: actions, situations (e.g., if an insured seeking coverage has made unfair profits), and expo-

sure. The three principal kinds of exposures that usually are excluded explicitly or impliedly include fines and penalties, punitive damages, and restitution (if it's not explicitly excluded, judges often find it to be excluded impliedly).

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## Those investing in businesses need protection from improper conduct. Those running businesses need to protect their wealth from their own errors and those of others.

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- **Conditions:** Execs need to be aware of three important conditions in policies. First, the insureds must report claims ASAP. Second, insureds must openly cooperate with insurers in working on claims. For example, it is almost always a bad idea for an insured to settle a case without notice to, discussions with and the express, written consent of the insurer. Third, insurers must cooperate with insureds. In D&O policies, the cooperation requirement is more explicit and more demanding than in BLIPs.

- **Claims Process:** The best way for insureds to deal with insurers is to provide honest and relatively complete application information before the beginning of each policy period. Further, during any claim period an insured should provide the covering insurer with substantially complete information about the evolution of a claim, the insured's view of its own guilt or innocence, plus summaries of evidence. Execs should follow up with defense counsel to ensure this is happening.

- **Legal Expenses:** Execs accused of wrongdoing that triggers their D&O coverage should use experienced, knowledgeable lawyers. A truly useful lawyer knows about his client's business and knows about insurance. Long before trouble breaks out, execs should consult with a lawyer to determine the right policies to buy. While retaining capable counsel is expensive, so is a finding of D&O liability. One ray of hope for execs is that, in 2004, the price of D&O coverage started to fall.

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*Michael Sean Quinn, Ph.D., J.D., is a solo practitioner in Austin. He mainly handles matters involving insurance law and lawyer conduct problems, and he writes and lectures frequently on these topics. He also often serves as an expert witness. Quinn's e-mail address is [mquinn@msquinnlaw.com](mailto:mquinn@msquinnlaw.com).*

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