The D & O Diary

Posted at 4:38 AM on August 10, 2010 by Kevin LaCroix

Guest Post: Actual and Potential Conflicts in D&O Coverage Placement and Claims

I am pleased to present below an article submitted by John Iole, a partner in the Insurance Recovery Practice of the Jones Day law firm. John notes with respect to his guest post that “the views expressed in this post are those of the author and not necessarily those of the firm or any of its clients.”

I welcome proposed guest post submissions from responsible persons on topics relevant to this blog or its readership. Please contact me if you think you might be interested in submitting a guest post.

I note that John’s post addresses conflicts of interest that may arise in connection with the D&O insurance policy. In addition to the conflicts John discusses in his post, an additional conflict that can arise under the D&O policy is a conflict between the interests of the non-officer directors and other persons insured under the policy. I discussed these conflicts involving non-officer directors in a prior post, here.

Here is John’s post.

> D&O insurance rightfully attracts the scrutiny of highly-placed personnel at purchasing companies. Likewise, the placing brokers are specialists with broad and deep experience in this line of cover. Nevertheless, a recurring issue that is infrequently addressed is the balance of interests that must be struck each year at the time of D&O renewal. This issue can arise again at the point of a claim.[1]
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> Several characteristics combine to create divergent interests among the parties involved in D&O coverage. First, standard D&O insurance is sold on an *aggregate limits* basis, meaning that the program limits in any given policy period are available for any and all claims made against the policy. With exceptions that are essentially immaterial, any claim made against a D&O policy will, to the extent it is paid, result in an erosion of the limits available to pay all other claims that are made during (or allocated to) that same policy period. This means that a claim that is paid today necessarily reduces the insurance limits available to pay another claim tomorrow.[2]
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> The second -- and for present purposes the most significant -- characteristic of D&O insurance is the fact that there are *multiple insured persons* who stand to receive the benefit of the insurance limits available. Each insured person has a separate interest in maximizing the limits available to pay a claim that might be asserted against that individual (or entity). Because insurance is protection purchased today against the financial consequences of events that might take place tomorrow, each insured person has an interest in guarding against erosion of limits – this holds true even when no claim has been asserted or is expected. Of course, if claims are *known* to be likely (known risks, not known losses, which would be excluded), then each insured person has an even greater interest in making sure that expenditures are kept to a minimum in order to protect the availability of funds. In addition, some individuals might have a particularly acute sensitivity to the potential for claims. For example, a member of the audit or compensation committee might expect a higher incidence of claims than non-member insureds. Although many insurance contexts represent the situation in which payment of claims results in a consumption of limits, the multiple insured persons that exist in the D&O context creates a potential for conflict.
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> A third complicating consideration is the interest of the *entity* in the case of a company that has cover under Side-B (reimbursement of the entity for claims paid on behalf of directors and officers) or Side-C (which provides coverage to the entity itself, generally for securities claims). Take the case of a claim asserted against a director or officer that falls within the Side-B cover, and the entity not only is permitted to indemnify the individual, but also is required as a matter of corporate by-laws and/or indemnification agreement to do so. In such a case, the entity will pay the individual’s legal

expenses as they become due, and these can be significant. In addition, the entity will stand ready to pay any judgment (or settlement) that results on the merits of the claim. In turn, the entity can expect to be reimbursed by the D&O insurance proceeds for the amount outlaid on behalf of the individual.[3] The individual's interests are protected by the entity's funds, and the individual has no direct concern as to whether the entity is reimbursed. Thus, a Side-B claim presents a conflict situation that is similar to the straightforward competition for limits (or preservation of limits) that exists between any two directors or officers. In a Side-B context, however, the competition is between the individuals (as a whole) and the entity.

The conflict is essentially the same when a Side-C claim is asserted, in that the entity's consumption of limits in the defense or resolution of a covered claim likewise reduces the limits available for other purposes (such as payment of Side-A claims). One significant difference in Side-C claims is that, unlike Side-B claims, a Side-C claim does not present any retirement of *individual* liability, but only pays for the elimination of *corporate* liability. In the case of a Side-B claim, the entity is reimbursed only after the individual claims already have been paid, whereas Side C claims potentially put the entity at the front of the claims line.

Additional conflicts arise when a D&O program is laden with coverage "enhancements" that branch out from the core purpose of D&O cover. These enhancements sometimes are offered as a way to add value to an expensive line of insurance. In this respect, it can be an alluring prospect to equip the D&O program with optional coverages with the idea that the entity is saving premium dollars that otherwise would be spent on separate policies. For example, some D&O programs include special coverages (or combined limits) for employment-related claims or fiduciary claims. This type of cover might take the place of separate Employment Practices Liability or Fiduciary coverage.[4] Similarly, some D&O programs provide Employed Lawyers coverage for in-house counsel when acting as a lawyer (as opposed to coverage for counsel acting as an officer of the company).[5] As with securities claims against Side-C cover, these coverage grants can result in claims that compete for limits with "standard" D&O claims. Moreover, these coverages can extend the scope of insured persons to a broad swath of employees.

