



Viva la captives!

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Side A D&O and Captives New Developments and Considerations

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WHY SIDE A AND CAPTIVES TODAY?

- D&O coverage includes 3 components, ABC
- Until recent developments, only BC coverages were widely accepted as being possible to insure within a captive
- SIDE A is the most essential coverage part, so this is a very significant development, which allows companies to explore a broader range of uses for captives in D&O

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WHAT IS THE SPECIFIC CHANGE

- Delaware, always a leader in D&O law and related insurance law, has now taken the position that non-indemnifiable loss can be insured through a captive.
- The recently approved amendment to Section 145(g) of Delaware's general corporation law expressly indicates that companies can include Side A coverage in captives where a loss may otherwise be non-indemnifiable by the company.

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INDEMNIFICATION IN A D&O CONTEXT

- A basic premise of the relationship between directors and officers and the corporation is the broad promise to indemnify these individuals for liability they might incur while acting in their capacity
- Three possibilities of non-indemnifiable situations stand out:
 - Derivative claims, where the claim is brought "on behalf of" the organization
 - Allegations of intentional wrongful acts (ie. Fraud or willful violations)
 - Financial insolvency and therefore inability to indemnify

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WHO WILL USE CAPTIVES FOR SIDE A

- Large amount of cash available
- Coverage not available at all due to
 - Capacity limitations
 - Underwriter hesitance based on industry
 - Underwriter hesitance based on company specific characteristics
- Coverage available, but premium required is unattractive
 - Variation of this situation: insuring in captive a portion of a very large self-insured retention; such as \$25M

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Public Company D&O Insurance

- A public company D&O policy typically has three insuring agreements, referred to as Side A, Side B, and Side C
- These insuring agreements typically appear on a single form and are subject to a single, aggregate limit of liability

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Public Company D&O Insurance

- Side A: coverage for non-indemnified loss
- Loss that an Insured Person becomes legally obligated to pay resulting from a Claim first made against the Insured Person during the Policy Period, for a Wrongful Act, but only to the extent that such Loss is not indemnified by an Organization

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Public Company D&O Insurance

- Side B: reimbursement for indemnified loss
- Loss that an Insured Person becomes legally obligated to pay resulting from a Claim first made against the Insured Person during the Policy Period, for a Wrongful Act, but only to the extent the Organization has indemnified the Insured Person for such Loss

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Public Company D&O Insurance

- Side C: company securities claim coverage
- Loss that the Organization becomes legally obligated to pay resulting from a Securities Claim first made against the Organization during the Policy Period for a Wrongful Act

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Senate Bill 203

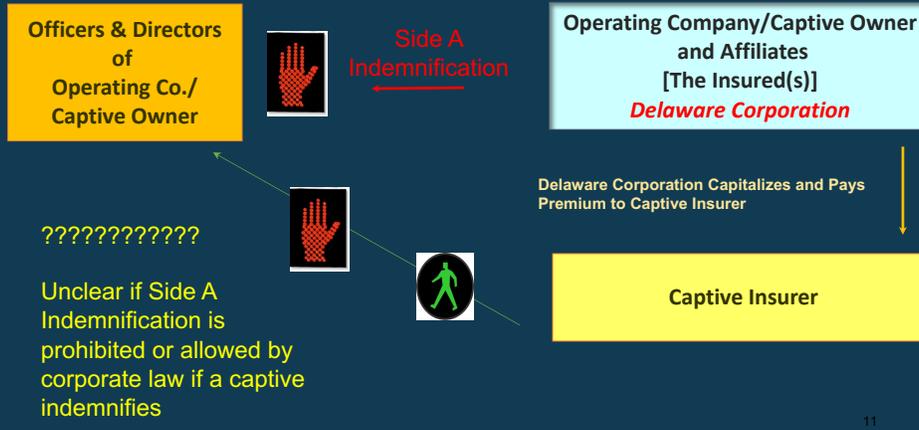
What it does and who does it impact

- Amends Section 145(g) of the Delaware General Corporation Law (DGCL) to expressly provide that the definition of “insurance” includes captive insurance.
- This makes captive insurers a viable alternative to traditional D&O insurance, even Side A D&O insurance, for claims that are not directly indemnifiable by the corporation due to DGCL Section 145(b).
- More than one million business entities have made Delaware their legal home and more than 60 percent of the Fortune 500 companies are incorporated in Delaware.

