

# Directors' and Officers' Insurance

A GUIDE FOR DIRECTORS OF INVESTMENT COMPANIES ON PROCURING  
DIRECTORS' AND OFFICERS' INSURANCE



If you would like to discuss any of the issues raised in this guide,  
please contact Mark Pangborn at:

**Howden Insurance Brokers Limited**  
**Bevis Marks House**  
**24 Bevis Marks**  
**London**  
**EC3A 7JB**  
**Telephone: 020 7648 7211**  
**Email: [mpangborn@howdenriskpartners.co.uk](mailto:mpangborn@howdenriskpartners.co.uk)**

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# Foreword

## Background to the guide

In today's environment the decisions and actions of directors are increasingly under scrutiny, not only by shareholders but also by a wider audience of regulators, government bodies, competitors, and industry commentators. With escalating duties, stricter corporate governance standards and a complex web of legislation with which to comply, directors face a greater threat of being investigated or sued. Directors and officers ("D&O") insurance offers protection against the costs of settling claims for actual or alleged wrongful acts. It provides cover for the directors and officers and reimburses the company where it provides indemnity for those directors and officers.

The Companies Act 1985 contains a basic prohibition on companies exempting directors from, and indemnifying them against, liability in respect of negligence, default, breach of duty or breach of trust in relation to the company. However, companies can, but are not required to, purchase liability insurance for directors. From 6 April 2005 the rules were amended to allow two important relaxations to the general prohibition: companies are now permitted, but not required, to indemnify directors in respect of most proceedings brought by third parties and are permitted, but not required, to pay directors' costs of defence proceedings as they are incurred. The director would still be liable to pay damages and to repay his defence costs to the company if his defence were unsuccessful.

Although there is no legal requirement for a D&O insurance policy to be in place, in practice it is no longer considered optional. The Combined Code (A.1.5) states: *"The company should arrange appropriate insurance cover in respect of legal action against directors"*. This is further supported by principle 8 of the AITC Code of Corporate Governance© ("AITC Code") which includes the following in its recommendations: *"Director's potential liability is currently a matter of concern. The first concern of directors in this regard is to ensure that their duties are carried out in such a way that no legal suit can be reasonably brought against them. They should still endeavour to ensure that they have suitable insurance cover. Cases might be brought by plaintiffs which conjoin directors to other parties and which can take years (and considerable legal fees) to be resolved. Directors need to take all action open to them to ensure that there is no possibility of any insurance cover lapsing before any legal proceedings commence, and that there are no other unforeseen limitations to their cover. Adequacy of insurance cover can be a very real issue in cases of large losses."*

The AITC Code highlights an important point. Even with insurance cover, directors cannot be completely safe from personal financial liability and their best protection is their own diligence.

### **Purpose of this guide**

An insurance policy is a legal contract where the parties make a series of undertakings to each other that are triggered by the occurrence of pre-defined events, known as claims. The board, or its representatives, need to be in a position to negotiate the most favourable and appropriate terms with the insurer. There are currently some 90 different D&O insurance policies on offer in the UK which, whilst similar, do not necessarily follow any standard layout or terminology. This guide aims to provide investment company boards with sufficient knowledge and confidence to obtain a policy that best reflects their needs and expectations. It explains common terms, sets out who and what should, and should not, be covered, describes the impact of general conditions attached to the policy, and discusses the factors in determining an appropriate level of cover. The guide should help to raise awareness of issues in evaluating the type and level of cover on offer.

This guide is written in general terms and it is no substitute for specific advice from an experienced insurance broker or legal adviser. Neither Howden Insurance Brokers Limited nor the AITC can accept any responsibility or liability whatsoever (whether in respect of negligence or otherwise) to any investment company or third party as a result of anything contained in or omitted from this guide nor for the consequences of reliance or otherwise on the contents of this guide.

## Executive Summary

- It is suggested that each individual investment company arranges its own D&O insurance policy, or if relying on cover arranged under a group policy or collective arrangement by the management company, the board members are fully appraised of the details of such a policy.
- Every person who is the subject of the insurance should understand his or her duties in terms of adherence to and compliance with the terms and conditions of the policy.
- Directors need to have a clear understanding of the meaning of defined terms, so that the exact purpose of a particular clause, condition or exclusion can be put into context.
- The conditions need careful consideration - some may be beneficial to directors, others may detrimentally widen the scope of risk.
- As well as reviewing what the policy does cover, it is equally, if not more important, for directors to understand the exclusions set out in the policy i.e. what it does not cover. In negotiating the terms of the policy document, directors should seek to narrow the remit of the exclusions. Generally speaking, the longer the preamble, the greater the breadth of the exclusion.
- It is important for directors to understand whether they are covered against claims from the company itself and/or from other directors covered by the same policy. Where the Insured v Insured exclusion does apply, the board should seek as many exceptions as possible.
- Some policies contain an exclusion for professional services performed by the company or the directors and officers. Directors need to be careful that the wording does not affect the ability of the policy to respond where shareholders seek to hold directors and officers responsible for the acts of others providing professional services to the company.
- Whenever accepting a replacement policy, preservation of any original Prior and Pending Litigation or Continuity date provision is an important consideration.
- Directors need to be aware of how the policy responds to claims made by the company in the event that a hostile investor gains sufficient shares to take control of the board, and of the level, if any, of ongoing insurance to protect the out-going board.

- It is recommended that directors seek to negotiate the inclusion of run-off provision into their policy.
- It is important to have a clear understanding of the directors' and officers' (and the company's) obligations under the claims notification section of the policy.
- It is essential to have access to competent advice at the point of notification of claims, particularly when notifying circumstances that might give rise to a claim in the future. Incorrect, deficient or inaccurate notification can have a very unwelcome impact on the success of the handling of the claim.

