Guide to **Directors and Officers Insurance**

Provided by: Tooher-Ferraris Insurance Group

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About This Guide

Directors and officers liability (D&O) insurance is a critical component of almost every organization's risk management program. In today's business climate, D&O insurance is no longer a necessity for just large, publicly traded companies. All organizations—regardless of their size, mission or structure—have some form of D&O exposure. Yet, despite the fact that D&O insurance has been around for decades, it remains one of the most complex and misunderstood insurance policies.

At Tooher-Ferraris Insurance Group, we feel it's essential to bring as much clarity as possible to the subject of D&O insurance. Doing so allows our clients to make informed buying decisions and structure well-rounded risk management programs. As such, we have developed this guide to educate organizations on the risks facing their directors and officers and how D&O insurance can help.

Remember, Tooher-Ferraris Insurance Group is here for you. Whether you represent a small nonprofit or a large public corporation, we will take the time necessary to fully understand your organization and find the insurance coverage to suit your needs. D&O insurance is ever changing and varies between insurance companies. Therefore, it is exceedingly important to work with an expert insurance broker that specializes in D&O insurance. Tooher-Ferraris Insurance Group is proud to provide knowledgeable staff that can protect your organization, boardroom and bottom line.

However, before learning about the mechanics of D&O policies, it's important to understand the basic duties of directors and officers. When organizations know what's expected of their leadership team, they are better prepared to mitigate the risks that lead to costly D&O claims.

Responsibilities of Directors and Officers

In order to understand the benefits of D&O insurance, we must first examine the responsibilities of directors and officers.

When it comes to basic corporate functions, directors and officers of both private and public companies have a number of specific duties. Directors and officers are expected to fulfill these duties and they have an obligation to act in a company's best interests. The following are some basic executive duties directors and officers should be aware of.

DUTY OF DILIGENCE

Sometimes referred to as duty of care, this responsibility requires directors and officers to act in good faith. This means that directors and officers must consider all available information before making a decision and act in the same way a reasonable person faced with the same decision and responsibilities would act.

This duty requires not only reasonable behavior with respect to matters submitted for approval, but also reasonable inquiry and monitoring of the organization's affairs. The duty of diligence may be higher for directors and officers of charitable or other types of not-for-profit entities in certain jurisdictions.

DUTY OF LOYALTY

Directors' and officers' duty of loyalty is meant to prevent them from engaging in conduct that would otherwise hurt or take advantage of the company they serve. Through this duty, directors and officers have an obligation to avoid any conflicts of interest. Some examples of leaders breaking their duty of loyalty include the following:

- Gaining secret profits or unfair gains through personal transactions with or on behalf of the organization
- Competing with the organization or stealing corporate opportunities
- Profiting from the use of the organization's material, nonpublic information

DUTY OF OBEDIENCE

Per their duty of obedience, directors and officers are obligated to follow the statutes and terms of their organization's agreements. Directors and officers may be held liable if they authorize an act that is beyond the powers established by their company's charter.

It should be noted that nonprofit organizations are frequently regulated by a multitude of statutes, rules and regulations—many of which are unfamiliar to outside directors and officers. As such, it's important for directors and officers of these organizations to be extremely careful in order to avoid a claim. Failure to comply with technical requirements may subject the directors and officers to personal liability for any organizational damage.

Sources of D&O Liability

Regardless of your company's size or mission, the legal costs associated with a D&O lawsuit can be crippling for both an organization and its leadership. To complicate matters, D&O liability can come from a variety of sources, and claims can arise without warning.

While D&O insurance provides a last line of defense for organizations and their leadership teams, the best way to protect against a D&O claim is to avoid them altogether. Understanding the main sources of D&O liability can go a long way in avoiding costly legal action.

EMPLOYEES

Most directors and officers are surprised to learn that employees are one of the most common sources of a D&O claim. In fact, for private businesses and nonprofit organizations, employees represent a major D&O exposure.

If employees are mistreated during any phase of their employment, they may bring their concerns to the organization's management team. If employees feel that their concerns have not been addressed in a sufficient manner, they may seek legal action as a means of resolving their grievances.

Common employment practices claims against directors and officers include the following allegations:

- Wrongful dismissal
- Discrimination, including workplace and sexual harassment
- Breach of employment contract
- Failure to address health and safety concerns

COMPETITORS

As organizations attempt to grow their market share, management teams must ensure that growth is achieved through fair business practices. If an organization's competitors believe that they have been unfairly disadvantaged by dishonest or illegal behavior, they may seek legal recourse.

Directors and officers can be brought into legal actions for a range of wrongdoings, including the following allegations:

- Breaches of intellectual property
- Misappropriation of trade secrets
- Collusion
- Anti-competitive behavior

What's more, directors and officers may be held liable for actions that are perceived as misleading or defamatory, with claimants seeking damages for their alleged losses.

CREDITORS

A management team has the responsibility of monitoring an organization's financial position and its ability to meet debt obligations as they become due. If an organization becomes insolvent, creditors will often scrutinize the decisions of directors and officers to see if they can be held personally responsible and will sometimes pursue executives in an attempt to recover outstanding funds.

Common allegations by creditors against directors and officers include the following:

- Breach of fiduciary duty
- Breach of duty of due care
- Negligence
- Deliberate misconduct

GOVERNMENT AND REGULATORY AUTHORITIES

Government and regulatory authorities monitor the environment in which organizations operate. These bodies help ensure that directors and officers and the organizations they control conduct their activities in a fair and lawful manner.

Government and regulatory bodies monitor compliance with a broad range of laws, including the following:

- **Corporations law**: Governs the ownership and management of organizations
- **Securities law**: Governs the administration of publicly listed companies
- **Consumer protection law**: Governs the way in which organizations distribute products and services to consumers
- **Occupational health and safety law**: Ensures that organizations maintain a safe workplace
- **Taxation law**: Governs the taxation of organizations and individuals
- **Environmental law**: Ensures that industry participants adhere to environmental restrictions

For directors and officers, the enforcement power held by these bodies presents a significant exposure to D&O claims. If regulators discover that wrongful conduct has occurred, they may pursue legal action against the organization and the executives involved.

SHAREHOLDERS

Due to their financial investment, shareholders have an incentive to monitor an organization's ongoing performance and ensure that directors and officers are acting in the organization's best interests. With potentially large sums of money at stake, if shareholders are not pleased with an organization's direction, they may take measures to protect their investment.

If it appears that management has breached their duties to the detriment of an organization, shareholders may bring a claim against directors and officers themselves. If shareholders wish to bring a claim against executives, legal proceedings typically come about in one of two ways:

1. **Direct action**—In a direct action lawsuit, a shareholder or group of shareholders bring a claim against management for damages in their interests as shareholders. In this instance, shareholders are the benefactors of any financial settlement.
2. **Derivative action**—In derivative proceedings, shareholders—acting as the organization—sue the directors and officers. In this form of litigation, shareholders generally claim for damages caused to the organization, with the beneficiary of any settlement being the organization itself.

CUSTOMERS

While customers dictate an organization's success, disputes from these individuals can bankrupt a company altogether. In fact, customer disputes can lead to lawsuits against an organization, as well as their directors and officers. Commonly, lawsuits from customers relate to contractual disputes, debt collection, the costs or quality of products or services, the refusal to extend credit and discrimination.

Protecting Directors and Officers

For an organization with many internal and external risks, protecting its directors and officers can feel like an uphill battle. While these risks are serious, companies can rest assured that they aren't without recourse. There are a number of strategies organizations can implement today that will protect their leadership team well into the future.

RISK MANAGEMENT

When it comes to limiting an exposure, specific risk management strategies are critical. For directors and officers, the first line of defense from a claim is to have a deep understanding of their responsibilities. In general, all directors and officers should be aware of the following:

- Their responsibility to the corporation
- The role they fulfill on the board or in a management capacity
- The expertise they are expected to bring to the position

With these responsibilities in mind, directors and officers must use sound judgment and act with care. This means they need to demonstrate tact and diligence when attending board meetings, reviewing board materials and questioning matters put before the board. Doing so will greatly reduce the risks of litigation.

Some carriers can provide general materials relating to risk management guidance upon request. Directors and officers are encouraged to consult their own legal counsel for specific advice as it pertains to corporate duties, responsibilities and exposures.

