STAND-ALONE "SIDE A" – WHAT IS IT (AND DO I NEED IT)?

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Background

The typical D&O Insurance Program for a publicly traded company contains three types of coverage, or "insuring agreements," in one policy. These coverages are often referred to as Side A, Side B and Side C (or Entity) coverage. In recent years, there has been a trend for companies to also purchase additional, stand-alone, Side A Coverage for their directors and officers.

Based on our experience, coverage provided under Side A is often misunderstood, or at least not clearly understood, by directors and officers. Therefore, we hope to provide some additional insight by way of this brief overview, along with several questions that can be used as a starting point to determine if additional Side A Coverage is appropriate for your circumstances.

Structure of a Typical D&O Insurance Program

As noted, the typical D&O Insurance Program contains three coverages (including Side A) under one policy. In short, these coverages are:

1. <u>"Side A"</u>– Coverage for both defense expenses and payments of settlements/judgments that arise from claims brought against directors and officers, when those costs cannot be indemnified by the company. Usually, no retention (deductible) applies to Side A coverage. Therefore, it affords protection against individual directors and officers having to use their own resources to pay the costs of any claims for which they are not indemnified by the company. In essence, Side A coverage provides the final layer of protection between an individual director's or officer's personal assets and the plaintiff(s) in a claim.

2. <u>"Side B" Coverage</u> – This is also often referred to as "company reimbursement" coverage. It reimburses the company for costs of claims when the company is permitted, or required, to indemnify individual directors and officers. Because the majority of claims against directors and officers are eligible for indemnification, Side B is the primary coverage under which payments are typically made under a D&O insurance policy.

3. <u>"Side C"/Entity Coverage</u> – This provides coverage for claims when the company itself is a defendant in the claim. For publicly-traded companies, it typically only provides coverage for securities-related claims. For example, if a securities-related lawsuit names both the company and individual directors/officers as separate defendants, Side C coverage will come into play for any defense costs and/or judgments or settlements that are attributable to the company's separate alleged liability. On the other hand, if a policy does not include Side C coverage, any amounts allocated to the company's defense or ultimate liability in that claim would not be covered by the policy.

Typical Claims Situations Triggering Side A Coverage

As discussed in the preceding section, "traditional" Side A Coverage is only triggered if the company cannot indemnify the directors and officers for a claim. Usually, this involves one of the following circumstances:

1. The claim is in the form of a derivative action, brought on behalf of the company, and state law prohibits the company from indemnifying defense costs or settlements/judgments arising from derivative actions.

2. The company is insolvent and, therefore, cannot indemnify the directors and officers.

In addition to these situations, a number of insurers offer stand-alone Side A policies, often referred to as "Side A DIC" or "Difference in Conditions" policies which profess to offer coverage in other situations, such as where the primary D&O insurers wrongfully refuse to provide coverage, where exclusions in the primary D&O Insurance Program preclude coverage or where the primary D&O Insurance Program has either been exhausted or rescinded. These types of policies vary widely with respect to the scope of coverage that they provide, and should be carefully reviewed by a specialist in D&O coverage to ensure that they offer the coverage they purport to offer.

How Can I Determine if Stand-Alone Side A is Appropriate?

As is the case with all D&O insurance, one size never fits all. Therefore, while additional Side A coverage may be highly desirable in some situations, it may be less desirable in others. To help determine whether additional Side A coverage is appropriate in your situation, you can start by asking the following questions:

1. **How do the limits of my company's primary (Side A, B and C) D&O Insurance Program compare to others in our peer group?**

A number of reputable organizations publish studies showing the limits of D&O insurance carried by publicly-traded companies. These are typically broken down by several different demographic factors, including industry, market cap and revenues. Your company's insurance broker should have this information readily available. This "benchmarking data" is a useful starting point, as it shows where your company's limits stand in comparison to other companies in your peer group. If your company's limits are significantly below those of other companies in your peer group, additional Side A limits (or additional Side A, B and C limits) may be appropriate.

