FALL 2012 VOLUME VII ISSUE 3

riskINSIGHTS

D&O Insurance

Layers, Tiers and Problems

Structuring a D&O Insurance Program

One of the critical issues in building a D&O insurance program is the question of how to structure the insurance. Among the more complex issues is how to divide the program between "traditional" D&O insurance coverage and Excess Side A DIC insurance (which in effect provides catastrophic protection for individual directors and officers in certain defined circumstances). A more basic issue is how to "layer" the program between primary and excess insurers, and how much capacity each of these layers should have in the overall program.

The question of how to layer a D&O insurance program is certainly not new, but it remains a vital question and a source of continuing scrutiny and debate. The latest example of how topical these issues are appeared in a May 8, 2012 post on Alison Frankel's *On the Case* blog. Within the context of a post in which Frankel discusses the overall importance of D&O insurance in securities suit settlements, Frankel quotes Steve Toll of the Cohen, Milstein, Sellers & Toll law firm. Toll has some harsh words towards the way companies structure their D&O insurance programs. Among other things, Toll objects to the fact that over the last decade, insurers have splintered their D&O insurance into multiple layers, which, in the event of a claim, means that plaintiffs lawyers are often negotiating with multiple insurance company representatives. In Toll's eyes, the problem with this arrangement is that "at every step, every carrier puts up a roadblock," which he says "dramatically affects the resolution of these cases. In almost every one, it's the same fight."

As Toll is one of the country's leading plaintiff's securities attorneys, his frustrations and comments are based on extensive experience. With nothing but the greatest respect for Toll, it is fair to note that it is hardly a concern to the parties to the insurance contract(s) that the plaintiffs or the plaintiffs attorneys do not like the way the insurance is structured. D&O insurance is not there to make claimants or their attorneys happy nor is it intended to be a reserve pool out of which claimants or their attorneys' get to draw; it is there to protect the company's directors and officers.

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It could be argued that it is to the long-term benefit of both companies and their insurers that there be some friction when plaintiffs and their attorneys try to access the insurance. It ensures that loss costs are contained, which in turn should help to keep insurance costs down.

For that very reason, at least one leading defense attorney has recommended that D&O insurance be arranged in tiers. In his venerable article entitled "The Veil of Tiers: Shareholder Lawsuits and Strategic Insurance Layers," first published way back in 1997, Boris Feldman of the Wilson Sonsini law firm argued that "the 'strategic tiering' of directors' and officers' (D&O) insurance is a useful consideration in designing an effective risk management program." Feldman argued in favor of arranging a D&O insurance program in multiple layers, asserting that "Each separate layer of insurance constitutes a firebreak. It is extremely difficult, in ordinary cases, for plaintiffs to jump from layer to layer in funding a settlement – especially early in the litigation." That is, what plaintiffs' lawyers are complaining about is the very thing that the defense attorneys are recommending.

Indeed, there is a lot more to the question of how to structure D&O insurance than just splitting the program into several layers to the everlasting frustration of plaintiffs' lawyers. Even Feldman acknowledges in his article that "there is no magic formula as to the right amount or structure of a D&O portfolio." He also says that if there are too many layers "you may expend substantial energy trying to keep your insurance house in order during a lawsuit" and "should you find yourself in a situation where you really need all of that insurance to settle a troublesome claim, it will be harder to get carriers to participate as you go higher up the chain." In other words, the issue of too many insurers and too many insurers' representatives in the settlement room can be a problem for policyholders and for defense counsel – as well as for plaintiffs' lawyers.

More recently, an entirely different perspective on the layering of D&O insurance has emerged. In an April 2012 paper entitled "How Collective Settlements Camouflage the Costs of Shareholder Lawsuits," Fordham Law School Professor Richard Squire raises an entirely different set of objections to the layering of D&O Insurance.

Professor Squire contends that insurers in the primary layer and lower level excess layers are often compelled to contribute toward settlement when the settlement demand exceeds their layer. This compulsion, Squire notes, is often effectively given legal force through a rarely identified but nonetheless very real "duty to contribute." The compulsion results in a "cramdown" effect, where the upper layer excess insurers and the policyholder pressure the primary insurer and lower level excess insurers to settle. These forces lead to a number of ills, including plaintiff "overcompensation" at insurer expense; overpriced liability insurance; and lawsuits of doubtful merit.

