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**SIDE-A ONLY D&O INSURANCE**

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*The material in this outline is not intended to provide legal advise as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.*

A. Need for “Clause A” D&O Insurance

The perceived need for “Clause A” D&O insurance (i.e., insurance for non-indemnifiable loss) is based upon the premise that financial protection through an applicable state indemnification statute may be inadequate. Historically, the primary areas in which indemnification has been deemed inadequate to provide sufficient protection are as follows:

1. The ability to indemnify for derivative suit judgments or settlements is severely limited or prohibited by most state indemnification statutes. The Delaware statute does not authorize indemnification of settlements or judgments in suits brought by or on behalf of the corporation (including derivative suits). This limitation is intended to avoid the circularity which would result if funds received by the corporation were simply returned to the person who paid them.
  - a. D&O insurance policies typically provide coverage for derivative suit settlements or judgments, subject to various “conduct” exclusions.
  - b. A few states amended their indemnification statutes in the late 1980s to limit or eliminate this indemnification restriction, at least under certain circumstances. See, e.g., Indiana Code § 23-1-37; New York Bus. Corp. Law § 722.
2. Indemnification against claims under the registration and anti-fraud provisions of the federal securities laws may be precluded by public policy or by preemption. The SEC’s long-standing view is that such indemnification is against public policy and unenforceable. See 17 C.F.R. §§ 229.510 and 229.512(i). That position has received some judicial support. See, e.g., *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2nd Cir. 1969), cert. denied, 397 U.S. 913 (1970); *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101 (4th Cir. 1989); *First Golden Bancorporation v. Weiszman*, 942 F.2d 726 (10th Cir. 1991); *Eichenhotlz v. Brennan*, 1995 U.S. App. LEXIS 6134 (3d Cir. 1995); *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946 (S.D.N.Y. 1975); *Ades v. Deloitte & Touche*, 1993 U.S. Dist. LEXIS 12901 (S.D.N.Y., Sept. 17, 1993). However, a settlement of federal securities law claims may be indemnified. *Raychem Corp. v. Federal Insurance Co.*, 853 F. Supp. 1170 (N.D. Cal. 1994).
  - a. The SEC does not regard the maintenance of D&O insurance to be contrary to public policy, even where the corporation pays the premium for such insurance. See 17 C.F.R. § 230.461(c).
  - b. Public policy may limit indemnification under other federal statutes (e.g., RICO anti-trust laws) where Congress intended personal liability as a deterrent. See, *Sequa Corporation v. Gelmin*, 851 F. Supp. 106 (S.D.N.Y., 1993) (indemnification for RICO liability prohibited as against public policy). Also, Congress expressly prohibited indemnification of individuals adjudged liable under the Foreign Corrupt Practices Act of 1977. 15 U.S.C. § 78ff(c)(3) and § 78dd-3(e)(4). Public policy may also

prohibit indemnification for liability based on failure to pay payroll taxes. Plato v. State Bank of Alcester, No. 19580 (S.D., Nov. 6, 1996). However, neither Congress nor public policy prohibits indemnification for liability under CERCLA. See, 42 U.S.C. § 9607(e); Witco Corp. v. Beekhus, 38 F.3d 682 (3d Cir. 1994); U.S. v. Lowe, 29 F.3d 1005 (5th Cir. 1994).

- c. D&O insurance policies typically provide coverage for certain securities and other federal law claims, subject to various “conduct” exclusions.
3. No indemnification is permitted unless certain standards set forth in the applicable indemnification statute are satisfied and a determination thereof is made by the designated person or body. The Delaware statute requires the director or officer who seeks to be indemnified to have acted in good faith and in the reasonable belief that his actions were in, or at least not opposed to, the best interests of the corporation. A determination whether indemnification is proper in a given circumstance is to be made by the disinterested members of the board, by special counsel appointed by the board, by shareholders, or by a court.
    - a. D&O insurance may provide protection for acts which do not satisfy the “good faith” and “reasonable belief” standards, so long as the insurance coverage does not otherwise violate public policy.
    - b. D&O insurance may provide protection for a director or officer when the incumbent board chooses, for whatever reason, not to make the required determination and further refuses to submit the question to special counsel or the shareholders. This circumstance is apt to arise, for example, in the aftermath of a hostile takeover.
  4. The corporation may be financially unable to fund the indemnification, either because it is insolvent or because of cash flow restraints. The recent explosion in D&O defense costs and settlement severity has resulted in an environment today in which even corporations that are financially healthy may be challenged to fund some large D&O losses. When evaluating this risk, one should consider the financial strength not only of the parent company, but also each of its direct and indirect subsidiaries since the D&Os of a subsidiary may have indemnification rights only against the subsidiary, not the parent company. Also, because the ability to indemnify is determined when the loss is incurred, one must predict the financial condition of a company for this purpose over the next 5-6 years, since it frequently takes that long for a newly filed lawsuit to be settled.
    - a. Subject to the coverage limitations and exclusions, a D&O insurance policy ensures that adequate resources will be available to fund the defense of the corporate managers and any settlement or judgment incurred by them.
    - b. Establishing a trust fund to pay the company’s indemnification obligations is not an adequate substitute for D&O insurance since creditors or a

