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IS SIDE A D&O COVERAGE RIGHT FOR YOU?

Executive Liability Coverage 101

For private companies, Executive Liability programs typically consist of three key insurance products. These include Directors and Officers liability, Employment Practices liability and Fiduciary liability. Many times, these coverages share a limit of liability. This fact, as well as the unique challenges faced by companies in financial distress can cause the standard Directors and Officers coverage to be inadequate. In these situations, companies should consider adding an additional product: "Side A" coverage. This article will explore the benefits and limitations of these important coverages.

The first component of an Executive Liability program is the Directors and Officers (D&O) Liability policy. Directors and Officers liability, most simply described, is corporate malpractice insurance. The D&O policy will protect the board of directors, officers of the company and the corporate entity itself from allegations of acts, errors, omissions, misstatements, misleading statements, breaches of duty and breaches of care by the decision makers of the organization. No private or non-profit company should be without this important coverage.

The second key insurance product included in an Executive Liability package is the Employment Practices Liability (EPL) policy. Employment Practices liability will pay defense costs and settlement or indemnity expenses on behalf of the organization if an employee, manager or supervisor, board member or officer, or the entity itself are targeted in litigation alleging an employment related tort such as discrimination, sexual harassment, wrongful termination, or retaliation. It only takes two

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employees for a harassment situation to occur, and only one to have a wrongful termination. In the current economy, where unemployment remains high, employment related complaints have risen significantly. EPL is a product that most companies will use at some point during their life-cycle.

Finally, the third component of a typical Executive Liability package program is Fiduciary Liability. Where D&O addresses the mismanagement of the organization or corporation, Fiduciary Liability insurance provides coverage for alleged mismanagement of employee benefit plans, such as the 401k. Individual Fiduciaries or trustees of a plan may find themselves facing personal liability for decisions made in relation to benefit plans, and the organization or corporation may also be liable. Fiduciary liability insurance has a low claims frequency rate, but when claims occur they can be severe.

It should be noted that some Executive Liability packages also include Employee Theft (Crime) coverage, Kidnap & Ransom coverage, or Miscellaneous Professional Liability coverages. These products are somewhat less common and normally do not share the limit of liability with the D&O, EPL and Fiduciary coverages.

Typical Executive Liability Programs Have Limits

Private and not-for-profit organizations purchase a Directors and Officers (D&O) Liability policy to protect the board and the balance sheet from litigation and other claims. Sharing limits may offer a reduced premium to purchasers, but may actually restrict the availability of coverage to

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“The “Side A” product is designed to protect the board and officers only”

the board. In fact, sharing limits can cause the policy to be completely exhausted by a large EPL or Fiduciary claim and leave the individual directors and officers without any coverage at all. Boards should be careful when choosing limits and policy structure in order to ensure that coverage is available when they need it most.

In order to explore options for structuring the D&O coverage, we must first understand how a D&O policy functions.

How Does a D&O Policy Work?

A typical D&O policy for a private or not-for-profit company will contain three insuring agreements. These are commonly referred to as Insuring Agreements A, B and C. Insuring Agreement C is for claims brought against the corporate entity itself. Insuring Agreement B is for claims brought against individual directors and officers when the corporation can and will indemnify the director or officer. Both Insuring Agreements C and B are subject to a self-insured retention or deductible. Insuring Agreement A is for claims brought against individual directors and officers when indemnification is not available to them. Indemnification can be denied for a public policy reason, because the board refuses to indemnify, or simply because the money is not available. Common claims under Insuring Agreement A occur when a company experiences financial insolvency or bankruptcy. Arguably, these



non-indemnified claims are the most important to individual directors and officers because individuals will be forced to use their personal funds to defend themselves when the corporation fails them.

Higher Limits May Not Be The Answer

To address limit adequacy, one option is to purchase a higher overall limit for the Executive Liability program (inclusive of D&O, EPL and Fiduciary). Insureds can purchase a higher limit for their D&O, EPL, and Fiduciary shared limit policy. Another option is to purchase a separate limit of liability for each coverage (D&O, EPL and Fiduciary). Separating limits will prevent the D&O limit from being exhausted by an EPL or Fiduciary claim. However, it can also be beneficial to consider a separation of the limit structure all together.

Adding additional limits to the standard D&O policy or increasing limits on the EPL or Fiduciary coverage will not necessarily protect the directors and officers from a catastrophic claim or the risk associated with financial insolvency of the entity. No one likes to admit that financial insolvency is remotely possible for a corporation, but companies nationwide file for bankruptcy protection every day. In many cases, directors and officers are finding themselves funding their litigation expenses out of their own pockets because they did not carefully choose their D&O policy structure.

Why Consider Side A?

