DIRECTORS AND OFFICERS LIABILITY

Prevention, Insurance and Indemnification

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CHAPTER 1

Duties of Directors and Officers

§ 1.01 Duties of Directors and Officers Generally
§ 1.02 Duty of Loyalty
[1] Definition and Purpose of the Duty of Loyalty
[2] Sources of the Duty of Loyalty
[a] State Corporation Laws
[b] Common Law and The Business Judgment Rule
[c] Charter and Bylaw Provisions
[a] Conflict of Interest
[b] Usurpation of Corporate Opportunity
[c] Failure to Disclose Material Facts
[d] Improper Use of Confidential Information
[e] Personal Advantage and Secret Profits

1.03 Duty of Care
[1] Standard of Care Defined
[a] Delaware
[b] Model Act State Laws
[c] Non-Model Act State Laws
[2] Negligence
[3] Matters Affecting or Limiting the Duty of Care
[a] Reliance on Others
[b] Charter Provisions Limiting Director Liability

§ 1.04 Other Duties
[2] Duty to Creditors

§ 1.05 The Business Judgment Rule
[1] Definition and Purpose
[a] Business Decision
[b] Disinterestedness and Independence
[c] Duty of Loyalty
[d] Duty of Care
[e] Limited Nature of Protection
CHAPTER 2

Derivative Litigation
§ 2.01 Overview
§ 2.02 Distinction Between Derivative and Direct Claims
  [1] Definitions
  [2] Derivative Claims
  [3] Direct Claims
  [4] Simultaneous Derivative and Direct Claims
  [5] Special Considerations for Directors and Officers in Settlement Negotiations
§ 2.03 Procedural Aspects of Derivative Litigation
  [1] Pleading Requirements
    [a] Federal Rules
    [b] State Procedural Rules
  [2] Pleading with Particularity
    [a] Particularity Defined
    [b] Rigorous Interpretation in Derivative Actions
    [c] State Law Claims Brought in Federal Court
    [a] Seventh Amendment Right
    [b] State Law Rights
  [4] Requirement to be a Shareholder
  [5] Loss of Standing in Merger Situations
  [6] Statutes of Limitations
  [7] Discovery Issues
§ 2.04 Bringing a Derivative Suit
  [1] Demand Requirement
    [a] Definition and Purpose
    [b] Making a Demand
  [2] Demand Futility
    [a] Aronson Test for Demand Futility
    [b] Rales Test for Demand Futility
    [c] Demand Futility in New York
    [d] Model Business Corporation Act
    [e] Situations in Which Demand Is Not Excused As Futile
    [f] Situations in Which Demand Is Excused
  [4] Special Litigation Committees
    [a] Purpose
    [b] Formation and Operation of Special Litigation Committees
CHAPTER 3

Class Action Litigation

§ 3.01 Direct Actions and Shareholder Class Actions
§ 3.02 Federal Securities Laws
§ 3.03 Common Features of the 1933 and 1934 Acts
      [a] Elements
      [b] Definition of "Control"
      [c] "Culpable Participation" Requirement
      [d] Defenses
  [3] Statute of Limitations
§ 3.04 Corporate Director and Officer Liability under the 1933 Act
§ 3.05 Liability for Lack of Required Registration—Section 12(1)
  [1] Registration Requirements
  [2] Potential Plaintiffs and Defendants
  [3] Remedies
§ 3.06 Liability for Material Misstatement or Omission in a Prospectus or Oral Offer for Sale—Section 12(2)
  [1] Elements
  [2] Potential Plaintiffs and Defendants
  [3] Defenses and Burdens of Proof
  [4] Remedies

(Rel. 0)
Table of Contents

Directors And Officers Liability

§ 3.07 Material Misstatements or Omissions in Registration Statements—Section 11

[1] Elements
[2] Potential Plaintiffs and Defendants
[3] Defenses
[5] Remedies

§ 3.08 Fraud Under the 1933 Act—Section 17(a)

[1] Elements
[2] Defenses
[3] Remedies

§ 3.09 Corporate Director and Officer Liability under the 1934 Act

§ 3.10 General Antifraud Provision—Section 10(b)

[1] Elements
[a] Relationship Between Section 10(b) and Rule 10b-5
[b] Definition of “Sale”
[c] Intent to Deceive or Defraud
[d] Knowledge and Reliance

[2] Standing

[3] Scope of Section 10(b) and Rule 10b-5
[a] Options
[b] Forward-Looking Statements

[4] Remedies

§ 3.11 Material Misstatements and Omissions in Proxy Statements—Section 14(a)

[1] Elements
[2] Remedies

§ 3.12 Tender Offers and Liability Under the Williams Act

[1] Elements
[2] Remedies

§ 3.13 Background of State Blue Sky Laws

[1] Purposes of Blue Sky Laws
[2] State and Federal Jurisdiction

§ 3.14 Control Person Liability under State Blue Sky laws

[1] Definition of "Control Person"
[2] Defenses
[3] Participation Requirement
[a] Participation Not Required
[b] Participation Required
[c] What Constitutes “Participation”

§ 3.15 Civil Liability Under State Blue Sky Laws

(Rel. 0)
CHAPTER FOUR

Other Liabilities of Directors and Officers

§ 4.01 Overview
§ 4.02 Common Law Liability
[1] Piercing the Corporate Veil
[2] Tort Liability
§ 4.03 Statutory Liability
[1] Environmental
   [a] Comprehensive Environmental Response, Compensation, and Liability Act
   [b] Resource Conservation and Recovery Act
   [c] Federal Water Pollution Control Act
   [d] The Clean Air Act
   [e] Oil Pollution Act of 1990
[4] Family And Medical Leave Act
[5] Tax
   [a] Payroll Withholding
   [b] Other Tax Liability
§ 4.04 Criminal Liability
[1] Criminal Fraud
   [a] Racketeer Influenced and Corrupt Organizations Act
   [b] Wire and Mail Fraud Statutes
[2] Criminal Counterparts to Statutory Civil Liability
   (Rel. 0)
CHAPTER 5

Indemnification of Directors and Officers

§ 5.01 Indemnification Basics
[1] The Concept of Indemnification
[2] Historical Background
[3] Distinguishing Indemnification from Insurance

§ 5.02 Statutory Indemnification
[1] Governing Law
[2] Scope of Coverage
Table of Contents

Directors And Officers Liability

[4] Types of Indemnification
   [a] Mandatory Indemnification
   [b] Permissive Indemnification
      [i] Third Party Actions
      [ii] Derivative Actions or Actions by the Corporation

[5] Requirements for Obtaining Relief
   [a] Success on the Merits or Otherwise
   [b] Good Faith

[6] Nonexclusivity

§ 5.03 Corporate Indemnification
[2] Shareholder Approval
   [a] Charter and Bylaw Provisions Generally
   [b] Scope of Covered Persons
   [c] Other Provisions
   [a] Advantages
   [b] Enforceability
   [d] Limitations on Coverage

§ 5.04 Public Policy Limits on Indemnification
[1] General Public Policy

CHAPTER 6

Overview of Directors and Officers Liability Insurance

§ 6.01 An Introduction to D&O Liability Insurance
§ 6.02 Applying for the D&O Policy
CHAPTER 7

