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TAXATION and REGULATION of FINANCIAL INSTITUTIONS

Directors and Officers Insurance Coverage After Dodd-Frank

In the wake of recent economic problems, and in light of the enhanced post-Dodd-Frank Act regulatory climate, a review of D&O coverage is a good idea. Banks and financial institutions are not the only companies under the magnifying glass, but they currently face intense scrutiny. The authors recommend that every company assess whether its D&O insurance program will cover the risks that it and its individual insureds expect the policy to cover; they identify specific issues to consider when evaluating D&O coverage or defending D&O claims.

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Financial institutions and other companies purchase, among other things, Directors and Officers (D&O) liability coverage to protect their directors and officers against claims alleging breach of their corporate duties and claims based on their status as directors and officers. Many companies also purchase D&O coverage to protect the company itself. When purchasing D&O insurance, companies—and the directors and officers they seek to protect—should recognize that policies may contain different wording and provide different levels of protection. Some D&O insurance policies, for example, contain broader exclusions and narrower definitions than do competing policies sold by other insurers. The present economic climate is favorable for insureds looking to purchase or alter their D&O coverage, and better coverage terms—at less cost—may be available today than in the recent past. In the current Dodd-Frank climate, every company should assess whether its D&O insurance program will cover the risks that the company and its individual insureds expect the program to cover. This article identifies some issues to consider when evaluating D&O coverage and defending D&O claims.

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BASIC ELEMENTS OF COVERAGE

D&O insurance policies typically include at least two coverage "parts." Subject to the policy's wording, Coverage Part A, commonly known as "Side A" coverage, requires the insurer to cover claims against directors and officers in the event that the company is not legally obligated to indemnify them, or is unwilling or unable to honor its indemnification obligations. Coverage Part B, or "Side B" coverage, requires the insurer to reimburse the corporation for such claims when it indemnifies its directors and officers. Side A coverage, therefore, is not implicated when a corporation properly indemnifies its directors and officers for covered claims.

Many insurance policies also include coverage for the company itself under Coverage Part C, or "Side C" coverage. Side C requires the insurer to cover the company for claims directly against it. Side C coverage often is limited to securities-related claims against public companies. Plaintiffs in securities actions usually name directors, officers, and the company itself as defendants. With Side C coverage, the directors, the officers, and the company all are protected against liability for covered securities-related claims and reimbursed for legal costs they incur defending such claims. Without Side C coverage, insurers may contend that, in the absence of policy wording to the contrary, the company must bear its own legal expenses and pay its share of any judgment or settlement, leading to thorny allocation issues if the company, its directors, and its officers share defense counsel.[1]

[1] Some insurers offer additional coverage parts that cover, among other things, expenses for certain investigation costs and claims arising out of service on outside non-profit boards.

Companies, accordingly, might prefer policies with Side C coverage because they eliminate a potential source of uninsured exposure and legal expenses. Directors and officers, however, should recognize that, when they are insured with the company under the same D&O policy or coverage tower, defense costs and settlements or judgments paid on behalf of the entity reduce the policy limits available to the directors and officers. In addition, individual directors and officers share these policy limits with each other. This might limit the amount of coverage available to each director and officer individually. Because defense costs generally reduce the limits of coverage under D&O policies, the defense of one hotly contested claim against a bad actor potentially could severely limit the amount of coverage remaining for the innocent officers and directors. If policy limits are exhausted, directors and officers could be personally responsible for any defense costs associated with the claims against them and for any related judgment or settlement. Under these circumstances, policyholders might be wise to carefully assess whether the available coverage limits are sufficient.[2]

BENEFITS OF ADDITIONAL DEDICATED SIDE A ONLY COVERAGE

Dedicated Side A Only coverage has become an increasingly common tool for protecting the personal assets of directors and officers. Dedicated Side A Only coverage can be purchased in addition to a traditional D&O policy. Only the individual directors and officers or other persons within the definition of insured enjoy the protections of a Dedicated Side A Only policy, since the entity is not an insured on it. This eliminates the possibility that claims against the company might exhaust all D&O coverage for the directors and officers, and Dedicated Side A Only coverage will respond if the company exhausts the traditional D&O insurance tower. Dedicated Side A Only coverage effectively provides an excess layer of coverage for only the directors and officers or other covered persons (hereinafter "directors and officers").

