

Dedicated Limit D&O Insurance: An Abbreviated Guide To The Policies That Protect The Personal Assets Of Directors And Officers

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Increasing numbers of directors and officers are demanding dedicated limit insurance policies – such as Side A or IDL – to help ensure that their personal assets are protected. Recent cases such as Enron and WorldCom, as well as larger settlements and verdicts, have helped fuel these demands. As dedicated limit policies become more popular, some companies have started to question whether the protection is worth the additional expense.

This article takes a closer look at the dedicated limit policy and explains just what protection it can really offer. We start by reviewing the structure and limitations of a traditional directors and officers (“D&O”) liability insurance policy. Then we examine the advantages of the various types of dedicated limit policies.

The Traditional D&O Policy

A traditional D&O policy will typically offer three main types of protection:

- Side A coverage which protects directors and officers against non-indemnifiable claims (i.e., claims for which the company either may not or cannot indemnify a director or officer due to legal or financial solvency reasons);
- Side B coverage which reimburses the company for amounts it pays to

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directors or officers as indemnification; and

- Side C coverage which pays losses arising out of certain securities claims against the company.

Only the Side A coverage in the traditional D&O policy protects the individual directors and officers. Sides B and C protect the company’s treasury.

Although most claims are paid under either the Side B or Side C coverage, having Side B and Side C coverage can have some real disadvantages from the perspective of the directors and officers. Chief among the disadvantages is that covered company losses can erode or exhaust the limits of the policy, leaving the directors and officers underinsured or completely uninsured. This risk has become more severe as settlements and judgments against companies have increased in size. Directors and officers also face increased competition for their traditional D&O insurance limits as partial settlements and opt-out cases become more popular.

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Another shortcoming in a traditional D&O policy is that it may be considered an asset of the company for bankruptcy purposes. In that event, the bankruptcy court could freeze the policy limits during the bankruptcy proceeding forcing the directors and officers to pay their own defense costs during what could be a multi-year litigation. Worse yet, the bankruptcy court could make the limits of a traditional D&O policy available to creditors. Either way, this could leave individual directors and officers without insurance protection when they need it most.

The Advantages Of A Dedicated Limit Policy

To help avoid the shortcomings of the traditional D&O policy, insurers developed the dedicated limit policy. These policies typically sit on top of a traditional D&O program and offer just Side A coverage. As explained above, Side A coverage only responds to losses of the directors and officers when the company may not or cannot indemnify those directors and officers. Since there are only a handful of situations where a company may not or cannot indemnify its directors and officers, the coverage offered by a dedicated limit policy is limited.

The following are some examples of non-indemnifiable claims:

- Derivative actions where the company is not permitted by law and/or public policy to indemnify directors or officers for judgments or settlements;
- Certain registration and anti-fraud suits brought under the federal securities laws where indemnification would be against public policy;
- Any claim where the company is financially unable to fund the indemnification; and
- Any claim where either the applicable law or the company’s certificate of incorporation or by-laws prohibit indemnification.

By limiting its coverage to only these non-indemnifiable claims, the dedicated limit policy avoids some of the main disadvantages of traditional D&O insurance. For example, since the company is not insured by the policy, company losses cannot erode or exhaust the limit. For the same reason, a dedicated limit policy cannot be treated as an asset of the bankruptcy estate. Thus, it will remain beyond the reach of the bankruptcy court and any creditors of the company.

Another advantage of a dedicated limit policy is that it generally provides broader coverage than a traditional D&O policy. For example, a typical dedicated limit policy will be completely non-rescindable and non-cancelable once the premium has been paid. Many of the exclusions generally found in a traditional D&O policy – such as the ERISA, failure to maintain insur-

ance, pollution, libel/slander and defamation exclusions – are not included in a typical dedicated limit policy. Moreover, the dedicated limit policy generally has several more insured friendly exclusions including the insured vs. insured and employment practices exclusions.

Yet another advantage of a dedicated limit policy is that it can be structured to best meet the risk transfer needs of management. The following are three examples of ways the dedicated limit policy can be structured.

First, the policy can be structured as a straight Side A excess policy which will cover directors and officers on an excess basis above a company’s traditional D&O program. This structure tends to be less expensive but offers less protection than other types of dedicated limit policies.

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Second, for broader coverage, a company can select a Side A difference-in-conditions (“DIC”) policy which can serve as an excess policy or drop down to the primary position if the underlying traditional D&O program cannot or fails to respond (rightly or wrongly) due to: (1) rescission by the underlying insurers; (2) wrongful refusal and/or financial inability of the underlying insurers or the company to indemnify a loss; and/or (3) denial of coverage by the underlying insurers due to coverage exclusions that are not contained in the dedicated limit policy.

Finally, a company may also select an independent directors liability (“IDL”) policy. This policy is similar to a Side A DIC policy except that an IDL policy only protects the independent or outside directors. The main advantage of an IDL policy (as opposed to a Side A or Side A DIC policy) from the perspective of the independent directors, is that the limits of an IDL policy cannot be eroded or exhausted by officers who typically face a greater risk of large defense costs, settlement amounts and judgments.

Is It Worth It?

The main purpose of D&O insurance is to protect the personal assets of the directors and officers. By adding a dedicated limit policy on top of a traditional D&O program, a company can fill potential coverage gaps in its insurance protection. This can help the company retain and attract directors and officers. More importantly, it can help ensure that directors and officers will be protected should the unthinkable occur. With so much at stake, companies should consider adding a dedicated limit policy to their management liability insurance program.

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