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Article abstract

Les administrateurs et les dirigeants d'une corporation à but non lucratif peuvent être légalement tenus responsables des conséquences de leurs actes ou de leurs décisions prises dans l'exercice de leurs fonctions et ce, au même titre que les membres d'un conseil d'administration d'une corporation à but lucratif. Des précisions sont apportées sur les principaux devoirs que les administrateurs et les dirigeants ont à remplir et sur la nature de l'assurance responsabilité civile des administrateurs des corporations à but non lucratif et des corporations privées.

D&O Liability Exposure of Nonprofit and Privately-Held Organizations*

by

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and

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Les administrateurs et les dirigeants d'une corporation à but non lucratif peuvent être légalement tenus responsables des conséquences de leurs actes ou de leurs décisions prises dans l'exercice de leurs fonctions et ce, au même titre que les membres d'un conseil d'administration d'une corporation à but lucratif.

Des précisions sont apportées sur les principaux devoirs que les administrateurs et les dirigeants ont à remplir et sur la nature de l'assurance responsabilité civile des administrateurs des corporations à but non lucratif et des corporations privées.

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It is a commonly held misconception that directors and officers of nonprofit and privately-held organizations do not face significant exposure to personal liability from the services they perform as directors and officers of those organizations. It can be argued that due to the unique nature of nonprofit and privately-

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held organizations, the directors and officers of such organizations are to some extent at greater risk for personal liability than their counterparts at large publicly-held corporations. This article summarizes the source and nature of the liability exposures faced by directors and officers of these organizations and addresses the issue of whether liability insurance is recommended to provide sufficient protection.

One possible reason for the misconception regarding the degree of liability exposure faced by nonprofit and privately-held directors and officers is the belief that the only significant source of liability to a director or officer is a disgruntled public shareholder—something that does not exist in the world of nonprofit and privately-held corporations. However, the 1991 *Directors and Officers Liability Survey* published by The Wyatt Company indicates that lawsuits filed by shareholders and other investors constituted less than 50 percent of all reported lawsuits brought against directors and officers of the for-profit companies that participated in the survey. Figure 1 shows that the remaining half of all reported D&O lawsuits in the survey were brought by third parties, which represents a D&O exposure regardless of the number or existence of shareholders.

Figure 1

Source of Director and Officer Liability Claims

Source of Claim	**Percentage of All Claims**
Shareholders and other investors, including partners and members	46.6
Past, current or prospective employees or unions	23.9
Customers, clients, rate payers, students, and consumer groups	19.4
Competitors, suppliers, and other contractors	5.5
Government and regulatory agencies	2.4
Other third-party claimants	3.0

Source: *Directors and Officers Liability Survey*, The Wyatt Company, 1991

The employees of a corporation represent the most significant source of non-shareholder liability to the directors and officers of that corporation. Almost one-quarter of all reported claims in the survey are employment discrimination or other labor-related claims. This exposure highlights the importance of devising and carefully implementing appropriate employment practices, particularly with regard to the organization's hiring, disciplinary and termination practices.

Nonprofit Organizations

Due to the unique nature of nonprofit organizations, the directors and officers of such firms often face more difficult challenges in fulfilling their responsibilities than do the directors and officers of publicly-held corporations. Most publicly-held corporations are subject to market pressures, reporting requirements, and regulatory oversight, which serve to guide corporate performance and behavior. Because of the general absence of such external forces, the nonprofit D&Os must implement their own procedures to evaluate and monitor the progress of the organization and the activities of its management. Additionally, the directors of nonprofit organizations serve with little or no compensation and typically perceive their role as merely voluntary or part-time, necessitating only limited attention to the affairs of the organization. Further, because of the organization's limited resources, the directors and officers are typically not able to avail themselves of the support provided by the consultants and professionals that typically serve their counterparts in publicly-held corporations. As a result, decision-making of nonprofit D&Os may be hindered by incomplete information, insufficient time, and inability or unwillingness to carefully investigate and document relevant factors.

