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Alternative business entities: liability and insurance issues

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For liability, tax and operating reasons, businesses are choosing with increasing frequency to organize other than as a traditional corporation. The most common alternative entity forms are partnerships (either general or limited), joint ventures or, more recently, limited liability companies. This report analyzes the primary differences in management liability and insurance issues between these alternative entity forms and a traditional corporation.

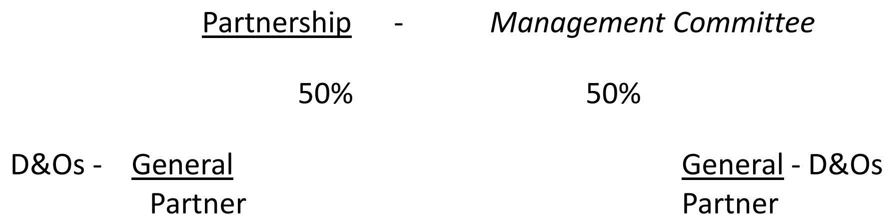
I. PARTNERSHIPS

A. Nature of Organization

Virtually every state by statute authorizes and regulates the existence of general partnerships and limited partnerships. A general partnership consists of two or more general partners who agree to associate together for a common business purpose. Either an organization or an individual can serve as a general partner. The general partners are jointly and severally liable for all debts and obligations of the partnership, including partnership liability solely attributable to the conduct of only one of the general partners. The rights, duties and liabilities between the general partners are largely determined by the applicable state partnership statutes and the terms of the partnership agreement.

A limited partnership consists of one or more general partners and one or more limited partners. The primary difference between a general partnership and a limited partnership is that a limited partnership has one or more limited partners who are passive investors in the organization and who are not generally liable for the debts and obligations of the partnership or the general partners. The legal status and the rights and liabilities of a limited partner are quite similar to those of a shareholder in a traditional corporation.

A common general partnership structure is depicted as follows:



One of the primary benefits to operating as a partnership is the avoidance of double taxation. A traditional "C" corporation must pay income tax on its earnings and its shareholders must again pay income tax when those earnings are distributed as dividends to the shareholders. A partnership, though, is not a separate taxable entity. Rather, tax incidents generally flow through the partnership and attach to the partners. By imposing the tax only to the partners, a partnership avoids the double taxation applicable to corporations.

A joint venture arrangement is essentially equivalent to a general partnership. The primary differences are (i) a joint venture is not a separate, legally recognized organization, like a partnership or corporation; and (ii) a joint venture is generally not subject to state statutes defining the rights and obligations of the organization and its constituents, like a partnership or

corporation. Instead, the relationship between the two or more joint venturers is governed almost entirely by the terms of the joint venture agreement.

A common joint venture arrangement is depicted as follows:

D&Os - Joint Venturer -------------------- Joint Venturer - *D&Os*

Notwithstanding these differences, the issues analyzed in this report are largely identical between joint ventures and general partnerships and therefore a joint venture arrangement will not be analyzed separately from a general partnership.

B. Liability Issues

The liability exposures for general partners in either a general partnership or limited partnership vary from traditional D&O liability risks in the following four areas primarily:

1. Higher Fiduciary Duty. General Partners are typically held to a higher standard of conduct than D&Os. This higher standard is tantamount to that imposed upon trustees of a trust, requiring utmost good faith and integrity.

2. Liability for Debts and Obligations of Partnership. A general partner is liable jointly and severally for all general debts, obligations and liabilities of the partnership. Unlike a corporation, there is no insulation of liability created by a partnership entity. Therefore, general partners are potentially liable not only for claims of misconduct, but also for all debts, obligations and liabilities of the partnership.

3. Potentially Broader Indemnification. The rights and limitations of a partnership to indemnify its general partners vary significantly from state to state. For example, under the New York limited partnership statute, a limited partnership may not indemnify a general partner in an action brought by or in the right of the limited partnership if a judgment or other final adjudication adverse to the general partner establishes that his or her acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated, or that he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled. Section 121-1004.

