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# Directors' and Officers' Liability Alert: Difference-in-Conditions Policies As an Answer to Heightened Risks Presented by the Crisis in the Financial Sector

12/19/2008

Directors and officers need protection for their personal assets. The need is especially great now, in the wake of the financial crisis, which has opened the door for government investigators and the plaintiffs' bar to seek to hold corporate officials responsible for investors' losses. In this climate, liability insurance tailored narrowly to the needs of directors and officers is an option every corporate board should consider. Protection for individual board members and officers, the original purpose of directors' and officers' (D&O) liability coverage, becomes critical in financial crises. A type of D&O coverage called "difference-in-conditions" coverage fulfills this need. It can be purchased as part of a company's D&O insurance program, in addition to the now-standard D&O coverage, which insures both directors and officers and the company for its own liability (or reimbursements of directors). A prudent choice is to hire counsel or a sophisticated broker to help navigate the different options that exist as regards D&O coverage.

## Introduction

The crisis in the financial services sector already has begun to cause a wave of litigation and investigations involving corporate officers and directors. Securities and other lawsuits place at risk the personal assets of corporate officers and board members. That risk ordinarily is dealt with through the purchase of D&O coverage. But recent events raise the concern that even standard D&O coverage is uncertain. Unlike standard D&O coverage, DIC policies typically cover *only* those situations in which the director or officer has not been indemnified by the company.

Specifically, the specter of insurance-company insolvency has joined the always-present risks of insolvency of the board member's or officer's company and of claims against the company that can deplete the amount of available D&O insurance in threatening the certainty every board member needs—that if he is faced with a lawsuit or investigation, his personal assets will be safeguarded. This is the whole point of D&O coverage. The solution for many public-company board members and senior managers to these problems may lie in the purchase—typically by the company which takes out liability policies for its board members—of "difference-in-conditions" coverage, sometimes also called "Side A," "excess difference-in-conditions," or "DIC" coverage`. These types of policies may be taken out as part of a D&O insurance program, which also includes the more traditional (or "standard") D&O coverage. DIC coverage has been available to directors in some form since the 1980s but in times of financial crisis—like the Enron crisis, and the current financial crisis—there is a heightened need for the added protection afforded to individual directors and officers by DIC coverage. Although they range broadly in the scope of their coverage, DIC policies generally insure *only* the company's individual directors and officers and can be insolvency-proof (whether the insolvency is the board member's company's or the underlying insurance company's). Because of the wide variety in the terms and protection afforded by DIC coverage, and the complexity of its interplay with standard D&O coverage, public company boards should seek the advice of counsel before making decisions regarding their DIC insurance and their D&O programs generally.

Difference-in-conditions coverage generally refers to insurance that exists to close specific gaps in the coverage afforded by standard policies.[1] It also means, in the D&O context, that DIC policies function to insulate their own limits. In effect, those limits cannot be placed beyond the reach of board members, when they need them most—in the event the company files for bankruptcy. Nor can those limits be drawn down and depleted by the company as co-insured (as frequently happens with standard D&O coverage). In this respect, DIC insurance provides "excess" coverage above the limits applicable to the company's standard D&O (primary and excess) policies. In effect, it protects directors and officers from the erosion or exhaustion of the limits under even multiple standard D&O policies that can occur during the highly litigious periods that follow in the wake of financial crisis. Other terms in D&O DIC policies shore up the protection afforded to insured directors and officers by covering them in the event that the *insurer* under the company's standard D&O policy is "financially unable" to pay—that is, insolvent, in liquidation, or bankrupt.

## Company Bankruptcy and Competition for D&O Coverage

Under a typical D&O insurance policy, it always is uncertain whether board members will have access to the policy in the event of a bankruptcy. This is because the typical D&O policy insures, in addition to the directors and officers (this is called "Side A" coverage), the company for its reimbursement of directors and officers (this is called "Side B" coverage) and, often, the company for its own liability for certain (typically securities) claims (this is called "Side C" coverage). When a bankruptcy filing happens, the D&O policy is frequently one of the principal—sometimes one of the few—available assets in play. This fact leads to a struggle for ownership of the D&O policy's proceeds or benefits. The struggle frequently involves every constituency:

- the company's creditors and investors, who may claim they were defrauded and sue the company and its directors for damages, hoping to recover those damages from the D&O policy;
- the company, through the bankruptcy trustee, who typically will seek to exert control over the D&O policy and its proceeds; and, of course,
- board members (and company officers) who are looking to the D&O policy to pay their legal bills and indemnify them for the amount of any judgment entered against them or settlement entered into by them

In the bankruptcy context, courts have been called on often to decide who owns the D&O policy and/or its proceeds, that is, whether they are property of the estate. And courts have held that D&O policies are property of the estate, subject to the bankruptcy court's control.[2] In *In re Minoco*, the court held that because the D&O policies provided corporate reimbursement coverage (for claims against directors and officers), in addition to liability coverage for the company's officers and directors, the policies were property of the bankruptcy estate.[3]

The uncertainty about whether a policy will be viewed by a bankruptcy court as estate property, and direct access to the policy by the directors and officers will thus be limited or barred, is exacerbated if the policy contains "Side C" entity coverage, which insures the company for its own liability for certain kinds of claims (most often securities lawsuits).