Rules of Policy Interpretation and Construction
Table of Contents

Directors And Officers Liability

§ 7.01 Contract Interpretation Generally
§ 7.02 Insurance Policy Interpretation
§ 7.03 The Parol Evidence Rule
§ 7.04 Determining Ambiguity
§ 7.05 Ambiguity and the Parol Evidence Rule
§ 7.06 Reasonable Expectations

CHAPTER 8

Exclusions in D&O Policies

§ 8.01 Introduction
§ 8.02 Insured vs. Insured Exclusion
§ 8.03 Prior Acts Exclusion
§ 8.04 Dishonest, Fraudulent, and Criminal Acts Exclusion
§ 8.05 Employment-Related Activities Exclusion
§ 8.06 Outside Directorship Exclusion
§ 8.07 Bodily Injury, Property Damage, Advertising Injury, and Personal Injury Exclusion
§ 8.08 Prior Notice Exclusion
§ 8.09 Prior and Pending Litigation Exclusion
§ 8.10 Regulatory Exclusion
§ 8.11 ERISA Exclusion
§ 8.12 RICO Exclusion
§ 8.13 Insurance Not Maintained Exclusion
§ 8.14 Personal Profit or Advantage Exclusion
§ 8.15 Return of Remuneration Exclusion
§ 8.16 Securities Exclusion
§ 8.17 Short-Swing Profit Exclusion

(Rel. 0)
CHAPTER 9

Claims Submission and Handling Under D&O Policies

§ 9.01 Notice of Claim
§ 9.02 Cooperation
§ 9.03 Insurer’s Duty to Investigate
§ 9.04 Insurer’s Duty to Pay or Advance Defense Costs
§ 9.05 Control of the Defense
  [1] Choice of Counsel
  [2] Separate Counsel
  [3] Litigation Guidelines
§ 9.06 Insurer’s Reservation of Rights
§ 9.07 Bad Faith
§ 9.08 Damages Available in a Bad Faith Action
  [1] Excess Judgments
  [2] Punitive Damages
  [3] Consequential Damages
  [4] Damages for Mental Suffering
  [5] Attorneys’ Fees
§ 9.09 Statutory Claims
CHAPTER 10

Litigation and Settlement Considerations

§ 10.01 Choice of Forum
[1] Venue

§ 10.02 Justiciability Issues

§ 10.03 Arbitration Requirements

§ 10.04 Discovery
[1] Areas of Discovery
[a] Drafting History of the Policy
[b] Reinsurance Information
[c] Reserve Information
[d] Claims Handling and Underwriting Manuals and Guidelines
[e] Advertising and Marketing Materials
[2] Privilege Issues

§ 10.05 Trial of the Directors and Officers Coverage Case
[1] Introduction
[a] Meaning of the Policy
[b] Application of the Policy Terms to Facts

§ 10.06 Issues Arising out of Settlements and Settlement Agreements
[1] Exhaustion of Underlying Coverage
[2] Priority of Coverage Among Directors and Officers and Corporation
6.03 Overview of Liability Insurance

Directors And Officers Liability
§ 6.03 Components of a D&O Liability Policy

Although each insurer uses its own policy form, D&O policies share a common structure. This section describes the principal components of D&O policies. Though the wording of each component may vary from insurer to insurer, most, if not all, D&O policies have each of the following components.

[1]—Declarations

The first page of most D&O policies is a “Declarations” page. The Declarations page contains much important information about the policy, including the type of policy, the amount of coverage it provides, and the period of coverage. Other parts of the policy often refer back to the Declarations page. Thus, in order to read the policy, the policyholder must move back and forth between the policy terms and the Declarations page. For example, the “Limits of Liability” provision of the policy may refer back to the Declarations page in describing the amount of coverage available under the policy.

The Declarations page of most D&O policies sets forth the following.

[a]—Claims Made vs. Occurrence

The Declarations page of many D&O policies states at the beginning that “[t]his is a ‘claims first made’ insurance policy.” “Claims first made” or “claims made” policies provide a different type of coverage from the “occurrence” general liability policies familiar to most corporate policyholders. An occurrence policy typically provides coverage for a claim made at any time during or after the policy period so long as the property damage or bodily injury on which the claim is based took place during the policy period. Claims made policies, on the other hand, generally provide coverage only if a claim is first made against the policyholder during the policy period. Many claims made policies also require that the policyholder report the claim to the insurance company during the policy period. Claims made policies with this requirement often are called claims made and reported policies.

[b]—Named Corporation

The Declarations page also lists the “Named Corporation.” D&O policies usually cover the directors and officers of the Named Corporation and any subsidiary of the Named Corporation. Some D&O policies define “subsidiary” as a corporation more than 50% of the
outstanding voting stock of which is owned by the Named Corporation either directly or indirectly through other subsidiaries of the Named Corporation. Sometimes the Named Corporation is referred to as the “Insured Organization.” Some D&O policies also list “Insured Persons” on the Declarations page. In such policies, the directors and officers insured under the policy usually will be listed there.

[c]—Each Wrongful Act and Aggregate Limits

The Declarations page also shows the monetary limits of the insurer’s liability under the policy. A typical Declarations page will contain a limit of liability for all claims arising out of each wrongful act of the Directors and Officers. In addition, the Declarations page will show an aggregate limit of liability for all claims made under the policy during the policy period. This aggregate limit generally applies to both claims made under the direct coverage insuring agreement of the policy and the corporate reimbursement insuring agreement. Moreover, if the policy provides entity coverage, the aggregate limit typically applies to the entity coverage as well. This can lead to competition between the corporation and its directors and officers for payment from the same pool of funds. This competition can be intensified because D&O policies typically provide that defense expenses exhaust the “each wrongful act” and aggregate limits of the policy. In large securities actions, defense expenses by themselves may very well exhaust the limits of liability of a primary D&O policy.

[d]—SIRs and Deductibles

Most D&O policies contain some form of deductible or self-insured retention. Although deductibles and self-insured retentions generally are referred to as serving the same purpose, there are distinctions between them.2

A deductible represents the amount that the insurance company deducts from its limit of liability for a claim. Thus, if an insurance company has a $10 million limit of liability and the deductible is $100,000, the insurance company will pay the policyholder only $9,900,000.


A self-insured retention is the amount that a claim must exceed before the insurer’s obligation to pay the claim attaches. Thus, if an insurance company has a $10 million limit of liability above a $100,000 self-insured retention, the insurance company will pay the full $10 million, but only after the policyholder has paid the first $100,000 of the claim.

The Declarations page of most D&O policies list separate deductibles for the direct coverage of the directors and officers, the corporate reimbursement coverage, and the entity coverage. Moreover, there are usually two different types of deductibles for the direct coverage of the directors and officers: (1) a deductible that each director or officer must satisfy for each claim; and (2) an aggregate deductible for each claim with respect to all directors and officers under the policy. Each of the directors and officers will have to pay his or her individual deductible unless the aggregate of the individual deductibles exceeds the aggregate deductible. In that case, only the aggregate deductible need be met before each of the directors and officers is entitled to payment.