10 Risk Management Strategies

When it comes to risk management, few things are more important than providing the proper education to directors and officers regarding their responsibilities and exposures. The following are strategies companies can use to ensure that directors and officers are aware of their expectations:

1. Provide training on negligence and liability.
2. Ensure directors and officers are aware of all risks and rules associated with their positions.
3. Establish the company's interests.
4. Implement policies and procedures for directors and officers to follow, and make sure they are aware of these policies.
5. Protect all employees from anticipated harm.
6. Establish a formal reporting system for directors and officers to receive information.
7. Encourage directors and officers to question anything they don't understand about the organization or its activities.
8. Document all decisions and processes.
9. Consult legal counsel when directors and officers make decisions.
10. Ensure directors and officers know their rights and obligations as well as how the organization can protect them.

INDEMNIFICATION

Another major form of protection for corporate officials is indemnification. This is a statutorily authorized protection that is often detailed in corporate documents, like an organization's incorporation or bylaws.

Indemnification provides the right to the advancement of defense expenses and general protection from any legal responsibility following a claim. Indemnification is particularly important when you consider that D&O insurance has its limits. D&O insurance is subject to limits of liability, whereas indemnification is unlimited in practice. While D&O policies are likely to change when they are renewed, indemnification is much more stable, especially when corporate officials are allowed to negotiate their own contracts.

However, indemnification can be limited based on the indemnifying company's financial resources. What's more, indemnification is often very broad, only applying to the maximum extent permitted by law. This contrasts with D&O insurance policies, which typically contain numerous exclusions and conditions.

A company's indemnification provisions will detail what procedures directors and officers must follow in order to receive protection. For added specificity, companies should consider creating a separate written indemnification provision, which provides clarity during times of corporate turbulence and certain protections against the wrongful withholding of indemnification.

INSURANCE

Dedicated D&O insurance is one of the best ways to protect against management risks. This coverage protects the personal assets of directors and officers in the event the company does not pay defense costs or fund indemnification, and it is essential to helping organizations attract qualified individuals to serve on their boards.

D&O policies are a no-brainer for companies of all sizes and industries, as they respond to financial losses that would not otherwise be covered by a general liability, securities claims or similar policy. What's more, unlike other professional liability policies, D&O coverage protects more than just the company, extending directly to leadership itself.

D&O insurance works best when it's used alongside a risk management program and indemnification. D&O insurance provides protection for company officials when corporate indemnification is not available, whether due to financial restrictions or legal prohibition. D&O insurance also provides a mechanism for corporations to be reimbursed when they do indemnify their executives.

D&O policies can be customized to meet the unique needs of any organization or leadership personnel. Companies and their directors and officers should evaluate their specific insurance requirements before the underwriting process begins. Doing so will ensure there are no gaps in coverage and that protection is available when it's needed.

A D&O policy is insurance coverage designed to protect directors and officers against personal liability and financial loss arising from a wrongful act committed, or allegedly committed.

WHY DO ORGANIZATIONS NEED D&O INSURANCE?

The need to obtain proper D&O insurance cannot be overstated. A common misconception is that alleged misconduct by directors or companies is covered under other liability policies, such as commercial general liability, errors and omissions, or other professional liability policy. In many cases, this simply is not true.

In some instances, misconduct may not fall within the scope of an organization's indemnification clause. Even if an organization has the ability to indemnify their directors and officers for the wrongdoing in question, it may not have the funds to finance the ongoing costs and expenses related to a lawsuit.

These costs can add up quickly and easily reach six figures. Without the financial backing of a D&O insurance policy, an indemnification clause might not adequately protect the directors and officers of the organization.

9 Reasons to Acquire D&O Insurance

1. **Personal assets are at risk**—If directors are accused of breaching one of their duties, they might be personally liable to defend the claim. Without adequate D&O insurance, their personal assets could be threatened.

2. **Attracting talent**—Individuals may be reluctant to take on a role as a director without the protection of a D&O insurance policy. Without D&O coverage, organizations can struggle to find the right people to serve in key corporate positions.

3. **Security in bankruptcy**—Businesses facing financial difficulty sometimes go bankrupt. In bankruptcy, creditors can pursue legal action against directors and officers if they feel that they have not acted in the organization's best interests.

4. **Protection from regulators**—Each day, regulatory bodies carry out investigations for potential corporate wrongdoings. As a result, regulatory bodies often impose costly fines against businesses.

5. **Small and medium-sized enterprises (SMEs) are at risk**—SMEs are not exempt from D&O claims. In fact, they face many of the same risks and regulations as their larger peers, but often do not benefit from in-house HR or legal teams.

6. **Competitor lawsuits**—If an organization's competitors believe that they have been unfairly disadvantaged by dishonest or illegal actions, they may seek recourse through legal action. Competitors may sue directors and officers for a wide range of perceived wrongdoings.

7. **Employee practices claims are on the rise**—In an increasingly litigious society, employment practices claims such as sexual harassment or wrongful dismissal can force directors to defend themselves against legal action. These claims can result in costly settlements for plaintiffs and put directors at risk.

8. **Protection from shareholder actions**—Due to their financial investment, shareholders have an incentive to monitor an organization's ongoing performance. Disgruntled investors may file suit against directors and officers if they are unpleased with an organization's direction.

9. **Buyer's market**—As more insurance companies have entered the market, competition has created broader coverage and reduced premium rates for policyholders. This combination makes D&O insurance an affordable risk management solution for most businesses.

Coverage Overview and Insuring Agreements

D&O insurance is crucial, but its complexity can make it difficult to fully comprehend. D&O insurance is rarely a “one-size-fits-all” solution, as policies are flexible enough to meet the unique needs of a variety of businesses. While no two policies are the same, a typical policy provides three standard forms of protection as outlined in insuring agreements—Side A, Side B and Side C. Understanding these agreements can help organizations better plan their risk management programs and protect their leadership team.

SIDE A: DIRECTORS AND OFFICERS COVERAGE

Side A is the first insuring agreement of a D&O policy and it insures individual directors and officers against losses that the organization is not legally or financially able to indemnify.

This coverage protects the personal assets of directors and officers in the event a company does not pay defense costs or fund indemnification. Side A coverage is essential to helping organizations attract qualified individuals to serve on their boards. What’s more, Side A coverage provides an essential last line of defense, ensuring the assets of directors and officers are shielded from the consequences of personal liability.

SIDE B: CORPORATE REIMBURSEMENT COVERAGE

Side B, also known as corporate reimbursement coverage, is the second insuring agreement of a D&O policy. Side B reimburses organizations for expenses they incur when defending directors and officers in accordance with their indemnification obligations.

By indemnifying their executives, organizations become responsible for paying legal expenses and claim settlements on their behalf. The costs of doing this can be financially crippling for even the largest organizations. Side B coverage provides balance sheet protection by agreeing to reimburse the company if it advances legal fees to officers or directors or indemnifies them against losses.

It should be noted that Side B will not protect an organization from direct claims and is only intended to protect against costs incurred on behalf of directors and officers.

SIDE C: ENTITY COVERAGE

Often, organizations are named in lawsuits alongside their directors and officers, leaving the entity exposed to serious legal action. Side C coverage, sometimes referred to as entity coverage, is the third insuring agreement of a D&O policy. This side insures organizations for claims made directly against the organization by providing entity asset protections and coverage for defense costs.

In policies issued to public companies, Side C coverage is often limited to securities claims. In contrast, coverage for privately held organizations often applies broadly to a wide range of claims arising from wrongful acts by the organization or its directors or officers. Another consideration is that entity coverage available under a private company policy is typically broader than protections found in public company policies.

This broader entity coverage could lead to limits of liability being eroded by the defense expenses and settlements of the entity. This would no doubt leave individuals without sufficient funds to defend themselves or settle claims. The broader entity coverage in an entity policy could influence some buyers

to increase the D&O insurance limits of liability as one way to protect against erosion or exhaustion limits.

Companies continue to become entangled in shareholder disputes, making Side C protection all the more important. This insuring agreement is generally optional and offered by insurers for an extra premium. It should be noted that Side C coverage can be limited in that it only applies to claims that result from an offer, sale or purchase of securities.

SIDE A EXCESS DIFFERENCE-IN-CONDITIONS (DIC)

Unlike standard Side A agreements, Side A DIC sits on top of a traditional D&O policy, effectively providing a broader coverage with separate limits for directors and officers. This fills the following gaps:

- Side A DIC coverage provides excess insurance that kicks in once a company's traditional D&O policy is exhausted.
- Side A DIC coverage provides protection when an underlying insurer fails or refuses to pay, attempts to rescind coverage or becomes insolvent.
- Side A DIC coverage is not typically subject to the exclusions found in traditional D&O policies, specifically the "insured versus insured" and "pollution" exclusions. This can create policies that are more dynamic.