Dedicated Side A Only coverage affords other protections to directors and officers, too. Like all Side A coverage, it protects directors and officers against claims when the company does not indemnify them. Dedicated Side A Only coverage, however, often includes broader coverage grants and provides more expansive coverage than a typical D&O policy. Dedicated Side A Only policies may contain fewer exclusions, or exclusions that apply in more limited circumstances. They also may be written on a "difference in conditions" (DIC) basis and drop down to extend coverage, including when the D&O insurers on the traditional tower decline coverage wrongfully. And, as discussed below, Dedicated Side A Only coverage also typically ensures that directors and officers will have access to policy proceeds in the event that the corporation becomes insolvent.

Every year, more and more public companies purchase Dedicated Side A Only coverage. According to the 2010 TW Survey, more than 80 percent of public company respondents reported purchasing Dedicated Side A Only coverage, representing a significant increase over 2008.[3] Accordingly, it appears that Dedicated Side A Only coverage has become a staple of many D&O insurance programs.

IMPACT OF A COMPANY BANKRUPTCY

The bankruptcy of the corporation presents many potentially vexing D&O insurance issues for directors and officers. The possibility exists that D&O policies and their proceeds might become an asset of the bankruptcy estate in the event that a company becomes insolvent. If that occurs, policy proceeds may be unavailable, or access to the proceeds may be delayed for claims against the directors and officers, leaving them responsible for funding their defense and liable for any resulting judgment.

Courts generally agree that a traditional D&O policy itself, like most liability insurance policies owned by debtors, becomes an asset of the bankruptcy estate.[4] Courts differ, however, in determining whether the proceeds of a D&O policy are estate property. Some courts have held that whether the proceeds of a D&O policy are an asset of the bankruptcy estate is a case-by-case determination that depends on the language of the policy itself and may hinge on who is a named insured under the policy.[5] Often, the court's

[2] For more than three decades, Towers-Watson, a global consulting firm that helps companies manage risk, has conducted a survey of D&O insurance purchasing patterns and trends. Its 2010 Directors and Officers Liability Survey (the "2010 TW Survey") describes the policy limits reported by survey participants and notes that the vast majority of companies reported maintaining or increasing the limits of their D&O insurance programs in 2010. See Towers Watson, "Directors and Officers Liability Survey: 2010 Summary of Results," (2011), available at http://www.towerswatson.com/united-states/research/3790.

[3] See 2010 TW Survey, supra note 2, at 5.

[4] See, e.g., AC&S, Inc. v. Travelers Cas. & Sur. Co., 435 F.3d 252, 260 (3d Cir.), cert. denied, 126 S. Ct. 2291 (2006); Houston v. Edgeworth, 993 F.2d 51, 55 (5th Cir. 1993).

[5] In re Allied Digital Techs. Corp., 306 B.R. 505, 509-10 (Bankr. D. Del. 2004)(citing In re Minoco Grp. of Companies, Ltd., 799 F.2d 517, 519 (9th Cir. 1986)).

holding will depend on whether the D&O policy provides coverage only to the debtor-company. If that is the case, and only the debtor-company is protected by the D&O policy, the proceeds more likely will be considered an asset of the bankruptcy estate.[6] In contrast, D&O policy proceeds are less likely to be considered an asset of the bankruptcy estate when the D&O policy provides coverage only to the directors and officers.[7]

The determination becomes more complex when the D&O policy provides coverage to both the company and its directors and officers—such as when it contains Side C coverage. A policy that provides coverage to both the company and the individual directors and officers has greater potential to be considered an asset of the bankruptcy estate.[8] In cases where the policy proceeds may be insufficient to cover the needs of the debtor-company, courts are more likely to find the policy proceeds to be part of the bankruptcy estate in order to protect creditors.[9] If the D&O policy proceeds are considered an asset of the bankruptcy estate, directors and officers may be prohibited from gaining any access to the proceeds during the automatic stay that is put in place at the beginning of a bankruptcy proceeding, potentially requiring them to fund their own defense costs during the pendency of the bankruptcy proceeding—a potentially expensive undertaking.[10]

To reduce the chance that the proceeds of a D&O policy will become an asset of the bankruptcy estate, it may be appropriate to include a "priority of payments" clause that requires payment of the claims under Side A before payment of claims under the coverage parts benefiting the debtor-company. At least one court has enforced such a clause,[11] although the possibility exists that other courts applying a fact-sensitive analysis could disregard a priority of payments clause.

