

Get Your Priorities Straight to Maximize Your D&O Coverage

By John C. Tanner

Your company has been embroiled in securities class-action and derivative litigation for years with one of the largest securities-plaintiff law firms in the nation. Your general counsel (GC) informs you that the company has finally negotiated a settlement of the securities class-action and tagalong derivative lawsuits for \$150 million. The parties have allocated \$125 million to settle the securities class-action claim and \$25 million to settle the derivative matter, which is non-indemnifiable under the applicable state law.

Fortunately, your company purchased \$150 million of directors and officers (D&O) insurance consisting of \$125 million of traditional D&O coverage for the company and its directors and officers, as well as \$25 million of that special excess “sleep insurance” you recommended to the CEO a few years ago called Side A Difference-In-Conditions coverage (also known as Side A DIC coverage). Now that the matter is resolved, the GC and CFO ask you to collect the \$150 million from the company’s insurers so the company’s board can put this matter behind it and focus attention on continued profitability and revenue growth.

The GC kept the company’s insurers fully informed throughout the litigation and sought advance consent to the proposed settlement terms. The upper excess layers were contacted very late during the mediation process, but each agreed not to raise lack of consent or otherwise object to the reasonableness of the settlement amount.

The settlement is for \$150 million and you have \$150 million of available limits, so there shouldn’t be much of an issue. Right? WRONG. The Side A DIC insurers refuse any payment and tell you that the extra \$25 million is the responsibility of the underlying primary D&O insurance. You have a meeting scheduled for early Monday morning to inform the GC, CEO, and CFO that the sleep insurance will not pay. Good luck sleeping.

This simple fact pattern (based on a true story) highlights a hidden issue of how a standard priority-of-payments provision contained in a D&O policy can lead to surprising, if not unintended, results.

What Is a Priority-of-Payments Provision?

A typical D&O policy will include coverage for Side A loss (coverage for individual directors and officers where the company cannot legally or financially fund

indemnification), Side B loss (coverage for the company essentially reimbursing the company for its indemnification and advancement payments to individual directors and officers), and separate Side C loss (direct coverage for the company itself). Under standard policies, Side A, B, and C coverage share the same aggregate limits of liability such that payment of a Side B or Side C claim will exhaust the available limits of liability for Side A protection and vice versa.

Priority-of-payments provisions are common in traditional A/B/C D&O policies and are intended to govern the order of payments when amounts are potentially due under more than one insuring clause. A typical priority-of-payments provision provides that any payments under the D&O policy will be paid first under Side A to protect the assets of individual directors and officers before any payments can be made to the company under the Side B or Side C insuring clauses.

Such provisions obviously offer comfort to individual directors and officers in the context of claim exposure exceeding the available insurance limits. Priority-of-payments provisions have also been cited in numerous court opinions as justification for the courts’ holding that a D&O policy’s proceeds fell outside the bankruptcy estate. Many companies now purchase dedicated excess Side A DIC coverage for directors and officers as additional protection against entity-coverage dilution of limits and/or as a further hedge against a bankruptcy court preventing individual access to the D&O proceeds at a time when needed most. Because the Side A DIC coverage only covers individuals for non-indemnifiable loss, there is no corporate dilution of limits and a corporate bankruptcy should not affect individual access to the Side A DIC limits.

Why Did the Side A DIC Insurers Refuse?

In the above scenario, the company purchased \$125 million of traditional shared A/B/C coverage and an additional \$25 million of dedicated excess Side A DIC coverage that only covered Side A loss where the directors and officers did not receive indemnification. The settlement allocated \$125 million to the securities class-action claim and \$25 million to settle the derivative matter, which was non-indemnifiable under the applicable state law.

The Side A DIC insurers pointed to the priority-of-payments provision in the traditional A/B/C coverage,

which granted absolute priority to payment of Side A loss over any indemnifiable corporate claim. As a result, the priority-of-payments wording obligated the traditional A/B/C coverage to first fund the \$25 million non-indemnifiable derivative matter before any further payment could be made.

While the company may have assumed that it could allocate the \$25 million of Side A DIC limits to settle the derivative litigation, the priority-of-payments provision meant that the \$125 million traditional D&O limits would fund the \$25 million derivative settlement first and only then fund any remaining indemnifiable loss. As a result, the remaining \$100 million of the \$125 million traditional limits could be applied to the class-action settlement—leaving \$25 million uninsured. The \$25 million Side A DIC limits did not respond to the class-action settlement, which was an indemnifiable Side B and C claim, but remained unimpaired and available to fund other outstanding non-indemnifiable loss.

