THOR
INSURANCE FINANCIAL

Protecting your Company and Personal Assets from Business Risk
Directors & Officers Insurance

You may have heard that incorporating your business will separate your personal assets from those of the your business. Unfortunately, this is not necessarily the case. Your personal assets can be available to settle litigation if you or your organization are sued for actions you did or did not undertake as a director or officer, actual or allegedly.

Duties of Directors and Officers

Duty of Diligence (Care): Act reasonably, in good faith, in the organization's best interest,
Duty of Loyalty: Place the interest of the organization before your own,
Duty of Obedience: Act within the scope of the organization, within applicable rules and laws.

Sources of Liability

Employees

- Wrongful dismissal
- Discrimination, including workplace and sexual harassment
- Breach of employment contract
- Failure to address health and safety concerns
- Changing environment – #Me Too, COVID-19

Competitors

- Breaches of intellectual property
- Misappropriation of trade secrets
- Collusion
- Anti-competitive behavior

Creditors

- Breach of fiduciary duty
- Breach of duty of due care
- Negligence
- Deliberate misconduct

Government & Regulatory Authorities

- Corporations law: Governs the ownership and management of organizations
- Securities law: Governs the administration of publicly listed companies
- Consumer protection law: Governs the way in which organizations distribute products and services to consumers
- Occupational health and safety law: Ensures that organizations maintain a safe workplace
- Taxation law: Governs the taxation of organizations and individuals
- Environmental law: Ensures that industry participants adhere to environmental restrictions

Shareholders

- Direct action - a shareholder or group of shareholders bring a claim against management for damages in their interests as shareholders. Shareholders are the benefactors of any financial settlement
- Derivative action - shareholders—acting as the organization—sue the Directors and officers. Shareholders generally claim for damages caused to the organization, with the beneficiary of any settlement being the organization itself

Customers

- Contractual disputes
- Debt collection
- Costs or quality of products or services
- The refusal to extend credit
- Alleged discrimination

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Protecting Directors and Officers

Risk Management – all Directors and officers should have a deep understanding of their responsibilities

- provide training on negligence and liability
- ensure Directors and officers are aware of all risks and rules associated with their positions
- implement policies and procedures for Directors and officers to follow
- establish a formal reporting system for Directors and officers to receive information
- document all decision and processes
- consult legal counsel when Directors and officers make decisions

Indemnification provides the right to the advancement of defense expenses and general protection from any legal responsibility following a claim,

Insurance protects the personal assets of directors and officers in the event the company does not pay defense costs or fund indemnification, and it is essential to helping organizations attract qualified individuals to serve on their boards,

Coverage Overview

Side A: Directors & Officers Coverage insures individual directors and officers against losses that the organization is not legally or financially able to indemnify.

Side B: Corporate Reimbursement Coverage reimburses organizations for expenses they incur when defending directors and officers in accordance with their indemnification obligations.

Side C: Entity Coverage insures organizations for claims made directly against the organization by providing entity asset protections and coverage for defense costs.

Side A Excess Difference in Conditions (DIC) sits on top of a traditional D&O policy, effectively providing a broader coverage with separate limits for directors and officers. This coverage

- provides excess insurance that kicks in once a company's traditional D&O policy is exhausted
- provides protection when an underlying insurer fails or refuses to pay, attempts to rescind coverage or becomes insolvent
- is not typically subject to the exclusions found in traditional D&O policies, specifically the "insured versus insured" and "pollution" exclusions. This can create policies that are more dynamic

Policy Extensions and Key Terms

Advancement of Defense Costs requires the insurer to forward defense costs to policyholders throughout a defined period of time.

Without this extension, an organization or its executives may be required to fund their own defense costs until an insurer can assess the claim and reimburse them.

Retired Directors & Officers - in order for an incident to be covered, organizations must have an active policy when a claim arises. Because some claims may take years to arise, a company's retired executives can be left unexpectedly exposed. Policyholders can protect their former directors and officers by including an extended reporting period in their D&O coverage allowing organizations or retired executives to report a claim to the insurer even if the organization no longer carries an active policy.

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Outside Directorships where an executive takes a leadership position for an external non-profit, standard D&O policies may not offer sufficient enough protection in these instances, and outside directorship coverage may be needed. This also ensures that executives will be covered in the event that their non-profit's insurance is insufficient or completely exhausted.

New Subsidiaries extension is meant to cover any new subsidiaries and provide them with the same protection as the parent organization.