These conflicts are not necessarily insurmountable problems, but should be adequately recognized and harmonized within the overall D&O program. There are many ways to deal with these issues, both at the point of policy placement, and also at the point of a claim. For example, a potential solution to invoke at the time of placement is to purchase substantial limits so that the risk of complete exhaustion is minimized, but of course this will bring extra cost. Another time-of-placement solution is to purchase Side-A only coverage (either excess, or excess difference in conditions) that sits above the Side A/B/C cover and comes into play if the A/B/C cover is exhausted (but of course this does not eliminate the potential for conflicts among insured persons). Another option is to purchase stand-alone individual Side-A-only cover for particular directors and officers.

So long as the policy language provides sufficient flexibility, different solutions can be used at the point of a claim in order to reduce competition for limits. If it appears that the program limits could be compromised by pending and expected claims, the potentially competing demands can be harmonized by an automatic or discretionary deferral of payments to the entity through an order of payments clause.[6] A problem with an automatic order of payments clause (*e.g.,* a clause stating that side A claims shall be paid before side-B or side-C claims), however, is that it can only operate with respect to *known* and ripe claims. If the policy also combines a discretionary feature that allows the designated person to direct when and how payments will be made, then a deferral can be invoked to preserve limits for pending claims that are not yet ripe for payment, or for potential unasserted claims.[7] Because of the delicate interests that must be balanced in such a situation, the designated decision-maker will play a critical role.

Given the inherent conflicts facing the directors and officers (both inter se and as between the entity), an additional consideration confronts each lawyer or other professional involved in policy placement and negotiation -- namely, the interests that he or she is protecting, and the extent to which he or she is charged with representing conflicting interests. It is basic black-letter legal ethics law that a lawyer representing a corporation represents "the organization acting through its duly authorized constituents."[8]

In the context of D&O insurance, however, the representation analysis is complicated by the fact that the entity is providing coverage for the benefit of the individuals, and potentially also for its own benefit. In that setting, there are multiple potential clients – or at least acutely interested parties – who do not share identical interests. Furthermore, because the actual or potential conflicts of interest might not be fully appreciated by each of the affected persons, and the role of counsel might not be clearly understood, some statement of role clarification ordinarily will be prudent.[9] Nevertheless, a potential adversity of interests does not necessarily require separate legal representation. In the case of divergent interests among clients, the basic ethics rules still permit a multiple representation, so long as the lawyer reasonably believes that each client can be competently represented and each provides informed consent.[10] Although conflicts of interest at the time of placement have not generated reported disputes or case decisions, similar conflicts that arise at the point of a claim can produce major difficulties if the rules are not carefully observed.[11]

Therefore, when embarking on a representation involving D&O insurance that might affect multiple constituencies, the most prudent course to follow is to clearly define and limit (if necessary) the scope of the representation, and to obtain informed consent of each affected client if representation of more than one party is undertaken.[12] Another option is to make clear that some constituencies are being represented as clients and others are not being represented. In cases of particular risks or sensitivities, there is always the option to retain separate counsel to represent one or more constituents who are adverse to the others. Depending on the interests and jurisdiction involved, this potentially could be accomplished through separate lawyers from the same organization, or might require separate outside counsel.[13] In the end, there is no certain decision that is foolproof, but a consideration of these items, along with thoughtful guidance when appropriate, hopefully will yield the most prudent decisions that properly accommodate the different interests involved.

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[1]This post does not address the obvious conflicts that occur when it becomes apparent that competing claims to limited insurance proceeds will eclipse the available limits, as discussed in *Tittle v. Enron Corp.*, 463 F.3d 410 (5th Cir. 2006). In that situation, jurisdictions develop rules to determine whether claimants will be treated on a "first in time, first in right" basis or an equitable apportionment basis.

[2] There are some ancillary coverages that do not significantly affect the analysis, in that they either are subject to defined sub-limits or allowances, or are likely to be so small as to be an inconsequential impairment of limits. For example, a D&O policy might provide coverage for "crisis management" or "crisis communications," or for responding to a subpoena for documents or testimony. Except in extraordinary situations, these claims will not seriously erode the limits, and these claims might be subject to a stated maximum amount. For example, the Chartis Executive Edge form provides: "This policy shall pay the Crisis Loss of an Organization, up to the $100,000 CrisisFund®. . . . ." A crisis under this form includes delisting events and events that cause or are reasonably likely to cause a material effect on stock price.

[3]Functionally, the insurance could pay instead of the entity in order to discharge the entity's indemnity obligation, or alternatively could reimburse the entity after it has made payments on behalf of the individual. For example, the Chubb Asset Management Protector form pays on behalf of the entity: "The Company shall pay, on behalf of an Organization, Loss for which such Organization grants indemnification to an Insured Person, and which the Insured Person becomes legally obligated to pay on account of any Claim first made against the Insured Person, during the Policy Period . . . for a Wrongful Act by such Insured Person before or during the Policy Period." The Chartis Executive Edge form provides reimbursement to the entity: "This policy shall pay the Loss of an Organization that arises from any: . . . . Claim . . . made against any Insured Person . . . for any Wrongful Act of such Insured Person . . . but only to the extent that such Organization has indemnified such Loss of, or paid such Loss on behalf of, the Insured Person."

