SIMPSON THACHER MEMORANDUM

Is Your Management Liability Policy What It Should Be?

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In the current environment, every type of business entity – public corporations, privately held companies, investment firms, financial institutions, non-profit organizations, advisors, consultants and others – should be aware that significant variations exist among liability insurance policies that provide coverage for their directors, officers, general partners, managers, and others involved in managing a business. Whether or not a policy includes a particular provision or endorsement can greatly expand – or narrow – the scope of coverage. In the wake of the investigations, administrative proceedings and litigations arising from the recent financial downturn, this is an optimum time to assess whether your company's management liability policies provide the appropriate breadth of coverage.

Management liability policies (generically, "D&O" policies) may have limitations in coverage that a firm may not recognize until it is about to make a claim. The scope of coverage available under D&O policies can vary significantly. Close scrutiny of proposed policy language when coverage is being obtained or renewed is essential to understanding the policy's terms, exclusions, conditions, and limitations. If your business does not neatly fit within the confines of "form" policies, it is possible to explore manuscript policies, tailored to address particular risks unique to your firm's enterprise. The following policy provisions, in particular, warrant careful consideration:

Basic Coverage Clauses: Sides A, B, and C. D&O policies typically provide three types of coverage. Side A provides liability coverage to the individual directors and officers. Side B provides reimbursement coverage to the company for claims for which it indemnifies its directors and officers. Side C provides "entity" coverage to the company for corporate liability such as securities claims. These coverages can be expanded by the inclusion of other optional insuring provisions which may provide: (i) coverage for civil, criminal, administrative or regulatory investigations by government agencies or authorities; (ii) derivative demand investigative cost coverage for amounts incurred in conducting an internal investigation triggered by a shareholder derivative demand, and (iii) crisis management coverage for amounts incurred in responding to circumstances such as restatements of financials, negative earning or sales announcements, product recalls, mass torts, or loss of key personnel.

Presumptive Indemnification. D&O policies generally presume that the company will indemnify its directors and officers up to the fullest extent permitted by law. Individual directors and officers, therefore, should look first to the company for indemnification. Side A coverage provides a backstop and generally responds only when the company is unable – either legally or financially – to indemnify the individual.

Non-Rescindable Coverage and Severability. D&O coverage is shared, often among numerous individual directors and officers. An issue that may arise, therefore, is whether the

insurer can rescind the policy against all insureds based on a material misrepresentation in the policy application by a single insured. Some D&O policies state specifically that the policy is non-rescindable as against any individual insured, and many D&O policies today will offer such a provision. In addition, to the extent the insurer has the right to rescind coverage under certain conditions, there should be adequate "severability" language, precluding the insurer from relying on a single insured's misrepresentation to void coverage for all insureds. Policies should be reviewed to confirm the presence of these terms.

Definition of Insured. The definition of "Insured" should be reviewed carefully to ensure that it includes those directors, officers and other individuals and entities the company wishes to cover. On the other hand, it should not be overly broad so as to potentially dilute the available coverage. For example, D&O policies typically extend coverage to persons serving as outside directors with the knowledge and consent of the insured company. Separate endorsements may be warranted to clarify who is and is not insured.

Definition of Claim. The term "Claim" should capture the widest array of potential actions that could be brought against any insured. "Claim" should typically be defined to include any written demands for monetary or non-monetary (including injunctive) relief, civil and criminal proceedings, administrative or regulatory proceedings, civil, criminal, administrative or regulatory investigations by governmental authorities such as the SEC, Equal Employment Opportunity Commission, Department of Labor, Department of Justice etc., any arbitration, mediation or other dispute resolution proceeding, securities claims, shareholder derivative demands and extradition requests.

Definition of Loss. The "Loss" definition lays out the scope of costs and expenses the insurer will be obligated to reimburse. "Loss" should include all defense costs, settlements, judgments and any damages incurred in connection with a Claim, including punitive and exemplary damages to the extent insurable under applicable law. "Loss" should also include pre- and post-judgment interest and, where applicable, investigative costs.

Advancement of Defense Costs. A key benefit of a D&O policy is the ability of the insured to recover defense costs on a relatively current basis. Thus, a D&O policy typically provides for the insurer to advance defense costs for covered claims as such costs come due. It is helpful to have provisions that set forth the time within which the insurer agrees to reimburse defense costs, e.g., within 90 days of the insurer's receipt of defense invoices submitted by the insured.

Entity Coverage/Shared Limits. As noted above, Side C provides "entity coverage" for claims brought directly against the insured company. Side A, B and C coverage typically share a single policy limit. Thus, individual directors and officers could be financially exposed if claims against the company covered under Side C exhaust the available policy limit. This exposure may be addressed, in part, through a "priority of payments" provision, stating that when claims are brought against the company and the individual directors and officers, the individual insureds should be paid first. In addition, many companies opt to address this "shared limits" issue by purchasing a "Side A only" policy, which typically sits above the D&O coverage tower and is available exclusively to the company's directors and officers, often with broader "differences-in-conditions" coverage.

Insured vs. Insured Exclusion. A D&O policy typically excludes coverage for claims brought by one insured against another insured under an Insured v. Insured exclusion (the "IvI exclusion"). The basic purpose of the IvI exclusion is to protect insurers against potentially collusive claims for coverage where there is no actual dispute between one insured and another. Most D&O policies contain carveouts from the IvI exclusion that have the effect of restoring coverage for certain claims by one insured against another. For example, IvI exclusions may contain carveouts that restore coverage for shareholder derivative claims, whistleblower claims, claims by bankruptcy trustees, and claims by insured individuals who have not been directors or officers in several years. A company should carefully evaluate its need to include such carveouts to enhance coverage.

Conduct (Fraud, Personal Profit) Exclusions. D&O policies typically contain "conduct" exclusions barring coverage for claims arising out of criminal, fraudulent, or deliberately dishonest acts, willful violations of law, or the gaining of personal profit to which an insured is not legally entitled. Conduct exclusions may provide that they apply only if a final, non-appealable adjudication adverse to the insured establishes that the alleged criminal, fraudulent or deliberate act occurred or that improper personal profit was obtained. If such language appears in the D&O policy, the insurer typically will undertake to advance defense costs unless and until there has been such a final adjudication. It is also common for the conduct exclusions to contain severability language, such that wrongful acts of one insured will not be imputed to any other insured for the purpose of applying such exclusions.

Tail Coverage/Extended Reporting. Most D&O policies provide the insured company with an option to purchase an extended reporting period (known as a "tail" period) in which to report claims made after the policy expires that are related to wrongful acts committed prior to expiration. In some policies, this option is triggered only if the insurer cancels or refuses to renew the policy. Some insurance policies allow this option to be triggered if either the insurer or the insured cancels or chooses not to renew the policy.

Other Exclusions. Other exclusions that appear from time to time in D&O policies relate to restatements of financial results, financial impairment, acts of war or terrorism, pollution, commissions and payments to customers, political contributions, professional services, and the failure to maintain other insurance. Policyholders should evaluate whether it makes sense to negotiate the scope of these provisions.

Other Provisions. Other provisions that warrant scrutiny in D&O policies relate to notice requirements, allocation, changes in control or status of the company, newly-created subsidiaries, mergers and acquisitions, and coverage territory.

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