Common Pitfalls and Exclusions of Directors and Officers (D&O) Insurance

Insight for business owners and risk managers—provided by **Crendon Insurance Brokers Ltd**

After assessing your company's risks, you've made the decision to purchase Directors and Officers (D&O) insurance. Now what?

It's essential to know the ins and outs of your D&O policy, including policy limits, what's covered and, most importantly, what's not. Why? Because you may assume you're covered for a claim when policy exclusions could apply. As time consuming as it may be, it's critical to read the fine print in your policy, as the language in the exclusions may affect the cover of potential claims.

Pitfalls in D&O Policies

The importance of reviewing all aspects of a complex D&O policy cannot be overstated. D&O policies vary widely and the smallest error or omission can create a large gap in cover.

- **Limits of Indemnity.** One of the most important aspects to review in a D&O policy is the limit of indemnity. You will have the option to choose different limits for your individual policy and you must decide how much is sufficient to cover your company's risks. This process includes assessing your company's specific circumstances and any possible claims that may arise including legal defence costs, expenses, settlements or damages awarded for alleged wrongful acts. For the majority of policies, the limit of liability is an aggregate limit for all claims during the period of insurance. This means that once the limit has been reached or paid out by the insurer, additional claims will not be covered by the D&O policy. There also may be sub-limits for certain costs, such as reputational crisis and emergency defence costs, written into the policy. Be sure that you are comfortable with the limit of indemnity set forth in your policy because claims that exceed this limit will be excluded.

- **Policy Period.** Typically, D&O policies only cover claims first made and notified to the insurer while the policy is in effect. It is important to carefully review the start and end date of the policy to ensure that you are fully covered. There can also be language in the policy that dictates discovery period (or run-off) terms, the period immediately following expiry of the policy in which the company (or insured) can still make claims if the wrongful act was committed during the period of insurance. The majority of D&O policies also offer the option to purchase an extended reporting period in the event you or the insurer declines to renew the policy. Like the discovery period, this extended reporting period only applies to wrongful acts committed prior to the expiry of the original insurance period. Terms for the discovery period and extended reporting period will differ policy to policy; therefore it is important to be aware of the exact terms and conditions in your specific policy. Also be sure that the policy is irrevocable by the insurer unless there is non-payment of the premium.

- **Claims made after retirement or resignation.** When a director retires or resigns, he or she is still vulnerable to claims of wrongful acts if the wrongful acts occurred prior to their departure. Most policies will grant directors retiring or resigning an additional lifetime discovery period (run-off) at no additional cost. However, there can be stipulations and conditions placed on this discovery period. Read your policy carefully to make sure that past, present and future directors are covered under your policy. If you are thinking about retirement soon, be aware of the length of the discovery period for retired insured persons in your policy and the conditions associated with it.

- **Personal Income Deduction.** Under the Income Tax (Earnings and Pensions) Act (ITEPA) 2003 Part 3, Chapter 10, employees (in non-excluded employment) are taxed on certain non-excluded employment-related benefits. D&O policy benefits paid for by the employer would fall under this category. However, Section 346 of the ITEPA allows directors and officers to deduct from their earnings of employment: (1) payments towards the discharge of liability related to the employment; (2) payment of costs or expenses in connection with an employment-related liability claim; and (3) payment of a premium under a qualifying insurance contract. Therefore, while D&O policies paid for by the employer are a taxable benefit under ITEPA, there are also deductions in place to offset the charges.

Types of Exclusions in D&O Policies
Some exclusions that insurers and insureds dispute about concern incidents that happened or allegedly happened before the D&O policy went into effect. In some cases, the insurer simply won't cover the claim; in other cases, the insurer may render the policy void.

- **The Known Circumstances Exclusion.** With this exclusion, the insurer will not pay for claims that arise from a negligent act, error, omission or personal injury that occurred prior to the start date of the D&O policy. The insurer attests that the insured *knew or could have foreseen* that any of the above happened and could have been the basis for a claim. This exclusion is found more frequently in private and not for profit policies than in public company policies. What is especially important to note is that the premium is usually not returned to the insured if it is determined that they withheld their knowledge of circumstances that occurred prior to the start of the policy.

  In the case of a **rescission** scenario, the premium is returned to the insured. Rescission means that the policy is rendered void after the insurer discovers that the insured answered untruthfully to any of the warranty questions on the insurance application. Warranty questions ask the applicant if they know of any fact, circumstance or situation that might reasonably be expected to give rise to a claim. Rescission also can occur if the applicant provided false or misleading information in the company's financial data. These scenarios usually happen only in public company D&O policies.