   In contrast, the Delaware Limited Partnership Act permits a limited partnership to indemnify and hold general partners harmless from and against any and all claims whatsoever. Section 17--108. There are no statutory limitations of any kind to the scope of the indemnification. The 1985 Revised Uniform Limited Partnership Act, which is the model statute for a number of state limited partnership laws, is silent on the issue of

indemnification, thereby presumably permitting broad rights of indemnification limited only by public policy.

4. Potentially Greater Limitation of Liability. Some states permit the limited partnership agreement to limit significantly the liability of the general partner to the partnership and to other partners. (See, for example, Section 17-403(b), Delaware Limited Partnership Act.) In those states, the limited partnership agreement typically provides that no general partner or any director or officer of a corporate general partner shall be liable to the partnership or to any limited partner unless certain difficult burdens are satisfied (e.g., recklessness, intentional misconduct, etc.).

C. Insurance Issues

The general partners liability ("GPL") policy is intended to serve the same role for partnerships that the D&O policy serves for corporations. The GPL policy form is quite similar to the D&O policy form in many respects. For example, both types of policies are claims made; are duty to pay, not duty to defend, with defense costs within the limit of liability; and contain similar exclusions for bodily injury and property damage, dishonest or fraudulent conduct, personal profit or advantage, and pollution.

The primary coverage issues unique to a partnership which should be considered when evaluating a GPL policy are the following:

1. Nomenclature. The various defined terms within the policy should correspond to the correct terms applicable to the entity. For example, if a joint venture is insured, reference should be made to the "joint venturers", not to the "general partners". Similarly, if a D&O policy form is used to afford the GPL coverage, references to the "company" and the "directors and officers" should be appropriately changed.

2. Insureds. Most GPL policies implement the same coverage concept applicable to D&O policies by insuring only claims against management, not against the entity itself. Thus, the policy insures claims against general partners and with respect to any corporate general partner, the directors and officers of that corporate general partner. However, the coverage for D&Os of a corporate general partner is limited only to matters relating to the corporate general partner's activities as a general partner of the partnership. A few GPL policies also cover a controlling entity of the general partner if the controlling entity is a co-defendant with the partnership or general partner.

   Although conceptually consistent, an important difference between D&O and GPL coverage is the existence of entity coverage under the GPL policy to the extent a corporation is an insured general partner. Claims against a corporate general partner in its capacity as such are typically covered

under a GPL policy whereas claims against a corporation are not covered under a typical D&O policy.

Many GPL policy forms extend coverage only to general partners and directors or officers of any corporate general partner, but do not insure any one appointed pursuant to the partnership agreement to a management position within the partnership. Some partnerships have "officers", "directors" or other management positions designated in the partnership agreement, which would not be insured under those policy forms unless those positions are specifically added by endorsement.

Some of the more modern policy forms broaden the number of insureds in several respects. The policy insures not only directors and officers, but also employees of a corporate general partner. In addition, the policy insures any person appointed or elected to a management position pursuant to the partnership agreement.

Another coverage enhancement which should be considered concerns the definition of related organizations covered under the policy. Unlike standard D&O and GPL policies, which insure a designated organization and its subsidiaries, a modified GPL policy could cover a designated entity as general partner in all limited partnerships sponsored by that entity in the same line of business. Depending upon the circumstances, this approach may result in significantly more partnerships and insureds covered under the policy.

Few of the existing GPL policy forms address the scope of coverage afforded when a general partner is itself a partnership. Are the general partners and the D&Os of any corporate general partner of that general partner-partnership also covered under the policy? By their silence, the existing GPL policy forms apparently do not extend coverage to those managers of a partnership which is a general partner. Conceptually, it appears such coverage extension should be made in order to be consistent with the extension of coverage afforded to corporate general partners.

3. Wrongful Act Definition. Most D&O insurance policy forms contain a two-part definition of "Wrongful Act", affording coverage (i) for acts or omissions by D&Os in their capacity as such, or (ii) for any other matter claimed against the D&O solely by reason of their status as such. A GPL policy should not and typically does not contain the second prong of that definition and thus does not afford coverage for "status" type claims in which the general partner is sued simply by virtue of his status as a general partner, not by virtue of any alleged act or omission. This restriction in GPL coverage is appropriate to avoid the policy responding to general debts and obligations of the partnership which by operation of

law flow-through to the general partner by virtue of the general partner's status as such.

