

**Directors' & Officers' Coverage Priorities  
in the Financial Crisis:**  
*A Seven-Point Inspection for Your D&O Policy*

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## **Directors' and Officers' Coverage Priorities in the Financial Crisis: A Seven-Point Inspection for Your D&O Policy**

Over the past year, the “financial crisis” has become a euphemism meaning different things to different people. For employees, the “financial crisis” may mean the loss of savings, wages or even a job. For thousands of homeowners, the “financial crisis” could suggest “foreclosure.” Alternatively, business owners may equate the “financial crisis” with an inability to obtain capital or a loss of revenue. For directors and officers, however, the “financial crisis” may also mean increased exposure, both in size and number, to claims by shareholders and regulators.

While opinions vary regarding the solution to the “financial crisis” as a whole, directors’ and officers’ (“D&O”) insurance is specifically intended to control the risk of suits, investigations and other proceedings against directors and officers. Yet, the dynamics of the current “crisis” have created new coverage issues and highlighted others with which every insured director or officer should be aware. Whether acquiring or renewing coverage or responding to a current claim, insured directors and officers should take inventory of their coverage to ensure that when viewed in the context of the “financial crisis,” their policies’ terms provide adequate protection against and those claims likely to arise from the present recession.

In particular, here is a series of questions constituting a seven-point inspection for your D&O policy. Understanding the issues presented by these questions and the analysis that follows will better position insureds to prepare for and respond to claims that otherwise could create a true “financial crisis” for corporate policyholders, directors and officers.

### **How Would A “Bankruptcy” Affect My Coverage?**

In the present economic climate, bankruptcy is a genuine risk for policyholders and insurers alike. In contrast to the 78 corporate bankruptcies filed in all of 2007, 139 U.S. firms, with assets of \$386.2 billion, sought bankruptcy protection or liquidation between January and July 2009.<sup>1</sup> Nearly an equal number of companies (138), with assets of \$1.16 trillion, filed for bankruptcy in 2008.<sup>2</sup> Apart from the general financial upheaval sustained by the company, its officers and directors, bankruptcy and the claims arising from bankruptcy create a unique set of issues for D&O insurance. Unless anticipated in advance, these issues can leave policyholders exposed at a time when they are most vulnerable financially.

Most D&O policies, for example, contain exclusions denying coverage for claims asserted “by or on behalf of” one insured against another.<sup>3</sup> These types of exclusions, collectively referred to as

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<sup>1</sup> Ben Steverman, *Bankruptcies: The Next Wave*, BUSINESS WEEK, at [http://www.businessweek.com/investor/content/jul2009/pi20090729\\_425780.htm](http://www.businessweek.com/investor/content/jul2009/pi20090729_425780.htm).

<sup>2</sup> *Id.*

<sup>3</sup> See, e.g., Chubb Form No. 14-02-0943 (Ed. 1/92), available at [www.irmi-online.com](http://www.irmi-online.com) (“The Company shall not be liable for Loss on account of any Claim made against any Insured Person: . . . brought or maintained by or on behalf of any Insured except: (i) a Claim that is a derivative action brought or maintained on behalf of an Insured Organization by one or more persons who are not Insured Persons and who bring and maintain the Claim without

the “insured v. insured” exclusion, were originally intended to prevent policyholders from colluding to reap the benefits of the insurance policy—not to eliminate coverage for truly adversarial claims.

However, in the context of claims asserted in bankruptcy, the “insured v. insured” exclusion may create unintended consequences for insured directors and officers. Specifically, those insured under a traditional D&O policy may include a “debtor-in-possession” or the equivalent outside the United States.<sup>4</sup> In cases where bankruptcy trustees or corporate receivers have asserted claims for damages *on behalf of* an insured company against its insured directors and officers, coverage has been found to be excluded by the “insured v. insured” exclusion, albeit inconsistently.<sup>5</sup> In order to avoid an unexpected loss of coverage in bankruptcy, policyholders should ensure that there is an explicit exception within the “insured v. insured” exclusion for claims asserted against directors and officers by a bankruptcy trustee or examiner of the insured entity or a rehabilitator, liquidator or comparable authority of the insured company.<sup>6</sup>

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the solicitation, assistance or participation of any Insured, (ii) a Claim brought or maintained by an Insured Person for the actual or alleged wrongful termination of the Insured Person, or (iii) a Claim brought or maintained by an Insured Person for contribution or indemnity, if the Claim directly results from another Claim covered under this coverage section . . .”).

<sup>4</sup> AIG Form 75011 (2/00), *available at* [www.irmi-online.com](http://www.irmi-online.com) (defining “Insured” as “Organization” and “Organization” “the resulting debtor-in-possession (or equivalent status outside the United States), if any” “in the event a bankruptcy proceeding shall be instituted by or against the company to whom the policy is issued.”).

