



**HindmanSanchez**

# ANATOMY OF A D & O POLICY

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## INTRODUCTION

An effective D&O loss prevention program for a non-profit association may accomplish numerous objectives, including:

- Reducing the liability exposure not only of the directors and officers, but also the association to the extent the association may indemnify losses incurred by management.
- Improving the association's ability to recruit qualified directors and officers.
- Avoiding time consuming, distracting and potentially embarrassing claims and litigation.
- Enhancing the defense of claims and reduce the potential recovery by a claimant.
- Improving the association's ability to obtain favorable D&O insurance coverage at reasonable costs.

The following discussion identifies various areas in which D&O loss prevention opportunities exist and should be considered. Although much of this discussion relates to the protection of officers, who are held to a similar standard of conduct as directors. An effective D&O loss prevention program includes comprehensive educational programs for board members, appropriate D&O insurance coverage and the utilization of loss prevention guidelines. We will focus on D&O insurance coverage issues, and to the extent permitted by our time constraints, additional D&O loss prevention measures.

## MANAGEMENT OF NON-PROFIT ORGANIZATIONS

Non-profit organizations should be operated and managed with the same degree of care as for-profit corporations.

Many non-profit associations have as directors individuals with substantial experience and expertise in business matters. Too frequently, though, those individuals abandon their business approach to decision making when they sit on the board of the non-profit association. This type of approach to service on the non-profit board is contrary to the director's legal and moral duty to act like a business person, using the same degree of commitment, attention and care as directors of for-profit corporations. Ironically, a non-profit directorship is often more demanding than its for-profit counterpart because some of the work will be unfamiliar and the business of the association may be conducted under less efficient conditions than in business corporations.

Directors should demand that the association be operated much like a for-profit business enterprise. For example, formal and well-defined operating procedures should be established, strong financial controls and systems should be implemented (including regular preparation of balance sheet and income statements rather than use of mere budgets), and risk management and loss control programs should be adopted.

## GENERAL PRINCIPLES GOVERNING D&O LIABILITY

The fundamental responsibility of directors and officers is to represent prudently the interests of the association's members and other constituencies in directing the business and affairs of the association within the law.

### BASIC DUTIES

Directors and officers are subject to three basic duties in performing their responsibilities:

1. **Duty of Diligence.** Directors and officers generally must act with the care that a reasonably prudent person in a similar position would use under similar circumstances. They must perform their duties in good faith and in a manner they reasonably believe to be in the best interest of the corporation. Prior to making a business decision, D&O's must inform themselves of all material information reasonably available to them.

This duty requires not only reasonable behavior with respect to matters submitted for approval, but also requires reasonable inquiry and monitoring of corporate affairs. Although directors and officers are not insurers of the integrity of their subordinates or of general organizational performance, they are required to implement reasonable programs to promote appropriate organizational conduct and to identify improper conduct.

2. **Duty of Loyalty.** Directors and officers are required to refrain from engaging in personal activities which would injure or take advantage of the association. They are prohibited from using their position of trust and confidence to further their private interests. This duty requires an undivided and unselfish loyalty to the association and demands that there be no conflict between one's duty to the association and self-interest. Examples of prohibited conduct in this regard include:
  - D&O's may not realize secret profits or unfair gain through personal transactions with or on behalf of the association.
  - D&O's may not compete with the association to its detriment.
  - D&O's may not usurp an opportunity of the association.
  - D&O's may not realize personal gain from the use of material, non-public information.
  - D&O's should avoid even the appearance of a conflict of interest.
3. **Duty of Obedience.** Directors and officers are required to perform their duties in accordance with applicable statutes and the terms of the association's charter. D&O's may be liable if they authorize an act which is beyond the powers conferred upon a corporation by its charter or by the laws of the state of incorporation.

### BUSINESS JUDGMENT RULE

Directors are presumed to have acted properly and to have satisfied these three basic duties if the Business Judgment Rule ("BJR") applies. The BJR recognizes that not all decisions of directors will result in benefit to the association and that directors will be personally liable for loss to the association only if the elements of the defense are not satisfied.