With these gaps addressed, Side A DIC coverage acts as a safety net that can help attract and retain board members who want broad protection.

HOW D&O INSURANCE IS STRUCTURED

	COVERED CLAIM AGAINST DIRECTORS AND OFFICERS		COVERED SECURITIES CLAIM AGAINST AN ORGANIZATION
	Side A	Side B	Side C
Indemnification?	No	Yes	N/A
Who is at risk?	Directors and officers	The company	The company as a defendant in securities claims
What is at risk?	Personal assets	Company assets	Company assets
Cover?	Nonindemnifiable liability of directors and officers	Company reimbursement of directors' costs (retention applies)	Company liability for securities claims (retention applies)

INSURING AGREEMENTS

The insuring agreements, sometimes referred to as insuring clauses, of a D&O policy specify the scope of coverage afforded by a policy. Insuring agreements are presented in broad terms and subsequently modified by exclusions, definitions, conditions and endorsements noted in a policy.

D&O policies will include separate insuring agreements for any Side A, Side B and Side C entity coverage the organization obtains. Each insuring agreement outlines the promise of the insurer to protect the policyholder (the insured) in accordance with the terms and conditions of the policy.

Sample Insuring Agreement Language

While no two policies are drafted the same, the following is sample text you might find in a standard D&O policy:

- **Side A:** The Insurer shall pay on behalf of each Insured Person Loss resulting from Claims first made against an Insured Person during the Policy Period, or, if applicable Extended Reporting Period, for a Wrongful Act, except for Loss which the Company is permitted or required to pay on behalf of the Insured Person as indemnification.
- **Side B:** The Insurer shall pay on behalf of the Company Loss which the Company is required or permitted to pay as indemnification to any of the Insured Persons resulting from a Claim first made against the Insured Persons during the Policy Period, or, if applicable Extended Reporting Period, for a Wrongful Act.
- **Side C:** The Insurer shall pay on behalf of the Company Loss resulting solely from any Securities Claim first made against the Company during the Policy Period, or, if applicable Extended Reporting Period, for a Wrongful Act.

Policy Extensions and Key Terms

While standard D&O policies are designed to protect a wide array of risks, they have their limits. Coverage extensions are used to address these limits, fill gaps and provide organizations with additional protections outside the scope of traditional D&O agreements.

The following are D&O extensions organizations should consider in order to secure the highest level of coverage.

ADVANCEMENT OF DEFENSE COSTS

One extension that can prove invaluable in the event of a claim is the advancement of defense costs extension. This extension requires the insurer to forward defense costs to policyholders throughout a defined period of time.

Without this extension, an organization or its executives may be required to fund their own defense costs until an insurer can assess the claim and reimburse them. This is typically a time-consuming process and can take months or even years.

This extension is critical, as legal costs can get expensive, and most organizations lack the upfront resources to pay for such services. It should be noted that, if it is determined that a claim is not covered, the policyholder would be required to repay any defense cost advancements.

RETIRED DIRECTORS AND OFFICERS

Under many D&O policies, in order for an incident to be covered, organizations must have an active policy when a claim arises. Because some claims may take years to arise, a company's retired executives can be left unexpectedly exposed. To make matters worse, retired directors and officers typically have no control over an organization's insurance once they have left the organization. Accordingly, they cannot ensure their former organization will purchase the proper D&O insurance.

To remedy this issue, policyholders can protect their former directors and officers by including an extended reporting period in their D&O coverage. An extended reporting period allows organizations or retired executives to report a claim to the insurer even if the organization no longer carries an active policy.

OUTSIDE DIRECTORSHIPS

In some cases, directors and officers serve on boards of outside organizations. This often occurs when an executive takes a leadership position for an external nonprofit.

Standard D&O policies may not offer sufficient enough protection in these instances, and outside directorship coverage may be needed. This extension is particularly useful, as it ensures that executives will be covered in the event that their nonprofit's insurance is insufficient or completely exhausted.

NEW SUBSIDIARIES

When an organization purchases a new subsidiary, it is possible that the executives of these acquired operations could be open to D&O exposures.

The new subsidiaries extension is meant to address this concern and automatically cover any new subsidiaries and provide them with the same protection as the parent organization.

It should be noted that coverage only applies to claims that arise following the date of an acquisition. Automatic coverage may also be subject to the size of the acquired entity, and an endorsement may be required.

SPOUSES, HEIRS AND LEGAL REPRESENTATIVES

To protect themselves in the event of a claim, some executives transfer ownership of their assets to a third party. This often includes husbands, wives or guardians.

While this might be a sound legal strategy, it can also leave these third parties open to claims. The spouses, heirs and representatives extension is designed to protect third parties and an executive's assets. However, it does not protect them from the consequences of their own activities.

CONTINUITY OF COVERAGE

Continuity of coverage is an extension that allows claims to be accepted late. Typically, this extension is available to policyholders that have held uninterrupted D&O coverage over a predetermined period.

This extension can prove useful for organizations that fail to notify their insurers of a claim they felt didn't warrant a notification or a notification was unsuccessful altogether. While continuity of coverage is an effective safety net, it shouldn't be relied on as a substitute for prompt claims notification.

KEY TERMS

To understand insuring agreements, organizations will have to interpret key terms scattered throughout their policies. Moreover, to learn specifics on how a D&O policy will respond to a claim, it's important to understand the following key terms:

- **Insured person:** For D&O and most forms of insurance, an insured person refers to the individuals or entities covered by a specific policy. To qualify as an insured person, directors, officers and organizations must fall under a broad, predefined description. These definitions often include all directors, officers and corporate entities of the named insured (the parent organization).
- **Loss:** Loss specifies the claim costs covered by a policy. Specifically, loss in D&O policies refers to expenses—investigation costs, legal fees and settlements—faced by defendants involved in litigation. Losses can also include court awarded judgments, like damages, civil fines and penalties. Covered losses depend heavily on the policy wording; however, the following are generally **not** included in standard D&O insurance:
    - Criminal fines and penalties
    - Taxes
    - Employment-related benefits
    - Restitution (the act of paying back money that was never yours)

- **Claim:** In order for the protection of D&O insurance to become active, a claim that falls under the scope of a policy must occur. Most policies define a claim to include any written demand received by an insured, as well as any civil, regulatory or administrative proceeding arising in the line of corporate duties. The definition of claim may also include any criminal proceeding bought against an organization or its managers.
- **Claims made (and notified):** D&O policies operate on what is known as a claims-made and notified basis. This means that a policy provides coverage for claims made against an insured and notified to the insurer during the period of insurance. In order for a claim to be covered, it must meet the following requirements:
  - Management must become aware of a claim during the policy period
  - The insurer must be notified of a claim within the policy period
- **Wrongful act:** The term wrongful act specifies what types of actions are covered by a policy. D&O policies often define this term broadly to ensure directors and officers are protected from a variety of claims. In most instances, a wrongful act is considered to be any actual or alleged act, error, omission, misstatement, misleading statement, breach of duty, breach of trust, neglect and breach of warranty of authority.

Policy Conditions

D&O policies contain detailed specifics on things like confidentiality, cost allocation and similar conditions. In order to understand the depth of their coverage, organizations must have a basic understanding of common policy conditions. Not only does this knowledge give policyholders a sense of how their insurance responds following a claim, but it can also provide peace of mind for organizations and their leadership.

CONFIDENTIALITY

D&O policies typically prohibit organizations and their directors and officers from disclosing information about their D&O coverage, such as terms, conditions, policy limits and self-insured retentions (SIRs), to third parties. The purpose of this policy condition is to protect the organization and the insurer from malicious third parties. For example, if a third party gathered information about an organization's D&O policy, the information could then be used to make unreasonable demands during litigation.

It should be noted that this policy condition allows organizations to discuss their D&O policy with hired professional advisors, such as insurance brokers, risk professionals and attorneys.

COST ALLOCATION

D&O policies typically contain an allocation clause, which states that an insurer is liable for any losses sustained by the insured and its management to the extent the policy affords coverage. Essentially, insurers only pay for claims they are legally required to based on the terms of the policy itself.

Allocation issues often arise in situations where two parties are facing the same claim and aren't covered by the same D&O policy. Commonly, allocation can occur if an executive and his or her organization are both named on a lawsuit and no entity coverage is included in the organization's D&O policy.

