

## Debunking D&O Insurance Myths: Separating Coverage Reality from Marketing Hype

Regardless of whether your approach to operational risk is top-down or bottom-up, the financing of your organization's Directors' and Officers' Liability (D&O) exposure is likely addressed through a traditional approach such as insurance. As anyone who has had the responsibility to procure their organization's D&O insurance can attest, it is one of the most complex and costly insurance products sold.

With corporate governance on everyone's radar, there is an increase in demand for D&O liability risk financing options. And as all commodity markets respond to increased demand, the "Sellers" ("Intermediaries" and "Manufacturers")<sup>1</sup> are coming out of the woodwork. With this and the abundance of misinformation floating throughout the market both here and abroad, we felt compelled to offer some basic buyer transparency.

The current market can be characterized as many buyers seeking complex products from "Sellers" providing few perceived options. Despite conventional wisdom, our experience is that it is a buyers' market and with our unconflicted navigation, our client-partners' *Coverage Value*<sup>2</sup> surpasses that being touted as "affinity, special or exclusive" in many current marketing offers. That's simply because no two organizations' risk profiles are the same and as such, "pre-negotiated terms" or cookie-cutter approaches to D&O insurance do not optimize individual buyers' *Coverage Value*. On the other hand, one can easily see how cookie cutter offerings would lower Sellers' costs; these cost improvements, however, are very unlikely to be passed on to buyers.

### Directors' & Officers' and Corporate Reimbursement Policy Basics

Directors and Officers of publicly-held or privately-held, for-profit or not-for-profit organizations based in the United States, are afforded indemnification (presumptive) by the statutes of the state in which their organization is organized. Typically the Articles of Organization or By-Laws also provide some additional level of indemnification to Officers and Directors (or equivalents) for claims made against them for their actions on behalf of the organization. It is this promise of indemnification that creates potential financial downside for the organization. This risk frequently is addressed (at least partially) by the purchase of Directors' and Officers' Liability insurance.

### Coverage Complexity

D&O coverage is complex. Unlike, say automobile liability insurance, no two "Manufacturers'" D&O policy terms are even remotely similar to those of another, which makes comparing alternatives quite a challenge. Some Manufacturers provide most of their coverage-reducing wording in the base policy form, whereas others prefer to grant coverage in the base form then

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<sup>1</sup> Intermediaries (Brokers) and Manufacturers (Insurers) are covered in-depth in the [Leveling the Playing Field](#) article.

<sup>2</sup> *Coverage Value* is a function of not just premium cost, but also the relevant coverage breadth and depth, as well as the insurer's propensity and ability to pay. See [Leveling the Playing Field](#) article.

take it away in exclusionary endorsements. It is not sufficient, for example, to look for a “pollution” endorsement and if it is not there, assume that you have some level of pollution coverage in your D&O policy (e.g. shareholder derivative and foreign jurisdictions situations).

*Buyer Takeaway:* It is imperative to read and understand the whole D&O policy (contract) in relation to your enterprise and understand how it interrelates with your other insurance coverages. In the event of a claim, a single word change can make the difference between being insured or uninsured.

*Rule of Thumb:* If you are not versed in the basic issues raised in this article, relying exclusively on “Sellers” for advice is, in our experience, not the most prudent path.

## Claims-Made and Reported

One of the most fundamental aspects of the D&O policy is that the contract is on a “Claims-Made and Reported” basis. Unlike the more traditional “Occurrence” form, the “Claims-Made and Reported” policy only responds to claims that are both made against an “Insured” and reported to the insurer during the policy period (or extended reporting period, if available). Additionally, the claim must arise from a “Wrongful Act” that occurred after the policy’s “Retroactive” or “Prior Acts” date (potentially differs for newly created or acquired entities).

*Buyer Takeaway:* Beware of policies that do not specify a “Retroactive” or “Prior Acts” date that is early enough to cover all past incidents for which any past, present or future Director or Officer (or equivalent) would be entitled to indemnification.

*Rule of Thumb:* Demand a Retro/Prior Acts date that takes into account all entities, including predecessor organizations.

## Insuring Agreement

The next key aspect of the policy is the Insuring Agreement. This is the part of the contract that spells out what the risk bearing entity will do when you submit a claim. There are basically three types of Insuring Agreements: “reimburse” the Insureds, “indemnify” the Insureds or “pay on behalf of” the Insureds.

*Buyer Takeaway:* The average D&O suit takes years to settle and even more time if it goes to final adjudication. The optimal choice will be found in the Insuring Agreement that offers the best present value, based on a particular situation or set of scenarios.

