

DIRECTORS AND OFFICER'S LIABILITY INSURANCE
– AN OVERVIEW

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I. INTRODUCTION

The rise in corporate malfeasance over the last decade or so is well known to most Americans. Lawsuits against corporate directors and officers used to be rare and corporations were often not permitted to indemnify their officers and directors against such lawsuits. The expense was not viewed as a real benefit to the corporation or its shareholders. The climate, however, has changed as have companies' attitudes and approach toward litigation against their officers and directors. In response to the increase in litigation, corporations now provide indemnity to their officers and directors. States have also adopted legislation permitting corporations to indemnify their officers and directors and corporations have begun to procure professional liability insurance in order to protect against such claims.

With the rise in litigation, the need for corporations to provide indemnity to their directors and officers and to procure insurance to cover such losses is fairly obvious. No one, or least no one that a corporation would want, will be willing to serve as a director or officer of a company if they are not protected against liability. The exposure and risk would be too great. In order to attract viable candidates, corporations have had no choice but to offer their officers and directors such protection. Litigation against directors and officers really picked up as a result of the savings and loan scandals in the 1980s. Some would argue, however, that directors and officers' liability and litigation, or at least the conduct of the directors and officers that has lead to the litigation, has reached a whole new level with the corporate scandals that have occurred over the last few years.

II. THE D&O POLICY AND COVERAGE

A. What it covers.

A directors and officers liability policy provides exactly that, liability coverage for the directors and officers of the company. It generally defines a "director and officer" to include any past, present, or future duly elected or appointed director or officer of the company. *See generally, Couch on Insurance*, Section

131:31(3rd Edition 1997). The policy is typically issued in the name of the company itself as the "Parent Company." Coverage can be provided directly to the directors and officers or to the company who in turn indemnifies the directors and officers pursuant to its bylaws. Coverage is often provided under both circumstances and delineated as Coverage A and B, with an insuring clause like the following:

- A. Carrier shall pay on behalf of the Directors and Officers' Loss resulting from any Claim, first made during the Certificate for a Wrongful Act.
- B. Carrier shall reimburse the Company for Loss which the Company pays as indemnification to any of the Directors and Officers resulting from any Claim first made during Certificate for a Wrongful Act.

"Loss" is typically defined under the policy as:

Loss means damages, settlements and **Costs, Charges and Expenses** incurred by any of the Directors and Officers, but shall not include:

- (1) Punitive or exemplary damages or that portion of any multiplied damage award which exceeds the amount multiplied, or
- (2) Taxes, criminal or civil fines, or penalties imposed by law, or
- (3) Matters deemed uninsurable under the law pursuant to which this certificate shall be construed.

Some policies, however, will include coverage for punitive or exemplary damages where they are legally insurable.

“Costs, Charges and Expenses” are then defined to mean:

Costs, Charges and Expenses means reasonable and necessary legal fees and expenses incurred by the Directors and Officers in defense of any Claim and cost of attachment similar bonds but shall not include:

- (1) Salaries, wages, overhead or benefit expenses associated with officers or employees of the Company, or
- (2) Any amounts incurred in defense of any Claim for which any other insurer has a duty to defend.

“Claim” is often defined to mean:

Claim means any judicial or administrative proceeding initiated against any of the Directors or Officers in which they may be subjected to a binding adjudication of liability for damages or other relief, including any appeal therefrom.

The coverage provided under Coverage B for the company is not for claims directly against the company itself, but only for claims against its directors and officers. Its simply provides that the company will be reimbursed if it reimburses the directors and officers. The company actually can often be a plaintiff in these types of suits, at least in a derivative capacity. Shareholders will bring a suit in the name of a company against the directors and officers in a company if they suspect that the directors and officers have been mismanaging the company. The company cannot itself bring a claim against and recoup any damages from its own directors and officers and recover monies under the directors and officers’ liability policy. They also cannot accomplish the same thing by having one or more of its directors or officers do the same thing. Recovery on these type of claims is for the shareholders.