To obtain the benefit of this important defense, directors must act in good faith and with a reasonable basis for believing that their conduct is in the lawful and legitimate furtherance of the association's purposes and must exercise their honest business judgment after due consideration of what they reasonably believe to be the relevant factors.

Five elements of the BJR are generally recognized:

- a. **Business decision.** The BJR protects directors against claims for wrongful acts, but not against claims for failure to act. Inaction by directors is protected by the BJR only if it a result of a conscious decision to refrain from acting.
- b. **Disinterestedness.** The BJR protects directors who are disinterested and independent with respect to the challenged action. For this purpose disinterested directors are those who neither appear on both sides of the transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which inures to the corporation or all the stockholders generally.
- c. **Due care.** The BJR protects directors if they reach an informed decision after making a reasonable effort to ascertain and consider all relevant information reasonably available to them and after reasonably deliberating the decision.
- d. **Good faith.** The BJR protects directors if they acted with a good faith belief that their business decision was in the best interests of the corporation. The protection will not apply if the directors acted solely or primarily to preserve their positions or otherwise to benefit themselves.
- e. **No abuse of discretion.** The BJR protects directors against honest errors of judgment, but does not provide protection for decisions that cannot be supported by some rational basis and are egregious on their face.

#### CAN INDEMNIFICATION SUBSTITUTE FOR D&O INSURANCE?

An association may seek to protect its directors' personal assets by indemnifying them. Through indemnification the association undertakes to pay legal costs, settlements and judgments on its directors' behalf. *Indemnification can be an empty promise, though, if the association does not have enough money to pay those expenses.* For most associations, indemnification is meaningful only if combined with D&O insurance.

Even for associations that do have substantial assets, insurance can provide board members with extra protection in certain situations when indemnification is not allowed. (On the other hand, the association may indemnify in some situations that are difficult to insure, such as payment of tax penalties.)

#### WHAT DOES A D&O POLICY COVER?

*Directors and officers insurance policies are designed for a variety of claims alleging harm attributable to the governance or management of an association.* The terms of any particular policy may make its coverage both broader and narrower than claims against boards. Policies may be broader by covering claims against the association itself as well as staff and volunteers other than board members. Policies are narrower because they do not cover all types of claims against boards. Most significantly, D&O insurance does not cover bodily injury or property damage claims.

Unfortunately, D&O policies are not standardized and tend to be complex. The discussion here highlights the principal features. Because policies differ so much among insurers, suggestions for comparing policies are offered below under the question, What features should a D&O policy have?.

One universal characteristic of traditional D&O policies is that they generally do not list specific types of claims covered. Instead they extend coverage for any "wrongful act," which is very broadly defined. The scope of that coverage is then narrowed by a list of limitations and exclusions.

One very significant difference among policies is their applicability to claims against the association itself and individuals other than directors and officers. Confusion regarding coverage for the association

may arise because all D&O policies reimburse the association if it indemnifies its directors for their expenses and claims they have paid. The less common form of coverage, "entity coverage," is for claims against the association directly.

This coverage for the association may be extended in several ways: by including the association in the definition of "insureds," by endorsement, or by adding an extra insuring clause (traditionally labeled "Part C"). A policy that includes the association is commonly referred to as "Association Professional Liability Insurance" (APLI), a term that may cause the mistaken impression that it is for associations only. Regardless of what the policy is called, entity coverage is very important if you are buying the policy to protect the association.

One further aspect of a policy's scope concerns the individuals coverage. Traditional D&O policies do not cover staff. Broader policies, such as the APLI form, include executive directors, personnel officers, managers, and committee members. If you want protection for D&O claims against these individuals, you must choose a policy that includes them as "insureds."