*Rule of Thumb:* Do the calculation based on your specific situation. Depending on your Risk Profile, a full “pay on behalf” Insuring Agreement may not optimize your *Coverage Value*. Remember, insurance is just access to capital subject to the terms of your negotiated contract (policy).

## Coverage Parts

The traditional D&O policy has four coverage parts or sides: A, B, C and D. These parts can be described as follows:

- **Side A: Non-indemnifiable**

Directly reimburses the Directors and Officers in situations where the organization is not able (bankruptcy) or not permitted (derivative claims) to indemnify.

- **Side B: Corporate Reimbursement**

Reimburses the organization if it is obligated (and permitted by law) to indemnify (and actually does) its Officers and Directors for their liability.

- **Side C: Entity Coverage**

Reimburses the organization for its own liability (for public companies typically only in securities claims).

- **Side D: Outside Entity Insured Person Coverage**

Reimburses the designated Insured Person for their liability arising from holding an Outside Entity position, excess of any indemnification or available insurance from the Outside Entity (so-called “Double Excess” basis).

*Buyer Takeaway:* We usually start by pointing out to our client-partners the interesting correlation between the Manufacturers’ preferred retention structure and the expected value of claim pay-out by coverage side.

*Rule of Thumb:* Understand what you need/can finance and what you should retain. The most basic level of analysis should be determining whether the financing is for personal asset protection of the D’s & O’s or for balance sheet protection of the organization. If you are publicly-traded and looking for balance sheet protection, what part of your D&O policy covers the organization for the entity’s liability from non-securities claims?

## Exclusions

Remember that either by state statute or Articles/By-laws indemnification provisions, the organization is likely obligated to defend itself and indemnify the D’s & O’s for claims made against them. The organization typically purchases a D&O Liability insurance policy to finance this risk, but the policy has many exclusions, which often restrict coverage.

A typical Exclusions section in a D&O Policy starts with something along the lines of:

*The insurer is not liable for defense costs or losses directly or indirectly, based upon or arising out of any of the following:*

- Bodily injury (emotional distress)
- Property damage
- Insured v. Insured
- Environmental impairment (pollution)
- Illegal acts
- Intentional misconduct
- Punitive damages
- Claims based on any Insured gaining personal profit or advantage
- Libel or slander
- Interrelated acts
- Pending and Prior litigation (not just D&O litigation)
- Acts of deliberate dishonesty
- Fines, penalties and matters uninsurable by law
- Failure to maintain adequate insurance
- ERISA liabilities
- Antitrust violations
- Credentialing or certification
- Employment practices (entity)
- Professional services
- IP infringement

*Buyer Takeaway:* Reductions in or exclusions of coverage are found not only in the Exclusion and/or Endorsement sections of the policy; you must also navigate through the larger morass of coverage reducing pitfalls, from every “Application” completed, to the scope of the entire policy.

*Rule of Thumb:* If your policy does not have at least as many coverage broadening endorsements as it has base policy form pages, you likely have material coverage deficiencies.

## The Myths

In the interest of time and space, the remainder of this article will focus on some of the more common and important “Myths” that exist in the current D&O insurance market, with the goal of helping buyers become more informed consumers of D&O insurance coverage. The “Myths” focus on process and coverage issues, as these typically are given less attention than the obvious objective of reducing risk transfer costs. As is implicit in the *Coverage Value* equation however, if you focus on price at the expense of coverage, you are likely just providing a false sense of security to the Directors, Officers and others who are promised indemnification and expect to be protected by the policy. Regardless how inexpensive the premium, if the policy does not respond as expected at claim time, it was a waste of money.

**Myth Number 1: You must and should provide the insurer with an “Application” each year.**

Providing an application to the insurer is not likely to help you in any way. The reality is that, should there be a claim the “Application” is the first place Manufacturers will look for reasons to deny the claim or worse yet rescind the policy, based on any “material misrepresentations”. A typical definition of “Application” includes the application itself (potentially a “fresh warranty”), any other application for which the current coverage is a renewal or replacement, and any other public document (like SEC filings and Press Releases). How “material” any alleged misrepresentations are is of course, highly subjective, and is likely to result in a protracted coverage dispute with the risk bearing entity that’s supposed to be funding the defense of your claim.

**Myth Number 2: If I’m not personally involved with or aware of the “Wrongful Acts”, then I will still have coverage under the D&O policy.**

The reality on this issue lies in the level of severability that was negotiated when you purchased the policy. Severability should be extended to both the “Application” and the Exclusions. Simply put, without “Application” severability your insurer may impute any “misrepresentations” contained in the “Application” to all Insureds or worst yet rescind the policy for all Insureds. Without severability of the Exclusions, the Manufacturer may impute the applicable Exclusion(s) for the “Wrongful Act” of one Insured Person to all Insureds.

