POLICY EVOLUTION

The ABCs of D&O Insurance Clauses

Problems continue to exist from coverage innovations of the mid-1990s

BY PETER R. TAFFAE

THERE HAS BEEN A PROLIFERATION of Side-A-only insurance forms to cover directors and officers in recent years, but few know the history of the underlying coverage of the full D&O policy—a policy now more than seven decades old.

The first ever D&O policy came out of Lloyd's of London in the late 1930s. Even after the depression, the directors and officers did not see a great need for this insurance and the coverage did not sell well. Companies were not permitted to indemnify their directors or officers at the time.

In the 1940s and 50s, corporations began to see the advantages to corporate indemnification, thus prompting state legislatures to pass laws that permitted corporations' by-laws to be amended by adding indemnification provisions. The courts upheld these changes.

The 1960s brought an onslaught of mergers and acquisitions. This period has been referred to as "conglomerate merger mania period," and the mergers resulted in litigation against the corporation and its directors and officers. This litigation, in turn, resulted in court interpretation of the securities laws—interpretations giving rise to the real possibility that boards of directors and officers of corporations could have personal liability exposure.

EASY AS A-B-C

WHAT ARE D&O'S BUILDING BLOCKS?

The D&O coverage parts are:

- **Side A**, which protects a corporation's directors and officers when the company can not indemnify the individuals.
- **Side B**, which is designed to reimburse the organization when it indemnifies the individuals, thereby protecting the company's balance sheet.
- **Side C**, also known as entity coverage. introduced to eliminate disputes of coverage allocation when both directors and officers and the insured organization itself are named as co-defendants in securities lawsuits.

As a result of these events, the "original" D&O policy now had the opportunity not only to protect the legal entity's balance sheet but also the personal liability of individuals.

The "newly improved" D&O liability policy (circa 1960s) was actually two policies usually stapled together, each word for word the same except each had its own insuring clauses.

Insuring Clause 1, or Side A as it later became known, provided personal financial protection to the corporation's directors and officers when the company could not indemnify the individuals. This was usually in the case of bankruptcy or the filing of a derivative suit.

(Editor's Note: Derivative suits are suits brought by shareholders on behalf of the company, naming directors and officers as defendants. Statutory prohibitions against indemnification of derivative suits exist in many states.)

Insuring Agreement B, or Side B, reimburses a corporation for its loss when the corporation indemnifies its directors and officers for claims against them.

Side B does not provide coverage for the corporation for its own liability. This insuring agreement protects the company's balance sheet, and in this respect is no different from a property policy, which also similarly provides balance sheet protection.

By the mid-eighties, all insurers except INAPro had changed to the current one policy with multi-insuring clauses format. (INA was the Insurance Company of North America, which later merged with Connecticut General to form CIGNA)

In the late 1980s, insurance companies—in the interest of becoming more efficient— started to issue one D&O policy with the two insuring clauses. Chubb took advantage of merging the two policies together to allocate certain policy exclusions to the particular insuring clause, thus in many ways enhancing the coverage. At the time, this was very innovative and later became the standard we have today.

THE POLICY EVOLVES

The development of the Side-A coverage of the D&O policy has a number of milestones and enforces how the D&O policy has matured over the years, reminding us of how the policy has had to adapt to both the litigation environment and human nature over the last

"Although D&O policies across the industry might share similar 'skeletons,' each insurer's D&O policy has a different heart, soul and skin. With the right guidance, this aspect of D&O coverage can provide substantial coverage positives to the directors and officers."

Peter R. Taffae

70-plus years.

An excellent example that demonstrates the evolution of ever-ameliorating D&O policy is the addition of the "presumptive indemnification" clause.

In the mid 1980s, a New York Stock Exchange-listed pharmaceutical company based in Philadelphia had accepted a Side-B/corporate reimbursement retention of $5 million. The hard market of 1985 mandated that Fortune 500 firms would have corporate reimbursement retentions ranging anywhere from $2.5 million to $5 million.

Shortly after the pharmaceutical company's renewal, the directors and officers became defendants in a class-action securities lawsuit. Because the policy was silent on when the individual side of the policy, Side A, would respond, and when the corporate reimbursement, Side B, would respond, the pharmaceutical's legal department "creatively" reasoned that if the company just decided not to indemnify the directors and officers, the claim would shift from Side B—with a $5 million retention—to Side A. At the time, most underwriters applied a $1,000 per individual and a $5,000 aggregate retention to the individuals protected under Side A.

The policy wording on when a loss would be paid under Side A versus Side B was so vague that by just declining to indemnify, the directors and officers shifted what normally would be a Side-B claim to Side A.

As the policy did not define the term "non-indemnification," the underwriter at the time handled the claim under Side A, thus supplanting the $5 million retention with a $5,000 one, even though $5 million is what was originally anticipated for this type of claims situation when the policy was written.

Almost immediately, the underwriting community responded by endorsing all D&O policies with a "presumptive indemnification" endorsement that stated that Side A would only apply when the insured organization could not legally indemnify directors and officers (as in the case of derivative litigation) or financially indemnify (as in a bankruptcy situation) indemnify, thus eliminating the insured organization's ability to just refuse to indemnify. Today, this clause is built into the policy.

