BAILEY | CAVALIERI

Excess Layers of D&O Insurance: Peeling the Onion

TABLE OF CONTENTS

TABLE OF CONTENTS I

A. EXCESS DIC SIDE-A POLICY 1
  1. STACKING MULTIPLE EXCESS SIDE A POLICIES 3
  2. QUOTA SHARE SIDE A PROGRAMS 4
  3. OVERLAPPING INSURERS 4
B. FOLLOW-FORM EXCESS POLICIES 5
  1. FOLLOW-FORM COVERAGE 5
  2. ATTACHMENT 5
  3. CONSENT 7
  4. QUOTA SHARE PROGRAMS 7
C. CONCLUSIONS 8

In the past, directors and officers generally recognized that their company should purchase D&O insurance, but they had little interest in the details. Besides the total amount of coverage purchased and the size of the deductible, little else was disclosed to the Board and few questions were asked. Instead, the risk manager was given wide discretion to evaluate and negotiate coverage terms that he deemed acceptable.

Those days of passive indifference by directors and officers to the details of their own insurance protection are long gone. In the aftermath of huge recent settlements, the highly-publicized personal settlement contributions by directors of Enron and WorldCom and the increasingly aggressive vigilance of institutional investors and regulators, directors today are demanding unprecedented information about the terms of their D&O insurance coverage and are becoming much more involved in both understanding the terms of coverage and demanding certain coverage enhancements. Frequently, boards now retain advisors independent from the company's insurance broker to critique their D&O insurance program and to assist in improving the protection afforded by that program.

In this environment, being an informed buyer of D&O insurance is critical. Most terms and conditions are negotiable at least to some extent. Knowing what to ask for and why is essential to obtain the highest quality coverage available. Although some coverage counsel and insurance brokers for the insureds have sufficient D&O insurance expertise to properly evaluate and negotiate important coverage terms, others do not. In any event, any professional who provides even cursory advice regarding D&O insurance programs should possess a basic understanding of key coverage variables so they can perform at least a rudimentary assessment of the insurance protection.

The following discussion briefly summarizes some of the more important excess D&O insurance policy terms which may under certain circumstances be enhanced through negotiation with the insurer. Obviously, an insurer's willingness to grant any of these enhancements depends on a number of factors, including the insureds' risk profile, the insurer's appetite for risk and the availability of additional premium. Ultimately, though, one will never know if the enhancement is available unless one asks for it.

A. Excess DIC Side-A Policy

Excess DIC Side-A policies can provide valuable additional coverage to directors and officers by affording extremely broad coverage excess of a standard A/B/C underlying D&O insurance program. Such a policy can provide several important benefits for directors and officers.

First, a Side-A policy, which only insurers directors and officers for non-indemnified loss, can provide many extraordinary coverage enhancements not available in a standard D&O insurance policy. However, there is a wide variety of Side-A policies available in the market. Only a few afford truly extraordinary coverage as opposed to simply deleting Insuring Clauses B

and C from a standard D&O policy form. For example, the broadest Side A policies contain the following coverage enhancements, among others:

- Policy non-rescindable.
- No ERISA exclusion.
- No bodily injury/property damage exclusion (or very narrow exclusion which does not apply to shareholder suits or to pollution/climate change claims).
- No pollution exclusion.
- Conduct exclusions do not apply to Defense Costs or to Independent Directors.
- No insured v. insured exclusion (or very narrow insured vs. insured exclusion which applies only if the Claim is by or on behalf of the Company and at least 2 current senior executive officers approve or assist in prosecuting the Claim; exclusion does not apply to whistleblower Claims, Defense Costs or to Claims by Insured Persons, or Claims outside U.S. or Canada, or Claims by bankruptcy or insolvency trustee or its assignee, or Claims made after Parent Company has a change of control, or if independent legal counsel opines the directors would breach their fiduciary duties by not bringing the Claim).
- No prior notice exclusion.
- Consent by Insurer to defense counsel not required.
- DIC coverage and non-indemnifiable loss coverage applies if underlying insurer or Company fails or refuses to pay for any reason (no presumptive indemnification provision).
- Blanket for-profit Outside Position coverage.
- "Claim" includes investigations, notice of circumstances, extradition proceeding and interviews/depositions as fact witness.
- "Loss" includes SOX Section 308 and FCPA penalties.
- Separate additional limit of liability for (i) Independent Directors, (ii) Officers, and (iii) Retired Directors.