<sup>5</sup> *Compare Stratton v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa.*, 2004 U.S. Dist. LEXIS 17613 (D. Mass. Sept. 3, 2004) (concluding that an insured v. insured exclusion precluded coverage for claims asserted by a successor company in bankruptcy against its predecessor’s former directors and officers); and *TIG Specialty Ins. Co. v. Koken*, 855 A.2d 900 (Pa. Commw. Ct. 2002) (holding that claims asserted by a regulatory receiver against a health plan’s directors and officers were not covered under a D&O policy excluding coverage for claims against any insured brought by, on behalf of or at the behest of the Company, its successor, its assignee, its trustee in bankruptcy, its debtor-in-possession, or its litigation trustee); *with In re Laminat Kingdom, L.L.C.*, 2008 Bankr. LEXIS 805 (S.D. Fla. Mar. 13, 2008) (“[T]he Trustee in this case is a legal entity separate and distinct from the Debtor, prosecuting claims that are not the Debtor’s, therefore, the ‘insured v. insured exclusion’ in the Policy does not apply.”); *Fed. Ins. Co. v. Cont’l Cas. Co.*, 2006 U.S. Dist. LEXIS 85323 (W.D. Pa. Nov. 22, 2006) (finding that claims asserted by a litigation trust established pursuant to a bankruptcy plan against directors and officers of the debtor company were not precluded by an insured v. insured exclusion denying coverage for claims against insured persons brought or maintained by or on behalf of any insured except a claim that is a derivative action brought or maintained on behalf of an insured organization by one or more persons who are not insured persons and who bring and maintain the claim without the solicitation, assistance or participation of any insured); *QBE Int’l Ins. Ltd. v. Clark*, 2003 U.S. Dist. LEXIS 19106, at \*17–22 (N.D. Ill. Oct. 23, 2003) (preserving coverage for claims asserted by a trust liquidator against former trustees notwithstanding the insured v. insured exclusion because “[w]e find no textual support either in the code or in the insured v. insured exclusion for making the question of coverage turn on whether the participant’s claim was asserted before or after the liquidation order”); *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 404 (D. Del. 2002) (“The court agrees with the D&O plaintiffs and the estate representative that the ‘insured v. insured’ exclusion should not apply to claims brought by a bankruptcy Estate Representative against the former directors and officers of the Debtor where the Debtor is the insured entity, because the Debtor’s Estate Representative (the RAG Estate) and the Debtor (RAG) are separate entities.”).

<sup>6</sup> *See, e.g.*, AWAC Form DO 00027 00 (05/07), *available at* [www.irmi-online.com](http://www.irmi-online.com) (“This policy shall not cover any Loss in connection with any Claim: . . . brought by or on behalf of the Company or an Insured Person, . . . ; provided, however, that this exclusion shall not apply: . . . to any Claim brought or maintained by or on behalf of a bankruptcy or insolvency trustee, examiner, receiver or similar official for the Company or any assignee of such trustee, examiner, receiver or similar official . . .”).

In addition to the “insured v. insured” exclusion, bankruptcy can pose other risks to coverage available for insured directors and officers. Unless carefully addressed in policy terms, insolvency can impair the insured organization’s ability to indemnify directors and officers for covered loss, leaving the director/officer’s personal assets potentially exposed to a policy “retention” or deductible, *i.e.*, the amount of loss that must be paid by the insured before an insurer is obligated to begin paying for a covered claim.

The applicable retention, in many policies, depends on whether the loss is one for which the insured director/officer has obtained or is entitled to obtain indemnification from the insured organization.<sup>7</sup> Loss payable by directors/officers, who are entitled to corporate indemnity, may be subject to a retention of thousands or even millions of dollars. By contrast, in order to protect the personal assets of insured directors and officers, many policies do not require any retention to be satisfied by those, whose company’s by-laws do not require or permit indemnification for a given claim.<sup>8</sup> However, in spite of this intentional scheme to shield non-indemnified directors and officers from personal risk of loss within a policy “retention,” a director/officer may nonetheless be forced to bear the financial brunt of a retention if the claim is one for which the insured entity is required or permitted to indemnify the director/officer but cannot because of insolvency.

Some policies explicitly provide that “[n]o Deductible Amount shall apply to Loss incurred by any Insured Person for which the Insured Organization is not permitted by common or statutory law to indemnify, or is permitted or required to indemnify, but is not able to do so by reason of Financial Impairment.”<sup>9</sup> Others do not. Given the financial burden a “retention” could otherwise create for an insured director/officer, it is important to include terms limiting the amount of the retention, if any, that may apply when corporate indemnity for directors and officers is interrupted by bankruptcy.

Even if a policy anticipates and eliminates exorbitant deductibles in bankruptcy, provision should also be made to ensure that policy proceeds are not commandeered by the bankruptcy estate or the insured entity, but remain available to indemnify or pay loss on behalf of insured directors/officers. There is always the risk that the finite limits provided by a policy or even multiple layers of coverage may be insufficient to pay the “loss” allegedly owed by both a corporate insured and its individual officers and directors. This issue, however, is magnified in bankruptcy, where the proceeds of a policy insuring both the debtor and its directors and officers

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<sup>7</sup> See, e.g., AIG Form 75011 (2/00), available at [www.irmi-online.com](http://www.irmi-online.com) (“For each Claim, the Insurer shall only be liable for the amount of Loss arising from a Claim which is in excess of the applicable Retention amounts stated in Items 4(a), 4(b) and 4(c) of the Declarations, such Retention amounts to be borne by an Organization and/or the Insured Person and remain uninsured, with regard to all Loss other than Non-Indemnifiable Loss. . . . No Retention amount is applicable to Crisis Loss or Non-Indemnifiable Loss.”).

<sup>8</sup> See also *id.* (defining “Non-Indemnifiable Loss,” for which no retention amount is applicable, as “Loss for which an Organization has neither indemnified nor is permitted or required to indemnify an Insured Person pursuant to law or contract or the charter, bylaws, operating agreement or similar documents of an Organization.”).