Since DIC policies only insure individuals, they belong only to those individuals, and their entire proceeds are available exclusively to the insured individuals when they need them. Since under a DIC policy the company is *not* an insured for *either* its own liability *or* reimbursement of its indemnification of officers and directors, the company (or its trustee in bankruptcy) cannot claim a proprietary interest against policy proceeds.

Furthermore, even where the company has not filed for bankruptcy putting its D&O policy in play, the company may face claims against itself. If the company has "Side C" (entity) coverage, it naturally will look to its D&O policy to pay for its own defense expenses or for settlements or judgments against it, potentially consuming all of the available insurance under its standard D&O coverage, and leaving board members and senior management seriously under- or completely un-insured for claims against them.

Because DIC policies only insure individuals, and not the company, their proceeds cannot be reached by the company to pay defense expenses, judgments, or settlements for suits against them. And, under DIC policies, those entire proceeds are exclusively available to the insured individuals when they need them. It can, therefore, make sense for board members and senior managers of public companies to obtain excess DIC or "Side A"-only (insuring only them) coverage, even though they already are insured under a standard D&O policy also affording the company "Side B" (company reimbursement in the event the company indemnifies its officer or director for a covered claim) and "Side C" (entity coverage insuring the company itself for securities and certain other claims against it) coverage.

## Insurer Insolvency

In addition to the threat to the reliability and integrity of board members' and senior managers' D&O coverage that is posed by the risk of their company's insolvency, the failure of liability insurers like Reliance, Kemper, and Quanta, and the recent downgrading by credit-rating agencies of financial services firms, including insurance carriers, presents the fear that

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D&O coverage in place to protect corporate officers and directors could be itself impaired by insolvency. To protect against this possibility, specifically, some DIC policies contain a clause providing that the policy will “drop down,” *i.e.*, provide primary insurance protection, in the event the underlying carrier (under the standard D&O coverage) is “financially unable” to indemnify its insureds. DIC coverage can also “drop down” and provide coverage in the event the company’s standard D&O carrier does not cover or refuses to pay a claim (*e.g.*, by rescinding its policy).

To hedge against the risk of carrier insolvency, it is important to choose a different carrier for DIC coverage than the carrier that provides the company’s standard D&O coverage. In order to enhance the protection afforded to directors and officers during a crisis like the one currently affecting the financial system, companies should carefully consider—in addition to considering what amount of coverage is needed to address their exposure to liability to securities plaintiffs—the amount of DIC coverage that is required to hedge effectively against their standard D&O carriers’ insolvency.

## Conclusion

When purchased (typically by the company with board approval) in addition to the standard D&O coverage every public company should have in place (in the absence of some viable self-insurance arrangement), DIC coverage provides company management with the certainty that they will have enough insurance, and that it will be available to them when they need it, to safeguard their assets in the event claims are filed against them by reason of their work as directors and officers. If carefully selected and negotiated, DIC coverage:

- provides that officers and directors will be protected in the event the company files for bankruptcy
- protects officers and directors from the possibility that they will be left uninsured if the policy limits under the company’s standard D&O coverage are depleted by virtue of claims against the company
- hedges the risk of unavailability of the insurance by virtue of the insolvency of the standard D&O carrier

A prudent course for the boards of public companies is to seek the advice of counsel or a sophisticated broker regarding the company’s D&O liability programs, in the course of which different options as regards difference-in-conditions coverage should be addressed.

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**Endnotes**

[1] So, in the D&O context, DIC coverage, depending on its terms, may, for example, have fewer exclusions than standard policies and, unlike standard policies, be non-rescindable based on restatement by the company of its financials or material errors contained in them. DIC coverage will therefore exist alongside the company’s traditional D&O coverage to fill in the above gaps in that coverage.

[2] *See, e.g., Minoco Group of Cos v. First State Underwriters of New England Reins. Corp. (In re Minoco Group of Cos.)*, 799 F.2d 519-20 (9th Cir. 1986).

[3] *Id.*

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