

Structuring D&O Insurance Programs: To Layer or Not To Layer

As more D&O insurers and greater capacity enter the D&O insurance market, many insureds are reexamining an age-old D&O insurance issue: is it better to place an entire D&O insurance program with one (or a select few) insurers, or is it better to place a D&O insurance program with multiple insurers? In other words, should a D&O insurance program of a given size consist of a few policies with large limits of liability or numerous policies with smaller limits of liability?

Not surprisingly, there is no universal answer to this important yet complex question. With either type of program structure, insureds realize some advantages and some disadvantages. The following discussion summarizes the more important advantages to the insureds under each type of program structure. The “correct” decision for each insured company will depend upon the relative importance each company gives to these various factors.

I. Fewer and Larger Policies

- A. Minimize Gap Issues. In any D&O insurance program with more than one policy, a risk exists that a gap in coverage will arise between the layers of insurance policies within the program. That risk primarily arises in two contexts.

First, even though excess D&O insurance policies are typically “follow form,” each excess policy has at least some terms and conditions unique to that policy. Therefore, in any layered program, there may be inconsistent coverage between layers. If one layer does not cover a loss, but another more excess layer does cover the loss, a gap in coverage would exist.

Second, a coverage gap may arise if one D&O insurer in the program asserts a partial coverage defense to a claim and as a result insists upon paying less than its full limit of liability. An insurer may be unwilling to pay its full limit of liability if it has a valid basis for a partial denial of coverage.

Depending upon the terms of the excess policies, the insureds may be liable not only for the amount of the gap but also for all loss otherwise covered under policies in excess of that gap if the excess policies do not attach as a result of the gap.

This risk of creating coverage gaps is minimized by purchasing fewer rather than more D&O insurance policies within an insurance program. With each additional

layer of coverage purchased, this risk of a coverage gap increases. Excess DIC policies, which drop down and fill gaps in underlying policies to the extent the gaps are covered under the broader DIC policy, also can reduce this risk.

In addition, the risk of losing coverage for all loss in excess of the gap can be minimized through use of broad attachment language in each excess D&O policy. Many excess D&O policies provide that the excess insurer's liability attaches only after the amount of the underlying limits of liability have been exhausted by payments by the underlying insurers. A broader attachment provision, like the provision in the ACE Excess D&O Policy, provides that the excess insurer's liability attaches under the excess policy if either the underlying insurers or the insureds pay the full amount of the underlying limits. Under this broader attachment provision, the insureds would be liable only for the amount of the gap in coverage between policies and would not be liable for covered loss in excess of that gap. Absent such a broad provision, though, all remaining excess insurers may contend that liability under their policies does not attach because the underlying insurer has not paid the full amount of the underlying limit.

- B. Resolution of Coverage Issues. By including fewer but larger policies with the D&O insurance program, the insureds may facilitate the easier resolution of at least some coverage issues which may arise in the event of a claim. Several factors could contribute to that result. First, relatively small monetary disputes between the insureds and the insurer will constitute a smaller percentage of the insurer's overall exposure (i.e. a smaller percentage of the limit of liability) and therefore in some instances the insurer may be more willing to compromise the amount in dispute. Second, for coverage disputes which involve all of the layers in the program, the parties have a better likelihood of consolidating or at least coordinating the coverage dispute resolution process if fewer rather than more insurers are involved.
- C. Conflicting Claim Philosophies. Use of fewer but larger D&O policies will likely reduce the risk of conflicting claim philosophies and positions among the D&O insurers. For example, if more and smaller policies are included in the insurance program, the lower layers of coverage may realize in a particular claim that their limits of liability will eventually be exhausted and therefore their strategic claims-handling preference would be to delay payment under their policies as long as possible by encouraging further defense rather than settlement of the claim. The higher excess insurers, though, may prefer to settle the claim early, thereby reducing defense costs and unnecessary erosion of the underlying limits.

The frequency of these conflicting positions can be reduced, and a better alignment of the interests of the insureds and the insurers can frequently be attained, through use of fewer but larger policies. In that type of insurance program structure, there is less likelihood the primary policy will concede the exhaustion of its full limit of liability prior to settlement of the claim and therefore there is less likelihood the lower-level insurers will seek to

unnecessarily defend the claim simply in order to delay payment of its full limit of liability.

- D. Negotiating Leverage Over Insurer. Including fewer but larger D&O policies in the insurance program also may enable the insureds to put greater pressure on the insurer to settle a claim. Several factors could contribute to that result. First, insurance case law in many jurisdictions provide that if an insurer unreasonably refuses to settle a claim within its policy limits, the insurer may under some circumstances be liable for loss in excess of the limit of liability. Insureds frequently use the threat of such extra-contractual liability as negotiating leverage over the insurer when seeking settlement payments from the insurer. However, such threat typically exists only if the plaintiff in the underlying lawsuit makes a settlement demand within the policy's limit of liability.

If the D&O insurance program is structured with fewer but larger D&O insurance policies, there is a better chance that a settlement demand will be within the limit of liability of the primary policy, thus potentially affording this greater negotiating leverage over the insurer. Conversely, if the primary policy has a relatively small limit of liability, there is less chance that the settlement demand will be within that smaller limit of liability. In many jurisdictions, a settlement demand in excess of the primary limit of liability but within the overall D&O insurance program may not trigger this duty to settle.

Second, larger policy limits obviously involve larger premium income to the insurer and therefore a more important business relationship. An insurer may under some circumstances be more willing to accommodate an insured's discretionary underwriting or claims-handling requests in order to preserve an important business relationship.