To have the best chance of avoiding a fact-sensitive battle in a bankruptcy proceeding, officers and directors may wish to consider ensuring that their company's D&O insurance program contains Dedicated Side A Only coverage. Dedicated Side A Only coverage helps to ensure directors and officers that their coverage will remain available and in force even after the corporation's underlying policy limits are exhausted. Since this type of coverage is available to provide coverage only for claims made against individual directors and officers, and provides no direct benefit to the corporation, the Dedicated Side A Only coverage policy proceeds typically should not be considered an asset of the bankruptcy estate and the proceeds are likely to be available to the officers and directors even during the duration of the bankruptcy proceeding's automatic stay.

COVERAGE FOR SEC AND OTHER GOVERNMENTAL INVESTIGATIONS

The Dodd-Frank Act expands the United States Securities and Exchange Commission's (SEC) oversight requirements and may lead the SEC to conduct additional investigations of companies and individuals. In addition, the Dodd-Frank Act's whistleblower provisions, which require the SEC to make monetary awards to persons who provide information leading to a successful enforcement action in which more than $1 million is recovered, also may trigger more SEC investigations. The SEC even accepts tips online.[12]

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Insurance coverage for SEC investigations remains a hot and evolving topic. Some D&O policies, insurers will argue, do not provide coverage for SEC investigations. Other policies extend coverage for SEC investigations and others only in limited circumstances. Coverage will depend on the language of the policy itself and the applicable facts and circumstances.

Some D&O policies define "Securities Claim" to include coverage for SEC investigations when the SEC takes formal steps to investigate an insured by indicating that the investigation is related to a possible violation of a regulation, rule, or statute, or if the SEC alleges a specific violation of a securities law. This typically occurs when the party being investigated is served with a subpoena "command[ing] the production of documents and threatens criminal

[6] Miller v. McDonald, 369 B.R. 805, 810 (Bankr. D. Del. 2007).

[7] Id.

[8] Id. (citing *Allied Digital Techs. Corp.*, 306 B.R. at 511).

[9] Id.

[10] Id.

[11] In re Enron Corp., Case No. 01-16034 (Bankr. S.D.N.Y. Apr. 11, 2001) [Docket No. 3278].

[12] The SEC accepts tips online available at https://denebleo.sec.gov/TCRExternal/questionaire.xhtml.

penalties for noncompliance."[13] Often, service of the subpoena constitutes one of the specifically delineated events that triggers coverage under the D&O policy. Other triggering events can include written notice from the SEC that the insured is a target, or a *Wells* notice. When one of these events occurs, the D&O policy should respond.

Other D&O policies explicitly provide coverage for some informal SEC and other investigations by broadly defining "Securities Claim" to include these investigations. For example, a policy may provide that a "'Securities Claim" is defined as, in relevant part, "a formal or informal administrative or regulatory proceeding or inquiry commenced by the filing of charges, formal or informal investigative order or similar document."[14] But insurers may argue that even broader definitions like these do not cover all such investigations. If the investigation does not begin with any type of charge, investigative order, or "similar document," the insurer may still deny coverage on the grounds that the government's actions do not even rise to the level of an informal investigation as defined by the policy. A federal appellate court recently handed policyholders a significant victory on this issue, however, in a case involving a financial services firm. In *MBIA Inc.*, the insured sought D&O coverage for, among other things, providing documents in response to subpoenas issued by the New York Attorney General (NYAG) under a policy that required a "Securities Claim" be commenced by the filing of a notice of charges, formal or informal investigative order, or similar document.[15] The NYAG had issued no such order. The D&O insurers argued that the subpoenas were mere discovery devices and not investigative orders or a similar document.[16] The court rejected that argument, however, finding that the "NYAG subpoena is at least a 'similar document' to a 'formal or informal investigative order' that commenced a regulatory proceeding, as stated in the policies."[17]

In this climate of increased regulation and scrutiny, public companies may wish to consider examining how their D&O policies would respond to government investigations.