How Should a Risk Manager Prioritize the D&O Coverage to Maximize Protection?

A chief risk officer or risk manager facing the above scenario might be extremely frustrated, to say the least; however, the insurance arguably operated as intended. The traditional A/B/C coverage included a mandatory priority-of-payments provision designed to maximize coverage for individual directors and officers even when detrimental to the corporate balance sheet. The priority-of-payments provision offered valuable protection to individual directors and officers against corporate dilution of limits and corporate bankruptcy risk. Had the entire loss been non-indemnifiable, the full \$150 million of insurance limits would have been available to respond on behalf of any individually named directors and officers. Nevertheless, explaining the nuances of indemnifiable and non-indemnifiable loss and/or a D&O priority-of-payments provision to the GC, CFO, or CEO only after incurring a \$25 million uninsured loss is certainly no happy place for a risk manager. So, what can a risk manager do to mitigate the risk of suffering such a surprising result?

1. Seek coverage advice early in the claim process and well in advance of resolution.
 - Employ a focused strategy, seeking global settlement within your traditional A/B/C D&O limits where feasible, leaving Side A-only limits as a source of payment of last resort.
 - Pay close attention to the timing of claims settlement, particularly as respects insurer reimbursement

of indemnifiable versus non-indemnifiable matters.

- Seek advance carrier consent as to settlement terms and as to each carrier's respective funding of settlement amounts.
2. During the underwriting process, carefully evaluate your priority-of-payments wording and explore the alternatives.
- Completely understand how your priority-of-payments provision will be applied. Priority wording varies from carrier to carrier in terms of whether Side A priority is mandatory or discretionary, as well as to the timing of when the priority applies. Keep in mind that granting priority to Side A-only non-indemnifiable loss affords substantial comfort to your individual insureds against a corporate claim or bankruptcy that exhausts or otherwise limits the individual D&O insurance protection. In the absence of priority-of-payments wording, or where such wording grants discretion to the company as to whether to invoke the priority, individual directors and officers are at further risk of suffering an uninsured loss.
 - Is the priority wording absolute, and if so, how would the wording affect a settlement that may involve both indemnifiable and non-indemnifiable claims? If your wording is discretionary, or otherwise allows the carrier to withhold payment in certain instances, determine the individual or individuals who may invoke the priority, and give thought to formalizing a process for evaluating the decision and any potential conflicts of interest.
 - Should consideration be given to eliminating or imposing further conditions to the priority language? In light of the concerns noted above regarding corporate exhaustion of policy limits or bankruptcy risk associated with seizing corporate assets, it is not likely under most circumstances that modifying the wording would be advisable. Nevertheless, if your company maintains Side A-only DIC limits sufficient to resolve most if not all potential non-indemnifiable loss exposure, an argument could be made in support of eliminating absolute Side A priority in the traditional program and/or modifying the wording so as to grant Side A non-indemnifiable loss priority solely in the context of financial insolvency.
 - Consider negotiating express wording in the Side A-only DIC policy clarifying that, while it provides coverage solely for Side A loss, it does not follow the underlying policy's priority-of-payments wording. The Side A DIC insurer would be prevented from avoiding an otherwise

covered claim based solely on an order-of-payments provision contained in the underlying insurance. Some insurers may refuse modification, but the Side A DIC market remains highly competitive.

3. Make sure you have the proper D&O limits in place.

- At some level, the above example highlights the importance of making sure that you have appropriate D&O insurance limits in place. The company involved may have thought \$150 million of insurance was adequate, but hindsight revealed a \$25 million shortfall in indemnifiable coverage.
- Some might advocate that insureds purchase completely separate Side A and B-C towers with excess Side A DIC coverage on top of the Side A-only tower (or with a complete Side A-only DIC tower), thus, avoiding the priority-of-payments issue entirely. Of course, this approach is the most costly alternative and still does not solve the issue of unused or inefficient use of the insurance program.

If you first understand your priorities for purchasing D&O coverage and then order your priorities consistent with that approach, you will maximize your insurance recovery in the context of a claim. In most cases, companies will likely decide it is not necessary to change anything about their respective programs or limits; however, the discussion will be a great opportunity to get all interests aligned and eliminate future surprises. Informed priorities should be the cornerstone of any prudent risk-management and litigation-management architecture. ✱

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