receiver may be able to repudiate the establishment of the fund or otherwise attach fund assets. Gibson v. RTC, 1995 U.S. App. LEXIS 10469 (11th Cir. 1995).

5. Either the applicable law or the corporation's articles of incorporation or code of regulations may be modified to reduce or eliminate indemnification for directors or officers. Because protection is probably determined by the indemnification provision in effect at the time the indemnification is sought, rather than when the act giving rise to the claim occurred, such subsequent modification may reduce or eliminate protection otherwise expected by directors or officers.
  - a. A D&O insurance policy cannot be unilaterally changed to reduce or eliminate coverage.
6. Unique regulations applicable to certain types of financial institutions also limit the ability to indemnify directors and officers. See, e.g., 12 C.F.R. §7.5217; 12 C.F.R. §545.121.

#### B. Benefits of Side-A Only D&O Coverage

A typical D&O Insurance Policy which affords both Side-A coverage for non-indemnified loss and Side-B coverage for indemnified loss is perceived by many to adequately respond to these non-indemnifiable exposures. However, under certain circumstances such a typical D&O Insurance Policy may not afford the desirable protection for the D&Os. In order to avoid that risk of inadequate D&O coverage, Companies should consider purchasing a Side-A only DIC Policy excess of its standard D&O insurance program. The following discussion identifies several areas where a D&O policy affording only Side-A coverage can provide greater protection to D&Os than a typical D&O insurance policy.

##### 1. No Limit of Liability Dilution

The limits of liability under a Side-A only policy are available to fund only non-indemnifiable loss incurred by the D&Os. In contrast, the limits of liability under a traditional Side A/B/C policy are also available to fund indemnifiable loss and corporate losses in a securities claim. In other words, D&Os can lose their personal protection under a traditional Side A/B/C policy if the corporation incurs significant covered losses. That risk does not exist under a Side-A only policy.

##### 2. Broader Coverage

Despite the typically huge difference between the resources and insurance needs of the Company and the individual D&Os, traditional D&O Insurance Policies afford essentially the same coverage for D&Os under Side-A and for the Company under Side-B of the Policy. Only the amount of the Retention and perhaps the applicability of a couple of exclusions will vary depending upon whether the loss is indemnifiable by the Company. Because loss under the Side-B coverage is far more frequent and generally far more severe, the scope of coverage afforded

under a traditional D&O Policy is crafted by the Insurers primarily with a view towards creating a reasonable underwriting response to a Company's D&O indemnification exposures.

Since the vast majority of Claims covered under a D&O Policy are indemnified by the Company, a Side-A only D&O Policy allows Insurers to afford much broader coverage terms than reasonably possible under a Side-B policy. For example, the following summarizes some of the features in the CODA Side-A Policy form that provide broader coverage protection than the typical D&O insurance policy form:

a. Scope of Coverage

- No presumptive indemnification (coverage applies without any deductible if the Company rightly or wrongly refuses, or is financially unable, to indemnify);
- Broad definition of "Insureds" (includes not only directors and officers, but also (i) LLC managers, in-house general counsel, comptroller, risk manager and their functional equivalent in a foreign Company, and (ii) non-officer employees while co-defendants in a Claim with D&Os);
- Broad definition of "Loss" (expressly includes exemplary, punitive and multiple damages, which are more likely to be insurable because the Policy is issued and construed in Bermuda);

b. Exclusions

- No express exclusions regarding:
  - ERISA,
  - Section 16(b) of the Securities Exchange Act of 1934,
  - pollution,
  - prior litigation, or
  - defamation or other personal injury;
- Narrow "personal profit" and "remuneration" exclusions:
  - not applicable to Defense Costs,
  - not applicable to illegal "advantage,"
  - applies only if adjudication or if illegal remuneration is repaid in settlement;

