Title: "What About Me?"
Subtitle: Guaranteeing Financial Protection for Individual Directors and Officers

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Too many directors and officers are unaware of the very real, and serious, limitations of the financial protection ostensibly afforded to them by both the corporate entity which indemnifies them and the Directors' & Officers' Liability (D&O) insurance purchased by the corporate entity. To wit, a corporate entity cannot indemnify its individual directors/officers if it is either financially or legally unable to do so. While the corporate entity likely purchases D&O insurance which includes coverage for such non-indemnifiable events, too often the coverage available for individuals is compromised. With the costs for defending and settling shareholder claims reaching record levels, individuals cannot afford to be without *"guaranteed"* financial protection in their roles as directors/officers. Whether you are a; director/officer, risk manager, or counsel, it is imperative that you understand the potential shortcomings of both corporate indemnification and D&O insurance and, more importantly, know how to maximize, if not guarantee, personal financial protection.

With respect to corporate indemnification, there are two main instances, as noted above, in which it fails to provide adequate financial protection for individuals:

Financial Inability to Indemnify – consider the many bankruptcies (Enron, WorldCom among others) in which the company no longer has the financial wherewithal to protect its directors and officers.

Legal Inability to Indemnify – in certain instances the corporate entity is legally precluded from indemnifying its individual directors/officers. The most notable instance is when shareholders bring derivative actions against individual directors/officers on behalf of the company (Disney, Oracle).

Fortunately, the vast majority of D&O programs are designed to provide insurance coverage when individual executives find themselves exposed in non-indemnifiable scenarios such as those noted above. Without delving into a full-scale insurance tutorial, virtually all corporate D&O insurance programs include what is most commonly referred to as *"Side A"* coverage (see the box below for a brief primer on D&O insurance) which is that part of the policy dedicated exclusively to non-indemnifiable claims against individual directors/officers.

How Does D&O Insurance Work?

D&O Insurance is designed to provide directors, officers, and their companies with coverage for the costs involved in defending themselves against and settling litigation brought by third parties alleging that they have suffered a financial loss due to the actions and omissions of directors/officers in managing their companies. A company's D&O program has a limit of insurance, applying to both any one claim and as an aggregate, from which defense and settlement costs is paid. Typically, there are three insuring clauses (known as "Sides" in insurance jargon), which are part of a D&O policy:

Insuring Clause A pays on behalf of the individual directors/officers if the company cannot indemnify them. This clause is designed to protect the personal assets of individuals.

Insuring Clause B pays on behalf of the company's obligation to indemnify its directors/officers.

Insuring Clause C pays on behalf of the company's liability for securities litigation in which it is named.

Unfortunately, for corporate executives, our story does not end here. As with corporate indemnification, there are several situations in which a company's D&O insurance can fail to provide financial protection to individuals:

Rescission of Coverage – in this scenario, the insurer rescinds or voids the policy *ab initio* on the basis that the company made material misrepresentations to the insurer. In a rescission case, neither the company nor its individual directors/officers has any D&O insurance.

Insufficient Limits – while the company has D&O insurance and it "*works*" (i.e. it responds to the claim), the company did not buy sufficient limits to cover the costs of both defending and settling the claim.

Denial of Coverage – an insurance policy is a contract which has very detailed language as to what type of claims the policy will, and will not, cover. Additionally, insurers protect their rights (and, from a cynic's perspective, their return to shareholders) under the policy by asserting potential contractual provisions that may limit their liability for paying claims. Whether an insurer's denial of coverage is "*right*" or "*wrong*", it often leaves both companies and individuals without the financial protection they thought that they had.

Bankruptcy of Insurer – in this scenario, the insurer responsible for paying the claim is unable to do so because of its own financial insolvency. In the last five years, two significant D&O insurers, Reliance and Kemper, went bankrupt; leaving both companies and their directors/officers without insurance.

Guaranteeing Financial Protection for Individual Directors and Officers

The potential consequences if any of the above scenarios occurs are far from academic – the personal financial liability of individual directors/officers can reach well into seven figures just for the cost of defending oneself against litigation with liability for settling litigation tolling easily into tens of millions of dollars. Understanding the financial magnitude of their personal liability as directors/officers, these individuals need to take personal responsibility for ensuring that they are maximizing the financial protection afforded to them via both corporate indemnification and Directors' & Officers' Liability insurance. While every director/officer needs to consider his/her own situation to plan accordingly, we can suggest a five step process to get individuals started in conducting due diligence for their personal risk management:

1. Have independent counsel review the corporate by-laws, particularly with respect to the scope of corporate indemnification for directors/officers. Is the indemnification as broad as legally permissible?

2. With counsel's assistance, consider an individual indemnification agreement. Attempt to include a provision requiring the company to maintain D&O insurance on behalf of a specific D/O not only for his/her tenure as such, but also for a six year period following the individual's departure from the company.

3. Have both qualified counsel and an insurance broker review the company's D&O insurance to provide an opinion as to its likely adequacy for the individual director/officer.

4. As part of the review noted above, determine whether the company maintains *"Non-Rescindable Side A Excess Difference-In-Conditions"* coverage (see below for a brief description). If not, is there any coverage in place just for the financial protection of individuals?

5. Any individual serving as a director/officer of one of more companies should give strong consideration to maintaining a personal D&O policy which provides non-rescindable coverage exclusively for that individual.

When we first became brokers specializing in Directors' & Officers' Liability insurance, neither one of us fully appreciated the importance of focusing on the protection afforded to each individual director/officer. After the past few years, however, of speaking with distraught executives who have found themselves, through no fault of their own, as targets of litigation with no corporate funds (including insurance) to pay the often huge sums involved in defending and settling litigation, our attention is increasingly focused on ensuring that each individual receives the maximum possible financial protection which can be afforded through the many different products available under the broad label of Directors' & Officers' Liability insurance.

What is Non-Rescindable Side A Excess DIC?

Once past its onerous title, this policy offers more benefits for individual directors/officers than any other policy currently available:

- It is **non-rescindable**; the insurer can't take it away.
- It is **for individual directors/officers only**.
- The DIC (Difference-In-Conditions) component of this policy typically includes **coverage for three litigation sources that are excluded from other D&O policies**; Pollution, ERISA, One Insured Suing Another Insured.
- In addition to the standard Side A Excess *"drop down"* provisions, it can also ***"drop down"* in the following instances**:
    - Insolvency of an underlying insurer
    - Wrongful refusal of primary insurer to advance defense costs
    - When its DIC component provides broader coverage than underlying layers

In closing, we also want to make our readers aware of a troubling trend in which D&O insurance for former directors/officers is terminated without notification being given to these individuals. This occurs most frequently when there is a significant change in the structure of the BOD/management/ownership in which the former BOD/management team departs. Typically the new team, which has few, if any, ties to the former team, comes in with a mandate to cut costs. Given the significant corporate dollars spent on D&O insurance, providing ongoing D&O insurance to cover litigation which may be brought against the former team becomes an expense which many new teams opt not to continue paying. Unfortunately, the previous directors/officers often don't become aware that they have lost their D&O insurance until litigation is brought against them and they attempt to seek coverage for their costs from the D&O insurance which they still believe is in place to protect them. We find this trend more real, and more troubling, than the recent decisions of two judges to have individual directors pay portions of a settlement from their own personal assets. In those cases (WorldCom, Enron), the behavior of the directors was egregious. In the trend we cite, in most cases, it's about individual directors/officers doing the best that they could under difficult circumstances. Aren't those the people that D&O insurance should protect?

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