## Ways of Obtaining Cover

*It is suggested that each individual investment company arranges its own D&O insurance policy, or if relying on cover arranged under a group policy or collective arrangement by the management company, the board members are fully apprised of the details of such a policy.*

Individual cover allows the board to ensure that the policy addresses its own unique circumstances, that the directors remain in control of the terms of the contract, and that the available limits of indemnity are not eroded by other entities outside the board's control. If a group or basket policy is arranged steps should be taken to ensure appropriate advice is given to all participants in the event of any claim being made.

## Introducing the Terminology

### Format

One of the key features of insurance policies is the use of defined terms, which have a specific meaning attributed to them. These words may appear in bold type, in capitals, italics or in title form, and are explained in the definitions section of the policy. Care should be taken to differentiate meanings attributed to instances where a phrase such as "Directors and Officers" is used in its defined form (i.e. **Directors and Officers**) and its undefined form (i.e. directors and officers). The difference is clearly shown in the following example: "*...provides cover for any **Director or Officer** whilst acting as a **Director or Officer** of the **Company** but not as a director or officer of any other company*".

The breadth of the policy is dependent upon the definitions applied to key items such as "Claim", "Loss" or "Financial Loss", "Wrongful Act", and "Directors and Officers" (or "Insured Persons"). These and other definitions are explained throughout this guide.

*Directors need to have a clear understanding of the meaning of defined terms, so that the exact purpose of a particular clause, condition or exclusion can be put into context.*

## Insuring Clause

A D&O insurance policy is based around the “Insuring Clause” which states what and who is covered. The insuring clause describes:

Content	Technical Term
Who is covered ↓ for what ↓ being caused by ↓ first made during the ↓ alleging a	Insured Persons i.e. Directors and Officers  Loss/Financial Loss  a Claim  Period of Cover  Wrongful Act

In most instances there are two types of insuring clauses, which operate in different ways. Clause A (Directors) covers claims brought directly against the directors and officers. Clause B (Company Reimbursement) reimburses the company when it indemnifies the directors and officers. Therefore, Clause A comes into effect when a claim is made against a director or officer who is not indemnified by the company, whereas Clause B is effective when the company does provide indemnification to the director or officer. There is a third insuring clause known as Clause C which provides an indemnity directly to the company in its own right in respect of securities claims, but this is generally not offered unless specifically requested.

## Who is Covered?

The insurance policy covers the “Insured Persons”, which, in the case of D&O insurance, is obviously the directors and officers. The definition should encompass:

- Past, present and future directors and officers of the company.  
This covers non-executive directors and executive directors of a self-managed investment company. Although the term “officer” is not defined, for investment companies it is likely to include the company secretary.
- The lawful spouse of any director or officer (some policies now include the term domestic partner).
- The estate heirs and legal representatives in the event of the death, incapacity or bankruptcy of a director or officer.

It may also include:

- Employees in a managerial capacity or who become conjoined in a claim.
- De facto or shadow directors.

## What is a Claim?

The term “Claim” will be defined in the policy document. ***D&O policies are written on a “claims made” basis.*** This means that a pre-determined event, a claim, must be made against the director and/or officer, and be reported to the insurers in the correct fashion, to trigger the obligations of the contract. It is usually irrelevant when the event itself occurred which brought about the claim; the important event is when the claim was made against the insured persons.

The insurance policy will include a definition of the term “Claim”. A claim is generally described as:

- Bringing of proceedings or suit
- Demands for damages or compensation
- Instigation of regulatory, official or administrative proceedings
- Bringing of a civil or criminal prosecution
- Bringing of an employment claim

The claim definition should not restrict the policy coverage to a demand for monetary damages, but should also include a demand for services or non-monetary relief.

## What is Covered?

### Loss/Financial Loss

The wording between different policies can vary greatly and it is important for directors to fully understand what is, and what is not, covered. Cover is commonly provided for claims made in respect of losses (or financial losses) arising from:

- Any amount which the directors and officers are legally obliged to pay by reason of any wrongful act; or
- Damages, judgements or settlements that any director or officer becomes legally liable to pay; or
- Sums which the directors or officers are legally liable to pay by way of compensatory damages for any wrongful act.

The term “Wrongful Act” will be defined in the policy and is discussed below.

It may also be possible, and indeed desirable, to include civil fines and penalties, and also punitive or exemplary damages (where insurable by law), although many draft policies may specifically state that the term loss does not include fines, penalties, taxes, punitive and exemplary damages.

### Wrongful Act

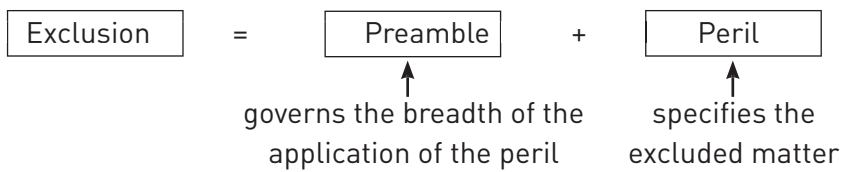
The definition of the term will be set out in the policy and should encompass as a minimum any actual or alleged error, misstatement, misleading statement, libel, slander or defamation (including injurious falsehood), act, omission, neglect, breach of trust, breach of duty or breach of warranty of authority.

Some policies may contain the additional wording “*or any matter claimed against the directors and officers by reason of their serving in such capacity*”.

Although instinctively directors may think that it would be better to use the term “any Wrongful Act”, there is precedent whereby the precise meaning of wrongful act has been challenged by insurers, hence the more commonly used expansive definition.