<sup>9</sup> See XL Form ELX0001\_0503 (Ed. 5/2003), available at [www.irmi-online.com](http://www.irmi-online.com) (emphasis added).

may be deemed the exclusive property of the estate for the benefit of creditors and shareholders.<sup>10</sup>

In order to conserve policy limits for those least able to compensate for the absence of insurance, *i.e.*, the directors and officers, terms have been adopted in some policies to give priority to insurance payments made on behalf of non-indemnified directors and officers.<sup>11</sup> Policies incorporating such terms require that claims against individual directors and officers be paid first before claims against the company. Other policies provide for a specific allocation of proceeds between the insured organization and its directors and officers.

Alternatively, to guarantee that sufficient policy limits remain available to protect non-indemnified directors and officers, stand-alone Side A coverage, *i.e.*, policies insuring just individual directors and officers without providing entity or company reimbursement coverage, may be purchased to insulate individual insureds from the claims of a debtor estate.<sup>12</sup>

While bankruptcy may be an ever-present risk to companies, large and small, in the current financial crisis, bankruptcy need not create additional risks to the coverage available to insured directors and officers. The “insured v. insured” exclusion can be modified to preserve coverage for claims asserted against directors and officers by a trustee or receiver in bankruptcy. “Retention” and “deductible” provisions can be crafted to reduce or eliminate the retention that might otherwise apply when the insured organization is required but unable to indemnify directors and officers due to insolvency. Side A coverage and/or priority of payments provisions may also be purchased to keep proceeds intended to protect directors and officers from the reach of company creditors.

### **How Does My Coverage Differ From One Layer To The Next?**

While the litigation arising out of the current financial crisis is far from over, there are already indications that subprime and related securities litigation may be exceptionally expensive to defend and resolve. Earlier this year, for example, Merrill Lynch agreed to pay \$475 million to settle class action claims that, among other things, Merrill Lynch misrepresented the firm’s

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<sup>10</sup> See, e.g., *In re World Health Alternatives, Inc.*, 369 B.R. 805, 810 (D. Del. Bankr. 2007) (“When a policy covers the debtor and its directors and officers, and there is a risk that payment of proceeds to the directors and officers will result in insufficient coverage of the debtor, then the proceeds are property of the estate, and any attempts to obtain the proceeds are prohibited under the automatic stay.”); cf. *In re Equinox Oil Co., Inc.*, 330 F.3d 614 (5th Cir. 2002) (“We are satisfied that the proceeds of the National Union policy are property of the bankruptcy estate.”).

<sup>11</sup> See, e.g., XL Form ELX0001\_0503 (Ed. 5/2003), available at [www.irmi-online.com](http://www.irmi-online.com) (“In the event of Loss arising from one or more Claims for which payment is otherwise due under this Liability Coverage Section but which Loss in the aggregate exceeds the remaining available Limit of Liability for this Liability Coverage Section, the Company shall: (1) first pay such Loss for which coverage is provided under Insuring Clause (A) of this Liability Coverage Section; then (2) with respect to whatever remaining amount of the Limit of Liability is available after payment of (1) above, pay such Loss for which coverage is provided under any other Insuring Clause of this Liability Coverage Section.”).

<sup>12</sup> Cf. *In re La. World Exposition, Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987).

exposure to collateralized debt obligations (“CDOs”) containing subprime mortgage debt.<sup>13</sup> Policyholders facing such costly subprime and related claims may need to draw on the full limits of their D&O tower. It is, therefore, imperative that the insured’s D&O program is prepared to respond to a single claim that could reach into multiple layers of coverage.

In any given D&O program, there may be an assortment of different contracts underwritten by a conglomeration of foreign and domestic insurers. In some cases, the excess policies in the tower may strictly incorporate and follow the terms of the underlying primary insurance. At other times, each layer may be subject to differing language, including different terms relating to who is insured, what exclusions apply, what law will govern the contract, and the manner in which disputes over coverage will be resolved.

Variations in policy terms between layers can unduly complicate coverage for claims implicating multiple policies. Depending on the terms of the subject policies, an insured may be compelled to file separate actions in different venues applying varying laws in order to obtain coverage for a single claim. At a minimum, unless the effort is made to ensure consistency among individual layers of excess coverage, resources that might otherwise be applied to defend against underlying liability or to resolve substantive coverage issues may be diverted to ancillary issues relating to jurisdiction and choice-of-law. In *In re Enron Corporation Securities Derivative & “ERISA” Litigation*, 391 F. Supp. 2d 541, 577–79 (S.D. Tex. 2005), for example, although the Court ultimately retained jurisdiction over the D&O insurers’ statutory interpleader action, the parties and the court were nonetheless forced to litigate inconsistencies in arbitration clauses between coverage layers as well as competing choice-of-law provisions in separate policies. Most of these types of complications can be avoided at the outset by negotiating and procuring consistent terms among excess coverage layers and between all subscribers to a single policy—particularly with respect to issues such as alternative dispute resolution, choice of law, and choice of forum.

### **Can I Trigger Coverage Under An Excess Policy By Payment Of A Settlement Or Judgment Within That Policy’s Limits?**

In the current financial crisis, insolvency is a risk—not only for insured corporations—but also their insurers. Most notably, AIG, whose subsidiaries include underwriters of D&O insurance, has accepted \$182 billion in federal funds as a result of the insurance company’s exposure to and participation in the “financial crisis.”<sup>14</sup> While devastating for the carrier, insurer insolvency can create gaps within a D&O tower, which could jeopardize excess coverage for directors and officers. Ensuring a means of filling those gaps is important to insured directors and officers faced with claims arising out of the financial crisis.

