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612-752-6000 thl@hcba.org

Directors and Officers Insurance: Things to Know About D&O

Directors and officers (D&O) insurance protects directors and officers, and the companies they serve, against certain liabilities arising from claims by third parties. This article provides some background and insight into recent and potential issues in D&O insurance. D&O insurance might be seen as a rare species of insurance policy—even more arcane than other kinds of insurance policies. But D&O insurance is also interesting because the coverage under the policies is unlike other types of insurance. In contrast to standard liability policies sold on a "take-it-or-leave-it" basis, D&O insurance is often customized to the individual insured's particular risks and exposures.

Andrew Deutsch
Contributing Author

Mr. Deutsch loves insurance law. He is an associate at Meagher & Geer, where he advises and defends insurers in property and liability insurance coverage disputes and litigation.

In addition, the coverage available under D&O insurance policies can evolve quickly in response to case law and anticipated risks. Insurers respond to court decisions by broadening or narrowing coverage to address issues raised in litigation, and by changing policy language to embrace or reject interpretations applied by the courts.

Policies also change as new risks and issues are anticipated. If an insurer can evaluate and underwrite the risk, and the insured is willing to pay the premium, individualized or manuscript policies can have coverage broadened, exclusions narrowed, and limitations altered.

Of course, it is never as simple as an insured buying coverage for all of its potential risks and exposures. The coverage available depends on the insured's circumstances and what is sold or can be found in the market. In addition, the language in the policy can vary depending on the broker involved in negotiating coverage, or the insurer issuing the policy. Differences in policy language can also be found in insuring agreements, exclusions, definitions, limitations, and just about every other provision. And because the policy is issued for potential and unknown future claims, there is a chance—or perhaps it is inevitable—that disputes will arise between the insured and insurer. Because of these variables, there is no shortage of emerging issues in D&O insurance.

This article has three parts. First, it gives a brief overview of some central concepts and issues for D&O insurance. Second, it addresses issues related to defense costs—specifically when an insurer must pay defense costs, and whether an insurer can recoup defense costs paid if it is later determined that coverage is not available. Last, this article discusses D&O insurance coverage issues related to emerging risks, using as an illustration the potential liability for limited sales of securities as permitted by the Jumpstart Our Business Startups Act or JOBS Act.

This article should be treated as a brief overview of recent trends and potential new issues in D&O insurance law in Minnesota.[1] The reader should note that the law that applies to interpret the policy can vary between jurisdictions. Insurance coverage issues frequently require a choice of law analysis, and may include looking at more than one state's laws. Minnesota has relatively little case law involving D&O insurance coverage. Cases from other jurisdictions therefore may provide persuasive authority and identify trends and majority or minority positions.

As a rule, if you face a D&O (or any other) insurance coverage issue, always read the policy—all of it. The actual policy language is critically important. The policy language

can appear the same as in another case with only a minor difference. These minor differences in policy language can make subtle and important differences in the insurance coverage analysis.

A Brief D&O Overview

D&O insurance policies have some important differences from other types of insurance policies. One difference is that D&O policies are typically "claims-made policies." Claims-made policies apply to claims made against the insured, and reported to the insurer, during the policy period or an extended reporting period. Claims-made policies typically involve only the policy in place at the time the claim is first made.

In contrast to claims-made policies, more familiar policies such as Commercial General Liability, Business Owner's Liability, and Homeowner's Liability policies are typically "occurrence-based." Occurrence-based policies apply to injury or damage that occurs during the term of the policy, regardless of when a claim is made against the insured. An occurrence-based policy could provide coverage for damage or injury occurring long ago. As a result, so-called long-tail claims, such as claims for bodily injury caused by asbestos exposure or property damage for pollution, could involve more than one insurance policy period.

D&O policies also usually contain one or more insuring agreements split into different parts or "sides." "Side A" coverage provides indemnity for individual directors and officers for covered claims made in situations in which the corporation itself cannot indemnify the "Ds" and "Os." Similar to Side A coverage, "Side B" coverage provides indemnity to the corporation for amounts paid to executives for covered losses. Finally, "Side C" coverage provides defense cost and indemnity coverage to the entity or organization itself.[2] For public companies, Side C coverage might be limited to securities claims. For private companies, Side C coverage can be broader and is often not limited to securities claims.

There is another significant difference in looking at D&O policies compared to other types of policies. More often than not, D&O insurance policies do not include a duty to defend the insured. When there is no duty to defend, a D&O insurer only has a duty to reimburse defense costs incurred by the insured.