Spouses, Heirs and Legal Representatives
To protect themselves in the event of a claim, some executives transfer ownership of their assets to a third party. This often includes spouses or guardians.

While this might be a sound legal strategy, it can also leave these third parties open to claims. This extension is designed to protect third parties and an executive's assets. However, it does not protect them from the consequences of their own activities.

Continuity of Coverage allows claims to be accepted late. Typically, this extension is available to policyholders that have held uninterrupted D&O coverage over a predetermined period. This can prove useful for organizations that fail to notify their insurers of a claim they felt didn't warrant a notification or a notification was unsuccessful altogether.

Common Policy Exclusions

Organizations should always sit down with their insurance broker and review the exclusions in their D&O policy. This will help ensure that the organization and their officers understand how their policy works in practice.

Known Claims & Circumstances
Due to the claims-made nature of D&O coverage, policies typically do not cover known claims and circumstances, claims that should have been reported during a past policy period.

Prior or Pending Litigation exclusion date ensures that the insurance company does not have to pay a claim arising from active or pending litigation that an organization knew about before the effective date of the coverage.

A typical scenario where the prior or pending litigation exclusions comes into play is when a lawsuit against an organization is later amended to include Ds and Os as named defendants after the inception date of the policy. In addition, Ds and Os can be exposed to this exclusion if a lawsuit is filed before the prior or pending date, but management doesn't find out about it until afterward.

Conduct Exclusions found in most policies preclude coverage for the following two categories of conduct:

- for claims related to fraudulent or criminal misconduct,
- for claims related to illegal profits or wages the insured executive was not legally entitled.

Some policies allow the insurance company to advance defense costs to a director or officer with the presumption of innocence, and a formal court ruling or admission of guilt is required to decline coverage completely.

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Insured Vs. Insured Exclusion

D&O policies preclude coverage for claims brought by one insured director or officer against another director or officer also covered under the same policy to eliminate coverage for internal disputes among directors and officers and claims involving collusion.

Limits of Liability sets the maximum amount that an insurance company is prepared to spend defending and settling claims on behalf of a business and its management. A limit of liability is available for the payment of legal defense costs, settlements and court awarded judgments throughout a policy period.

D&O policies are typically subject to an **aggregate limit of liability**, meaning that the limit applies to all claims combined during the policy period. Accordingly, one large, expensive loss or a number of smaller losses that accumulate during the policy period could exhaust a limit of liability.

Defense Costs

Most D&O policies are defense cost inclusive, meaning that rather than paying legal expenses in addition to claims up to the policy limit, D&O policies subtract legal expenses from the policy limit itself.

As a claim is defended, the limit of liability gradually erodes, leaving less funds available for settling claims or paying for future claims during the policy period.

Selecting A Limit Of Liability

The level of coverage under a D&O policy could be the difference between an organization and its leaders being comfortably protected and financial ruin.

But how does an organization know how much D&O coverage to carry? This is a complex question, as companies need to balance their unpredictable, future liabilities with today's premium expenses to determine the level of coverage they need.

D&O insurance limits need to be sufficient enough to pay for a vigorous defense of claims for all directors and officers, as well as the company itself. What's more, there needs to be enough funds remaining following a defense to settle claims and satisfy any judgments. This ensures that plaintiffs will not go after your directors' and officers' personal assets.

Consideration 1 - Ownership Structure: Public Vs. Private

An organization's ownership structure plays an important role in determining the level of D&O coverage needed.

Public Companies must contend with the ever-present threat of a securities class-action litigation. In many cases, a securities suit represents the company's largest management liability exposure. As a result, publicly held organizations tend to carry D&O policies with higher limits than their privately held counterparts.

Private Companies

While public company policies are generally limited to securities claims, private company entity coverage is generally broader. This broader coverage creates the possibility that defense expenses and settlements of the entity could erode the limits of liability.

This could leave individual directors and officers with little or no insurance remaining to defend themselves or settle claims. Broader entity coverage could influence some buyers to increase their limits of liability in order to protect against erosion or exhaustion of policy limits.

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Consideration 2 – Size

A company's size is also a good indicator of D&O exposure. A number of metrics can measure the size of an organization, including annual revenue, market capitalization and employee count. Generally, larger organizations experience more severe and frequent D&O claims.

Consideration 3 - Number Of Directors And Officers

The total number of executives requiring protection under a D&O policy has a substantial effect on the level of D&O coverage needed by an organization. When defending claims, all directors and officers draw coverage from the same insurance policy and limit of liability.