4. Insuring Clauses. Like the traditional D&O insurance policy, the GPL policy forms contain two insuring agreements, one extending coverage to the insured general partners, and the other extending reimbursement coverage to the partnership to the extent the partnership indemnifies the general partners. Most existing GPL policy forms do not expressly include within the reimbursement insuring clause coverage to a corporate general partner to the extent that corporation indemnifies its directors and officers for an otherwise covered loss. Presumably, that corporate reimbursement coverage is implied in the policy. To avoid possible confusion and inadvertent coverage duplication, the reimbursement insuring clause could expressly cover the corporate general partner for its indemnification of otherwise covered loss incurred by its D&Os.

5. Deductibles. For optimum coverage, the GPL policy should apply the same higher deductible to the partnership reimbursement and the direct corporate general partner coverage, but a separate and lower (or non-existent) deductible for individual general partners. Several more recent GPL policy forms recognize a lower deductible for natural persons. Applying a different deductible depending upon whether the insured is an entity or an individual seems consistent with the purposes of the deductible and with the approach taken in D&O policies. However, it may require an additional allocation in those situations where both the corporate general partner and its D&Os are sued. For example, if the claim against the individual D&Os is non-indemnifiable, the lower individual deductible would apply to that claim, although a higher deductible would apply to the claim against the corporate general partner. An allocation of defense costs and settlement amounts between the corporate general partner and the individual defendants would thus be required. However, the likelihood of non-indemnifiable claims against the D&Os of the corporate general partner in that context appears to be rather remote.

6. Presumptive Indemnification. The typical D&O presumptive indemnification provision applies the larger entity deductible if the corporation is permitted or required by law to indemnify the defendant D&Os for the subject loss. As explained above, many state partnership statutes permit extremely broad indemnification, limited only by public policy constraints. If such a broad indemnification statute applies, the indemnification "permitted by law" may be considerably broader than the indemnification permitted by the partnership agreement, which frequently either tracks a standard corporation law indemnification provision or prohibits indemnification for gross negligence or other comparable misconduct. To the extent the statutory indemnification

authorization is broader than the partnership agreement authorization, a gap in coverage will exist for the insured general partners if the presumptive indemnification policy provision speaks in terms of indemnification "permitted by law" instead of indemnification "permitted by the partnership agreement". This gap in coverage would exist because the broader "by-law" language would trigger the large entity deductible even though the partnership agreement prohibits indemnification, thereby forcing the individual general partner to fund the higher entity deductible.

7. Exclusions. GPL policy forms consistently apply the same exclusions to both insuring clauses, unlike a few D&O policy forms which apply some exclusions only to the direct insuring agreement. This approach appears appropriate since many states impose virtually no restriction on the ability of the partnership to indemnify its general partners. In those instances, there appears to be no logical reason to distinguish between insuring agreements when applying the exclusions.

   Most GPL policy form exclusions are comparable to D&O policy form exclusions. Two issues arise with respect to those common exclusions. First, for those exclusions which require some requisite wrongful intent by the insureds (e.g. dishonesty exclusion), how does the exclusion apply with respect to corporate general partners (i.e. how is the intent of a corporation determined?). Existing GPL policy forms do not address this issue. If any one director, officer or employee of a corporation possesses the requisite intent, does the exclusion apply to a claim against the corporation or must a senior level manager possess the requisite intent? To enhance coverage, the exclusion could expressly be limited to situations where a director, officer or equivalent level executive of the corporate general partner possesses the requisite intent.

