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Directors and Officers Liability:

Take Steps In Order To Secure Insurance Coverage

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When catastrophe strikes—a lawsuit against directors and officers of a corporation, a charity, a governmental or quasi-governmental organization—consider the potential insurance coverage available under a directors and officers (D&O) liability insurance policy.

The Long Road

It takes years to resolve lawsuits against directors and officers. After that it takes even more years to resolve the resulting insurance claim for insurance coverage by the policyholder and its directors and officers. All too often steps taken by the policyholder during the early stages of the lawsuit against the directors and officers will be used by the D&O insurance company against the policyholder and its directors and officers during the years while the insurance coverage claim is pending.

When a claim is threatened or filed against the directors and officers, policyholders need to hit the ground running in the *right* directions. One direction is to obtain the best possible defense of the claim against the directors and officers. The other direction is toward insurance coverage.

Chronology

Year One, The Insurance Acquisition Phase—-The decision is made to buy a D&O insurance policy. Working with an insurance broker, an easy to answer application is completed. The questions are broad, but far from penetrating. Look out! When a loss happens, the insurance company is going to scrutinize the policyholder and each of its directors and officers.

Does the D&O insurance policy fit the policyholder, its by-laws, corporate charter, state corporation laws and other state laws? A D&O insurance company may deny insurance coverage, for example, for corporate indemnification if there is no corporate indemnification provision in corporate by-laws or charter or if indemnification has not, in fact, been made. A careful mesh must be made of the state corporation law, the corporate charter and the by-laws.

Year Two—The policy is purchased and the insurance begins. Then, a catastrophe happens; the directors and officers of a corporation are sued following a $20 million drop in the market value of the corporation's securities.

Insurance company D&O claims handlers have testified and will claim that the very purchase of D&O insurance raises a "red flag" in their minds. Their first assumption is that the policyholder purchased D&O insurance or increased the insurance coverage limits because it knew it was going to be sued. This leads the D&O insurance company claims handlers immediately to investigate and begin developing facts upon which a decision to deny insurance coverage can later be based. This goes back to the overwhelming importance of the application for D&O insurance referred to above in Year One.

Back to Year Two. The claims against the directors and officers have been filed or threatened. Since the policyholder is accentuating the positive, its lawyers conclude that it is not necessary to give notice of the claim or lawsuit to the D&O insurance company. This is a another misstep. Notice even a few days late, will result in a contention by the insurance company that all insurance rights are forfeited!

Give Notice. Give Notice. Give Notice

When a D&O claim is threatened, immediately send notice to the D&O insurance company. Notice is usually, and probably best given, by brokers and not by the policyholder's general counsel or outside counsel. If not already done, notice of the claim should also be provided to the insurance broker and the policyholder's risk management department.

A frequent misstep is the failure to make the policyholder's risk manager and broker key players at all stages of the D&O insurance claim process. D&O litigation often extends years into the future. D&O insurance companies use the passage of time to their advantage. To ensure that the policyholder is not manipulated along the way, participation by the risk manager and the broker must be secured at the beginning of the claims process. The participation should be ongoing.

Another common possible misstep during the early stages of D&O litigation is to rely on the policyholder's general counsel and its regular outside counsel for insurance coverage advice. The typical policyholder's general counsel usually lacks insurance expertise and the same may be true of outside counsel. Further, outside counsel frequently have "positional conflicts" since many represent insurance companies.

The Reservations of Rights Letter

When a policyholder submits a claim for directors and officers insurance coverage, insurance companies routinely respond with a long, legalistic and threatening reservation of rights ("ROR") letter. The ROR letter will generally set the boundaries for the insurance coverage dispute that will follow. These letters are largely incomprehensible and often request disclosure of highly confidential information. They usually recite the insurance company's position as to why insurance coverage may be denied or substantially reduced and usually list possible applicable exclusions. These letters shock and anger policyholders and, as a result, are often left unanswered. The effect of failing to respond to the ROR letter may be devastating.

Failing to respond may bind the policyholder to the D&O insurance company's ROR letter. A "must do" is to preserve the policyholder's rights with a response. The response can be as simple as: "We are in receipt of your letter and we disagree!" Unanswered letters are a mistake. Copies of the ROR letter and the response must be sent to each of the defendant directors and officers.

Send Monthly Status Reports

During the entire course of the case against the directors and officers, defense counsel should prepare and send monthly status reports and copies of bills showing all defense costs to the insurance company, the risk manager, the broker and monitoring counsel. Status reports should do more than update the insurance company, they should also be used as a vehicle to invite participation by the insurance company. Careful records should be kept of the time and expenses incurred directly by the policyholder's general counsel and these should be included in the regular reports. Internal policyholder legal expenses may be covered by the insurance policy.

In addition to the monthly status reports, provide the insurance company with a monthly billing statement detailing time and expenses incurred during the period.

The status reports and the underlying records must *exclude* time and expenses related to insurance coverage matters. Including these items may be grounds for insurance companies to argue that the policyholder waived work product and attorney/client privileges.

Years Three through Five—During this period, the policyholder's general counsel and outside counsel vigorously defend the lawsuit against the directors and officers. In Year Five, settlement negotiations with the class action lawyers begin.

During Settlement Discussions, Think Insurance

When participating in settlement discussions, bring the insurance company into the discussions; directly or indirectly. Seek resolution of any insurance coverage dispute as part of the underlying settlement. This is frequently impossible. The most that the policyholder will get is a statement from the insurance company that it "will not object" to the amount of settlement, but that it otherwise reserves its rights to deny insurance coverage.

The case against the directors and officers settles. Unstated is the proposition that the D&O insurance company will pay the $10 million settlement plus the $4 million of incurred defense costs.

At the End of Every Road

Year Six—-An insurance claim for $14 million is prepared and submitted to the D&O insur-

ance company. The insurance company denies insurance coverage.

Years Seven through Ten—The policyholder's regular outside counsel commences an insurance coverage lawsuit against the insurance company claiming $14 million. Another $1 million a year is spent by the policyholder for legal fees.

Year Eleven—The insurance coverage case is ready for trial. Settlement discussions with the insurance company begin. The insurance coverage case settles for $4 million.

The insurance company informs the policyholder that it intends to commence a subrogation action against the policyholders' outside counsel and accountants. The policyholder settles this by agreeing to pay an additional premium of $1 million per year for each of the ensuing three years. The policyholder has paid $22 million and has received $1 million.

Conclusion

D&O claims and D&O insurance coverage controversies are litigated over many years. Policyholders must be aware that missteps at very early stages may jeopardize their ability to collect insurance coverage from the D&O insurance company years in the future. Learning the rules to the insurance coverage "shell game" will help ensure that when the policyholder is faced with a D&O claim its insurance coverage will be available. ■

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