Simpson Thacher

Memorandum

Is Your D&O Insurance What It Should Be?

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Every business entity and non-profit organization bears some risk arising from the activities of its management—public corporations, privately held companies, investment firms, financial institutions, charitable foundations, advisors, consultants and others. Insurance for such risk is widely available, but significant variations exist among policies that provide coverage for directors, officers, general partners, managers, and others involved in management (generically, "D&O" policies). Importantly, whether or not a D&O policy includes a particular provision or endorsement can impact the outcome of a request for coverage. A firm may not recognize limitations in its D&O policy, however, until a claim or potential claim arises. Of course, it is difficult to predict when or how a lawsuit, governmental investigation, securities claim, arbitration or other action targeting management may arise. This is a good time to assess whether your management liability policy provides the appropriate breadth of coverage.

Close scrutiny of proposed policy language when coverage is being purchased or renewed is essential to understanding the policy's terms, exclusions, conditions, and limitations. If your business or organization 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.

Pre-Claim Inquiry Coverage

Courts continue to uphold D&O insurers' declination of coverage for investigations by the Securities and Exchange Commission ("SEC") and other government investigations that do not target a specific director or officer but seek documents and interviews without specifying the alleged wrongdoing that is the focus of the investigation. Such investigations may not constitute a "Claim" under a D&O policy. Thus, there may be no coverage for the costs of complying with subpoenas and other investigative efforts. Certain D&O policies offer provisions that afford at least some coverage. For example, policies will provide "Pre-Claim" coverage or "Noticed Investigations" coverage. Essentially, if an investigation does not constitute a Claim but later develops into a Claim, coverage will relate back to the point at which the investigation began, subject to certain limitations. Thus, the policyholder can keep track of its costs in connection with an investigation and if it turns into a Claim, those costs may be covered. Some D&O policies provide coverage for complying with SEC subpoenas and other similar investigations, e.g., in the form of "Inquiry Coverage," which may reimburse the insured for certain costs associated with preparing and accompanying directors, officers or other covered individuals who are called in for an interview by a government agency pursuing an investigation.

Employment Practices/Sexual Harassment Exclusion

D&O policies often exclude coverage for employment practices or sexual harassment claims. Such claims are typically addressed by an employment practices liability policy. It is important to review any employment practices exclusion or sexual harassment exclusion that may appear in a D&O policy to avoid any coverage gap. For example, if a securities claim or a claim against the company, directors or officers alleges mismanagement for allowing sexual harassment to take place, the company would want to secure coverage for that mismanagement claim. A case settled by 21st Century Fox highlights this issue. The settlement resolved a derivative suit against the company brought by its shareholders. The shareholder derivative suit alleged that the company's management allowed a culture of sexual and racial harassment, resulting in financial harm to the company. A press release issued by 21st Century Fox indicated that at least part of the settlement would be funded by insurers, without specifying which insurers and what type of coverage was involved.

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, 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. The basic purpose of the Insured vs. Insured ("I v I") 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 I v I exclusion that have the effect of restoring coverage for certain claims by one insured against another, such as shareholder derivative claims, whistleblower actions, 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 should provide that they apply only if a final, non-appealable adjudication adverse to the insured in the underlying action (not a coverage action) establishes that the alleged criminal, fraudulent or deliberate act occurred or that improper personal profit was obtained. Such language typically requires the insurer 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, newly-created subsidiaries, mergers and acquisitions, and coverage territory.

For further information, please contact either Elisa Alcabes or Steven R. DeLott:

Elisa Alcabes
+1-212-455-3133
ealcabes@stblaw.com

Steven R. DeLott
+1-212-455-3426
sdelott@stblaw.com

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-Gil, Jung-Gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000