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Securities Enforcement & Litigation Alert

Dispelling the Myths of Side A Directors and Officers Insurance[1]

By Robert F. Carangelo and Paul A. Ferrillo

Almost like King Solomon's mines, there is no greater mystery in the world of Directors and Officers (D&O) insurance than that of "Side A" D&O insurance. As described by a good friend and mentor, it is like "some ethereal layer of D&O insurance that sits on top of a traditional tower of D&O insurance. Sometimes it is there. Sometimes it is not. Almost 'Houdini-like.'" Though amusing, this comment actually reflects the views of many sophisticated professionals in the D&O and securities litigation spaces. This article will serve as the legend to the "map" of Side A D&O insurance for Directors and companies to use to better understand its myths and realities, including what it covers and what it does not cover, and what type of Side A insurance is worth purchasing.

By way of background, Side A D&O insurance (also referred to as "Coverage Part A") covers non-indemnifiable (or "not indemnified," depending on the wording) Loss[2], meaning that a Company (1) cannot advance or indemnify its directors and officers under its bylaws, or (2) is financially unable to do so (such as when a company files a proceeding under Chapter 11 of the United States Bankruptcy Code).

The latter proposition is pretty simple: no money in the corporate treasury means no advancement or indemnity – and that is why Side A D&O insurance exists from "dollar one" of the D&O tower of insurance. It provides coverage for the Directors and Officers only (not the company), and most Side A policies contain some language to clarify that it is not an asset of the estate.

The former proposition is often misunderstood. For a company organized under the laws of Delaware, the settlement of a shareholder derivative action is non-indemnifiable, but defense costs associated with a shareholder derivative action *are* indemnifiable. A judgment against a Director that he or she committed "bad faith" under Delaware Law also is non-indemnifiable (and also is outside of Delaware's raincoat provisions). Most other things are indemnifiable (like the settlement of a securities class action against a solvent company), and that is why there is a lot of confusion about when the Side A policy is available (or not).

Various Side A D&O Products

Though there are some variations around the edges of each insurance policy, there are generally three different types of Side A D&O coverage.

Side A Excess D&O insurance is exactly what that phrase says. It is excess Side A coverage above the company's traditional D&O tower (which itself has Side A coverage, Side B Company Reimbursement Coverage, and Side C Corporate Entity coverage imbedded therein). It generally follows the form of the underlying primary D&O insurance policy, but again only on a Side A basis (note that not all Side A policies truly follow form and should be checked for "liberalization" endorsements). Buyers should be careful, as sometimes Side A excess D&O carriers include exclusions or restrictions in definitions or elsewhere rather than putting them up front. Companies buy traditional Side A excess D&O coverage to supplement their traditional tower of insurance by providing some "sleep insurance" in case of a corporate calamity like a restructuring, and to provide for a separate pot of insurance for the settlement of a shareholder derivative action.

Side A Excess Difference in Conditions (DIC) coverage is a little different. It is excess Side A D&O insurance, but it tends to be a bit broader, and tends to have fewer exclusions, like, for instance, the traditional "insured versus insured" exclusion or a "pollution exclusion" that are normally contained in a primary D&O policy. Side A DIC could respond when the Company itself refuses to advance or indemnify. Side A DIC coverage also can drop down and fill in gaps in a tower of insurance when an underlying carrier fails or refuses to pay for any reason under a policy, or attempts to rescind or avoid coverage. Side A DIC coverage also provides coverage if an underlying excess carrier becomes insolvent. Side A DIC coverage is not a one-trick pony, and is therefore useful to have in a company's risk management toolbox.

Independent Director Side A D&O coverage (or "IDL") is Side A excess coverage for independent directors only. It is not shared with officers, or inside directors. It thus is a separate source or pool of D&O insurance to help settle "the bad case" against the independent directors, for example, in a shareholder derivative action or a bankruptcy proceeding. Side A IDL is more commonly procured by bigger companies, which have boards generally consisting mostly of independent directors.

How Much Side A Excess Insurance Should You Buy?

This is a question that we often get asked by companies. Unfortunately, the question usually comes after it is too late:

- After the filing of a major shareholder litigation, with corresponding shareholder derivative litigation, driven by a large stock drop;
- After the commencement of a major regulatory investigation; or
- After the need arises to file for Chapter 11.

As we have counseled in prior articles (*see, e.g.*, Berkovich and Ferrillo, "Securing the Directors and Officers Liability Insurance Lifelines," available here), these are obviously the worst times to try to purchase additional Side A coverage to protect the directors and officers, mainly because: (1) carriers generally will not offer additional coverage when conditions are bleak, and (2) the cost will be prohibitive.

There is no "correct" answer as to how much Side A coverage a company should have, and in what form, because that calculation depends on many factors. But *assuming* a Company has sufficient resources to fulfill its risk management needs under ideal circumstances (and to protect its most valuable assets, *e.g.*, its people), here are some observations and guidelines based on experience gleaned from difficult situations companies have faced over the last several years:

- Many companies do not buy enough insurance to cover their most dangerous exposure: their market capitalization risk in the event a company suffers a dramatic stock drop due to "bad news," *e.g.*, a failed product, a missed quarter, or worse yet, inaccurate or fraudulent financial statements.

