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The Devil Is in the Details: Negotiating Favorable D&O Insurance Coverage

By Nicholas R. Maxwell and Amber N. Morris

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Most insurance policies are sold on a take-it-or-leave-it basis, leaving policyholders with little opportunity to proactively maximize coverage. Directors & officers insurance can be an exception to that rule—but only if policyholders understand the negotiating power afforded to them by the large premium payment they have to offer. Today more than ever, D&O coverage can be a vital risk transfer mechanism for businesses seeking to obtain protection in the face of the evolving labyrinth of statutes, regulations and common law rules. Whether policyholders are negotiating next year's policy or pursuing coverage under their current policy, they must know how to recognize the soft spots in standard-form language. This article discusses a few examples where language that may appear standardized can, with the right base of knowledge, be molded to the policyholder's benefit.

DEFINITION OF 'SECURITIES CLAIM'

While the name suggests that D&O insurance is a tool to protect directors and officers from liability, modern D&O coverage can also provide valuable protection for the company itself, via so-called "Side C" coverage (Sides A and B cover directors and officers or the company in its capacity as indemnitor for the directors and officers). Side C coverage is often limited to "securities claims," so policyholders must understand what exactly a securities claim is. Unsurprisingly, the scope of the term has been an ongoing source of dispute between policyholders and their D&O insurers. The good news for policyholders is that not all securities claim definitions are created equal.

For example, certain courts have interpreted a common definition of securities claim (which requires an alleged "violation" of a "regulation, statute or rule regulating securities") as not encompassing common law claims like breach of fiduciary duty. However, other D&O policies available in the marketplace do not require that the law in question be "regulating securities." A seemingly minor distinction like that can be the difference between coverage for tens of millions of dollars of defense costs and outright denial. As such, the devil is in the details when negotiating a policy renewal or facing the prospect of litigation over a preexisting policy.

CONDUCT EXCLUSION

Even when an insured files a qualifying claim, there are still exclusions to navigate. Many exclusions are straightforward, but others are less so. The so-called "conduct" exclusion purports to exclude coverage for certain types of wrongful acts.

Like securities claim definitions, not all conduct exclusions are created equal. Consider two exclusions, from real policies, precluding coverage for: "willful violations of any statute or regulation"; and "deliberately fraudulent or criminal acts." Policy (2) is clearly narrower, and therefore, more policyholder friendly. Most underlying cases allege a violation of a "statute or regulation," and often a willful one, so a court could read policy (1) to encompass a wide swath of otherwise covered claims. This is a perfect example of where a savvy policyholder can recognize and leverage the power of its premium, rather than simply accepting the policy form offered by the insurer.

And there are other ways in which conduct exclusions meaningfully vary. As one example, any well-negotiated conduct exclusion should include a "carveout" for the policyholder's attorney fees in the underlying action—policyholders should enjoy the presumption of innocence (and a funded defense) unless and until it is determined that they in fact committed the acts alleged. The opportunity to maximize the likelihood of coverage concerns *what* constitutes such a finding. Consider two real provisions, in which the exclusion applies if there is: a "finding of fact" that the conduct occurred; or a "final, nonappealable adjudication in any underlying action." Policy (2) is clearly more favorable—only when the underlying lawsuit is adjudicated by a court and the judicial process is exhausted can the exclusion potentially apply. Meanwhile, insurers may claim the exclusion in policy (1) is activated by a trial court ruling that was later reversed, or even by a finding of fact in a lawsuit commenced by the D&O insurer itself. Again, the devil is in the details—astute policyholders must be aware of this landscape when negotiating coverage or disputing a claim denial.

ALLOCATION

Even if the policyholder can establish a qualifying Claim and the absence of any applicable exclusions, the insurer may still try to use other tools to avoid or limit coverage. One thorny example is allocation. Underlying litigation may allege non-covered claims alongside covered claims (whether because they are against an uninsured *person* or because they are against an insured person for uninsured *conduct*). Most D&O policies include "allocation" provisions for this situation but, unsurprisingly, they are not all created equal. Especially where underlying defense costs cannot be neatly divided between the covered and noncovered matters or parties, disputes are likely.

Particularly unfavorable provisions allow the insurer to decide which claims are covered and to allocate defense costs as it sees fit. Consider a situation where the insurer decides 90% of the claims are uncovered and the suit will cost $25 million to defend: the impact of allocation is huge. And even if the policyholder can convince a court that a greater percentage of the claims *are* covered, it could cost the policyholder millions in additional legal fees just to get there.

The good news is that insurer-friendly allocation language can often be modified through negotiation. For example, policyholders can seek language providing that, in the event of an allocation dispute, the insurer shall advance 100% of defense costs subject to a later determination of relative liability. When the underlying action is resolved by unallocated settlement (as the majority are), the *insurer* must decide if it's worth it to file suit against the policyholder just to—potentially—recoup some percentage of previously advanced defense costs.

NOTICE-PREJUDICE

"Notice" clauses are another example of terms that can imperil coverage even after the policyholder presents an otherwise covered claim. Historically, a policyholder's late notice could be fatal to coverage. More recently, many states have modernized their laws to require the insurer to show that notice was late *and* that it prejudiced the insurer in some way. Even still, there continues to be a steady stream of late-notice disputes, especially in the context of claims-made policies that may have more stringent notice rules. Sophisticated D&O insurers and policyholders have begun to address this uncertainty via policy language defining what is and is not "prejudice." Consider two real policy provisions: coverage is barred if the late notice "actually and materially prejudiced the insurer's rights"; or if the underlying action ends before notice is provided, there is an "irrebuttable presumption of prejudice." Policy (2) may be narrower, but it provides greater certainty and, by implication, gives the policyholder a tool to defeat the insurer's prejudice argument if notice is given *before* the end of the underlying action.

CONCLUSION

D&O policies may initially appear to be standardized, but a well-informed policyholder can recognize opportunities to negotiate more favorable language. Whether discussing next year's policy or seeking coverage under a current policy, familiarity with this ever-evolving landscape can help policyholders maximize their chances of recovery.

Nicholas R. Maxwell is counsel and Amber N. Morris is an associate at insurance recovery law firm Cohen Ziffer Frenchman & McKenna in New York. They represent a broad range of corporate policyholders in high stakes insurance coverage disputes.