Directors and officers may not have the same interest and, therefore, may require their own separate legal counsel. This can lead to the rapid exhaustion of the limit of liability. For example, some officers may be alleged to have knowingly participated in fraudulent acts, while others are alleged simply to have breached their duty of care. When this occurs, innocent directors and officers are forced to share defense costs with those directly implicated in a claim.

Consideration 4 - Territory

The location of an organization's operations and business interests should also be considered when selecting limits of liability. Organizations that operate in foreign markets tend to face a higher risk of claims due to increased compliance obligations. What's more, when organizations first enter a new market, they can be relatively unfamiliar with local laws. This can lead to unlawful conduct and claims against directors and officers.

Finally, organizations that operate in highly litigious jurisdictions, such as the United States or European Union, should be especially mindful of their policy limits considering the escalated risk of legal action.

Consideration 5 - Peer Benchmarks, Market Reports and Loss Trends

A growing number of organizations take a data-driven approach when selecting their policy limits by examining the purchasing decisions of peer organizations. This data is sorted in such a way that organizations can review D&O insurance purchasing trends in their industry. Organizations can then benchmark their policy's limit against the limits of their peers.

In addition to reviewing peer-benchmarking data, organizations should scrutinize claims trends in the D&O market. D&O market reports—available through insurance brokers, underwriters and other third parties—can provide insights into D&O litigation trends, new pieces of legislation and overall market conditions. These reports contain information about claims in various industries, the size of lawsuit settlements and the type of claims commonly brought about.

Consideration 6 - Budget

The vast majority of businesses do not have an unlimited budget to spend on insurance and must take into account the cost of acquiring D&O coverage. This is especially true of smaller organizations that are more cost-conscious. Like other forms of insurance, organizations need to weigh liability scenarios against the level of premium they can afford.

Implications of Entity Coverage

One way to alter the operation of a limit of liability is to include entity coverage within a D&O policy. The following are some considerations organizations should keep in mind when adding entity coverage:

Removing Cost Allocation Disputes

When organizations include entity coverage in their D&O policies, it removes the tedious issue of cost allocation. Without entity coverage, the potential for a diversion of interests becomes apparent. This is because insurers are paying on behalf of executives and organizations are paying for themselves while attempting to divide the costs of litigation.

When entity coverage is in place, both management and the organization are insured under the same policy.

Sharing the Policy Limit

While entity coverage can go a long way in controlling cost allocation disputes, it's not without its drawbacks. One major downside to entity coverage is the way it affects the limit of liability.

The coverage available to directors and officers shrinks every time an organization defends its own interests. In some cases, the limit of liability can be exhausted completely, leaving a company's management team without financial recourse in the event of a claim.

With this in mind, organizations must consider how including entity coverage can negatively impact their directors and officers.

Solutions For Shared Limit Of Liability

Because entity coverage and shared limits of liability have the potential to exhaust coverage for an organization's management team, many steer away from it. However, there are ways to overcome the issues created by entity coverage

- Remove entity coverage altogether. Organizations have the option to not insure Side C or elect employment practices liability (EPL) coverage. By doing this, the issue of shared limits is removed altogether. Instead, organizations can preserve their entire limits to protect their management team and recoup the costs of indemnification.
- Purchase stand-alone entity coverage. While removing entity and EPL coverage from a D&O policy can solve the issue of shared limits, it can leave organizations exposed. To counteract this, companies could purchase stand-alone entity coverage. While this is typically more expensive, it prevents entity claims from draining a D&O policy limit.
- Elect separate towers. Whenever small to mid-sized businesses acquire management liability coverage, they have the option of electing separate towers for each insuring agreement. This means each section of coverage is isolated with its own limit of liability. This can be particularly useful in the event that corporate liability coverage is exhausted, as other insuring agreements would remain intact.
- Purchase additional Side A coverage. To garner higher limits than what's often offered by traditional D&O policies, organizations have the option to purchase additional Side A coverage. Many insurers offer stand-alone Side A coverage to compliment standard agreements, which can provide the following benefits:
    - Difference-in-limit (DIL) coverage—A key benefit of purchasing additional stand-alone Side A protection is that it provides DIL coverage. In essence, this gives organizations excess limits, available on standby, if a primary policy limit is exhausted.
    - DIC coverage—DIC works effectively as "drop down" coverage that indemnifies executives if an organization or a primary D&O policy cannot protect them. This is possible because stand-alone Side A policies provide organizations with broader protection and less exclusions.

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