

# REFJ

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# D&O Insurance for Real Estate Companies

Robert Cohen

**Both public and private real estate companies should ensure that they have adequate and comprehensive D&O coverage.**

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In today's highly litigious environment, and as a result of Sarbanes-Oxley, recruiting and retaining highly talented directors and senior officers is a difficult endeavor. Given such high-profile corporate scandals as Enron and WorldCom, most directors and officers are very concerned about personal liability for wrongful acts committed by the company, other board members and officers, and other employees.

Consequently, most publicly traded Real Estate Investment Trusts ("REITs") and other public real estate companies and many privately held real estate companies purchase directors & officers liability insurance ("D&O"). D&O policies typically provide liability protection to directors and officers.

In consideration for the payment of a premium and subject to the terms of the policy, an insurance company will generally:

- (1) pay on behalf of the directors and officers losses which the directors and officers are legally obligated to pay as a result of a claim made against them;
- (2) reimburse the company for indemnification payments it makes to or on behalf of directors and officers; and
- (3) pay claims against the company which the company is legally obligated to pay (if the company purchases "entity" coverage).

## **Key Terms**

Several key insurance terms need to be understood in the context of D&O coverage:

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*Limits.* The amount of coverage provided by the insurer to the insureds. Policies have an overall limit of liability, including claims expenses. According to a 2003 survey conducted by the National Association of Real Estate Investment Trusts ("NAREIT Survey"), the mean D&O limit for REITs was \$31.8 million and median limit was \$25 million. It is important to understand that policy limits can be exhausted by defense costs.

*Coverages.* D&O policies typically have separate insuring agreements for directors and officers (Side A) and for company reimbursement (Side B).

*Premium.* The amount that the company pays the insurer for the insurance. For example, according to the NAREIT Survey, the mean D&O premium for a residential REIT was approximately \$400,000.

*Retention.* The deductible that the insured must cover before the insurer pays certain claims. Most D&O policies include separate retention levels for claims made against individual directors and officers and those made against the insured entity.

*Policy Period.* The length of the policy. D&O policies in the real estate sector generally run for one year.

*Exclusions.* What the policy does not cover. For example, D&O policies typically include fraud, dishonesty, personal benefit, and criminal act exclusions. Additionally, many D&O policies impute bad acts by one person to others in the company, thus leading to the denial of coverage in some situations. Other common exclusions include mold and terrorism.

## **Key Issues**

When purchasing D&O insurance, a real estate company should be concerned with several key issues that

may not be obvious when the policy is being purchased but can have a major impact if a claim is made on the policy. Among them are the following:

*Severability For Misrepresentations In Insurance Applications.* Many D&O policies include provisions to rescind all or parts of coverage for material misrepresentations or fraudulent statements in the application. However, some policies include an excellent endorsement that limits the insurer's ability to deny coverage to directors and officers who did not have knowledge of these bad acts. This type of endorsement goes beyond standard endorsements. Independent directors greatly benefit from this endorsement and are likely to keep their coverage even if the company loses coverage based on false statements in its insurance application.

*Severability Of Fraudulent Or Criminal Conduct.* Fraudulent or criminal conduct by one director or senior officer should not be imputed to other directors or officers, especially securities claims. Additionally, coverage for these bad acts should only be excluded if formally established by a final adjudication in a judicial, arbitration, administrative or regulatory proceeding or a written admission of a director and/or an officer of the company. Further, only facts pertaining to and knowledge possessed by any past, present or future chairman of the board, president, chief executive of-

ficer, chief operating officer or chief financial officer of the company should be imputed to the company. This feature is much better than other policies that impute fraudulent or criminal conduct to all parties and can infect the entire board or company.

*Bankruptcy Protection.* Given the recent bankruptcy court decision in *National Century Financial Enterprises v. Gulf Insurance Co.*,<sup>1</sup> companies should consider purchasing separate non-rescindable policies for independent directors in order to protect them if the corporation goes bankrupt. The court in *National Century* reallocated the insurance proceeds to the detriment of the directors.

### Conclusion

In summary, both public and private real estate companies and their officers and directors should take steps to ensure that they have adequate and comprehensive D&O coverage. D&O insurance policies should be subjected to independent review. Good corporate governance and comprehensive D&O coverage are the only ways to protect directors, officers, and the company.

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<sup>1</sup> Bankr. S.D. Ohio (Jan. 10, 2005).