RETROSPECTIVE COVERAGE

> Most understand that D&O insurance protects executives from their current or future actions. However, D&O policies often offer retrospective coverage as well, providing much needed protection from actions committed in the past.

Retrospective coverage is usually unlimited, and, in most cases, insurance will kick in regardless of how long ago a wrongful act occurred. In some circumstances, however, a limitation may be placed on retrospective coverage. This is known as a retroactive date, which removes coverage for claims that arise as a result of actions committed before a specified time.

Retroactive dates will be specific in a policy's schedule and are often applied by underwriters on a case-by-case basis. Retroactive dates are often used if an underwriter believes that an applicant's past exposures are too great to insure.

SEVERABILITY

Most D&O policies contain an exclusion severability provision. This provision dictates that an exclusion applying to one executive's behavior won't affect the coverage afforded to another. In simple terms, this means that innocent executives will be protected regardless of whether or not other leaders act outside the boundaries of a policy.

For example, if a claim is brought against a board of directors for the deliberate and illegal actions of one executive, such as fraud, a policy exclusion may be triggered. With exclusion severability in place, instead of coverage being excluded for the entire board, the exclusion will only apply to the offending executive.

POLICY INTERPRETATION

The policy interpretation clause outlines which jurisdiction's laws govern the policy. For the vast majority of policies, the laws of the country in which the policy was issued control the policy interpretation. The purpose of this clause is to ensure that all parties involved have a clear understanding of how the policy will be interpreted in the event of a dispute that leads to litigation.

TERRITORIAL AND JURISDICTIONAL LIMITS

Territorial and jurisdictional limits of a D&O policy are of particular importance for organizations with international operations. Specifically, these limits refer to the jurisdictional region in which the insurer will respond with coverage, should a legal action arise. Similarly, territorial limits refer to the geographical area from which a claim can originate.

While many policies provide worldwide territorial coverage, they can also limit the jurisdictional coverage available for regions that are considered highly litigious.

RUN-OFF COVERAGE

Following a change in control, an organization's D&O policy will automatically convert into run-off. Run-off coverage is when a policy remains in force but only cover claims that materialize from actions that have occurred before the date of a transaction. Policies that automatically convert into run-off can be particularly beneficially, as any claims or circumstances that arise from past actions can be notified under the existing policy until the end of the insurance period.

Run-off premiums are calculated using a range of methods but typically reflect the diminishing risk of new claims over time. Insurers can provide a range of options for run-offs, though organizations should seek coverage for as long as possible.

Overall, run-off coverage is a critical risk management tool that helps effectively insure directors and officers for decisions made in previous roles.

Common Policy Exclusions

D&O liability insurance is intended to provide broad and sufficient coverage for policyholders and their officers. However, D&O policies do not cover all conduct and many contain a number of notable exclusions. Some exclusions are commonplace and can be found in the vast majority of D&O policies, while others are rare.

As time consuming as it can be, organizations should always sit down with their insurance broker and review the exclusions contained in their D&O policy. This will help ensure that the organization and their officers understand how their policy works in practice. In many cases, organizations assume they are covered for a claim when, in fact, policy exclusions could apply.

This section examines common exclusions found in D&O insurance policies.

KNOWN CLAIMS AND CIRCUMSTANCES

Due to the claims-made nature of D&O coverage, policies typically do not cover known claims and circumstances. Put another way, D&O policies do not cover claims that should have been reported during a past policy period. Accordingly, all claims and circumstances that an organization is aware of before the inception of a policy are excluded from coverage.

PRIOR OR PENDING LITIGATION

This exclusion removes coverage for claims that arise from litigation that was pending prior to a certain date set forth either in the policy declarations or in the exclusion itself.

The pending and prior litigation exclusion date ensures that the insurance company does not have to pay a claim arising from active or pending litigation that an organization knew about before the effective date of the coverage.

A typical scenario where the prior or pending litigation exclusions comes into play is when a lawsuit against an organization is later amended to include directors and officers as named defendants after the inception date of the policy. In addition, directors and officers can be exposed to this exclusion if a lawsuit is filed before the prior or pending date, but management doesn't find out about it until afterward.

CONDUCT EXCLUSIONS

Coverage for certain types of conduct is excluded from D&O policies. The conduct exclusions found in most policies preclude coverage for the following two categories of conduct:

1. For claims related to fraudulent or criminal misconduct
2. For claims related to illegal profits or wages the insured executive was not legally entitled

These conduct exclusions exist because insurance companies are prohibited from covering criminal or fraudulent activity. It should be noted that some policies allow the insurance company to advance defense costs to a director or officer. This is done on the presumption of innocence, and a formal court ruling or admission of guilt is required to decline coverage completely.

INSURED VS. INSURED EXCLUSION

D&O policies preclude coverage for claims brought by one insured director or officer against another director or officer also covered under the same policy. The purpose of this exclusion is to eliminate coverage for internal disputes among directors and officers and claims involving collusion.

CATASTROPHIC HAZARDS

D&O policies, like other types of insurance classes, often exclude losses or include exclusions for losses that are deemed catastrophic hazards to the insurance company. These include claims where the insurance company could not realistically cover the cost of payouts without destroying its own financial position.

Examples of catastrophic hazards include losses resulting from war, terrorism and instances of catastrophic environmental damage. Some of these exclusions, particularly the environmental damage exclusion, will often have coverage carve-backs for certain types of claims.

PARTICULAR CIRCUMSTANCES EXCLUSIONS

During the D&O underwriting process, an insurance company may identify specific circumstances or risks it is unwilling to insure. Accordingly, the insurance company may offer coverage to the organization on a restricted basis. These exclusions, which are sometimes referred to as laser exclusions, are often used when an organization has disclosed a serious claim or circumstance that occurred during a past policy period. Particular exclusions are relatively common, but, if possible, an organization should attempt to acquire D&O coverage without them.

Companies seeking D&O insurance should work with a qualified insurance broker to find a policy that fits their needs. Depending on the particulars of an organization's operations, it may be important to ensure a policy doesn't contain certain exclusions. If this is the case for your business, be sure to be honest and bring up your specific needs during the underwriting process.

Limits of Liability

When it comes to understanding what coverage your organization has available following a claim, it's critical to examine your limits of liability. Every D&O policy includes a limit or limits of liability that specifies the amount of insurance available to a policyholder.

Put simply, the limit of liability sets the maximum amount that an insurance company is prepared to spend defending and settling claims on behalf of a business and its management. A limit of liability is available for the payment of legal defense costs, settlements and court awarded judgments throughout a policy period.

D&O policies are typically subject to an aggregate limit of liability, meaning that the limit applies to all claims combined during the policy period. Accordingly, one large, expensive loss or a number of smaller losses that accumulate during the policy period could exhaust a limit of liability.

To better understand how their insurance responds to a claim, organizations need to examine the essentials of limits of liability, which are outlined below.

DEFENSE COSTS

Most D&O policies are defense cost inclusive, meaning that fees accrued to pay lawyers contribute to the overall policy limit. So, rather than paying legal expenses in addition to claims up to the policy limit, D&O policies subtract legal expenses from the policy limit itself.

As a claim is defended, the limit of liability gradually erodes, leaving less funds available for settling claims or paying for future claims during the policy period. In fact, with every dollar an organization spends on litigation, less funds will be available for any settlements or judgments.

To ensure that you have adequate limits of liability to defend and settle serious claims, you must consider your defense expenses carefully. This is especially important when you consider that both settlements and litigation expenses have been escalating year over year.

SELECTING A LIMIT OF LIABILITY

Selecting a limit of liability is arguably one of the most important considerations for an organization's management when acquiring D&O insurance. The pressure to select an adequate limit of liability is magnified when you consider that the wrong limits could affect the livelihood of directors and officers in the event of a claim. The level of coverage under a D&O policy could be the difference between an organization and its leaders being comfortably protected and financial ruin.

But how does an organization know how much D&O coverage to carry? This is a complex question, as companies need to balance their unpredictable, future liabilities with today's premium expenses to determine the level of coverage they need.

D&O insurance limits need to be sufficient enough to pay for a vigorous defense of claims for all directors and officers, as well as the company itself. What's more, there needs to be enough funds remaining following a defense to settle claims and satisfy any judgments. This ensures that plaintiffs will not go after your directors' and officers' personal assets.

