D&O INSURANCE

Limits Selection and Program Structure

This article discusses the perennial questions of limits selection and program structure — that is, how much insurance is enough, and how should the insurance be structured? As explained below, these two questions are inextricably linked.

LIMITS SELECTION

One of the most challenging questions for anyone that advises D&O insurance buyers is "What is the right amount of insurance?" Answering the question inevitably involves a mixture of art and science, particularly because the analysis is affected by basic considerations of cost and risk tolerance. While there are certain objective benchmarks that can help to inform the process, the benchmarks must be considered in conjunction with relevant factors that should also influence the analysis.

The question of D&O insurance limits selection is, of course, different depending on whether the buyer is a publicly-traded company or privately-held. The difference in analysis between the two is not just in the total quantity of insurance purchased, but also in how the limits selection question is analyzed. Limits selection for public and privately-held companies will be discussed separately below.

For publicly-traded companies, there are some basic benchmark reference points and some additional considerations that every insurance buyer should assess.

Publicly-traded companies will first want to approach questions surrounding limits selection from the perspective of basic limits adequacy, taking into account the company's likely securities class action litigation settlement exposure. The securities suit settlement exposure is the appropriate starting place because for the majority of companies in most circumstances, a securities suit represents the company's largest management liability exposure. The company should be provided with information sufficient to allow it to assess the range and distribution of settlements for companies of its size and other characteristics.

A second benchmark publicly-traded companies may want to consider is peer purchasing patterns – that is, how much D&O insurance do other companies like ours elect? Some buyers find this information reassuring, although care should always be taken to make sure that peculiar purchasing patterns, which sometimes can be industry-wide, do not inappropriately drive an important decision like limits adequacy.

In addition to these basic, relatively objective guidelines like settlement trends and peer purchasing patterns, there are other considerations that should also be taken into account.

The first is that the information about securities class action settlements, discussed above, does not take into account defense expense. Defense costs must be considered, because under most D&O insurance policies, defense costs erode the limits of liability. Every dollar of defense cost means one less dollar available for settlements or judgments. For a company to be sure that it has adequate limits of liability, both to defend and to settle serious claims, appropriate consideration must be given to likely defense expenses as well as to settlement amounts. Along those lines, it is critical to note that both settlements and defense expenses have been escalating in recent years, much faster than the rate of economic inflation.

The other consideration that should be taken into account is that the most important value of D&O insurance is the protection it affords individual insureds in the event of a catastrophic claim. When things go seriously wrong, the D&O insurance may be the individuals' last line of defense.

When these catastrophic type events occur, the company and the individual directors and officers may find themselves battling multiple legal proceedings simultaneously. In addition, the interests of the various defendants in the multiple proceedings may conflict dramatically, particularly when ousted former management is faulted for the company's woes. Often when this occurs, each defendant will retain separate counsel. Under these circumstances, defense expenses can mount astonishingly quickly, causing the rapid depletion, or even the complete exhaustion of, the available insurance.

The possibility of a catastrophic claim that could consume available limits underscores the importance of careful consideration of limits selection issues. Simply put, what other cases might have settled for in the past, or how much insurance other companies buy, may provide little guidance for the question of how much insurance a particular company might need in the future. Further, settlement and purchasing pattern data tend to be backward looking and incorporate historical patterns that may not be relevant to future requirements.

On the other hand, the difficulty of using a catastrophic claim scenario is that it may quickly lead to the rather unhelpful conclusion that no amount of insurance is enough to address the top end exposures. At some point, the analysis must shift from the quantity of insurance to the structure of the insurance, a question that is addressed further below.

With respect to private companies, the issues are different, primarily because privately-held companies do not typically face class action securities litigation risks. However, merely because private companies have no class action securities litigation exposure does not mean that private companies and their directors and officers do not face serious liability risks. We have in fact witnessed numerous private company D&O claims that have settled for millions of dollars.

For private companies, the objective reference standards are peer purchasing patterns by company asset size. These peer data have the same benefits and limitations as they do for public companies, but many buyers find this data useful and reassuring in the insurance acquisition process.

The limit of liability for private company D&O insurance is, like public company D&O insurance, in most instances subject to erosion by defense expenses, so many of the same considerations concerning defense expenses should also be taken into account for questions of private company D&O limits selection.

One added consideration particular to private company D&O insurance is that the entity coverage available under a private company policy is quite a bit broader than is the entity coverage in a public company policy. (The public company policy is limited to securities claims; the private company policy does not maintain this limitation).

The broader entity coverage available in the private company policy creates the possibility that the limits of liability could be eroded by the defense expenses and settlements of the entity, potentially leaving the individuals with less (or no) insurance remaining to defend themselves or settle claims. The broader entity coverage in the D&O policy could influence some buyers to increase the D&O insurance limits of liability, as one way to protect against erosion or exhaustion of the limits by entity claims.

PROGRAM STRUCTURE

In light of the escalating average claims severity and of the catastrophic potential for defense expense to deplete policy limits, it may be necessary to reconsider commonplace concepts of limits adequacy. Increased limits alone, however, may not solve all of the problems.

Part of the solution has to be program structure. Clearly, one of the factors that can contribute to limits depletion or exhaustion is that so many different people are accessing the insurance, particularly when there are multiple simultaneous claims. One way that well-advised corporate officials can ensure they are not left without insurance to protect them as individuals is through supplemental D&O insurance structures dedicated solely to their own protection.

These supplemental structures might take any one of a number of different forms, including for example, excess Side A coverage for a specified group of individuals, or an individual D&O insurance policy (so-called IDL coverage). While there are a variety of ways this supplemental insurance might be structured, the possibility of catastrophic claims underscores the importance of addressing these issues as part of the insurance acquisition process.

The point of these supplemental insurance structures is to ensure that no matter what happens, the individuals (or some subset of them, for example, the non-officer directors) will have insurance devoted to protect them.

Moreover, these alternative structures often have broader coverage than the "traditional" D&O insurance; for example, they often contain fewer exclusions. They also provide so-called "drop down" protection when they provide first dollar coverage, for example, in the event, that the underlying traditional D&O insurers have become insolvent or seek to rescind coverage. In addition, because these alternative insurance structures protect only specified individuals, the insurance cannot be siphoned off for the payment of entity claims or the claims of other individuals who are not insured under the structure.

The complexity of these limits selection and program structure issues underscore how indispensable it is that insurance buyers enlist knowledgeable and experienced advisors in their D&O insurance acquisition process. In particular, it is important that buyers ensure not only that their advisors have access to the data described above as it is relevant to the limits selection process, but also have the ability to explain the limitations of the data as well as the additional considerations that should be taken into account. In addition, the insurance advisor should be able to guide the company through the process of selecting the right insurance structure to ensure that the company and its directors and officers are adequately protected, even in the event of a catastrophic claim.

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