The trend is for insurers to impose a very small or no deductible on the direct coverage of directors and officers. Insurers impose a much larger deductible on the corporate reimbursement and the entity coverage.

D&O policies also may contain a retention waiver provision, which provides that if the policyholder is successful in having the claim dismissed, the deductible is waived. Under this type of provision, no amount is deducted from the amount that the policyholder expends in defending the case so long as the policyholder is successful. Such a provision might read as follows:

“Notwithstanding the foregoing, solely with respect to a Securities Claim, the Retention shall only apply to Defense Costs. Further, solely with respect to a Securities Claim or a Year 2000 Claim, no Retention shall apply to Loss arising from such Claims and the Insurer shall reimburse Defense Costs otherwise covered hereunder and paid by the Insured, in the event of:

(1) a determination of No Liability of all Insureds in a Securities Claim; or

(2) a determination of No Liability of all Directors and Officers in a Year 2000 Third Party Claim; or

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(3) a dismissal or a stipulation to dismiss all Insureds in a Securities Claim without prejudice and without the payment of any consideration by any Insured; or

(4) a dismissal or a stipulation to dismiss all Directors and Officers in a Year 2000 Third Party Claim without prejudice and without the payment of any consideration by such Insureds;

provided, however, that in the case of (3) and (4) above, such reimbursement shall occur 90 days after the date of dismissal or stipulation as long as such Claim is not brought (or any other Claim which is subject to the same single retention by virtue of Clause 6 is not brought) again within that time, and further subject to an undertaking by the Company in a form acceptable to the Insurer that such reimbursement shall be paid back by the Company to the Insurer in the event the Claim (or any other Claim which is subject to the same single retention by virtue of Clause 6) is brought after such 90-day period and before the expiration of the statute of limitations for such Claim.”

[e]—Policy Period

The Declarations page also sets forth the period of the policy. Usually, the policy will provide coverage for claims made against the policyholder during the policy period. Moreover, D&O policies typically require the claim or a circumstance giving rise to the claim to be reported during the policy period or shortly thereafter during the policy’s extended reporting period.

[f]—Retroactive Date

The Declarations page often also lists a “Retroactive Date.” This date typically relates to the policy’s prior wrongful acts exclusion, and excludes coverage, in some circumstances, for claims based on wrongful acts that took place before the retroactive date.

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5 See § 6.03[1][a] supra.
6 See § 6.03[5][a] infra.
7 See § 8.03 infra.
[2]—Insuring Agreements

D&O policies today often provide two and, in some cases, three different types of coverage. First, D&O policies provide directors and officers direct individual liability coverage for claims for which the corporation cannot or will not indemnify them. Second, D&O policies provide reimbursement coverage for the corporation when the corporation does indemnify the director or officer for a claim. Finally, in a number of cases, D&O policies provide “entity coverage,” which indemnifies the corporation for securities claims made directly against the corporation.

[a]—Direct Coverage of Directors and Officers

“Coverage Part I” or “Coverage A” of D&O policies usually contains the insurer’s promise to provide direct coverage for directors’ and officers’ individual liability when they are not indemnified by the corporation. Though each insurer has its own form, the direct coverage they provide is similar. A typical direct director and officer coverage insuring agreement provides:

“COVERAGE A: DIRECTORS AND OFFICERS INSURANCE

“This policy shall pay the Loss of each and every Director or Officer of the Company arising from any claim or claims first made against the Directors or Officers and reported to the Insurer during the Policy Period or the Discovery Period (if applicable) for any alleged Wrongful Act in their respective capacities as Directors or Officers of the Company, except for and to the extent that the Company has indemnified the Directors or Officers. The Insurer shall, in accordance with and subject to Clause 9, advance to each and every Director and Officer the Defense Costs of such claim or claims prior to their final disposition.”

Many of the terms referred to in the insuring agreement are defined elsewhere in the policy.

The policy’s direct coverage is extremely important to the financial security of the directors and officers. Defending and settling securities and other corporate liability claims can cost hundreds of thousands of dollars and can tax the financial resources of any individual, but in a number of circumstances the corporation will be unwilling or unable to indemnify its directors and officers. For example, if there has been

8 National Union Fire Insurance Company of Pittsburgh, PA. Directors and Officers Insurance and Company Reimbursement Policy Form No. 47353, N. 1 supra.
a change of corporate control, a new board may exercise whatever discretion it has to refuse to indemnify former directors and officers. Alternatively, the corporation may be insolvent and unable to indemnify the directors and officers. In addition, some state statutes restrict a corporation’s indemnification of directors and officers with respect to derivative claims.  

Some D&O policies’ direct coverage insuring agreement contains language that proves troublesome to directors and officers when the corporation is permitted to indemnify them but does not:

“A. To reimburse the Directors and Officers for Loss not exceeding the Limit of Liability in excess of the applicable Retention set forth in Item D of the Declarations sustained by such Directors and Officers resulting from any Claim first made during the Policy Period or the Optional Extension Period, if applicable, against any of them for a Wrongful Act, except for such Loss which the Company actually pays to the Directors and Officers as indemnification, and except for such Loss which the Company is required or permitted by law to indemnify the Directors and Officers unless and to the extent that the Company is unable to make actual indemnification solely by reason of its financial insolvency.”

These insuring agreements typically bar coverage for claims for which the company is “required or permitted by law” to indemnify the director or officer. If the company is permitted by law to indemnify the director of officer but does not, the director or officer may be left without coverage.

Other D&O policies provide coverage if the corporation is permitted to and has not indemnified the director or officer, but require the director or officer to pay the high deductible applied to claims under the corporate reimbursement insuring agreement. The D&O policies that do this do so through a presumptive indemnity clause:

“PRESUMPTION OF INDEMNIFICATION; APPLICABLE RETENTION:

“(1) The certificate of incorporation or articles of association, by-laws and resolutions of the Parent Corporation and each Subsidiary shall be deemed to have been adopted or amended to provide indemnification to the Insured Persons to the fullest extent permitted by law.

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9 See § 5.02[4][b][ii] supra.
“(2) Regardless of whether Loss in connection with any Claim is payable under Section I. Insuring Agreement (A) or (B) the retention applicable to Loss under Section I. Insuring Agreement (B) shall apply to such Loss if indemnification by the Company is legally permissible, whether or not actual indemnification is made, unless such indemnification is not made by the Company solely by reason of its financial insolvency.

“(3) If Loss from a Claim is covered under more than one Insuring Agreement, the applicable retention stated in Item 4 of the Declarations shall be applied separately to that part of the Loss covered by each Insuring Agreement, and the sum of such retentions shall be the retention applicable to such Claim. The total retention shall not exceed the largest retention stated in Item 4 of the Declarations.”

Insurers contend that this higher deductible requirement is necessary to prevent the corporation from denying indemnity and having the directors and officers claim under the direct coverage with its lower deductible. Nevertheless, the higher deductible and the presumptive indemnity clause can impose great hardship on directors and officers who are not indemnified by the corporation.

D&O policies typically restrict coverage to wrongful acts committed by directors and officers in their official capacities. There are two common ways in which directors and officers can be excluded from coverage: (1) by acting in a non-official capacity, or (2) by acting beyond the scope of their official duties.