The coverage provided by a true excess policy is triggered only after the limits of all underlying policies have been exhausted. Although some excess policies allow the insured to exhaust

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<sup>13</sup> See Kevin LaCroix, *Merrill Lynch Enters Massive Subprime Securities Lawsuit Settlements*, THE D&O DIARY (Jan. 19, 2009), available at [www.dandodiary.com/2009/01/articles/subprime-litigation/merrill-lynch-enters-massive-subprime-securities-lawsuit-settlements](http://www.dandodiary.com/2009/01/articles/subprime-litigation/merrill-lynch-enters-massive-subprime-securities-lawsuit-settlements).

<sup>14</sup> See, e.g., Mary Williams Walsh, *After Rescue, New Weakness Seen at A.I.G.*, THE NEW YORK TIMES (July 30, 2009), available at [www.nytimes.com/2009/07/31/business/31aig.html?pagewanted=1&\\_r=2&hp](http://www.nytimes.com/2009/07/31/business/31aig.html?pagewanted=1&_r=2&hp).

underlying policy limits by payment of “covered” damages either through settlement or satisfaction of a judgment, other policies’ terms require that the underlying insurer(s) actually pay or be found liable to pay all underlying policy limits before the excess carrier will be required to respond. In the past, courts have sustained this requirement by reasoning that to allow an insured to trigger an excess policy before the underlying carrier had contributed the full limits of its policy would “remove the incentive of the primary insurer to defend in good faith or to discharge its duty . . . to represent the interests of the excess carrier.”<sup>15</sup>

However, when the policy calls for exhaustion only by the underlying insurer, a coverage dispute, bankruptcy or other event compromising the primary layer or other underlying limit of insurance can sabotage remaining policy limits. Recognizing this, other courts have concluded that “[t]o require an absolute collection of the primary insurance to its full limit would in many, if not most, cases involve delay, promote litigation, and prevent an adjustment of disputes which is convenient and commendable.”<sup>16</sup>

While the case law addressing exhaustion of underlying limits is somewhat inconsistent, the common thread between these cases is the importance of the policy language in determining the outcome for the policyholder. Here is a sample of how some specific policy terms have been interpreted in recent decisions:

Entitling the Insured to Exhaust Underlying Limits		Requiring Exhaustion by Underlying Insurers	
<i>HTLH Corp. v. Agricultural Excess &amp; Surplus Ins. Co.</i> , 2008 WL 3413327, at *15 (Del. Super. Ct. July 31, 2008).	"Only in the event of exhaustion of the Underlying Limit by reason of the insurers of Underlying Insurance, or the insureds in the event of financial impairment or insolvency of an insurer of the Underlying Insurance, . . . , this policy shall continue in force as primary insurance . . . ."	<i>Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London</i> , 73 Cal. Rptr. 3d 770 (Cal. App. Ct. 2008).	"Underwriters shall be liable only after the insurers under each of the Underlying Policies have paid or have been held liable to pay the full amount of the Underlying Limit of Liability."
<i>Pereira v. Nat'l Union Fire Ins. Co.</i> , 2006 WL 1982789, at *7 (S.D.N.Y. July 12, 2006)	"The Company shall provide the Insured with insurance excess of the Underlying Insurance . . . only after all Underlying Insurance has been exhausted by actual payment of claims or losses thereunder."	<i>Comerica Inc. v. Zurich Am. Ins. Co.</i> , 498 F. Supp. 2d 1019, 1032 (E.D. Mich. 2007).	"In the event of the depletion of the limit(s) of liability of the 'Underlying Insurance' solely as a result of actual payment of loss thereunder by the applicable insurers, this Policy . . . shall continue to apply to loss as excess over the amount of insurance remaining . . . ."

Given both the rising risk of insurer insolvency and the potential for a single claim implicating multiple layers of coverage, directors and officers should ensure that their excess D&O policies

<sup>15</sup> See *United States Fire Ins. Co. v. Lay*, 577 F.2d 421, 423 (7th Cir. 1978).

<sup>16</sup> *Zeig v. Mass. Bonding & Ins. Co.*, 23 F.2d 665, 666 (2d Cir. 1928).

expressly allow the insured to trigger coverage through payment of a judgment or settlement—without relying on the actual payment by an underlying carrier.

### **Will The Insurer Pay The Cost Of Defending A Claim?**

Just as high-dollar settlements may become a hallmark of litigation arising out of the financial crisis, the cost of defending subprime and related securities litigation could be equally staggering.<sup>17</sup> Therefore, understanding and maximizing coverage for defense costs is critical for directors and officers defending claims arising out of the financial crisis.

Unlike most general liability insurance imposing a duty to defend on the issuing insurer, D&O insurance typically enables the policyholder to select its own counsel (albeit oftentimes from a panel of firms pre-selected the insurer) and to control the defense of a claim, subject to the reasonable consent of the insurer.<sup>18</sup> Although D&O insurers are not usually obligated to “defend” insured directors and officers, D&O carriers are nonetheless obligated to pay “loss,” including “defense costs,” and the duty to pay is determined in the same manner as the “duty to defend”—by reference to the allegations of the underlying complaint for which coverage is sought.<sup>19</sup>

While the insured is contractually in control of its own defense, many insurance carriers attempt to assert indirect control over defense counsel through the use of “billing” or “litigation management” guidelines. These so-called “guidelines” purport to restrict or eliminate payment for inter-office conferences, duplicate attendance at depositions or hearings, computerized legal research, and even such expenses as telecopier charges, secretarial overtime, long-distance telephone charges, and courier fees.

