In Practice

10 Surprises That May Be Lurking In Your D&O Policy

By G. Andrew Lundberg

Even directors and officers at America's biggest public and private companies can receive a rude surprise when they discover that a claim they assumed was covered by their directors and officers (D&O) liability insurance isn't. Is your D&O policy harboring one or more of these 10 surprises—each of which has actually caught insureds off guard—that lurk in the fine details of the policy definitions, conditions, and exclusions, emerging only when a big claim is made? If so, it's time to close with your broker and coverage counsel and root them out beforehand—or be prepared to push back when one is sprung.

1. Target of an investigation—or merely a subject? Insureds find comfort in seeing that they have coverage if they are named as "the target of an investigation" by regulatory authorities. Surprise: if you're the subject of a federal investigation but not identified as a "target" under the specific definition of that term in the prosecutors' manual, your insurer may deny coverage. Prosecutorial guidelines distinguish between "targets" and "subjects" of an investigation—but D&O policies don't tell you that, or define "target," or suggest that the term is used in a technical sense. You'll sure feel like a "target" even if you are merely a "subject," though—and you'll sure need a lawyer. The fix: amend the definition of claim to include being a subject of investigation.

2. "Previously alleged" and trotted out again. D&O policies typically include a "prior or pending" exclusion, protecting the underwriters from an exposure that already materialized into a claim before they came on the risk. Coverage is barred, for example, for "any claim based upon or in any way involving any fact alleged in any suit pending prior to" a stated date. But talk is cheap, and lawsuits often include "background" allegations—i.e., facts that have no real legal significance for the current lawsuit but that let the plaintiff claim that this case is "merely the latest in the long, sorry history" of the defendant. Surprise: coverage denied, because the old facts are "involved in any way" in the new case. The fix: limit the exclusion to cases where the previously alleged facts are legally material to the current claim.

3. Pending or prior litigation—against whom? D&O insurers occasionally stun their insureds by pointing out that their particular flavor of "pending or prior" exclusion isn't limited to claims that were asserted against the insured in a prior case. No, they say, the exclusion applies even to claims asserted against an unrelated third party. Lo and behold, your exclusion isn't limited, and—surprise!—the insurer says ABC Corp. and its directors and officers have no coverage for a similar claim asserted against XYZ Corp., their competitor, two years earlier. The fix: make sure the pending-or-prior exclusion is limited to prior claims against the insured.

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4. Exhaustion of underlying coverage. Not all excess D&O policies are created equal when it comes to what will trigger coverage. If a primary or lower-layer excess insurer is willing to contribute some, but not all, of its limits to a settlement, it's crucial that the insureds be able to throw in their own funds to "fill the gap" and access their higher-layer excess coverage. But surprise: an excess insurer's "exhaustion-only-by-payment" clause, requiring full actual payment by the underlying carriers themselves, can derail the settlement. The fix: make sure all excess policies permit payment of the underlying limits by the insured or others, as well as by the underlying insurers.

5. Claim "commenced by"… what? You learn that you're being sued in a shareholder case. You haven't been served yet, but of course you hire counsel. The complaint isn't served for another three months. Surprise: the insurer refuses to pay the legal bills incurred in those three months because your policy defines a claim as "a proceeding commenced by the service of a civil complaint," not by the filing of the complaint. What? Federal Rule 3 says "a civil action is commenced by filing a complaint." But at least one D&O carrier has insisted on its "service" language and denied coverage. The fix: amend the definition of claim to refer to the commencement by "filing or service" of a complaint.

6. Consent to defense costs—over and over? D&O policies typically cover the costs of defending covered claims, but require that such costs be "consented to by the insurer." So when the claim hits, you get your insurer's OK to hire your go-to law firm, and figure that its bills will be paid as rendered. Surprise: six months later, the insurer is withholding payment on that research project or this deposition campaign, saying, "Sure, we agreed with your choice of lawyers, but we never consented to those expenses." You're in a coverage debate, and your lawyers aren't getting paid. The fix: amend the consent provision to state that all reasonable and necessary costs are covered from the date the insurer first consents forward.

7. Consent even to a non-covered settlement? Your policy provides that you "agree not to settle or offer to settle any claim" without the insurer's consent. You assume that such consent can't possibly be required for a claim that you settle within your $500,000 self-insured retention (SIR), and so settle a single gadfly shareholder's claim for $40,000. Six months later, you draw a class action making the same allegations. Surprise: coverage denied, because you settled the individual claim without the insurer's consent, and the consent provision isn't clearly limited to settlements of claims that exceed the SIR. The fix: make sure your policy specifically gives you the right to settle within the retention without the insurer's consent.

8. Where did these billing guidelines come from? D&O insurers often complain that the bills rendered by the insured's lawyers don't comply with the insurer's billing guidelines—coverage-limiting provisions that were never negotiated as a term of coverage and aren't even provided until a claim hits. Surprise: the "guidelines" prove to be less of a guide and more of a set of firm—and often arbitrary ("no mileage charges for under 25 miles")—rules used to deny payment. But the policy says that "reasonable and necessary" defense costs are covered. If the guidelines narrow that coverage to something less—or if the insurer conditions its consent to your choice of counsel on compliance with them—that agreement has been changed unilaterally. The fix: don't accept "guidelines" that are not negotiated as part of the policy, and insist that the insurer pay the full "reasonable and necessary" costs appropriate to the defense.

9. "Reasonable" legal fees. Insurers regularly resist paying legal bills on the grounds that "we never pay" rates that high, or that "fully capable counsel are available much cheaper." But the policy doesn't contain a rate schedule, and an insurer's attempt to negotiate one after the bombs start to fall is improper. D&O policies cover "reasonable and necessary" defense costs, incurred at "reasonable" hourly rates. "Reasonable" doesn't mean average or market-wide. The fix: hire lawyers who regularly sell their time at the rate they charge you, and don't assume you have to foot the bill for the excess over what the insurer offers.

10. Redefining what a defense cost is. Insurers in recent years have accomplished a drastic withdrawal of coverage for legal expenses by, in effect, redefining what a "defense cost" is. Traditionally, a covered defense cost was any expenditure a reasonable lawyer would conclude would sensibly be spent in defending a covered claim. The fact that the spend might also aid in the defense of a non-covered claim, or benefit the defense of a non-covered party, was immaterial. Today, insurers slash their payments under provisions that allow them to "allocate" costs between covered and non-covered claims or parties on a virtually arbitrary basis. The fix: resist "allocation" provisions entirely, or negotiate for a (high) pre-set allocation to covered claims.

These aren't the only "sleeper cell" provisions that dwell in D&O policies, but if you can root them out or anticipate them before a claim arises, you stand a chance of avoiding a big surprise from your insurer at the time you need it least. D

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