

BAILEY CAVALIERI LLC

ATTORNEYS AT LAW

One Columbus 10 West Broad Street, Suite 2100 Columbus, Ohio 43215-3422
telephone 614.221.3155 facsimile 614.221.0479
www.baileycavalieri.com

SIDE A POLICY ENHANCEMENTS: HAS COVERAGE GONE TOO FAR?

One of the primary reasons to purchase a Side A Excess DIC policy is to obtain extraordinarily broad coverage for non-indemnifiable losses incurred by directors and officers. Because the frequency of non-indemnifiable losses is far less than the frequency of indemnifiable losses, insurers can offer much broader coverage terms under a Side A policy than under a standard D&O insurance policy which also covers indemnifiable losses.

As the popularity of Side A policies has increased in recent years, the competition among insurers to sell Side A policies has increased significantly. Prior to 2000, CODA was for all practical purposes the only insurer selling Side A policies. Today, more than ten insurers are actively marketing some type of Side A policy. Not surprisingly, as more insurers enter that market, the competition among insurers has resulted not only in lower premiums for Side A policies, but also in broader and broader coverage terms. These more protective insurance policies for non-indemnifiable losses give directors and officers important comfort that their personal assets are not realistically at risk in today's volatile post-Enron environment.

However, some of the newest and broadest Side A coverage features arguably are not in the best interests of the directors and officers. Some of these extraordinarily broad features appear to allow a truly "black hat" insured to deplete the policy limits of liability to the detriment of more deserving "white hat" insureds, and may allow the company and underlying insurers to dump indemnifiable or otherwise insured losses into the Side A policy, thereby potentially jeopardizing the long-term viability of Side A insurance. Like any other business relationship, the ideal Side A policy should reasonably protect both parties to the contract by affording the broadest financial protection reasonably available for fortuitous losses which are not paid by the company or other insurers, and by shielding the insurer against collusive behavior or inappropriate exposures. Some of the broadest features in the newest Side A policies appear to be approaching if not crossing that line between balanced and sustainable coverage versus imprudent and unsustainable coverage.

The following summarizes many of the new and creative coverage features found in at least some of the newest Side A policy forms. Most of these features are clearly beneficial to the insureds and should be included within a high quality Side A policy if available. As noted below, though, a few of these features should be evaluated to determine whether their inclusion within the Side A policy truly is in the best interests of the insureds.

1. Non-indemnified Loss. Traditionally, Side A policies covered non-indemnified losses only if the company refused or was financially unable to indemnify the insured person. Insurers insisted upon the company affirmatively refusing to indemnify the insured person, as opposed to simply failing to indemnify the insured person, because insurers believed it was less likely that a company would wrongfully withhold indemnification if the company was forced to

affirmatively deny the indemnification request rather than simply ignore the request. Fundamentally, Side A insurers expect the company to indemnify the insured person if the company is legally and financially able to do so.

Although the “refusal” requirement makes sense from the insurers’ standpoint, it creates a potential gap in protection for the insured persons. If the company simply ignores an indemnification request from an insured person, that insured person will not be indemnified by the company and will not be covered under the traditional Side A policy since the company has not “refused” to indemnify the insured person. In order to eliminate that potential gap in protection, many of the new Side A policy forms state that coverage exists if the Company fails to indemnify the insured person within a defined time period (usually 60 to 90 days) after the insured person requests indemnification from the company, whether or not the company affirmatively refused to indemnify. This is a valuable coverage enhancement for insured persons, but will probably remain available in the market only if companies fulfill their indemnification obligations and do not try to abuse the Side A policy by ignoring indemnification requests from insured persons.

2. DIC Trigger. Similar to the non-indemnified losses issue discussed above, Side A Excess DIC policies traditionally stated that the DIC coverage is triggered due to an underlying insurer’s wrongful failure to pay a covered loss only if the underlying insurer refuses to pay the covered loss. Again, by including a “refusal” requirement, Side A insurers sought to discourage an underlying insurer from trying to push a covered loss into the Side A Excess DIC Policy since the underlying insurer probably incurs greater liability exposure by wrongfully refusing to pay the loss as opposed to wrongfully failing to pay the loss.

This “refusal” requirement created a potential coverage gap for the insured persons if the underlying insurer failed but did not “refuse” to pay the covered loss since the DIC coverage would not be triggered in that circumstance. To eliminate that potential gap in coverage, many of the newer Side A policy forms now state that the DIC coverage is triggered if the underlying insurer refuses to pay or fails to pay within a defined time period (usually 60 to 90 days) after the insured person requests payment from the underlying insurer. This is an important coverage enhancement for insured persons. Although the provision potentially exposes the Side A insurer to greater risk if the underlying insurers seek to push covered loss into the Side A Excess DIC Policy, the Side A insurers are more willing to grant this enhancement in the current market because most of the underlying insurers now also sell Side A policies and are therefore less likely to abuse another insurer’s Side A Excess DIC policy in a claim situation.

