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BERKSHIRE HATHAWAY SPECIALTY INSURANCE

Executive & Professional Lines
Side A Series

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Often referred to as "sleep at night" coverage, Side A insurance can pay on behalf of individual persons when the company cannot or will not pay for (i.e., indemnify) an individual's defense costs, settlement or monetary court judgment. While the general concept of Side A insurance is straightforward, the application of Side A insurance across various insurance programs can be complex in a claim scenario.

This article provides an overview of coverage afforded under the Side A insuring agreement and details alternative Side A tower structures, including Excess Side A, Excess Side A DIC, Ground Up Side A and Side A Only IDL. This article also provides general examples of how different types of Side A coverage respond to claims.

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WHAT IS SIDE A INSURANCE COVERAGE?

A traditional Directors & Officers ("D&O") insurance policy has three insuring agreements: Side A Coverage, Side B Coverage and Side C Coverage, which together protect both individual persons and the company's balance sheet.

Side A insurance, like D&O insurance generally, is "claims made" insurance, which means that the policy in effect at the time the claim is first made is the policy that responds. In general, Side A coverage pays for defense costs or amounts that an insured person is obligated to pay because of a claim against such person for a wrongful act when the company cannot or will not pay; however, the extent of coverage available varies depending on whether the claim is civil or criminal.

Defense cost coverage is available for either class of claim, assuming that the company is not paying on the insured person's behalf. For claims arising from criminal investigations, however, coverage may be limited, as fines and penalties are often legally uninsurable and excluded from coverage. Although Side A policies often include a conduct exclusion, which precludes coverage for any illegal profit or fraud, Side A policies may provide coverage for defense costs and for a settlement arising from this conduct (when insurable) as the conduct exclusion usually does not apply until after a final judgment has been entered against the individual.

TRADITIONAL D&O POLICY INSURING AGREEMENTS

Insuring Agreement A (Side A Coverage)

- Specifically designed to protect the individuals for claims made against them arising from wrongful acts in their capacity as director or officer.
- Only triggered when the company cannot or will not indemnify the individuals.
- Pays from the first dollar to fully protect the individuals' personal assets (i.e., no applicable retention).

Insuring Agreement B (Side B Coverage)

- Reimburses a company for its indemnification of directors and officers and is subject to a self-insured retention.

Insuring Agreement C (Side C Coverage)

- Protects the entity itself when sued and is also subject to a self-insured retention.

WHO IS AN INSURED PERSON UNDER SIDE A INSURANCE?

In a traditional D&O insurance policy, insured person is a defined term which generally includes elected or appointed directors, officers, in-house general counsel, risk manager, controller, trustees, mangers, members of a board of managers, or board observers. Often added by extension, the definition of an insured person can be expanded to include an outside entity executive, meaning a director or officer serving in their capacity for another entity, such as a not-for-profit entity.

Given the claims made trigger of the policy form, a Side A policy may provide coverage for former directors and officers, as well as current, if the claim is premised on actions taken while the individual was on the board or employed by the company. In other words, the resignation of a director or officer does not terminate coverage for actions previously taken.

WHAT ARE THE VARIOUS SIDE A COVERAGE INSURANCE PROGRAM STRUCTURES?

Side A insurance comes in many versions, each unique in its own way. Below is an overview of the different types of Side A insurance program structures.

Traditional D&O Insurance Program (Includes Side A Insuring Agreement):

A traditional primary D&O insurance policy includes three types of insuring agreements: Side A Coverage, Side B Coverage and Side C Coverage (as shown in Illustration A). Excess limits may be purchased from additional insurance companies, with these excess policies following form to the terms and conditions for all insuring agreements of the primary D&O insurance policy (as depicted in Illustration B).

Illustration A.

Traditional D&O Insurance Primary Policy
Primary D&O Retentions • Insuring Agreement A: Not Applicable • Insuring Agreements B and C: Applicable Retention

Illustration B.

Excess D&O Insurance (2nd Excess Layer)
Excess D&O Insurance (1st Excess Layer)
Traditional D&O Insurance Primary Policy
Primary D&O Retentions • Insuring Agreement A: Not Applicable • Insuring Agreements B and C: Applicable Retention

Under a traditional primary D&O insurance policy, what would trigger Side A coverage?

The most common reasons Side A insurance covers a loss are because a company is insolvent and because the company is legally prohibited from paying, such as corporate bylaw restrictions or for a derivative lawsuit settlement or judgment.

What is a derivative lawsuit? It is a lawsuit brought by a shareholder, on behalf of a corporation, against the corporate leadership for breach of their fiduciary duties to the company and it seeks to redress harm caused to the company itself. By suing derivatively, shareholders "stand in the shoes" of the corporation to protect the present and future value of the company's stock. Because a shareholder suing derivatively is not seeking damages for themselves, but is seeking damages for the company, there are certain legal restrictions on whether a company can indemnify its directors and officers. Since a shareholder derivative lawsuit is filed pursuant to state law, each state's law will determine whether a company can pay its shareholders to remedy its directors' and officers' breaches of fiduciary duty.