The chief advantage of expanding the coverage is that doing so extends protection wherever it may be needed. The most likely disadvantage is a higher premium, although expanded coverage from one insurer may cost less than narrower coverage from another, and an insurer will sometimes add coverage without charge. A less obvious drawback of expanding coverage is that it can dilute the policy's protection for directors and officers. A claim against a manager may exhaust the policy limits, leaving no insurance for a subsequent claim against a director. One way to reduce the danger of using up the coverage is to increase the dollar limits of the policy.

#### ARE THERE GAPS IN D&O COVERAGE?

Several characteristics of most D&O policies create potential gaps or deficiencies that must be checked. Caution is urged in this area because D&O insurance differs in so many respects from other types of coverage that ordinary assumptions about how insurance works may be entirely erroneous. As explained below, the treatment of any of the following items may produce a coverage gap or reduce the value of a policy.

- Incidents that occur before the policy is in effect
- Claims that occur after the end of the policy term
- Explicit exclusions
- Definitions of key terms, e.g., "wrongful act," "claim," "loss," that constrict coverage
- Reimbursement of expenses rather than payment as incurred
- Deduction of legal defense costs from the maximum amount the policy will pay for a claim
- Defense costs for excluded claims

Several of these items concern insurers' procedures for paying D&O claims. Most significantly, traditional D&O policies provide only for reimbursement of expenses rather than payment directly to the other party. To reduce the potential cash-flow burden, some policies provide for advancing expenses upon request by the policyholder. Good language to look for in a policy form reads, "pay on behalf of," "pay as incurred," "pay on a current basis," or "expenses paid upon notice."

#### Claims-made policies

One of the most striking differences between D&O policies and general liability policies is the methods they use for determining whether claims are within the time period the policy covers. Directors and officers policies are frequently written on a "claims-made" form that limits insurers' long-term obligation to pay claims.

The essence of the "claims-made" rule is that the claim, rather than the incident, must occur within the time period the policy covers. To see how this works, assume a newly incorporated association purchases a "claims-made" D&O policy from one insurer in 1991 and switches to another insurer in 1992.

**If an incident in 1991 leads to a claim in 1992, which policy will pay?**

**1991 Policy:** Absent special arrangements, the 1991 policy does not apply because the claim was not filed during the policy year. Coverage may depend on whether the policyholder provided sufficient notice of the potential claim during 1991 or purchased an extended reporting period (tail) for the policy.

**1992 Policy:** The insurer's obligation under the 1992 policy depends on its treatment of prior acts. Some policies have a total prior acts exclusion. Others provide coverage for all prior acts unless a specific potential claim is explicitly excluded. Still others set a "retroactive date" that specifies how far into the past the policy extends coverage for prior acts.

The nature of claims-made coverage necessitates extra care to avoid a coverage gap. One strategy is to remain forever with the same insurer. Staying with the same carrier automatically extends coverage from one policy period to the next.

The claims-made feature does not prevent changing insurers, however, especially if no incidents likely to lead to claims have occurred. The prudent strategy is to choose a policy that includes coverage for wrongful acts that occurred while the previous policy was in effect or, better still, regardless of when a wrongful act occurred.

Without prior acts coverage, an association must rely on the extended reporting period (tail) of the previous policy. Most policies will specify whether an extended reporting period is available and, if so, how much it will cost if the association chooses to purchase it at the end of the policy period. The extended period typically lasts only a year, whereas claims may be filed far into the future, especially if a minor has been injured.

These characteristics of claims-made policies can diminish the value of D&O insurance as a guarantee against board liability. Purchasing a policy does not assure a board of coverage forever for whatever happens during the policy term in the same way that a general liability or auto policy does. If a subsequent board allows the policy to lapse, changes insurers in a way that leaves a coverage gap, or dissolves the association, the old board may eventually be hit with an uninsured suit. These prospects, though remote, are the unfortunate consequences of this form of coverage.

**Exclusions**

If one had only five minutes to read a D&O policy, the time would be well spent examining the list of exclusions. In the exclusions section the broad coverage granted elsewhere can be whittled away. Because specific exclusions vary substantially among policies, lining up the exclusions of different policies for a side-by-side comparison is a critical step in choosing among them. Clarifying the exclusions is also the first step to asking the insurer to eliminate unacceptable items.

