



“HOW SHOULD WE PROTECT OUR COMPANY’S DIRECTORS AND OFFICERS?”

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In US jurisdictions, directors and officers of corporations face *personal* liability for certain breaches of duty. Consequently, in order to recruit qualified directors/officers, companies routinely undertake to indemnify them. This direct corporate obligation typically is provided in corporate bylaws or in an employment agreement. While it is permissible for the corporate indemnity to be less expansive than the maximal allowed by law, or to be discretionary in whole or in part, for insurance purposes the corporate indemnity is assumed to be both mandatory and as expansive as the law permits.

Directors’ and Officers’ Liability insurance, or D&O insurance, is written against the backdrop that the directors’/officers’ principal source of financial protection is the corporate indemnity (and not insurance). To the extent that the corporation is unwilling or unable to provide indemnification, or is barred from doing so as a matter of law, insurance is triggered. This is referred to as “Side A” coverage; this terminology stems from the fact that the first insuring agreement in D&O policies is denominated by the letter A.

To the extent the corporation is willing, able, and permitted to indemnify the director or officer, then Side A coverage does not apply. The structure of D&O coverage presumes that in most circumstances when a director or officer is sued, the corporate indemnity will apply. Consequently, corporations protect themselves

from the financial risk of having to perform the corporate indemnity by the purchase of “Side B” coverage. In other words, any time the corporation has an obligation and is able to indemnify, the Side A coverage *does not* apply. The purpose of Side B coverage, then, is to fund the corporation’s indemnity obligation, which is presumed to be applicable in most circumstances.

Accordingly, the rationale for purchasing Side B coverage is that most cases involving directors and officers should be covered by the corporate indemnity, which is the principal source of financial protection against the personal liability directors and officers otherwise would face in an action involving breach of duty.

Side A coverage, that is, coverage that protects the directors and officers when the corporate indemnity does not apply or is unable to be performed, often is invoked when there is a change in control or insolvency. When there is a change in control, the “new” board may be reluctant to perform the corporate indemnity and may err in refusing to indemnify; the Side A insurance would apply in such circumstance, but the insurer then becomes subrogated to the directors’/officers’ right to claim protection under the corporate indemnity. Of course, when the company is insolvent, the company is unable to perform the corporate indemnity, and thus the Side A coverage applies. There are also certain types of claims where, as a matter of law, the corporate indemnity may not be performed (even if its terms otherwise are sufficient to encompass the particular matter), in which case the Side A coverage applies.

A separate form of D&O insurance can be purchased to provide excess/difference-in-conditions coverage. Insofar as the “excess” feature of this coverage, the purpose of such policies is to provide supplemental monetary limits to guard against the risk that the underlying Side A coverage becomes exhausted through payment. Usually, it is more cost effective to purchase limits via layering, that is, to have primary and excess coverage. Purchasing coverage through layers also is used to mitigate the risk of an insurance company’s becoming insolvent. In other words, if a corporation desires to purchase \$25 million in coverage, if it purchases a single \$25 million policy, it is incurring the risk that that insurer could go out of business. If, instead, that \$25 million of coverage is divided between one carrier at \$10 million and the second carrier paying the next \$15 million, the potential sting arising from an insurer insolvency is mitigated.

The “difference in condition” or “DIC” feature provides additional protection in the event of insolvency of the underlying insurer: if the underlying

insurer, in my example, the first \$10 million layer, becomes insolvent, then an insurer with DIC features will “drop down” and provide coverage at the first dollar. In other words, the excess/DIC policy will both (i) supplement the coverage once the underlying coverage becomes exhausted through payment and (ii) replace the underlying coverage in the event the underlying insurance company becomes insolvent.

Further, DIC coverage is intended to extend coverage to risks that are not covered by the underlying insurer (even if the underlying insurer were solvent). DIC coverage is thought to be “broader” than the underlying coverage, and to the extent a loss is not covered by the underlying but is covered by the broader DIC coverage, the DIC coverage drops down and functions as first-dollar or primary coverage.

Most Side A/DIC policies provide that this broader or “umbrella” feature applies if the underlying insurer (i) correctly denies coverage for a loss or (ii) erroneously denies coverage for a loss. In other words, if the underlying insurer refuses to pay for a loss that should be covered by the underlying or primary policy, and if the loss is otherwise encompassed within the terms of the DIC policy, then the DIC insurer will start paying at first dollar, even if the underlying insurer should be performing.

Accordingly, when a director or officer faces a claim that is not covered by the corporate indemnity or the corporation is financially unable to perform the indemnity, he or she can turn first to the Side A carrier for performance. If the Side A carrier refuses to perform, or is unable to perform due to insolvency, then the Excess/DIC policy applies at first dollar (assuming the loss is covered by the terms of the Excess/DIC policy). If the Side A carrier *does* perform, then the Excess/DIC policy will supplement the policy limits afforded by the underlying Side A coverage and provide additional financial protection once the underlying is exhausted through the payment of claims.



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