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SIDE A CLAIMS HANDLING: EXPERIENCE MATTERS

Side A policies afford the ultimate backstop protection for directors and officers. Extraordinarily broad coverage terms and limits of liability dedicated to only the insured persons provide strong assurance to directors and officers that their personal assets will be protected when no other insurance or indemnification is available. However, even the broadest Side A policy form will not fulfill this expectation unless the Side A insurer matches its high quality policy form with equally high quality claims-handling services.

The nature of coverage under Side A policies, particularly Difference-in-Conditions ("DIC") coverage, gives rise to numerous claims-handling issues not typically encountered under traditional "ABC" policies. Insurers who have little or no experience with these unique issues are far more likely to mishandle a Side A claim to the detriment of the Insureds. As a result, from whom a Side A policy is purchased is at least as important as the terms of the Side A policy since the true benefit of a Side A policy is realized only if the Insurer is willing to timely pay covered losses.

The following summarizes some of the unique claims handling issues that can arise under Side A policies and the importance of the Side A insurer properly addressing these issues.

A. UNDERLYING ABC CARRIERS' FAILURE TO PROVIDE COVERAGE

Under a typical Side A Excess DIC policy, coverage drops down into the underlying ABC program if a covered loss is not paid by the underlying ABC carriers for any reason, including the underlying insurer's failure, refusal or financial inability to pay the loss. In that situation, the Side A insurer must carefully balance two competing concerns.

On one hand, the Side A insurer (like any insurer) should confirm that payment of the loss under the Side A policy is necessary. If the underlying ABC insurer is wrongfully failing or refusing to pay the loss (perhaps with the intent of dumping the loss into the Side A Excess DIC policy), the Side A insurer should engage the underlying insurer in an attempt to get the loss paid out of the ABC policy, thereby preserving the Side A limits for other losses and protecting the integrity of the Side A insurance product.

On the other hand, the Side A insurer should not prejudice the interests of the Insureds by not paying the covered loss in a timely manner. If the underlying insurer can and should pay the loss, the Side A policy is designed to enforce the ABC insurer's obligation by first paying the loss then subrogating against the ABC insurer to recover the paid loss.

At what time should the Side A insurer abandon the first concern stated above and address the second concern by paying the loss? Each claim is obviously unique, so there is no universal answer. But, an insurer with considerable experience in these issues is more likely to navigate these competing concerns properly.

B. PRIORITY OF PAYMENT ISSUES

Most primary ABC policies contain a "priority of payment" provision, which typically states that when loss that is otherwise due and owing under the ABC policy exceeds the limits available under the ABC policy, then the ABC insurer is obligated to pay any Side A losses before paying any Side B or Side C losses. The intent of this provision is to protect the directors and officers by assuring that coverage for the company under Side B and Side C does not deplete the Side A coverage for the directors and officers.

This provision most frequently applies in connection with the settlements of a securities class action (which is typically covered under Side B and Side C) and a related shareholder derivative lawsuit (which is typically covered under Side A). If both settlements occur at the same time, the priority of payment provision should apply and the ABC insurers should pay the derivative settlement first before using the remaining ABC limits to pay the class action settlement. This result preserves the Side A policy limits for other losses and protects the integrity of the Side A insurance product, although it reduces the amount of the ABC policy limits which is available for the company's settlement of the class action lawsuit.

Company counsel often resist this result and seek to maximize the Side B and Side C coverage for the company by trying to push the derivative settlement into the Side A policies. However, the priority of payment provision clearly requires the ABC policies to first pay the non-indemnifiable derivative settlement if both the derivative and class action lawsuits are settled at the same time. As a result, some company counsel manipulate the coverage by settling only the class action first (thereby accessing the full ABC limits for the company), then several months later trying to settle the derivative lawsuit.

That strategy, though, is often not in the best interest of the directors and officers who are defendants in the derivative lawsuit. If for some reason the derivative lawsuit cannot later be settled for an amount within the remaining Side A limits, the directors' and officers" personal assets will be exposed to the uninsured and non-indemnified derivative settlement amount. An experienced Side A insurer can explain to the directors and officers the dangers of this coverage manipulation strategy and facilitate a settlement strategy that fully protects the directors and officers.

C. PAYMENT OF PLAINTIFFS' FEE AWARD IN DERIVATIVE LITIGATION

The indemnification statutes of most states (including Delaware) prohibit indemnification by the company of settlements and judgments in shareholder derivative lawsuits. Such a prohibition is intended to avoid the circularity that would result if the defendant directors and officers pay the derivative lawsuit settlement or judgment to the company, and then the company turns around and indemnifies the directors and officers for such payment.

Although this indemnification prohibition for derivative lawsuit settlements is well recognized, disputes can arise as to whether the plaintiff attorney fees which are payable at the time of the derivative settlement are considered part of the settlement (and thus not indemnifiable) or separate from the settlement amount (and thus indemnifiable). Because this question is irrelevant under ABC policies which cover both indemnifiable and non-indemnifiable

losses, this question very rarely arose prior to the recent popularity of Side A policies, and therefore there currently is virtually no authority addressing this issue.

Similar to their handling of DIC issues, Side A insurers in this situation must carefully balance the competing concerns of not paying an indemnifiable loss, on one hand, and protecting the Insured Persons, on the other hand. An experienced Side A insurer would seek to convince the company that the plaintiff fees are indemnifiable (at least in certain circumstances) but would at the appropriate time pay those fees to facilitate the Insured Persons' settlement, subject to the Side A insurer's right to subrogate against the company to enforce the company's indemnification obligations. The more aggressive and the less experienced the Side A insurer is, the more likely the insurer will not properly handle this sensitive but very important issue, thereby potentially jeopardizing the derivative settlement.

D. POTENTIAL INFLATION OF DERIVATIVE SETTLEMENT VALUES

Under certain circumstances, a company and its defense counsel can be incentivized to artificially inflate the settlement value of a derivative lawsuit, thereby increasing the amount of Side A losses. For example, a securities class action and the related shareholder derivative lawsuit are frequently settled at the same time, utilizing a so-called pass-through settlement structure pursuant to which the derivative settlement amount "passes through" the company and is ultimately paid by the company towards the much larger class action settlement. Unquestionably, such a settlement structure is an efficient method of settling both lawsuits for the least amount of money since the same dollar that settles the derivative lawsuit is also contributed to the class settlement. The larger the derivative settlement, the larger the pass-through payment towards the class action settlement.

However, if the amount of the derivative settlement is artificially inflated, the Side A policy could be forced to pay an unreasonable and disproportionately large share of the total global settlement amount. As a result, Side A insurers should become actively involved in negotiating the allocation of the global settlement amount between the class action and the derivative lawsuits to avoid an abuse of the Side A policy. Usually, ABC insurers ignore that allocation negotiation since both settlements are covered under ABC policies. In that negotiating process the Side A insurers must carefully balance the insurers' legitimate interest in avoiding an unreasonably large derivative settlement and the Insured Persons' legitimate interests of resolving a potentially dangerous and non-indemnifiable derivative lawsuit. An experienced Side A insurer with a proven reputation for claims-handling practices is more likely to properly balance those competing interests.

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