[4]Towers Perrin reports that, for 2008 (the most recent year for which data is available), 57% of the surveyed companies purchased EPL coverage with their D&O insurance policy, whereas 33% purchased a stand-alone EPL policy (10% purchased no EPL coverage). Towers Perrin, *Directors and Officers Liability: 2008 Survey of Insurance Purchasing Trends* (Sept. 2009), at 7. Of those surveyed companies that purchased any fiduciary coverage, Towers Perrin reports that roughly half bought combined limits for D&O and fiduciary cover. *Id.*

[5]Additional coverages might include cover for shareholder derivative demand investigations or cover for participation as a member of the board of other organizations.

[6] The Chubb Asset Manager Protector form directs that Side-A claims, and covered loss to be paid on behalf of a benefits plan (if such coverage is

purchased), be paid first before all other claims. The form specifically permits the insurance to pay claims without regard to whether there is a "potential for other future payment obligations" (*i.e.,* future claims). The Chartis Executive Edge form provides:

> In the event of Loss arising from a covered Claim(s) and/or Pre-Claim Inquiry(ies) for which payment is due under the provisions of this policy, the Insurer shall in all events:
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> (1) First, pay all Loss covered under Insuring Agreement A. *Insured Person Coverage*;
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> (2) Second, only after payment of Loss has been made pursuant to subparagraph (1) above and to the extent that any amount of the Limit of Liability shall remain available, at the written request of the chief executive officer of the Named Entity, either pay or withhold payment of Loss covered under Insuring Agreement B. *Indemnification Of Insured Person Coverage*; and
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> (3) Lastly, only after payment of Loss has been made pursuant to subparagraphs (1) and (2) above and to the extent that any amount of the Limit of Liability shall remain available, at the written request of the chief executive officer of the Named Entity, either pay or withhold payment of Loss covered under Insuring Agreement C. *Organization Coverage and Insuring Agreement D. Crisisfund® Coverage*.
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> In the event the Insurer withholds payment pursuant to subparagraphs (2) and/or (3) above, then the Insurer shall, at such time and in such manner as shall be set forth in instructions of the chief executive officer of the Named Entity, remit such payment to an Organization or directly to or on behalf of an Insured Person.

[7]Even though D&O insurance is sold on a claims-made basis (i.e., it pays covered claims made against the insureds during the policy period), it is not true that all payable claims will be made before the end of the policy period. For example, if a later claim (made after the policy period) is sufficiently related to a claim made during the policy period, then the limits of the first policy will respond to the claim and it will be excluded from later policies.

[8]*See, e.g.,* ABA Model Rule 1.13, Organization as Client. This rule is emphasized by the Corporate Governance Recommendations adopted by ABA House of Delegates in 2003, which include the following statement: "A lawyer representing a public corporation shall serve the interests of the entity, independent of the personal interests of any particular director, officer, employee or shareholder." Report of the American Bar Association Task Force on Corporate Responsibility, at p.32 (March 31, 2003).

9] For example, ABA Model Rule 1.13(f) provides: "In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing."

[10] ABA Model Rule 1.7(b) provides: "Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if: (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; . . .and (4) each affected client gives informed consent, confirmed in writing." Each state has a different formulation of the rule, and some are dramatically different, so the relevant rule must be verified. For example, some states require consent to be confirmed in writing, whereas others do not. It is also clear that in-house counsel are treated essentially the same as outside counsel, and thus company counsel must be mindful of the conflicts presented by intra-corporate representations. *See, e.g.,* ABA Model Rule 1.0(c) ("Firm" or "law firm" denotes . . . the legal department of a corporation or other organization."); *see also* Association of the Bar of the City of New York, Committee On Professional And Judicial Ethics, Formal Opinion 2008-2, "Corporate Legal Departments And Conflicts Of Interest Between Represented Corporate Affiliates" (Sept. 2008) (discussing responsibilities of in-house counsel in the conflicts context).

[11] *See, e.g., U.S. v. Ruehle*, 606 F. Supp.2d 1109 (C.D. Cal.) (law firm referred for discipline for failure to properly advise and/or document warning to officer that firm represented corporate entity and not individual officer), *rev'd on other grounds,* 583 F.3d 600 (9th Cir., Sept. 30, 2009) (indictment dismissed on remand).

[12] *See, e.g.,* ABA Model Rule 1.13(g) ("A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.").

[13] The lawyer ethics rules have not completely caught up with the realities of corporate law departments. The Model Rules define a "firm" to include a corporate legal department. The trouble arises when the imputation rule applicable to law firms is applied indiscriminately to corporate law departments. In that setting, no two lawyers in the law department are permitted to represent adverse interests unless two lawyers within a private firm would be permitted to do so. *See, e.g.,* The Association of the Bar of the City of New York Committee on Professional and Judicial Ethics, Formal Opinion 2008-2, "Corporate Legal Departments And Conflicts Of Interest Between Represented Corporate Affiliates" (Sept. 2008). Some accommodation of corporate realities to permit ethical screens in this context to take the place of separate "firms" would appear to be appropriate in most cases.

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