Directors and officers policies (“D&O policies”) typically do not provide a duty to

defend, often specifically stating that it shall be the duty of the directors and officers and not the duty of the carrier to defend any claims. D & O policies do, however, typically provide for the reimbursement of defense costs and provide for such reimbursement during the course of the litigation. As a result, the policies provide much of the same defense benefits as a general liability policy does. The carrier of course does not control the selection of counsel and often ends up paying much higher rates for the defense of such claims than it would if it were controlling the defense, although there is still theoretically a reasonableness component as to how much the carrier must reimburse for defense costs. The company generally has to pay for the defense up front and there is often a significant delay in the payment or reimbursement of defense expenses from the carrier to the company or the individual officers and directors.

There is also often a dispute over the reimbursement of defense costs when there are significant coverage issues. However, as a practical matter, the issue often works itself out much like it does in the context of a typical liability policy, with defense costs being reimbursed even when the actual coverage for the claim is still very much in doubt, treating the defense obligation as broader than the actual coverage obligation. The carriers do generally have to advance defense costs as they are incurred. While there is no duty to defend under the policy, there is a duty to pay any “loss” under the policy and, as in the example above, “Loss” under the policy is often defined to include defense costs and expenses. See, *In Re WorldCom, Inc. Securities Litigation*, 354 F.Supp.2d 455 (S.D.N.Y. 2005); *Federal Ins. Co. v. Tyco International, Ltd.*, 784 N.Y.S.2d 920 (Supp. 2004), appeal dismissed, 792 N.Y.S.2d 397 (1st Dept. 2005); *Mt. Hawley Ins. Co. v. Federal Savings & Loan Ins. Corp.*, 695 F.Supp. 469 (C.D. Cal. 1987).

Sometimes advancement of defense costs can be allocated between covered and non-covered claims when it is clear that some of the claims are not going to be covered under the policy. See *Gon v. First State Insurance*

Company, 871 F.2d 863 (9th Cir. 1989) (applying California law, court allowed carrier to apportion defense costs between covered and non-covered claims prior to an actual determination of coverage); *National Union Fire Insurance Company of Pittsburg, Pa. v. Ambassador Group, Inc.*, 157 A.D.2nd 293, 556 N.Y.S.2nd 549 (1st Dept. 1990). Whether such allocation is available, however, may depend on the precise wording of the policy. For example, some courts have held that the D&O policy at issue was a liability policy as opposed to an indemnification policy, requiring the insurer to pay for loss, including defense costs, as they were incurred. An indemnification policy would have created no obligation on the part of the carrier until the loss had actually been finally determined. See *In Re World Com, Inc. v. Security Litigation*, 354 F.Supp.2nd 455 (S.D.N.Y. 2005) and *Federal Insurance Co. v. Tyco International Ltd.*, 784 N.Y.S.2nd 920 (Sup. 2004), appeal dismissed, 18 A.D.3rd 33, 792 N.Y.S.2d 397 (1st Dept. 2005).

B. D&O Policies Are Claims Made Policies.

Directors and officers liability policies are “claims made” policies, not “occurrence” policies. They therefore only cover claims made during the policy period. As a result, the company’s application for a directors and officers’ liability policy is critical. The application itself is often attached to and made a part of the primary D & O policy. It requires the company to list all current litigation pending against the company and its officers. It also requires the company and its officers and directors to disclose facts or circumstances that may give rise to a claim. The carrier is of course assessing the potential risk that a claim may be made during that one year policy and is not insuring against any claims that may have been made prior to the issuance of its policy.

Not surprisingly, D & O policies typically contain an exclusion excluding any prior or pending litigation or any claims that are related to any prior or pending litigation. Such policies also often include an exclusion for claims that the company or its directors and officers were aware of prior to the issuance of

the policy. These claims are, or at least should have been, the subject of prior notice because the company and/or its directors and officers were aware of them. They should have been disclosed on the application for the policy in question and if there was a previously existing D & O policy, they would have been the subject of notice under that policy and should be covered by that policy. These so called prior notice exclusions also typically exclude any claims that are related to those that are the subject of prior notice by way of a common nexus of facts, circumstances, situations, events, or transactions, referring to them as “Interrelated Wrongful Acts.”