Legal Basis for Nonprofit Organizations' D&O Liability

In general, nonprofit directors and officers are subject to the same or sometimes stricter standards of conduct than apply to the directors and officers of for-profit corporations. Directors and officers of a public benefit or charitable organization may be subjected to the standards of trust law. However the current trend is to apply the somewhat less rigid standards applicable to the directors and officers of for-profit corporations, rather than trust standards, when evaluating the conduct of a director and officer of a nonprofit organization. The following discussion summarizes those business standards as applied in the nonprofit context.

Duty of Loyalty

44 Directors and officers are required to refrain from engaging in personal activities that would injure or take advantage of the organization and are prohibited from using their position of trust and confidence to further their private interest. Examples of cases asserting claims against nonprofit directors and officers for breach of this duty include the following.

- A trustee pledged assets of a charitable trust to obtain a personal loan. Under California law, trustees are strictly prohibited from self-dealing, and the trustee was held liable.
- A nonprofit organization was used as a business conduit through which the chairman of the board of the organization personally profited. A creditor of the organization was permitted to recover from the chairman.
- A charitable hospital corporation sold a parcel of land adjacent to the hospital to a corporation owned by one of the trustees of the hospital corporation who intended to build an apartment and office building. The court held that the facts were sufficient to avoid the sale.
- A former president purchased land on which the organization's clubhouse was located and which the organization had taken steps toward purchasing for itself.
- The trustee of a hospital corporation, who was also the corporation's attorney, was paid a finder's fee in connection with a hospital transaction.

- The treasurer failed to collect from the president of the organization rents related to the operation by the president of a tavern on the organization's property.

Other examples of alleged breaches of the duty of loyalty include disclosure to third persons of information the D&O has gained as a consequence of his position; commingling of funds; purchase by a corporate trustee of its own or an affiliated company's stock for the trust; and loans of organization funds to a director and officer. The breach of the duty of loyalty, which is one of the most frequently invoked bases for claims against nonprofit D&Os, can arise when a mere appearance of a conflict of interest exists.

Duty of Care

Directors and officers must generally act with the care that a reasonably prudent person in a similar position would use under similar circumstances and must perform their duties in good faith and in a manner they reasonably believe to be in the best interest of the organization. This duty requires reasonable inquiry into and monitoring of the organization's affairs. Although the directors and officers are not the insurers of the integrity of their subordinates or of the organization's performance, they are required to implement reasonable programs to promote appropriate organization conduct and to identify improper conduct. Examples of cases asserting claims against nonprofit directors and officers for breach of the duty of care include the following.

- The trustees of a charitable organization sold an old building that had been used to house the poor and invested in a newer, better building. They were sued for wasting the assets of the trust.
- A church secretary sued the members of the church's governing board alleging that the minister had sexually imposed on her and that the trustees were negligent in the selection of the minister and in failing to supervise his activities.

- A plaintiff alleged that the trustees of a private foundation improperly refused to employ him as a director, to give scholarships to his children, and to provide housing and other perquisites that went along with his position. The New York court held that the complaint stated a cause of action for damages and for revocation of the tax-exempt status of the foundation.
- Directors allegedly authorized the organization to become involved in attempts to influence legislation beneficial to the organization, thereby jeopardizing the organization's tax-exempt status.
- Directors of a charitable organization failed to make dividend distributions to beneficiaries but instead placed the monies in a non-interest-bearing checking account for 5 years. The directors were surcharged jointly and severally for the interest that should have been collected and distributed.
- A college and its vice president of operations were sued by a student for damages suffered when she was raped on campus. The defendants were held negligent in failing to provide security, and judgments against both defendants were sustained.
- Museum trustees were sued for improperly storing the collection, failing to conduct annual audits, releasing a trustee from a long-term lease obligation to the museum without adequate consideration, failing to properly supervise the museum director, permitting private borrowing from the collection, failing to prevent the purchase of nonauthentic art objects, and permitting the facilities to fall into disrepair.

Duty of Obedience

Directors and officers are required to perform their duties in accordance with applicable statutes and the terms of the organization's charter. In addition to observing the formalities and separate existence of the organization, directors and officers must also obey a variety of laws that may impose direct liability on them for wrongful conduct. Examples of statutorily imposed liability on nonprofit directors and officers are shown in Figure 2.