- **Prior Acts Exclusion.** Similar to the known circumstance exclusion, this exclusion is also concerned with pre-policy circumstances. The insurer is not responsible for wrongful acts committed or attempted before the cover was enacted. A wrongful act is that which damages the rights of another. These acts are not only limited to criminal offences, but can also include acts that result in civil legal actions.

- **Bodily Injury Exclusion.** Many standard policies come with a bodily injury exclusion. This means that the D&O policy will not cover costs and claims made for a bodily injury. However, one can negotiate for the exclusion to not apply in respect to corporate manslaughter proceedings or employment practice liability. Make sure you know whether there is a bodily injury exclusion in your policy, when it applies and whether it is absolute (broad or narrow).

Other exclusions found in D&O policies revolve around the duty to defend and defence expenses in the event of a claim. If the insurer has the right to the duty to defend, then they are able to select the insured's defence and have greater control over the rates and billing practices of the defence counsel.

- **Reasonableness of Defence Fees.** This is more prevalent in private company and not for profit D&O policies, as most of those policies give the insurer the right and duty to defend the insured's claims; whereas, public companies retain the right to choose their own defence counsel. If this is written into your D&O policy, it means that the insurer will only pay for "reasonable and necessary" defence fees. Some insurers also provide detailed information on litigation guidelines.

- **Consent to Settle and the Hammer Clause.** If the insurer has no duty to defend, such as in cases against public companies, then they have no right to settle the case when they want to settle it. As a result, the insured may elect to continue with litigation, even if that would exhaust the policy limit, because the defendants don't want settling the case to be perceived as an admission of their wrongdoing or incompetence. This creates a lot of tension between insurers and the insured, especially if the insured does not include the insurer in the settlement discussion. Therefore, some insurance policies have a consent to settle exclusion in the policy, prohibiting the insured from settling the claim without the insurer's prior written consent.

  The hammer clause is similar to the consent to settle exclusion, although less common. Basically, the hammer clause informs the insured that if they go against the insurer's recommendation to settle, the insured will be responsible for any judgement won by the claimant plus legal fees that go beyond the settlement offer.

Most D&O insurers expect that D&O insurance is only a part of a company's wider insurance portfolio. In some cases, however, this assumption doesn't always prove to be true. Certain firms may go without Difference in Cover/Difference in Limits insurance or even Public/Products Liability insurance policies, making D&O one of their only forms of insurance. Because of this, many D&O insurers write exclusions in their policies stating what claims they won't cover because other types of insurance would potentially cover the claim.

- **"Other Insurance" Exclusions.** D&O insurance is just one form of insurance in a comprehensive risk management plan for most companies. Because of this, most D&O policies have exclusions for claims that involve bodily injury, property damage claims, which could be covered by other types of insurance, such as a Public/Products Liability policy. In the event of a claim, the insured should notify all insurers from their various policies, in order to allow the insurers to determine who is liable for the claim.

- **Contractual Liability Exclusion.** This exclusion is especially pertinent to private companies and not for profits that have broad entity cover under a D&O policy. Since contractual obligations are not liabilities imposed by law but rather an obligation that is voluntarily undertaken, many D&O policies have an exclusion that prevents insurers from having to cover contract-related claims, especially breaches of contract that arise when the company enters into a contract with another party.

When examining this exclusion in your D&O policy, make special note of the wording of this clause. This exclusion can substantially affect the extent of your cover under the policy—the narrower the scope of the exclusion, the better for you.

D&O insurance protects directors and officers from poor business decisions, but most policies do not protect them from wrongful acts and gross misconduct. These exclusions include:

- **Conduct Exclusions.** Most D&O policies have exclusions that deny cover for certain types of misconduct. There are two categories of misconduct exclusions:

  1. For loss relating to fraudulent or criminal conduct
  2. For loss relating to illegal profits or remuneration to which the insured was not legally entitled

  It's especially important to look at the wording on these exclusions in the policy; subtle wording differences can significantly impact the accessibility of the cover.

- **Insured vs. Insured Exclusion**. In some D&O cases, one insured director may bring a claim against another insured director, and some insurers do not want to cover this because they don't want to get involved in the infighting between a company's directors and officers.

Obtaining D&O insurance is important to protect the directors and officers of your company; but simply purchasing the policy won't benefit you unless you know the extent of your cover.

Do you understand your D&O insurance policy? Contact **Crendon Insurance Brokers Ltd** today for more information about your cover and exclusions.