Unfortunately, for businesses considering D&O insurance, selecting a limit of liability is not an exact science, and there is no one formula to determine how much a company will need. Selecting the proper limit of liability depends on examining a wide range of factors alongside a knowledgeable insurance broker.

The next sections will describe six factors to consider when selecting a limit of liability for a D&O policy.

CONSIDERATION 1 - OWNERSHIP STRUCTURE: PUBLIC VS. PRIVATE

An organization's ownership structure plays an important role in determining the level of D&O coverage needed. While both public and private organizations face D&O exposures, public organizations tend to face the most severe and costly claims.

Public Companies
Public companies must contend with the ever-present threat of a securities class-action litigation. In many cases, a securities suit represents the company's largest management liability exposure. As a result, publicly held organizations tend to carry D&O policies with higher limits than their privately held counterparts.

Private Companies
This is not to say that private organizations do not face complex D&O exposures. In fact, D&O claims against private organizations often settle for hundreds of thousands of dollars or, in some cases, millions. Similar to public companies, the limits of liability for private companies is subject to erosion by defense expenses. This means that many of the same considerations public companies take concerning defense expenses apply to private companies selecting a limit of liability.

An additional consideration for private organizations that carry D&O insurance is that the entity coverage contained in most private company policies is broader than the entity coverage provided to public companies. While public company policies are generally limited to securities claims, private company entity coverage is not as narrow.

This broader coverage creates the possibility that defense expenses and settlements of the entity could erode the limits of liability. This could leave individual directors and officers with little or no insurance remaining to defend themselves or settle claims. Additionally, broader entity coverage could influence some buyers to increase their limits of liability in order to protect against erosion or exhaustion of policy limits.

CONSIDERATION 2 - SIZE

Similar to an organization's ownership structure, a company's size is also a good indicator of D&O exposure. A number of metrics can measure the size of an organization, including annual revenue, market capitalization and employee count.

As a general rule, larger organizations experience more severe and frequent D&O claims. Thus, these organizations tend to seek higher D&O policy limits. By contrast, smaller organizations generally carry less D&O risk and subsequently seek smaller limits. In some cases, underwriters may not offer higher levels of coverage where the limit of liability is larger than the total value of the organization itself.

CONSIDERATION 3 - NUMBER OF DIRECTORS AND OFFICERS

The total number of executives requiring protection under a D&O policy has a substantial effect on the level of D&O coverage needed by an organization. When defending claims, all directors and officers draw coverage from the same insurance policy and limit of liability.

In many cases, directors and officers may not have the same interest and, therefore, may require their own separate legal counsel. This can lead to the rapid exhaustion of the limit of liability. For example, some officers may be alleged to have knowingly participated in fraudulent acts, while others are alleged simply to have breached their duty of care. When this occurs, innocent directors and officers are forced to share defense costs with those directly implicated in a claim.

Accordingly, a limit of liability should take into account the number of individuals covered under the policy. Organizations that have a large number of people under their D&O policy should consider raising their limits of liability.

CONSIDERATION 4 - TERRITORY

The location of an organization’s operations and business interests should also be considered when selecting limits of liability. Organizations that operate in foreign markets tend to face a higher risk of claims due to increased compliance obligations. What’s more, when organizations first enter a new market, they can be relatively unfamiliar with local laws. This can lead to unlawful conduct and claims against directors and officers.

Finally, organizations that operate in highly litigious jurisdictions, such as the United States or European Union, should be especially mindful of their policy limits considering the escalated risk of legal action.

CONSIDERATION 5 - PEER BENCHMARKS, MARKET REPORTS AND LOSS TRENDS

A growing number of organizations take a data-driven approach when selecting their policy limits by examining the purchasing decisions of peer organizations. This data is sorted in such a way that organizations can review D&O insurance purchasing trends in their industry. Organizations can then benchmark their policy’s limit against the limits of their peers.

This information is often provided by underwriters and insurance brokers and can be useful. However, organizations should always ensure that their D&O policy is adequate enough to meet their own specific needs. There is no guarantee that an organization’s peers are purchasing the correct limit. What’s more, benchmarking data varies and can be biased.

In addition to reviewing peer-benchmarking data, organizations should scrutinize claims trends in the D&O market. D&O market reports—available through insurance brokers, underwriters and other third parties—can provide insights into D&O litigation trends, new pieces of legislation and overall market conditions. These reports contain information about claims in various industries, the size of lawsuit settlements and the type of claims commonly brought about.

CONSIDERATION 6 - BUDGET

The vast majority of businesses do not have an unlimited budget to spend on insurance and must take into account the cost of acquiring D&O coverage. This is especially true of smaller organizations that are

more cost-conscious. Like other forms of insurance, organizations need to weigh liability scenarios against the level of premium they can afford.

Insurance brokers can be a vital resource for businesses balancing the need for D&O coverage and their budgetary constraints. With the help of insurance brokers, organizations can often reduce their premium expenditures by safely altering the covers of their D&O policy.

The complexity of these limit selection and program structure issues underscore how indispensable it is that insurance buyers enlist knowledgeable and experienced advisors in their D&O insurance acquisition process.

IMPLICATIONS OF ENTITY COVERAGE

One way to alter the operation of a limit of liability is to include entity coverage within a D&O policy. The following are some considerations organizations should keep in mind when adding entity coverage:

Removing Cost Allocation Disputes

When organizations include entity coverage in their D&O policies, it removes the tedious issue of cost allocation. Without entity coverage, the potential for a diversion of interests becomes apparent. This is because insurers are paying on behalf of executives and organizations are paying for themselves while attempting to divide the costs of litigation.

When entity coverage is in place, both management and the organization are insured under the same policy. This aligns the interests of the insured and the insurer, which could lead to smoother claims resolutions.

Sharing the Policy Limit

While entity coverage can go a long way in controlling cost allocation disputes, it's not without its drawbacks. One major downside to entity coverage is the way it affects the limit of liability.

Again, the limit of liability is commonly shared across all sections of a D&O policy and, as such, any costs that accumulate when defending an entity from a claim adversely impact the overall policy limit. In short, the coverage available to directors and officers shrinks every time an organization defends its own interests. In some cases, the limit of liability can be exhausted completely, leaving a company's management team without financial recourse in the event of a claim.

With this in mind, organizations must consider how including entity coverage can negatively impact their directors and officers. When seeking coverage, be sure to bring up specific concerns with a qualified insurance broker. Your broker will then build a policy that meets your unique needs without leaving key individuals open to the financial impact of a claim.

SOLUTIONS FOR SHARED LIMIT OF LIABILITY

Because entity coverage and shared limits of liability have the potential to exhaust coverage for an organization's management team, many steer away from it. However, there are ways to overcome the issues created by entity coverage, including the following:

1. **Remove entity coverage altogether.** Organizations have the option to not insure Side C or elect employment practices liability (EPL) coverage. By doing this, the issue of shared limits is

removed altogether. Instead, organizations can preserve their entire limits to protect their management team and recoup the costs of indemnification.

2. **Purchase stand-alone entity coverage.** While removing entity and EPL coverage from a D&O policy can solve the issue of shared limits, it can leave organizations exposed. To counteract this, companies could purchase stand-alone entity coverage. While this is typically more expensive, it prevents entity claims from draining a D&O policy limit.

3. **Elect separate towers.** Whenever small to mid-sized businesses acquire management liability coverage, they have the option of electing separate towers for each insuring agreement. This means each section of coverage is isolated with its own limit of liability. This can be particularly useful in the event that corporate liability coverage is exhausted, as other insuring agreements would remain intact.

4. **Purchase additional Side A coverage.** To garner higher limits than what's often offered by traditional D&O policies, organizations have the option to purchase additional Side A coverage. Many insurers offer stand-alone Side A coverage to compliment standard agreements, which can provide the following benefits:

    a. **Difference-in-limit (DIL) coverage**—A key benefit of purchasing additional stand-alone Side A protection is that it provides DIL coverage. In essence, this gives organizations excess limits, available on standby, if a primary policy limit is exhausted.

    b. **DIC coverage**—DIC works effectively as "drop down" coverage that indemnifies executives if an organization or a primary D&O policy cannot protect them. This is possible because stand-alone Side A policies provide organizations with broader protection and less exclusions.

D&O PROGRAMS

Organizations that require a larger limit of liability must work with an experienced insurance broker to develop a D&O program. These programs allow organizations to acquire their total policy limit of liability from multiple insurers. This is particularly useful when a company's unique requirements are too much for one insurer.