   Second, the "insured versus insured" exclusion may require adaptation to GPL coverage. For example, the wrongful termination exception to the exclusion could apply only to "wrongful termination of employment", not simply "wrongful termination". The latter could be construed to except from the exclusion (i.e. to cover) claims by a general partner for wrongful termination as general partner, which is presumably not intended to be covered. In addition, if the number of insureds is significantly expanded, for example by including as insureds not only subsidiaries but affiliates, the scope and effect of the insured versus insured exclusion is significantly broadened. Finally, the derivative suit exception to the exclusion should apply not only to derivative suits on behalf of the partnership-insured organization, but also any insured corporate general partner. GPL policy forms typically do not recognize this coverage expansion, probably inadvertently.

The following summarizes the primary exclusions which are not included within a D&O policy but frequently included in a GPL policy, either in the policy form or by endorsement:

a. Commingling of Funds. This exclusion eliminates coverage for claims based on or arising out of the commingling of funds by insured general partners.

b. Tax Law Changes. This exclusion eliminates coverage for claims arising out of any change in the Internal Revenue Code, its regulations, or any state or local tax law or any new judicial or administrative ruling or interpretation thereof which results in adverse tax consequences to the limited partners.

c. Asset Valuation. This exclusion eliminates coverage for claims based upon or attributable to an inaccurate valuation of the partnership's assets. Presumably, this exclusion is intended to apply (i) when limited partners are found personally liable for the repayment of capital contributions returned to the limited partner at a time when the partnership's liabilities exceeded the fair value of the partnership's assets; or (ii) when the partnership's business or activities involved to a significant degree asset valuation.

d. Partnership Reorganization. This exclusion eliminates coverage for claims based upon or arising out of an actual or attempted liquidation, roll-up, roll-over, incorporation, consolidation or other reorganization of the partnership or the purchase, sale or exchange of securities or assets of the partnership by an affiliate of the partnership. This exclusion is analogous to a takeover exclusion in a D&O policy and should be avoided if possible, particularly in light of the popularity and frequency of partnership reorganizations in many settings.

e. Fees. This exclusion eliminates coverage for claims for the return or reimbursement of fees paid by the partnership to a general partner or affiliate. Frequently, defense costs are excepted from the exclusion.

8. Subsidiary. If the partnership is a subsidiary, the definition of "Subsidiary" should include either specific reference to the partnership or, if the definition otherwise refers to "election of directors," then the definition should be amended to also refer to the appointment or selection of general partners.

9. Changes in Exposure. Many D&O policies provide automatic coverage for newly created or acquired subsidiaries. GPL policy forms are typically

silent on this issue, thus presumably not providing this automatic coverage. More modern policy forms provide automatic coverage for a period of ninety days, for example, if the newly formed partnership is engaged in the same line of activity as those already insured or if an insured entity is the sole general partner of the new partnership. The automatic coverage expires following that ninety day period unless the insurer agrees by endorsement to cover the newly formed partnership. Because of the dramatic difference in exposures from one partnership to another, it appears inappropriate to provide full automatic coverage for the balance of the policy period, although the limited automatic coverage approach contained in some forms appears reasonable and should be attractive to insureds.

II. LIMITED LIABILITY COMPANIES

A. Nature of Organization

A limited liability company is a relatively new legal entity which seeks to realize the benefits of both a corporate and partnership legal structure. Within the last few years, more than forty states have enacted statutes which authorize this form of new legal entity. Like partnership statutes, limited liability statutes vary significantly from state to state and therefore the issues analyzed below must be reviewed in each specific case in light of the applicable state statute.

Generally speaking, limited liability companies ("LLC") provide the liability protection afforded by corporations (i.e. unlike a partnership, principals of the organization are not personally liable for the debts and obligations of the organization) and provide the tax benefits and flexibility afforded to partnerships (i.e. avoid double taxation and permit allocation of taxable income and deductions). In short, LLCs are classic examples of trying to achieve the best of both worlds.

LLCs have their limitations, though. For example, this legal structure is available only for privately held companies and the equity interest in an LLC is not freely transferable. If an LLC wishes to become publicly held, a new corporation is formed and all of the assets of the LLC are transferred to the new corporation. Because most existing corporations would incur undesirable tax consequences by converting to an LLC, this new form of entity is typically selected when an organization is first formed. Many business advisors are now predicting that LLCs will become the common and preferred choice of entity form for most new business organizations in the future.

