Side A D&O

Why company directors need this coverage

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After the directors and officers of failed corporate giants Enron and Worldcom were forced to contribute to class action settlements from their own assets, board members everywhere woke up to the fact that traditional directors and officers liability (D&O) insurance policies could leave them unprotected in certain situations. In response, insurers introduced a new type of D&O policy called a Side A policy. Side A policies respond when a company cannot indemnify its directors and officers for lawsuit expenses and settlements and, for any of a variety of reasons, coverage is not available under traditional D&O policies. Side A coverage is now routinely purchased by large public corporations for their directors and officers, but board members of smaller public companies, private companies and even non-profit entities also could benefit from the additional protection provided by these policies.

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When a director is sued, he or she usually is indemnified by the company for the cost of defending the suit and any settlements. If the company cannot indemnify the director, then D&O insurance should step in. But under some circumstances, for example, if a company is bankrupt and coverage under the conventional D&O policy has been exhausted by payments to other defendants, a director's personal assets may be exposed to defense costs and settlements. In litigation involving bankrupt shoe retailer Just For Feet, to cite one example, the D&O policies were essentially exhausted by the settlement of claims against the officer defendants, leaving the director defendants uninsured for related claims by the bankruptcy trustee. Another scenario is the settlement of a derivative action – a suit brought by shareholders on behalf of the company – which, under the laws of most states, cannot be indemnified by the company.

Directors of large public companies increasingly require Side A coverage as a condition of serving on boards. However, directors of smaller public companies, private companies and even non-profit entities have many of the same exposures. In fact, under some circumstances these directors may be even more exposed than their large company counterparts.

D&O basics

The standard D&O policy provides three types of coverage, known as Side A, Side B and Side C. Side C is coverage for the company when it is named, typically along with its directors, in certain types of lawsuits. Side B reimburses the company for indemnification paid to directors and officers for defense costs and settlements. Side A pays the directors and officers directly for defense costs and settlements if the company is unable to indemnify them.

Under most circumstances, the traditional three-part D&O policy, along with director indemnification agreements found in bylaws or articles of incorporation, provides adequate protection for directors. However, combining Side A coverage – D&O protection for the directors and officers themselves – with Side B and Side C coverage in a single policy can prove insufficient for directors and officers under some scenarios such as when losses to the company triggering recoveries under Side C erode or exhaust the limit of the D&O policy, leaving directors and officers

underinsured or, in some cases, completely uninsured. Another concern is that a D&O policy may be considered an asset of a bankrupt company, blocking recoveries by the directors and officers.

Side A policies overcome the limitations of three-part D&O policies. These policies typically are written on an excess basis, which means that they sit above traditional D&O programs and provide additional limits of liability when the underlying program has been exhausted. Side A policies will respond to situations where a company is not permitted to indemnify its directors and officers, including shareholder derivative suits, certain suits where indemnification would be against public policy, situations where applicable law or a company's articles of incorporation or bylaws prohibits indemnification, and when the company is insolvent. Since these policies protect only a company's directors and officers, losses sustained by the company itself cannot erode the policy limit and recoveries under the policy are beyond the reach of a bankruptcy court and creditors of the company.

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Side A policies usually provide "difference in conditions" (DIC) coverage, which means simply that the Side A policy has broader coverage grants and fewer exclusions than the underlying three-part policy. The Side A policies will "drop down" to provide protection when coverage is available under the Side A policy but not the underlying traditional D&O policy. Unlike traditional policies, Side A policies typically cannot be rescinded or cancelled once the premium is paid. Moreover, certain exclusions generally found in a traditional D&O policy are not included in many Side A policies. Side A policies also often provide broader coverage for insured-versus-insured claims.

A recent case dramatically highlights the value of Side A policies. In one of the largest shareholder derivative lawsuit settlements, parties to a federal derivative lawsuit agreed to settle the case for $118 million. The settlement was funded entirely by the company's D&O insurance carriers, including $40 million from Broadcom's Excess Side A insurers.

Private companies, non-profit entities and Side A D&O insurance

Side A policies are now routinely purchased for the directors and officers of large public companies. In some cases, large companies are choosing to forego traditional three-part D&O coverage altogether, relying exclusively on Side A policies. Side A policies are purchased far less frequently for directors and officers of private companies and non-profit entities, though they also are exposed to situations where their personal assets may be at risk. According to Towers Perrin's 2009 Directors and Officers Liability Survey, only one percent of private companies bought Side A policies for their directors in 2008, and only one of 343 non-profits surveyed purchased the coverage.

The types of lawsuits typically experienced by private companies and non-profits differ somewhat from those of public companies, but they can be equally ruinous if adequate D&O coverage is not in place. Public companies are often targeted by shareholders alleging nondisclosure or inadequate disclosure of financial material or

business information. Directors of private companies also are exposed to lawsuits from shareholders. With private companies, however, shareholder suits often are brought by minority shareholders alleging that controlling shareholder directors took actions that principally benefitted themselves at the expense of minority shareholders. Private company directors and officers also are exposed to lawsuits that may trigger coverage under D&O policies from employees, business partners, competitors and regulatory agencies.

Employment-related lawsuits are the most common type of D&O claim for non-profit entities. These suits often allege some manner of harassment or discrimination, or assert that one or more employees were wrongfully terminated. Other situations that may lead to a claim under a non-profit's D&O policy include failure to provide services or mismanagement of assets. Vendors, other non-profits, and even directors suing other directors also can be sources of D&O claims.

For directors of both private companies and non-profit entities, the current economic climate presents increased exposure to unindemnified losses. Commercial bankruptcies are soaring. According to federal bankruptcy court records, 21,453 companies filed for bankruptcy in the first quarter of 2010 – almost 1,000 more than the highly elevated first quarter of 2009. Non-profits rarely file for bankruptcy, but many are shutting down and filing plans of dissolution. As is the case with public companies, insolvent private companies and non-profits are at risk of drawing lawsuits and are unlikely to be able to indemnify directors and officers.

Derivative actions are less commonly filed against directors of private companies than against directors of public companies, but the incidences of suits naming the directors of private companies has been on the rise. Derivative actions are lawsuits filed by shareholders or other stakeholders on behalf of the company, alleging that the directors violated their fiduciary duties to the company and its shareholders. Derivative actions typically demand changes in corporate governance rather than monetary damages. However, settlements usually require defendant directors to pay the plaintiffs' legal expenses. Additionally, while still uncommon, both the frequency and size of monetary settlements have been increasing in recent years. In most states, companies are not permitted by law to indemnify directors for derivative action settlements or judgments, making it more likely that Side A policies will come into play.

Assure that coverage under the Side A policy will provide broad protection when the underlying policy fails to respond.

Buying Side A coverage

Insurance buyers should work closely with their brokers to be sure they are purchasing Side A policy that provides protection appropriate to their needs at an acceptable price. In particular, since D&O policies can vary substantially among insurers, brokers need to analyze the coverage offered by the insured's traditional D&O policy, and assure that coverage under the Side A policy will provide broad protection when the underlying policy fails to respond. Insurance buyers also should work closely with their brokers to decide on appropriate policy limits for the combined A/B/C and Side A program.

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