Whether some of these extraordinary coverage features afford appropriate protection to directors and officers, or unreasonably and unnecessarily dilute coverage can be debated.

Second, a Side-A policy dedicates its limit of liability exclusively for the benefit of directors and officers rather than the company. Third, a Side-A policy should not be subject to

the bankruptcy automatic stay if any insured company files bankruptcy. Fourth, a Side-A policy affords greater flexibility in settling claims since the policy preserves its limits for subsequent non-indemnifiable settlements.

If extraordinary protection for only outside directors is desired, a company can purchase an Independent Director Liability ("IDL") Policy, which is a Side-A policy insuring only the outside directors and not officers or other employees for non-indemnified loss. Such a policy frequently contains all of the extraordinary coverage enhancements of the standard Side-A policy plus a few additional coverage enhancements such as elimination of the fraud and illegal remuneration exclusions in their entirety.

To afford maximum protection, these Side-A policies can be purchased with difference-in-conditions ("DIC") coverage, thereby requiring the policy to drop down and fill any gaps in coverage for losses not covered under the underlying policies, but covered under the broader excess Side-A policies. Broad Excess DIC Side-A policies can provide not only high quality insurance protection for the directors and officers, but can also give important psychological comfort to the directors and officers that their risk from serving as a director or officer is being aggressively managed.

The following summarizes several structural issues that should be considered when purchasing a Side A excess program.

1. Stacking Multiple Excess Side A Policies. Many companies are now choosing to purchase several layers of Excess DIC Side A coverage within their D&O insurance program. Too often, though, unintended coverage gaps exist in such multi-layered programs due to the way in which those Side A policies are stacked on top of each other.

In a traditional D&O insurance program, each excess layer of insurance consists of a "follow form" excess policy which generally follows the terms of the primary policy and any more restrictive underlying excess policy. Liability attaches to each excess policy only if all of the underlying limits are paid in full by the underlying insurers (or perhaps the Insureds). If maximum insurance protection is desired, that same approach should not be used with respect to multiple layers of Side A Excess DIC policies for two reasons.

First, the lowest level or "lead" Excess DIC Side A policy should be treated conceptually as the primary or base policy for purposes of all of the other Excess DIC Side A layers in the program. That means that those other excess DIC policies should designate the base DIC policy (not the true primary policy) as the "followed policy," and only the underlying Side A policy should be listed as "underlying insurance" in the Side A policies excess of the base Side A policy. By doing so, the higher level Side A policies will drop down on top of the base Side A policy whenever the base Side A policy drops down pursuant to its DIC provisions, regardless whether the policies underlying the base Side A policy are exhausted. If the policies underlying the base DIC policy are listed as "underlying insurance" in the higher level Side A policies, the entire Side A program may not drop down into a lower layer when a DIC event occurs.

Second, several provisions in the standard excess follow-form policy should be amended or deleted if the intent is for higher-level DIC policies to potentially drop down into lower-level DIC policies (i.e. DIC into DIC coverage). For example, the "attachment" language should be amended so the DIC provisions in the base Side A policy apply when a DIC event occurs with respect to an underlying Side A policy. Sample language to accomplish that result is:

> Except as otherwise expressly provided in the Base DIC Policy with respect to difference-in-condition (DIC) coverage, liability for any covered Loss shall attach to the Insurer only after the insurers of the Underlying DIC Policies shall have paid, in applicable legal currency, the full amount of the Underlying DIC Limit.