C. Significant Exclusions

There are of course a number of other exclusions under a typical D & O policy. One such exclusion is the so-called insured versus insured exclusion. This prevents coverage for claims by one or more directors or officers against other directors or officers or claims by a director or officer against the company. Such exclusions often exclude claims that are brought by, on behalf, or at the direction of an insured director or officer. An exception that is typically included to this exclusion is for a claim that is brought derivatively against the company by a shareholder who happens to also be a director or officer when such claim is brought in that capacity, usually alleging corporate mismanagement. Claims for alleged wrongful termination by a director or officer are also often excepted from this exclusion, as many D & O policies provide coverage for claims for wrongful termination.

Another exclusion that is becoming increasingly more common is a regulatory exclusion. These exclusions arose out of the bank and savings and loan failures resulting from misconduct on the part of directors and officers. After having to provide coverage for a wave of litigation by the FDIC and FSLIC to recover bank assets and preserve depository insurance funds following the banking and savings and loan crisis, carriers began to exclude claims brought by governmental agencies. *Crouch on Insurance*, Section 131:34. These exclusions have been attacked on public

policy grounds, but they have largely withstood such attacks and have been upheld as legitimate and viable exclusions. *Crouch on Insurance*, Section at 131:35.

Another standard exclusion, and one that has become a major battleground in the wake of the corporate scandals that have occurred over the last few years, is the dishonesty and personal profit exclusion. If the insured director or officer gained a personal profit or personal advantage as a result of dishonest or fraudulent conduct, then the claim is most likely excluded by the dishonesty and personal profit exclusion. See *TIG Specialty Ins. Co. v. PinkMonkey.com Inc.*, 375 F.3d 365 (5th Cir. 2004) (insured CEO gained a personal advantage to own and run a successful business funded by money wrongfully obtained from investors). The exclusion can apply even if the insured director or officer did not actually profit from the alleged wrongdoing, but only gained a business advantage. See *Jarvis Christian College v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 197 F.3d 742 (5th Cir. 1999) (insured created a viable opportunity for his business and therefore gained a personal advantage even when there was no evidence that he actually made a profit). Directors and officers often make out quite well when the company is performing well. They do so through their compensation packages and the stock options and other bonuses that are included in those packages. When the company falters, and the stock price goes in the tank, shareholders naturally get upset. Directors and officers are often accused of misconduct in making corporate decisions that were designed to benefit them personally and not necessarily the company. There are also often allegations of insider trading that go along with such claims.

The directors and officers are obviously supposed to be running the company to benefit the shareholders and not themselves. Directors and officers liability policies therefore typically exclude any claims brought about by any personal profit or advantage gained by the directors or officers to which they were not legally entitled, as well as any claims for any dishonest, fraudulent, or criminal acts or

omissions. Such exclusion generally does not apply, however, until there is a determination that the insured *in fact* engaged in such acts and/or profited illegally. See *St. Paul Mercury Ins. Co. v. Foster*, 268 F. Supp. 2nd 1035 (C.D. Ill. 2003). Accordingly, until there has actually been a judicial determination that the insured engaged in any of the acts covered by the exclusion, the exclusion is not applicable. This makes it difficult for carriers to obtain a determination by way of declaratory relief prior to the adjudication of the underlying action and therefore often brings them to the settlement table, even when it appears that the claim may ultimately be excluded under the policy.

III. CURRENT BATTLEGROUNDS – UNINSURABLE LOSS.

An issue that has increasingly become the subject of litigation with D&O claims revolves around the question of what constitutes a “loss” under the policy. This argument, or at least the issues raised by it, is somewhat related to the dishonesty/personal profit exclusion and the two are often used together to argue against coverage. In securities fraud cases where one or more of the directors has personally profited significantly from the actions that are the subject of the claim, carriers are increasingly arguing that this does not constitute a “loss” under the policy.

