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Corporate Governance Update

The Essentials of Directors and Officers' Insurance

Directors and officers face personal liability for breaches of their fiduciary duties to the corporation(s) they serve. Without the protection afforded by directors and officers ("D&O") insurance, the personal assets of such persons are exposed to claims alleging a breach of those duties. In the current environment, directors and officers should carefully review any existing D&O coverage, consider purchasing D&O insurance if they do not currently have it and, in any event, take the necessary steps to be sure they understand the protections that are (and are not) afforded by D&O coverage. The following includes a brief description of the general attributes of D&O insurance, and suggested features insureds should seek to include or avoid in their policies. Another source of protection for directors and officers is indemnification by the corporation. A subsequent update will address this protection.

Overview of D&O Insurance

D&O insurance covers board members and officers, in the event a third party alleges that one or more of them breached their fiduciary duties to the corporation. Typical lawsuits that invoke D&O coverage include: shareholder suits alleging misrepresentations in SEC filings and press releases or inappropriate self-dealing by management; litigation alleging breaches of state or federal law, such as ERISA; and claims by creditors or receivers alleging mismanagement of company assets in the event that the corporation becomes financially distressed.

If D&O insurance is purchased, the insurance carrier becomes obligated to indemnify the directors and officers if a breach of duty is established. To the extent the insurance company must pay claims covered by the policy terms, the financial assets of the individual directors or officers are protected.

All Corporations Should Consider D&O Protection

Traditionally, smaller businesses, start-up organizations and non-profit corporations have not felt a strong need to purchase D&O insurance, viewing the risk of such litigation to be low. However, the number of D&O lawsuits against all types of entities has been increasing, making it prudent for all types of entities to consider such coverage. Outside directors may be unwilling to serve on a board without such coverage. New investors (such as venture capitalists) may demand D&O insurance as a condition of funding a company. Although the cost of D&O coverage is high, the potential consequences of "going bare" must be weighed carefully against the expense of this insurance protection.

Features of D&O Policies

Adequate policy limits. You must of course consider whether the policy limits offer adequate protection. In assessing the limits, be advised that most D&O policies provide for "defense within limits," meaning the payment of legal defense expenses (*e.g.,* attorneys fees and court costs) will erode the limits available to pay damages. Because the defense of D&O claims is often very expensive, the policy limits must be sufficient to pay both defense costs and any potential claims. Further, inadequate limits could expose directors and officers personally for damages that exceed the available policy limits.

Severability clause. Historically, D&O policies have contained a "severability clause," so if one insured committed intentional fraud and thereby was ineligible for coverage, the remaining unknowing and innocent directors and officers could still claim coverage. Recently, however, some insurers are eliminating this clause from their D&O policies, with the rationalization that the role of all directors and officers is to help detect and prevent fraud by rogue individuals. If the policy does not contain a "severability clause," you may lose coverage if a rogue officer "cooks the books" without your knowledge or participation.

Advancement of defense costs. The policy should clearly provide that the insurer will advance defense costs. In the absence of such a provision, the directors and officers may have to pay such costs up-front and seek indemnification from the insurer after-the-fact, a situation which can be a significant and adverse cash flow issue for individual defendants.

Waiver of retention. If the policy calls for a self-insured retention, the policy should waive that retention if the insured is determined not to have been liable for a breach of corporate duties.

Entity coverage. The D&O policy should provide coverage for both the individual directors and officers and the corporation itself. The latter is necessary to provide a source of funds for the corporation's obligation under the bylaws to indemnify directors and officers. D&O policies should also provide coverage directly to the corporation when the organization is named in a lawsuit. Some newer policies provide coverage only to independent directors, as an additional layer of protection for non-management directors in the event of wrongdoing by insiders.

Defense of Claims. Most policies provide that the insurer has the duty to defend all covered claims. However, some insurers may permit the insured to assume the defense of a claim, with oversight by the insurer. With professional reputations at stake in a D&O lawsuit, you may desire to control the defense of claims, including the selection of counsel and any decision as to whether the claim will be settled.

Secure Expert Advice

This article has highlighted only a few of the many important policy provisions. Terms, conditions and prices can vary widely among the various D&O insurers. Before purchasing a policy, one should fully understand the policy terms, conditions, exclusions and limits. Directors and officers should obtain assistance from knowledgeable professionals when purchasing a D&O policy - experienced insurance brokers who have familiarity with this type of insurance and available products and counsel who are experienced in both corporate and insurance matters and have represented clients in connection with obtaining D&O coverage and asserting claims under such policies.

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