The SEC also commences informal investigations by simply sending a written inquiry and requesting that the insureds or the company voluntarily provide the requested information. Companies often hire counsel, conduct internal investigations, and incur significant costs to respond to informal SEC inquiries. Many companies have been forced to bear these costs out-of-pocket because informal inquiries commenced this way, insurers may contend, do not satisfy the definition of Securities Claim.[18]

The Dodd-Frank Act also may cause other federal and state agencies to increase their investigatory activities. The Act and its regulations grant state attorneys general some enforcement powers. It created a new federal agency, the Consumer Financial Protection Bureau (CFPB), with significant power to protect consumers. The CFPB oversees depository institutions with over $10 billion in assets. These institutions hold a combined total of 80 percent of the U.S. banking industry's assets.[19] The CFPB, among other things, can investigate whether a person or entity has violated federal consumer financial protection laws. The CFPB already has published final interim rules that directly impact banks and other financial institutions that interact with consumers. It has been reported that even before the CFPB commenced formal operations, some banks hired internal consumer advocates to help ensure that their policies on overdraft fees and other issues would not be flagged as abusive.[20]

The FDIC also has increased its efforts to pursue the directors and officers of banks it has seized. When the FDIC commences an investigation, it often sends bluntly worded letters to targets in a specific effort to preserve potential insurance proceeds.[21]

One insurer recently introduced a new policy for public companies that is specifically designed to cover costs the company incurs responding to securities investigations brought by a wide range of authorities worldwide.[22] This stand-alone policy is designed to

[13] MBIA Inc. v. Fed. Ins. Co., 2011 WL 2583080, (2d Cir. July 1, 2011).

[14] Id.

[15] Id. at 4-5.

[16] Id. at 18.

[17] Id. at 17.

[18] See, e.g., Office Depot, Inc. v. National Union Fire Ins. Co., 734 F. Supp. 2d 1304 (S.D. Fla. 2010).

[19] See John Sutton, "Regulatory Watch: Banking on the CFPB—New Dodd-Frank Sheriff in Town," (Aug. 25, 2011), available at http://currents.westlawbusiness.com/Article.aspx?id=f77e9532-c141-4564-8e25-e08045d955d5&cid=&src=&sp=.

[20] See Clea Benson & Phil Mattingly, "Dodd-Frank Act Forcing Banks to Slim Down, Reshape Swaps: One Year Later," Bloomberg (July 11, 2011), available at http://www.bloomberg.com/news/2011-07-11/dodd-frank-act-forcing-banks-to-slim-down-reshape-swaps-one-year-later.html.

[21] See Joe Adler, "First the Failures, Then the Lawsuits," American Banker (July 1, 2010), available at http://www.americanbanker.com/magazine/120_7/first-the-failures-then-the-lawsuits-1021272-1.html.

[22] See Chartis, Investigative EdgeSM, available at http://www.chartisinsurance.com/us-investigation-edge_295_328234.html.

supplement traditional D&O coverage and imposes additional premium cost on companies that elect it. The insurer's marketing materials highlight the SEC's increased budget and anticipated vigor as a result of the Dodd-Frank Act.[23]

In this climate of increased regulation and scrutiny, public companies may wish to consider examining how their D&O policies would respond to government investigations.

UNDERSTANDING THE IMPACT OF EXCLUSIONARY CLAUSES

Exclusions for Claims Arising From Deliberate Fraudulent or Criminal Conduct. D&O policies typically contain exclusions for claims arising from deliberate fraudulent or criminal conduct and illegal profit or gain. The standards for determining whether these exclusions apply, however, can vary. Two common standards are "in fact" and "final adjudication."

"In Fact" Standard. Some policies—generally less favorable from the insureds' perspective—apply when the prohibited conduct has occurred "in fact." Under an "in fact" standard, an insurer may deny coverage under an exclusion when it concludes that the banned conduct "in fact" occurred. For example, in a case alleging that a director committed securities fraud or engaged in insider trading, an insurer might conclude, based on its investigation, that the director in fact committed fraud, and deny coverage before the claim against the director is resolved. Some courts have held that "in fact" policy exclusions applied merely because the allegations asserted against the insured fell within a policy exclusion.[24] At least one court has gone as far as to hold that an "in fact" policy exclusion barred coverage even when the insured was acquitted of the criminal charges forming the basis of the insurer's decision to deny coverage.[25]

"In fact" exclusionary standards, accordingly, may present significant risk to insureds and afford insurers undesirable discretion in determining the scope of their coverage obligations. With this type of clause, the insured may be required to litigate over whether there is coverage due to the insurer's interpretation of the facts surrounding the insured's conduct, potentially losing coverage for defense costs long before the insured is ever deemed to have acted improperly by a court.

