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Directors & Officers Insurance:

Practical considerations on the interaction between insurance and company indemnities

A Directors & Officers ("D&O") policy is a fundamental part of a company's insurance programme. It provides protection to directors and other senior individuals who may face personal liability for matters related to their role. Individuals may also have protection via indemnities from the company. The interaction between D&O and company indemnities can be complicated and there are issues to consider from a policy perspective, even if there are no company indemnities. In this article, our Legal, Technical and Claims team consider some of the practical implications for directors and companies.

The role of the insurance broker:

This article highlights some of the practical issues that may arise when explaining the operation of a policy or making a claim. Ultimately, your broker is here as your technical partner, assisting you with responses to internal queries, helping your consideration of a D&O policy as a risk management tool, and guiding you through the submission of a claim and pursuit of that claim with insurers. A D&O policy is a valuable product, and your broker can help you (and your directors) achieve the value from the policy and help avoid or overcome many of the practical issues that can arise.

Who makes a claim under a D&O policy – directors or company?

The short answer is that it can be either, or both. A D&O policy is designed principally to cover the personal liability of directors and officers, which liability may arise (or be alleged to arise) whilst they are acting in their capacity as directors and officers of a company. Where there is no company indemnification of a director (e.g. where the company does not cover a director's legal costs in defending a claim), a D&O policy will cover that personal liability directly. This is known as Side A or cover for non-indemnifiable loss, and so it is the director making the claim on the policy directly.

Most D&O policies also provide cover where the company does indemnify their directors. Indemnification would usually be by reason of law, the company's articles/constitutional documents, and/or the director's contract (including any severance agreement). Ultimately, the aim of the arrangements as a whole is still to protect against the personal

liability of the director (as it is the director that is being sued as an individual). However, it is the company that is actually (and legally) suffering the financial loss, since the company is indemnifying the director. This is known as Side B or cover for indemnifiable loss, meaning that it is the company making the claim on the policy.

It is important to remember that a D&O policy is a severable policy and there can be multiple claims on it at the same time – both Side A and Side B.

Why does it matter if a claim is Side A/non-indemnifiable or Side B/indemnifiable?

Practically speaking, the main difference between Side A and Side B is that Side A will always have a nil deductible[1]. Therefore, if a claim is Side A, insurers pay from the first penny. Side B often does have a deductible, meaning that the company will pay the first portion of the loss, before the insurers start paying above that.

There has been greater focus on this issue recently with Side B deductibles increasing dramatically as the risk appetite of the insurance market contracts (known as a "hard market"). In the soft market, deductibles were often lower, and in certain sectors there may not have been a Side B deductible at all.

The increase in deductibles has led directors to ask what would happen if they are not indemnified by the company, even if they could be. That may be because a director does not have a right of indemnity from the company, or because a company is insolvent and simply does not have the money, or because the company chooses not to indemnify. In these circumstances, could a director have to pay the deductible?

Does the policy protect a director if a company does not pay the deductible?

There can be provisions that help, although each policy will need to be checked individually. Policies may include a term that states that if the company refuses to indemnify the insured person, but is legally able to, insurers will pay the policy deductible. Insurers will then be entitled to pursue the company for reimbursement of the deductible (assuming the matter is properly indemnifiable).

Depending on the drafting of the insuring clauses, it may also be possible to argue that the director is entitled to recover costs from insurers if, as a matter of fact, the company has not indemnified the director, and regardless of whether there is a right of indemnity. Again, the policy provisions must be checked carefully. Further, the protection this argument may offer is not as clear as a specific clause that deals with a situation where a company does not indemnify.

If my policy has these provisions, does a director have nothing to worry about?

There can still be practical risks that fall to the director if a company does not indemnify, even if insurance policy provisions provide protection from the first penny (as it would be the director dealing with the insurer rather than the company).

In particular, insurers may hold back payment whilst they investigate coverage for the director's claim, which can take time, especially if the claim is complex. For example, insurers will want to satisfy themselves that there has been no breach of duty of fair presentation (e.g. if anyone was aware of the matter prior to the policy period), that the matter was notified in a timely manner, and that no exclusions apply.

[1] A sum that the insured is required to pay before insurers become liable to pay the claim. It may also be referred to as the "excess" or "retention".