- E. Administration. Both the underwriting and claims administration for the insureds will be less if the D&O insurance program includes fewer rather than more insurers. With each additional insurer in the program, the insureds assume greater administrative requirements to keep the insurers fully informed and to obtain the insurers' consent and agreement to various underwriting and claims matters.

In addition, maintaining fewer insurers within the insurance program may expedite some underwriting and claims decisions by the insurers. With fewer insurers, there frequently is less need to coordinate decisions among the numerous insurers. Also, because each insurer has greater amounts at risk in the program, the insurers are more likely to more closely monitor the insureds and any pending claims, thus enabling the insurers to make informed decisions quicker.

- F. Cost. Frequently, the total insurance program cost will be somewhat less if the program is structured with fewer but larger policies. In part, this savings reflects

the administration efficiencies typically associated with maintaining fewer policies.

II. More and Smaller Policies

- A. Insulation Against Underwriting Changes. Long-term relationships between insureds and an insurer help maintain a productive relationship between the parties in times of underwriting difficulty, such as changes in the insurance market or the insureds' underwriting profile. To the extent insureds increase the number of insurers with which long-term relationships are maintained, the insureds tend to insulate themselves, at least in part, if one or more insurers abandon the insurance program or seek to significantly restructure or limit the coverage. Stated differently, it is safer not to "put all your eggs in one basket" by limiting the number of long-term relationships to a select few insurers.
- B. Negotiating Firewalls with Plaintiffs. When negotiating large settlements with plaintiffs, it may be advantageous for the D&O insurance program to consist of several policies with relatively small limits of liability rather than fewer policies with larger limits. Each insurer within the insurance program will frequently want to save at least a portion of its limit of liability and therefore to the extent possible will aggressively negotiate a settlement within its limit of liability. The exhaustion of each layer of coverage serves as a resistance point to plaintiffs' negotiation for a larger settlement.

For example, experienced plaintiff's counsel realize that in order to negotiate a relatively early settlement in a case, plaintiffs frequently must provide to the defendants (including the D&O insurers) an economic incentive to settle sooner rather than later. The most effective incentive is to allow the insurers to preserve a portion of their limits of liability which are otherwise exposed in the litigation. By maintaining relatively small limits of liability, the insureds may indirectly encourage smaller settlement demands.

However, once a layer of D&O coverage is exhausted and the next layer of coverage attaches, there is a tendency for the settlement negotiations to quickly subsume a significant portion of that next layer. In other words, once a "firewall" is breached, the negotiation "fire" tends to initially spread quickly into the next layer of coverage. As a result, a D&O insurance program which is structured to maximize the potential benefits of these negotiating "firewalls" should not contain too small of limits of liability since the opposite of the desire negotiating benefit may actually be attained. Also, too small of layers dilute the effectiveness of this strategy since plaintiffs are more likely to ignore the layers and simply insist upon full policy limits from several layers where the per policy limit of liability is rather modest (e.g. less than \$5 million).

- C. Resolving Disputes. Because each insurer's exposure is less where numerous small policies are purchased, the insurers may be somewhat less inclined to "go

to the mat” on some coverage issues. Conversely, insurers with large limits of liability may have far more at stake and therefore may have a greater incentive to more aggressively pursue certain coverage defenses.

- D. Collective Efforts. The more insurers that participate in a D&O insurance program, the more insurers there are to help investigate and evaluate claims and aggressively negotiate with plaintiffs. Although in some situations the presence of numerous insurers can be a negative for the insureds, in other situations it can be a positive in that multiple insurers who all maintain a consistent and aggressive claim negotiation posture with plaintiffs can be an effective means of negotiating with plaintiffs. As a practical matter, more credibility may exist with plaintiffs or at least a settlement mediator when numerous insurers, rather than only one insurer, aggressively argues for a lower settlement. Negotiation credibility can be achieved simply through having more people say the same thing.

III. Summary

Like many issues involving D&O insurance, the question of how a D&O insurance program should best be structured encompasses many complex issues and has no clear and universally preferred answer. For large insureds, a program involving fewer insurers with larger limits of liability is frequently viewed as preferred. The perceived benefits of such a program, as outlined above, are frequently viewed as outweighing the benefits which may be attainable through a more layered program. In particular, the negotiating benefit of maintaining numerous “firewalls” is somewhat minimized for companies with large financial resources, since the amount and structure of the D&O insurance program becomes less important to plaintiffs when negotiating a settlement.

Conversely, for small companies with limited resources, a program with more layers of coverage may be more desirable since the existence and structure of the insurance program will more likely be of greater importance to the plaintiffs in negotiating a settlement. However, such a program structure may not only frustrate plaintiffs in their negotiating a settlement, but also in some instances may frustrate the insureds in their attempt to easily and quickly settle a claim. As a compromise to these conflicting yet important considerations, it may be appropriate for such companies to structure a sliding-tier program whereby the lower layers of coverage in the program are relatively modest in size and the higher layers of coverage contain much larger limits of liability. This affords the important firewall for early negotiations with plaintiffs, but also allows easier access to the excess layers for cases with catastrophic exposure.

Ultimately, the degree of mutual loyalty, trust and commitment between the insurers and the insureds will determine to a large extent the criteria which should be used to evaluate the preferred D&O insurance program structure. Because those criteria will vary among insureds, the appropriate D&O insurance program structure will also vary among insureds.

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