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<sup>17</sup> See, e.g., J. Robert Brown, *US v. Stockman and the Burn Rate on the D&O Policy*, [THERACETOTHEBOTTOM.ORG](http://THERACETOTHEBOTTOM.ORG) (June 2, 2008), available at [www.theracetothetbottom.org/stockman/us-v-stockman-and-the-burn-rate-on-the-do-policy.html](http://www.theracetothetbottom.org/stockman/us-v-stockman-and-the-burn-rate-on-the-do-policy.html) (detailing the exhaustion of a \$50 million tower of D&O insurance through defense costs accruing at a rate of \$1.67 million per month).

<sup>18</sup> See, e.g., *Executive Risk Indem., Inc. v. Jones*, 89 Cal. Rptr. 3d 747, 751 n.4 (Cal. Ct. App. 2009) (“D&O Policies are indemnity-only policies, whereby the insurer reimburses defense expenditures only after the insured selects counsel, controls the defense, and submits the defense bill.”); see also AIG Form 75011 (2/00), available at [irmi-online.com](http://irmi-online.com) (“The Insureds shall select a Panel Counsel Firm to defend the Securities Claim made against the Insureds in the jurisdiction in which the Securities Claim is brought. In the event the Claim is brought in a jurisdiction not included on the list, the Insureds shall select a Panel Counsel Firm in the listed jurisdiction which is the nearest geographic jurisdiction to either where the Securities Claim is brought or where the corporate headquarters of the Named Entity is located. In such instance the Insureds also may, with the express prior written consent of the Insurer, which consent shall not be unreasonably withheld, select a non-Panel Counsel Firm in the jurisdiction in which the Securities Claim is brought to function as “local counsel” on the Claim to assist the Panel Counsel Firm which will function as “lead counsel” in conducting the defense of the Securities Claim.”).

<sup>19</sup> See, e.g., *Bodewes v. Ulico Cas. Co.*, 336 F. Supp. 2d 263, 271 (W.D.N.Y. 2004) (“[C]ases interpreting the scope of the insurer’s contractual duties under New York law have found ‘no relevant difference’ between the allegations that trigger an insurer’s duty to defend and allegations that trigger an insurer’s obligation to pay defense expenses”); *PepsiCo, Inc. v. Cont’l Cas. Co.*, 640 F. Supp. 656, 660 (S.D.N.Y. 1986) (finding a duty to pay all defense costs as incurred until the insurer “could establish as a matter of law that there was no possible factual basis on which it might be obligated to indemnify the directors and officers”).

The audits and fee deductions made by insurers pursuant to such litigation “guidelines” have sparked many disputes between policyholders, their lawyers and D&O carriers. However, it is important to remember that unless made a part of the insurance policy itself, billing guidelines do not alter the rights and obligations of the parties to the contract—the directors/officers and the insurer.<sup>20</sup> The textual requirement of most D&O policies is that defense costs be “reasonable”—not that they conform to some arbitrary billing guidelines.<sup>21</sup>

Moreover, defense counsel, as well as insurers, should be aware of the risks created when a D&O insurer becomes unduly intertwined in decisions driving the insured’s defense—particularly when there are unresolved coverage issues between the insurer and its insureds. For example, ethical standards in many states prohibit controls placed on defense counsel that could compromise counsel’s judgment in defending the insured.<sup>22</sup> Likewise, whether pursuant to an audit or otherwise, disclosure of attorney work product or privileged communications to an insurer, whose coverage positions overshadow the community of interest that might otherwise exist vis-à-vis opposing parties in the liability suit, creates an unnecessary risk of waiver.<sup>23</sup>

In short, most D&O policyholders have a contractual right to control their own defense and should therefore be wary of attempts by insurers to circumvent the policy’s terms through litigation “guidelines,” which could ultimately threaten the independence of defense counsel and confidentiality of the insured’s relationship with defense counsel. Understanding these rights

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<sup>20</sup> Cf. *Ulico Cas. Co. v. Allied Pilots Ass’n*, 187 S.W.3d 91, 104 (Tex. App.—Fort Worth 2005, pet. granted), *rev’d on other grounds*, 2008 Tex. LEXIS 769 (Tex. Aug. 29, 2008) (“[N]othing in the Association’s policy indicates that defense costs must be in compliance with the litigation management guidelines promulgated by Ulico . . .”).

<sup>21</sup> See, e.g., AIG Form 75011 (2/00), available at [www.irmi-online.com](http://www.irmi-online.com) (“Defense Costs” means *reasonable and necessary* fees, costs and expenses consented to by the Insurer (including premiums for any appeal bond, attachment bond or similar bond arising out of a covered judgment, but without any obligation to apply for or furnish any such bond) resulting solely from the investigation, adjustment, defense and/or appeal of a Claim against an Insured, but excluding any compensation of any Insured Person or any Employee of an Organization.” (emphasis added)).