When a director or officer also is a corporate shareholder, courts must evaluate whether his or her actions were taken in his or her capacity as a director or officer, or as a shareholder. One court held that when an officer/shareholder sued to enjoin the corporation’s board of directors from negotiating a takeover of the corporation by another company, the action was brought by the plaintiff as a shareholder, not as an officer of the corporation.

13 Id.
14 See text at N. 8 supra.
15 Olson v. Federal Insurance Co., 219 Cal.App.3d 252, 262 (Cal. App. 1990) (actions taken by officer in the capacity of shareholder of a corporation held not to be (Rel. 0)
When directors or officers breach a fiduciary duty to the corporation, they typically are held to be acting beyond the scope of their duties and thus are not entitled to coverage. In one case, a court held that minority shareholders and officers of a corporation were not entitled to coverage for their alleged breaches of the fiduciary duties of loyalty and prudence resulting from actions intended to “cripple” the corporation and misrepresentations to a potential purchaser about the corporation’s financial condition. The court held that any injury caused by the officers was not caused while acting within the scope of their duties or with respect to their duties as officers.

In another case, the court noted that while an officer may have taken actions that she was not authorized to take as an officer, that fact did not automatically disqualify her from coverage. The D&O policy required that the officer be entitled to indemnification by the insured corporation before coverage would exist. Noting that the insurer was equating the officer’s “capacity as director” with her “authority as director,” the court stated, “plainly a director may take actions in her capacity as director that are not within her authority to take. The real question is whether, if she does so, she is ‘entitled to indemnification by the Company,’ as the policy requires before reimbursement is due.” Therefore, the court held that summary judgment in favor of the insurer was not appropriate.

[b]—Corporate Reimbursement Coverage

16 Farr v. Farm Bureau Insurance Co. of Nebraska, 61 F.3d 677, 681 (8th Cir. 1995) (D&O policies . . . cover injuries caused by corporate officers . . . “properly carrying out their duties to the corporation and are designed to protect the officer who acts to advance the business interests of the corporation, not the officer who acts in a manner that is antagonistic toward the corporation’s business interests”).

17 Id. See also National Union Fire Insurance Co. v. Jordache Enterprises, Inc., 652 N.Y.S.2d 966 (N.Y. 1997) (officers who withdrew money from corporation to finance new company were not acting on behalf of corporation, but to benefit themselves; therefore, no coverage existed).


19 Id.

20 Id.

21 Id.
In Most D&O policies, “Coverage Part II” or “Coverage B” contains a corporate reimbursement insuring agreement such as the following:

“COVERAGE B: COMPANY REIMBURSEMENT INSURANCE

“This policy shall reimburse the Company for Loss arising from any claim or claims which are first made against the Directors or Officers and reported to the Insurer during the Policy Period or the Discovery Period (if applicable) for any alleged Wrongful Act in their respective capacities as Directors or Officers of the Company, but only when and to the extent that the Company has indemnified the Directors or Officers for such Loss pursuant to law, common or statutory, or contract, or the Charter or By-laws of the Company duly effective under such law which determines and defines such rights of indemnity.”

Because of the broad scope of most corporate indemnification laws, most D&O claims will be covered under this insuring agreement.

Historically, D&O policies did not cover claims against the corporation itself for its own wrongful activities or for its derivative or vicarious liability, covering only amounts the corporation expends to indemnify its directors and officers for their liability.

A typical corporate reimbursement clause states that the insurer will pay on behalf of the corporation all loss for which the company is required to indemnify or for which the company has, to the extent permitted by law, indemnified its officers and directors. Thus, the issue of coverage often turns on whether applicable state or federal law allows the corporation to indemnify the directors or officers. For example, Delaware law permits indemnification for judgments, fines, settlement costs, and expenses when directors or officers have acted in

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22 National Union Fire Insurance Company of Pittsburgh, PA. Directors and Officers Liability and Corporate Reimbursement Policy Form No. 47353, N. 1 supra.


State Courts:
Wisconsin: In re Liquidation of WMBIC Indemnity Corp., 499 N.W.2d 257, 262, 175 Wis.2d 398, 409 (Wis. App. 1993) (policy covered amounts directors and officers were legally obligated to pay; because underlying claims were against bank, not its officers, directors and officers were not legally obligated to pay; therefore, insurer not required to cover bank’s losses).
good faith and in a manner they reasonably believed to be in or not opposed to the best interests of the corporation, provided, with respect to any criminal action or proceeding, that they had no reasonable cause to believe their conduct was unlawful.\textsuperscript{25}

In some cases, courts have found that a corporation is not entitled to reimbursement under the corporate reimbursement provision because the corporation failed to follow the proper procedures in indemnifying its directors and officers. In a case in which a federally insured savings and loan (S&L) failed to follow federal law requiring it to comply with procedures prescribed by the Federal Home Loan Bank Board before indemnifying its directors and officers for actions brought against them in their official capacity, the court held that the S&L was not entitled to recover under the corporate reimbursement coverage provision allowing recovery when permitted by law.\textsuperscript{26} The court, however, allowed the S&L to proceed as the directors’ and officers’ subrogee, rejecting the insurer’s argument that the corporate reimbursement coverage provision “pre-empted” the S&L’s subrogation rights under common law.\textsuperscript{27} The court held that “nothing in the language of [the corporate reimbursement coverage provision] indicates that it was intended to nullify any common law rights of subrogation.”\textsuperscript{28}

In one case, a corporation sought recovery for legal fees, expenses, and costs totaling $13 million after its shareholders sued to block a corporate restructuring and to enjoin the sale of the corporation.\textsuperscript{29} The corporation conceded that it never indemnified its directors or officers for the sums sought but argued that its power to indemnify them enti-

\textsuperscript{25} 8 Del. Code Ann. § 145(a).
\textsuperscript{26} Atlantic Permanent Federal Savings & Loan Association v. American Casualty Co., 839 F.2d 212, 215 n. 5 (4th Cir. 1988).

See also:
First Circuit: Waldboro Bank v. American Casualty Co. of Reading, Pa., 775 F. Supp. 432, 434 (D. Maine 1991) (insurer not obligated to cover expenses incurred by S&L in indemnifying its officer when indemnification was not permitted by law; law allowed indemnification only when paid after a final judgment, not a settlement, and only after S&L provided sixty days’ notice to federal agency; neither provision was complied with; therefore, indemnification was improper.)

Atlantic Permanent Federal Savings & Loan Association v. American Casualty Co., N. 26 supra, 839 F.2d at 216.

\textsuperscript{27} Id.
\textsuperscript{28} Id.
tled it to recover under the policy. The court rejected the corporation’s argument, finding that the plain meaning of policy language stating that the corporation would be covered for amounts for which it “grants indemnification,” required the corporation to indemnify its directors or officers before coverage would exist. The corporation further argued that because the policy was purchased by the corporation and because the policy benefited the directors and officers of the corporation, the corporation was entitled to recover as the real party in interest. The court rejected that argument, noting that state law allowing recovery by real parties in interest does not apply if there is a possibility of double recovery. In this case, there was significant risk of double liability, because there was no guaranty that the directors and officers themselves would not seek recovery under the policy. Therefore, the court granted the corporation more time to “remedy the problem of potential double liability under the policy through appropriate procedures, including joinder, substitution, ratification or, of course, indemnification.”