3. Separate Limit of Liability. Several recent claims highlight the fact that different types of insured persons under a Side A policy may have competing interest in accessing the Side A Policy’s limit of liability. In today’s complex D&O claims environment, it is common for several different types of proceedings to be brought against several different groups of insured persons at the same time, and it is increasingly difficult to resolve all of those multiple claims against multiple insured persons in a single global settlement. As a result, partial settlements pursuant to which some claims against some insured persons are settled without resolving other claims against other insured persons are much more frequent. For example, in the Enron D&O litigation, the outside directors’ settlement exhausted the remaining D&O insurance proceeds, thereby leaving the officer defendants with no insurance (and no

indemnification from the bankrupt company) to fund defense costs and any settlements or judgments incurred by the officers. Similarly, in the highly-publicized Just For Feet D&O litigation, the D&O insurance policies were essentially exhausted by a settlement of securities class action claims against the officer defendants, leaving the director defendants uninsured for related claims by the bankruptcy trustee.

To provide greater comfort to directors and to officers that their important Side A coverage will not be exhausted due to losses incurred by each other, Side A policies which cover only officers or only outside directors are now available. However, partly because the decision to purchase those separate policies can create internal political issues within a company, very few of those separate policies have been purchased. In order to overcome those political issues, a few Side A policies now contain a provision which allows the company to purchase separate limits for only outside directors and only officers within the context of the standard Side A policy. These separate limits are in addition to the standard aggregate limit of liability of the Side A policy applicable to all insured persons combined.

Under the broadest version of this feature, the additional limits are purchased when the policy incepts and automatically spring into existence (without any additional premium) if the Side A policy's base limit of liability is exhausted by covered losses incurred by any insured person. The additional limits then apply to any covered claim first made at any time during the Policy Period, and therefore the separate limits afford greater coverage than a traditional limit reinstatement provision. These specialized and separate limits of liability are typically excess of all other policies specifically excess of the Side A policy (i.e., afford "round the clock" coverage), subject to the Side A policy's DIC feature.

This additional limit of liability provision can also include a priority of payment provision which maximizes the total amount payable under the Side A policy in the event a covered loss is subject to both the base limit and the separate additional limit. Absent such a provision, the Side A insurer could pay out of the base limit the loss which is otherwise covered by the additional limit, thereby leaving other loss which is covered only by the base limit uninsured. For example, assume a Side A policy is subject to a \$10 million base limit and an additional \$5 million limit for outside directors only, and further assume officers incur \$10 million and directors incur \$5 million in non-indemnifiable covered losses. The Side A insurer could contend that the directors' \$5 million of losses is paid out of the base \$10 million limit, leaving only \$5 million in the base limit to fund the officers' \$10 million of losses and leaving no losses payable under the \$5 million additional limit for the outside directors. To avoid that result, a few Side A policies expressly state that if covered loss could be subject to both the base limit and the additional limit, then the loss shall be allocated between the two limits "in whatever portions will maximize the total amount of such Loss paid under the Policy."

A similar need for separate limits of liability arguably exist with respect to retired outside directors. Because D&O insurance is claims-made coverage, an outside director who leaves the Board must rely on the company to maintain adequate coverage for that outside director for the next 4 to 6 years while the outside director is still susceptible to claims for alleged wrongdoing while serving as an outside director of the company. In order to provide those outside directors comfort that their future exposure will be adequately insured, a long term runoff Side A policy which insures only former outside directors is now available from a few insurers. That long term

Side A coverage typically is afforded through a separate retired director policy, but could be incorporated into the standard Side A policy, subject to an additional limit of liability as described above.

4. Insured v. Insured Exclusion. The insured v. insured exclusion is contained within virtually every standard D&O insurance policy for two reasons. First, insurers do not intend to cover collusive suits brought by a company against its directors and officers, particularly where the motive for such a suit is to recover money from the D&O insurance policy. Second, insurers do not intend to cover in-fighting between insured persons since those types of claims are frequently driven by emotion and other irrational factors. Broad Side A policies traditionally have limited the insured v. insured exclusion to only certain types of claims by or on behalf of the company and have covered claims between insured persons. In other words, traditional Side A policies have covered in-fighting between insured persons but have not covered potentially collusive suits by or on behalf of the company.

