ARE YOU CONFIDENT?

FINPRO COVERAGE CONSIDERATIONS WHY A COMPANY SHOULD CONSIDER BUYING SIDE A DIFFERENCE IN CONDITIONS ("SIDE A DIC") COVERAGE

A typical D&O insurance policy is comprised of three insuring agreements – Side A, Side B and Side C. Of those three coverage parts, Side A coverage is the only coverage that applies solely to the directors and officers. Side A coverage is insurance for the directors and officers of the company, and is triggered if the company refuses or is unable to indemnify its directors and officers. Side A coverage operates as personal asset protection for the directors and officers as it covers a loss incurred by individual directors and/or officers resulting from claims for which the company has not indemnified them.

Traditional Side ABC coverage can be exhausted by indemnifiable losses (for example, securities claims against the company and the directors). As a result, a majority of publicly traded companies purchase what is referred to as Side A difference-in-conditions (Side A DIC) coverage in excess of its Side ABC limits. This type of coverage provides additional limits dedicated to individuals — only directors and officers are covered insureds under the policy. Side A DIC policies can also fill gaps in the underlying traditional coverage (for example, the company refuses to indemnify a director or one of the underlying insurers becomes insolvent). Because the company is not an insured under a Side A DIC policy, the company's own defense or indemnity payments cannot erode the Side A DIC limit of liability.

WHAT RETENTION APPLIES UNDER SIDE A COVERAGE?

If coverage under Side A is triggered, a covered director or officer does not need to pay a deductible or self-insured retention.

WHEN IS SIDE A COVERAGE TRIGGERED?

There are situations in which an insured company is prohibited by law, corporate authority, or other corporate contracts from indemnifying one if its officers or directors:

- **Derivative litigation judgments or settlements.** Derivative litigation is brought by the shareholders on behalf of the company itself. As such, the ability of the company to indemnify its directors or officers for judgments or settlements resulting from a shareholder derivative action may be significantly limited or prohibited by statute. For example, Delaware does not allow indemnification of settlements or judgments in an action brought by, or on behalf of, a company against its D&Os.

- **Conduct not in "good faith" and "reasonable belief."** A Delaware corporation may indemnify a director or officer only if such person acted in good faith and in a manner he or she reasonably believed to be in, or not opposed to, the best interest of the company. As a result, acts that do not satisfy the "good faith" and "reasonable belief" standard may not be indemnified by the company.

- **Public policy prohibition or statutory limitations against indemnification.** Indemnification may be precluded by public policy. For example, indemnification is precluded for claims under the registration and antifraud provisions of the federal securities laws. The Securities and Exchange Commission's (SEC) view is that such indemnification is against public policy. Other laws that may prohibit or limit indemnification include claims under the Racketeer Influenced and Corrupt

Organizations Act (RICO), certain antitrust violations, failure to pay payroll taxes, and some penalties under the Foreign Corrupt Practices Act (FCPA).

There are situations in which an insured corporation has an obligation to indemnify one of its officers or directors, but is either unwilling or unable to do so.

- **Refusal by Board to Indemnify.** There are several scenarios in which a corporation is able to indemnify its directors and officers, but chooses not to do so. For example, in a corporate crisis or in the aftermath of a hostile takeover, when part of an executive team or board of directors becomes hostile to other current (or former) members of an executive team or board, a covered individual may, rightly or wrongly, be denied indemnification. Any newly constituted board would make indemnification decisions and, if indemnification were permitted but not mandatory, might decide that there may be no benefit to the corporation to indemnify. Although the affected director or officer (or former director or officer) may seek redress through litigation, costs and expenses become magnified.

- **Near Insolvency.** As a company approaches insolvency, it approaches the "zone of insolvency" where officers and directors owe certain fiduciary duties to creditors. Although not yet insolvent, a company might choose not to indemnify a particular director or officer for fear that such act may be a breach of fiduciary duty owed to creditors of the corporation or for fear that the indemnification proceeds may be ordered returned to the company by a bankruptcy trustee.