Figure 2

Sources of Statutorily Imposed Liability

- Employment claims
- Antitrust claims
- Copyright/patent claims
- ERISA claims
- Pollution claims
- Credentialing claims
- Professional liability claims
- Securities law claims
- Miscellaneous state statutes

As previously alluded to, sources indicate that the majority of all claims brought against the directors and officers of nonprofit organizations are employment-related. Credentialing claims present a significant source of liability to hospitals, which must credential their professional staff members. Securities laws can also present some exposure to the directors and officers of certain nonprofit organizations since a wide variety of activities, such as membership and initiation fees, mortgage bonds, pooled income funds, and scholarship trust funds, have been viewed as securities by the courts.

Nonprofit Organizations' Need for Insurance

In view of the substantial liability exposure faced by the directors and officers of nonprofit organizations, one of the most frequently asked questions is whether those organizations should obtain liability insurance to cover these exposures. Although state volunteer protection statutes and the availability of indemnification from the organization will provide some degree of comfort for the nonprofit director or officer, they do not provide a sufficient shield in today's legal climate.

State Liability Limitation Statutes

Every state now has at least one law pertaining specifically to the legal liability of directors and officers of nonprofit organizations. Each of the so-called volunteer protection laws modifies the legal standard for determining whether directors and officers are legally liable for the harm their actions purportedly cause. Although the statutes vary greatly, they generally substitute the ordinary standard for judging the conduct of directors and officers with a standard of gross negligence, recklessness, willful and wanton conduct, or some other less exacting standard.

However, contrary to the intent of these volunteer protection laws, few of the laws provide sufficient protection. The state statutes do not limit liability imposed by federal statutes, including those federal statutes that provide the basis for most employment-related lawsuits. Many statutes limit their protection to non-compensated volunteers and only apply to certain types of nonprofit organizations, such as tax exempt or charitable organizations. Additionally, many of the statutes do not apply to claims based on a breach of the duty of loyalty. Finally, as a practical matter, the new standards of care, particularly the standard of gross negligence, may not significantly reduce liability in practice.

Even for those exposures covered by the protection statutes, lawsuits can still be filed and the directors and officers are still required to defend the claim and fund the costs associated with that defense. These lawsuits can often be protracted and very costly to defend.

Indemnification from the Organization

The statutes of each state permit a nonprofit organization to indemnify its directors and officers against loss incurred as a result of certain types of claims. Through indemnification, the organization undertakes to pay legal costs, settlements, and judgments on behalf of its directors and officers. In order to fully exercise this power of indemnification, the organization may need to state in its charter or bylaws that it will indemnify its directors in specified situations or to the maximum extent permitted by law.

However such indemnification may not provide the D&O of a nonprofit organization with sufficient protection in all instances. Nonprofit organizations, which are often not well funded, may not have sufficient financial resources with which to pay the losses and defense costs. Also, organizations that rely on government grants or contracts may not be permitted to use those funds for indemnification, and many organizations may determine that it is inappropriate to use contributed funds for indemnification. Finally, some claims, although insurable, may not be indemnifiable due to public policy or statutory imitations. For example, indemnification of damages incurred by directors and officers of a private foundation may be considered prohibited self-dealing, and indemnification of settlements or judgments in suits by or on behalf of the organization may be proscribed by statute.

Liability Insurance

D&O liability insurance can provide protection to directors and officers for nonindemnifiable exposures as well as exposures for which no protection is provided under state volunteer protection statutes. D&O insurance policies transfer to the insurer the organization's financial risk of funding its indemnification obligations.

Some nonprofit organizations that seek to obtain D&O liability insurance do find it difficult to obtain because such organizations often appear risky when judged by ordinary business standards. Because nonprofit organizations frequently have no financial reserves and often earn revenues that barely exceed their expenses, they may be perceived as poor insurance risks by underwriters. The frequent use of volunteers by a nonprofit organization may create the perception on the part of the underwriter that the organization will be subjected to liability incurred by poorly trained and minimally supervised individuals. These factors emphasize the need for proactive "selling" of the risk to underwriters and establishing a loss prevention program, which encompasses training for all personnel and volunteers, including board members (The Chubb Group of Insurance

Companies has prepared a booklet entitled *Directors and Officers Liability Loss Prevention for Nonprofit Organizations*, a copy of which can be obtained by contacting a Chubb representative.)