The basis for this argument is rooted in the nature of damages or remedy sought in many shareholder lawsuits under the federal securities laws. Many such lawsuits involving some form of securities fraud allege that the defendant directors and officers misled the plaintiffs into selling their shares at a too low of a price and the shareholders have brought a claim seeking essentially to get their money back. They seek as damages the difference between the actual value of the shares and the price that they were paid for them. The argument is that if not for the inappropriate actions of the defendant directors and officers, the shareholders would have been able to receive the actual value for their shares. Damages in the form of the difference between the price received for the stock and the actual value of the shares if not for the inappropriate conduct can be said to be

restitutionary damages. They are intended to restore the plaintiff shareholders to the position they were in before the inappropriate conduct by having the parties who were allegedly responsible for the drop in value pay to restore it. In short, they are seeking to have the defendants return what they inappropriately acquired, their “ill-gotten gain” so to speak. Another way of describing the remedy sought is disgorgement of unlawful profit.

The landmark case in this area is *Level 3 Communications, Inc. v. Federal Insurance Company*, 272 F.3d 908 (7th Cir. 2001). *Level 3* was a case involving a claim for increased merger consideration. The plaintiffs claimed that they should have received more for their shares as part of a merger and claimed that the defendant directors and officers bought shares in a company from the plaintiffs at an unfairly low price. The plaintiffs claimed that the directors and officers failed to make certain disclosures that would have resulted in the plaintiffs receiving more for their shares if the disclosures had been made. The 7th Circuit essentially characterized the claim as one for the return of improperly obtained property. The plaintiff shareholders were asking the defendant directors and officers to return the profit that they inappropriately obtained on the purchase of the shares. The 7th Circuit stated:

[The plaintiffs in the underlying suit] were seeking the difference between the value of the stock at the time of trial and the price they had received for the stock from *Level 3*. That is standard damages relief in a securities-fraud case. But it is restitutionary in character. It seeks to divest the defendant of the present value of the property obtained by fraud, minus the cost to the defendant of obtaining the property. In other words, it seeks to deprive the defendant of the net benefit of the unlawful act, the value of the unlawfully obtained stock minus the cost to the defendant

of obtaining the stock. It is equalivant to seeking to impress a constructive trust on the property in favor of the rightful owner. How the claim or judgment order or settlement is worded is irrelevant.

Level 3, 272 F.3d at 910 to 11.

In analyzing whether such a claim could be covered under a directors and officers’ liability policy, the Court in *Level 3* concluded that such restitutionary damages did not constitute a “loss” under the policy. Focusing on the remedy sought, the Court in *Level 3* found that the claim was nothing more than one for a return of ill-gotten gain and was therefore not covered under the terms of the policy. Finding that the claim did not constitute a “loss” under the policy, the Court in *Level 3* stated “[A]n insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than ‘stolen’ is used to characterize the claim for the property’s return.” *Id.* at 911. The Court treated the action as if it was one in which the plaintiffs were seeking to get their “property” back in the form of damages for the amount that they should have received for the true value of their stock. Since the claim was just one for the return of property wrongfully obtained, the Court concluded it did not constitute a “loss” under the policy.

Not surprisingly, plaintiffs in class action securities lawsuits involving alleged securities fraud have argued that the *Level 3* decision is seriously misguided and legally flawed. They point out that a fundamental premise of the *Level 3* decision is that the defendant directors and officers are actually treated like thieves who are accused of stealing the plaintiffs’ money or property. This is so presumably without regard to whether the defendant directors and officers actually acquired the money or property themselves. The claim to return the plaintiffs the profit they should have received is cast as “restitutionary in character” and labeled as a claim for disgorgement or return of “ill-gotten gain” by

the defendant directors and officers. This is so without regard to whether the conduct of the defendant directors and officers was negligent, intentional, or somewhere in between. They are treated like criminals, the plaintiffs' bar argues, for purposes of determining whether the claim constitutes a "loss" under the directors and officers liability insurance policy. This may seem to be a little extreme, but it is all made to get their point across.

