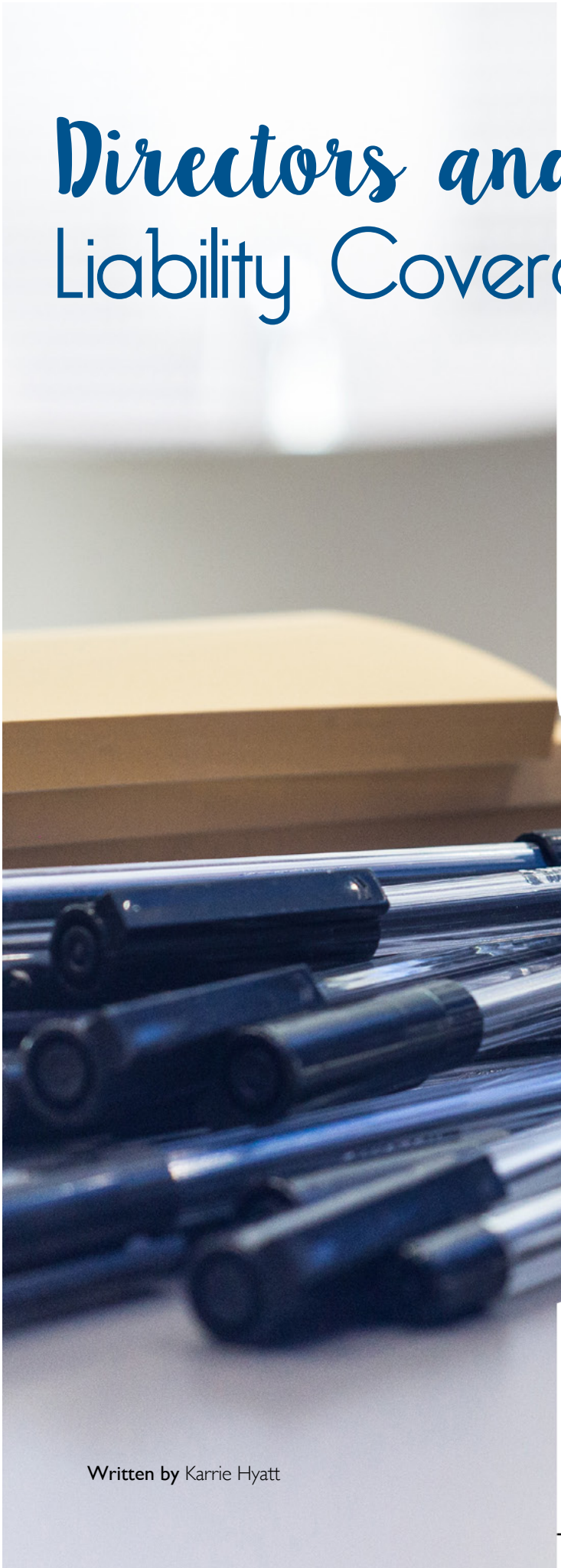
Directors and Officers Liability Coverage

is More Important Than Ever Before



Written by Karrie Hyatt

Directors and Officers liability (D&O) insurance should be at the top of list of things to think about when recruiting members for a captive Board, or in considering being a Board Director. In today's litigation-happy environment it is more important than ever for captives to provide their Board members with a comprehensive D&O policy. From emerging risks like cybercrimes to increased actions by state and federal agencies against company Directors, having the right type of coverage to protect the captive's Board is key to attracting and retaining quality Board members.

D&O liability policies cover claims made against Board members or officers of a captive based on actions taken during their tenure. D&O policies generally offer coverage for decisions by the Board that result in adverse financial outcomes and usually only cover monetary damages. Broadly speaking, these policies offer general coverage for "wrongful acts" and are meant to protect the personal assets of Board Directors.

Even incredibly conscientious Boards can find themselves at the wrong end of a lawsuit. Clayton Ingram, a former captive insurance regulator now working as an independent Director for captive insurance companies, has experience on both sides. "If you are truly an active Board—and every Board member should understand and be involved in the actions and decisions of the company—then there is always the chance that a decision may one day result in a result that becomes actionable. Litigation without coverage could leave an individual highly exposed to legal costs and recovery."