Under similar circumstances, however, another court held that formal indemnification by the corporation is not required before the corporation is entitled to coverage, and that the corporation need show only that “it was required by law to indemnify the officers and directors.”

[c]—Entity Coverage

Before the mid-1990’s, D&O policies contained a very significant flaw or gap in the coverage they provided for securities claims. Although most securities plaintiffs asserted claims against the corporation and its directors and officers, D&O policies covered only the claims against the directors and officers. This created significant problems for insurers and policyholders relating to the allocation of defense and settlement payments between covered and uncovered

30 Id., 741 F. Supp. at 1082.
31 Id.; see also Farmers & Merchants Bank v. Home Insurance Co., 514 So.2d 825, 829 ( Ala. 1987).
33 Id., 741 F. Supp. at 1086.
34 Id.
35 Id.
6.03 Overview of Liability Insurance

Directors And Officers Liability

claims.\(^\text{37}\) Often a corporation would be required to shoulder a large portion of the defense costs and settlement payments.\(^\text{38}\)

In 1993, National Union Fire Insurance Company of Pittsburgh, Pa. began selling D&O policies containing a limited form of “Entity Coverage” insurance for the corporation itself.\(^\text{39}\) These early policies provided entity coverage to the corporation only if the directors and officers also were being sued.\(^\text{40}\) Thus, if the director and officers were dismissed from the case, the corporation would lose its coverage.\(^\text{41}\)

By 1995 and early 1996, however, broader entity coverage became available, covering the corporation for securities claims even when its directors and officers were not co-defendants.\(^\text{42}\) Insurers provide entity coverage today by modifying “Coverage Part II” or “Coverage B” to include entity coverage for securities claims against the corporation:

“COVERAGE B: CORPORATE LIABILITY INSURANCE

“This policy shall pay the Loss of the Company arising from a:

(i) Securities Claim first made against the Company, or

(ii) Claim first made against the Directors or Officers,

during the Policy Period or the Discovery Period (if applicable)
and reported to the Insurer pursuant to the terms of this policy for any actual or alleged Wrongful Act, but, in the case of (ii) above, only when and to the extent that the Company has indemnified the Directors or Officers for such Loss pursuant to law, common or statutory, or contract, or the Charter or By-laws of the Company duly effective under such law which determines and defines such rights of indemnity. The Insurer shall, in accordance with and subject to Clause 8, advance Defense Costs of such Claim prior to its final disposition.”\(^\text{43}\)

[d]—Defense Coverage

Another important feature of any D&O policy is coverage for defense costs and expenses. Most D&O policies cover defense costs but

\(^{37}\) See § 6.04 infra.

\(^{38}\) See Olson, Hatch, and Sagalow, Director & Officer Liability: Indemnification and Insurance, § 10.09 (West Group 1999).

\(^{39}\) Id.

\(^{40}\) Id.

\(^{41}\) Id.

\(^{42}\) Id.

\(^{43}\) American International Companies Directors Officers and Corporate Liability Insurance Policy Form No. 62335 (5/95).

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do so by including those costs in the definition of “loss,” rather than covering them in a separate insuring agreement.

[3]—Exclusions

Like all insurance policies, D&O policies contain many exclusions. The exclusions usually are set forth in a separate section of the policy, but exclusionary language can be found in other sections of the policy, including the insuring agreements and the definitions. Courts construe exclusions narrowly in favor of coverage.\(^\text{44}\)

[4]—Definitions

Many terms in a D&O policy are specifically defined in the policy. The insuring agreements, in particular, contain a number of terms that are defined in the definitions section of the policy. Three of the most important definitions in D&O policies are the definitions of “claim,” “loss,” and “wrongful act.”

[a]—Claim

Many D&O policies provide a definition of the term “claim.” The definitions of “claim” in D&O policies vary widely. Some policies define claim in the following manner:

“Claim shall mean any judicial or administrative proceeding initiated against a Director or Officer in which such Director or Officer may be subjected to a binding adjudication of liability for damages or other relief, including any appeal therefrom.”\(^\text{45}\)

Some D&O policies do not define the term “claim” at all.\(^\text{46}\) Policies that do not define the term “claim” may be held to have significantly broader coverage than those that do. In interpreting the term, numerous courts have held that a claim is not merely a contention that some wrongdoing occurred\(^\text{47}\) but “a demand for specific relief owed because

\(^{44}\) See § 7.02 infra.


\(^{46}\) E.g., National Union Fire Insurance Company of Pittsburgh, PA. Directors and Officers Insurance and Company Reimbursement Policy Form No. 47353, N. 1 supra.

\(^{47}\) See, e.g., MGIC Indemnity Corp. v. Home State Savings Association, 797 F.2d 285, 288 (6th Cir. 1986) (letter identifying particular savings and loan officers as (Rel. 0))
of alleged wrongdoing.”

Further, a claim must have been made against the directors and officers, not simply the corporation, for coverage for the directors and officers to exist.

[b]—Loss

Typical D&O policies state that they will reimburse directors and officers, or the company, for “Loss.” “Loss” is defined under D&O policies. For example, a D&O policy sold by National Union Fire Insurance Company defines “Loss” in the following manner:

“‘Loss’ means damages, judgments, settlements and Defense Costs; however, Loss shall not include civil or criminal fines or penalties imposed by law, punitive or exemplary damages, the multiplied portion of multiplied damages, taxes, any amount for which the Insureds are not financially liable or which are without legal re-
course to the Insureds, or matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed.”

D&O policies’ definitions of loss usually include defense expenses. Thus, defense expenses typically will exhaust the limit of liability of the D&O policy instead of being paid in addition to the limit of liability.

It is important to remember, however, that there are many different definitions of “Loss.” Each D&O policy should be reviewed carefully to determine what is encompassed within the term “Loss.”

Often, the definition of “Loss” contains exclusionary language. Many policies attempt to exclude coverage for the following within the definition of “Loss”:

- Civil or criminal fines;
- Punitive or exemplary damages;
- Amounts for which the policyholders are not financially liable;
- Amounts which are without legal recourse to the policyholders; and
- Matters deemed uninsurable.

Not all policies exclude all of these items. For example, a number of D&O policies specifically include coverage for punitive damages. One of these policies provides the following:

“‘LOSS’ shall mean any and all amounts that the INSURED are legally obligated to pay by reason of a CLAIM made against the INSURED for any WRONGFUL ACT, and shall include but not be limited to compensatory, exemplary, punitive and multiple damages, judgments, settlements, and reasonable and necessary costs of investigation and defense of CLAIMS and appeals therefrom (including but not limited to attorneys fees but excluding all salaries and office expenses of the COMPANY, amounts paid to counsel as general retainer fees, and all other expenses that cannot be directly allocated to a specific CLAIM), and cost of attachment or similar bonds, providing always, however, LOSS shall not include taxes, fines or penalties imposed by law, or matters that may be deemed uninsurable under the law pursuant to which this POLICY shall be

50 National Union Fire Insurance Company of Pittsburgh, PA. Directors and Officers Insurance and Company Reimbursement Policy Form No. 47353, N. 1 supra.
6.03 Overview of Liability Insurance

Directors And Officers Liability

construed. (“Fines or penalties” do not include punitive, exemplary, or multiple damages).”