A note of caution in ascertaining the complete list of exclusions is that they are not always included in a policy's exclusions section. The definitions of "wrongful act" or "loss" may function to exclude certain types of claims. To construct a complete list you should examine the entire policy, including endorsements, to see how each provision limits coverage. The exclusions checklist on the next page may be used to help identify exclusions. As the checklist indicates, some of the standard exclusions apply to claims covered under other insurance policies. (If you give this list to your agent to check against the policy, be sure to add "Other" to the list.)

## COMMON D&amp;O POLICY EXCLUSIONS

Bodily injury (General Liability)  
 Property damage (General Liability)  
 Professional services (Malpractice)  
 Handling Funds (Fidelity, Bond)  
 Nuclear radiation, pollution damage  
 Illegal acts  
 Dishonest acts  
 Intentional misconduct  
 Punitive damages  
 Fines, penalties and matters uninsurable by law  
 Failure to obtain adequate insurance  
 Contract claims  
 Employee retirement income security act (ERISA)  
 Antitrust, price-fixing, restraint of trade  
 Peer review, standard setting  
 Credentialing, certification  
 Discrimination  
 Sexual misconduct  
 "Insured versus insured claims"  
 Injunctions/non-pecuniary suits

One exclusion with potentially unrecognized adverse consequences for a nonprofit association is generally phrased as the "insured versus insured" exclusion. This exclusion is designed to eliminate coverage for struggles over control of the association, which can be intractable. Any "insured versus insured" exclusion must be examined to determine how it applies to employment-related claims.

## DEFENSE COSTS

Because someone may sue a blameless board, many D&O insurance purchasers value the policy primarily for its use in meeting legal defense costs. Before relying on a D&O policy for this purpose you should be aware that the legal defense arrangements under various D&O policies can be the difference between quick dismissal of a legal claim through the efforts of a good lawyer and financial distress for an association and its board members if they do not have funds on hand to pay legal fees. As with so many other elements, the legal defense provisions of most D&O policies are unlike common insurance arrangements.

The first difference from ordinary insurance is that D&O policies typically do not include a duty to defend pro se. Instead of requiring the insurance company to retain legal counsel and defend against a lawsuit, the traditional D&O policy simply requires the insurer to pay defense costs the policyholder incurs.

A related difference is that legal defense costs are within the policy limits of most D&O policies. Rather than paying legal expenses in addition to claims up to the policy limit, the D&O policy subtracts legal expenses from the policy limit. Thus, a one million dollar limit does not provide adequate protection for a one million dollar claim. It is possible for legal defense costs to exhaust the entire policy limit, leaving no coverage for a settlement or judgment. Many D&O policies require that the insurance carrier choose the defense counsel. Policies which provide that the Association retains its right to choose its defense counsel are preferred.

Because defense costs are treated the same as claims expenses, they are subject to the retention or deductible of a D&O policy. ("Retention" and "deductible" are often used interchangeably, but differ technically in that a deductible, but not a retention, is subtracted from the policy limit.) If the policy has a \$5,000 retention or deductible, the insurer will not pay legal costs below that amount.

One highly variable feature among D&O policies is their handling of defense costs for excluded claims. Although no policy will pay judgments or settlements for claims arising from intentional misconduct, they differ as to whether they will pay the costs of defending against such claims. To the blameless director named in a lawsuit, that has no merit, defense costs are tremendously important.

Policy wording for this point is among the least standardized and can be confusing. Some policies clearly state that defense costs will be paid for certain categories of claims that are otherwise excluded. In other policies the critical language is in the definition of coverage, terms of specific exclusions, or a separate section specifically for this issue. In light of the importance of this issue, you should be clear about the rules.

#### **WHAT FEATURES SHOULD A D&O POLICY HAVE?**

The list of desirable features in a D&O policy depends largely on the needs of the association. The preceding discussion has identified the principal advantages and drawbacks of various features so you can assess their value for your board and association. The following items are almost always desirable.