Absent this type of provision, each Side A policy would not drop down into a lower Side A policy if a DIC event occurs with respect to the lower Side A policy (e.g., the insurer of the lower Side A policy is insolvent, wrongfully denies coverage, etc.). In addition, the standard language in excess follow-form policies which state that the excess policy follows the most restrictive terms in any underlying policies should be deleted in order to maximize the value of the DIC coverage.

2. Quota Share Side A Programs. Some large D&O insurance programs are now being structured with large quota share layers, for a variety of reasons. Although large quota share layers can reduce some difficult claims issues (as explained below), a quota share structure for large Side A programs can create unintended coverage limitations and usually results in higher premiums.

Each participant in a quota share program typically is liable for only that participant's quota share percentage of the total loss which is covered under the quota share layer. The liability of any one insurer in the quota share program is not increased if another insurer in the quota share does not pay a loss for any reason. If an insurer in the quota share program does not pay a covered loss, a gap in coverage exists.

Such a result should be unacceptable to Insureds in a Side A program, which is intended to eliminate rather than create gaps in coverage. Conceivably, a Side A quota share program could state that if an event that would normally trigger DIC coverage occurs with respect to another insurer in the quota share program, all of the other quota share Side A insurers will fill the gap created by the non-paying insurer. However, it is doubtful all participating insurers in the Side A quota share program would agree to such a provision. Absent such a provision, the Insureds are better protected by multiple layers of Excess DIC Side A policies (with each policy potentially dropping down into a lower level Side A policy if a DIC event occurs with respect to the lower level Side A policy), as opposed to a quota share Side A program.

3. Overlapping Insurers. Another issue that arises when purchasing Excess DIC Side A coverage is whether it is prudent to purchase the Side A policy and one or more of the underlying policies from the same insurer. Such a practice is generally not advisable since it reduces the value of the DIC coverage. Among other things, the DIC coverage in the Excess Side

A policy protects against an underlying insurer wrongfully refusing to pay a loss or becoming insolvent. Obviously, such coverage has questionable value to the extent one of the underlying insurers is also the Excess DIC insurer. In that situation, the insurer is insuring the risk that it will wrongfully refuse to pay or become insolvent. In addition, an insurer which issues both an underlying policy and an excess DIC policy may be incentivized to push a loss into the excess policy for a variety of reasons, and thus may be more inclined to deny coverage under the underlying policy since there would be no risk the Excess DIC insurer will subrogate against the underlying insurer to challenge the denial (i.e., the insurer will not subrogate against itself).

In other words, in order to maximize the value of the DIC coverage and to minimize the risk of creating artificial coverage dynamics in a claims situation, all of the Excess DIC Side A policies should be purchased from insurers that do not participate in the underlying D&O insurance program.

B. Follow-Form Excess Policies

The following summarizes issues to consider when negotiating a so-called "follow-form" excess D&O policy.

1. Follow-Form Coverage. Although excess D&O liability policies generally state that coverage afforded by the policy is in accordance with the same terms, conditions and limitations as contained in the primary policy, the excess policy usually contains numerous specific provisions which render the coverage far from pure "follow-form." For example, excess policies frequently will not follow the primary policy, but will have their own unique provision with respect to when and how claims are reported under the policy; the availability and terms of a Discovery Period; what substantive law applies to the policy; how coverage disputes must be resolved (i.e., mediation, arbitration or litigation) and the terms of that dispute resolution process; who can cancel a policy for what reasons; and how related claims are treated.

Excess insurers include these unique provisions in the excess policy in order to satisfy their unique underwriting criteria and to confirm the excess insurer's separate rights. However, the provisions can create inconsistency among the primary policy and the various excess policies and can result in added complexity to the claims process. For example, if different policies within the same D&O insurance program are governed by the laws of different jurisdictions, or if some policies are subject to mandatory arbitration and others are not, a single coverage issue may need to be resolved in multiple coverage proceedings in different forums subject to different laws, thereby causing enormous inefficiency and creating the potential for inconsistent rulings. From an insureds' perspective, the excess policies should provide as close to pure follow-form coverage as possible, although it is often difficult to obtain pure follow-form coverage.

