RELATED PRACTICE AREAS

COVID-19 Resources
Directors and Officers Liability
Insurance Recovery and Counseling

RELATED TOPICS

D&O
Policy Renewal

D&O Renewals In The Age Of COVID-19

Six Issues to Consider Before Renewing Your D&O Insurance During a Pandemic

December 7, 2020 | | Policyholder Protection,D&O,Insurance,Policy

Joshua B. Rosenberg
Partner

At the start of 2020, the market for directors and officers (D&O) insurance in the public company sector was already hardening. A significant rise in IPOs over the past few years resulted in a sharp increase in securities litigation and steadily rising settlement values. The onset of the COVID-19 pandemic only increased public companies' woes. The pandemic-fueled economic collapse has deeply eroded their market capitalization, and the resulting economic slowdown shows no end in sight.

Litigation seeking to allocate blame for massive pandemic-related business losses only increases the risk faced by public companies. As the risk environment grows increasingly uncertain, D&O insurers have become increasingly cautious about renewing their existing policies on expiring terms and conditions.

Risk managers at public companies need to be prepared to have difficult conversations with their insurers about how COVID-19-related claims will be handled under their D&O insurance programs. Here are six important issues that public companies may need to address when it comes time to renew those programs.

1. Bodily Injury Exclusions

The prefatory language at the start of a policy exclusion often passes under the radar of even the most scrupulous risk manager – but it shouldn't. The precise wording of this language can have an enormous impact on the scope of the exclusion. Bodily injury exclusions in D&O policies are a prime example. Certain versions apply to claims "for" bodily injury (which can include physical injury, sickness, disease and death). Courts generally construe this terminology as relatively narrow in scope, rendering the exclusion applicable only in circumstances where a claim seeks to hold the policyholder directly or vicariously liable for injury or death.

Other versions of the exclusion apply to claims "alleging, based upon or attributable to, arising out of, in consequence of or in any way related to" bodily injury. This language tends to be read by the courts as permitting the exclusion to apply in cases where bodily injury or death has an indirect relationship to the claim, such as financial losses to shareholders flowing from events involving bodily injury. As pandemic-related claims continue to rise, public companies will need to pay close attention to how broadly this exclusion is drafted.

2. Pollution Exclusions

For some public companies, broad pollution exclusions in D&O policies are a thing of the past, as carriers have come to recognize that management liability for misrepresentations in the purchase and sale of securities should not be excluded because the alleged misrepresentations somehow touch on "pollution." However, for many public companies, broad pollution exclusions are still alive and well. In this uncertain risk environment, insurers can be expected to push back on any expectation of coverage of pandemic-related loss.

Many insurers argue that their current pollution exclusions implicitly apply to viruses as "pollutants," but well-reasoned decisions of respected courts (like the California Supreme Court) have narrowly construed excluded "discharges" of pollutants, finding that pollution exclusions do not apply in the absence of the widespread dispersal of synthetic contaminants traditionally associated with environmental liability and cleanup. Other carriers, seeking to shore up a perceived exposed flank, will be tempted to expressly add exclusions for claims arising out of COVID-19 or viruses in general. Public companies will need to keep a sharp eye on efforts by carriers to insert new or expanded pollution exclusions in proposed D&O renewal policies.

3. Conduct Exclusions

Virtually all D&O policies include exclusions for fraud, criminal conduct and certain other types of intentional or deliberate wrongdoing. Such exclusions, absent more, potentially can be triggered by mere allegations or supposed admissions by the insured of such conduct. Given a litigation environment where plaintiffs often embellish their allegations against public companies to garner publicity or raise the stakes of the litigation, these exclusions – standing alone – can fatally undermine the value of their D&O insurance.

Many D&O policies therefore include a "final adjudication" exception in these exclusions. Under this provision, the exclusion can apply only in the event that a non-appealable dispositive ruling establishes that the insured actually engaged in such conduct; if the case settles before such a ruling, the exclusion cannot apply. Some carriers have tried to get around this limitation by bringing coverage litigation against their own policyholders for adjudication of the conduct issue. In effect, the carrier ends up finishing the lawsuit that the underlying claimant had started – leaving the insured to continue litigating the underlying allegations without the benefit of a defense paid by the insurance company.

In response to such carrier abuse, many policyholders have insisted that the "final adjudication" caveat specifically apply only to an adjudication in the underlying lawsuit. Public companies should ensure their conduct exclusions have similar caveats.

4. Transactions

For many public companies, business as usual prior to the pandemic is no longer possible. In response to the changing economic environment, acquisitions, consolidations, mergers or divestments that may have been unthinkable or impractical are now necessary for the survival of many public companies. These transactions can be fraught with tricky insurance issues, some of which should be considered at renewal.