When Must the Insurer Pay the Insured's Defense Costs?

When the insured begins to incur defense costs, and requests coverage from the insurer, there is a question about when the insurer must pay defense costs. Is it at the time the costs are incurred? Or only after coverage is determined under the policy?

There is no definitive law in Minnesota. And as noted in *American Cas. Co. of Reading, Pa. v. Bank of Montana Sys.*, "[c]ourts which have reviewed D&O policies with identical or similar language are divided on whether or not the policy is ambiguous as to whether the insurer has a duty to advance legal fees prior to final disposition of the action."[3]

The policy language at issue in *American Casualty* is not uncommon in D&O insurance policies. That policy defined "loss" as "any amount which the Directors and Officers are legally obligated to pay . . . and shall include . . . costs . . . , and defense of legal actions . . . ." The policy also said that the insurer "may at its option and upon request, advance . . . expenses . . . incurred in connection with claims . . . ."

The *American Casualty* court concluded that the policy language was ambiguous as to when the insurer must pay defense costs. The court noted that it was not clear under the policy if "costs" and "defense of legal actions" included within the definition of "loss" were also considered "expenses" in determining if the insurer had the option to advance the insured's expenses.[4] In *McCuen v. Am. Cas. Co.*, a later case from the Eighth Circuit, the court applied Iowa law to the

same policy language and reached the same result as in *American Casualty*.[5]

By contrast, the Sixth Circuit in *Valassis Communications, Inc. v. Aetna Cas. & Sur. Co.*, applying Michigan law, held that when an insurance policy requires reimbursement of defense costs but does not include a duty to defend, the insurer must only pay defense costs if there is actual coverage under the policy.[6] The court's reasoning was based on the determination that the duty to reimburse defense costs is not as broad as the duty to defend, and therefore did not require reimbursement of defense costs if there was no coverage under the policy.

As noted at the outset, the applicable law and the language in the policy are important in determining when defense costs must be reimbursed under a D&O insurance policy. The federal court in the District of Minnesota, and the Eighth Circuit Court of Appeals (applying Iowa law), found that the insurer had a duty to reimburse defense costs as incurred. But those decisions could have ended with different results if the courts had interpreted different policy language or applied different law.

When Can the Insurer Recoup Defense Costs Paid to the Insured?

A related issue is what happens when the insured tenders a claim, but the insurer believes that the claim might not be covered. Sometimes an insurer will advance defense costs based on the language in the policy, an agreement with the insured, or out of an abundance of caution when a claim against the insured is potentially covered. As part of one or more of these approaches, in its coverage position letter, the insurer might advance defense costs subject to a reservation of the right to seek recoupment or reimbursement of those costs. If there is a later determination that the claim against the insured is not covered by the policy, the insurer might seek reimbursement from the insured for any advanced defense costs.

Courts have struggled with whether defense costs paid by an insurer can be recouped if there is a later determination that no coverage exists under the policy. In *Westchester Fire Ins. Co. v. Wallerich*, the Eighth Circuit discussed many of the decisions on the issue, noting the split between those decisions allowing recoupment and those not.[7] The split in the courts is represented within conflicting decisions from the federal court in Minnesota. In *Knapp v. Commonwealth Land Title Ins. Co.*,[8] a 1996 case, the court permitted recoupment and noted that allowing the insurer to seek reimbursement was the majority position of other courts. But in a case decided a decade later, *Employers Mut. Cas. Co. v. Indus. Rubber Prod., Inc.*, the court held that the insurer had no right to reimbursement.[9] In that case, the court noted that no Minnesota court had followed *Knapp* and that the Eighth Circuit, in *Liberty Mut. Ins. Co. v. FAG Bearings Corp.*,[10] had denied the insurer recoupment of defense costs.

In *Wallerich*, the insurer had agreed to advance defense costs while reserving the right to seek reimbursement of any costs paid if the policy did not provide coverage for the claim being defended. The Eighth Circuit looked to the policy language and the facts before it as well as the previous decisions from other courts, including the Minnesota cases. It then followed what it called the recent trend in the case law by declining to allow the insurer to recoup defense costs. In reaching its holding, the court noted that nothing in the policy allowed the insurer to seek recoupment. In addition, the court pointed out that when the insurer reserved the right to recoup costs, the insured had responded by rejecting the insurer's right to seek recoupment.

