Tips And Traps In Corporate Liability Coverage

by Brian G. Friel and Murray D. Sacks

Board members, especially those at major public companies, know the importance of solid directors and officers insurance. However, did you know that many clauses in your policy are ill-defined, and easy to violate? Did you know many expenses you assume are *not* covered may actually be covered? Or that a small application oversight could invalidate the entire policy?

Well-run companies often overlook and even mishandle their most important asset when facing legal exposure: professional liability insurance. This can cost a lot. In fiscal year 2016, the SEC brought a record 548 enforcement actions, and obtained judgments totaling more than $4 billion. Plus, consumers, investors, business partners and competitors compound a corporation's liability with lawsuits of their own.

The corporate price tag for managing litigation is enormous in terms of company resources, adverse publicity, legal fees, settlements, and adverse court judgments. Increasingly, lawsuits and governmental investigations are brought against executives and board members personally. At the Department of Justice, Securities and Exchange Commission, Consumer Financial Protection Bureau, and many other federal and state agencies, civil and criminal prosecutions (with hefty fines, penalties and settlements) are being lodged not just against corporate entities, but against individual officers and board members.

If handled correctly, insurance can pay for the vast majority of lawsuits and governmental investigations. If handled incorrectly, coverage may be diminished or even forfeited. Executives and board members need not know everything about insurance, but awareness of a few make-or-break pitfalls is vital. Following are our top ten ways that corporate executives and board members can maximize insurance coverage while minimizing corporate legal fees.

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☐ ***Give timely notice of insurance claims.*** The most fundamental and important issue for management is notice. Too often, we see corporate policyholders forfeit or seriously jeopardize valid claims, risking millions of dollars, simply because they (or their lawyers) failed to give timely notice.

While the general concept of providing timely notice is simple enough, this is a very complex area of law. Notice provisions in an insurance policy can be confusing, and do not always lead policyholders to a clear-cut answer as to what should be done. In addition, notice-related provisions may be found in different parts of the policy. Sometimes these provisions are complementary but oftentimes are inconsistent, particularly in programs with multiple polices.

Finally, ever-changing court decisions across the country addressing what constitutes a "claim" for purposes of triggering notice make it difficult to apply clear cut rules regarding notice. Sometimes the only solution is to know the policy details and the relevant case law, so that proper and timely notice is provided.

Notice provisions should be strictly followed. Notice is often required to be provided during the policy period when the claim is made. In some situations, notice should be provided even before a formal claim is made. Notice that is one week late, or even a day late in certain situations, can mean the difference between obtaining a $10 million insurance recovery or nothing, regardless of the substantive merits of the claim.

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The bottom line is, proper and timely notice can be the difference between coverage and no coverage. Further, it cannot be delegated to a risk manager or general counsel. Every executive must be sensitized to the issue, so that when a subpoena is issued, a consumer complaint letter is delivered or a lawsuit is filed, the question is asked: Does this trigger coverage under our policies, and should we place our insurers on notice? Do not spend money buying insurance policies only to burn these assets by not giving proper notice.

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☐ ***Know how to get defense costs covered.*** Liability insurance policies cover both the defense of claims and the indemnification of judgments or settlements. While large settlements and jury verdicts grab the headlines, the most significant value in a company's insurance portfolio is usually coverage for legal fees. Here, the numbers are staggering. American companies spent $2.17 billion in legal fees defending class action lawsuits in 2016.

The defense obligation is paramount in any liability insurance policy. As many courts have acknowledged, the essential value of liability insurance is that it provides "litigation insurance." In most claims, a policyholder's biggest and most immediate exposure is paying for defense counsel. Yet, even when an insurer agrees to advance or pay defense costs, they will look for ways to pay less than one hundred percent of costs incurred. Knowing the defense cost tricks that insurance companies play is an important prerequisite to the full recovery of these costs.