That is, Squire contends that as a result of the pressures that the insurance layering brings about, plaintiffs (and, presumably their lawyers) are "overcompensated." We suspect that Steve Toll might dissent from this perspective, or from any contention that his clients or he are overcompensated. Toll's comments certainly don't evince any awareness of a cramdown effect.

In our view, there is no single perspective that explains the way that the layering of D&O insurance will affect the settlement dynamic in every case. In cases involving particularly egregious facts, the layering is going to be irrelevant. For example, the entire Lehman Brothers D&O insurance tower was always going to be exhausted, regardless of how it was layered. And in weaker cases, layering could have the firewall effect that Feldman described in his article, which given the weakness of the case involved, is a good thing. In most other cases, the impact will be complicated and will vary according to the circumstances, including in particular how quickly defense expenses are accumulating and how likely it is that future defense expenses will burn through several of the lower layers.

Reasons for Layering a D&O Program

What is important to understand is why D&O insurance is layered in the first place. The reason that D&O insurance programs are layered is that no D&O insurer could sustain the concentration of risk that would be involved with exposing outsized amounts of capital to any single, large corporate exposure. As a result, the insurance needs of

most buyers of D&O insurance (particularly among public companies with significant market capitalizations) exceed the insuring capacity of any one carrier – and usually, the insurance capacity of several carriers is required in order to put together a program large enough to meet the insurance needs of most buyers.

In general, most buyers would probably prefer fewer, larger layers in the program. However, it is not always feasible to obtain larger layers, and so in most cases the participation of multiple carriers will be required to complete most buyers' D&O programs.

There might be ways to avoid the layered insurance structure. One possibility would be to arrange the D&O insurance in a quota share program. In a quota share program, the various carrier participants' interests are arranged vertically, rather than horizontally. Under this arrangement, each carrier would share ratably in each dollar of loss costs, so the carriers' interests in trying to save loss costs would be aligned in a way that would eliminate many of the conflicts the various commentators have noted.

The shortcoming of the quota share approach is that it would be very difficult for all of the participating insurers to cede claims control to a single decision maker. In the absence of a single point of control, the claims process could be reduced to chaos. The other thing about quota share D&O insurance is that people have been talking about it for years, yet it has never gained acceptance in the domestic D&O marketplace. As a practical matter, at least as things currently stand, quota share insurance is not a viable alternative to the current customary layering of D&O programs.

Recommendations

If D&O insurance layering is an inevitable aspect of most D&O Insurance programs, the question then is how can the problems the various commentators have identified be reduced? We have no comprehensive solutions, but we do have a few suggestions on how some of the problems might be reduced:

1. **Keep the Excess Carriers informed:** Problems often arise when the excess carriers are advised only at the eleventh hour that there is a settlement demand that pierces their layer or that the defense expenses are about to exhaust the underlying layers. If the excess carriers are provided complete information as the claims develop, they are less likely to resist requests for quick action based on lack of information.

2. **Keep Track of Difficult Insurance carriers:** It could be argued that as an industry, we do not do nearly enough to hold carriers accountable over time for recalcitrant behavior. Over the long haul, everyone would benefit if there were a league table of claims responsiveness. If carriers knew that their claims reputations truly depended on their responsiveness, there would be greater disincentives against foot-dragging and other undesirable behavior.

3. **Horses for Courses:** This point is really a corollary of the prior point. That is, when the D&O insurance program is being structured at the outset, a great deal of care should be taken to give preference to the carriers that have consistently demonstrated themselves to be responsive participants.

4. **The Broker Has a Role to Play:** One way to try to keep the claims process on track and settlement efforts moving forward is to enlist the assistance of the insurance broker that placed the coverage, at least to the extent that the broker has claims personnel available with sufficient knowledge and experience to be able to participate meaningfully in the claims process and to be able to act as a claims advocate for the policyholder. The broker can also remind the various carriers involved of points 2 and 3 above.

All of this underscores the fact that the process of putting together an appropriate D&O insurance program is an art, and not a science, and it requires not only a great deal of technical knowledge, but a broad perspective on the claims process and on the various carriers' track records in that process. Which is another way of saying that the most important step in putting together an appropriate D&O insurance program is making sure that a knowledgeable and experienced broker has been enlisted to guide the process.

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