the Management file

The Pitfalls of Directors and Officers (D&O) Insurance

Insight for business owners and risk managers—provided by Proudfit Insurance

After assessing your company's risks, you've made the decision to purchase directors and officers (D&O) insurance. Now what?

It's essential to know the ins and outs of your D&O policy, including policy limits, what's covered and, most importantly, what's not. Why? Because you may assume you're covered for a claim when policy exclusions could apply. As time consuming as it may be, it's critical to read the fine print in your policy, as the language in the exclusions may affect the coverage of potential claims.

Types of Exclusions in D&O Policies

Some exclusions that insurers and insureds dispute about concern incidents that happened or allegedly happened before the D&O policy went into effect. In some cases, the insurer simply won't cover the claim; in other cases, the insurer may render the policy void.

- **The Known Circumstances Exclusion.** With this exclusion, the insurer will not pay for claims that arise from a negligent act, error, omission or personal injury that occurred prior to the start date of the D&O policy. The insurance carrier attests that the insured *knew or could have foreseen* that any of the above happened and could have been the basis for a claim. This exclusion is found more frequently in private and nonprofit policies than in public company policies. What is especially important to note is that the premium is usually not returned to the insured if it is determined that they withheld their knowledge of circumstances that occurred prior to the start of the policy.

  In the case of a **rescission** scenario, the premium is returned to the insured. Rescission means that the policy is rendered void after the insurer discovers that the insured answered untruthfully to any of the warranty questions on the insurance application. Warranty questions ask the applicant if they know of any fact, circumstance or situation that might reasonably be expected to give rise to a claim. Rescission also can occur if the applicant provided false or misleading information in the company's financial data. These scenarios usually happen only in public company D&O policies.

- **Prior Acts Exclusion.** Similar to the known circumstance exclusion, this exclusion is also concerned with pre-policy circumstances. The insurer is not responsible for wrongful acts committed or attempted before the coverage was enacted. A wrongful act is that which damages the rights of another. These acts are not only limited to criminal offenses, but can also include acts that result in civil lawsuits.

For informational purposes only.
Not intended as legal advice.
© 2012 Zywave, Inc. All rights reserved.

PROUDFIT
RISK SOLUTIONS

Other exclusions found in D&O policies revolve around the duty to defend and defense expenses in the event of a claim. If the insurer has the right to the duty to defend, then they are able to select the insured's defense and have greater control over the rates and billing practices of the defense counsel.

- **Reasonableness of Defense Fees.** This is more prevalent in private company and nonprofit D&O policies, as most of those policies give the insurer the right and duty to defend the insured's claims; whereas, public companies retain the right to choose their own defense counsel. If this is written into your D&O policy, it means that the insurer will only pay for "reasonable and necessary" defense fees. Some insurers also provide detailed information on litigation guidelines.

- **Consent to Settle and the Hammer Clause.** If the insurance carrier has no duty to defend, such as in cases against public companies, then they have no right to settle the case when they want to settle it. As a result, the insured may elect to continue with litigation, even if that would exhaust the policy limit, because the defendants don't want settling the case to be perceived as an admission of their wrongdoing or incompetence. This creates a lot of tension between insurers and the insured, especially if the insured does not include the insurer in the settlement discussion. Therefore, some insurance policies have a consent to settle exclusion in the policy, prohibiting the insured from settling the claim without the insurer's prior written consent.

  The hammer clause is similar to the consent to settle exclusion, although less common. Basically, the hammer clause informs the insured that if they go against the insurer's recommendation to settle, the insured will be responsible for any judgment won by the plaintiff plus legal fees that go beyond the settlement offer.

Most D&O insurers expect that D&O insurance is only a part of a company's wider insurance portfolio. In some cases, however, this assumption doesn't always prove to be true. Certain firms may go without Umbrella insurance or even General Liability insurance policies, making D&O one of their only forms of insurance. Because of this, many D&O insurers write exclusions in their policies stating what claims they won't cover because other types of insurance would potentially cover the claim.

- **"Other Insurance" Exclusions.** D&O insurance is just one form of insurance in a comprehensive risk management plan for most companies. Because of this, most D&O policies have exclusions for claims that involve bodily injury, property damage and Employee Retirement Income Security Act (ERISA) claims, which could be covered by other types of insurance such as a Commercial General Liability policy or a Fiduciary Liability policy. To protect their best interests in the event of a claim, the insured should notify all insurers from their various policies, thus allowing the insurers to determine who is liable for the claim.

- **Contractual Liability Exclusion.** This exclusion is especially pertinent to private companies and nonprofits that have broad entity coverage under a D&O policy. Since contractual obligations are not liabilities imposed by law but rather an obligation that is voluntarily undertaken, many D&O policies have an exclusion that prevents insurers from having to cover contract-related claims, especially breaches of contract that arise when the

company enters into a contract with another party.

When examining this exclusion in your D&O policy, make special note of the wording of this clause. This exclusion can substantially affect the extent of your coverage under the policy—the narrower the scope of the exclusion, the better for you.

D&O insurance protects directors and officers from poor business decisions, but most policies do not protect them from wrongful acts and gross misconduct. These exclusions include:

- **Conduct Exclusions.** Most D&O policies have exclusions that deny coverage for certain types of misconduct. There are two categories of misconduct exclusions:

  1. For loss relating to fraudulent or criminal conduct
  2. For loss relating to illegal profits or remuneration to which the insured was not legally entitled

  It's especially important to look at the wording on these exclusions in the policy; subtle wording differences can significantly impact the accessibility of the coverage.

- **Insured vs. Insured Exclusion**. In some D&O cases, one insured director may bring a claim against another insured director, and some insurers do not want to cover this because they don't want to get involved in the infighting between a company's directors and officers.

  However, with recent changes to the whistleblower provision of the Dodd Frank Act, most insurers are now agreeing to cover insured vs. insured claims if the whistleblower is also one of the insured directors.

Obtaining D&O insurance is important to protect the directors and officers of your company; but simply purchasing the policy won't benefit you unless you know the extent of your coverage.

Do you understand your D&O insurance policy? Contact Proudfit Insurance today for more information about your coverage and exclusions.