To address the issue of coverage structure, many boards choose to add additional policy limits to their D&O coverage for “Side A” claims. While the purchase of overall higher limits or separated limits can mitigate the risk of limit inadequacy for a large claim or series of large claims, the purpose of including a “Side A” D&O policy in the insurance program is not exclusively to obtain higher limits.

“Side A” D&O coverage performs three important roles for the directors and officers. First, “Side A” coverage is an excess policy. It provides additional limits for the directors and officers when the primary policy is exhausted due to claims. “Side A” policies became popular with public company directors and officers in the wake of Enron, WorldCom and other catastrophic level scandals. Public company executives were finding themselves personally exposed when their D&O policies were exhausted by a securities claim or series of other claims. The “Side A” product is designed to protect the board and officers only; the limits are not available to the entity. The “Side A” policy adds extra protection (limits of liability) for the directors and officers when the underlying limit purchased is inadequate.

A second reason to consider a “Side A” D&O product is the absence of entity coverage. In the event of a bankruptcy or receivership, the underlying D&O policy, which includes coverage for the corporate entity, may be declared an asset of the bankruptcy estate. When this happens, the limits are unavailable for directors and officers. With a “Side A” policy, the limits of this policy are still available to the directors and officers even when their primary policy is unavailable. Separating limit structure to ensure that some limits are exclusively available to directors and officers is vital in the event of financial collapse.

Finally, financial insolvency is not the only circumstance where indemnification may be unavailable to directors and officers. In certain circumstances, the board of directors may rightfully refuse indemnification to a board member or officer or a new board may choose not to indemnify former management. There may be public policy reasons why an organization is unable to indemnify. The “Side A” policy should be negotiated to respond in the event of any failure to indemnify individual directors or officers, even if financial resources exist. In these cases, the “Side A” policy will respond as if it were the primary policy (rather than excess). Purchasing a “Side A” product is the best way to ensure that directors and officers have a product that guarantees available limits for their individual exposure.

“Side A” products available today can be negotiated to also include a ‘difference in conditions’ or DIC provision. This DIC provision simply means that the “Side A” product contains fewer exclusions and is less restrictive than the underlying D&O policy. There may be situations where the

underlying or primary D&O policy denies a claim. In that case, the "Side A" DIC policy 'drops down' to provide coverage on a primary basis. The primary limit does not even need to be exhausted to trigger this provision.

Not Just For Public Companies

Even though "Side A" D&O policies are commonly purchased by publicly traded companies, private and not-for-profit organizations share many of the same risks. Current economic conditions have made indemnification more difficult for many companies, yet the litigation environment has not slowed the prevalence of suits against decision makers. Since the corporation is not covered by the limits in a "Side A" product, the policy is not held as an asset of the bankruptcy estate when insolvency occurs. This allows the directors and officers to access these limits when they need them the most. Remember that directors and officers can be named in litigation even when they have done nothing wrong. It is in these cases when "Side A" coverage for defense costs can be extremely valuable.

The Best Security for Directors and Officers

The best protection for a private or not-for profit organization is to have a comprehensive executive liability insurance program, which includes D&O, EPL, and Fiduciary Liability coverages to protect the entity and the individuals. Adding an extra layer of protection for the individuals on the board is highly recommended to provide assurance that coverage will be there when they need it the most. Careful consideration should be given to the structure and functionality of this extra protection. Higher limits for the entire Executive Liability program can be very helpful; however determining how to structure these limits is the most important decision. Adding limits for "Side A" D&O coverage in the insurance program can be the best way to protect directors and officers of an organization while not sacrificing entity

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coverage, Employment Practices coverage or Fiduciary policy with a DIC provision can be the best way to protect your leadership. Contact your D&O broker to further discuss this coverage and to obtain pricing for your company.

ABOUT THE AUTHOR



Monica M. Minkel joined Van Gilder in January 2010 as the leader of the Executive Liability practice. In this role, she oversees a wide range of clients that include public, private, and non-profit companies in a variety of industries. She also manages the team of individuals who support this business. She has spent nearly a decade as an underwriter or broker focusing exclusively on Executive Liability products,

which include Directors and Officers, Employment Practices, Fiduciary Liability, Crime, Kidnap & Ransom, and Employed Lawyers Professional Liability.

Monica began her insurance career in 2001 underwriting Directors and Officers liability coverage for AIG. Most recently, Monica spent six years as Assistant Vice President of a Financial Services insurance brokerage team in Denver. She also spent five years working in Financial Institutions prior to coming to the insurance world.

Monica has published articles relating to Directors and Officers Liability in the PLUS Journal and American Agent & Broker Magazine. She holds a Bachelor's degree in Finance from Regis University in Denver and a Graduate Certificate in Leadership and Organizational Change from Colorado State University. In addition, Monica has earned the Management Liability Insurance Specialist (MLIS) designation.