Some of the newer Side A policies delete the insured v. insured exclusion in its entirety. Although deleting the exclusion can be beneficial to insured persons, the absence of this exclusion in a Side A policy could invite collusive lawsuits by or on behalf of the company. Since settlements and judgments in lawsuits by or on behalf of the company are typically not indemnifiable, the company does not expose itself to any liability by initiating such claims against its insured persons, and could effectively convert its Side A insurance policy into a liquid asset by prosecuting such a claim against its insured persons. Such behavior by the company would obviously not be in the best interests of either the Side A insurer or the insured persons, and therefore complete deletion of the insured v. insured exclusion arguably is not a prudent coverage enhancement.

A more balanced approach to this exclusion could be to retain a very narrow version of the exclusion which only applies to the claims which are most likely to be truly collusive. For example, the narrowest version of this exclusion applies only to claims by or on behalf of the company (not by or on behalf of insured persons) and only if the claim is brought within the United States by or with the active assistance or participation of at least two senior executives of the company, subject to the following carve-outs (i.e., the exclusion does not apply to the following claims):

- Claims made after a change in control or bankruptcy of the company;
- Claims by or on behalf of a bankruptcy or insolvency trustee, examiner, creditors committee, etc., or an assignee thereof;
- Claims in which the senior executive's assistance and participation is protected by a whistleblower statute or is pursuant to a subpoena or similar legal process;
- Defense costs.

A few new Side A policy forms include an additional carve-out which states that the exclusion does not apply if independent legal counsel opines in writing that the failure of the company to bring the claim would likely result in liability to the insured persons for failure to

assert the claim. This type of carve-out to the exclusion should allow coverage for meritorious claims by or on behalf of the company, but should exclude collusive lawsuits brought by the company for the purpose of collecting money under the Side A policy.

5. Bodily Injury/Property Damage Exclusion. Virtually all standard directors and officers liability insurance policies exclude claims for bodily injury or property damage. Since coverage for such claims should be and typically is afforded under the company's general liability insurance program, which insures both the company and its directors and officers. Broad-form Side A policies have in the past added carve-outs to this exclusion so that the Side A policy covers claims by securities holders and claims for emotional distress or mental anguish. A very limited number of Side A policy forms historically also included a carve-out to this exclusion for pollution claims. At least one of those policy forms now also includes carve-outs for claims relating to climate change, as well as claims against outside directors.

Some of the newer Side A policy forms delete the bodily injury/property damage exclusion in its entirety. However, this expansion of coverage arguably is not in the interests of the insured persons since the absence of such an exclusion may allow a company's general liability insurer to shift losses which are otherwise covered under the general liability program to the Side A policy, thereby unnecessarily diluting the Side A limit of liability.

6. Conduct Exclusions. Like all D&O policies, Side A policies continue to exclude coverage for claims arising out of deliberately fraudulent conduct, willful violations of law, or receipt of illegal personal profit or remuneration. Although a few new Side A policy forms purport to delete the "Exclusions" section of the policy in its entirety, even those policies do not cover this type of egregious wrongdoing by adding the conduct exclusions to the definition of Loss.

Historically, the main issue for debate under the conduct exclusions has been what events will trigger the exclusions. Insureds frequently seek a provision which states that the exclusions apply only if a final adjudication adverse to the insureds establish that the referenced conduct actually was committed by the respective insured person. However, because D&O claims almost always are settled without such a final adjudication, that type of exclusion trigger effectively eliminates the exclusion in virtually all claims and allows a truly "black hat" insured person to dilute or exhaust the Side A policy limits to the detriment of the "white hat" insured persons. To avoid that unfair result, some Side A policies have in the past stated that the conduct exclusions apply if either a final adjudication or a guilty plea (or perhaps a written admission under oath) by the insured persons establishes that the insured person actually committed the excluded conduct. Some insureds resist that broader trigger language for fear that the exclusion will inadvertently be triggered in instances where coverage in fact was intended and is desired by the insureds.

In order to create a more balanced approach which addresses the legitimate concerns of the Side A insurers and the insured persons, at least one new Side A policy now states that the conduct exclusions apply if either of the following occur:

- A final adjudication in any proceeding, other than a proceeding initiated by the insurer, establishes the respective insured person actually committed the referenced conduct; or

- The respective insured person admits to committing the referenced conduct in a guilty plea or other written admission under oath, provided that the exclusion does not apply based upon such a guilty plea or written admission if a majority of disinterested directors of the parent company elect to waive the applicability of the exclusion with respect to the insured person.

This type of narrow exclusion trigger should give insured persons greater comfort that their coverage will not be diluted by a true “black hat” insured person and that their coverage will not be inadvertently excluded if coverage appears appropriate under the circumstances.