To help move the process along it is important that the director provide the insurer with reasonably requested information as soon as possible. Your broker can assist with this process by helping to identify with you early what information insurers will require. We do find that with Side A claims (where but for the insurer paying the director would be left paying from their own pocket) insurers do try to expedite matters appreciating the situation the director is in – often legal costs are significant and directors may simply not have the money available.

Once coverage is resolved, is that the end of the practical issues for a director?

There can be risks associated with ongoing claims conduct, such as agreement of lawyer rates, legal budgets for certain work, and failure to seek consent for settlement. Policy provisions will require insurer consent for certain claims conduct activity. Failure to seek consent causes a clear issue (as the insurer may then refuse to pay at all) but even if consent is sought, an insurer may not provide that consent (and may be entitled to refuse to provide it) if it considers the request is unreasonable.

As an example, if a director retained a top lawyer with a significant hourly rate, insurers may say they are not prepared to pay a rate of more than 75% of the retained lawyer's rate. If the company refuses to indemnify the director, the director is faced with a choice of paying the extra 25% themselves, changing lawyers, risk having their lawyer stop acting whilst they argue with insurers, and/or suing insurers for the full fees. None of those are particularly attractive options. It is important that if these issues arise they are resolved early, with help from your broker.

We now have lawyers' fees agreed and have obtained consent as required by the policy. Can a director finally stop worrying about insurance?

There can still be delays in payment whilst insurers review invoices and satisfy themselves that time has been properly spent, and that narratives are appropriately detailed. Those delays may need to be managed with the director's lawyers, who may be asked to provide further information to support their work. In some cases, insurers will refuse to pay certain elements of an invoice if it goes outside of an agreed approach (for example, if there is repetition of work by multiple fee earners). There remains a risk, therefore, that a director may have to pick up some element of the fees if the lawyers cannot be persuaded to write off disputed sums. Again, it is important that if these issues arise they are resolved early, with help from your broker.

What are the concerns for the company regarding interaction between the D&O policy and company indemnification?

In short, there are a few. A D&O policy usually provides a direct right for a director to bring a claim for cover. If a director (or other individual) falls within the scope of cover, he or she will be entitled to a copy of the policy and to bring a claim – it is a severable policy. That is seen as a key protection for directors, but a company should be aware that it will not be able to restrict access to the policy after the event (for example, if it has fallen out with the director).

Importantly, a D&O policy may require the company to pay the deductible even if the company is under no obligation to indemnify the director. A typical clause will, effectively, require indemnification if legally permitted (i.e. so long as there is no legal bar on indemnification, the D&O policy will assume indemnification has taken place). The reason for that is so that a company does not simply choose not to indemnify, and thereby avoid the deductible associated with a Side

B/Indemnifiable Loss claim. As a result, a company may be faced with a significant bill (particularly given increases in deductible) in circumstances in which it has no obligation to indemnify a director if a director makes a claim on the policy.

Of course, there are many reasons to offer indemnities to directors or other individuals, including reputation as an employer generally and to persuade individuals to take on director or other senior roles that come with personal responsibility and potential liability. Consideration of how the indemnities (or decision not to provide indemnities) interacts with a D&O policy is, however, important in a full understanding of the practical impact on a company of a claim against one of its directors.

What are the conclusions for a director?

A D&O policy does many things to protect directors, including if a company is unable or unwilling to indemnify. Many directors have claims paid each year, and the points identified in this article should not be overstated – it is a crucial cover and your broker will help you through the complexities we have identified. However, it is clear that there can be practical difficulties with recovering under an insurance policy, even in relatively straightforward claims, and that the risks of payment delays will fall to the director if it is they rather than the company making the claim.

Directors should, therefore, consider carefully their indemnification position with the company, to ensure there are no surprises if a claim does arise. For example, directors should review the protection they have under articles of association, consider contractual indemnities in place (and ensure that these provisions operate clearly in the event of claim), and review arrangements periodically to check that they remain fit for purpose.

A final point is that, with D&O policies increasing in price, companies may look to reduce the amount of D&O cover that they buy, increasing the risk that the policy limits will be exhausted (either by the claim against the director, or by other claims). If there is no cover remaining, company indemnities will, once again, be the principal protection for directors.

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