In part because of decisions like *Wallerich*, D&O policies are more likely to have express provisions regarding what happens when the insurer pays defense costs but the policy does not provide coverage. In a recent decision by the Minnesota Court of Appeals, the court enforced the express language under the policy that allowed the insurer to seek reimbursement for advanced costs. In *Northstar Educ. Finance, Inc. v. St. Paul Mercury Ins. Co.*,[11] the court held that the insurer could recoup defense costs because the policy stated, "to the extent that any . . . Defense Costs are not covered under this Policy, the Insureds . . . agree to repay the Insurer such Defense Costs." Because the policy specifically addressed reimbursement to the insurer, the court ordered the defense costs paid back to the insurer because the policy did not provide coverage to the insured.

Potential New Claims under the JOBS Act

The issues related to payment and reimbursement of defense costs is not new, or even limited to D&O insurance. However, the landscape continues to change as D&O insurers and insureds respond to case law and emerging risks.

One potential area of new claims and emerging issues for D&O insurance could be the Jumpstart Our Business Startups Act (JOBS Act). [12] In April 2012, President Obama signed this act into law. One part of the JOBS Act, Title III, makes is easier for certain companies, including small businesses, to obtain limited funding by selling equity securities and by streamlining the legal and regulatory framework for such sales. Specifically, the JOBS Act exempts from more stringent requirements an offer or sale of securities totaling less than $1 million in in the preceding 12 months.[13]

In principle, the JOBS Act exemption will reduce reporting requirements for small businesses that decide to raise funds by selling equity interests in the company. By design and necessity, these sales will tend to be completed with small shares bought by many purchasers. The JOBS Act was designed to allow small companies to continue to grow by seeking equity contributions while avoiding undue regulatory burdens that are associated with offering or selling securities. As part of meeting that goal, the JOBS Act allows for the creation and regulation of crowdfunding "portals" that do not need to register with the Securities and Exchange Commission (SEC) as a licensed broker-dealer.[14] The crowdfunding portals will still be subject to SEC rules and regulations, however. But the use of crowdfunding portals increases the possibility that less sophisticated buyers will have greater access to equities online through the Internet.

Although it became law in April 2012, the SEC is still collecting public comments before publishing proposed rules under Title II of the JOBS Act.[15] The Act initially gave the SEC 270 days to draft proposed rules—or roughly until the end of 2012. But as of mid-October 2013, the SEC had not published any proposed rules for Title III of the JOBS Act. Before voting on whether to adopt final rules, the SEC must first publish the proposed rules. And a vote will not occur until the SEC has allowed time for public comment (typically 90 days), and any possible further agency review of comments. As a result, it is almost certain that final rules will not be adopted before 2014.

D&O Insurance Coverage Issues for Crowdfunding Claims

Although the final rules are not yet ready for crowdfunding under the JOBS Act, the act presents a real risk of novel claims. The act includes a provision that permits a private cause of action and imposes liability on crowdfunding issuers for material misstatements or omissions in connection with offerings.[16] As a result, the issuer, directors, or officers in an action brought by a purchaser could be liable for a refund of the amount paid for the securities, or for the purchaser's actual damages, resulting from material misstatements or omissions. The act's private cause of action could result in increased claims made against companies or executives involved in crowdfunding.

Because the SEC has not adopted final rules permitting crowdfunding, it is unknown whether and to what extent the JOBS Act could impact D&O insurance coverage. The relaxed regulations and the increased ability of small companies to sell equitable shares through crowdfunding under the JOBS Act could lead to increased litigation as the pool of unsophisticated purchasers is likely to increase. In addition, crowdfunding sales will presumably tend to encourage investment by many people, from diverse geographic areas with limited access to information on the risks of investing. Some have expressed concerns that crowdfunding will lead to greater opportunity for fraud and abuse, which could outweigh any benefit of the limited regulations under the JOBS Act.[17] The SEC has expressed similar concerns about the JOBS Act. It recently filed a civil lawsuit against a company alleging that it had engaged in securities fraud by telling investors it could raise billions of dollars under the JOBS Act.[18]

The impact of crowdfunding claims on D&O insurance coverage remains to be seen. It could be several months until the SEC has proposed rules for the JOBS Act. Nevertheless, insurers have already taken positions, with some moving to exclude coverage while others advertise new coverage specifically geared to the risk.[19] Insureds and brokers will likely need to wait for further direction from the SEC and insurers before deciding whether, or to what extent, coverage for such claims will be available.

