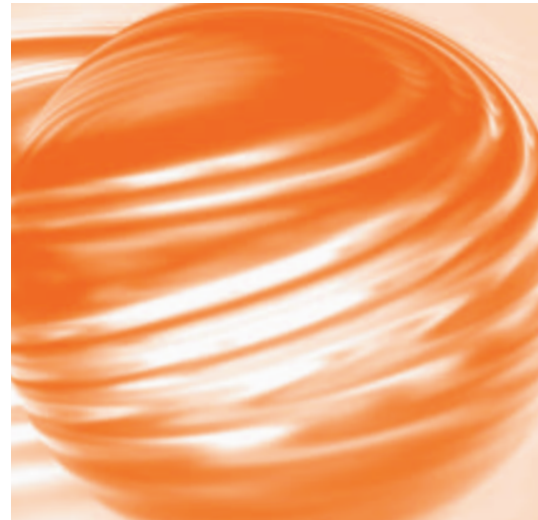


USING CAPTIVES FOR A-SIDE D&O COVERAGE

Successful global companies are adept at deploying executive talent around the world. One key element in their success is providing protection for the executives wherever they go - typically by supplementing corporate indemnification through the purchase of Directors & Officers Liability (D&O) insurance.

To handle the complexities of international coverages, some companies strategically utilize their own captive insurance company. For some types of executive exposures, however, including D&O, privately owned captives may not provide all of the desired protection.

Specifically, a single parent captive may not be an effective risk transfer conduit for A-Side D&O coverage, which protects your executives when the company itself is not legally (or financially) able



to indemnify them. A-Side, or non-indemnifiable, D&O claims generally include those brought by the company itself against its own executives. *Having the company's wholly owned captive insure or reinsure a claim or suit brought by the company itself may defeat the purpose of the corporation taking the action in the first place.* This is known as the circularity problem in D&O insurance.

USING A CAPTIVE FOR A-SIDE D&O INSURANCE: WHAT YOU NEED TO KNOW

- A-Side, or non-indemnifiable, D&O claims generally include claims brought by the company itself against its own executive(s).
- Similarly, "derivative actions" by the company's stakeholders seek to return to the company the assets or earnings that would have inured to the company but for the failure of the board to properly manage or supervise the company.
- When a company's wholly owned captive insures or reinsures a claim or suit brought by the company itself (whether as to defense or indemnity) the purpose of the corporate action may be defeated.
- Using the assets of the captive to repay the parent company frustrates the goal of a suit brought by or on behalf of the company, which is to increase the overall assets of the firm; this has been referred to as the circularity problem in D&O insurance.
- Most corporate directors are unlikely to condone the use of captives for A-Side coverage, preferring separate, independent D&O coverage clearly written by third parties.
- Fronting carriers are also likely to be hesitant. Of five major global fronting carriers, three carriers reported never having fronted for A-Side D&O coverage; one is currently investigating the option, and another has fronted A-Side D&O coverage for two non-U.S.-based companies but excluded the U.S. risks under these programs.

Similar issues arise with derivative actions, which are technically brought on behalf of the company by the company's stakeholders against the company's executives. These actions seek to return to the company the assets or earnings that would have inured to the company but for the failure of the board to manage or supervise the company's affairs. *In another demonstration of the circularity problem, using the assets of the captive to repay the parent company frustrates the goal of the suit, which is to increase the overall assets of the firm.* While derivative actions are possible in a number of jurisdictions (including the U.K.), they are almost exclusively brought in the U.S., where they have recently undergone a resurgence in popularity. They can involve significant damages: seeking tens of millions if not hundreds of millions of dollars from the company executives.

Local insurance for Executive Risks can be problematic for international companies due to the variability of local laws as to indemnification as well as insurance. Local limitations on the permissibility and extent of local indemnification for local claims may well override provisions made in the parent company's home domicile. These local rules are usually untested and can be narrower in scope than comparable laws in the U.S., for, until fairly recently, there were few notable D&O suits outside the U.S. With no real perceived exposure, local law had little need to address indemnification for personal liability for individual executives.

This is not to say that owned or single parent captives cannot easily be used for what is commonly referred to as B- and C-Side D&O claims (matters that are indemnified by the company or are securities claims brought against the company itself). They can. B- and C-Side D&O coverages essentially provide corporate balance sheet protection and do not raise questions of circularity. However, some of the biggest and most sophisticated global companies focus on insuring only A-Side exposures, which makes this discussion on the use of one's captive to provide D&O insurance relevant.

"A captive insurance company is a bona fide insurance or reinsurance company. Its business is primarily supplied by and controlled by its owners, which are also normally the principal insureds. These owners/ insureds participate in controlling the underwriting, claims and investment decisions of the insurance company."¹

Despite the questionable value, the use of captives for A-Side coverage proceeds, albeit on a modest scale. Fronting carriers are not entirely on board. Of five major global fronting carriers asked recently about A-Side D&O insurance, three reported never having fronted for A-Side D&O coverage, one said it was currently investigating doing so but had not done it to date, and the fifth said it had fronted A-Side D&O coverage for two non-U.S.-based companies but had excluded the U.S. risks under these programs.

Companies considering the use of a captive for A-Side D&O coverage should be sure to seek legal counsel before pursuing the option.

For more on concerns relating to global D&O insurance, please see the Willis *Executive Risks Alerts* "**How Global Has Your Global D&O Program Become,**" "**How Global is Your Global Directors & Officers Policy?**" and "**Anatomy of Derivative Claims.**"

¹ "**Captives 101: Managing Cost and Risk**" from Towers Perrin, now Towers Watson.



CONTACTS

EXECUTIVE RISKS

For additional information, please visit the **Willis Executive Risks website** or contact:

Atlanta, GA

Charles Maxell
404 224 5123
charles.maxell@willis.com

New York, NY

Steve Pincus
212 915 7940
steve.pincus@willis.com

Boston, MA

David Goldstein
617 351 7498
david.goldstein@willis.com

Radnor, PA

Matt Schott
610 254 5642
matt.schott@willis.com

Chicago, IL

Brian Gauen
312 621 4855
brian.gauen@willis.com

San Francisco, CA

Michael Mahoney
415 291 1535
mike.manoney@willis.com

Denver, CO

Jim Iacino
303 218 4039
jim.iacino@willis.com

CAPTIVES

Les Boughner

802 264 2064
les.boughner@willis.com

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