Directors & Officers Liability Insurance

Watch Out for the Small Print

By Dennis Gustafson

D&O Market Overview

Last year was tumultuous for the insurance industry. The year started with the investigations of the insurance sector by New York Attorney General Elliot Spitzer and other regulators. The eventual financial impact of these investigations, particularly toward financial institutions, may not be revealed for years.

2005 also represented a year of significant environmental disasters, which amounted to billions of dollars of insurance losses. And lastly, there is still fear by underwriters that Section 404 certifications and Sarbanes-Oxley Act requirements will lead to a rash of litigation as companies miss deadlines or report material weaknesses. Some of their fears were confirmed by the record number of restatements in 2004, as reported by Huron Consulting (414 in 2004 vs. 323 in 2003).

All of these factors combine to create compelling reasons for insurance companies to raise rates.

And yet, director and officer liability insurance rates for community banks continue to decrease or remain level. Our analysis shows that the reason for these patterns is not a result of a decrease in claims activity, but a result of continued increased limit capacity in the marketplace.

In situations where carriers are charging rates that they feel may not be commensurate with the risk associated with the bank, it is more important than ever to understand all of the terms and conditions associated with a D&O policy.

D&O Policy Structure

With regards to an analysis of the key terms and conditions of a D&O liability policy, the most logical place to start would be an overview of the typical structure of a D&O policy.

Insuring Clause A of the D&O policy extends coverage to the individual directors and officers in the event the corporation cannot or does not provide indemnification to them for their wrongful acts. The most notable example of these types of claims are derivative action matters where the corporation may be prohibited from providing indemnification or bankruptcy claims where the corporation does not have the financial wherewithal to honor their indemnification obligation. Recent trends in litigation indicate that such lawsuits are becoming more common. Some examples of recent claims with "Side A" implications include: In re Disney (the Michael Ovitz litigation); In re Abbot Labs, and In re Emerging Communications.

Insuring Clause B is designed to cover the corporation for its indemnification obligation to the individual directors and officers. This provides a transfer of risk for the corporation to help protect its balance sheet and to help back up its indemnification responsibilities to the individual directors and officers. Most D&O claims against the individual directors and officers fall into this category.

Insuring Clause C extends coverage to the corporate entity for its own obligations, typically with respect to securities claims only.

Important Policy Terms

Fraud/Personal Profit exclusions and the issue of in fact vs. final adjudication language. D&O policies, purchased to protect against securities suits that allege fraud and profiteering by insiders, always include exclusions for fraud and personal profit. While excluding the essence of the lawsuits they are intended to protect against might seem to make the coverage meaningless, the exclusions must be individually applied to each insured party and include a high standard of proof.

The standard for applying these exclusions can be written as 'in fact' or 'final adjudication.' Most insurance carriers offer a spectrum of alternative language. We prefer language that prevents the insurer from denying a claim unless there is final adjudication of fraud or profiteering by the courts, preferably limited to the underlying action. In-fact wording, by comparison, allows the insurance carrier to deny coverage when they are reasonably satisfied that the decision will not be later shown to have been unreasonable, exposing the carrier to bad faith litigation.

The severability issue: protecting the innocent director and officer. It is important to negotiate policy language that provides protection for innocent directors and

officers in the event of securities litigation. Because securities suits involve accounting irregularities and often require the restatement of public filings that insurers rely on to underwrite D&O policies, particular attention must be paid to the wording to ensure that the insurance carriers cannot rescind the policy. Insurance carriers may be able to return the premium paid for the coverage and "rescind" the policy if they can show that the financials used to underwrite the policy were materially wrong. This is a significant issue in a litigation environment in which most significant securities litigation involves restatement—a public filing that is by definition an admission that a previous filing was materially wrong.

Severability provisions provide protection for the innocent individuals caught up in securities claims by limiting the rights of an insurance carrier to seek rescission. In the last five years, insurance carriers have increasingly used rescission as a means of avoiding coverage. Severability and rescission is a complicated analysis that involves the interplay of policy definitions, state law, and filings made with the Securities and Exchange Commission. Poor severability language has had significant consequences, particularly for directors in many recent cases. Special attention to severability language is crucial to ensure that coverage is there for innocent individuals.

Order or priority of payments provision—protection in bankruptcy. The D&O policy or an endorsement should state that payments are first available for the protection of the individual directors and officers. Only then can remaining funds be used to pay claims and the company's expenses. This provision states that in the event of a loss arising from a claim the carrier shall pay out in the following order.

1. First to any director or officer, when they are not already indemnified by the bank (Side A).
2. Next to the bank where it indemnified the individual director or officer for a claim made against that individual (Side B).
3. Lastly to the bank itself, for claims made against the bank (Side C).

In cases such as bankruptcy, without such a provision, it is possible that the policy will be considered an asset of the company, preventing defense costs being paid to protect the individual directors and officers. Insurers will typically add this wording for no additional premium; however it is up to the insurance broker to make sure that this is done.

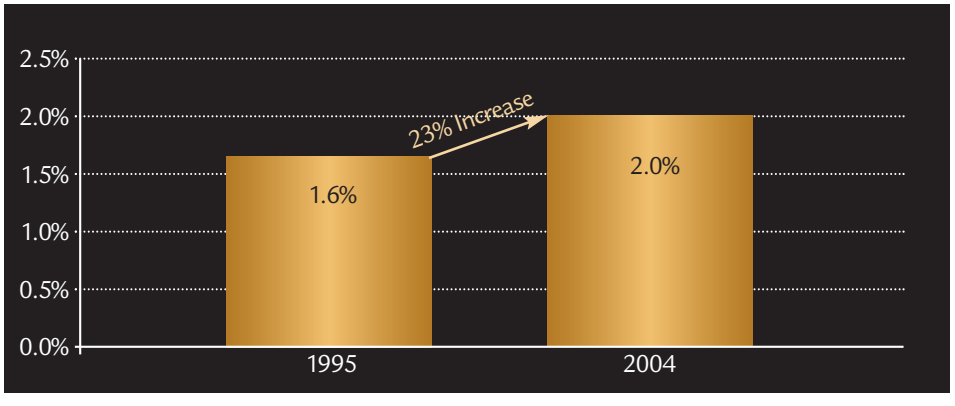
Side A coverage: maximum protection for individual directors and officers. Many companies are creatively restructuring their D&O programs by replacing a portion of their entity/corporate coverage with a separate non-rescindable Side A DIC (difference in conditions) policy.

Side A coverage refers to a section of a D&O policy stating the protection for individual directors and officers for non-indemnifiable loss. This can save the company a premium and provide extra limits available for situations where the primary policy cannot (derivative suits) or will not (unfavorable terms and conditions) react. The non-rescindable aspect of the coverage ensures that a claim cannot be denied as it applies to the non-culpable directors and officers.

D&O Checklist

- Aggressively participate in brokering your D&O program.
- Utilize an established and experienced D&O insurance carrier.
- Start the process early.
- Insist on direct meetings with insurance carrier underwriters.
- Determine whether you have sufficient policy limits.
- Investigate a separate non-rescindable Side A policy exclusively for the protection of the directors and officers, or investigate higher Side A limits with priority of payments provisions within the traditional policy.
- Learn the difference between the denial of a claim and rescission of your policy.
- Review your policy language carefully.
- Choose a broker with extensive experience in the D&O field.

Annual Probability of Facing a Securities Class Action Lawsuit Has Steadily Increased



Source: NASDAQ Insurance Agency LLC

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