- **Actual Insolvency or Bankruptcy.** The insured corporation may be unable or unwilling to indemnify an officer or director if a bankruptcy court determines in its judgment that such indemnification is either unwarranted or improper. Moreover, assuming that such indemnification of an officer or director is determined to be warranted and proper, the proceeds of the traditional Side ABC policy may be deemed an asset of the "estate," subject to an automatic stay, and the obligation to indemnify may be deemed an unsecured obligation, placing the affected officer's or director's interest behind the interest of secured creditors and on par with other unsecured creditors awaiting payment or settlement.

WHAT ARE THE BENEFITS OF SIDE A DIC INSURANCE VERSUS SIDE A INSURANCE?

- **Broader Coverage Terms.** Coverage written on a Side A DIC policy is broader than if written on the Side A component of a more traditional ABC form. It is also broader than a "standard" excess Side A form (a policy form that does not include DIC features). Coverage enhancements in these forms may include:
  - Limited exclusions if any – it is not uncommon to only see a conduct exclusion in a Side A DIC policy (i.e. no exclusions for bodily injury/property damage, pollution, insured versus insured, ERISA, FLSA).
  - Nonrescindable (the policy cannot be rescinded for any reason).
  - Noncancelable policy once premium is paid.
  - Insurer's consent to defense counsel not required.
  - Broad definition of insureds.

- **Drop-down provision/protection against insurer dissolution and presumptive indemnification risk.** In general, the limits purchased for a traditional D&O policy are layered and placed with a number of different insurers, because no single insurer wants to insure the entire risk of exposure for any one company. The potential downside is that if one insurer dissolves or is otherwise unwilling or unable to fund its limit of loss, insurers that have the obligation to insure a loss in excess of that "uncovered loss" may not respond unless that "uncovered loss" is otherwise covered or "backfilled." An excess Side A DIC policy will drop down and respond to such an "uncovered loss."

- **Undiluted dedicated limits for claims against directors and officers.** Under a traditional ABC D&O policy, with all three insuring agreements, the limits purchased by the company are shared limits that cover both the personal assets of individual directors and officers and certain financial obligations of the company. To the extent limits under the program are exhausted to cover any one exposure, the result will be less limits available to cover other exposures. An excess Side A DIC policy will provide dedicated and exclusive limits for claims made against directors and officers that cannot or will not be indemnified by a company.

- **Later settlement or judgment in derivative claim vs. securities class action.** Unlike many other types of insurance, D&O policies protect two distinct sets of beneficiaries: the company and the individual directors and officers of a company. Because there is a limit of liability for D&O programs, situations may arise when the insurance proceeds may have to be prioritized among the insured parties. Typical D&O policies have a provision that prioritizes payments made by insurers in the event there are concurrent claims made against a company and its individual directors and officers, including both shareholder derivative claims (settlements of which are generally not indemnifiable) and securities class-action claims (which are indemnifiable). In general, such provisions state that proceeds should be paid first to cover claims made against directors and officers for nonindemnifiable claims, then second to the company to cover corporate reimbursement and securities claims. In theory, there should be no issues. However, with increased frequency, derivative cases (sometimes multiple) are being filed as "companion" or "tag-along" suits to securities class actions. Moreover, such derivative suits are being settled after settlement of the securities class actions. Because many derivative suits cannot be indemnified by the company and the priority of payment provisions require payment to be made first to cover settlement of derivative suits, the result is that insurers cannot immediately pay a settlement for a class action for fear that the later settlement of the derivative suit may be in excess of the policy limits. A Side A DIC policy would avoid that circumstance by providing drop-down dedicated limits for settlement of that derivative suit.

