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STRUCTURING SIDE A PROGRAMS: TRAPS FOR THE UNWARY

The popularity of Side A D&O insurance policies (which insure only non-indemnified losses incurred by directors and officers) continues to increase. As both outside directors and officers become more familiar with the extraordinary protections available through a broad and high-quality Side A policy, it is not surprising that directors and officers are requesting, and public companies are now purchasing, this type of coverage with greater frequency. However, there appears to be considerable confusion and misunderstandings in the market regarding what to look for in a preferred Side A policy and how to structure a multi-tiered Side A program. Unlike many standard D&O policy forms, there is a vast difference between various Side A policies available in today's market, and some of the common notions regarding how to structure a traditional D&O insurance program do not apply to structuring a Side A D&O insurance program.

The following discussion identifies some of the unique issues which should be considered when structuring and purchasing a Side-A insurance program.

I. Scope of Coverage

Not all Side A policies are created equal. There is a wide diversity of Side A products available, ranging from a standard D&O policy form which simply deletes the coverage for the company under "Side B" and "Side C," to a specifically tailored broad Excess DIC Side A Policy with extraordinarily broad coverage terms. Examples of provisions contained only in the broadest Side A policy forms, such as the recently revised "Premier" CODA policy form, include the following:

- The policy is non-rescindable in whole or in part for any reason;
- No presumptive indemnification (coverage applies if the Company rightfully or wrongfully refuses to indemnify);
- No ERISA exclusion (a few Side A policies also broaden the insured capacity to include wrongdoing by Insureds as ERISA fiduciaries, as distinct from wrongdoing as directors and officers, but that broadened "capacity" coverage may unnecessarily dilute the Side A coverage for the directors and officers if the Company maintains adequate fiduciary liability insurance);
- No pollution exclusion, and the bodily injury/property damage exclusion does not apply to pollution claims;
- Very narrow insured v. insured exclusion (exclusion applies only to Claims brought by or on behalf of the Company, not Insured Persons, and only if such

Claim is made with the approval or assistance of at least two current senior executive officers; the exclusion does not apply to Claims made after the Parent Company has a change of control or to Claims by bankruptcy trustees, etc. or to Claims outside the U.S. or Canada, or to Claims by whistleblowers or to Defense Costs);

- Conduct exclusions (fraud, illegal personal profit, improper remuneration) not applicable to Defense Costs;
- Broad difference-in-conditions ("DIC") provisions (coverage drops down if underlying insurers rightfully or wrongfully refuse to pay, are insolvent, rescind coverage or are legally not permitted to pay loss because of the Company's bankruptcy);
- Coverage follows any broader provision in any underlying insurance;
- No consent from the Insurer required for Defense Costs;
- Notice to the Insurer of a potential claim constitutes a "Claim" (defense costs coverage applies to potential Claims).

If the Side A policy does not include all of these features, it does not afford the broadest coverage available for non-indemnified losses incurred by directors and officers.

II. Stacking Multiple 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). 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. 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 other words, each Side A policy should DIC not only into the policies underlying the base Side A policy, but also into any underlying Side A policy. 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.

III. Quota Share Side A Programs

Large D&O insurance programs are now more frequently being structured with large quota share layers, for a variety of reasons. Using a quota share structure for large Side A programs can create unintended coverage limitations.

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.

IV. Separate Limits for Directors and Officers

In response to the many highly publicized huge D&O claims recently, there is increasing interest by independent directors in Side A policies which only protect a company's independent directors, not its officers. This Independent Director Liability ("IDL") policy, which is typically excess of one or more standard Side A policies, can provide valuable additional protection for the independent directors in two respects. First, the limit of liability under an IDL policy is not eroded by losses incurred by officers, who typically have far greater exposure than directors in light of their greater knowledge about and involvement in the company's operations. Second, IDL policies usually have even fewer and narrower exclusions than a standard broad-form Side A policy. For example, some IDL policies do not contain any fraud or illegal personal profit exclusions.

Thus, an Excess DIC Side A IDL policy which sits on top of all of the other policies in a D&O insurance program can provide valuable "fail safe" coverage for outside directors in case the rest of the program is exhausted or otherwise unavailable for a Claim.

Despite these attractive features, few companies have purchased an IDL policy, for a variety of reasons. In an attempt to make that valuable additional coverage for independent directors more popular, CODA recently introduced a creative new Side A policy which combines the attractive features of a broad IDL policy with CODA's standard "Premier" Side A policy for directors and officers. Under this new policy form, if the standard limit of liability applicable to all directors and officers is exhausted, the Side A policy automatically affords an additional limit of liability only for the independent directors without an additional premium. That additional limit is excess of all other policies in the Company's D&O insurance program, including any policies specifically excess of the Side A policy, subject to a DIC provision if any of those other policies fail to pay loss. A priority of payment provision is included within the policy, thus maximizing the total amount payable under both limits of liability in the event directors and officers incur covered loss which is subject to both the standard limit and the additional IDL limit.

In addition, this new policy states that the fraud, illegal personal profit and improper remuneration exclusions do not apply to claims against independent directors. As a result, by purchasing the new CODA Premier policy, not only do directors and officers obtain the extraordinary coverage available under a broad Side A policy, but the independent directors obtain the separate limit and other additional benefits normally available only through a separate IDL policy.

CODA also recently introduced an innovative Side A policy form which only covers current and former officers of a company. Similar to an IDL policy for outside directors, this unique policy protects the insured officers against limit of liability erosion by reason of losses incurred by the independent directors.

The Officer Liability policy contains all of the broad features contained in CODA's standard Premier Side A policy, but the limit of liability is dedicated only for the benefit of officers. Coverage under the policy extends to officers in their capacity as an officer or director

of the Company, as well as other employees if the other employees are codefendants with the officer.

The Officer Liability policy or the IDL policy can be purchased alone or in tandem. If both types of policies are purchased in tandem for the same layer in the D&O insurance program, the Insureds can maximize the personal protection afforded the directors and officers without making either the directors or the officers more attractive targets for the plaintiffs since neither the directors nor the officers would have more insurance coverage than the other. Also, it may be advisable to purchase each type of policy from the same insurer if possible in order to reduce the potential for allocation disputes between the two policies when a non-indemnified claim is made against both directors and officers.

The need for specialized coverage protecting only independent directors and only officers is very real in light of the increasing frequency of partial settlements, pursuant to which some but not all of the defendant D&Os are settled. As demonstrated by the highly-publicized settlement in the Enron D&O settlement, the proceeds of a standard D&O policy may be used to settle the claims against some Insureds (such as the outside directors in the Enron situation) without settling the claims against other Insureds, thereby leaving the other Insureds with little or no insurance to defend and settle the remaining claims against them. The separate IDL limit of liability and the Officers Liability policy not only protect against that situation, but also afford extremely broad Side A coverage for the Insureds.

V. 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.

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