Some policies limit coverage by providing that losses are covered only if applicable state law or corporate bylaws allow the indemnification of the directors and officers. In those cases, a court must not only interpret the policy’s definition of the term loss but also construe state law or bylaw indemnification provisions.

In the absence of such a provision, there can be little question that a corporation suffers a loss when it is adjudicated liable for money damages or enters into a monetary settlement after a suit has been commenced. Those situations fit nearly every definition of loss. For example, a court held that a corporation had suffered a loss when it entered into a settlement to refund the proceeds of a letter of credit it allegedly wrongfully received as a result of its officers’ allegedly wrongful acts. After refunding the proceeds, the corporation sought recovery from its D&O insurer.

Even when settlements or judgments do not involve simple monetary payments, courts often construe the term “loss” broadly to include other types of financial damage. One court held that a settlement of a class action that required corporate officers to forego a portion of their annual bonuses and required another officer to agree to shorten the term of a consulting contract he had entered into with the corporation were “losses” under the policy at issue. According to the court, the reduction in the amount of the bonuses was a loss because it fit within the policy definition of being an amount paid as a result of the wrongful acts of the directors that they had become legally obligated to pay. In addition, the court held that the shortening of the term of the consulting contract involved the director’s relinquishing a portion of a

54 Id.
55 Id., 911 F.2d at 159.
56 International Insurance Co. v. Johns, 874 F.2d 1447, 1454 (11th Cir. 1989).
57 Id.
contract he had previously been entitled to enforce. Therefore, although the director did not suffer an out-of-pocket loss, he nonetheless suffered a financial loss.\footnote{Id.}

Some courts hold that costs incurred in pursuing a counterclaim on behalf of the insured director or officer are not covered losses.\footnote{See, e.g., Perini Corp. v. National Union Fire Insurance Co. of Pittsburgh, Pa., 1988 WL 192453, at *2 (D. Mass. 1988).} In addition, at least one court has held that a corporation’s voluntary payment of funds, before any claim had been made against it, to settle criminal charges as a result of its directors’ allegedly wrongful acts was not a payment the corporation was legally obligated to make and therefore did not qualify as a loss under the policy definition.\footnote{MGIC Indemnity Corp. v. Home State Savings Association, 797 F.2d 285, 288 (6th Cir. 1986).}

Courts also have excluded other costs that do not directly relate to or result from a judgment or settlement. In a case in which an attorney was held to have breached his fiduciary duty to a financial institution by exploiting his position as a director to generate loans to collect attorneys’ fees, the court held that the attorney could not recover the value of his time spent defending the claims.\footnote{Federal Savings & Loan Insurance Corp. v. Mmahat, 97 B.R. 293, 300 (E.D. La. 1988).} The court held that the attorney’s claim was excluded from coverage under the policy definition of loss, which excluded losses resulting from actions taken to gain a personal advantage to which directors were not legally entitled and actions involving the dishonesty of directors.\footnote{Id., 97 B.R. at 298, 300.} The court also held that the costs were not recoverable because the attorney did not serve as his own trial attorney, but rather had separate counsel conducting his defense, and therefore he had suffered no loss under the D&O policy.\footnote{Id.}

6.03 Overview of Liability Insurance

Directors And Officers Liability

[c]—Wrongful Act

D&O policies contain many different definitions of the term “wrongful act.” The differences in definitions can be significant. Early D&O policies, and some modern ones, define the term “wrongful act” very broadly. For example, a National UnionFire Insurance Company of Pittsburgh, Pa. policy defines the term as follows:

“‘Wrongful Act’ means any breach of duty, neglect, error, misstatement, misleading statement, omission or act by the Directors or Officers of the Company in their respective capacities as such, or any matter claimed against them solely by reason of their status as Directors or Officers of the Company.”65

Notably, this definition lists a series of acts that constitute wrongful acts and then provides that other unspecified acts may constitute wrongful acts as well. In addition, the definition includes all matters claimed against directors and officers based solely on their status as directors and officers. Thus, even if a claim asserts no particular wrongful act by a director or officer, it still may be covered within the definition if the claim is based on the status of the policyholder as a director or officer.

Other definitions do not provide as broad coverage. For example, a definition of “wrongful act” in a Progressive CasualtyInsurance Company policy provides the following:

“‘WRONGFUL ACT’ shall mean any actual or alleged negligent act or omission, error, misstatement, misleading statement or neglect or breach of duty by the Directors or Officers in the discharge of their duties solely in their capacity as Directors or Officers of the Company, individually or collectively.”66

Notably this definition may narrow the scope of “wrongful acts” covered by the policy in three significant ways.67 First, the definition does not contain the catchall “other act” language. Second, it requires a “negligent act,” and insurers might argue that “negligent” modifies all of the enumerated acts so that omissions, errors, misstatements, misstatements, and breaches of duty are not wrongful acts if they are non-negligent. Finally, the definition omits the language bringing within the scope of the definition claims based on the directors’ or officers’ status as directors and officers and requires that acts be

65 National Union Fire Insurance Company of Pittsburgh, PA. Policy Form No. 47353, N. 1 supra.


67 Id.

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committed “solely in [the directors’ or officers’] capacity as Directors or Officers of the Company.”

Some insurers specifically exclude coverage for intentional, dishonest, criminal or fraudulent acts. When policies do not include such exclusions, courts must determine whether a policyholder’s act was intentional and, in turn, whether an intentional act is covered under the policy. In one case, an association was found to have illegally retaliated against an employee who had filed a lawsuit pursuant to the Civil Rights Act of 1866. The association then sought recovery from its D&O insurer for the amount of the judgment. The insurer argued that the policy did not cover intentional conduct and that retaliation was intentional conduct. The policyholder, however, argued that the definition of wrongful act as “any negligent act, error, omission, misstatement or misleading statement” was ambiguous. Specifically, the policyholder argued that the term “negligent” modified only the word “act” in the definition, not the terms “error, omission, misstatement or misleading statement.”

Citing cases in which other courts held that employment discrimination constituted intentional conduct, the court held that the term negligent modified every “relevant term in the definition” of wrongful act. Consequently, the court held that there was no coverage under the policy for the judgment against the association for retaliation.

One court held that a definition of “wrongful act” that limited coverage to directors’ and officers’ actions taken “while acting in their individual or collective capacities, or any matter . . . claimed against them solely by reason of their being Directors or Officers” of the insured did not limit coverage to acts committed “solely” in such capacity. The court held that actions committed by persons who

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69 Id., 761 F. Supp. at 1486.
70 Id., 761 F. Supp. at 1489.
71 Id., 761 F. Supp. at 1490.
72 Id.
73 Id., 761 F. Supp. at 1491. (“We believe the policy clearly limits its coverage … to negligent acts, negligent errors, negligent omissions, negligent misrepresentations and negligent misleading statements”).
74 Id.
served both as corporate officers and as trustees for a trust set up and maintained by the corporation were covered under the terms of the D&O policy at issue. The court found that the insureds’ “duties as corporate officers are not easily, if at all, distinguishable from their duties as trustees” and remanded the case to the trial court to determine which claims were covered under the policy.\textsuperscript{76}

However, in another case involving a policy with a similar definition of “wrongful act,” one individual acted as an attorney and as the controlling director of a financial institution. The court noted that the attorney/director’s actions arose “in the context of his dual role as director and attorney” and “cannot be said to have arisen solely from [his] actions as director.”\textsuperscript{77} Therefore, the court held there was no coverage under the D&O policy.\textsuperscript{78}

[5]—Conditions

D&O policies, like other policies, contain a distinct section setting forth conditions with which a policyholder must comply to obtain coverage. The most significant of these conditions are discussed below.