Layering of Indemnity Limits: The D&O Tower

Most insurance companies manage their own exposures by limiting the amount of D&O insurance they sell to any one organization. Typically, insurance companies are able to provide coverage up to $10 million. When an organization requires a higher limit of D&O coverage than an insurance company is willing to provide, they will need to work with an experienced insurance broker to develop a D&O tower. D&O towers are constructed to allow organizations to acquire their desired policy limit from multiple insurance companies.

Often, a lead insurer helms a panel of insurers that make up a D&O tower. This group is very experienced with D&O policies and is tasked with handling claims and creating policy wording. In addition, the lead insurer is responsible for issuing the primary layer of coverage and is the first group to pay out when claims arise.

Following the primary layer, excess layers of coverage are acquired from other insurers and stacked until a desired limit is met. Excess layers are subject to the same terms and conditions of the primary layer in what's known as follow form.

With a basic knowledge of how D&O towers are established, it's important to understand the mechanics of how they react following a claim. Whenever a claim is brought against a D&O program, the limit liability is eroded from the bottom up. Effectively, once a claim exceeds the self-insured retention, the primary layer of coverage is eroded until the first excess layer is reached, then the second and so on. This continues until the total program limit is exhausted or the policy period ends.

Due to this structure, the lead insurance is often the one that incurs the majority of the losses and is responsible for settlement and defense cost payments. However, because the lead insurer invests the most time into negotiating the terms and conditions of coverage, they receive a much larger share of the premium than excess layer insurers. Insurers responsible for the excess layers typically play a secondary role, covering large claims or ones that have accumulated to a high level.

To get a better understanding of how layering works, see the following example below:

Excess Layer Structure $100M:

- Total cover of $100M
- Insurer A pays initial losses up to $50M
- Further losses covered by Insurer B and Insurer C
- Insurer A carries the most costs and claims and therefore receives a larger share of the premium

Coinsurance

Outside of a layered format, D&O programs can take on a proportionate coinsurance structure. In this structure, the panel of insurers share the risk equally and agree to pay the same percentage of any claim made against a policy. Because of this, each insurer receives an equal share of the premium.

Self-insured Retention

Self-insured retention (SIR), sometimes simply referred to as retention, is an important component of D&O policies. SIR is a dollar amount specified in a liability insurance policy that must be paid by the insured before the policy will respond to a loss.

For D&O policies with SIR provisions, organizations pay the initial costs of a claim, such as the early-stage legal fees and settlements, until the SIR limit is reached. After that point, the insurance company makes any additional payments for expenses covered under the policy until the policy limit is reached. In instances where a claim is small and can be settled for an amount less than the SIR, an organization's D&O policy may not respond at all.

In essence, SIR provisions represent the amount of risk an organization is willing to absorb before a policy kicks in and provides protection. SIR provisions can be complex, and there are a number of considerations organizations and their directors and officers should keep in mind.

SIR VS. DEDUCTIBLE

While SIRs and deductibles are similar in that they both require the insured party to bear the financial portion of a loss, there are important distinctions in the way they operate.

POLICY WRITTEN WITH DEDUCTIBLE	POLICY WRITTEN WITH SIR
Dictate that the insurer will pay the defense and indemnity costs in connection with a covered claim, and then charge or bill back the deductible amount of the insured.	Places responsibility for claims handling with the insured until the amount of retention has been exhausted. Instead of being paid at the beginning of a claim or deducted at the end, SIR is the value of loss that must be first incurred by an organization before an insurer will contribute.

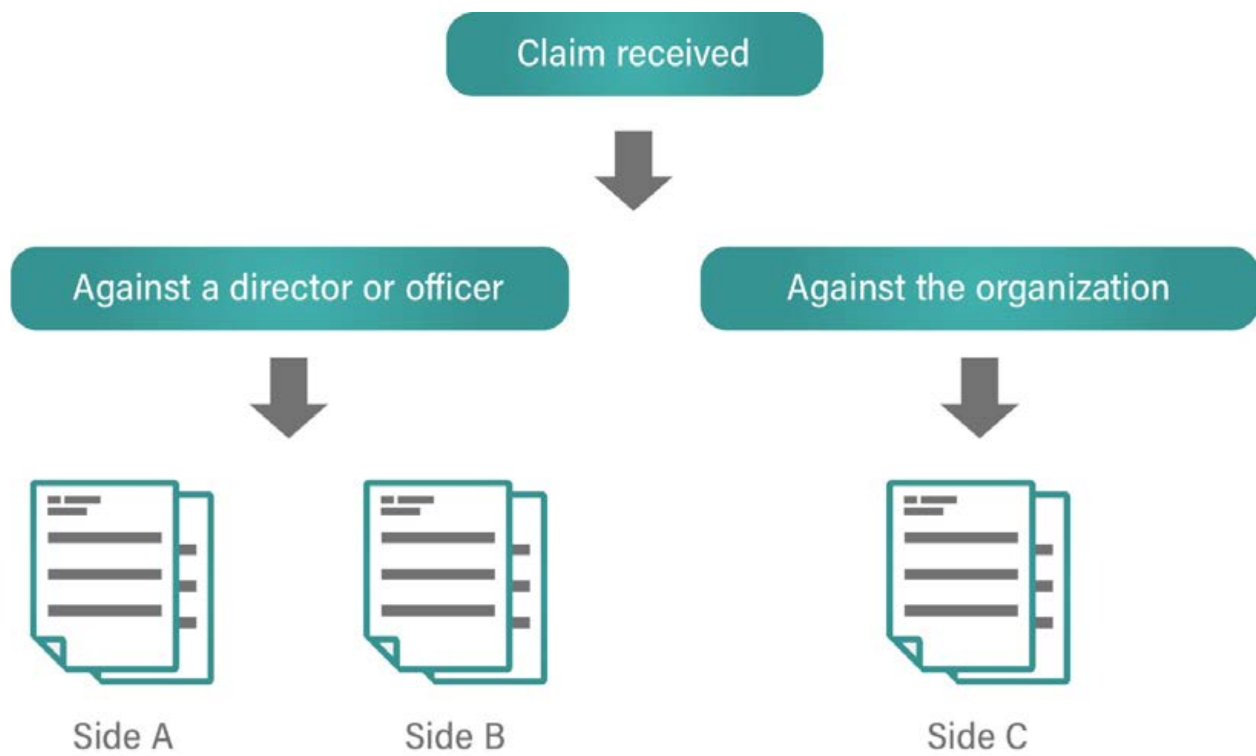
DOES SIR APPLY?

As previously mentioned, a standard D&O policy has three insuring agreements, often referred to as Sides A, B and C. These insuring agreements specify the degree of coverage provided by a D&O policy and summarize the promise by the insurer to indemnify the policyholder from losses incurred from an insurable event.

It should be noted that each insuring clause in a D&O policy is subject to a separate level of SIR, which can add a layer of complexity when it comes to understanding coverage. The following is a brief overview of how retention applies to specific sides of D&O policies:

1. **Retention applying to Side A**—As a reminder, Side A is the first insuring agreement of a D&O policy and it insures individual directors and officers against losses that the organization is not legally or financially able to indemnify. When it comes to SIR, Side A coverage is typically not impacted. This means that directors and offices can seek protection from an insurer at no cost, provided they haven't be indemnified by an organization.
2. **Retention applying to Side B**—Side B, also known as corporate reimbursement coverage, is the second insuring agreement of a D&O policy. Side B reimburses organizations for the expenses they occur when defending their directors and officers in accordance with their indemnification obligations. Side-B coverage is generally subject to a moderate level of SIR. This is because an organization is viewed as having the financial resources to contribute to the cost of claim, when defending directors and officers.
3. **Retention applying to Side C**—Side-C coverage, sometimes referred to as entity coverage, is the third insuring agreement of a D&O policy. This coverage insures organizations for claims made directly against the organization by providing entity asset protections and coverage for defense costs. Any entity coverage applying to D&O is subject to a self-insured retention. Because organizations with entity coverage generally use insurance as part of a broader risk management program, it is expected that they can afford to contribute to their own claims cost and share some of the risk. This is similar to Side B, however, Side C attracts a high level of retention as organizations with entity coverage are often more prone to litigation.

For more clarity on how SIR applies to D&O policies, see the flowchart below.