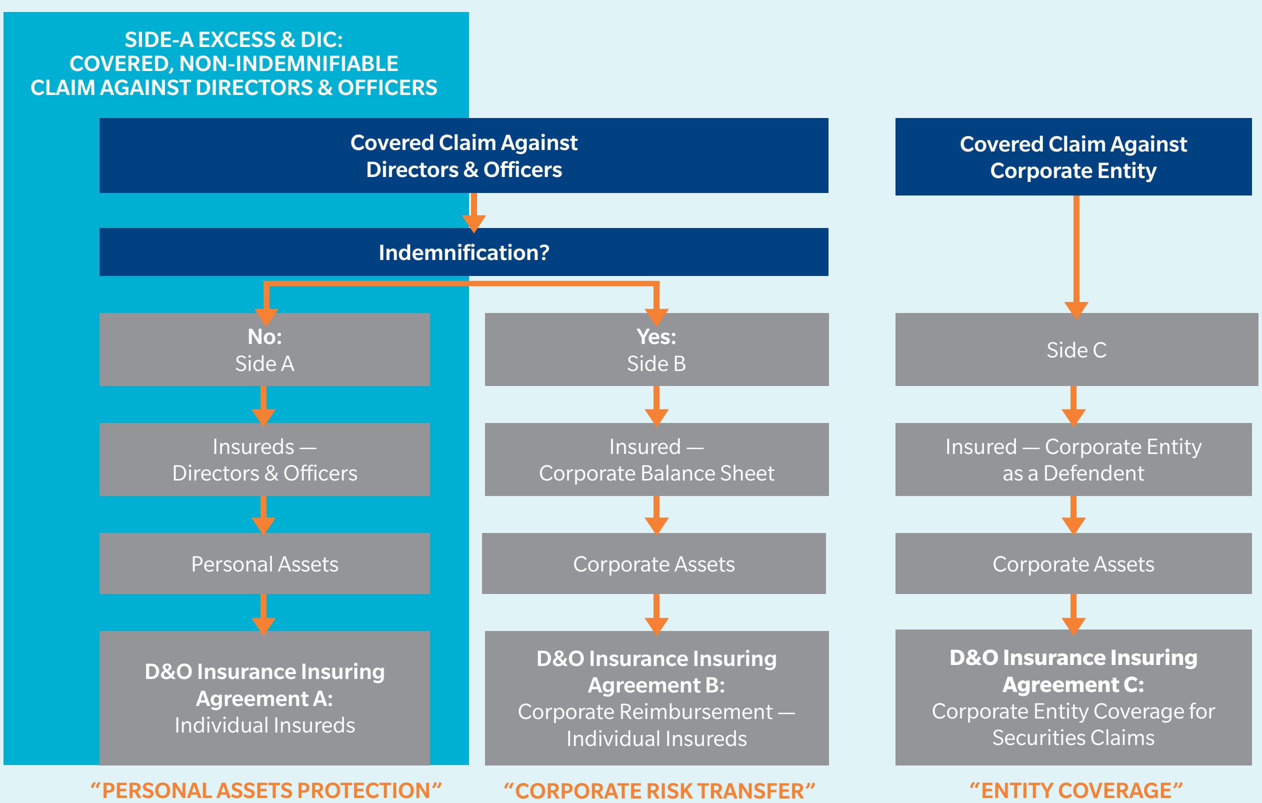
A clear understanding of the additional protection Side A DIC coverage offers can help ensure your directors and officers are thoroughly protected in the event of a claim.

Directors and officers (D&O) liability insurance comprises distinct insuring agreements, each of which has a different function in the financial protection of either the company and its financial obligations or the assets of individual directors and officers.

Side A: Many companies buy Side A coverage, which is insurance for the directors and officers that is triggered if the company refuses or is unable to protect or indemnify its directors and officers. Side A coverage operates as personal asset protection. Side A DIC coverage is broader than traditional Side A coverage.

Side B: Reimburses the company for costs it pays on behalf of a director or officer (typically legal defense costs, settlements, or judgments).

Side C: Protects the company if it gets sued and operates as balance sheet protection.



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