7. Claim. Coverage under D&O insurance policies traditionally applies only to “claims” made against insured persons for Wrongful Acts committed by the insured persons. If a non-defendant director or officer incurs legal costs or other loss as the result of being interviewed or deposed by regulators or plaintiffs, coverage for that director and officer typically would exist only if the interview or deposition was part of an investigation of the director or officer and if the director or officer is an identified target against whom a claim may be made in the future. Costs incurred by a director and officer purely in his or her capacity as a fact witness, as opposed to a defendant or potential defendant, typically is not covered under a D&O policy.

Some of the new Side A policy forms now extend coverage to an insured person who is interviewed or deposed merely as a fact witness. Although the amount of costs incurred by an insured person as a fact witness is not likely to be large, those costs may not be indemnifiable by the company and almost certainly will not be covered by the underlying D&O insurance program. As a result, this enhancement of coverage in the Side A policy can be valuable and will probably result in the Side A policy dropping down to provide coverage for those costs on a primary basis without any retention.

8. ERISA Fiduciary Coverage. D&O policies traditionally do not cover loss incurred by directors and officers in their capacity as ERISA fiduciaries because D&O policies traditionally include an ERISA exclusion and because the definition of Wrongful Act typically does not include conduct by directors and officers in their capacity as an ERISA fiduciary. Broad Side A policies historically have not included an ERISA exclusion, but like other D&O policies, traditionally cover only wrongdoing by insured persons in their capacity as directors or officers, not as ERISA fiduciaries.

A few new Side A policy forms expressly include coverage for claims against insured persons in their capacity as ERISA fiduciaries. This ERISA fiduciary coverage arguably dilutes the Side A limits of liability unnecessarily since such coverage is otherwise available under the company’s fiduciary liability insurance program. Because indemnification for ERISA fiduciaries is far less certain than indemnification for directors and officers, this express coverage for ERISA fiduciaries could trigger coverage under the Side A policy more frequently than the traditional director and officer coverage, and therefore the risk of unnecessary limit dilution by reason of this coverage is very real.

9. For-Profit Outside Position Coverage. Side A policies traditionally have afforded blanket coverage for insured persons serving at the request of the company as directors or officers of outside non-profit organizations. This blanket non-profit outside position coverage is

“triple excess” (i.e., the coverage is excess of any indemnification and insurance available from the outside entity, as well as any indemnification from the company.) Some new Side A policy forms extend this blanket outside position coverage to service as a director or officer of any for-profit outside entity, provided such service is at the request of the company. If not properly managed by the company, this coverage could result in an unintended dilution or exhaustion of the Side A limits of liability if an insured person serves at the request of the company as a director or officer of a large publicly-held company which is the target of shareholder class action or other significant litigation. To protect against such unintended dilution of the Side A limits, this for-profit outside position coverage could be limited only to private for-profit companies (unless the publicly-held for-profit outside entity is specifically scheduled in the Side A policy) or limited only to directors or senior executive officers of the company serving the outside for-profit entity.

10. Follow Form Coverage. A few new Side A policy forms purport to provide a coverage enhancement by stating that the Side A policy follows form to most of the provisions in the underlying D&O insurance program. However, such broad follow-form coverage actually limits the scope of coverage which can be afforded under an extremely broad Side A policy, since one of the principle benefits of purchasing a Side A excess DIC policy is to obtain much broader coverage than available in the underlying D&O insurance program. Stated differently, if the Side A excess policy affords follow-form coverage, the value of the DIC coverage within that Side A policy is greatly reduced.

The broadest Side A policy forms are “self-contained” (i.e., contain all of the applicable coverage terms and conditions without reference to the underlying policies). A few of these self-contained broad Side A policies contain a follow-form provision which applies only to the extent an underlying policy affords broader coverage than the self-contained terms and conditions of the Side A policy. In other words, the follow-form provision should be structured to only expand, not restrict, coverage under the Side A policy.

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The current Side A insurance market allows insureds to obtain remarkably broad and protective coverage for non-indemnified losses incurred by directors and officers. More than any time in the past, insureds can tailor the terms and structure of their Side A insurance program to meet the unique preferences of each company. However, in determining what are the preferred coverage terms, it is more important than ever that insureds carefully consider the consequences of various perceived “enhancements” and determine whether those consequences are consistent with the goals of the insureds. Use of a highly knowledgeable D&O insurance broker or other professional is essential in that process since many of these consequences are not readily apparent, as highlighted above. The good news for insured persons, though, is that unprecedented Side A insurance protection is now readily available for most companies at an economical cost.