3 POTENTIAL BENEFITS OF SIR

1. **A cleaner claims history**—By managing claims on their own under SIR, organizations can maintain a clean claims history. This can make these organizations more attractive to insurance companies. In the long run, a clean claims history can lead to insurance companies offering better terms to the organization for its D&O insurance.
2. **Consistent coverage**—SIR provisions typically apply to every claim, with organizations paying for losses up to the level of retention for each separate claim. However, many policies treat multiple claims that arise from the same wrongful act as a single claim, thus attracting only one SIR.
3. **Lower premiums**—Organizations that retain more of their own D&O risk through a higher SIR limit can have their premium costs reduced. In some cases, organizations do not have a choice, as high retentions are often imposed on risky accounts and frequently claimed policy sections.

SELECTING A SIR LEVEL

There are many factors to consider with selecting a level of SIR. It's important for organizations to consider their ability to bear the costs of claims and overall level of risk.

If the SIR is too high, an organization may not be able to afford to finance claims to that level, especially if it is defending multiple claims at the same time. Conversely, if retention is set too low, the policy may respond too frequently, establishing a poor claims history for the organization.

In general, an organization's level of SIR is relative to the size of its assets. When selecting a SIR level, businesses should consider their ability to meet retention obligations and only choose levels they can afford.

The Application and Underwriting Process

Every D&O insurance policy begins with a formal application for coverage. Insurance companies use the application and underwriting process to determine an organization's operations. The information collected during the application and underwriting process allows insurance companies to assess an organization's level of D&O risk, price the D&O coverage appropriately, and apply terms and conditions to the policy.

While the application and underwriting process might seem straightforward, it is nonetheless important that organizations take the time to put together a complete and thorough application for coverage. Doing so can help eliminate future headaches.

THE APPLICATION

In order to obtain D&O insurance, organizations must submit an application that consists of two parts. The first part is the proposal form. This form is a formal application document that asks a wide range of questions about an organization, its operations and its managerial-related exposures.

In addition to the proposal form, organizations typically have to submit a series of supporting documents. These documents allow underwriters to take a closer look at an organization and its standing. Generally, insurance companies will require an organization to submit the following:

- Audited financial statements
- Annual statements
- A complete list of directors, trustees, executives and officers
- Copies of the organization's bylaws, indemnification provisions, charter or constitution, and other similar documents
- Copies of the organization's employee handbook or other similar document or policies

GET BETTER RESULTS WITH QUALITY APPLICATIONS

Organizations have an incentive to present underwriters with a complete and accurate application. When underwriters have a complete picture of an organization, they tend to be more comfortable with the management risks the organization presents. This comfort level creates conditions where underwriters may be more willing to offer an organization D&O coverage.

DISCLOSURE REQUIREMENTS

Organizations and their management have a duty to act in good faith when completing applications for D&O insurance. In particular, organizations are required to disclose information that could lead to future claims during the application process. Typically, the information organizations are required to disclose includes the following:

- **All material facts**—In short, a material fact is any piece of information or knowledge that could influence an underwriter when deciding to take on an organization's risk. Underwriters use material facts to create a risk profile and determine a policy's terms and conditions.

- **Prior claims and circumstances**—Insurers require organizations to disclose all prior claims and any circumstances that could lead to future liability. Often, these prior claims and circumstances are excluded from coverage as the organization moves through the underwriting process. Underwriters will take into account an organization's disclosure of prior claims when determining a policy's premium and terms of coverage.

An organization's duty of disclosure is not simply a one-off affair, but rather, a continued responsibility. Businesses and their executives must continually notify their underwriters of accurate information throughout an application up until coverage is granted. In the event that facts or circumstances change at any point during the initial stages of electing coverage, it's in management's best interest to disclose any relevant information.

UNDERWRITING CONSIDERATIONS

Over the years, insurance companies have refined their underwriting practices for D&O insurance to reward organizations that implement proactive risk management measures. While companies across the country have developed a greater appreciation for the importance of D&O insurance, many misconceptions about the underwriting process for D&O insurance persist. Understanding the underwriting process can help organizations get a better grasp on how to prepare when seeking coverage.

The Nature and History of Operations

Applications for D&O insurance generally start by asking applicants for a basic profile of their organization. In particular, underwriters want to establish the organization's size, location, history and industry. While this information may seem elementary, it affects an underwriter's willingness to accept an application for coverage, as well as sets the price, terms and conditions of the policy. Of these, general items, an organization's history can be a major factor in determining premiums. Underwriting is usually more favorable for organizations that have successfully been in business for longer periods of time. This is because these companies have demonstrated that they have what it takes to run without serious issues.

It should be noted that an organization's industry may contribute to an insurance company's perception of the D&O risk posed by an applicant. When forming an opinion of a potential new client, underwriters will often take into consideration any recent litigation trends, along with their own underwriting experience with organizations in that sector.

Underwriters may also use a company's ownership structure as an indicator of D&O risk. Understanding whether a company is public, private or nonprofit can help underwriters infer what kind of claims could occur.

Publicly traded companies often have the most risk, making them subject to higher levels of scrutiny. For these organizations, insurance companies require additional analysis during the application process and may examine operational specifics like accounting practices, corporate structure, stock price volatility, executive compensation, disclosure practices and corporate governance.

Financial Condition

Typically, underwriters require organizations to submit a copy of their audited financial statements along with their application for D&O coverage. Underwriters require this information so they can develop an understanding of an organization's financial circumstances, particularly its key income statement components and balance sheet components. This information is used to create a range of financial ratios and benchmark an applicant to other similar organizations within its industry.

One of the main questions underwriters try to answer is whether an organization has sufficient cash or credit available to fund its operations and service its debt obligations throughout the proposed policy period. Underwriters generally look upon organizations with a strong financial standing favorably, especially if they operate in an industry with a positive economic outlook.

To help benchmark a company's financial ratios against similar firms, underwriters will often examine the following:

- Current ratios, which compare a company's assets and liabilities
- Debt-to-equity ratios, which display the proportion of shareholder equity and debt used to fund an organization's assets
- Interest cover ratios, which determine how easily an organization can pay the interest on its outstanding debts
- Profit margins, which compare net profits against overall revenue to express an organization's operating profitability

In addition to the above, stock price volatility is an import factor for underwriters when examining an applicant's financial condition. In general, a company that has a share price that dramatically registers even small events is capable of producing large shareholder damages. For that reason, companies with volatile stock prices represent an unfavorable risk class for many underwriters.

Merger and Acquisition Activity

If an organization has been involved in merger or acquisition (M&A) activity, underwriters will typically investigate the reasons for these transactions to gain an understanding of any associated risk. Insurance companies are interested in this information because financing and M&A activities often lead to D&O claims.

In general, the size and nature of an M&A has an influence on the likelihood of claims. Often, the larger the transaction, the higher the risk. Depending on the nature of an organization's M&A activity, an underwriter may impose certain conditions or restrictions, such as placing retroactive exclusions, imposing sublimits, charging higher premiums or declining coverage altogether.

Claims History

Insurance companies, by their nature, want to extend coverage to organizations that will allow them to remain profitable. Insurance companies generally view an organization with a history of frequent claims or pending litigation as undesirable, and may decline to offer coverage or charge more for coverage based on the likelihood of a future loss.

While each insurance company has its own internal D&O underwriting practices, underwriters typically look at the following:

- Recent civil or criminal action, or administrative proceedings alleging violation of a federal, state or foreign securities law
- Involvement in insolvency or bankruptcy proceedings
- Instances of employment or labor-related litigation or proceedings
- Disputes over employee benefits or pension plan

By analyzing previous claims and circumstances, underwriters attempt to weed out bad risks before offering coverage. Underwriters will typically request a summary of each incident, as well as the value (or estimated value) of the losses incurred.

Employment Practices

Current and former employees are a common source of D&O insurance claims, especially for private and nonprofit organizations. In order to get a better sense of how likely an organization's directors and officers are to be pulled into a dispute with employees, insurance companies will typically ask a series of questions related to employment practices. Common questions include, but are not limited to, the following:

- Does your organization have a formal human resources department?
- Does your organization have an employee handbook?
- Has your organization recently completed any layoffs, facility closures or early retirement programs?
- What is your organization's annual turnover rate?
- Does your organization have policies forbidding discriminatory conduct in the workplace?
- Does your organization have formal hiring and interviewing guidelines?

International Exposures

Underwriters often take extra considerations for companies that have international business. This is because organizations that have operations in foreign countries tend to face a higher degree of D&O risk due to the complex compliance requirements that exist in outside jurisdictions.

