ARE YOU CONFIDENT?
FINPRO COVERAGE CONSIDERATIONS: UNDERSTANDING THE PRIORITY OF PAYMENTS CLAUSE

A priority of payments clause (also referred to as an order of payments clause) specifies the order in which payments are to be made under a directors and officers (D&O) liability policy, with insured persons' non-indemnifiable loss prioritized over the corporate entity. Such clauses are essential to protect insured persons' interests in D&O policy proceeds, especially where there may be competing interests for the proceeds of the policy (for example, in a bankruptcy scenario).

A priority of payments clause is important for several reasons:

- A D&O liability policy is composite in nature. A typical D&O policy covers insured persons for non-indemnifiable loss (Side A), the corporate entity where it has indemnified its directors and officers (Side B) and the entity where it is the defendant in securities litigation (Side C).
- A D&O policy typically contains an aggregate limit of liability for an annual policy period, meaning there is a single limit of liability for all claims made during that policy period.
- Typically, if multiple parties claim rights under the policy (for example, individual directors and officers and the corporate entity), claims are paid in the order in which the costs have been incurred and submitted to the insurer for reimbursement. This becomes relevant where the limit of liability might be insufficient compared to the projected total loss.
- In the US, a D&O insurance policy with Side C coverage is often considered to be part of the estate of a company that has filed for bankruptcy protection.

A priority of payments clause — a relatively standard provision in a D&O policy — details the order in which payments under the policy are to be made if there are competing claims for coverage or payment. Most priority of payments clauses contain a "release" feature stating that the insurer will pay the Side A loss first and will withhold payment for any other loss until a nominated individual (or group of individuals) decides to release the proceeds. Often, this decision is made by the company's decision-maker, but sometimes it is made by a majority of independent directors or sometimes no specific decision-maker is referenced in the policy. A potential conflict of interest may arise when the decision-maker is to make the decision around the release but is also a defendant.

While a priority of payments clause seeks to prioritize the Side A portion of a D&O policy where competing claims exist, the clause does not remove the need for D&O buyers to maintain both:

- Adequate limits of liability.
- A robust Side A/Side A DIC policy to ensure there are dedicated limits for individual insureds.

A clear understanding of the nuances in priority of payments clauses can help ensure your directors and officers and your organization are protected in the event of a claim.

EXAMPLE CLAIMS SCENARIOS

Example 1: A Side C claim is notified to a D&O policy (with Sides A, B, and C and a priority of payments clause); no claims against individual insureds have been made. The total D&O limit available is $10 million. Outside counsel budgets $15 million for defense costs. In the same period, and after $5 million of costs have been paid for the Side C claim, a Side A claim is made against individual insureds, which their outside counsel estimates will generate $7 million in defense costs. The priority of payments clause effectively freezes the remaining Side C claim payments so that the Side A claim costs can be paid first up to the remaining $5 million in limits.

Practical considerations: The individual insureds are potentially exposed to $2 million in defense costs, which they would have to self-fund ($7 million in costs less the $5 million in limit used). The company would be exposed to $10 million in defense costs, which it would have to self-fund ($15 million in costs less the $5 million in limit used). Absent a priority of payments clause and assuming Side C claim defense costs had been incurred at a faster pace than the Side A claim defense costs, the individual insureds might be required to self-fund a larger portion of their defense costs. If purchased, the excess Side A DIC program should drop down to cover any Side A costs that exceed the remaining limits or, if there is no priority of payments clause, the Side A DIC program should drop down and fund the individual directors' or officers' covered defense costs up to the Side A DIC program's limits.

Example 2: A company has entered Chapter 11 bankruptcy protection. The company maintains $100 million of ABC cover (without a priority of payments clause) and $25 million of excess Side A DIC cover. A Side A claim is made against individual insureds prior to Chapter 11 and $5 million of an estimated $20 million in defense costs is reimbursed by the D&O insurer under the Side A portion of the ABC program. The bondholders bring a Side C claim against the company, which is expected to cost $70 million to defend. Once the company files for bankruptcy protection, the remaining $95 million in ABC limits will likely be frozen.

Practical considerations: To the extent the litigation against individuals remain ongoing, individual insureds and the company's D&O insurers will likely agree to request that the court lift the stay with respect to the remaining ABC limits to allow individual insureds to access the Side A coverage to pay for their continued defense costs and/or a settlement or judgement. It is possible that the bankruptcy court will agree to lift the stay; it is more likely that the court will allow a conditional or limited lift of the stay — meaning that individual insureds are allowed access to a portion of the remaining $95 million in ABC limits. If the stay is not lifted and/or the individual insureds do not have access to sufficient limits under the ABC program, the individual insureds should still be able to access the $25 million in dedicated excess Side A DIC coverage. The Side A DIC coverage is not accessible to the company and therefore should not be subject to a stay by the bankruptcy court.

While this is a very technical nuance of D&O, it is important to be familiar with how this provision could impact coverage.

For more information, contact:

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