Despite protests from the plaintiffs' bar, a number of cases have followed the *Level 3* decision analysis. The Ninth Circuit recently followed the Level 3 analysis in a couple of decisions involving California law. In *Pan Pacific Retail Properties v. Gulf Insurance Company*, 471 F.3d 961 (9th Cir. 2006) and *Unified Western Grocers, Inc. v. Twin City Fire Insurance Company*, 457 F.3d 1106 (9th Cir. 2006), the Court of Appeals for the 9th Circuit cited with approval the reasoning of the 7th Circuit in *Level 3*. The *Pan Pacific* case involved a claim for increased consideration paid to shareholders in a merger and the *Unified Western Grocers* case involved a claim by creditors concerning the approval of a leverage buy-out by a company in the acquisition of assets that were detrimental to several creditors. Following the reasoning of *Level 3*, these cases noted that a determination of whether the loss was uninsurable turned on the nature of the remedy sought, not the labels attached to such remedy. See, *Unified Western Grocers*, 457 F.3d at 1115, and *Pan Pacific*, 471 F.3d at 966.

Other cases have likewise found that the underlying claims did not constitute a "loss" under the policy when the damages or remedies sought could be cast as claims for restitution. See *Reliance Group Holdings, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 188 A.D.2d 47, 594 N.Y.S.2d 20 (1st Dept. 1993) (involving a "greenmail" scheme in which the subsidiaries of a wholly owned holding company of a director and officer purchased large amounts of stock in another corporation in an attempted hostile takeover, selling the stock back to directors, officers and shareholders of the target corporation at a substantial profit and the damages were for the wrongful obtained

profit); *Conseco, Inc. v. First National Union Fire Ins. Co. of Pittsburgh, Pa.*, 2002 W.L. 31961447 (Ind. Cir. Ct. 2002) (securities litigation); *Executive Risk Indem., Inc. v. Pacific Educational Services, Inc.*, 451 F.Supp.2d 1147 (D. Haw. 2006) (claims for misrepresentation about the accreditation status of a school; the only monetary claims were ones for restitution of monies wrongfully obtained as part of the scheme). Other cases have refused to deny coverage in its entirety despite the fact that some of the loss claimed was for restitution. Those courts have required an allocation between damages seeking restitution, which are not covered, and other damages which would be covered under the policy. *Unified Western Groceries*, 457 F.3d 1106 (some of the losses involved claims for restitution of money and assets that were funneled to the insured, but other claims were for losses suffered by the bankrupt company which would have been covered under the policy). See also, *St. Paul Mercury Ins. Co. v. Foster*, 268 F.Supp.2d 1035 (Cd. Ill. 2003) (finding that some of the claims involved claims for damages that could be categorized as divesting the defendant-insureds of the net benefit of unlawful actions but some could not and the latter would constitute "loss" under the policy because those defendants had no ill-gotten gain to restore).

With *Level 3* and its prodigy, more and more carriers are raising the argument in securities fraud cases that the claims are uninsurable and/or do not constitute a "loss" under the policy. The extent to which courts are going to allow D & O carriers to cast the remedies sought in terms of restitutionary damages and restoration of "ill-gotten" gain remains to be seen. *Level 3* and its growing prodigy are providing a rather solid foundation for such arguments.

IV. PRACTICAL ASPECTS OF RESOLVING D & O CLAIMS

D & O claims have some interesting and unique characteristics. The majority of companies that carry directors and officers' liability insurance carry a good bit of it. There is typically excess insurance and there is often quite a bit of excess insurance. It is not at all

uncommon to have a 50 or even a 100 million dollar tower of directors and officers liability insurance at issue in one of these class action security lawsuits. Not surprisingly, the claim on behalf of the plaintiff class often seems to be for just within the policy limits.