D&O policies typically used to insured nonprofit organizations are somewhat different than those used to insured the D&O liability exposure of for-profit companies. D&O coverage purchased by for-profit companies invariably provides coverage for the corporation only to the extent it is required to indemnify its directors and officers. Nonprofit organizations, though, can purchase insurance that provides coverage for the organization's own liability as well as its indemnification responsibilities.

Nonprofit organizations with a relatively tight cash flow should consider whether the policy mandated the advancement of defense cost. Some policies do advance these funds while others only obligate the insurer to reimburse the organization after the case is settled or final judgment is entered.

It should be noted that the D&O insurance policies of many for-profit corporations cover their executives for the volunteer service on the boards of other organizations. This feature is sometimes added to the policy in the form of an endorsement and may provide coverage for individuals who serve on a board at their employer's request. Finally, if faced with a claim involving property damage or bodily injury, the nonprofit director of officer should also look to his or her personal umbrella liability policy to determine if it affords coverage for the claim.

Privately-Held Organizations

Although the legal duties of the directors and officers of privately-held organizations are similar to those of their publicly-held counterparts, the privately-held sector's directors and officers often encounter difficulties that the directors and officers of publicly-held companies do not face. Outside directors are more likely to become personal advisers to senior management of privately-held companies since those companies generally do not have extensive depth in their levels of management. The importance of an outside director's role is heightened when the corporation is dominated by one or a small group of controlling shareholders. The dominant shareholders are more likely to operate the organization without full regard to the rights and interests of minority shareholders and other company constituents. In such an instance, the outside director must be particularly mindful of the duty to represent all shareholders, not just the faction that elected that director to office, and must be prepared to oppose the wishes of the dominant shareholders when appropriate.

As with the directors of nonprofit organizations, the directors of privately-held companies will often serve on the board in a limited part-time capacity with relatively small compensation. Similarly, the resources of these corporations may be insufficient to provide the directors with effective support. Thus, the directors may not have access to all relevant information before making decisions.

Potential Claimants

Many directors and officers of privately-held corporations take false comfort in the fact that the corporation is not publicly traded and generally has fewer shareholders than larger publicly traded corporations. However, liability exposure to shareholders of privately-held corporations does exist. The minority shareholders may assert D&O claims alleging that business was conducted for the interest of the controlling shareholders to the detriment of the minority shareholders. Even in a situation where the shareholders are viewed as colleagues or friendly business associates, the potential for shareholder liability exists. Events such as divorce, death, foreclosure on a stock pledge, or the insolvency of one of the shareholders may suddenly and dramatically thrust new shareholders with new perspectives and expectations into the picture.

Additionally, third-party claims brought by "outsiders" against directors and officers of privately-held corporations have been increasing in frequency and severity in recent years. A director who directs or participates in a tort against a third party is not exempt from liability simply because his or her action was taken on behalf of the corporation. Examples of cases asserting claims by third parties against directors and officers of privately-held corporations include the following.

- The president of a livestock auctioneer corporation was held liable to a secured creditor for conversion of cattle where the president arranged the sale of cattle without determining the existence of a security interest in the cattle.
- Corporate officials were held liable in a trademark infringement case despite their claim that they acted primarily for the benefit of the corporation.
- The president of a construction company was held liable for negligence in the construction of a building because he was at the construction site on a daily basis, undertook to supervise construction, and failed to act with reasonable care.
- A corporate president was held liable to the lessee of adjoining premises damaged by demolition of a building owned by his corporation, where he gave the contractor no instructions concerning the demolition despite his knowledge that if the demolition was not done properly, it would damage the adjoining property.
- A corporate president was held liable for breach of contract, where his corporation refused to deliver goods to a consumer and sold the goods to another party at the direction of the president.
- The president and vice president of a corporate waste disposal service were held Liable for the corporation's illegal dumping and storage activities.

Finally, claims brought by regulatory agencies against directors and officers have increased significantly in recent years. Although the most publicized lawsuits have involved financial institutions, this exposure exists in any corporation subject to governmental regulations. Regulators typically pursue these claims with zeal because they seek not only to recover money from the directors and officers, but to deter others from committing similar acts.

Legal Basis for Privately-Held Organizations' D&O Liability

As with the directors and officers of nonprofit organizations, the directors and officers of privately-held corporations are subject to the three basic duties of loyalty, care, and obedience.