## What is Not Covered (Exclusions)?

***As well as reviewing what the policy does cover, it is equally, if not more important, for directors to understand the exclusions set out in the policy i.e. what it does not cover.*** The main consideration when reviewing a draft policy is to understand what is meant to be excluded, what actually is excluded, and how widely the exclusions apply. To do this two elements should be considered:



The rest of this section considers common preambles and common exclusions that investment company directors may come across.

### Common preambles

Common preambles are shown in the table below. **Generally speaking, the longer the preamble, the greater the breadth of the exclusion, which clearly limits the level of cover provided by the policy.**

#### Common preambles:

*(This insurance does not apply to any liability/Claim.....)*

- *“arising from....”*
- *“arising from or attributable to....”*
- *“arising from or attributable to or in any way involving....”*

Directors may come across many alternative preambles such as:

- *“arising directly or indirectly as a result of or in connection with....”*
- *“arising from, based upon, attributable to or as a consequence of directly or indirectly or in any way involving....”*
- *“of whatsoever nature, directly or indirectly caused by, resulting from or in connection with any of the following regardless of any other cause or event contributing concurrently or in any other sequence to....”*

### Use of “for” language in policy documents

One of the detrimental effects of certain preambles is to extend the remit of the exclusions not only to acts committed by the directors and officers themselves, but also to situations arising from the acts of others. This means that investment company directors and officers would not be covered under the terms of the insurance policy for acts committed by third party service providers such as the fund management, company secretarial and accounting functions of an investment company. This situation is avoided through the use of “for” language as a preamble. The effect of this is shown in the example below.

### Example of the effect of “for” language

Consider the difference between the following two variations of the same basic exclusions:

*This insurance does not apply to any liability/claim*

- *arising directly or indirectly as a result of or in connection with market abuse*
- *for market abuse*

Assume that an investment company has suffered loss resulting from an act of market abuse committed by its appointed investment manager, and that an action is brought by shareholders who are seeking to hold the directors responsible for the actions of the manager.

Where the exclusion uses “for” language, although any claim by shareholders alleging that the directors may have been negligent in their duties may derive from the act of market abuse committed by the manager, the claim is outside the scope of the exclusion and therefore the directors are covered by the policy. The exclusion only relates to acts of market abuse committed by the directors.

However, where the words “*arising directly or indirectly as a result of or in connection with*” are used, it is irrelevant who committed the act of market abuse. The fact that market abuse lies at the root of the claim is sufficient for the claim to be denied.

***In negotiating the terms of the policy document, directors should seek to narrow the remit of the exclusions and should request the use of “for” language where appropriate, and satisfy themselves that the balance of the exclusions are worded in an equitable fashion.***

### Burden of proof

Under the terms of any insurance policy it is normally beholden upon the insurers to seek to prove the application of an exclusion rather than for the policyholder to prove otherwise. However some exclusions (generally those that appear far reaching and complex in nature) conclude with the following statement: “*if the Insurer alleges that by reason of this exclusion, any loss, damage, cost or expense is not covered by this insurance the burden of proving the contrary shall be upon the Policyholder*” which seeks to reverse the norm. With such an exclusion it would be prudent not to expect any policy coverage. Such language should be rejected.

## Reasonable Exclusions

When reviewing a draft policy, directors will come across certain exclusions which are usually considered reasonable for two reasons. Firstly, cover may be granted under other insurance policies. Secondly, such exclusions may deny cover that, if granted, would be deemed to be against public interest. So-called reasonable exclusions are set out in the table below:

### Reasonable exclusions are:

- Known claims or circumstances: Cover normally excludes any loss arising from or attributable to earlier claims or circumstances notified to a prior policy, or known to the directors or officers before the period of insurance. This is reasonable as cover should be provided by the previous policy.

***Directors should avoid exclusions which include the phrase “or matters known to the Directors and Officers” because the word “matters” is open to interpretation and invariably not defined in the body of the wording.***

- Property Damage is generally excluded.
- Bodily Injury (except Employment Claims) is generally excluded. It is recommended that “for” language is sought as a preamble to this exclusion so that cover is provided for losses arising from the indirect consequences of bodily injury.
- Fraudulent, dishonest or illegal acts: Cover normally excludes claims arising from or attributable to the committing of any dishonest or fraudulent act or omission or any personal profit or advantage gained by any of the directors and officers to which they were not legally entitled. Care should be taken to see that this exclusion does not extend to include the terms “*criminal or wilful acts*” and that the committing of the dishonest or fraudulent acts have to be established “*in fact*” or by a judgement or final adjudication. This will allow the policy to provide defence costs for such allegations up and until the point of, or an admission of, or proven, guilt. Some policies have a requirement for all costs and expenses associated with the defence to be repaid to the insurers in the event of an admission of guilt or a guilty verdict. The principle of providing a defence up and until proven guilty is known as “final adjudication” language. It may be argued that by also including the term “or an admission of” (guilt) the policy may be weaker in so far as it has been held that this may mean that the policy

would cease to provide a defence upon evidence (for instance of a written nature) being uncovered supporting the contention that the alleged acts took place.

- Illegal or inappropriate remuneration: Cover normally excludes claims for the return by any of the directors and officers of any remuneration paid to them inappropriately or illegally. It is important to ensure that the policy provides for the exclusion only to operate where the illegality is proven in a court of law.
- Pollution: Cover normally excludes claims arising from or attributable to pollution. The conditions of the policy usually allow for the payment of costs and expenses expended in defending claims involving pollution. Some policies cover derivative actions brought by shareholders against directors and officers (i.e. where the shareholders compel the company to take action against the directors and officers) or direct actions brought by shareholders against directors and officers where there has been a diminution in value of assets arising from an event involving pollution. Often it is not possible to obtain cover in relation to defence costs associated with claims arising from pollution brought in the courts of the USA/Canada.
- Nuclear: Claims associated with or arising from bodily injury, sickness, disease, death or property damage or destruction in relation to ionising radiations or contamination by radioactivity from any nuclear fuel or from any nuclear waste from the combustion of nuclear fuel are usually excluded.