<sup>22</sup> *In the Matter of the Rule of Professional Conduct and Insurer Imposed Billing Rules and Procedures*, 2 P.3d 806 (Mont. 2000) (concluding that (1) “the requirement of prior approval [for deposition scheduling, undertaking research, employing experts or preparing motions] fundamentally interferes with defense counsels’ exercise of independent judgment, as required by Rule 1.8(f), M.R. Prof. Conduct”; and (2) “disclosure by defense counsel of detailed descriptions of professional services to third-party auditors without first obtaining the contemporaneous fully informed consent of insureds violates client confidentiality under the Rules of Professional Conduct”); *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 634 (Tex. 1998) (Gonzalez, J., concurring) (“Some insurance companies impose billing restrictions and subject lawyers to billing audits. \*\*\* Some companies even dictate whether an attorney or a paralegal does some of the work. \*\*\* There is a real risk that these efforts at cost containment compromise a lawyer’s autonomy and independent judgment on the best means for defending an insured.”); State Bar of Texas Ethics’ Opinion No. 533 (“[I]t is impermissible under the Texas Disciplinary Rules of Professional Conduct for a lawyer to agree with an insurance company to restrictions which interfere with the lawyer’s exercise of his or her independent professional judgment in rendering such legal services to the insured/client.”).

<sup>23</sup> See, e.g., *Bovis Lend Lease, LMB, Inc. v. Seasons Contracting Group*, 2002 WL 31729693, at \*8 (S.D.N.Y. Dec. 5, 2002) (compelling production of correspondence between insurer and insured because (1) “[m]erely because a communication is between an insurer and insured does not render it privileged;” and (2) at the time this letter was written, the insurer was not defending the insured); *In re Imperial Corp. of Am.*, 167 F.R.D. 447 (S.D. Cal. 1995) (correspondence from insured to adverse insurance carrier was not privileged, and work product immunity was waived with respect to opinions and analysis contained therein).

and the policyholders' ability to resist the imposition of litigation "guidelines" will ensure that the D&O policy's coverage for defense costs is maximized—particularly when needed most in the current financial crisis.

### **When Is "Bad Conduct" Excluded Under My Policy?**

The claims asserted against directors and officers arising out of the financial crisis are, more or less, claims based on classic fraud. Shareholders allege that financial institutions understood but failed to disclose the risk of mortgage-backed securities and their exposure to such assets.<sup>24</sup> Investors claim that issuers misrepresented the value of mortgage-backed securities in offering documents.<sup>25</sup>

While these claims resonate with the traditional coverage provided by D&O insurance for "wrongful acts," allegations of deliberate "fraud" are also traditionally excluded from coverage by so-called "bad conduct" exclusions denying coverage for, among other things, claims "arising out of, based upon or attributable to the committing in fact of any deliberate criminal or deliberate fraudulent act by the Insured."<sup>26</sup> Of course, it is intuitively inconsistent for policies intended to insure directors and officers against, for example, securities claims to contain a *per se* exclusion of coverage for "fraud."<sup>27</sup> Yet, short of arguing that the "bad conduct" exclusions are invalid for rendering coverage illusory, policyholders can nonetheless take steps to ensure that such exclusions are sufficiently qualified so as to preserve coverage for, among other things, securities claims.

Specifically, many policy forms already contain "final adjudication" language whereby coverage is extended for allegations of fraud until such allegations are established by "a judgment or other final adjudication adverse to [the] Insured."<sup>28</sup> Other policies may permit the insurer to glean a finding of fraud from "a plea agreement, an alternative dispute resolution proceeding, a judgment, settlement or a final adjudication in the underlying action or in a separate action or proceeding."<sup>29</sup> Ordinarily, a guilty plea may not constitute a "final adjudication" for purposes of the traditional "fraud exclusion."<sup>30</sup> Nor would a settlement ever "establish" wrongful conduct by an insured.

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<sup>24</sup> See, e.g., *In re 2007 Novastar Financial, Inc. Securities Litig.*, 2009 U.S. App. LEXIS 19634 (8th Cir. September 1, 2009).

<sup>25</sup> See, e.g., *Bohl v. The Charles Schwab Corp.*, 1:08-CV-10593 (D. Mass.).

<sup>26</sup> See AIG Form 75011 (2/00), available at [www.irmi-online.com](http://www.irmi-online.com).

<sup>27</sup> See, e.g., *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 396 (D. Del. 2002) (finding that a policy's fraud exclusion did not apply to securities fraud claims because "[i]f the deliberate fraud exclusion applied to securities claims, there would be little or nothing left to that coverage." (collecting cases)).

<sup>28</sup> Zurich Form U-DO-100-A CW (5/93), available at [www.irmi-online.com](http://www.irmi-online.com).

<sup>29</sup> See Beazley Form BICPC00020705, available at [www.irmi-online.com](http://www.irmi-online.com).

<sup>30</sup> See, e.g., *Great Am. Ins. Co. v. Gross*, 2005 U.S. Dist. LEXIS 8003 (E.D. Va. 2005).

Policyholders, therefore, should be vigilant about the scope of events that trigger the “fraud exclusion” under the terms of their policies. The same principles apply to other “bad conduct” exclusions commonly found in D&O policies, including those provisions excluding coverage for “any personal profit or advantage gained by any of the Insured Persons to which they were not legally entitled.”<sup>31</sup> Ideally, policy terms should provide that only a final judgment in the underlying liability proceeding (as opposed to a subsequent coverage action) would be sufficient to establish either fraudulent conduct or an “illegal profit” against an insured director or officer for purposes of “bad conduct” exclusions.