Duty of Loyalty

As with nonprofit corporations, directors and officers of privately-held companies are prohibited from using their positions of trust and confidence to further their own private interests and are required to exhibit undivided and unselfish loyalty to the corporation. Thus, the directors and officers may not transact business with the corporation unless they can prove that the transaction was fair and reasonable to the corporation. In the context of a privately-held corporation controlled by one or a limited number of shareholders, it is imperative that the directors assure that the transactions do not benefit the controlling shareholders at the expense of the minority shareholders. Transactions with affiliates should be reviewed and approved by independent, disinterested directors.

Examples of cases asserting claims against directors and officers of privately-held corporations for breach of the duty of loyalty include the following.

- Directors approved bonuses for themselves when the facts did not justify such bonuses.
- The president approved an unreasonable leasing arrangement between the corporation and himself.

- The president of the corporation approved interest-free loans to himself and another officer without obtaining board authorization.
- The director personally purchased land that his corporation was also seeking to buy.
- The director diverted a promising product line from the corporation to his personal business.
- A director who was also a creditor of the corporation obtained an unfair advantage over other corporate creditors.

Duty of Care

As with nonprofit corporations, the directors and officers of privately-held corporations generally must act with the care that a reasonably prudent person in a similar position would use under similar circumstances. The duty of care may pose a more significant threat of liability for the directors of privately-held corporations than for publicly-held companies because the smaller size of most privately-held corporations provides for a much smaller "margin of error" for a director's decision-making. What would be a relatively minor business decision with limited impact in a large publicly-held corporation may have much more visibility and impact on a smaller privately-held corporation. Thus, bad decisions, even if made in good faith and entirely defensible, are likely to attract scrutiny from shareholders and others.

Examples of cases asserting claims against directors and officers of privately-held corporations for breach of the duty of care include the following.

- Director of a mutual fund failed to monitor the conduct of the officers, made no effort to determine the officers' policies and whether such policies were being followed, and generally permitted the company to be run by the officers without consultation with or approval by the directors.

- Directors acted improperly by authorizing a massive acquisition program based on an artificially inflated surplus, eventually causing the corporation's insolvency.
- Directors failed to review all financial statements and knew virtually nothing about corporate affairs and thus were liable for funds misappropriated by the officers.
- Officers failed to adopt and implement appropriate safety and operational procedures at a company facility, thereby causing the facility to be shut down by regulators.
- Directors and officers approved and permitted the investment of company assets in an insolvent investment company.

Duty of Obedience

Directors and officers of privately-held companies are required to perform their duties in accordance with applicable statutes and the terms of the corporation charter. Too often, the formalities of corporate operations are not observed by directors and officers of small privately-held corporations. Shareholders' and directors' meetings must be regularly held, separate books and records for the corporation must be properly maintained, and the directors' resolutions approving significant transactions must be recorded. Additionally, these companies are frequently subject to agreements that substantially restrict corporate activities. For example, loan documents may contain restrictive covenants that may require or restrict certain corporate activities. Directors may incur personal liability if they permit the company to violate such contractual provisions.

As with nonprofit corporations, there are a myriad of federal and state statutes that potentially regulate director and officer conduct and create liability exposure. It should be particularly noted that the broad anti-fraud provisions of the federal securities laws apply to the purchase or sale of any security, whether or not publicly traded, and therefore can create liability exposure to privately-held corporations and their directors and officers. The term "security" is broadly defined to include more than common and preferred equity stock, and can also include various types of financing arrangements.

Another source of liability to the directors and officers of privately-held corporations involves the area of corporate takeovers. Directors often have inherent conflicts of interest when considering transactions that will result in a change in control. They may have a personal interest in preserving their job security and in preventing an outsider from obtaining control of "their corporation." When responding to a takeover bid, the directors must make a thorough, well-documented investigation before acting and must create an appearance that an independent investigation and analysis of all relevant factual and legal considerations were made. Before adopting any defensive measure to an actual or threatened takeover bid, directors should have reasonable grounds to believe that a danger or threat to corporate policy and effectiveness exists and that the defensive measure adopted was reasonable in relation to that threat. If control over the corporation is to be sold, the directors should not interfere with an open, unrestrained bidding process.