Insurers' tactics include asserting that certain underlying claims are not covered, so only a fraction of the defense costs are paid. Insurers also may contend that some of the defendants are not "insureds" under the policy, or they will not pay for defense costs that do not comply with their "litigation guidelines" (even though no such guidelines are set forth in the policy). Insurers also refuse to pay anything close to defense counsel's normal hourly rate. They ignore factors such as complexity of a case, the amount of dollars at stake and/or the location of the dispute (such as New York City versus Dubuque, Iowa).

☐ ***Coverage for government investigations is fair game.*** Responding to a government investigation, whether federal or state, is a formidable task. Even if the government's allegations lack merit, an investigation can last years and cost millions of dollars. Companies get caught up in the details of the investigation, but often forget about insurance. This is a big mistake.

Policyholders can obtain coverage for the cost of responding to government investigations under Directors and Officers (D&O) or Errors and Omissions (E&O) policies. These include the cost of responding to subpoenas, civil investigation demands, and regulatory actions.

Because government investigations can start in so many different ways, the most important factor is the definition of "claim" in the policy. The broader the definition, the more likely the costs of responding to the investigation will be covered and from the earliest time. Ideally, the claim definition in the policy will encompass a formal or informal administrative order, a subpoena, a civil investigative demand, and even a simple document request or request for an interview.

Courts have construed the "claim" definition in favor of coverage in most cases. Believe it or not, many insurance companies also have contended that the beginning stages of government investigations are claims under their policies. However, the best policy language is useless if the policyholder does not give prompt notice.

☐ ***Even* internal *investigations may be covered.*** In certain circumstances, a public company's board of directors must conduct an internal investigation of alleged misconduct. Invariably those companies retain outside counsel, usually one of the AmLaw 100 law firms, who bring a deep bench of lawyers with experience in tax, governmental regulations, corporate governance, and criminal and civil litigation. As any company learns, this type of legal expertise is very expensive, with seven- and even eight-figure legal fees the norm. Unfortunately, many companies

and their outside counsel incorrectly assume that all such investigations are not covered by insurance.

The starting point for some of the misunderstanding is terminology. Most investigations conducted by corporate entities are not "voluntary." An organization may suspect wrongdoing, for example, and, to avoid serious legal repercussions, they begin an internal investigation. Insurance companies often characterize this kind of investigation as voluntary and deny coverage.

The investigation, however, is not truly voluntary. It is conducted as part of the overall defense of a claim. In-house and outside counsel should carefully review policy language, and never assume that some kinds of investigations are not covered.

Most insurance policies include exclusions for criminal or fraudulent acts—but those exclusions almost always contain exceptions.

☐ ***Look for exceptions to criminal defense cost exclusions.*** A common perception is that insurance coverage for criminal activities does not exist, because either the policy bars coverage, or public policy prohibits obtaining coverage for criminal acts. That perception is incorrect, especially for obtaining defense cost coverage for such allegations.

Most insurance policies do indeed include exclusions for criminal or fraudulent acts—but those exclusions almost always contain exceptions for defense of allegations that have not been adjudicated. In other words, the insurer agrees to pay for the defense of criminal or fraudulent allegations until a final adjudication has been entered against an insured.

In many policies, the definition of claim triggering defense coverage under the policy includes the return of a criminal indictment. Thus, not only do many policies provide defense costs for criminal acts, but if a policyholder fails to give notice of such allegations, it could lose all coverage for that claim and all claims related to the criminal claim. If companies assume all criminal allegations are not covered and fail to pursue coverage, there is no chance of tapping into a valuable insurance resource.

☐ ***Policy language may cover cyberattacks and intellectual property liability.*** Cyberattacks are well-known, and have struck companies such as Home Depot, Target, Sony, and JPMorgan Chase. The associated claims cost businesses hundreds of billions of dollars each year, and seriously jeopardize a company's ability to retain customers and expand its business. Corporate cyberattacks are on the rise.