Conclusion

There is no shortage of new issues that will continue to develop and emerge in D&O insurance. This article should give you a basis for understanding and appreciating some unique and recurring issues that arise under D&O insurance policies, such as those related to defense costs and potential new risks for crowdfunding under the JOBS Act. In some cases, the legal issues in play may be familiar, but the relevant policy language might have changed, such as disputes about payment and recoupment of defense costs. In other cases, new risks have arisen under the JOBS Act, creating novel issues of interpretation under existing policy language. In any event, due to the evolving nature of D&O insurance, new challenges will continue to emerge for attorneys representing clients on matters involving this type of corporate insurance coverage.

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[1] An excellent resource for the reader seeking a more comprehensive treatment of the subject is "Directors and Officers Liability Insurance," Chapter 23 in the Minnesota Insurance Law Deskbook, written by Gary J. Haugen, Margo S. Brownell, and Joseph P. Ceronsky of Maslon, Edelman, Borman & Brand, LLP.

[2] *Compare* Piper Jaffray Cos., Inc. v. Nat'l Union Fire Ins. Co. of Pitts., Pa., 38 F. Supp. 2d 771, 774 (D. Minn. 1999) (noting that the insurers' "D&O insurance policies, in accordance with industry practice, reimburse corporations for indemnification of their offices and directors for covered losses but do not provide coverage for independent claims against a corporate entity.") *with* Gulf Ins. Co. v. Skyline Displays, Inc., 361 F. Supp. 2d 986, 990-91 (D. Minn. 2005) (holding that D&O coverage applied to the corporation but not to the individual director).

[3] American Cas. Co. of Reading, Pa. v. Bank of Mont. Sys., 675 F. Supp. 538, 541 (D. Minn. 1987).

[4] *Id.* at 543-44.

[5] McCuen v. Am. Cas. Co.,946 F.2d 1401, 1406 (8th Cir. 1991).

[6] Valassis Communications, Inc. v. Aetna Cas. & Sur. Co., 97 F.3d 870, 876 (6th Cir. 1996) (citing Board of Trustees of Mich. State Univ. v. Continental Cas. Co., 730 F. Supp. 1408, 1411, 1414 (W.D. Mich. 1990)).

[7] Westchester Fire Ins. Co. v. Wallerich, 563 F. 3d 707, 714-17 (8th Cir. 2009) (discussing cases on both sides).

[8] Knapp v. Commonwealth Land Title Ins. Co., 932 F. Supp. 1169 (D.Minn.1996).

[9] Employers Mut. Cas. Co. v. Indus. Rubber Prod., Inc., No. Civ. 04-3839, 2006 WL 453207 (D. Minn. Feb.23, 2006).

[10] Liberty Mut. Ins. Co. v. FAG Bearings Corp., 153 F.3d 919 (8th Cir. 1998) (applying Missouri law).

[11] Northstar Educ. Finance, Inc. v. St. Paul Mercury Ins. Co., No. A12–0959, 2013 WL 141712 (Minn. App. Mar. 27, 2013).

[12] Jumpstart Our Business Startups Act, Pub. L. No. 112-106 (April 5, 2012).

[13] *See id.*, at § 302. The more stringent requirements are under § 4 of the Securities Act of 1933, 15 U.S.C. § 77d.

[14] *See Jumpstart Our Business Startups Act Frequently Asked Questions About Crowdfunding Intermediaries*, U.S. Securities and Exchange Commission (May 7, 2012), *http://www.sec.gov/divisions/marketreg/tmjobsact-crowdfundingintermediaries-faq.htm*.

[15] *See Comments on SEC Regulatory Initiatives Under the JOBS Act: Title III–Crowdfunding*, U.S. Securities and Exchange Commission, *http://www.sec.gov/comments/jobs-title-iii/jobs-title-iii.shtml*.

[16] *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106 (April 5, 2012), § 302 (amending the Securities Act of 1933 by adding § 4A).

[17] Lyndon M. Tretter, *Crowdfunding: Small-business incubator or securities fraud accelerator?* Westlaw Journal Securities Litigation & Regulation (Aug. 22, 2012).

[18] Press Release, *SEC Seeks to Halt Scheme Raising Investor Funds Under Guise of JOBS Act* (April 25, 2013), *http://www.sec.gov/news/press/2013/2013-73.htm*.

[19] *See Crowdfunding – D&O Implications*, Barney & Barney LLC (Nov. 1, 2012), *http://www.barneyandbarney.com/crowdfunding-d-o-implications/*. *See also* Kevin LaCroix, *What to Watch Now in the World of D&O*, The D&O Diary (Sept. 6, 2012), *http://www.dandodiary.com/2012/09/articles/d-o-insurance/what-to-watch-now-in-the-world-of-do/*.