- Narrow “dishonesty” exclusion:
  - not applicable to Defense Costs,
  - applies only if adjudication of active and deliberate dishonesty committed with actual dishonest purpose and intent;
- Narrow “bodily injury/property damage” exclusion:
  - not applicable to pollution claims;
  - not applicable to emotional distress or mental anguish;
- Narrow “insured v. insured” exclusion:
  - applies only if the Claim is (i) by or on behalf of Company, and (ii) at least two current senior executive officers approve or assist in prosecuting the Claim;
  - not applicable to Claims by Insured Persons;
  - not applicable to Claims outside US or Canada;
  - not applicable after Parent Company has change of control;
  - not applicable to Claims by bankruptcy or insolvency trustee, examiner or receiver or its assignee;
  - not applicable to Defense Costs
- Narrow “other insurance” and “prior notice” exclusions:
  - apply only to the extent Loss is actually paid under other policy;

c. Miscellaneous

- Policy may not be rescinded for any reason;
- Consent by CODA to defense counsel not required;
- Mandatory binding arbitration of any coverage dispute;
- Policy non-cancelable except for non-payment of premium;

- Notice of Claim to CODA required after in-house general counsel or risk manager of Company first learns of Claim;
- Protective bankruptcy provisions:
  - Policy not subject to automatic stay under bankruptcy law;
  - Policy proceeds first applied toward pre-bankruptcy Wrongful Acts
- Broad Difference-in-Conditions drop-down feature if CODA Policy is excess:
  - DIC applies if Underlying Insurance wrongfully denies coverage, excludes coverage, is financially unable to pay, rescinds coverage or is subject to bankruptcy stay.

### 3. Financial Inability to Indemnity

If the Company becomes subject to a bankruptcy proceeding, the Company will likely be unable to fund its D&O indemnification obligation. In that circumstance, Side-A coverage will be the only financial protection available to the D&Os. If that coverage is unavailable, the personal assets of the D&Os will be at risk. An issue will likely arise in the context of the bankruptcy proceeding as to whether the D&O Policy is an asset of the bankruptcy estate. If it is, the automatic stay applicable to all assets of the bankruptcy estate will effectively freeze the policy and may preclude the D&Os from accessing the policy's proceeds.

Courts have disagreed as to whether a typical two-part D&O Insurance Policy constitutes an asset of the bankruptcy estate. Some courts have concluded the Policy is such an asset since the Policy affords coverage for the Company's D&O indemnification obligation. Although other courts have either ruled that the D&O Policy is not an asset of the estate or have ruled that the proceeds of the D&O Policy (as distinct from the Policy itself) are not assets of the estate, it is unclear what result will occur in any particular bankruptcy proceeding. This uncertainty is exacerbated if the D&O Policy also affords securities entity coverage since insurance policies that afford coverage for claims against the Company are typically considered by courts as assets of the bankruptcy estate.

In other words, under a typical D&O Insurance Policy, it is uncertain whether D&Os will have access to the Policy proceeds in the event of the Company's bankruptcy. However, that uncertainty is virtually eliminated under a Side-A only Policy since the Company is not an insured under that type of Policy, either with respect to its D&O indemnification obligation or with respect to securities claims against the Company. Stated differently, a Side-A only Policy can afford more predictable and potentially more protective coverage for D&Os in the event of the Company's bankruptcy.

#### 4. Derivative Settlements/Judgments

Shareholder derivative lawsuits can be filed either in tandem with a shareholder class action lawsuit or as an isolated lawsuit. A typical two-part D&O Insurance Policy will respond to a settlement or judgment in either type of lawsuit, provided that the class action lawsuit (or any other Claim in the same Policy Period) does not exhaust the available limit of liability before the potentially non-indemnifiable derivative lawsuit settlement is paid. Because tandem class action and derivative lawsuits are frequently settled at the same time, prior exhaustion of the limit of liability is typically not a problem.

However, there is now a somewhat greater tendency to settle the larger class action lawsuit quickly, even if, for whatever reason, the tandem derivative lawsuit cannot be settled at the same time. For example, in one recent case, a company elected to settle a securities class action within a few months after its filing for more than \$100 million (thereby exhausting the D&O Policy's limit of liability) even though the tandem derivative lawsuit could not then be settled for a reasonable amount. Approximately 18 months later, the tandem derivative lawsuit was settled for approximately \$15 million. Fortunately for the D&Os, the company maintained an excess Side-A only D&O policy, which was not implicated in the indemnifiable class action settlement and therefore was available to fund the non-indemnifiable derivative settlement.

In those types of situations where the Company wants to settle a large class action but cannot yet settle the tandem derivative lawsuit for a reasonable amount, the Insureds are faced with a difficult dilemma under a standard two-part D&O insurance program. On the one hand, the Insureds can use the proceeds from the D&O insurance program to fund the class action settlement, thereby creating potentially significant benefits to the Company by eliminating the risks, distractions and adverse publicity associated with such a potentially catastrophic claim. However, such a strategy may leave the defendant D&Os with inadequate insurance protection for a subsequent non-indemnifiable derivative settlement. On the other hand, the Insureds can preserve the D&O insurance proceeds for a subsequent derivative settlement. However, such a strategy would deprive the Company of a large source of funds to pay the early class action settlement.