Less well known is that cyberattacks and intellectual property liabilities can be covered under the broad personal and advertising injury coverage of a standard general liability policy. "Personal and advertising injury" is defined in many general liability policies to include oral or written publication of material that violates a person's right of privacy. Courts have held that some cyber liability claims for theft of consumer data and misuse of customer information are covered under this definition.

For intellectual property claims, standard policy language has been held to cover such things as traditional patent, trademark, trade secrets, and copyright claims, as well as various other business torts commonly associated with these kinds of claims. Knowing what policy language triggers intellectual property claims is crucial to realizing the coverage potential.

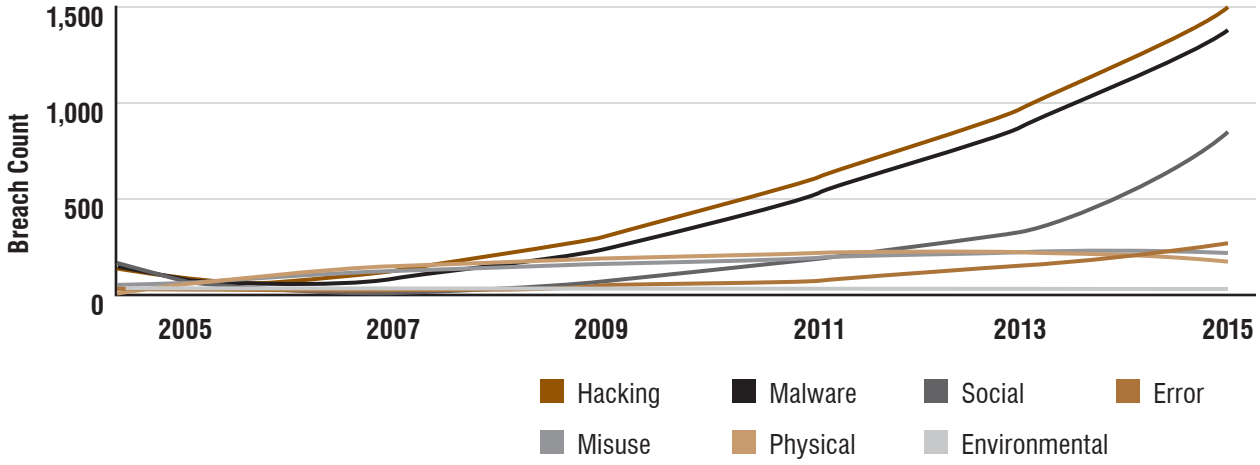
Today, policy rescission tactics are standard procedure. Insurers look for any mistake or error in an application to claim that it justifies rescinding the policy.

☐ ***A common "gotcha" tactic is rescinding policies for inadvertent errors.*** When a court rescinds a contract, it voids it entirely—as if it never existed. In the insurance context, rescission can be raised by the insurer if it claims the policyholder has committed fraud or made a material misrepresentation when it applied for the policy. The typical scenario is when a policyholder fails to disclose something in the application that then becomes the subject of an insurance claim.

Ten years ago, insurers rarely sought to rescind insurance policies in response to claims. Today, it is standard operating procedure. We call it "gotcha"

Are Hacking Claims Excluded?

Incidents And Losses Are Soaring



Source: Verizon 2016 Data Breach Investigation Report

claims handling practice, because insurers look for any mistake on an insurance application or some error in a company's financial documents (which are typically considered part of a management liability application) to claim that a policyholder made a material misrepresentation that justifies rescission of the policy.

Rescission claims are best fought using a two-prong strategy. First, attorneys need to address insurance application issues with the broker and company management prior to a claim being made. While policyholders need to answer the questions as precisely as possible, it is also critical to create a written record identifying and striking ambiguous or overly broad application questions.

Second, an insurer's attempt to rescind must be countered with a thorough knowledge of rescission law. Rescission is a drastic remedy that insurers should apply only to intentional or fraudulent misrepresentations or omissions that are material in nature—not innocent mistakes.