For clarification, Side A then and now only protects the individuals. Side B is designed to reimburse the organization when it indemnifies the individuals, thus protecting the company's balance sheet.

Both Side A and B provide personal/individual protection. The term "corporate reimbursement" used to describe Side B is confusing and can be misleading. The legal entity is NOT an insured under an A&B D&O policy.

SIDE C INTRODUCED

For decades, the D&O policy had only two insuring clauses and with rare exceptions the claims process was fraught with arguments because the insured organization (company) was often named as a co-defendant along with the directors and officers when lawsuits were filed. This is frequent in securities class action litigation.

Because the intent of the D&O insurance has always been that of an "individual protection" policy (unlike the general liability policy), the insurance company and the insureds were at odds when trying to determine a fair allocation of defenses costs and any settlement. Frequently, this led to litigation between the company and D&O underwriters.

It was not until the now famous *Nordstrom vs. Chubb* decision in 1995 that insurers were forced to address this historical allocation dilemma.

The U.S. 9th Circuit Court of Appeals in *Nordstrom* determined that a means of differentiating the liability between directors, officers and the legal entity did not exist in securities litigation, and that Chubb was on the hook for paying the entire settlement of a securities case that named both the directors and officers and the company as defendants.

The initial underwriting community response was to establish a predetermined allocation between the individuals and legal entity at the inception of the policy. The percentages ranged from 70 percent to 100 percent, and the policies were supposed to be priced accordingly.

There was initially a cost involved, and the coverage was endorsed to the policy via a Predetermined Allocation endorsement.

As a result of competition, this lasted less than a year, and 100 percent became the norm with no increase in premium. As the insurance industry revised and introduced newer versions of their D&O policies, the Predetermined Allocation endorsement soon became SEC Entity coverage, also known as Side C.

By adding Side C, the insurance industry solved one problem while creating others, which to this day have not been resolved.

The first problem is that the substantial increase in exposure (due to adding the entity as an insured) did not affect the pricing. Now, for the first time, insurance companies were insuring the legal entity (although only in securities litigation) and the directors/officers. Some estimate that by adding Side C, the risk to underwriters increased fivefold.

Second, most insureds continue to purchase the same limit of liability. Many broker experts believe that by adding Side C, the individuals' protection actually substantially decreased because now the limit of liability will be greatly diluted since it is shared with the legal entity.

This is an excellent reason to secure standalone Side-A coverage, and it has contributed to the increased interest in this standalone coverage in recent years.

MONOLINE SIDE-A POLICIES: THE NEW GENERATION

Although theoretically available prior to 1986, it was not until the creation of Corporate Officers Directors Assurance (CODA) that monoline Side-A policies became commercially available.

The attraction to Side A has evolved over the last 20-plus years. Initially it was created to address the lack of affordable and available coverage for Fortune 500 companies during the hard market of 1985. Lately, renewed interest has been fueled by several factors, including the high defense costs associated with securities litigation, the large number of corporate bankruptcies and insider versus outsider allegations of fraud.

Executive Risk Management Associates (the underwriting manager for Executive Risk, which was acquired by

Chubb in 1999) introduced a by-product of the standalone Side A policy, called IDL, or the Independent Director Liability policy. The IDL policy introduced in the late 1990s got off to a slow start; however, in the last five years it has taken Side A to the next level by furthering expanding the financial protection for the independent director constituency.

The needs of independent (non- employee) directors became very evident during the litigation of companies like Enron, WorldCom, HealthSouth earlier in this decade. During the litigation of these and other companies, we were reminded of the specific and unique duties, responsibilities and exposures of inside officers/directors and outside/independent directors. Sometimes we refer to the separation by referring to the guilty as "black hats" and innocent as "white hats."

Keep in mind the D&O policy limit of liability is a depreciating asset and does not discriminate in its burn rate. Thus first to spend is first to be defended.

Layering a program with A-B-C, followed with Side A, topped with IDL is considered today's state-of-the-art architecture. (See related article, page 28, for more on this layering approach.)

With that said, please take note that there is no standard or generic A-B-C, Side A and IDL policy language. Each underwriter has its own propriety products with unique terms, conditions and exclusions.

Today's D&O policies have come a long way since the 1960s, and the insuring clauses are only one example how the industry has responded to the ever-changing environment over the years.

For many people who have not worked with the D&O policy to a great extent, it is uniquely different from other insurance policies which are based on ISO forms (crafted by the Insurance Services Office.)

In the absence of ISO forms, although D&O policies across the industry might share similar "skeletons," each insurance company's D&O policy has a different heart, soul and skin. With the right expertise, this aspect of D&O coverage can provide substantial opportunities to be creative and enhance the coverage for the directors and officers. Alternatively, without the right guidance, if the D&O purchasing process is treated with a generic commodity approach, it can lead to great problems. NU

Reprinted with permission from National Underwriter P&C. ©2008 The National Underwriter Company. All rights reserved.