#### **Further exclusions when cover is sought for claims brought in the courts of the USA or Canada**

##### **Further exclusions when cover is sought for claims brought in the courts of the USA or Canada**

- The Employee Retirement Income Security Act of 1974
- The Securities Exchange Act of 1934

Where cover is required for breach of US Securities legislation this can be negotiated but there may be additional cost involved. Furthermore, there is often a restricted or “sub-limit” of indemnity, this being included within and not in addition to the overall sum insured.

- Blanket or absolute pollution exclusion

The provision for defence costs and expenses may not apply to actions brought in the courts of the USA/Canada.

- Punitive and Exemplary damages

If these are covered under the terms of the policy, it is likely there will be a blanket or absolute exclusion with regard to actions brought in the USA/Canada. Cover can be negotiated where such damages are insurable by law but often additional cost is involved.

### Exclusions in common use but worth negotiating

The following table shows exclusions which directors may find in their draft insurance policy but which can either be removed by negotiation or avoided by selecting a policy from another insurer. Some of these exclusions may be acceptable to the board upon reflection but it is important for their implications to be considered fully.

#### Exclusions in common use but worth negotiating are:

- Insured v Insured exclusion: Many policies do not cover actions between parties covered by the same policy. An example is an action taken by the company against a director covered by the same policy, or where an action is brought by one director against another director covered by the same policy.

There are generally a number of exceptions or 'carve outs' to this exclusion which allow for certain types of claims to be covered. The general rule is that, at the very least, cover should be sought for:

- costs and expenses associated with defending claims brought by former directors; or
- claims brought derivatively by shareholders; or
- claims brought by a liquidator or administrator; or
- contribution or indemnity if the claim results from another claim covered under the policy.

Generally the policy will dictate that in respect of claims brought either derivatively by shareholders, or by a liquidator or administrator, there must be no solicitation or assistance from the company.

***It is important for directors to understand whether they are covered against claims from the company itself and/or from another director covered by the same policy. Where the Insured v Insured exclusion does apply, the board should seek as many exceptions as possible and seek to restrict the application of the exclusion to certain onerous territories (such as the USA/ Canada). It is, however, recommended that the exclusion is removed if at all possible.***

- **Money Laundering:** This exclusion is usually preceded by a widely drawn preamble. “For” language should be sought (see page 11).
- **Professional Services:** Some policies contain an exclusion for professional services performed by the company or the directors and officers. Directors need to be careful that the wording does not affect the ability of the policy to respond where shareholders seek to hold directors and officers responsible for the acts of others providing professional services to the company. ***It is recommended that directors seek a carve out to the professional services exclusion along the following lines: “It being understood and agreed that this exclusion shall not apply to Claims alleging failure to manage, appoint or supervise or whilst the directors and officers are acting in their capacity as Directors and Officers of the Company”.***

## **Unreasonable exclusions**

The following table sets out exclusions which are often presented in an insurance policy as being standard, or of no consequence or importance, but which are not appropriate for an investment company. ***It is recommended that directors seek to have these exclusions deleted.***

### **Unreasonable exclusions are:**

- Laddering, spinning and tie-in (being inappropriate actions in public markets during an offering of securities, generally only applicable to the USA)
- False accounting
- Market abuse preceded by a widely drawn preamble
- Market fluctuations or investment performance (excluding claims arising from stocks, commodities or investments failing to perform as warranted, represented or as expected to perform or claims arising from fluctuations in the market which are beyond the control of the directors and officers)

- The actual or alleged failure to effect or maintain any insurance
- Market timing/late trading
- Major shareholder, shareholders suits or closely held exclusions (imposing a specified percentage limit) i.e. claims by shareholders holding in excess of a stated percentage of the share capital
- Claims made by the manager of the investment company
- Blanket or absolute professional indemnity exclusion (directors should instead seek a carve-out for claims alleging failure to supervise or manage)
- Bodily injury and property damage exclusion preceded by a widely drawn preamble (the pre-ambule should use “for” language)
- A number of policies, providing cover on a world-wide basis, impose exclusions relating to violation of USA regulatory, federal and state matters in addition to those exclusions mentioned above under “Further exclusions when seeking cover for claims brought in the courts of the USA/Canada”. The terms of the policies also seek to exclude similar violations committed outside the USA, which if committed in the USA would be a breach of the relevant regulatory, federal or state matter. Such exclusions will relate to a variety of codes which may seem obscure to a UK director and which may have an impact on the policy if not fully understood. **Comfort cannot be taken from assuming their application will only be for claims arising within the USA and it would be wise for directors to seek a concise explanation of their application from the insurance broker.**

### Inadvisable areas of policy cover

Many policies are drafted with extensions that provide cover thought to render them attractive to potential purchasers. Whilst some of these enhancements are undoubtedly beneficial, others need careful consideration. In particular, **consideration should be given to cover that extends the benefit of the policy to the company as an entity in its own right, or to its shareholders.** Such cover may protect the balance sheet and preserve the shareholders’ assets but on the other hand it may erode the sum insured available to the directors and officers. An example might be where the policy provides cover for shareholders’ expenses whilst bringing a claim against the directors.

## Period of Cover

The policy is only applicable for claims first made or brought against the directors and officers, and notified to the insurer, during the period of insurance which is set out in the policy schedule.

The policy may contain a clause giving a limited extension to this period, typically thirty days, which is generally called a Discovery or Extended Reporting Period. Therefore claims, which would otherwise qualify under the claims reporting conditions, may be reported to the insurers up to 30 days after the expiry of the policy period. (This should not be confused with the terms Optional Discovery or Extended Reporting Period which are available should the insurers refuse to renew a policy at its expiry (see page 21).

