

D&O A-Side Report

A-Side coverage is still an A-list item for many purchasers of Directors & Officers (D&O) insurance. The reasons are more compelling than ever.

- An increase in the number of \$100 million+ mega D&O claims in the US
- Well-publicized personal settlements in WorldCom and Enron
- Advice of counsel in response to an ever-active plaintiffs' bar
- Request of (new) board members
- Softening in the D&O marketplace, freeing additional funds to secure more coverage

Below we share some key findings from our annual review of the changing D&O purchasing trends in Fortune 500 companies.

The Trends

In Canada, A-Side purchasing has grown substantially in the past two years. Our 2007 D&O A-Side Purchasing Survey revealed that 80 percent of Fortune 500 companies purchase A-Side D&O coverage in some form. Furthermore, companies that already purchase A-Side coverage are often adding additional A-Side limits. It is too early to tell if the

recent *Just for Feet* settlement in the US, in which four former outside directors paid a combined \$40 million out of their own pockets, will increase the demand for A-Side coverage, but one can certainly imagine it.

Litigation Environment: Derivative Claims

Although 2006 marked the lowest number of securities claims in the last decade, the frequency of derivative claims (shareholder claims brought by or on behalf of the company against its directors and/or officers) is rising. This is a critical fact in the context of A-Side coverage, as settlements or court awards of derivative claims are generally thought to be non-indemnifiable – *putting them on the A-Side of a D&O policy*. In the US, where statistics regarding the frequency and severity of D&O actions is available, the research shows that in 2006, 108¹ derivative actions relating to stock options issues were filed. In addition, the severity of derivative suits, which historically have resulted in fairly low damage awards, is also on the rise. Two of the largest derivative settlements – \$200 million and \$100 million – occurred last year. Finally, the number of securities cases with a partner derivative action has been escalating: over 45 percent of cases settled in 2006 were accompanied by a

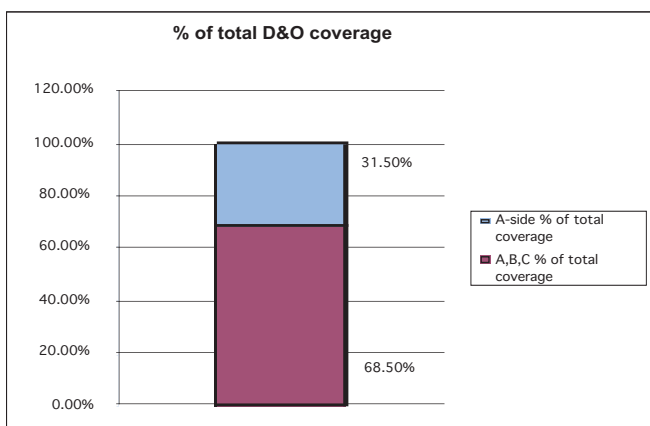
A-Side	B-Side	C-Side
The part of a D&O policy that protects the personal assets of executives by covering them where the company cannot legally or financially indemnify them against claims. Every D&O policy contains this insuring agreement. What has increased in recent years is the amount of A-Side coverage and the number of companies that buy only A-Side coverage.	The part of a D&O policy that covers the directors and officers where the company can indemnify them – in effect, protecting the company's own balance sheet. Historically, all D&O policies contained this insuring agreement along with the A-Side; this is no longer true.	Covers the company itself for securities claims (where the company is usually a codefendant). A modern development, this is now standard in most D&O policies.

derivative action.² (See our March 2005 *Alert*, “Anatomy of a D&O Derivative Claim.”) In Canada, it is important to note that the statutory oppression remedy has resulted in oppressive claims overshadowing derivative actions. The statutory oppression remedy allows a complainant to seek redress, both for personal and derivative claims relating to conduct that is found to be oppressive, or to be unfairly prejudicial to the interests of a corporate stakeholder, or to have unfairly disregarded those interests. The oppression remedy is an extraordinarily broad and flexible remedy, and, in its sweep, unique to the Canadian legal environment. In Canada we see claims brought under the derivative action, the oppression remedy, or both.

A-Side in Combination

Most A-Side coverage is purchased on an excess basis, over a broader base of D&O coverage that typically covers both individuals and the company (A+B+C coverage).