2. Attachment. Most excess D&O policies issued by domestic insurers state that liability attaches under those policies only after the insurers of the underlying insurance have exhausted their respective limit of liability by payment of loss under those underlying policies. In contrast, excess D&O policy forms issued by Bermuda insurers historically have

stated that liability attaches under those excess policies if either the insurers of the underlying insurance or the insureds pay the amount of the underlying limit(s). Under the more restrictive attachment language in the domestic policies, an excess insurer can refuse to pay loss under its policy if the underlying insurer fails or refuses to pay its full limit of liability due to its insolvency, a coverage issue or any other reason.

Although some older case law states that an excess policy is implicated even though the underlying insurers have not paid their full limits of liability, more recent case law interpreting more recent excess policy language has held that liability does not attach to an excess policy unless and until the underlying insurers pay the full amount of the underlying limit. For example, in *Comerica, Inc. v. Zurich Am. Ins. Co.*, 2007 U.S. Dist. LEXIS 54517 (E.D. Mich. July 27, 2007), the court ruled that an excess D&O insurer was not liable for loss in excess of the underlying limit where the primary insurer did not pay the full amount of the primary limit. The excess policy in that case stated that coverage attached to the excess policy only if the limits of liability under the underlying policies were exhausted "solely as a result of actual payment of loss thereunder by the applicable insurers." Because the primary insurer compromised a coverage dispute with the insureds by paying only $14 million of its $20 million limit of liability, the court ruled that the excess insurer was not liable for any loss in excess of the underlying limit. The court distinguished the leading case which holds otherwise (*Zeig v. Massachusetts Bonding & Insurance Co.*, 23 F.2d 665 (2d Cir. 1928)) and its progeny because the excess policies at issue in those prior cases were "silent about whether the full amount of the underlying policy needed to be collected or actually paid out before the excess policy was triggered." In contrast, the excess policy in this case imposed a specific exhaustion requirement—"actual payment of loss thereunder by the applicable insurers." The court reasoned that "[p]ayments by the insured to fill the gap, settlements that extinguish liability up to the primary insurer's limits, and agreements to give the excess insurer 'credit' against a judgment or settlement up to the primary insurer's liability limit are not the same as actual payment." See, also, *The Unencumbered Assets Trust v. Great American Insurance Co.*, 2007 U.S. Dist. LEXIS 49711 (S.D. Oh., July 10, 2007) (excess D&O insurer not obligated to advance defense costs until underlying limits are exhausted).

In many D&O claims today, insurers raise potentially significant coverage issues and insist upon paying less than their full limit of liability in light of the coverage defenses. In those situations, the more restrictive attachment language can create a major obstacle to settling a large claim. The primary insurer will refuse to pay its full limit because of the significant coverage issue and the excess insurers will refuse to pay any amount because the primary insurer has not exhausted its limit. Frequently, the insureds and the insurers negotiate a global resolution of all of those issues based on the particular circumstances of that claim.

If Insureds want to have the flexibility to negotiate a coverage settlement with some but not all insurers within the D&O insurance program, broader attachment language similar to that contained within the traditional Bermuda excess policy forms is desirable for Insureds. In other words, the Insureds can settle the coverage dispute with the primary insurer even if one or more excess insurers do not agree to a similar settlement. Absent that flexibility, the Insureds

and all the insurers may be forced to submit the dispute to a winner-take-all lawsuit or ADR proceeding.