## Conditions of Cover

All D&O insurance policies have conditions attached to them. Failure to comply with, or being in breach of, these conditions can allow the insurers to exercise certain rights against the directors and officers, leading to claims either being compromised or not being met or, in certain circumstances, rescission of the policy. Amongst the many policies on offer there is by no means any consistency in the items included. ***The conditions need careful consideration - some may be beneficial to directors, others detrimental.***

The following items are likely to be included in the insurance policy:

### DISCLOSURE OF INFORMATION AND NOTIFICATION OF CLAIMS

- **Claims notification:** The conditions that govern the notification of claims should be clear, unambiguous and workable. ***It is important to have a clear understanding of the directors' and officers' (and the company's) obligations under this section of the policy.*** The policy conditions may require immediate written notice, or written notice within a fixed time period, or as soon as practical, or as soon as reasonably possible.

Matters requiring notification will include actual, intimated or anticipated claims, as defined. The meaning of 'anticipated' matters will differ between policies. Some require notice of

matters, which it is reasonable to assume, *could* give rise to a claim in the future or those which *may* give rise, or which are *likely* to give rise to a claim in the future. Some policies require precise details of the matter including the situation, dates, and details of potential claimants and reasons as to why the situation could (may or is likely to) give rise to a claim. Some policies include a useful extension called “risk management expense” which offers a sub-limit for costs incurred in obtaining legal advice to avert or minimise the impact of a situation which could give rise to a claim under the policy (see page 25).

The claim notification provisions put the onus upon the policyholder to notify the insurers, which is not unreasonable, but do not explain the position of the insurers as to their right to challenge either the details or the basis of the notification.

If the claim notification provisions name the insurance broker as the party to whom notification should be made, it is important to ensure that the policy deems this act as putting the insurers on notice for the purposes of the clause.

***It is essential to have access to competent advice at the point of notification of claims, particularly when notifying circumstances that might give rise to a claim in the future. Incorrect, deficient or inaccurate notification (in relation to the terms of the policy) can have a very unwelcome impact on the success of the handling of the claim.*** The insurers can at any time during the claims handling process raise issues as they come to light and challenge their responsibility to provide cover. Of particular importance is where a situation develops that may result in multiple claims, particularly if their gestation straddles policy periods and possible future change in insurance providers. More specifically, assume a notification is made in year 1 under policy A with insurer A of a situation which may give rise to a claim. Then assume that at the end of year 1 policy A is replaced by policy B with insurer B, and that during year 2 more details come to light which extend the scope of the claim made in year 1. Which insurance company is responsible for the extended areas of the claim? If the original claim notification to insurer A was made in narrow terms, then insurer A may argue that the additional factors give rise to a new claim in year 2 under policy B. Insurer B may argue that the directors should have known about the potential for the additional factors at the time of making the claim under policy A and therefore they are excluded under either any prior or pending (PPL) provision (which excludes claims arising out of litigation known about by the directors at the inception date) or any specific exclusion relating to claims notified under a prior policy or known about prior to inception (see page 13) of policy B.

It should be stressed that, from a legal perspective, taking a policy from an insurer for consecutive periods or taking subsequent policies from different insurers confers no greater or lesser duties upon the directors and officers in terms of the notification of claims and general disclosure. Nor does it confer upon the same or different insurers any greater or lesser rights to resist claims (assuming the same policy terms and conditions are maintained throughout).

***The golden rule is to make sure that the letter of the policy has been followed*** and the correct advice obtained in relation to the notification process, even if this means understanding that there may be dangers in following a particular course of action. ***Generally, it is unwise to notify claims until after thorough discussion with advisers, with the course of action to be adopted having been understood and agreed.***

- **Innocent non-disclosure provision:** A few policies contain provisions to protect the directors and officers in the event of an innocent and genuine error or non-disclosure in the information provided to the insurers prior to the inception of the policy. Such error or non-disclosure could put the insurers in a position where they were entitled to reject a claim or possibly rescind the policy in respect of that director or officer. The policy may contain what is known as severability of the proposal form (see page 28), but this provision only benefits the directors and officers other than the party making the error or non-disclosure.
- **Prior and Pending Litigation (PPL)/Continuity date provision:** Many policies contain a PPL exclusion or continuity date provision. In these clauses one of the areas of exclusion relates to claims arising out of litigation known about by, or outstanding against, the directors and officers or the company as at a certain date (often the first inception date). The purpose of this clause is to exclude matters which should have been notified to earlier policy periods or where the insurers do not wish to entertain any subsequent, but connected, litigation or claims which may arise. ***This means that whenever accepting a replacement policy, preservation of any original PPL or Continuity date provision is an important consideration.***
- **Discovery or Extended Reporting Period:** Many policies have a condition whereby claims, which otherwise qualify under the claims reporting conditions, may be reported to the insurers up to 30 days after the expiry of the policy period.

- **Optional Discovery Period:** This clause provides for an extended period of time after the expiry of the policy period during which claims arising out of wrongful acts committed prior to the expiry date can be reported. This clause can be exercised at a pre-determined additional premium that should be agreed at the inception of the policy. There are two types of clause that may be used:
  - **Bilateral version:** allows the clause to be exercised in the event that either the company (and the directors and officers) decide not to renew the policy or the insurers decline to provide renewal terms.
  - **Unilateral version:** is only exercisable in the event that the insurers decline to renew.

The following points should be noted with regard to the bilateral clause. The quoting of an unacceptable renewal premium does not constitute a refusal to renew. If exercised, the clause generally contains a provision that if any replacement policy is arranged by the directors and officers during the discovery period, then the optional discovery period is regarded as terminated. Generally the clause does not describe what happens to the premium that has been paid to the insurers, although some describe it as fully earned at the time the option is exercised, therefore non-refundable under any circumstances.