☐ ***Ensure adequate "tail coverage" for mergers and acquisitions.*** Providing adequate insurance for corporate acquisitions and spin-offs is also crucial. Claims that arise from the acts of the acquired company before the merger or acquisition should be covered under what is called "tail coverage" of the acquired company's policy. This is especially important because the acquiring company's policy often excludes claims relating to pre-transaction conduct.

Most companies involved with acquisitions are aware of the concept of tail coverage. Many, however, miss the second more important step in the process, which is to specify that the acquiring company has rights to pursue coverage for claims arising out of pre-acquisition wrongful acts. This simple concept is not always executed properly because it requires that specific endorsements be added to the acquired company's policies. Very few risk professionals obtain these. Because of the high cost of tail coverage, the acquiring company's tolerance for risk will play an important factor in fashioning an optimal plan.

☐ ***Directors and officers need the right kind of coverage.*** D&O insurance is unique in that it protects both corporate and personal assets. From the corporate entity standpoint, it affords some of the broadest coverage available. Yet it also affords the last backstop against the loss of personal assets for company directors and officers.

With D&O insurance, the stakes are high. Sophisticated companies have long recognized that it is critically important to negotiate D&O policy

language that not only addresses and resolves thorny and cutting-edge legal issues, but that also covers industry and company-specific risks.

Coverage counsel plays an important role in buying proper D&O insurance. They can advise on what language to ask for in a policy; how to negotiate a broad definition of "claim," which is what triggers D&O coverage; and how to narrow key exclusions, such as the personal conduct and fraud exclusions, so that defense cost coverage is preserved for the entire period of defending the claim. Simply put, better coverage results from demanding the broadest, most favorable policy terms and conditions available in the insurance marketplace.

☐ ***Mistaken waivers of attorney-client privilege are common.*** Most business executives understand the importance of protecting communications that are subject to the attorney-client privilege. Yet in the insurance world, those privileges can easily be waived. Two situations are particularly treacherous: communications about claims with insurance brokers, and defense counsel communications with insurance companies.

Insurance brokers can be incredibly helpful. With respect to claims, however, if the relationship is not structured properly, coverage can be lost by communication waivers. As a general rule, it is best to assume that all communications between policyholders or their defense counsel and the broker are *not* privileged.

For example, there have been cases where policyholders have been required to turn over sensitive coverage discussion documents to insurers because those documents were disclosed to the broker. Even worse, policyholders have lost coverage because the broker was asked an opinion in a deposition of whether a certain policy provision applied, and did not provide an answer that favored coverage.

There are ways to avoid this problem, such as going through coverage counsel who hired the broker as a consulting expert. Still, there is the risk that a judge will not recognize the privileged nature of these communications and require full disclosure. The key is to be aware of the issue. If an insurance broker is handling a substantial claim without the assistance of legal coverage counsel, coverage is at risk.

The second situation involves communications between defense counsel and the insurance company's claim representative that occur when the insurance company has denied the claim or asserted what is called "a reservation of rights." This is essentially a placeholder to deny the claim later. The disclosure of privileged information to a third party waives any privilege in most circumstances. If the insurer has reserved its rights, even if it is paying for the defense, the interests of the insurance carrier are arguably not aligned with the policyholder, and disclosure to the insurer usually does not fall within the privilege.

As a result, if a policyholder or defense counsel discloses privileged information about the underlying litigation (including matters as seemingly benign as status reports or defense counsel bills) the privilege is waived, and the plaintiff who sued the corporation gets the communication. This potential disaster can be avoided if lawyers negotiate common interest and joint defense agreements, but this must be done before any privileged information is disclosed to the insurance carrier.

Oftentimes, a smart approach to corporate insurance is the key to successfully defending a lawsuit or government investigation and, if necessary, funding a settlement or court judgment. Every senior executive and board member must know how to ask the right questions, to act promptly when claims arise, and to have on board experienced outside counsel who can properly evaluate the company's insurance program and steer the insurance side of its litigation strategy when the inevitable happens. ■