Recent soft market conditions have made it difficult for insurers to include "in fact" exclusionary standards in new D&O policies.

"Final Adjudication" Standard. A "final adjudication" standard, on the other hand, typically permits an insurer to deny coverage only when there has been a "final adjudication" that the insured has engaged in the impermissible conduct excluded by the policy. For example, such a clause may provide that the insurer cannot escape coverage for an insured's fraudulent or dishonest conduct "unless a judgment or other final adjudication adverse to any of the Insureds in such Claim shall establish that such Insureds committed such . . . deliberate fraudulent act."[26] A "final adjudication" clause gives the insurer less discretion to deny coverage under the D&O policy, and no leeway to base its coverage denial on alleged facts that have not yet resulted in a final adjudication. Some policies contain "final adjudication" language that makes a judgment "final" only after all appeals have been decided.

Courts usually permit a carrier to deny coverage pursuant to "final adjudication" language only when that adjudication occurs in the underlying liability action.[27] A court's determination in a subsequently filed coverage action is often insufficient to allow an insurer to deny coverage.

Perhaps most significantly, courts generally do not consider the settlement of a civil claim to constitute a "final adjudication."[28] Historically, virtually all securities cases which are not dismissed on motion have settled.[29] Accordingly, "final adjudication" based exclusionary clauses typically will not preclude coverage when cases settle. Nor, and equally important,

[23] See Chartis Press Release: Chartis Introduces Investigative EdgeSM, Insurance Coverage for SEC Investigations, available at http://www.chartisinsurance.com/us-investigation-edge_295_328234.html.

[24] See, e.g. Steadfast Ins. Co. v. Stroock & Stroock & Lavin, L.L.P., 108 Fed. App'x. 663 (2d Cir. 2004).

[25] Gardner v. Cumis Ins. Society, Inc., 582 So. 2d 1094, 1096 (Ala. 1991).

[26] Wojtunik v. Kealy, 2011 WL 1211529, at 8 (D. Ariz. March 31, 2011).

[27] See Pendergest-Holt v. Certain Underwriters at Lloyd's of London, 600 F.3d 562, 572-73 (5th Cir. 2010) (noting that "courts have consistently held that the adjudication must occur in the underlying D&O proceedings, rather than in a parallel coverage action or other lawsuit" to permit an insurer to deny coverage under a final adjudication exclusion in a D&O policy)(internal quotations omitted).

[28] See id. at 572 n.11; Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Cont'l Ill. Corp., 666 F. Supp. 1180, 1191 (N.D. Ill. 1987); and Harristown Dev. Corp. v. Int'l Ins. Co., 1988 U.S. Dist. Lexis 12791 (M.D. Pa. 1988).

[29] See Cornerstone Research, Securities Class Action Filings, 2010 Year in Review, 15 (2011).

can an insurer escape coverage for defense costs for such claims.[30]

Insured vs. Insured Exclusion. The insured versus insured exclusion also is common in D&O policies. It has been stated that the original intent of this exclusion was to preclude coverage for certain types of internal disputes, e.g., between individual directors or officers, former management and the company, the company and current directors or officers, or vice versa. Since D&O policies are intended to protect a corporation and its directors and officers against claims from third parties, not insiders, this type of exclusion appears in many D&O policies.[31] Likewise, it has been stated that the insured versus insured exclusion is also intended to protect the insurer from collusive suits by one insured against another, by the corporation against the insured, or by a party closely affiliated with an insured against the company or another insured, in an attempt to impede other individuals or companies from obtaining the proceeds of a D&O policy.[32]

Insured versus insured exclusions can be problematic in other circumstances. Courts may find that claims brought by a bankruptcy trustee against directors and officers may not be covered due to this exclusion. Although at first glance a bankruptcy trustee pursuing claims against directors and officers appears to be a third party, some courts have found that the bankruptcy trustee steps into the shoes of the corporation during the pendency of the bankruptcy proceeding, creating an internal dispute subject to the insured versus insured exclusion.[33] Many policies, however, unambiguously provide for coverage when a bankruptcy trustee brings claims against directors and officers, while other policies specifically exclude coverage in this context.[34]