Alternatively, with respect to any exclusion or limitation on coverage, the D&O policy should include clear terms whereby the application of a policy exclusion to one insured does not eliminate coverage with respect to all other insureds. “Severability” or “non-imputation” provisions are common in many policies, but directors and officers should examine the wording carefully to ensure that (1) facts pertaining to one insured do not compromise coverage for any other insured; and (2) knowledge or conduct of only a select individual or group of insureds can be imputed to the insured organization for purposes of any exclusion.<sup>32</sup>

### **Will My Policy Cover The Cost Of Regulatory Investigations As Well As Private Suits?**

The only thing more ubiquitous than the financial crisis itself is the increased regulatory oversight the crisis is expected to spawn. Even now, shareholder class actions are often pored with SEC investigations and enforcement actions.<sup>33</sup> Although an insured director or officer is arguably as likely to be named in a subpoena or investigation by the SEC as the same director or officer is to be named a defendant in a lawsuit, only some D&O policy forms make express provision for coverage for the cost of responding to a subpoena or regulatory investigation. Instead, D&O policies have historically limited those “claims” to which an insurer is required to respond to (1) a written demand for monetary damages; (2) a civil proceeding commenced by the service of a complaint or similar pleading; (3) a criminal proceeding commenced by a return of an indictment, or (4) a formal administrative or regulatory proceeding commenced by the filing of a notice of charges, formal investigative order or similar document.<sup>34</sup>

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<sup>31</sup> Beazley Form BICPC00020705, available at [www.irmi-online.com](http://www.irmi-online.com).

<sup>32</sup> See, e.g., AWAC Form DO 00027 00 (05/07), available at [www.irmi-online.com](http://www.irmi-online.com) (“In determining the applicability of Exclusions (a), (b) or (c), the facts pertaining to, the knowledge possessed by, or any Wrongful Act committed by, any Insured shall not be imputed to any other Insured; however, the facts pertaining to, the knowledge possessed by, or any Wrongful Act committed by, an Insured Person who is a past or current chief executive officer or chief financial officer of the Company shall be imputed to the Company.”). Likewise, directors and officers should pay similar attention to terms addressing severability of insureds for purposes of representations made in the policy application. Compare, e.g., *ClearOne Communications, Inc. v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa.*, 494 F.3d 1238 (10th Cir. 2007) (finding that a severability provision addressed only specific representations in an application and, therefore, did not prevent rescission) with *In re HealthSouth Corp. Ins. Litig.*, 308 F. Supp. 2d 1253 (N.D. Ala. 2004) (interpreting a non-imputation provision to prevent the insurer from rescinding a policy without showing that each individual insured knew of the alleged misrepresentation).

<sup>33</sup> See, e.g., Rachele Younglai, Karey Wutkowski, Tim Dobbyn and Brian Moss, *U.S. SEC probes subprime, builders, hedge funds*, REUTERS (Mar. 20, 2009), available at [www.reuters.com/article/topNews/idUSTRE52J3JP20090320?pageNumber=1&virtualBrandChannel=0](http://www.reuters.com/article/topNews/idUSTRE52J3JP20090320?pageNumber=1&virtualBrandChannel=0).

<sup>34</sup> See, e.g., Chubb Form 14-02-0943 (Ed. 1/92), available at [www.irmi-online.com](http://www.irmi-online.com).

In some cases, the cost of responding to regulatory investigations may be sufficiently related to the defense of a parallel civil “claim” to justify coverage.<sup>35</sup> Alternatively, policyholders may at the outset seek to include terms that expand the definition of “claim” to expressly insure defense costs or other loss relating to subpoenas and internal investigations undertaken in response to regulatory authorities or even shareholder demands.<sup>36</sup>

In the present litigation/regulatory environment, an investigation by a regulatory authority may be just as probable and just as expensive as a traditional lawsuit. Directors and officers, therefore, should ensure that their policies provide equal protection against both conventional “claims” and regulatory actions in whatever form, whether a subpoena, informal investigation, or formal enforcement proceeding.

### **What Constitutes “Loss” For Purposes Of Coverage Under My Policy?**

Most consumers of D&O insurance are familiar with the popular argument made by many insurers that certain categories of damages claimed in securities actions, as well as any damages in the nature of disgorgement or restitution, do not qualify as a “loss” insured under a typical D&O policy. Although definitions vary according to the policy, “loss” is generally defined as “damages, settlements, judgments (including pre/post-judgment interest on a covered judgment), Defense Costs and Crisis Loss; however, “Loss” (other than Defense Costs) shall not include: (1) civil or criminal fines or penalties; (2) taxes; (3) punitive or exemplary damages; (4) the multiplied portion of multiplied damages; (5) any amounts for which an Insured is not financially liable or which are without legal recourse to an Insured; and (6) matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed.”

However, regardless of how “loss” is defined, absent a specific provision to the contrary, many insurers understand “loss” to exclude the “restoration of an ill-gotten gain.”<sup>37</sup> Applying this

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<sup>35</sup> See, e.g., *Hansen Natural Corporation v. St. Paul Mercury Insurance Company*, 2:08-CV-05067-VBF (C.D. Cal. 2009) (order finding a genuine issue of fact precluding summary judgment denying coverage for the cost of conducting a special committee investigation in response to an investigation by the SEC).