Privately-Held Companies' Need for Insurance

Directors and officers of privately-held corporations are clearly exposed to significant potential liability, although the dollar value of that exposure, at least to shareholders, is generally less than the exposure faced by directors of larger publicly-held corporations. Although state liability limitation statutes and indemnification from the corporation will provide some degree of comfort for the officers of a privately-held corporation, they do not provide immunity or absolute protection against liability.

State Liability Limitation Statutes

Most sates have enacted statutes that purport to eliminate or limit certain types of D&O liability exposure. However, for many of the same reasons discussed with regard to nonprofit organizations, these statutes do not provide absolute protection to the officers of a privately-held corporation. The statutes do not provide protection against liability under any federal statute, including the statutes discussed above. Many liability-limiting statutes are applicable only to claims by the corporation and its shareholders and are not applicable to claims by employees and other third parties. Also, the statutes frequently apply only if the directors are deemed to have acted in "good faith" and do not provide protection against exposure for alleged breach of the duty of loyalty. Even if a claim is meritless under the standards set forth in the liability limitation statutes, the directors and officers will still be required to incur substantial costs in defending the action.

Indemnification from the Corporation

As with nonprofit organizations, state statutes that permit a privately-held corporation to indemnify its directors and officers against loss have been proven to be inadequate to provide sufficient protection for a number of reasons. Many smaller privately-held corporations do not have sufficient resources with which to fund such indemnification. The 1991 D&O survey conducted by The Wyatt Company concluded that the average reported defense costs per case for U.S. D&O claims was $596,000. Additionally, indemnification against claims under the anti-fraud provisions of federal securities laws may be precluded by public policy or by doctrines related to federal preemption, and many state statutes do not authorize indemnification of settlements or judgments in suits brought by or on behalf of the corporation, including derivative suits.

Public policy may also limit indemnification under other federal statutes, such as the antitrust laws, where Congress has intended personal liability to be a deterrent. Further, no indemnification is permitted unless certain standards set forth in the applicable indemnification statute are satisfied and a determination thereof is made by the designated person or body. Finally, the corporation's articles of incorporation may be modified to reduce or eliminate indemnification for directors and officers. This factor may come into play after the corporation has undergone a change of ownership.

Liability Insurance

D&O liability insurance can provide protection to directors and officers for most nonindemnifiable exposures, as well as exposures for which no protection is provided under the state liability-limiting statutes.

Even if a privately-held corporation concludes that its present condition does not require the purchase of D&O insurance, it is advisable to purchase the insurance if there is a possibility that the corporation will make a public offering of either debt or equity securities in the future. It is important to establish a relationship with a D&O insurer well before the time of a public offering. If the company waits until the offering is imminent, coverage will be difficult to find and, if available, considerably more expensive with less favorable terms.

D&O Insurance Considerations

D&O insurance is somewhat unique in nature, and certain aspects of the coverage merit careful attention by any organization seeking to purchase such coverage.

Nature of Coverage

Traditional director and officer liability insurance coverage is actually two distinct coverages within one policy The first coverage, referred to as the personal (or direct, or D&O) part of the policy, usually reimburses the individual directors and officers from losses for which they are not indemnified by their corporation. The second coverage, referred to as the corporate reimbursement part of the policy, is intended to reimburse the corporation for amounts that it is lawfully permitted or required to expend in indemnifying its officers and directors. Although both coverages are within the same policy, each may have its own retentions, deductibles, and exclusions. The corporate reimbursement part of the policy is the one under which most claims are made, and each part of the policy will contain definitions of their respective insureds. It is crucial that those definitions include all persons and entities intended to be protected. For instance, it is important to determine whether the definition automatically includes all persons who become directors or officers after the inception date of the policy, whether the definition includes management positions such as comptroller or general counsel, and whether the definition includes appointed officers as well as elected officers.

Allocation

It is important to note that for-profit corporation policies do not insure the liabilities or defense costs of the corporation itself, although some nonprofit policies cover claims against the entity. In lawsuits in which both covered and non-covered claims are asserted, the parties and the insurer should agree on allocations of defense costs and settlement payments. In the absence of such agreements, expensive and time-consuming litigation with the insurer over allocation issues will probably result.