[a]—Notice of Claim/Circumstances

Most D&O policies specifically state when the policyholder must report a claim made against the policyholder to the insurance company. This requirement can take several different forms.

For example, many D&O policies require the policyholder to report the claim during the policy period or within a short time—identified as the “Discovery” or “Extended Reporting” period—after the policy period:

“The Company or the Insureds shall, as a condition precedent to the obligations of the Insurer under this Policy, give to the Insurer notice in writing of any claim made against the Insureds as soon as
practicable and during the Policy Period or during the Discovery Period, if effective in accordance with Section 7.”

Other D&O policies require the policyholder to notify the insurer within a specified number of days after the claim is made:

“The DIRECTORS or OFFICERS shall, as a condition precedent to their rights under this Policy, give the INSURER notice, in writing, as soon as practicable of any CLAIM first made against the DIRECTORS or OFFICERS during the POLICY PERIOD or DISCOVERY PERIOD, but in no event later than thirty (30) days after such CLAIM is made, and shall give the INSURER such information and cooperation as the INSURER may reasonable require.”

Finally, some D&O policies just require the policyholder to notify the insurer of a claim as soon as practicable:

“As a condition precedent to the right of the Insured Persons to payment under this Policy, the Insured Persons or the Company must give Aetna written notice by certified mail of any Claim as soon as practicable after it is first made.”

D&O policies also often contain “notice of circumstances” provisions. These provisions allow the policyholder to obtain coverage for claims that take place after the policy period if during the policy period the policyholder reports the wrongful acts or circumstances that may give rise to the claim. A typical notice of circumstances provision provides the following:

“If during the Policy Period or the Optional Extension Period, if applicable, the Directors and Officers or the Company first become aware of a specific Wrongful Act, and if the Directors and Officers or the Company shall, during such period, give written notice to Underwriters as soon as practicable of:

(1) the specific Wrongful Act, and
(2) the consequences which have or may result therefrom, and
(3) the circumstances by which the Directors and Officers or the Company first became aware thereof,

then any Claim not otherwise excluded by the terms of this Policy subsequently made against the Directors and Officers arising out of such Wrongful Act or any other Wrongful Act which, together with such Wrongful Act, would constitute Interrelated Wrongful Acts, shall be deemed for the purposes of this Policy to have been made during the Policy Year in which such notice was first given.”

To determine the sufficiency of a policyholder’s notice of circumstances, courts look to (1) the requirements of the insurance policy; (2) the specificity of the policyholder’s notice letter to the insurer; and (3) the allegations contained in the subsequently filed complaint. There is case law, however, stating that policies requiring notice of a “wrongful act” may require less specificity than policies requiring notice of a “specified wrongful act.”

The most important factor in determining the sufficiency of notice is the specificity with which the policyholder notifies the insurer. “[N]otice of a wrongful act invokes coverage as long as that notice is sufficiently specific.”

Thus, a policyholder’s notice that attached a copy of one complaint filed against the policyholder and a “laundry list” of claims that potentially could arise out of the wrongful act was a sufficiently specific notice of circumstances to satisfy the terms of the policy even though it did not include all of the information in the policyholder’s possession.

Similarly, in a case involving a claim by the FDIC, as receiver of a failed bank, against a former director of the bank, the policyholder gave sufficiently specific notice when it first sent notice to the insurer of “potential loss resulting from dishonest or fraudulent acts of an em-

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85 Continental Insurance Co. v. Metro-Goldwyn-Mayer, Inc., 107 F.3d 1344, 1347-1348 (9th Cir. 1997). See also: District of Columbia Circuit: FDIC v. Interdonato, 988 F. Supp. 1, 6 (D.D.C. 1997) (reviewing case law addressing the sufficiency of notice and stating that “all of [the] cases indicate that an important factor in considering the sufficiency of an insureds’ notice is its specificity.”)
employee committed alone or in collusion with others,” mentioning potential liability on the part directors and officers, and subsequently sent the insurer a second letter with a more detailed description of transactions that might have resulted in wrongdoing, including information setting forth possible loan violations and unsafe lending practices.\footnote{The sufficiency of notice is not lessened by the fact that a notice of circumstances letter does not identify a particular lawsuit.}

Some courts hold that the policyholder’s notice must objectively comply with the provisions of the policy. In one case, for example, the court rejected the argument that constructive notice of circumstances to the insurer established objective compliance with a policy requiring notice of “specified wrongful acts.”\footnote{FDIC v. Interdonato, N. 85 supra, 988 F. Supp. at 2-4, 8 (stating that the notice met or exceeded the notice that other courts have found sufficient to satisfy similar notice provisions in insurance policies).}

Courts also compare the policyholder’s notice of circumstances to the insurer with the allegations in the complaint later filed against the policyholder to determine whether the policyholder’s notice was proper.\footnote{McCullough v. Fidelity & Deposit Co., 2 F.3d 110, 113 (5th Cir. 1993).} The sufficiency of notice is not lessened by the fact that a notice of circumstances letter does not identify a particular lawsuit.\footnote{See Continental Casualty Co. v. Coregis Insurance Co., No. 1-98-0777, 2000 WL 339968, *9 (Ill. App. Mar. 31, 2000).}

[b]—Arbitration

Many D&O policies now contain arbitration provisions, requiring the policyholder and insurer to undertake some form of alternative dispute resolution in resolving claims submitted under the policy. One of these provisions, contained in National Union Fire Insurance Company of Pittsburgh, Pa.’s Securities Plus endorsement, provides the following:

“Clause 17, Arbitration, is deleted in its entirety and replaced by the following:

“DISPUTE RESOLUTION PROCESS

“It is hereby understood and agreed that all disputes or differences which may arise under this policy, whether arising before or after termination of this policy, including any determination of the
amount of Loss, shall be subject to the dispute resolution process (“ADR”) set forth in this clause.

“Either the Insurer or the Insureds may elect the type of ADR discussed below; provided, however, that the Insureds shall have the right to reject the Insurer’s choice of ADR at any time prior to its commencement, in which case the Insureds’ choice of ADR shall control.

“The Insurer and Insureds agree that there shall be two choices of ADR: (1) non-binding mediation administered by the American Arbitration Association, in which the Insurer and Insureds shall try in good faith to settle the dispute by mediation under or in accordance with its then-prevailing Commercial Mediation Rules; or (2) arbitration submitted to the American Arbitration Association under or in accordance with its then-prevailing commercial arbitration rules, in which the arbitration panel shall be composed of three disinterested individuals. In either mediation or arbitration, the mediator(s) or arbitrators shall have knowledge of the legal, corporate management, or insurance issues relevant to the matters in dispute.