- **Notices:** This provides for the method of communication between the parties. It should be noted that in relation to the giving of notice of claims some policies may require written notice to the insurer and some to the insurance broker. The contact details will be set out in the policy. If notice is to be given to the broker, the terms of the policy should state that the insurers will be deemed to have been notified as well.
- **Authorisation:** This states that the company is authorised to give notice and act in all matters relating to the policy on behalf of the directors and officers. Sometimes it may be preferable to restrict the authority of the company to act only in certain specified instances.

## DEALING WITH AND SETTLING CLAIMS

- **Settlement:** Typically, insurers will state they have the right but not the duty to defend any claim. In order that they are able to compromise and settle out of court insurers will seek the right under the policy to avoid being forced to defend actions that are, on taking legal advice, unlikely to succeed and ***it is desirable to have adequate provision within the policy to be able to dispute such a stance, if taken, with an independent party acting as an adjudicator should the directors and officers not agree.***
- **Subrogation:** In the event of the insurers having to meet a loss under the policy it is generally the case that they are able to assume any rights that may exist against the party that has caused the loss. This may include seeking recovery from an insured party under the policy. Most policies contain a waiver of these rights against the directors and officers, unless the loss has been caused by dishonesty or fraud.
- **Other Insurance:** Most policies have a provision that where a claim is covered under more than one policy the amount paid out by the insurers will be compromised in some way. The provisions of these clauses vary from an averaging or pro-rata provision to stating that the policy will only operate in excess of the limit of liability of the other. ***This latter provision is to be avoided particularly in the event that both policies in question have the same provision.***
- **Order of Payments provision:** Many policies do not contain provisions governing the order in which the insurers will pay claims. Before the Companies Act 1985 amendment came into effect, a company's ability to indemnify a director or officer was somewhat limited. Consequently, the A side of a policy, which covers claims brought directly against directors and officers (see page 8), would come into play. However, in light of a recent amendment to the Companies Act 1985 allowing wider indemnification provisions to be adopted in a company's Articles of Association, it is worth considering the value of an order of payments provision. Consider the situation where a multiplicity of claims are made in a policy period, some capable of indemnification by the company and some not. Given the inevitable lapse of time as these claims progress it would become a lottery as to which were dealt with first under the policy. Consider also that the limit of indemnity may well be insufficient to provide for all the claims notified. In such a situation ***it would be prudent to have a condition built into the policy whereby the board of directors had the right to elect to decline to receive reimbursement from the policy***

*for claims where the company was providing an indemnity* (Clause B - see page 8). Such a provision would preserve the policy limits for those claims against the directors and officers where indemnity from the company was not possible.

## EXTENDING OR LIMITING THE SCOPE OF COVER

- **Retired Directors Provision:** Most policies have provision to continue to indemnify directors and officers who retire during the policy period for any claims made against them for a specified period of time into the future in the event there is no policy available, either through non-renewal or lapse of insurance. This period may vary from 12 to 72 months. Some policies may seek to limit this cover should the future lapse in cover be due to insolvency or liquidation; however this terminology should be avoided.
- **Outside board cover:** The majority of policies provide cover to directors and officers (or indeed employees as may be relevant) where they are, at the request of the company, required to sit on the board of another company, which is not a subsidiary. There may be a requirement to list such other companies in the policy document and generally the extent of the insurance provided will only cover the individual who is the subject of the extension. This cover will generally be in excess of any other insurance policy or indemnification available to the director or officer.
- **Marital Estates Extension:** Whilst in some policies cover is provided by means of a specific extension to the lawful spouse of any director or officer, in other policies the cover is provided within the definition of “Director or Officer” or “Insured Person”. Some policies now include the term domestic partner in addition to the term spouse.
- **Conditions precedent:** Any clause which contains the phrase (or similar) “it is a condition precedent to the obligations of the Insurers under this policy that...”, known as “conditions precedent”, means that being in breach of the provisions of the clause entitles the insurers to avoid liability.

## SPECIFIC CLAIMS

- **Employment Disputes:** Cover should be sought for claims against directors and officers arising from employment related disputes. The definition of an employment dispute will differ from policy to policy but includes, inter alia, allegations of wrongful dismissal, harassment sexual or otherwise, violation of applicable legislation regarding employment, failure to promote, wrongful discipline, and wrongful deprivation of a career opportunity. It is important to ensure that if a policy with an Insured v Insured exclusion has been accepted (see page 15), there is an appropriate easement in the language to allow one director or officer to sue another arising from an employment dispute. Similarly, any bodily injury exclusion requires an exception in the case of an employment claim.
- **Pollution:** The level of cover for, and indeed the definition of pollution, differs from policy to policy, and may include the following variations:
  - Blanket exclusion
  - Blanket exclusion for claims brought in the USA and Canada only
  - Full cover
  - Limited cover (i.e. up to the level of a sub-limit within the overall stated limit of liability)
  - Cover for defence costs and expenses only
  - Limited cover for defence costs and expenses (i.e. up to the level of a sub-limit within the overall stated limit of liability)
  - Cover for shareholder derivative actions only

## COSTS

- **Allocation:** In the event that a claim involves matters covered and matters not covered by the policy, or indeed involves a claim both against the company and the directors and officers, the policy should provide adequate provision for an allocation to be made as to the expenditure of defence costs and expenses. Typically policies seek to enable the insurers to determine a fair and reasonable allocation but provision should be in place to provide for adjudication in the event that agreement cannot be reached. Some policies may provide for allocation on a pre-determined ratio irrespective of the balance of responsibility between the parties.
- **Defence Costs:** Defence costs should be payable by the insurers as they fall due or advanced periodically. Generally costs will only be met if they have been incurred with the insurer's written consent. In the event that costs and expenses are incurred by the insurers which are the responsibility of an insured party there is

a requirement to reimburse the insurers. Cover should be sought for the advancement of defence costs in the event of a criminal investigation, with the costs only terminating if there is a finding of guilt. Some policy terms request reimbursement of these costs in the case of a guilty verdict. If there is an excess (or retention) operating in respect of Clause B (Company reimbursement) sometimes this can be applicable to costs and expenses, which then become the responsibility of the company and only fall to the account of the insurers once the excess has been exhausted.