- There are metrics to find out what "enough" means. Some brokers use bench-marking (*i.e.*, comparing companies of the same size to see what "the other guy" buys). Others do market capitalization analyses using average settlement figures used by NERA and Cornerstone. The most sophisticated D&O brokers use both. Understand though that those metrics normally only cover "settlement costs" of securities class actions and derivative actions. In a worst-case scenario, there also could be millions of dollars in defense costs from both the litigations themselves, and from the costs of the inevitable regulatory investigations. These fees erode the limits of the traditional insurance coverage, which makes an adequate supply of Side A coverage even more important (especially for the independent directors). Lastly, another metric is simply a rule of thumb to which some companies adhere, *i.e.*, if a Company buys $200 million in traditional insurance coverage, it will allocate 1/3 of that coverage for Side A Excess coverage (in some form of product described above). We do not ascribe perfection to any particular analysis. Instead we urge consideration of all of these methods in making an adequate purchase of Side A Excess D&O insurance. Because the worst news a director needs to hear *after* learning that the company needs to restate its financial statements is that its management also did not buy enough insurance (or the right type of insurance) to cover the costs of the litigation and regulatory investigations.
- **Buy Your Side A from Experienced, Claims-Paying Carriers:** Another common (but frustrating) misconception is that all Side A carriers are alike, and that all Side A carriers pay claims. We can tell you from experience that this misconception has been the source of much frustration for public companies, their D&O insurance brokers and their securities lawyers. So how can you better understand which carriers pay claims and which do not? Sophisticated D&O brokers who have been involved with major shareholder and merger disputes often deal with numerous carriers, so they can often give very good advice. Ask other risk management professionals who they use as Side A carriers, and learn from their experience. Finally, ask your securities litigators (who often see many Side A carriers in mediations) who they prefer to see on their side of the table, and who they do not want. This is too important a question to ignore or take for granted. Experienced (paying) carriers have credibility that can make a real difference. If things are bad enough that you have to rely on Side A coverage, having a carrier that has the respect of the plaintiff bar, defense bar and mediators alike can prove invaluable. Resolving tough claims is always easier when defense counsel and the carriers work well together and trust each other. Reputation is important. A Side A claim is no place to break in an inexperienced carrier.
- **When in Doubt, Err Towards Side A DIC Coverage:** For the reasons set forth above, it is simply more useful than standard Side A Excess Coverage (without the DIC feature).
- **Buy Side A in "Big Chunks":** From a securities litigator's perspective, there is nothing more harrowing than entering into a mediation process (in the attempt to settle "a bad case") and learning that there are 15–20 D&O carriers sitting around the table with you, all of whom may have the same view as you, or, more likely, differing views as to what the underlying case is worth, and what coverage exclusions apply (or not) to the case. For a Fortune 100 company that buys a lot of D&O, that situation might not be avoidable, but we have seen multiple D&O carriers show up for much smaller companies (extending limits of $5 million to $10 million per layer). In this insurance market, it is possible to buy more than $50 million in Side A limits from the same carrier. At least one carrier offers up to $100 million in limits. Obviously, for resolving matters, fewer carriers are much better and ultimately worth the additional costs.
- **Counterparty Risk to Inexperienced A-Side Carriers:** Overlayering limits does not help mitigate counterparty exposure. Actually, it increases it. Fewer layers allow you to cherry pick your carriers. Start with claims behavior, look at surplus, solvency, and what other programs your

enterprise has with them—how much of their skin is in your game? Small specialty Side-A-only carriers have less to lose by stonewalling or foot dragging, but with only the relatively modest Side A premiums to rely on, it is easy to see how they may balk when asked to pay millions. "Go to" primary carriers that pay claims make the best Side A play—too much is at stake, and with their bigger piece of the premium pie, they have the resources to deliver. As we see it, you are far better off buying a bigger Side A tower with larger layers than risking a Tower of Babel through over-layering a smaller one. Let the DIC features do their job and offset counterparty risk.

- **Negotiate Your Side A Terms Hard:** In the current environment, the Side A D&O market is very competitive, with some carriers even agreeing to forego an "insured versus insured" exclusion (which is very important in bankruptcy settings). One carrier has gone even further. If a company buys its primary policy and its Lead Side A excess DIC policy from this carrier, it in essence "deletes" the "insured versus insured" exclusion up the whole tower of insurance. That could potentially be a huge advantage for directors and officers involved in a corporate meltdown or bankruptcy. If possible, such wording should be sought out by companies since it makes their Side A coverage more user-friendly in the event something bad happens.

We hope the above helps to decipher Side A D&O insurance. But given that judgment calls must be made in this process, it is always wise to consult not only with your securities lawyers, but also with a sophisticated D&O broker to get additional advice. This is too important an area to leave to chance.

1. Originally Published in D&O Diary on January 22, 2014.
2. For purposes of this article, the term "Loss" means defense costs, expert costs, judgments and settlements.

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Editors:

Christian Bartholomew (DC)	Bio Page	christian.bartholomew@weil.com	+1 202 682 7070
Jonathan Polkes (NY)	Bio Page	jonathan.polkes@weil.com	+1 212 310 8881

Contributing Authors:

Robert F. Carangelo (NY)	Bio Page	robert.carangelo@weil.com	+1 212 310 8499
Paul A. Ferrillo (NY)	Bio Page	paul.ferrillo@weil.com	+1 212 310 8372