In a parallel development, most states have recently adopted legislation permitting the conversion of traditional general partnerships into limited liability partnerships ("LLP"), sometimes also called registered limited liability partnerships. The LLP is designed primarily to protect the partners from vicarious liability for the professional malpractice of other partners and employees, and is a viable alternative legal entity for entities providing professional

services. Unlike a LLC, a LLP does not insulate its partners from vicarious liability for the commercial debts of the partnership.

B. Liability Issues

LLC statutes require an LLC's members (analogous to shareholders) to adopt an "operating agreement" that will govern the internal affairs of the LLC. In general, the statutes are extremely flexible and provide that such documents can be drafted to provide for two alternative types of LLCs: (i) member-managed and (ii) manager-managed. Member-managed LLCs are similar to partnerships, in which owners/members have statutorily granted agency powers and the authority to make management decisions. Manager-managed LLCs are similar to corporations, in which managers (who are not necessarily owners/members) exercise agency authority on behalf of the entity and have the authority to make most ordinary management decisions, similar to directors in a corporation. In manager-managed LLCs, the members generally elect the managers, but, again, the operating agreement can provide a different election or appointment mechanism due to the flexibility permitted by the statute.

1. Duties of Managers. The duties of managers (or members acting as managers in a member-managed LLC) in an LLC context will be developed through reference to statutory provisions, as well as case law, just as has been the case with directors in the corporation context. Some LLC statutes specifically address the duties of managers. In general, those statutes either adopt the same duties imposed on directors of a corporation or adopt the same duties imposed on general partners of a partnership. The statutes also usually permit the managers to rely on the same information, opinions, reports, etc., that directors are entitled to rely upon in a corporation.

   Other LLC statutes are silent regarding manager duties, thus deferring to the courts to articulate applicable standards. The development of such case law may be many years off. In the opinion of most commentators, the duties that will exist will likely depend on the governing structure. In member-managed LLCs, it is likely those duties will be based on partnership-type fiduciary duties while in manager-managed LLCs, it is likely the duties will be similar to those found in the corporation context. Although the fiduciary duties owed by LLC managers or members may vary depending on the governing structure and the terms of the operating agreement, the general nature of the fiduciary duties will include the traditional duties of loyalty, care and obedience.

2. Liability of Members and Managers. Neither a member nor a manager of an LLC is liable for any debts, obligations or liabilities of the LLC, whether arising in tort, contract or otherwise, solely by reason of being such member or manager or by otherwise participating in the conduct of the business of the LLC. Many LLC statutes permit the LLC operating agreement to eliminate or limit the personal liability of managers to the

LLC or its members for damages for any breach of duty in such capacity, subject to various limitations set forth in the statute. These provisions are similar to the director liability limitation statutes adopted in the late 1980's in most states. Although somewhat helpful in defending claims against directors, those corporate statutes have not resulted in a meaningful reduction of director liability exposure since the statutes contain numerous "loopholes." For example, the statutes do not limit or reduce in any way any liability exposure under any federal statute or regulation. However, it is likely the LLC manager-liability-limitation statute will be somewhat more effective than the director-liability-limitation statutes because as privately-held organizations (as opposed to a public company), the LLC's primary mismanagement exposure will be for breach of fiduciary duties (not federal securities law liability), some of which liability is eliminated by the statute.

In summary, members are afforded the protection of limited liability enjoyed by shareholders of a corporation and managers are afforded similar protections as directors in a corporation. Such general rules, however, can be altered by the explicit language of the articles of organization and/or the operating agreement of an LLC. Therefore, it would be important to review the articles of organization and operating agreement for an LLC to determine whether they have altered the general statutory limitations on liability and other protections.

C. Insurance Issues

A standard D&O insurance policy form is generally appropriate for use with an LLC. The relatively few issues unique to an LLC which should be considered when evaluating such coverage are summarized below:

1. Nomenclature. LLC statutes typically use different terms for the different participants in an LLC than are used with corporations. For example, shareholders are typically called "members", directors are typically called "managers" and no officers typically exist. Most statutes permit the LLC by agreement to eliminate "managers", in which case the rights and obligations otherwise applicable to managers apply to the members (i.e. shareholders). Accordingly, the definitions in the insurance policy should correspond to the appropriate terminology used by the particular LLC. Frequently, the policy insures directors, officers, managers, management committee members, members of the board of managers or equivalent executive.