Here are two claim examples:

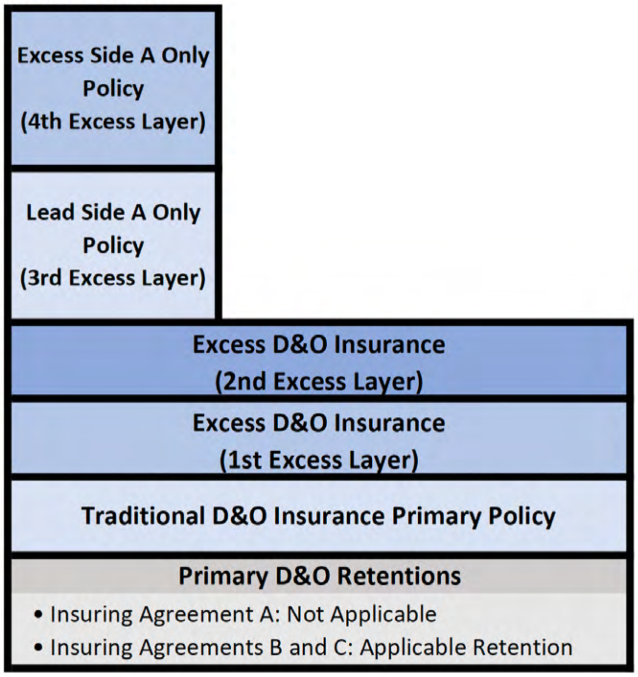
Primary Side A Claim Example: A company is experiencing financial difficulties and cannot pay its vendor's invoices. The vendor sues the company for breach of contract, but also names several executives as defendants in the same lawsuit. The vendor alleges that the executives fraudulently induced the vendor to provide supplies when the executives knew that the company could not afford the supplies. The executives ask the company to indemnify them in the lawsuit, but the company refuses because it has no resources to pay their defense bills. The traditional D&O policy, under Side A, will pay the directors and officers' defense costs and all or part (depending on policy language) of settlement or a judgment because the company has refused to indemnify directors and officers.

Primary Side A and B Claim Example: Shareholders file a derivative action against both its directors and officers. The traditional D&O policy, under Side B, pays the directors' and officers' defense costs during the litigation, noting that because the entity is only named as a nominal defendant in a derivative lawsuit, coverage is typically not triggered for the entity. However, once the defendants reach a settlement with the plaintiffs, primary Side A coverage pays for the monetary part of the settlement on behalf of the directors and officers since applicable law in most states does not permit the company to indemnify for derivative settlements or judgments.

Excess, Dedicated Side A Insurance:

Some companies also purchase Side A "only" policies that sit excess of the traditional D&O tower, often referred to as "excess Side A." The first excess Side A only carrier often issues a "lead" (aka primary) Side A policy. Illustration C. below provides an example of this insurance program:

Illustration C.



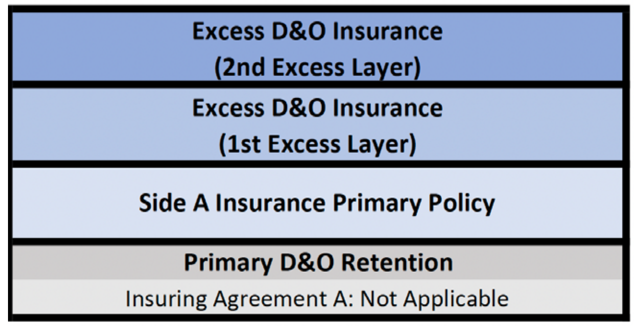
Why would a company need additional or excess Side A coverage? Here is an example:

Excess Side A Claim Example: Shareholders file a securities class action against the company and the directors and officers. Later, shareholders file a "tag-along" derivative lawsuit against the directors and officers. The underlying D&O insurance policies pay the policy limits to defend the individuals and the entity (under Side B and C, respectively) for the securities class action. The settlement of the securities class action exhausts the remaining underlying excess D&O insurance limits (under Side B and C). Then the parties want to settle the derivative lawsuit. Because the traditional D&O insurance policies are fully exhausted (including any available Side A limits), the excess Side A insurance, starting with the Lead Side A, will pay the monetary part of a derivative settlement on behalf of the directors and officers since the applicable state law does not permit the company to indemnify.

Ground Up Side A Insurance Program:

Some companies with enough cash on their balance sheet choose to self-insure for most claims, but still need protection for their directors and officers in case of a bankruptcy or a derivative lawsuit. These companies often utilize "ground up" Side A programs. These are insurance towers composed entirely of Side A coverage. Illustration D shows an example of this program:

Illustration D.