These so-called towers of directors and officers liability insurance present a number of interesting issues, particularly with respect to negotiations and resolution of claims prior to trial. Most of the excess policies are follow form so the coverage issues generally don't vary significantly among the group of insurers up and down the tower of insurance. There can be specific exclusions that are added to one or more of the excess policies, but they are generally very similar and all the coverage under the tower insurance follows what coverage is provided under the primary policy. The tower itself, however, can present some interesting dynamics during the course of attempting to negotiate a resolution of the underlying claim.

The unique dynamics begin with the fact that you generally have multiple insurance carriers who are involved as part of the insurance tower. Each of them may have anywhere from a million to 10 or 15 or even 20 million dollars of coverage in what is referred to generally as a layer of coverage under the insurance tower. Different carriers of course often have different views on coverage. Some may be more aggressive in taking coverage positions and some simply view a particular set of facts and circumstances and whether those create coverage under a policy differently. Each carrier of course has a lawyer or lawyers who are representing that carrier's interests in the litigation and most of the those lawyers have an opinion on the coverage issues. The underlying case and the potential exposure created by that claim is also always at issue, although it sometimes appears that the parties lose site of that fact and what the likely verdict would be if the underlying case actually went to trial. The carriers seem to be focused on arguing the coverage issues, the plaintiffs seem to be focused on tapping the full tower of insurance, and defense counsel seems to be focused on getting the claims settled within the insurance

limits regardless of the actual value and verdict potential of the underlying claim.

The dynamics at work during negotiations get very interesting. The amount that is being discussed for potential settlement usually gets fairly significant and involves several layers in the tower of insurance. Each of the layers in the tower condition coverage on full exhaustion of the underlying limits. If all of the insurance under a particular layer has not been fully exhausted, then there is no coverage under the policy in question. This creates a sort of domino affect in that no layer of coverage is "in play" until all of the coverage under it has been exhausted. During negotiations, the practical effect of this phenomenon is that each of the carriers commit their limits one by one. As one might imagine, different carriers often have different views on coverage for the underlying matter as well as in the value of the case. The negotiations therefore often ebb and flow and start and stutter as they work their way up the tower.

Not surprisingly, carriers at the lower level of the tower are sometimes angling to save a little bit of money and pay something short of their policy limits. It is even fairly common for the same carrier to have multiple layers at varying points in the tower. The lower level carriers often propose some sort of pro rata settlement with all of the carriers up and down the tower paying a portion of the settlement. An equal pro rata settlement is often a tough sale given the fact that the carriers who have the layers at the higher end of the tower have far less of an expectation that their layer will ever be reached and presumably their premium reflects that. However, a weighted pro rata approach is sometimes proposed and can potentially have some appeal to all parties involved.

Usually, when there are coverage issues the question of whether the insured is going to contribute anything themselves to a potential resolution comes into play. Quite often, the directors and officers are wealthy entrepreneurs and executives who have done quite well through their association with the company in

question and the actions that led to their accumulation of wealth are often at the center of the litigation. Consequently, there is often an effort made to get one or more of the directors and officers to contribute a substantial portion to the settlement. This dynamic can take on an even more significant element when one or more of the carriers at some point in the tower take a particularly strong coverage position. An effort is often made to have one or more the insureds contribute to the settlement and have their contribution “fill the gap” in the tower of insurance, creating an exhaustion of that layer or layers to trigger coverage under the excess policies above that layer. Whether such an arrangement can actually constitute exhaustion is debatable and is often debated among reinsurers, who are of course the ones that end up paying for these losses at the end of the day on many occasions anyway. All of which makes for very lively and interesting negotiations.

V. CONCLUSION

Directors and officers liability policies are somewhat unique. When you add to that the complexity and dynamics that come with multiple layers and multiple insurance carriers, D&O claims are incredibly interesting with many different facets to them. The underlying actions that give rise to D&O claims are often very colorful and fascinating as well. While the corporate scandals of recent years may have been a high mark for greed and corporate corruption, the actions that lead to D&O claims will continue as long as business continues to be done in the corporate context and there is pressure and a drive to succeed.