Insurance Considerations for Directors and Officers of Delaware Entities

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As directors and officers (Ds&Os)[1] face exposure to potential personal liability claims, they should consider the principal protections available to them. Part one of this two-part series provided a "nuts and bolts" overview of key indemnification and advancement provisions for Ds&Os of Delaware entities.[2] This second part outlines certain key features of director and officer insurance policies (D&O policies), including core coverage parts, "tail" coverage and select exclusions. D&O policies are a creature of contract, and specific outcome-determinative terms can vary widely. Companies should carefully review their policies with their broker and counsel.

'Three-Sided' Coverage

D&O policies are generally designed to cover loss (including defense costs, settlements and judgments) incurred by insureds arising from certain claims. "Insureds" typically include the company itself (and direct and indirect subsidiaries) and its directors or officers (and their functional equivalent) acting in their capacities as such. D&O policies generally provide three core coverage parts:

- **Side A:** Covers Ds&Os for loss incurred in their capacity as such when the company does not indemnify them (because it is legally or financially unable). Side A is sometimes colloquially referred to as "personal asset protection." Because of D&O lawsuits' relative ubiquity, companies also frequently purchase excess dedicated Side A coverage — available only to Ds&Os and not shared with the company — that often contains a "Difference in Conditions" feature providing broader coverage than the underlying insurance policies and, in delineated circumstances, dropping down and covering Ds&Os where underlying insurance policies fail to respond. No retention should apply to Side A coverage, *i.e.*, it should provide Ds&Os with "first dollar" coverage.
- **Side B:** Covers the company to the extent it indemnifies a director or officer for loss. A retention (varying from policy to policy) nearly always applies.
- **Side C:** Covers the company for claims made against it. In the public company setting, coverage is typically limited to securities claims. As with Side B, a retention nearly always applies. Together with Side B, Side C protects the company's assets and is sometimes colloquially referred to as "company balance sheet protection."

Whether Side A, B or C applies to a particular claim can materially impact the scope and extent of coverage available to the company or its Ds&Os.

'Tail' Coverage

D&O policies are almost always written on a "claims made" basis, meaning they generally respond to claims made against an insured during the policy period. As a result, companies typically try to maintain coverage throughout statute of limitations periods applicable to potential claims, regardless of when the underlying conduct occurred. Companies regularly renew coverage in the ordinary course. However, in a change of control scenario, such as a typical M&A transaction or emergence from bankruptcy, Ds&Os would need to rely on the new owners of the company to continuously renew coverage, with terms and conditions at least as favorable as the existing D&O policies, for the duration of any limitations period that may apply to claims arising from conduct that occurred at or prior to the change of control event.

[1] All references to Ds&Os are also intended to include, where applicable, individuals serving as members or managers of a Delaware limited liability company.

[2] *See* "Indemnification Considerations for Directors and Officers of Delaware Entities."

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Alternatively, the company can, and typically does, purchase "tail" coverage, providing an extended reporting period under the terms and conditions of the existing D&O policies for noticing claims arising out of conduct that occurred at or before a change of control. D&O insurance tail periods are typically six years in length, accounting for most potentially applicable statute of limitations periods in the United States. The premium for tail coverage — typically a multiple of the current annual premium — is often paid in one lump sum up front, and the tail policy should be (and usually is) non-cancellable. These features combine to provide Ds&Os, including those departing following the change of control, with certainty of coverage throughout the tail period.

When assessing the necessity and adequacy of tail coverage, parties should carefully consider the applicable policy limits: Those in place when a D&O insurance program is "tailed off" are typically the same limits available for the duration of the tail period. If the initial limits have been, or may be, eroded or impaired by prior or pending claims, the company may want to purchase new or supplemental tail limits providing sufficient coverage for claims received during the tail period.

Key Exclusions

After coverage under a D&O policy has been triggered, exclusions must be evaluated to determine whether particular claims are covered. Each exclusion's specific wording can drastically impact this determination, and precise terms should be considered carefully. The following is a list of illustrative exclusions that may be found in D&O policies:

- **Conduct:** As explained in part one of this series, Delaware law prohibits indemnification for actions taken by Ds&Os in bad faith. D&O policies also typically do not cover certain specified forms of misconduct, including fraudulent or criminal acts, losses relating to illegally obtained remuneration by Ds&Os, and other actions taken for their personal profit, if the proscribed conduct is established by a final, non-appealable adjudication.
- **Pending and prior litigation:** D&O policies typically list a date, often referred to as the "pending and prior litigation date," and exclude from coverage any litigation or other proceeding pending on or before that date. The policy may also exclude any claims arising from the same factual circumstances at issue in pending and prior proceedings.
- **Prior acts:** Similarly, D&O policies sometimes contain an exclusion for claims arising out of actual or alleged conduct occurring before a specified date.
- **Previously reported claims:** Any claims previously noticed under a separate D&O policy will generally not be covered. Sometimes this exclusion only applies where the applicable insurer accepted the previous notice.
- **Insured versus insured:** This exclusion generally prohibits coverage of disputes among the insureds — including between the company and its Ds&Os, or the Ds&Os themselves. In the public company setting, this exclusion is typically limited to claims brought by the company (*i.e.*, not claims brought by Ds&Os). A number of important exceptions or carve-backs to this exclusion should be carefully considered, including:
  - **Derivative claims:** Claims brought by shareholders on behalf of, or in the right of, a company are common. While this exclusion would, on its face, preclude coverage for derivative suits, D&O policies generally cover them.
  - **Insolvency:** Similarly, if a company commences a bankruptcy case, the United States Bankruptcy Code and related common law may permit certain third-party constituencies to bring claims on behalf of the debtor, including trustees and examiners, as well as committees of creditors or shareholders.
- **Bodily injury and property damage:** D&O policies typically do not cover claims for bodily injury and property damage, because these claims are typically the province of general liability and property insurance policies, among other reasons. However, securities claims arising from or relating to bodily injury or property damage claims often are excepted from this exclusion.
- **ERISA:** Violations of ERISA, and related laws or regulations, are typically excluded from coverage. Generally, these claims fall within the parameters of a fiduciary liability insurance policy.
- **Specific matters:** Carriers sometimes exclude coverage for types of claims particular to a specific policyholder. These exclusions often concern a specific event, such as claims arising from a prior merger, acquisition, investigation or disclosure, or concerning a certain entity or person.