Many standard D&O insurance policies with securities entity coverage now contain a Priority of Payment provision which, depending on its language, usually mandates that all proceeds under the Policy be maintained for the non-indemnifiable derivative settlement, regardless of the size of the D&O insurance program, the amount of the class settlement or the likely amount of the subsequent derivative settlement. Thus, if the Company desires or is compelled to settle the class action early, it must fund the entire settlement amount out of its own assets and seek reimbursement under the D&O Insurance Policy for the covered Loss at some unknown subsequent date when the derivative lawsuit is settled. As demonstrated by the case described above, this result can require the Company to advance tens of millions of dollars, if not hundreds of millions of dollars, to resolve the class action, even though much or all of such a settlement is otherwise covered under the untapped D&O insurance program.

From the perspective of the defendant D&Os, this dilemma is especially frightening. If the current Company management is not sympathetic to the defendant D&Os, the Company may

choose to access the D&O insurance program to fund the indemnifiable class action, thereby leaving the defendant D&Os with little or no insurance to settle the subsequent non-indemnifiable derivative lawsuit. Although the defendant D&Os would likely object to that use of the Policy, at best a difficult controversy will exist which will create uncertainty as to the extent of the defendant D&Os' financial protection under the Policy.

These problems can be greatly mitigated, if not eliminated, by the purchase of Side-A only DIC coverage excess of the Company's standard D&O insurance program. Such excess coverage assures the existence of insurance protection for non-indemnifiable claims against D&Os even if the rest of the D&O insurance program has been exhausted by indemnifiable or entity losses. In addition, such coverage may allow for deletion of the Priority of Payment provision in the underlying D&O policies, thereby enabling the Company to access the underlying D&O insurance proceeds for an early settlement of the class action even if the tandem derivative lawsuit is not settled at the same time. Obviously, the larger the limits for this Side-A only coverage, the greater the likelihood that this type of insurance program structure will accomplish the goals of both the Company and the insured D&Os.

## SAMPLE CODA CLAIM PAYMENTS

The following briefly summarizes some of the types of D&O claims in which CODA has paid losses. This summary is not an exhaustive list of all CODA losses or potential types of covered claims. CODA's liability with respect to any claim is subject to the terms and conditions of the applicable policy and the circumstances of the particular claim.

### A. SHAREHOLDER DERIVATIVE LAWSUITS

1. A \$22 million payment by CODA in settlement of a shareholder derivative lawsuit arising out of the insured company's failure to timely complete development of a new product. A related shareholder class action lawsuit was settled for \$55 million, which was fully indemnified by the insured company.
2. A \$10 million payment by CODA in settlement of a shareholder derivative lawsuit involving the acquisition of the insured company by a third party. Although the CODA coverage was a high level excess policy, the underlying coverage was depleted by a \$72.5 million settlement in shareholder class action litigation relating to disclosures involving the acquisition, leaving the non-indemnifiable derivative lawsuit settlement for payment under the CODA policy.
3. A \$7 million payment by CODA as part of a \$33 million settlement in shareholder derivative litigation in connection with alleged illegal activity by officers and employees of the insured company.

### B. DIC COVERAGE

1. A \$3 million payment by CODA under a CODA excess DIC policy which was excess of \$90 million of underlying insurance. The settled lawsuit involved claims of wrongdoing by D&Os of an investment advisor subsidiary of the insured company. All of the underlying policies, unlike the CODA policy, contained a broad investment advisor exclusion, thus causing the CODA coverage to drop down and become primary. The settlement amount was not indemnifiable because the defendants' conduct did not satisfy the requisite indemnification standard, but was covered under the CODA policy because the dishonesty exclusion was not applicable.
2. A \$8.25 million settlement payment by CODA under a CODA excess DIC policy. The underlying insurance policies excluded the settled lawsuit by reason of the insured v. insured exclusion, although the CODA exclusion did not apply. The settlement amount was not indemnifiable because the company filed bankruptcy.

C. FINANCIAL INSOLVENCY

1. A \$47 million payment by CODA in settlement of more than 180 different lawsuits alleging a wide variety of wrongdoing by D&Os of a company which eventually filed for bankruptcy. The CODA payments were in addition to approximately \$50 million of payments from other insurers and payments by individual D&Os well in excess of \$100 million.
2. A \$10 million payment by CODA in settlement of various claims which alleged wrongdoing by D&Os prior to the bankruptcy of the insured company.