ASSOCIATION RISK MANAGEMENT

THE MYTHS OF D&O INSURANCE
Including what it does and doesn’t cover

Most board members have a good idea of who is covered under a directors and officers (D&O) liability policy (it doesn’t exactly require an insurance scholar to figure that out, given the hint offered by the name). But even experienced volunteer leaders are challenged by the question of what the policy covers and how they should be involved in choosing the right one. My goal is to provide you with a basic working knowledge of D&O insurance, skewer some myths (or at least misunderstandings) about D&O, and identify several important but rarely discussed provisions of D&O policies that are of particular interest to you as a board member.

What is D&O?
D&O is intended to protect board members against allegations of wrongdoing that may arise from their roles in the governance and administrative management of an organization. In the nonprofit version of D&O insurance, directors, officers, committee members, employees, and, in some cases, volunteers acting at the direction of the association are all insured under the policy. The association is also insured (a feature referred to as entity coverage).

Myth: D&O is the single most important policy in the association’s insurance portfolio.
Truth: Association executives often take this view. The commitment to shield directors and officers from financial losses that could arise from their good-faith board service is a cornerstone of the relationship between board members and their associations. Without that assurance, many of the most capable leaders would, understandably, be unable to serve. For associations, more than for most private companies, the protections of D&O insurance are essential.

But individual association directors or officers are rarely the subject of D&O lawsuits, except when personal misconduct is alleged. Just as important, directors and officers may be exposed to liability for operations of the association other than those covered under the D&O policy. Fortunately, directors and officers are also insured under other policies in the association portfolio, such as general liability and errors and omissions.

Myth: My homeowners policy covers me.
Truth: In some cases it might, but for the most part, board members cannot rely on their homeowners insurance to cover their association board service (regardless of whether they’re compensated for that service).

What does D&O cover?
Claims of adverse employment action account for nearly 90 percent of reported D&O claims. Employment actions tend to be high-frequency but relatively low-severity events; most close at less than $100,000.
The next most frequent sources of claim are personal injury (e.g. libel, slander, and defamation) and publisher’s liability (e.g. plagiarism, copyright infringement, and so forth). These tend to occur with low frequency and are relatively low in severity as well.

By their very nature, some associations may be exposed to claims alleging violation of state or federal antitrust statutes. Antitrust coverage is provided on a limited basis and for some organizations not at all. These sorts of losses tend to be low in frequency but very high in severity.

The typical D&O policy (but not all) will include defense expenses within the limit of liability, which means that the costs of defense will reduce the amount of insurance available to pay settlements and judgments (indemnity). Routine contractual and employment-practice claims rarely involve significant defense expense. On the other hand, complex matters, those requiring special expertise to litigate, and those that involve a high likelihood of significant expert-witness testimony will result in higher defense costs. When selecting appropriate coverage limits, your association should be mindful that defense costs have the potential to significantly erode, and possibly even exhaust, the liability limits.

Since more than one half of all D&O claims close at zero indemnity – with no payment to the plaintiff – the duty of the carrier to defend covered claims is, in many cases, of greater value than the duty to pay settlement or judgment amounts.

Myth: More is better.
Truth: Some types of insurance coverage – workers compensation, for instance – are very similar from one carrier to the next. But this is not the case with D&O. The terms of coverage often differ widely from one policy to the next. The association that focuses primarily on liability limit and premium expense overlooks the most important elements of comparative analysis: which policy provides the broadest safeguards? A million-dollar limit of comprehensive coverage is almost certain to be of greater value than higher limits of liability in a policy where the terms of coverage are most restrictive.

What doesn’t D&O cover?
Every D&O policy includes exclusions involving bodily injury and property damage, fraud and dishonest acts, pollution, and breach of contract. Often, the policy includes endorsements that impose additional exclusions based on the applicant’s risk characteristics. These exclusions might relate to areas such as professional services, antitrust, medical malpractice, and publishing.

Myth/misunderstanding: “…we agree to pay on behalf of the insured all sums they become legally obligated to pay…” (this is insuring-agreement language similar to that found in most D&O policies)
Truth: If you read only these words in the policy, you’d have to conclude that the coverage is pretty good. Of course, there are a few relevant policy provisions that follow, limiting the obligation of the carrier.
Knowing what’s excluded is more important than knowing what’s covered. Few association executives (and very few association lawyers, for that matter) are well versed enough in this area to recognize the exclusions and restrictive provisions found in D&O policies and the impact these have on the association. That’s why it’s essential to get guidance from a truly knowledgeable resource with broad understanding and experience in nonprofit risk management and current marketplace experience.

**What is the Board Member’s role in procuring D&O insurance?**

As is the case with most administrative functions, the best interests of the association are served when the board leaves the procurement of D&O insurance to appropriate senior-level staff. However, it’s true that one of the board’s primary responsibilities is to safeguard association resources. So of course the board should convey to staff the organization’s tolerance or aversion to risk in a way that will inform the staff’s decision making about buying D&O. In this context, the board articulates in broad measures whether association resources will be protected by means of risk transfer (more insurance) or risk retention (less insurance supplemented by the organization’s financial strength). There is one role the board plays that may not seem important until trouble arises. Board members and association executives share responsibility for ensuring that the application for insurance is filled out correctly. The officer signature required on the application often is a warrant that the representations contained in the application are true (an absolute truth). When representations are found to be untrue (typically at the time of the claim) they are referred to as misrepresentations.

Even innocent misrepresentations can have the effect of limiting coverage, in some cases voiding the insurance contract altogether. Many associations overlook the need to poll directors and officers to ensure that all the representations are correct for all the parties. Although any misrepresentation is significant, some application questions (and by extension, the responses) have more importance (or materiality) than others.

Therefore, effective polling of board members does not require them to review all application responses. We advise clients to poll the board (and senior management) on those questions relating to claims and knowledge of circumstances that may lead to a claim. It’s a low-cost, relatively low effort step to making your D&O coverage as effective as possible.