“The mediator(s) or arbitrators shall also give due consideration to the general principles of the law of the state where the Named Corporation is incorporated in the construction or interpretation of the provisions of this policy; provided, however, that the terms, conditions, provisions and exclusions of this policy are to be construed in an even-handed fashion in the manner most consistent with the relevant terms, conditions, provisions or exclusions of the policy. In the event of arbitration, the decision of the arbitrators shall be final and binding and provided to both parties, and the arbitrators’ award shall not include attorneys fees or other costs. In the event of mediation, either party shall have the right to commence a judicial proceeding; provided, however, that no such judicial proceeding shall be commenced until the mediation shall have been terminated and at least 120 days shall have elapsed from the date of the termination of the mediation. In all events, each party shall share equally the expenses of the ADR.

“Either choice of ADR may be commenced in either New York, New York; Atlanta, Georgia; Chicago, Illinois; Denver, Colorado; or in the state indicated in Item 1 of the Declarations page as the mailing address for the Named Corporation. The Named Corporation shall act on behalf of all Insureds in selection of the ADR in accordance with this clause.
Features of arbitration provisions may be detrimental to the policyholder. For example, many arbitration provisions attempt to prevent the arbitrators from applying the doctrine of contra proferentem and other pro-policyholder rules of construction. Courts generally enforce “mandatory” arbitration provisions, but if the provisions make arbitration optional in any way it can be avoided.

[c]—Choice of Law

Many D&O policies now contain choice of law provisions. For example, an arbitration provision in one policy provides in the following manner that New York law is to govern disputes:

“ARBITRATION AND SERVICE OF SUIT

“Any controversy or dispute arising out of or relating to an interpretation of breach of this POLICY, shall be settled by binding arbitration in accordance with the Rules of the American Arbitration Association and judgment upon the award rendered by the arbitrator(s) may be entered in any court having jurisdiction there over. The arbitration process shall be governed by and conducted in accordance with the laws of the State of New York. . . .”

Policyholders should be wary of such requirements because some states have pro-insurer precedent governing many coverage issues.

[d]—Consent to Settlement/Defense

Many policies also require a policyholder to obtain the insurer’s consent before incurring defense costs or settling a claim:

“No cost, charges and expenses shall be incurred or settlements made without the insurer’s consent which consent shall not be unreasonably withheld; however, in the event such consent is given, the insurer shall pay, subject to the provisions of Section 4, such costs, settlements, charges and expenses.”

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91 National Union Insurance Company of Pittsburgh, PA. Securities Plus Endorsement Form (2/90).
92 See § 10.03 infra.
When a policy contains a provision requiring the policyholder to obtain the insurer’s consent prior to settlement, some courts require compliance with the provision before allowing the policyholder to recover, while others require that the insurer show prejudice from the policyholder’s failure to comply before denying coverage.

In a case in which a policy required the policyholder to “refrain from taking on any financial obligation or paying out any money, without [the insurer’s] authorization,” the court held that the insurer did not waive its right to require consent to settlement by refusing to contribute to the settlement or by filing a declaratory judgment action to establish that it has no obligation to the policyholder under the policy. The court noted that the insurer continued to defend the policyholder in the underlying action while pursuing the declaratory judgment action. The court also rejected the policyholder’s argument that the insurer must show prejudice to deny coverage, holding that prejudice is “irrelevant where the insured breaches a condition precedent to its recovery.”

In another case, the policy required that the policyholder allow the insurer to “associate with the Directors or Officers in the investigation, defense or settlement of any Claim” and that the policyholder “not admit liability for, or settle, any Claim” without the insurer’s written consent. The policyholder made several settlement offers without notifying the insurer but obtained the requisite written consent from the insurer before agreeing to a final settlement. The insurer argued that the policyholder’s unreasonably high initial settlement offers breached both policy provisions by creating an artificial and unnecessarily high floor for future settlement negotiations and therefore relieved the insurer of its obligation to cover the settlement amounts. The court, however, held that the provision allowing the insurer to “associate” with the policyholder regarding a settlement, read in light

96 Id., 929 F.2d at 433
97 Id., 929 F.2d at 434 (“The failure of [the insured] to obtain [the insurer’s] consent, by itself, precludes recovery.”) But see Public Utility Dist. No. 1 of Klickitat County v. International Insurance Co., 124 Wash.2d 789, 804, 881 P.2d 1020, 1029 (Wash. 1994) (in liability policy context, court required insurer to show prejudice before denying insured coverage for failing to comply with consent to settlement provision).
99 Id.
of the written consent provision, made the policy ambiguous as to whether the policyholder needed the insurer’s consent before making a settlement offer and therefore ruled in the policyholder’s favor.  

[e]—Extended Reporting Period

Claims made policies can be extended after the policy termination date on the basis of a “discovery” clause if the events giving rise to the claim took place prior to the policy’s termination date. Such a clause typically provides that the insured may, after paying a certain percentage of the premium, extend the policy coverage for a specified period of time with respect to wrongful acts committed before the date of the policy’s termination.

In one case, the court held that a policyholder’s failure to apply for an extended reporting period within the ninety day policy requirement precluded its ability to later assert such coverage, denying the policyholder’s argument that the insurer breached an obligation to notify it of the extended reporting provision. In another case involving an extended reporting period, the court held that the extended reporting period endorsement incorporated the notice provisions of the original policy, thus requiring the policyholder to provide notice of a claim made during the extended reporting period in accordance with the general terms of the policy.

Finally, a court has held that an insurer’s conditioning the renewal of a D&O policy on several changes, including a reduction in the policy period, an increase in the deductible, a reduction in the discovery period, and the addition of a regulatory endorsement, amounted to a refusal to renew that entitled the policyholder to exercise the extended

100 Id., 864 F. Supp. at 860.
101 See, e.g., American Casualty Co. v. FDIC, 958 F.2d 324, 328 (10th Cir. 1992).
102 Mt. Hawley Insurance Co. v. Federal Savings & Loan Insurance Corp., 695 F. Supp. 469, 481 (C.D. Cal. 1987) (holding that policyholders should have known the policy contained a discovery clause; “[t]hey do not contend that the clause was unclear or ambiguous, nor could they” because the policyholder has a duty to read its policy).
103 FDIC v. Booth, 82 F.3d 670, 675 (5th Cir. 1996) (court held that allowing coverage for a claim made after termination of the policy, but during extended reporting period, without requiring notice to insurer under terms of original policy would "provide an extra benefit to an insured whose policy has been canceled, a benefit unavailable to an insured who is still covered during the regular policy period").
reporting clause.\textsuperscript{104} Therefore, a claim that arose during the discovery period, and about which the policyholder gave notice to the insurer during the extended reporting period, was held covered.\textsuperscript{105}

\textsuperscript{104} McCuen v. American Casualty Co., 946 F.2d 1401, 1404-1405 (8th Cir. 1991).

\textsuperscript{105} Id.
6.03 Overview of Liability Insurance
Directors And Officers Liability