2. Does my company's primary D&O Insurance Program contain an ''Order of Payments'' provision?

One of the traditional selling points of stand-alone Side A coverage is that it provides dedicated limits for the individual directors and officers. As discussed previously, most primary D&O Insurance Programs include Side A, B and C coverage in one policy. Therefore, directors and officers share the limits of the policy with the company. If the company's indemnification obligations, or its separate liability, deplete the limits of insurance under the Side B and C coverage, this can leave the individual directors and officers "bare."

Despite the preceding, the problem of being left bare by depletion of the policy's limits under Sides B and C can be significantly reduced if the primary D&O Insurance Program contains an appropriate "Order of Payments" provision. In general, such a provision will provide that in all claims situations, any payments due under Side A must be made before the company is reimbursed or otherwise receives any coverage under Sides B and C. Thus, the "Order of Payments" provision can largely have the effect of dedicating the primary D&O Insurance Program limits to the individual directors and officers, at least as they relate to any particular claim.

3. Is the Side A coverage in my company's primary D&O Insurance Program fully non-rescindable and/or does the coverage have strong severability language for application misrepresentations?

Another selling point of many stand-alone Side A insurance policies is that they are non-rescindable. That is, once they are written, the insurer cannot later look for misrepresentations in the application to void the coverage. This can be an important feature, as it avoids the situation where the coverage is seemingly in place, but "disappears" when a claim arises and the insurer discovers an alleged misrepresentation in the policy application. However, many insurers have recently begun to alleviate this potential problem in primary D&O insurance coverage by offering Side A, B and C policies that include non-rescindable Side A coverage.

In addition to the preceding, if your company's primary D&O Insurance Program includes a favorable "severability" provision relative to application misrepresentations, this can alleviate much of the potential for rescission of your individual coverage at the time of a claim. Such a provision should essentially provide that in the event the application contains any misrepresentations, the policy can only be rescinded as to those individual directors and officers who knew the misrepresentation existed in the application. In this regard, it should be noted that the provisions relative to application misrepresentations and severability vary widely among insurers, and seemingly small differences in language can lead to significantly different coverage consequences. Accordingly, these provisions should be carefully reviewed by a professional that is well-versed in D&O insurance coverage.

4. Does state law allow my company to indemnify me for costs arising from derivative actions?

Both the number of derivative actions, and the costs of resolving those actions, have risen in recent years. As such, it is important to know whether state law in your company's state of domicile allows the company to indemnify individual directors and officers for both defense costs and settlements/judgments related to derivative actions. If state law does not allow such indemnification, or places burdensome restrictions on such indemnification, it increases the likelihood that you may sometime be faced with a situation where you will be seeking Side A coverage for costs that are not indemnified by the company. In turn, this increases the desirability of additional Side A coverage.

5. Does my company have a strong and stable balance sheet?

Because insolvency is one of the primary instances where Side A coverage might be triggered, it is important to understand the current strength, and the likely ongoing stability, of the company's balance sheet when evaluating the need for additional stand-alone Side A coverage. Of course it is always difficult to predict what the balance sheet will look like at the time a claim is actually filed, but the more volatile the balance sheet, typically the more the potential need for additional Side A coverage might come into play.

Conclusion

The preceding questions and their potential answers are not meant to be an exhaustive list of all considerations that should go into the decision-making process regarding stand-alone Side A insurance coverage. However, they provide a good starting point for evaluating whether or not your company should further explore the purchase of stand-alone Side A coverage. Other considerations that should be kept in mind include the fact that stand-alone Side A coverage typically commands premiums in the range of 70%-80% of the premium for the same limits of Side A, B and C coverage, despite the more limited circumstances in which it typically responds. Additionally, if the decision is made to purchase stand-alone Side A coverage, it should always be kept in mind that these policies vary widely in the coverage that they provide. The policies should be carefully reviewed and heavily negotiated to ensure that they provide the broadest protection available to best protect the personal assets of individual directors and officers.