Loss

In all policies, "loss" includes damages, settlements, judgments, defense costs, charges and expenses incurred in the defense of actions or proceedings. Different insurers variously exclude from the definition of "loss" fines or penalties imposed by law or matters deemed uninsurable under the law pursuant to which the policies are construed, as well as punitive or exemplary damages, treble damages, taxes and costs, charges and expenses of grand jury, or criminal proceedings. Traditionally, D&O policies have never imposed a duty to defend upon the insurer. D&O insurers have historically contended that the policy is an "indemnity" policy and that the insurer has no obligation to pay any losses under the policy until a claim is finally determined.

Claim

Because coverage under the policy is invoked only when a "claim" is made, the definition of "claim" may become significant. Where the policy does not define the term "claim," courts have used their own definition. Frequently, courts define the term as a demand for some discrete amount of money owed to the claimant on account of the alleged wrongdoing. Other courts have required that a lawsuit or other legal action be filed before a "claim" is made.

Notice

All policy forms require the corporation and the directors and officers to give the insurer notice in writing as soon as practicable of any claim made against them. The policies also contain provisions that if during the policy period or the extended discovery period, if applicable, the insureds become aware of any circumstances or a wrongful act which could become the basis of the claim, notice may be given to the insurer of such circumstances, and any claims subsequently arising therefrom will be considered to have been made at the time notice of the circumstances was given to the insurer.

Prior Acts

Because D&O liability polices are written on a claims-made basis, the policies cover prior acts (unless otherwise excluded) if a claim arising out of those acts is made during the policy period. However, it is common for insurers to include a retroactive date in D&O liability policies, which precludes coverage for claims arising from wrongful acts committed prior to the specified date. Obviously, it is in the insured's best interest for this date to be as far back in the past as possible. If an organization changes insurers, a "gap" in coverage may result if the new policy contains a retroactive date excluding claims arising from wrongful acts committed prior to the new policy's effective date. This may be particularly problematic for nonprofit organizations that provide services to children, since many states allow children to wait until their twenty-first birthday to file suit.

Extended Discovery Period

Most policies provide an opportunity to purchase an extended reporting period or extended discovery period upon the insurer's cancellation or refusal to renew the policy This extended discovery period applies to claims made during the extended period for wrongful acts occurring prior to the cancellation or non-renewal of the policy. Most policy forms provide that the extended reporting or extended discovery period is added to the last policy year and that the stated limit of liability per policy year applies to that entire period of time. Cancellation by the insurer or a refusal to renew the policy is usually required to trigger the opportunity to purchase the additional coverage. Most policy forms provide that the offer by the insurer of renewal terms, conditions, limits of liability or premiums different from those of the expiring policy will not constitute refusal to renew. The length of the discovery period typically ranges from 90 days to one year. However there has been an indication that some state regulators may not accept anything less than one year. The amount of the additional premium required to purchase the extended discovery period will fluctuate with the length of the period.

Policy Application

Because of the potential coverage of prior acts, the applicant for D&O liability insurance must complete an extensive application containing numerous questions regarding the existence of any facts that could give rise to covered claims. Courts have held that misrepresentations by the officer who completes the application may void policy coverage for all directors and officers of the corporation even if they are not directly involved in the application process. Since it is imperative that the insurance application be complete and accurate, all directors and officers should be polled to determine their knowledge of matters inquired of in the application. Some policies contain a desirable "severability" provision which provides that the policy will be construed as a separate agreement with each insured director and officer. This protects the coverage for innocent directors when one or more other directors fail to properly disclose requested information.

Insurer Selection

D&O liability insurance should not be viewed as a "commodity" to be purchased at the cheapest possible price. It is preferable to view the D&O policy as a relationship with an insurer. Seek an insurer with a reputation for quality of claims handling service, financial integrity, and long-term commitment to providing D&O liability insurance. Price should be considered only when comparing otherwise acceptable insurers and policies.

Conclusion

In contrast to what many people think, directors and officers of many privately-held companies and nonprofit organizations face potentially severe D&O liability exposures. State limitation of liability statutes and indemnification from the organization provide only partial protection for these individuals, and it is therefore advisable for such organizations to also consider purchasing D&O liability insurance.