- **Public Relations expense:** Some policies include this extension which gives a sub-limit for costs incurred in obtaining public relations services. An example might be where it was felt prudent to use the services of a public relations company due to the share price having suffered a sudden and dramatic fall.
- **Risk Management expense:** Where this extension is available it offers a sub-limit for costs incurred in obtaining legal advice to avert or minimise the impact of a situation that could give rise to a claim under the policy .

## LEGAL MATTERS

- **Governing Law and Jurisdiction:** The governing law and jurisdiction is usually the registered domicile of the company. However, if required a different jurisdiction can be agreed between the parties. This clause will determine the country whose law will govern the interpretation of the policy and the domicile of the courts where any action against the insurers (in the event of a dispute regarding cover) will take place.
- **Representation:** Not all policies provide for the parties to agree on the appointment of legal representation. However in certain situations conflict can arise between the directors and officers and it is useful to have prior agreement to individual representation if required. This is particularly beneficial if ever a conflict of interest arises either between the directors and officers and/or the company.

## CORPORATE STRUCTURE AND EVENTS

- **Subsidiary:** It is usual practice for the insurance policy to include all subsidiary companies. Subsidiaries are generally defined as any company which the company named in the policy or a subsidiary controls through:
  - holding 50% or more of the voting rights, or
  - the right to appoint or remove 50% or more of its board of directors; or
  - controlling alone, pursuant to a written agreement with other shareholders or members, 50% or more of the voting rights therein; or
  - controlling the composition of the board.
- **Automatic acquisition of subsidiary companies:** The definition of the term subsidiary company generally includes automatic cover in the event of the acquisition or creation of a new company where the gross assets of the new company are below a specified percentage of the gross assets of the holding company. If the percentage limit is exceeded, reference to the insurers is usually required.
- **Merger or Acquisition:** Different insurers deal with the acquisition of the company in differing ways. As a general rule, in the event of the majority of the outstanding shares being acquired, the policy will terminate as to ongoing cover from such date. It should, however, remain in force to provide cover for claims for any actual or alleged wrongful acts committed or attempted prior to the date of such acquisition but where such claims are made against the directors and officers, and notified to the insurers, prior to the expiry of the policy period.

The majority of policies make no provision for the acquisition of a substantial block of shares, not in itself constituting acquisition of a majority, but sufficient to enable control of the board to be taken at an extraordinary general meeting. A relevant example for investment companies is the action of hostile investors. This may lead to substantially all of the board resigning as a consequence and possible termination (and replacement) of the investment management contract. In these circumstances, the outgoing board would have little or no control over the insurance policy and it is possible that the new board could be regarded as hostile. Although this situation may be rare, **directors need to be aware of how the policy will respond to claims made by the company in this event, and how the ongoing insurance will continue to protect the out-going board.** Directors may wish for the policy to treat this event as if

it were an acquisition and vest in them the ability for the policy to remain and protect the outgoing members.

- **Prospectus Liability:** In the case of launching a new investment company, it is important to establish whether there is cover for the liability of issuing of the prospectus. Most policies do not automatically cover any additional offerings of securities unless notice is given to the insurers and their agreement is obtained.
- **Compulsory/Voluntary Liquidation:** Many policies contain a termination provision (that operates in the same way as the merger and acquisition provision (see page 26) in the event of either compulsory or voluntary liquidation. Upon being triggered, such a clause will restrict the policy from providing cover for any actual or alleged wrongful acts committed or attempted after the trigger date. The policy assumes that the trigger provisions coincide with the resignation of the board; however, where this is not the case, there is a danger of liability arising from wrongful acts falling outside the scope of the policy. There are specific conditions available in the event of liquidation occurring during the currency of the policy to provide adequate protection - advice should be sought from the insurance broker in the circumstances.
- **Run-off Provision:** In the event of a compulsory or voluntary liquidation (see above) or winding-up the directors and officers may be concerned regarding their ongoing liability during the seventy two month period of the Limitation Act 1980. Run-off cover is generally sought to protect the directors and officers during this period.

Customarily, those insurers who had insured the company prior to its wind-up would be the natural providers of terms for run-off cover. Typically the first year's premium would be equal to or slightly less than the last active year. The major difficulty comes when establishing who is to pay for the ongoing run-off premiums if several successive policy years are required. Unless it is possible to purchase a long-term policy it may prove difficult to put the money aside for future insurance.

A limited number of policies contain provisions for either automatic run-off protection or a guaranteed offer of protection for the requisite six years (or any lesser period). Some policies make the statement that the insurers may offer, but not guarantee, a six-year run off period. ***It is recommended that directors seek to negotiate the inclusion of run-off provision into their policy.***

## FRAUD, WRONGDOING, UNTRUE STATEMENTS ETC

- **Severability:** A policy with severability provisions allows an innocent director or officer to retain the benefit of insurance protection despite the fraud or wrongdoing of another director or officer. Most policies are rescindable by the insurer in the event of fraud or misrepresentation, especially in relation to the proposal form. Severability restricts the rescission only to those with knowledge of the fraud or misrepresentation, essentially treating each director and officer as individually insured.