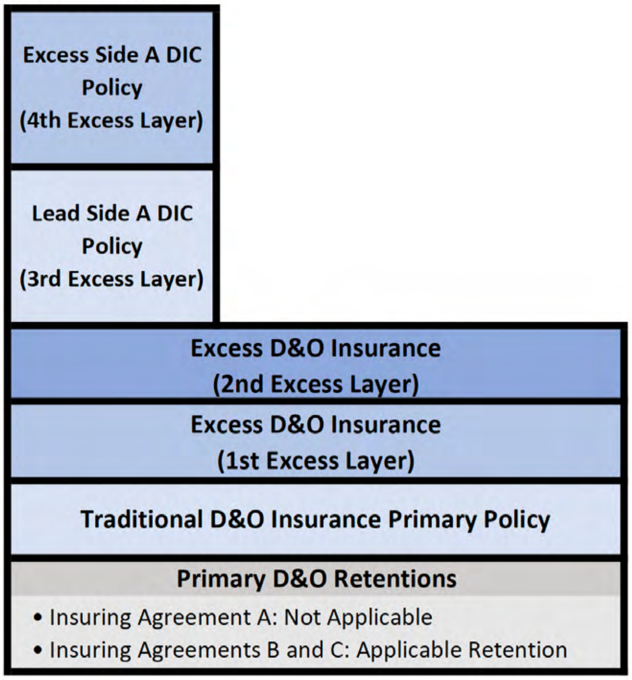
Side A Difference-In-Conditions (DIC) Insurance Coverage:

It is also common (and even standard now) for a company to purchase Side A DIC insurance, which stands for "difference in conditions." Side A DIC insurance provides typical Side A coverage (by following the coverage provided by the Side A insuring agreement in the primary D&O policy), but it also steps in to provide coverage to an insured person when a "DIC event" occurs. A DIC event includes instances in which a primary D&O insurer refuses or is unable to pay, or where the primary D&O policy terms do not provide coverage and the broader Side A DIC policy terms do provide coverage. Side A DIC policies can provide broader protection than a typical Side A policy (or Side A insuring agreement) through coverage enhancements.

By way of example, DIC enhancements can include investigations of directors and officers; broader range of covered loss, including for pre-claim inquiries, costs to produce documents, coverage for certain fines and penalties, and plaintiff's fees; defense costs associated with compensation claw back claims; narrower conduct exclusion; and fully non-rescindable coverage.

Side A DIC insurance coverage is often purchased from the "lead" or first excess Side A only carrier, as shown in Illustration E:

Illustration E.



Why would a company need Side A DIC coverage? Here is an example:

Side A DIC Claim Example: The Financial Industry Regulatory Authority ("FINRA") files a complaint against an insured person of a bank. FINRA accuses the insured person of misrepresenting to the bank that she was a passive, rather than active, investor in a hedge fund and accuses her of soliciting investments from the bank's customers. The bank refuses to indemnify the insured person. Additionally, the bank's traditional D&O insurer denies coverage for the insured person because its definition of "wrongful act" does not cover a FINRA action against the insured person. However, the Side A DIC policy has a much broader definition of "wrongful act" such that there is coverage for the insured person's defense costs under the Side A DIC policy. Therefore, the Side A DIC policy "drops down" and pays for the insured person to defend herself before FINRA and through any appeal. However, a Side A DIC policy most often will not cover fines or penalties, so any FINRA fines assessed against the insured person are likely her personal responsibility.

Side A-Only Independent Directors Liability Insurance Coverage:

Companies who currently have or who want to recruit independent directors may need to purchase Side A-Only Independent Directors Liability ("IDL") insurance coverage. Side A-Only IDL policies provide a stand-alone, dedicated layer of Side A protection solely for independent directors, which responds to a claim for non-indemnified loss only when the underlying coverage does not respond. When the underlying coverage does not respond, IDL coverage is structured to "drop down" and provide the first dollar coverage, i.e., no applicable retention. IDL coverage is designed to supplement the liability coverage afforded to independent directors by the traditional Side A Only or Side A DIC policies, such as when the company's coverage is depleted through claim payments.

CONCLUSION

Purchasing the right kind of Side A insurance coverage is the most important step companies need to take to help ensure that directors and officers are protected when they need it most. Not all Side A policies or insurance carriers are created equal, so it is essential that companies and insured persons understand how their policy will respond in different scenarios. Additionally, adequate evaluation of a company's risk is essential to determine how large of an insurance tower should be purchased.

While this article has covered some Side A basics, stay tuned for future Side A discussions, including why Side A DIC policies are vital to protecting individual persons and why carrier DIC terms matter. Future editions will also discuss how Side A coverage works in conjunction with derivative lawsuits and bankruptcies.

We encourage you to reach out to your broker partner and Berkshire Hathaway Specialty Insurance underwriter for further information and guidance when selecting a Side A product that is right for you and your company.

ABOUT THE AUTHOR

Laura Fahey is Complex Claims Director in Executive & Professional Lines Claims at Berkshire Hathaway Specialty Insurance, working in BHSI's Chicago office. Laura has more than 10 years of experience in the legal and insurance industries, most recently focusing on high severity Directors & Officers, Bankers Professional, Insurance Company Professional, Private Equity and Investment Advisor Professional liability claims.

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