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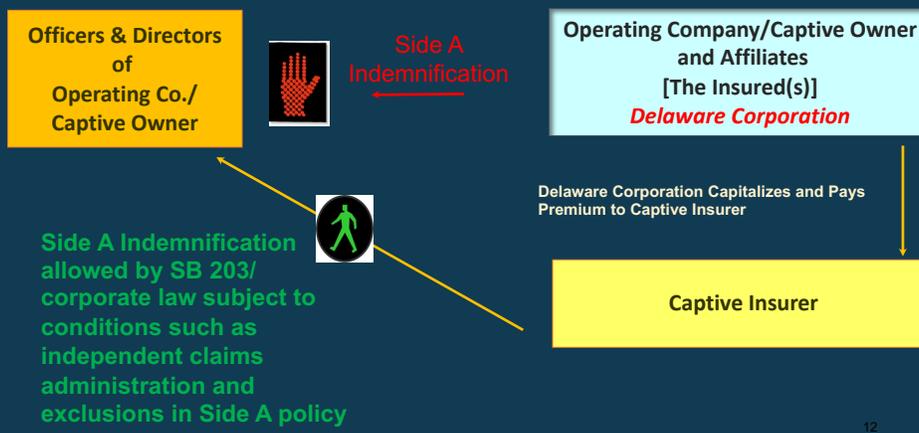
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Before Senate Bill 203 Captive Insurer D&O Insurance Indemnification Flow for Side A



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After Senate Bill 203 Captive Insurer D&O Insurance Indemnification Flow for Sides A



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Senate Bill 203

What does it specifically allow and disallow

- Does not mandate the use of a Delaware domiciled captive insurer – the captive can be organized and licensed in any jurisdiction.
- Does not mandate the type of captive insurer – the captive can be a pure, cell, series, or any other form that fits the insured and its risk.
- SB 203's synopsis clarifies that a captive insurer may indemnify the same way a third-party insurer would do so whether or not the corporation would have the power to indemnify the directors, officers, employees, other persons under Section 145, subject to limited exclusions from coverage
- The synopsis contemplates the use of a fronting insurer where the captive act as a reinsurer.

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Senate Bill 203

What does it specifically allow and disallow

Conduct exclusions

- Captive insurer may not make any payment in respect of loss arising out of conduct, based upon or attributable to:
 - (1) any personal profit to which the covered person was not legally entitled;
 - (2) any deliberate criminal or deliberate fraudulent act; and
 - (3) any knowing violation of law.
- These conduct exclusions apply only if it is established after a final, non-appealable adjudication in the underlying proceeding in which the prescribed conduct has occurred.

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Senate Bill 203

What does it specifically allow and disallow Conduct exclusions

- Because the conduct exclusions apply only after a final, non-appealable adjudication in the underlying proceeding, a captive insurer can pay amounts agreed to in a settlement even if there are allegations of the exclusionary conduct.
- The conduct of an insured person shall not be imputed to any other insured person when applying the conduct exclusions.
- Non-imputation provision is a clause found in most D&O policies stating that intentional misstatements or omissions in the application for coverage will not be imputed to, and therefore will not bar coverage for individuals who did not sign the application.

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Senate Bill 203

What does it specifically allow and disallow Claims payment requirements

- Any determination to make payment under a captive insurance policy must be made either by an independent claims administrator or in accordance with Section 145(d).
- Section 145(d) allows determinations by a majority of directors not party to the proceeding; a committee of such directors if the independent directors direct; independent counsel; or the stockholders make the decision.
- Independent claims administrator is currently undefined, but it may be defined as, “a third-party that is not directly or indirectly controlled by the corporation or any officer, director, employee, or other fiduciary of the corporation and who has contracted with the captive insurer to provide claims adjudication services.”

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Senate Bill 203

What does it specifically allow and disallow Claims payment requirements

- A corporation is not required under the DGCL to notify its shareholders that it has adopted a captive insurance arrangement or is using a captive insurer to provide Side A D&O coverage, nor is it required to seek or obtain approval from shareholders or the court to adopt a captive arrangement or use a captive insurer.
- However . . . before a captive insurer pays a claim in connection with the dismissal or compromise of any action, lawsuit, or proceeding brought by or in the right of the corporation as to which shareholder notice is required, the corporation must include in the notice that the claim payment will be made by the captive insurer.

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Typical D&O Claims

- Securities Litigation
 - Section 10(b) / Rule 10b-5 (Federal 1934 Act)
 - Section 11 (Federal 1933 Act)
- Derivative Litigation
 - Claims under state law, usually alleging breach of fiduciary duty

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Securities Litigation

- Section 10(b) / Rule 10b-5 (Federal 1934 Act): a purchaser or seller of securities seeks damages caused by an omission or misstatement of a material fact
 - Plaintiff must have actually purchased or sold
 - The misstatement or omission must be in connection with the purchase or sale
 - The misstatement or omission must be material
 - The misstatement or omission must have been intentional (“scienter”)
 - Plaintiff must have relied on the misstatement or omission
 - The misstatement or omission must have caused damages
 - Plaintiff must have cognizable damages (i.e., stock price drop)

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Securities Litigation

- Section 11 (Federal 1933 Act): a purchaser in an IPO seeks damages caused by an omission or misstatement of a material fact
 - Plaintiff must have purchased in the IPO
 - The misstatement or omission must be in the Registration Statement filed with the SEC (which includes the Prospectus)
 - The misstatement or omission must be material
 - The misstatement or omission need not have been intentional
 - Plaintiff need not have relied on the misstatement or omission
 - The misstatement or omission must have caused damages
 - Plaintiff must have cognizable damages (i.e., stock price drop)