An example of such a clause would be:

*“The Proposal shall be construed to be a separate application for cover for each Director and Officer. In respect of the declarations and statements contained in the proposal form no statement in the proposal form or knowledge possessed by any Director or Officer shall be imputed to any other Director or Officer for the purpose of determining the availability of cover under this Policy.*

*Nor shall the Wrongful Act of any Director or Officer which gives rise to a Claim be imputed to any other Director or Officer for the purposes of determining the availability of cover under this Policy including the application of any policy exclusions.”*

- **Warranty of Statements/Declarations:** Any statement within a policy to the effect that the insurer has relied upon the statements contained in the proposal form (and therefore implicit within those statements is the fact that the statements are truthful) renders such statements a warranty or promise as to their truthfulness. In the event that any statements are found to be untrue, the insurers may be entitled to rescind the policy. Much will depend on the extent of the severability clauses (see above) as to the impact of this right of rescission and how it affects those (innocent) directors and officers.

## DISPUTES

- **Arbitration:** Not all policies provide for the use of arbitration proceedings in relation to disputes and differences arising under the policy. The omission of such a clause does not in itself mean that arbitration, rather than resort to legal process, is unavailable in the event of a dispute. The reality is that the courts now direct that most such disputes be mediated at an early stage in legal proceedings.

## CANCELLATION

- **Cancellation:** Ideally the policy should be non-cancellable, except for non-payment of the premium.

## Amount of Cover

Insurance policies are written with a specific monetary limit which is the maximum amount that the insurers will pay out. The limit therefore applies to the total of all claims reported to the insurers during the period and consideration should be given to the fact that claims rarely settle during the period of the policy and any inadequacy in the limits will invariably only become evident after the policy has expired.

It is impossible to give any specific guidance, or a formula, to calculate the desirable level of cover that should be obtained for an individual investment company, and it is a matter for the board to determine. Some general comments can however be made. The decision will depend on the:

- level of cover available in the market
- cost of premium
- likelihood of claims, and their potential size
- whether directors can call upon other resources to indemnify them or fund defence costs in advance
- peer group comparison (although information may be difficult to obtain)
- the views of the board.

Another consideration is that, initially, policies respond in respect of defence and investigation costs and it is not unknown for each director or officer to require separate representation. This inevitably has a financial impact given that the limit of indemnity is generally an aggregate limit.

Where the policy is arranged by the management company and covers more than one investment company, each entity can erode the available limits of indemnity. It is particularly important to ensure that all members of the collective group of companies be made aware of the dangers inherent in a shared limit of indemnity. That is to say, potential claims may not only erode but also totally eliminate that limit, leaving no protection for directors who have had no involvement in such claims. For those boards concerned that they may have, as yet unknown, matters to report during the balance of the policy period, there may be the opportunity to arrange additional, or excess, cover for themselves provided they are made aware of the notification of claims by other investment companies covered under the policy. It may also be possible for the collective arrangement to have reinstatement provisions built in that would provide additional (reinstated) limits of indemnity in the event of exhaustion. The insurance broker should be able to advise as to how to maximise protection.

## Making a Claim

***First and foremost every person who is the subject of the insurance should understand his or her duties in terms of adherence to and compliance with the terms and conditions of the policy.*** The initial duties of any legal representative appointed by the insurers are to confirm such compliance in conjunction with reporting to the insurers on the general issues surrounding the claim. During this period it is quite usual to be informed that the insurers have accepted the claim notification under a “reservation of rights” and that all insured parties should act as “prudent uninsureds”. This means:

- Do not admit liability.
- Do not enter into correspondence following an allegation except to acknowledge receipt of correspondence.
- Do not make any offer or settlement.

Sometimes the fact that the insurers are reserving their rights can cause unease. However, even after the insurers have accepted a claim and confirmed that they will respond in accordance with the terms of the policy, if some fact, matter or circumstance comes to light which would have affected their earlier view of the claim, they are entitled to alter their stance.

In terms of what should be notified under the terms of the policy, if any situation arises where there is doubt as to whether it constitutes a notifiable matter, directors should consult with their insurance broker.

## New Directors

***Directors who are appointed to the board during the year should be provided with a copy of the D&O policy document.*** They should take care to read the policy and understand what it covers, what it does not cover, and how the cover operates particularly with regard to the notification of claims. New directors should also seek to ascertain the procedures for renewing the policy, or amending any of its terms.

## Practical Tips on Reviewing a Draft Policy

The following is a useful list of points for consideration by directors who are in the process of reviewing a proposed insurance policy:

- As a rule of thumb the greater the number of addenda accompanying the policy the less specific to your business the policy is likely to be. These addenda may be extensions to the policy although they are more likely to be exclusions.
- It is possible to find errors and inconsistencies in the policy by paying careful attention to the policy definitions. This is particularly important when the policy has been amended by a series of additional conditions or exclusions by way of addenda. It is often the case that in drafting addenda little or no attention is paid to defined terms and the meaning of the addenda may thereby be open to misinterpretation and misunderstanding. Until recently the generally held view was that a court would invariably find in favour of the policyholder in the event of unclear or inconsistent terms. However, there has been recent case law concerning the drafting of contracts where the courts have found meaning in ambiguously drafted documents and have applied such meaning without recourse to the intent of the drafting parties.
- Some definitions may include an explicit exclusion by stating that the defined term does not apply to certain specified matters. Care should be taken to differentiate these meanings.
- Never accept terms and conditions that cannot be understood. If the policy is unclear, seek advice.





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Website: [www.aitc.co.uk](http://www.aitc.co.uk)

Registered Office: 9th Floor, 24 Chiswell Street, London EC1Y 4YY. Telephone: 020 7282 5555.