- In our survey, approximately 92 percent of those who purchased some form of A-Side did so in combination with underlying A+B+C coverage.
- These combination programs had their A-Side coverage attaching as low as \$15 million and as high as \$250 million.
- Total A-Side purchases in these programs ranged from \$10 million to \$300 million.
- In combined programs, 68.5 percent is traditional D&O insurance (A+B+C coverage or A+B) and 31.5 percent is A-Side only.



Stand-Alone A-Side

Companies that purchased *only* stand-alone A-side coverage constituted six percent of those surveyed. These stand-alone programs are found primarily in the Fortune 100, particularly in the financial institution arena. This may be due to several factors.

- Corporate retentions for these firms can be \$50 to \$100 million for each claim, so that companies are loath to pay costly premiums

- Companies may be buying combined limits of coverage where the D&O exposures share limits with other risks
- Executives may be seeking certainty and clarity for A-Side claims
- Available coverage for indemnifiable loss (B-Side claims) diminishes for larger accounts)

The average limit on stand-alone programs is approximately \$100 million. Large financial institutions, however, purchase stand-alone A-Side programs that are *significantly larger* than those for commercial accounts.

Not All A-Side Coverage the Same

A-Side coverage was first customized by the Bermuda market; the policies were considered the gold standard and were typically more expensive. However, we have witnessed a surge of domestic carriers drafting and rewriting their A-Side difference-in conditions (DIC) forms (defined below) with fewer exclusions and broader coverages in order to be more competitive. The result is an increase in market share by domestic carriers; *47 percent of companies in our study purchase their A-Side coverage with a domestic primary carrier.*

A-Side pricing may also be negotiable. Historically, \$10,000 per million was the absolute minimum pricing available in the marketplace. Today, perhaps due in part to the introduction of non-rescindable base A+B+C programs as well as a softening D&O insurance market, A-Side premiums continue to decrease. Buyers today should be sure to review their programs with an experienced insurance professional in order to ensure the ultimate breadth of coverage and premium savings.

A-Side in Perspective

Indemnification

Executives have several sources of protection against the potentially heavy costs of litigation: indemnification statutes (according to where the company is incorporated), corporate indemnification agreements (bylaws), individual contracts of indemnification and D&O insurance.

A common misperception is that corporate indemnification will cover directors and officers for any and all liabilities. This is not true, as a company’s bylaws or statutory law may limit or prevent the company from indemnifying its executives under certain circumstances. We have also seen situations in the US where zealous prosecutors actively encourage, if not pressure, a company into denying indemnification to some or all of its executives under investigation or in litigation. Prosecutors have been found to be overzealous, as in the

KPMG case, where the court chastised prosecutors for pressuring the organization to withhold payment of legal fees from 16 former executives. (See our January 2007 *Alert*, "The Top 10 Court Awards and Settlements from 2006" as well as our August 2007 *Marketplace Realities Special Report on Executive Risks*.)

Even if a company can legally indemnify its directors and officers, the company may not have sufficient assets to do so. A corporation's insolvency, of course, does not constitute a defense to a D&O claim. When claims arise out of insolvency, or when claims are simply non-indemnifiable and no A-Side D&O coverage is in place, directors and officers will likely have to pay defense and settlement costs out of their personal assets. In the face of these scenarios, A-Side D&O protection may be sought by an executive before accepting a position as a director or officer.

Presumptive Indemnification

D&O insurance often requires and usually presumes that the insured company will indemnify its executives. In a traditional A+B+C D&O policy, a presumptive indemnification provision appears in the section that states that the company is required to pay a deductible if the corporation is *legally permitted* to indemnify its executives. For large corporations, this retention is often \$1 million or greater for each and every claim; this seven-figure obligation would have to be met before the insurance could be accessed. Please note that should there be a dispute between the insureds and the insurer, the potential gap in coverage may be filled by a special type of A-Side D&O contract: an A-Side difference-in conditions (DIC) policy. If the company is legally permitted to indemnify, but denies indemnification to an executive, the Side-A DIC coverage may fund the corporate retention under the primary policy, saving the individual from needing to do so. Did we mention that retentions can be in the millions of dollars? And that directors and officers often take a keen interest in D&O coverage? This interest is likely to remain for the foreseeable future. (See our June 2006 *Alert*, "Presumptive Indemnification in Executive Liability Policies.")

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¹ 2006 Securities Litigation Study, PriceWaterhouseCoopers

² Cornerstone Securities Class Action Settlements 2006 Review and Analysis