Many (but not all) domestic D&O insurers now offer a "shaving of limits" or "limit reduction" endorsement which allows Insureds to pay some or all the underlying limits for purposes of liability attaching under the excess D&O policy. These endorsements do not cause an excess insurer to drop down, but merely allows the Insureds to pay a portion of the underlying limit. The endorsements vary considerably. Some are limited only to situations where the underlying insurer is insolvent; some contain a "most favored nation" clause which says the excess insurer must receive at least as large a discount off its limit of liability as any underlying insurer discount; some require the underlying insurer's discount to be based solely on reasonable coverage defenses; and some require the excess insurer's consent to the Insureds' payment of the underlying limit.

3. Consent. Some excess D&O policy forms state that the Insureds cannot incur any loss without the excess insurer's consent, even if the loss is below the excess policy's attachment. Excess insurers understandably are concerned about settlements within the underlying policies because those settlements dilute the available underlying coverage for other claims. Insureds understandably want to avoid the administrative burden, time delay and risk of seeking consent from all the excess insurers particularly for a small loss payment. As a compromise to these two legitimate but competing concerns, the consent provision in some excess policies require the excess insurer's consent only if loss exceeds, for example, 50% of the Underlying Limit or, alternatively, only if loss is reasonably likely to involve the excess policy.

4. Quota Share Programs. Most large D&O insurance programs are structured with layered excess policies. Each layer is issued by a different insurer and is subject to a separate policy form. Because the premium for each layer is usually calculated as a percent of the premium for the immediately underlying layer, this type of structure typically results in the lowest total premium cost. However, that type of insurance program structure can lead to enormous inefficiencies and unnecessary disputes in the claims context. For example, as explained above, each layer of coverage will likely have its own unique coverage terms and conditions. Also, the insurers for each layer in the program have complete claim control over that layer of coverage. Thus, in a large claim, it is not unusual to have 10 to 20 insurer representatives involved since each layer frequently will have one or two internal claim representatives and an external law firm working on the claim for each layer in the program. As the number of insurance companies and individuals involved in claim issues increases, the likelihood of prompt, efficient and consistent coverage decisions decreases. For example, excess insurers are not bound by the coverage determinations of the primary insurer even under follow-form excess policies since each policy is a separate contract. *Allmerica Financial Corp. v. Certain Underwriters at Lloyd's*, 2007 Mass. LEXIS 519 (Mass., May 8, 2007)

In contrast, a large D&O insurance program which is structured as one or more quota share arrangements reduces many of those risks and can provide a more efficient claims handling structure if one or a small number of participating insurers are granted claims control

for the entire quota share layer. Attachment issues are eliminated within the quota share and all the participating insurers are subject to exactly the same policy terms. The consolidation of claim decision making with one or a small number of participating insurers is difficult to obtain in today's market because excess insurers are very reluctant to give up their claim control. However, the benefits to Insureds from that type of program structure can be significant.

C. Conclusions

The existence of high quality D&O insurance protection has become a necessity for companies to successfully recruit and retain quality directors. Companies can obtain the broadest scope of D&O insurance protection only through negotiating coverage enhancements which are not contained within an insurer's standard policy form. All of the coverage enhancements summarized above have been afforded by at least some insurers in some circumstances, and therefore it is reasonable to at least request those enhancements if desired. Obviously, there are many other possible coverage enhancements or clarifications which may be appropriate and available depending upon a particular policy form and the unique facts or circumstances applicable to the Insureds.

About the Author:

Dan A. Bailey is the Chair of the Firm's Directors & Officers Liability Practice Group and represents and consults with directors and officers, corporations, insurance companies, and law firms across the country. In addition to advising Boards and drafting most of the D&O insurance policies in the market, he has represented clients or served as an expert witness in many of the largest D&O claims for more than 30 years. He is co-author of Liability of Corporate Officers and Directors, a leading treatise on the topic, has published dozens of articles and speaks at more than 20 seminars a year on the subject.

He can be reached at (614) 229-3213, or dbailey@baileycav.com.

This alert is published as a service to our clients and friends. It should be viewed only as a summary of the law and not as a substitute for legal consultation in a particular case. Please contact legal counsel to discuss your specific situation.