**Myth Number 3: All coverage parts of our D&O policy are non-rescindable.**

Just because your policy is non-cancelable except for non-payment of premium, does not make it non-rescindable by the insurer. No matter what you’ve been told, true non-rescindable coverage can be negotiated, but the policy you buy “off-the-shelf” almost certainly will be rescindable.

**Myth Number 4: If the insurer wants to settle the case, but the Insureds (management) decide to defend the claim further, the insurer is still liable for the amount of any settlement, up to the full policy limit (less retention).**

Even though the typical policy is on a “non-duty to defend” basis, if you do not consent to any settlement offer proposed by the insurer (and acceptable to the plaintiff), per standard policy wording, most likely the insurer will have capped its exposure to the proposed settlement amount (that you declined to accept) plus incurred defense costs up to the date of your non-consent.

**Myth Number 5: If we want to settle a lawsuit within our policy’s retention, we are free to do so.**

Most likely your policy requires the insurer(s)’ approval before any settlement can be entered into, even within your retention. Those with substantial retentions and/or multi-layered programs will find this especially problematic.

**Myth Number 6: My policy affords “worldwide coverage territory” and has been amended to add “foreign equivalent positions” to the definition of Insured Person. I’ve been told this should be adequate to address our global footprint.**

Not necessarily. Although these clauses are both valuable, the risks of the multinational organization are jurisdiction dependent. As such, these coverage extensions alone do not address all the potential risks (e.g. Insured versus Insured Exclusion in countries such as Australia and Germany).

**Myth Number 7: The definition of Insured Persons for Securities Claims includes all Employees (non-Directors and Officers).**

It is true that many policies provide this clause. However, almost as many limit such coverage to a “co-defendant” basis, which means that if all Directors and Officers are dropped from the suit, there is no further coverage for the (non-Director/Officer) Employee(s).

**Myth Number 8: Investigations by the SEC or other regulatory authorities are covered by the policy.**

Most policies that include SEC investigations within their definition of Claim likely will stipulate that the investigation must also be maintained against an Insured Person (not an Employee) in order for the regulatory investigation to be a covered Claim.

**Myth Number 9: Our corporate philosophy is to purchase “Extended Reporting Period” or “Additional Discovery” (so called “Run-off”) for the companies we acquire. We’ve been told that any claim that arises from an alleged “Wrongful Acts” that took place before the acquisition date will be covered by the “Run-off” policy (6 years?) and “Wrongful Acts” after the transaction date are covered by our current policy.**

Not exactly -- there are many pitfalls to this approach. The one most often cited by Manufacturers to the detriment of Insured’s is the “Interrelated Acts” exclusion. As far as the current coverage is concerned, you also need to be aware of any acquisition threshold clauses in your policy.

**Myth Number 10: All public companies need a D&O insurance policy.**

Not true. Actually, many companies forgo traditional insurance and retain their D&O risk. This decision is often based on three primary factors: 1.) their balance sheet is stronger than that of the insurers offering “reasonable premiums”; 2.) the most probable loss (MPL) estimate for their company is greater than the capacity of the traditional market (approximately \$1.3Billion US); and/or 3.) the company can use an alternative mechanism such as a Captive Insurer<sup>3</sup> or trust to finance their promise of indemnification.

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<sup>3</sup> See [Maybe It’s Time for a Captive Insurer](#) article.

## Closing Thoughts

Why is D&O insurance so complex? It's not, if you deploy the right knowledge-based strategies. When it comes to D&O insurance purchases, a good offense is your best defense and a good offense doesn't consist of relying exclusively on a "Seller" or their pre-negotiated terms to cover the risks specific to your organization.

The Myths and concepts addressed here are by no means comprehensive – there are many more. This article is intended to provide you with a sample of the many challenges and complexities of procuring appropriate D&O coverage, not a substitute for competent, unconflicted advice. If you find yourself bringing the ideas in this article to the attention of your current "Sellers" (which remember, includes your "Intermediary") to make sure you're covered, you should really consider an alternative source of counsel. In order to navigate these turbulent waters, you need an unbiased advisor that has the knowledge to challenge the "Sellers" on their highly specialized turf.

We demand more so our client-partners get more. The results speak for themselves. Just ask any one of our client-partners, the outcomes are always the same – coverage up and premium down!

*Disclaimer - These Exclusions, Myths and concepts are not "Seller" or buyer specific or by any means exhaustive. Depending on your particular Risk Profile, if these and other issues are not understood in relationship to your organization, they can create unanticipated holes in the financing of the Directors', Officers', and Entity's liability. This article is in no way to be construed as legal, tax, or insurance advice. We highly recommend that you consult with qualified legal, tax, and insurance counsel regarding your particular situation.*