Companies seeking a merger partner or trying to divest or spin off assets should review the "change in control" provisions or "takeover" exclusions in their D&O policies. Typically, these provisions afford coverage only to the extent the claims are based on "wrongful acts" committed prior to the spin-off or after the acquisition – that is, while the relevant entity was or is an insured. However, some of these provisions are more broadly worded such that they exclude coverage for acquired entities on the basis of any conduct that began prior to the acquisition date – thereby defeating coverage even for related post-acquisition conduct. Policyholders should be on the lookout for such language.

Many D&O policies also include provisions that automatically cover an acquired company so long its assets are less than a certain percentage of the insured parent's total consolidated assets. However, when an acquired company's assets exceed this threshold, coverage is only extended on a temporary basis after which the insurer will seek to underwrite the new subsidiary's risk, i.e., request additional premium. Strategic buyers that have shed assets in response to the pandemic should reevaluate these thresholds or bear them in mind when considering a transaction.

5. Government Investigations

In the wake of the outbreak of H5N1 (bird flu) in the mid-2000s, risk managers came under increased regulatory pressure to make the risk of a pandemic part of the enterprise risk management of a public company. COVID-19 may ratchet up that pressure even more, spurring regulators, at both the federal and state levels, to closely scrutinize how companies prepared for and reacted to the pandemic.

Most modern D&O policies provide some form of coverage for the cost of responding to government investigations. Generally, they include government investigations within the policy's definition of a covered "claim." Which investigations are covered – and the extent to which they are covered – can differ dramatically among policies. Some policies cover only formal government investigations or administrative proceedings, while others also cover informal investigations (i.e. requests for documents). Some policies may also limit coverage to investigations that expressly target a certain entity or individual, while others cover any investigation to which an insured must respond, regardless of the target of the investigation.

The distinctions between what is formal or informal, or whether anyone is the target of an investigation, may not seem important to a policyholder incurring substantial costs of responding to any governmental inquiry – but they can be decisive for coverage. If a policy covers only the costs of responding to formal government investigations, a company may find itself with hundreds of thousands or millions of dollars of costs in responding to an informal investigation – and end up with no coverage. In light of what is certain to be a regulatory fallout from the COVID-19 pandemic as the SEC investigates whether corporate financial projections took into account a pandemic risk identified almost a generation ago, public companies should pay close attention to the scope of government investigation coverage in their D&O policies.

6. Insolvency or Bankruptcy

The pandemic has forced many companies, especially those in the hospitality, retail and travel sectors, to confront acute shortages of liquidity and credit. For some, these shortages may lead to insolvency or bankruptcy, and an inability to indemnify their directors and officers against lawsuits outside of available insurance. Even companies with a healthy balance sheet would be well advised to evaluate whether their D&O coverage provides adequate protection to their key personnel during these unprecedented times. A company that is known for protecting its directors and officers is a company that can attract the most qualified personnel.

An important first step in evaluating whether a D&O policy will protect a company's directors and officers in bankruptcy is to ensure that the policy's "insured vs. insured" exclusion has an exception for claims brought by an "examiner, trustee, receiver, liquidator or rehabilitator" of the company. Such exclusions were developed to prevent collusive lawsuits in which an insured company would, in effect, force its insurer to pay for the poor business decisions of its directors and officers by causing the company to file a lawsuit against them. While most carriers would view a bankruptcy trustee as truly adverse to the debtor company's directors and officers, some carriers and courts have taken the opposite view. Accordingly, a broad and express exception for such bankruptcy-related claims may be a prudent addition to a company's D&O policy.

Most D&O policies provide what is known as "Side A" coverage directly insuring the company's directors and officers for liabilities that the company is prohibited from or financially unable to indemnify. Such coverage usually is not subject to a self-insured retention, which means the directors and officers would be covered without having to bear some dollar amount of financial responsibility before the policy kicks in. In the event of insolvency or a bankruptcy, Side A coverage serves as an insolvent company's last line of defense protecting its directors' and officers' personal assets. While the amount of Side A coverage that a company may need will vary widely, there are some coverage enhancements that a company would be wise to consider at renewal. First, non-rescindable Side A coverage prevents an insurer from rescinding coverage for individual insureds that were unaware of a material misrepresentation in the purchase of the policies. Second, difference-in-conditions (DIC) Side A coverage is designed to fill gaps in coverage by "dropping down" to cover liabilities that are excluded or outside the scope of standard D&O policies. In addition, Side A-only coverage provides separate, dedicated limits to individual directors and officers that cannot be reduced or exhausted by the company.

Risk managers at public companies must be vigilant about all sorts of coverage issues at policy renewal time. The COVID-19 pandemic has only added to the list of items to consider in a public company's risk portfolio. To more fully consider the strengths and weaknesses of their existing D&O coverage as policy renewal time approaches, public companies should consider performing a comprehensive review of those policies.

This article was originally published in the 2020 edition of Corporate Policyholder Magazine.