2. Capacity. In a member-manager type LLC, coverage should apply to the Insured Persons only in their capacity as managers, not in their capacity as members (i.e. equity Owners).

3. Presumptive Indemnification. For the same reasons as discussed above with respect to GPL policies, the presumptive indemnification provision applicable to LLCs should apply if the LLC is required or permitted to indemnify "pursuant to the terms of the LLC operating agreement", not "by law".

4. Exclusions. Like partnerships, LLCs are largely structured for tax purposes. Therefore, underwriters may impose an exclusion for claims arising out of any change in the tax laws, similar to the tax exclusion described above with respect to GPL policies.

5. Subsidiary. If the LLC is a subsidiary, the definition of "Subsidiary" should include either specific reference to the LLC or, if the definition otherwise refers to "election of directors," then the definition should be amended to also refer to the appointment of LLC Managers.

III. COVERAGE FOR AFFILIATES

When two or more companies form a common entity (either partnership, joint venture or LLC) to pursue a project or line of business, the participating companies should agree to indemnify and insure the managers of that common entity ("Affiliate") either through the entity or individually through the participating members. Under either alternative, overlapping, inconsistent, inefficient, inequitable and perhaps inadequate insurance coverage may exist. No universal rules or answers apply in this area. Instead, each situation must be analyzed separately, taking into consideration the participants' existing insurance programs, risk management philosophies and business agreements. The primary alternatives to address this situation and the issues created by each alternative are discussed below.

A. Separate Policy

The Affiliate could purchase its own D&O/GPL policy, which would afford coverage separate and independent from the coverage otherwise maintained by the participating companies. The primary benefits and potential problems with this approach are as follows:

1. Benefits

- Cost of coverage shared by all participating companies;
- Limits of liability separate from coverage maintained by participating companies (see below re stacking issues);
- Coverage not diluted by unrelated claims against participating companies;
- Coverage can be tailored to specific risks of the entity.

2. Potential problems

- Probably more expensive for insureds than if coverage was combined with existing coverage maintained by participating companies;

- All participating companies must agree on terms of coverage, which may be difficult if each company has different risk management philosophies;

- Possible duplication of coverage, particularly if a GPL policy is purchased which insures the directors and officers of each participating company which serves as a corporate general partner. If the participating companies' directors and officers are insured under both the companies' D&O policy and the Affiliate's GPL policy, numerous issues will arise, including the need to allocate among insured defendants and their insurance policies loss incurred in a claim for purposes of determining depletion of applicable deductibles and limits of liability and determining the extent of coverage if some policies exclude coverage and others do not.

- If the same insurer writes two or more of the applicable policies, limit of liability stacking concerns may arise.

Some partial solutions to these possible problems include the following:

- A tie-in or anti-stacking limit of liability endorsement could be added to the various policies if the same insurer writes all policies. The Aegis D&O and GPL policy forms contain a per claim "non-duplication of limits" provision. A limit tie-in should apply, like the Aegis provision, only on a per claim basis and all excess policies should provide that their attachment point drops down to the extent the limit tie-in applies at the primary level. This partial solution does not eliminate the necessity to allocate loss among the respective insured defendants and policies.

- The duplication of coverage could be eliminated by either excluding from the D&O policy claims for wrongful acts relating to the corporation serving as the corporate general partner or excluding in the GPL policy coverage for directors and officers of the corporate general partner. If one insurer writes both policies, it is likely the insurer will request a limit of liability tie-in endorsement even if this coverage duplication is eliminated since a common occurrence could trigger coverage under both policies even without the coverage duplication. In addition, the allocation issue will remain even in the absence of coverage duplication.