<sup>36</sup> See, e.g., Chubb Form C33304 (11/2003 ed.), available at [www.irmi-online.com](http://www.irmi-online.com) (defining “claim” to include “a civil, criminal, administrative or regulatory investigation of an Insured Person for a Wrongful Act, once such Insured Person is identified in writing by such investigating authority as a person against whom a proceeding described in paragraph (b) above may be commenced. In the case of such investigation, subject to the terms and conditions of this policy, *Defense Costs shall be provided for any Insured Person who is served with a subpoena in connection with such investigation.*” (emphasis added)).

<sup>37</sup> *Level 3 Communications, Inc. v. Fed. Ins. Co.*, 272 F.3d 908, 910, 911 (7th Cir. 2001) (“An insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than ‘stolen’ is used to characterize the claim for the property’s return.”); *accord CNL Hotels & Resorts, Inc. v. Twin City Fire Ins. Co.*, 2007 WL 4705021 (11th Cir. Nov. 6, 2007) (finding that damages paid by an issuer insured in response to claims that the insured sold stock worth \$12 for \$20/share did not constitute insurable “loss”); see also *Alanco Techs., Inc. v. Carolina Cas. Ins. Co.*, 2006 WL 1371633, at \*4 (D. Ariz. May 17, 2006) (“Because rescissory damages are uninsurable under the law, and defense costs are recoverable only for covered losses, Plaintiffs have suffered no loss under the policy.”); *Nat’l Union Fire Ins. Co. of Pittsburgh, Pa. v. U.S. Bank, Nat’l Ass’n*, 2008 WL 2405975 (S.D. Tex. June 11, 2008) (following *Level 3* in a case involving claims for “severance payments” allegedly wrongfully retained by defendant).

principle, these same insurers have denied policyholders coverage for claims under Section 11 of the '33 Act on the basis that the damages available under the statute—essentially the difference between the amount paid for a security and its actual value—constitute nothing more than the return of proceeds to which the issuer was never entitled.

This argument, however, arguably does not apply when the same damages are sought from a defendant who never received or benefitted from the allegedly ill-gotten gain. For directors and officers of the issuer, accountants, and underwriters exposed to a judgment or settlement of a Section 11 claim, the same damages arguably do represent a “loss” rather than a restoration or disgorgement.<sup>38</sup>

In the context of litigation borne out of the financial crisis, those damages claimed against financial institutions are perhaps uniquely susceptible of characterization as “restitutionary.” It is, therefore, imperative that policyholders—whether engaged in financial services or otherwise—carefully negotiate the definition of the term “loss” in their D&O Policies, and if necessary, obtain a specific endorsement ensuring coverage for claims asserted under Section 11 of the '33 Act.

## Conclusion

When the story of the present financial crisis is written, at least one chapter will undoubtedly be devoted to answering questions about why economists and regulators did not anticipate or predict the collapse of worldwide credit markets and the ensuing economic turmoil. Yet, for directors and officers in the midst of the “financial crisis” it is not too late to anticipate those coverage issues that could arise in defending or resolving claims likely to surface in the present litigation and regulatory environment. Reviewing your policy using the foregoing seven-point inspection will help to prepare and maximize coverage when the real “financial crisis” arrives.

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<sup>38</sup> See, e.g., *Bank of Am. Corp. v. SR Int'l Business Ins.*, 2007 WL 4480057, at \* 13 (N.C. Super. Ct. Dec. 19, 2007) (distinguishing Level 3 on the basis that “[t]he damages claimed in the WorldCom Litigation were different,” i.e., “[t]he investment bankers were not issuers and did not receive the proceeds of the bond offerings”); cf. *Conseco, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 2002 WL 31961447, at \*16 (Ind. Cir. Ct. Dec. 31, 2002) (considering arguments that damages sought from individual director/officer defendants under Section 11 did constitute “loss” because such defendants “realized no gain when the securities were issued to the public” but ultimately concluding that the individual defendants paid no amount of the settlement or defense costs for which coverage was sought); see also *Liss v. Fed. Ins. Co.*, 2006 WL 2844468, at \*6–7 (N.J. Super. Ct. Oct. 6, 2006) (distinguishing Level 3 because (1) “no overriding public policy bars coverage for damages resulting from a civil wrong such as [underlying plaintiff] alleges”; and (2) plaintiff “sought damages (instead of rescission) because the acquired company was no longer viable, making it impossible to unwind the transaction and return the shares”); *Nutmeg Ins. Co. v. East Lake Mgmt. & Development Corp.*, 2006 WL 3409156, at \*7 (N.D. Ill. Nov. 22, 2006) (refusing to apply Level 3’s interpretation of “loss” to interest and damages claimed against a landlord equal to “two times the amount of the security deposit” under a professional liability policy); *Acacia Research Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 2008 WL 4179206, at (C.D. Cal. Feb. 8, 2008) (concluding that sums paid to settle an underlying claim of misappropriation did constitute loss because the “[a]ll the evidence presented in this case shows that Plaintiffs did not misappropriate any confidential information from Defendant,” i.e., “Plaintiffs claim that they agreed to the settlement . . . because they could not afford to litigate the case despite their innocence”); *Virginia Mason Med. Cntr. v. Executive Risk Indem. Inc.*, 2007 WL 347683, at \* (W.D. Wash. Nov. 14, 2007) (holding that damages sought in connection with differential pricing claims against a medical clinic did constitute legal damages as opposed to restitutionary damages distinct from the damages at issue in Level 3).