- Broad coverage
- Defense costs for excluded claims
- Coverage for insurable incidents that occurred prior to the policy period
- Protection for "innocent directors" who are unaware of a misrepresentation in the policy application
- Adequate notice of cancellation (or noncancellation)

The value of additional features depends on the circumstances of the association and all affected individuals. Extension of coverage to the association, employees and volunteers other than board members ordinarily is preferable. Associations with a tight cash flow should be especially sensitive to both advancement of costs and the amounts of the retention (deductible) and co-payments (participation), if any.

Deciding upon the amount of the policy limit is especially difficult because costly lawsuits may be filed against small associations. Most D&O claims are roughly proportionate with the size of the association, but not always. Because defense costs are paid within the limit, a final decision must take those potential costs into account.

Some insurers, often in conjunction with nonprofit umbrella groups, offer policies designed for particular types of organizations, e.g., schools, associations, and foundations. These specialty policies are generally better suited for their policyholders than a standard D&O policy.

The list below is designed to help you choose the desirable features for your association and to compare the features of alternative policies. To evaluate policies, we suggest working with your insurance agent and attorney to place the features of the policy into this standardized format so you can compare "apples to apples".

CHECKLIST OF D&O INSURANCE POLICY FEATURES
Premium Policy limits: incident, total Retention (Deductible) Co-payment (Participation) Coverage for: The organization (Part C) Subsidiaries, committees, advisory boards Staff, volunteers Types of claims covered (definition of "wrongful act") Exclusions (review list on p. 8) Defense of excluded claims Advancement of expenses If it is a claims-made policy: Coverage for prior acts Availability and cost of extended reporting period Protection for "innocent directors" Cancellation and notice

#### IS A GENERAL LIABILITY POLICY THAT COVERS THE BOARD SUFFICIENT?

A general liability policy may provide coverage for an association's board, but that coverage differs from the coverage of a D&O policy. A general liability policy is easily confused with a D&O policy because a single incident may result in claims under both. For example, a drowning claim will ordinarily be covered under the general liability policy, even if the suit alleges that the board was negligent for operating a pool without a lifeguard. If the suit alleges a civil rights violation because the board failed to make the pool safe for a swimmer with a partial disability, the D&O policy would respond.

This case illustrates both the truth and the limitation of the statement that directors and officers are covered by a general liability policy. Regardless of whether the general liability policy names board members, its scope of coverage does not include most employment-related actions and other kinds of claims typically filed against boards. The standard general liability insurance policy covers only claims for bodily injury or property damage. Complete coverage for the board requires both a general liability policy that includes directors and a D&O policy.

#### WHAT IF BOARD MEMBERS HAVE THEIR OWN INSURANCE?

Few liability insurance policies that individuals purchase primarily for other purposes will protect them against a D&O claim. At one time many homeowners policies and personal umbrella policies included such coverage. Now, the protection is rarely available and, if so, usually costs extra. Far more people believe that because their personal liability insurance policies do not list "board service" among the exclusions, they have adequate protection. The flaw in this reasoning has to do with the scope of coverage under these policies.

Personal insurance policies are very specific in terms of what they cover. The implications of this point are clearest for an auto insurance policy. A board member's auto policy ordinarily will cover claims from accidents that occur in the course of board service. It will not cover claims for breach of a director's duties to the association.

Thus, the terms of a personal insurance policy's coverage are critical even if the policy explicitly encompasses board service. Many homeowners policies apply only to claims based on bodily injury, property damage, and a few other specific types of harm. That coverage is not likely to apply to wrongful termination, discrimination, misuse of funds, or defamation (libel or slander) claims.

As a final note, the D&O insurance policies of some business corporations and nonprofits cover their executives for volunteer board service elsewhere. This feature is usually added as a special endorsement and may be available only for individuals who serve on a board at their employer's request. Moreover, most business corporations' policies have a high deductible.