More favorable insured versus insured exclusions carve out other exceptions that preserve coverage for some common situations. An example of this type of carve-out is the "wrongful termination" exception. Under a strict insured versus insured exclusion, claims by former employees against the corporation for wrongful termination potentially would not be covered, as D&O policies typically include former directors and officers within the definition of an "insured." The wrongful termination exception, however, works to preclude an insurer from denying coverage when a former executive alleges a claim for wrongful termination.[35]

Another carve-out that narrows the scope of the insured versus insured exclusion preserves coverage for shareholder derivative suits. Typically, a shareholder derivative suit is considered a suit by the shareholders on behalf of the corporation against its directors and officers.[36] Most policies specifically except these claims from the exclusion. The shareholder derivative suit exception may not apply, however, if "some or all of the shareholders are also insured directors and officers."[37] Another way to limit the scope of the insured versus insured exclusion is to include a provision in the policy that renders the insured versus insured exclusion inapplicable to directors and officers who have held their positions for a set number of years.

These are just a few points to consider when determining the scope of coverage under a D&O policy with an insured versus insured exclusion. Directors and officers may wish to consider carefully reviewing the policy language in their specific D&O insurance policies to determine the extent of coverage actually afforded.

DEFINITION OF "APPLICATION"

Some insurers have tried to rescind coverage for insureds that provide inaccurate information in their applications. The more broadly the policy defines the term "application," the greater the potential pitfalls the insureds face. This definition often includes filings with a regulatory agency such as the SEC. If it turns out that there are errors or omissions that render the financial filings incomplete or inaccurate, an insurer may seek to rescind coverage under the premise that the policy was obtained under false pretenses and is void based on the incorrect financial filings. This can be especially problematic for public companies that restate their earnings.

In order to ensure the broadest coverage possible, and the least likelihood that an insurer will be permitted

[30] Most D&O policies do not require an insurer to defend its insured. Defense costs are often payable as part of a loss, but many policies may require an insurer to advance funds for defense costs at the request of the insured.

[31] Joseph Warren Bishop II et al., *Law of Corporate Officers & Directors: Indemnification & Insurance* (2010), at § 8:18.

[32] Id.

[33] Id.

[34] See, e.g., In re HA 2003, Inc., 310 B.R. 710 (Bankr. N.D. Ill. 2004)(claims brought by debtor in possession do not fall within the insured versus insured exclusion and insurer is required to provide coverage).

[35] Bishop et al., supra note 31, at § 8:18; Link Snacks, Inc. v. Fed. Ins. Co., 2009 WL 3380383 (W.D. Wis. 2009).

[36] David J. Marchitelli, *Construction and Application of Insured vs. Insured Exclusion of Directors and Officers Insurance Policy*, 14 A.L.R. 6th 687, at § 2 (2006).

[37] Id.

to rescind coverage if it later turns out that there are errors or omissions in past financial filings, directors and officers may wish to consider looking for a very narrow definition of "application" that includes only current, rather than prior, financial filings. Applicants may wish to consider looking to exclude or limit prior filings from the definition of application on renewal. Although the consequences of misrepresentations in an application may be limited by a well drafted severability clause, as discussed below, a narrow definition of "application" can help to ensure that all directors and officers remain covered under their D&O policy without a battle over the extent of protection provided by the policy's severability clause.

SEVERABILITY

Some D&O policies include a severability clause establishing that the knowledge and misconduct of one individual insured will not be imputed to other individual insureds. Severability clauses can prevent the application of exclusions—like the fraud exclusion—to innocent directors and officers. Severability clauses also protect innocent directors and officers when an insurer seeks to rescind a policy based on the knowledge or misconduct of another insured. Under normal circumstances, if an insurer is permitted to rescind a policy, insurers will typically argue, the policy no longer exists and all insureds would lose their coverage. With a favorable severability clause, the rescission of a D&O policy would be limited to the bad actor or actors (and sometimes the company if the bad actor is a high-ranking executive).

Protective severability clauses, called severability of application clauses, provide for full severability and treat each director or officer as if he or she had a separate, individual D&O policy in his/her name alone.[38] If a D&O policy contains a full severability clause, an insurer may only be permitted to rescind coverage for directors and officers who acted improperly, or those who knew of the fraudulent or improper conduct, subject to the specific policy wording.[39] Under a full severability clause, coverage should remain intact for the rest of the directors and officers.