B. ODL Coverage

Instead of the Affiliate purchasing its own insurance, each of the participating companies could purchase outside directorship liability ("ODL") coverage for its representatives who serve as managers of the Affiliate.[1] The benefits of and the possible problems from this approach are summarized below:

1. Benefits

- This coverage is likely more economical than purchasing a separate policy for the Affiliate;
- Each participating company does not depend upon the agreement of the other participating companies with respect to determining the terms and maintaining the existence of the insurance coverage;
- Duplication of coverage is avoided.

2. Potential problems

- If the Affiliate is a partnership, no coverage would be afforded for claims against any corporate general partner and no reimbursement coverage would be afforded to the partnership to the extent the partnership indemnifies its general partners or management committee. If some participating companies do not purchase insurance for their representatives, the insurers for the remaining participating companies may bear a disproportionate share of the liability since they may be the only available deep pocket to pursue under joint and several liability theories;
- Coverage for other D&Os of the participating company may be diluted by this ODL coverage extension;
- The ODL coverage extension should address the unique insurance issues applicable to partnerships as discussed in section I(C) and section II(C), above.

C. Name Affiliate as Additional Insured

[1] This alternative would apply only if a representative of the participating company served as a general partner or direct manager of the Affiliate. If the participating company or its subsidiary served as a corporate general partner, and none of its representatives served in a direct management position with the Affiliate, no further extension of coverage would be necessary to insure the individuals since the participating company's D&Os would be covered with respect to their conduct relating to the Affiliate under the participating company's D&O policy.

One of the participating companies could add the Affiliate as an additional insured organization under its existing D&O insurance policy. The benefits and potential problems from this alternative are summarized below:

1. <u>Benefits</u>

- Affords reimbursement coverage to the Affiliate to the extent it indemnifies its managers;
- Affords common coverage with same terms and conditions for all managers of the Affiliate, thereby avoiding the necessity for allocation among defendant insureds and their respective insurance policies;
- Avoids any duplicative coverage, stacking of limits issues, and the necessity for allocating loss between defendant insureds and their policy. The extension of coverage to the Affiliate should address the coverage issues described in sections I(C) and II(C) above.

2. <u>Possible Problems</u>

- Potentially dilutes coverage otherwise available for the participating company's D&Os;
- Does not afford coverage to any corporate general partner of the Affiliate;
- Results in one participating company bearing the full cost of the coverage for representatives of the other participating companies, unless a cost sharing agreement is reached.

To address several of these possible problems, the Affiliate and its managers could be named as an additional insured to the participating company's D&O policy "as its interest may appear", thus extending coverage to the Affiliate and its managers only to the extent of the participating company's interest in the Affiliate. This is not a complete solution, though, because for example the participating company's other partner may become insolvent, thereby subjecting the participating company to 100% of a joint and several liability even though its interest in the Affiliate is less than 100%.

D. <u>No New Coverage</u>

The participating companies could elect to purchase no additional coverage with respect to the Affiliate. This is a particularly viable alternative if the Affiliate is a partnership with only corporate general partners, in which case no additional coverage is necessary to cover individuals. Similarly, this is a viable alternative if the Affiliate is more than fifty percent owned

by one of the participating companies, thereby making it a "subsidiary" under the participating company's D&O policy. The possible problems with this alternative are summarized below.

- If the Affiliate is not an insured subsidiary, no indemnification reimbursement coverage is afforded to the Affiliate and any individual who serves as a general partner or other manager of the Affiliate is not insured in that capacity;
- No coverage is afforded to any corporate general partner of the Affiliate; if directors and officers of several corporate general partners are named as defendants, an allocation of loss between those defendant D&Os and their respective policies will be required.

About the Author:

Dan A. Bailey is the Chair of the Firm's Directors & Officers Liability Practice Group and represents and consults with directors and officers, corporations, insurance companies, and law firms across the country. In addition to advising Boards and drafting most of the D&O insurance policies in the market, he has represented clients or served as an expert witness in many of the largest D&O claims for more than 30 years. He is co-author of Liability of Corporate Officers and Directors, a leading treatise on the topic, has published dozens of articles and speaks at more than 20 seminars a year on the subject.

He can be reached at (614) 229-3213, or dbailey@baileycav.com.

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