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Derivative Litigation

- A derivative action is a suit brought by one or more shareholders to enforce a right of action belonging to the corporation.
- Commonly, derivative actions allege that defendants breached fiduciary duties owed to the corporation.
 - Directors and officers owe duties of care and loyalty to the corporation
- Before filing a derivative action, plaintiffs must make a demand on the Board of Directors for the relief sought.
 - If the demand is refused, or if plaintiffs can establish that demand would have been “futile,” plaintiffs may proceed

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Side A Coverage

- Side A provides insurance for non-indemnifiable loss, thereby providing extra protection for D&Os for wrongful acts alleged against them in their capacity as D&O of the company.
- Additional Side A-Only insurance can be placed at the top of (excess to) the ABC insurance program to provide extra protection.
 - Cannot be used to cover claims against the company
 - Provides coverage for the D&Os if the company is financially unable to provide indemnification (e.g., the company is bankrupt)
 - Provides coverage for the D&Os if the underlying ABC insurance is exhausted.

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Side A Coverage

- A common non-indemnifiable loss is the settlement of derivative litigation—Side A insurance typically provides coverage for such settlement payments.
- This is essential protection for D&Os, as the frequency and severity of derivative litigation has increased recently.

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Side A Coverage—DIC

- An additional Side A insurance product is known as “Difference in Conditions” or “DIC” insurance.
- As the name suggests, DIC insurance endeavors to provide even broader coverage than underlying ABC insurance, i.e., when there a difference in conditions in policy terms.
- For example, DIC insurance may apply where an underlying insurer asserts an exclusion from coverage and refuses to pay.
- DIC insurance normally “drops down” so that there is no gap in coverage.

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Side A Claims—Derivative Litigation

- The most common Side A exposure is shareholder derivative litigation.
- Most state laws—including Delaware—prohibit indemnification of derivative settlements.
- As previously noted, derivative plaintiffs allege that defendants breached fiduciary duties owed to the corporation.
- Derivative litigation may be a “tag along” to securities litigation, or it may be “event driven” stand-alone litigation.

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Derivative Litigation—Tag Along

- Derivative plaintiffs allege breach of fiduciary duty based on the same allegations made by plaintiffs in companion securities litigation (i.e., misstatement or omission of material facts).
- Often this tag along derivative litigation is stayed pending resolution of the companion securities litigation, and may be resolved as part of a settlement of the securities litigation.

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Derivative Litigation—Event Driven

- Derivative plaintiffs allege breach of fiduciary duty based on an event other than a stock price drop
- Business operations, e.g., merger transaction
- Extraordinary occurrence
 - Airplane crash
 - Pipeline explosion
 - Improper consumer banking practices
 - Opioid distribution
 - Hostile work environment/harassment

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Derivative Litigation—Life Cycle

- Filing(s)—venue transfer/consolidation
- Motion to dismiss for lack of demand
 - Often turns on the “independence” of the directors
 - If directors are independent, the Business Judgment Rule applies and provides a presumption that the directors acted on an independent and fully informed basis
- “Caremark” (lack of oversight) claims becoming more difficult to dismiss

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Derivative Litigation—Life Cycle

- Inflection points for settlement:
 - Before a ruling on the motion to dismiss
 - After the motion to dismiss is denied, but before summary judgment
 - After summary judgment is denied, but before trial
- Important strategic considerations at each point
- Company may be motivated to settle due to negative publicity

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Derivative Litigation—Life Cycle

- Settlement efforts usually proceed through mediation session(s) before one of several nationally-recognized mediators
- Strategic considerations include:
 - Amount of quantifiable loss
 - Procedural posture of the litigation
 - Strength of defense(s)
 - What discovery has shown/will show
 - Available insurance
 - “Comparable” settlements

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Derivative Litigation—Life Cycle

- In considering settlement, an insurer must balance strategic considerations with the obligation to make reasonable efforts to settle.
- As one California court has stated, “An offer to settle an insurance claim is generally multidimensional...”

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Derivative Litigation—Life Cycle

- Special care must be taken in the settlement of derivative litigation: complexity and exposure has increased significantly in recent years:
- Wells Fargo-\$320mm (improper consumer banking practices)
- Activision-\$275mm (improper conduct in merger transaction)
- Boeing-\$237.5mm (airplane safety)
- McKesson-\$175mm (opioid distribution)
- News Corp-\$139mm (merger conduct and journalism practices)
- Cardinal Health-\$125mm (opioid distribution)

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GB Specialty has significant experience and deep expertise in handling D&O claims, especially Side A claims, and welcomes the opportunity to work with Captive Insurers to deploy this experience and expertise as a third-party claims administrator required by Delaware law.



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GB Specialty Expertise includes:

- Primary and Excess D&O Side A
- Primary and Excess D&O Side A-DIC
 - Including Lead Side A-DIC
- D&O ABC, primary and excess
- Employment Practices Liability (EPL), primary and excess
- Fidelity/Crime
- Fiduciary Liability, primary and excess
- Public Offering Securities Insurance (POSI), primary, excess and Lead Side A DIC

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Questions or Comments?



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