EXHAUSTION OF PRIMARY POLICY LIMITS BEFORE TRIGGERING EXCESS COVERAGE

Another important issue for insureds to assess is the requirement for exhausting primary D&O coverage before reaching excess coverage. Typically, excess insurers pay only after primary coverage has been exhausted.[40] Each excess D&O policy defines how underlying coverage must be exhausted for a claim to trigger the excess coverage. Some policies require that the underlying insurer make the payment, while others permit the insured to make some or all of the underlying payment. Exhaustion of underlying coverage becomes a significant issue when resolving D&O insurance coverage disputes. If the policyholders settle a coverage dispute with a primary carrier for something less than full policy limits, excess carriers could seek to escape coverage on the grounds that the underlying coverage was not properly exhausted under policies which require the underlying insurer to make the payment. Some courts have rejected such arguments, because they frustrate settlement, finding that the settlement with the primary carrier functionally exhausts the primary policy.[41] The policyholder, however, typically forfeits its right to coverage for the amount between what the primary carrier paid and the primary policy's limits. The excess carrier typically must pay only the amount of the underlying settlement that exceeds the primary insurer's policy limits, regardless of the amount actually paid into the settlement by the primary insurer.[42]

Severability clauses can prevent the application of exclusions—like the fraud exclusion—to innocent directors and officers.

Other courts have strictly enforced the requirement that only payment by an underlying insurer exhausts policy limits. These courts have disagreed with courts permitting insureds to access excess coverage where the primary carrier itself does not pay all of its limits, finding the line of cases permitting such recoveries generally relied on interpreting policy ambiguities in favor of the insured.[43] Courts encountering this more specific

[38] Bishop et al., supra note 31, at § 8:35.

[39] See, e.g., In re HealthSouth Corp., 308 F. Supp. 2d 1253 (N.D. Ala. 2004) (holding that D&O policy provided for full severability and permitting insurer only to rescind coverage for directors and officers who knowingly provided false information).

[40] North River Ins. Co. v. Am. Home Assurance Co., 210 Cal. App. 3d 108, 112 (Cal.App. 1989) ("There are two levels of insurance coverage-primary and excess. Primary insurance is coverage under which liability attaches to the loss immediately upon the happening of the occurrence. Liability under an excess policy attaches only after all primary coverage has been exhausted.") (internal citations omitted).

[41] See, e.g., Koppers Co. v. Aetna Cas. & Sur. Co., 98 F.3d 1440, 1454 (3d Cir. 1995); Zeig v. Massachusetts Bonding & Ins. Co., 23 F.2d 665, 666 (2d Cir. 1928).

[42] Koppers, 98 F.3d at 1455; Zeig, 23 F.2d at 666.

[43] See, e.g., Comerica Inc. v. Zurich Am. Ins. Co., 498 F.Supp. 2d 109, 1030 (E.D. Mich. 2007).

language—specifically requiring payment of underlying limits by the insurer—appear to be enforcing it.

Insureds may wish to consider trying to obtain policy language that permits them, in addition to their insurers, to pay the underlying limits before triggering excess coverage, i.e. "shaving of limits provisions." Courts have upheld these explicit clauses,[44] and they afford insureds the most leeway in resolving claims against them that impact numerous coverage layers. Even as some court decisions examining older language continue to be decided against insureds, insurance brokers often have had success securing the more favorable language in new policies, so this issue may disappear over time as future policies give insureds the right to pay part of the limits to exhaust a policy.

[44] See Walbrook Ins. Co., Ltd. v. Unarco Indus., Inc., 1994 WL 411404, 3 (N.D. Ill. 1994).

CONCLUSION

D&O policy provisions differ greatly between insurers. For this reason, directors, officers, and companies may wish to review carefully their D&O insurance program and the coverage options available to them from other insurers. In a climate of increasing governmental regulation and scrutiny, policyholders should ensure their comfort with the limits and types of coverage available to protect them against the risks of managing a business. It has been noted that the majority of companies have not recently undertaken an independent review of their insurance programs.[45] Given favorable current market conditions, now is a good time to supplement, change, or add coverage to bring reality closer in line to expectations. ■

[45] See supra note 3.