MARSH CAPTIVE SOLUTIONS

Are Captives an Option for D&O Liability Insurance?

With the transitioning insurance market, clients are experiencing capacity and pricing challenges in a number of coverage lines, including Directors & Officers Liability insurance (D&O).

What Is D&O Insurance?

The directors and officers of a company lead and carry out the business of an organization. Directors and officers have a responsibility to avoid conflicts of interest and exercise care and diligence in managing the affairs of the corporation; failure to fulfil their corporate obligations can expose directors and officers to liability. Claims against directors and officers can be expensive to defend, and directors and officers may be personally liable if they are found to have acted disloyally or failed to exercise care that causes a loss to the corporation, shareholders, or others.

If directors and officers are sued, the company will likely provide indemnification in the form of the advancement of defense costs and payment of settlements and judgments so they are not paying out-of-pocket. However, when the company is unable or refuses to indemnify its directors and officers, D&O insurance becomes critical. D&O insurance will protect the company, reimburse the company for its obligations to indemnify the directors and officers, and will also protect the directors and officers if the company can't, or won't, indemnify and they are personally exposed.

The coverage is generally made up of three main insuring clauses summarized as follows:

- Side A: Insures wrongful acts of directors and officers when the company is not permitted to indemnify by the broader of applicable law or by-laws, due to bankruptcy, or refuses to indemnify.
- Side B: Reimburses the company for the indemnification it provides to the directors and officers for claims against them alleging covered wrongful acts.
- Side C: Insures the company itself for its own liability and, in the public company context, is usually limited to securities claims.

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Captive Utilization for D&O Insurance

Captives are a natural option when companies face capacity and pricing challenges, especially when commercial pricing is viewed to be higher than the perceived risk. Using a captive to provide D&O insurance has been limited to date and has involved mainly Side B and C coverage. The primary reason for the lack of captive involvement has been the abundance of capacity in the traditional market, available at a low cost. In addition, there is a concern that the use of a captive is not appropriate for the provision of Side A D&O (non-indemnifiable loss) due to the potential for conflicts to arise and questions surrounding bankruptcy remoteness and potential indemnification issues.

Over the years, clients have looked into alternatives for Side A D&O, including trusts and captives; whether Side A D&O can be put in a captive is an open question as the results are mostly untested. A concern with placing Side A D&O in a single-parent captive relates to the actual or potential conflict that could arise in the event that the captive (a subsidiary of the company) is asked to pay a claim for an alleged act by a director or officer that the company is not permitted to indemnify.

Depending on the specific terms of the policy, Side A D&O coverage will respond in the event that the company cannot, or will not, indemnify a director or officer. The reasons for the inability to indemnify are, in large part, due to jurisdictional or corporate prohibitions, being unable as a matter of law to provide indemnification (i.e., for a derivative action settlement), or due to corporate bankruptcy. A company may choose not to indemnify a director or officer even though it is legally permitted to do so – examples of this action would include a “bad actor” or disenfranchised former leader. In these situations, subject to policy terms, Side A D&O might respond.

An example would be a situation where a derivative claim is brought by shareholders against senior executives. In most jurisdictions, derivative action settlements and judgments can only be funded under Side A D&O, i.e., they are non-indemnifiable. If the claim funding is provided via the captive, there is a circularity argument in that the claim is being funded by the company itself, via its single-parent captive (an entity owned by the company). To the extent that a company is in a jurisdiction that permits indemnification of derivative claims, this conflict is less of a concern.

Protected Cell Company Alternative

The use of a protected or segregated cell facility (PCC) could arguably be deemed more arms-length from the company itself and therefore might be a better fit to fund non-indemnifiable loss. However, again, this remains relatively untested. A PCC is a stand-alone entity with ownership, management, and control largely independent of the company seeking to insure its directors and officers. Decisions related to the policy's response and the provision of Side A D&O coverage can be set up to be independent of the company. Potential concerns about influence by the company's management and concerns about unhappy shareholders should be ameliorated.

One of the considerations of using a cell as a Side A D&O option is the cost of the transaction. The aggregate policy limit written by the cell must be fully funded through a combination of the premium (arms-length) for Side A D&O coverage plus collateral. Prudence would dictate that funds should be in the form of cash rather than a letter of credit to minimize risks should a bankruptcy event occur. The opportunity cost of funding the full aggregate limit, fees to access the cell, and the untested nature of a claim payment via a PCC may outweigh the cost of commercial market insurance. In addition, the fact that the company has the right to any net profit (and return of collateral) at policy expiration could be a perceived conflict. One way to address that concern could be to make sure that the net profit and return of collateral, instead of reverting back to the company itself, is paid to a third party such as a charity. To date, we have only seen cells being used for Side A D&O coverage when traditional insurance has been unavailable.

The Value of D&O Coverage Alternatives

The issues related to D&O coverage alternatives are both complex and near and dear to every corporate director and officer. At this point, alternatives to the D&O commercial market have not been perfected, though the building blocks for such a solution do exist. Alternatives will involve their own set of complexities and trade-offs, and while solutions will not look the same for all companies, they may play a part in protecting directors and officers in a transitional market. Defining how to handle D&O plans for your captive can be a challenge. Marsh Captive Solutions, with your D&O insurance and legal advisors and tax and accounting teams, can help you determine the setup that meets the unique needs of your organization.

For further information, please contact your local Marsh office or visit marshcaptivesolutions.com.