Managing the complexity of international compliance and fair business practices places an administrative burden on leadership, which could, in turn, lead to errors and subsequent claims. Accordingly, underwriters will typically ask an organization applying for D&O coverage to estimate what percentage of its business is done at home compared to what's done in other countries.

The Quality of Management

When underwriting D&O policies, the qualifications and experience of your executives will no doubt be examined. Underwriters will often analyze each leader's managerial track record to forecast their future

performance. Underwriters may request detailed professional profiles of your executives, so it's important to prepare your leadership team before entering the application process.

Related to the experience of your management team, underwriters will often look at executive compensation. Excessive executive compensation is sometimes cited as the single most reliable risk marker, as it usually invites a host of dangerous (and sometimes destructive) behaviors. Essentially, paying executives generously upfront does not incentivize higher performance. When executives are paid well up front, they are less likely to focus on long-term strategies, which could lead to decisions made in silos.

SELECTING THE RIGHT INSURER

When selecting a D&O policy, it's tempting to simply choose the policy with the lowest premiums. However, when selecting an insurer, organizations should keep the following in mind:

- **Terms and conditions**—Perhaps the most important factor to consider when deciding which D&O policy to purchase are the terms and conditions of the policy itself. Above all, it's important to remember that terms and conditions in D&O policies are not standard. An insured who saves a few dollars in premiums by selecting an inferior policy may find itself without adequate protection.
- **Claims handling**—Never forget that you purchase a D&O policy to pay claims. Different insurers handle claims using their own unique methodology. Before deciding to purchase a D&O policy, it is important to know the insurer's reputation for paying claims. Insureds may also find it helpful to know whether the insurer has its own experienced claims staff or whether it uses outside firms for its claims.
- **Financial ratings**—The financial strength of an insurer is important. One way to determine the financial strength of a company is to consider its rating from A.M. Best or a similar rating agency.
- **Longevity in the industry and experience with D&O insurance**—Some insurers try to time their entry and exit from particular areas of insurance with the hard and soft market cycle. While such an insurer may be able to offer lower prices during certain times of the year, it is typically better to work with an insurer who will remain in the market.

While no one knows your business better than you, insurance brokers have a detailed understanding of the D&O risk landscape. D&O insurance is often the last line of defense for the personal assets of a director or officer. As such, selecting an insurer is a process that shouldn't be taken lightly.

Dealing with Claims

Typically, a D&O insurance policy isn't used in a given year, and organizations can go years between D&O claims. However, when a D&O claim arises, it is imperative that an organization knows how to respond. Often, correctly responding to a D&O claim can mean the difference between peace of mind and financial disaster.

NOTIFICATION

As previously mentioned, most D&O policies are underwritten on a claims-made and notified basis. For policyholders, this means that they must notify their insurer when they first become aware of a claim or specific circumstances that could lead to a D&O claim.

Accordingly, if an organization believes that a certain action or event is likely to create a D&O claim in the future, they should provide the following to their insurer and insurance broker:

- Details regarding the nature of the claim and the circumstances that lead to it (include the names of actual or potential claimants, your views on the claim or circumstance that lead to it, and any allegations that have been made or might be made against you)
- A list of parties involved (other than the claimant)
- The date you were first made aware of the claim or the circumstances that led to it

It's crucial to include as much detail as possible when you first notify your insurer. As long as notification is done properly, an insurer is obligated to cover the incident, even if it does not develop into a claim until after the policy has expired.

Before notifying your insurer, there are a number of legal protocols to keep in mind, and organizations should avoid doing the following six things:

1. Admitting liability
2. Corresponding with outside parties regarding a claim
3. Making or promising any payment
4. Incurring any costs without an insurer's approval
5. Taking any action that might hinder an insurer's ability to investigate a claim or circumstance
6. Providing details of their D&O policy to the claimant

In most circumstances, for a D&O policy to respond effectively, organizations must provide their insurers with a claim notification within the policy period. Again, most policies require the insured to notify their insurer as soon as reasonably practicable or immediately after a notifiable circumstance.

LATE AND DELAYED NOTIFICATION

In limited circumstances, insurers may provide some leeway for a claim notification to be accepted. This generally happens in situations where an organization's D&O policy has an extended reporting policy provision. An extended reporting period is a designated amount of time after a claims-made policy has expired. During this time frame, a claim may be made and coverage can be triggered just as if the claim had been made during the originally stated policy period.

Failure to properly notify an insurer of a claim or circumstances that lead to a claim can have drastic consequences for an organization, even if the insurer has not been affected by the late notification. If a notification is made late and there is no extended reporting period in place, any subsequent claim may be declined by the insurer. Conversely, if late notification is permitted, but not made within a reasonable time frame, an insurer may argue that it has been prejudiced by the delay. This means that the insurer may attempt to reduce its liability or deny a claim.

To avoid late notices, consider doing the following:

1. Have a candid discussion with your trusted counsel. This discussion should revolve around claims asserted, your company's defenses and claims that could be asserted.
2. Communicate with your insurance broker on a regular basis. These correspondences should focus on all of your various insurance policies and needs, not just your D&O liability.
3. Consult with your trusted coverage counsel on specific policy provisions regarding claims, notice and interrelated wrongful acts. It's important that you understand the basics of your policies and what is expected of you.
4. Provide notice if you are ever in doubt about a particular claim or circumstance.

COOPERATION

Once a D&O claim begins, an insured organization and its representatives have an obligation to cooperate with the insurer. The cooperation clause found in most D&O policies requires the insured to co-operate with the insurer in the investigation, settlement or defense of a claim.

In some cases, a D&O policy will explicitly state what is expected of the insured party during the claims process. Other times, the policy will not spell out exactly what policyholders must do to cooperate. In either case, it is expected that directors and officers provide the insurance company with all information and assistance requested, and help in mitigating further losses wherever possible.

In terms of cooperation, directors and officers should do the following:

- Keep their carrier informed about a claim.
- Provide copies of pleadings and other key documents to the insurance company.
- Provide the insurance company with information related to the defense of a claim.

While the above steps may not be required, carrying them out is good practice and will likely lead to a smoother claims resolution. Some cooperation provisions may require the insured to file responsive pleadings, attend hearings and report to the insurer on the status of a claim.

CONSENT TO SETTLEMENT AND THE HAMMER CLAUSE

In most cases, insurers will insist on being closely involved in a claims proceeding. Often, insurers play pivotal roles throughout the duration of the legal process, providing financing, working with legal counsel and helping determine an effective defense.

As such, it's important for policyholders to obtain their insurer's blessing before a claim is settled. If multiple insurers are involved in a claim, all interested parties must sign off before a settlement can be finalized.

In the event that a policyholder fails to inform their insurer of a claim's progress, settlement authority issues may arise. For example, if an insurer is informed of a significant increase in a claim at the last minute, there may be delays in arranging a settlement while the necessary authority is sought.

If an insurer believes that a settlement is in the best interests of both parties, and the insured does not approve the recommended course of action, the insurer may invoke a protective clause referred to as the hammer clause.

Insurers use the hammer clause to limit liability to the amount that the claim could have been settled for and any defense costs incurred. If a claim ends up costing more than the recommended settlement value, the insurer will not pay additional costs.

SUBROGATION

In the event that a D&O insurer protects a policyholder from a covered claim, it inherits the right to subrogate against others. This means that an insurer can assume the rights of the insured and recover damages from any parties found responsible for causing the loss. This is done as a means of recovering the amount of the claim paid by the insurance carrier to the insured for the loss.

Next Steps

Directors and officers are often the key decision-makers in a company, helping steer organizations toward success. In the event that things go bad, however, they could be held accountable, resulting in a major loss of personal assets. Whether you are a private or a publicly held company, your directors and officers face serious risks every day, regardless of the industry in which you operate.

With claims becoming increasingly common, it's more crucial than ever to seek protection using D&O insurance. Unlike a commercial general liability policy, D&O policies provide coverage for a wrongful act, such as an actual or alleged error, omission, misleading statement or neglect. In today's risk environment, you can't afford to leave your leadership team exposed to D&O liabilities.

While the application and underwriting process for D&O insurance may seem daunting, Tooher-Ferraris Insurance Group's knowledgeable insurance professionals are here to ensure your organization finds the coverage it needs. We encourage you to use this guide as a resource to help you better understand your coverage options before you enter the underwriting process.

Contact us today to learn more about the appropriate level of protection for your company in order to safeguard your firm from potential D&O liability.