According to Gary Osborne, president of USA Risk Group, Inc., a US-based captive management company, *"We are always recommending that captive companies get D&O. We are far more adamant about it if it's a group captive or a risk retention group [RRG], because then it's not in the same family."*

"D&O coverage is especially important for group captives and even more so for risk retention groups which can have many members and wider ranging operations than other types of captives," said Joseph T. Holahan, of Counsel of Morris, Manning & Martin, LLP's Insurance Practice.

While a pure captive is not as likely to have as many conflict of interest issues as a group captive or RRG, there are still openings for legal action to be directed at the captive's Board. "If it's a single parent captive or a family-owned captive we basically try to make sure the captive is properly covered under the controlling entity's program," Osborne said. "Even if it's a single parent captive we still recommend that any coverage available at the corporate level applies to the captive… We also recommend it even for family-run companies. It's amazing how even brothers and sisters can decide to fight over anything through a captive."

A captive offering a comprehensive D&O policy can be an important aspect in attracting quality candidates for the Board. According to Holahan, "Board members should rightfully expect the captive to provide D&O coverage, and captives should provide the coverage as a way of attracting and retaining good Board members. If a captive does not provide D&O insurance, the Board members should obtain it themselves."

As captive managers will often serve on the Board of captives they manage, in the role of a domicile's Resident Director, a strong D&O policy becomes more than an attraction, it becomes a necessity. Osborne added, "Sometimes the captive manager

has to be the resident Director and we point blank won't do it unless they're buying D&O coverage, because my own history is that I've been sued as a Director of a captive because I was the Resident Director and the state came after me."

Even in the case of a pure captive, or single-parent captive, a comprehensive D&O policy for the captive Board will help protect the Board's Directors in case the parent company fails. In the last ten years, there have been several cases where a captive domicile regulator took action against a captive that failed due to the failure of its parent.

Legal Actions Captives Face

Legal actions against Board Directors are typically summed up as: Breach of duty, or failure to fulfill proper care and loyalty to the company; Misappropriation of company assets, primarily for personal use; Intermixing personal assets with those of the company; Failure to disclose conflicts of interest; and Crimes against the company.

For captives, "Many types of disputes can arise, especially with group captives and risk retention groups," said Holahan. "These include disputes concerning decisions to change or expand the operations of the captive, disputes over return of capital or the payment of dividends, disputes over poor investment returns, disputes over coverage and claims decisions and regulatory actions."

Some of the more common challenges that Osborne has experienced as a captive manager are, "Did you discriminate against a member because they compete with you? Did you partake in self-enrichment? … The argument often comes up that a member wasn't treating everyone equally—undo enrichment or just discriminatory treatment."

Osborne continued, "When you're on a Board of a captive you're supposed to be wearing your insurance company hat, many times we see arguments that say you were serving your interests as the insured rather than the interests of the insurance company."

"As a former regulator, I witnessed several cases of outright fraud by companies leaving Boards exposed to action from regulators, investors, and insureds," said Ingram. "I never would want to be a Board member either actively engaged in such activity or blissfully ignorant of it."

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Key Components to Quality Policies

While D&O policies offer fairly general liability coverage, there are some important aspects that captives and Directors need to be aware of. When purchasing a D&O policy, Holahan offers this suggestion, "The D&O policy should include language ensuring the exclusion for wrongful conduct is severable as to each insured. In other words, the policy should state that a finding that one insured has engaged in wrongful conduct will not result in a loss of coverage for other insureds. Otherwise, innocent Directors could find themselves without coverage."

He added, "D&O policies typically include certain exclusions that can cut off coverage for suits brought by a liquidator. Be certain the policy does not bar coverage for such claims."

According to Osborne, if a captive goes to a liquidator or into receivership policy exclusions can be a real problem for Directors. "We've seen government action against Directors. We warn people to be careful that their policies may have government exclusions, some of them do. We've seen that, when the captive or RRG fails, the state will come after the Director for undue enrichment or failing in their fiduciary duty."

Cyber liability coverage has been a hotly discussed topic in the captive industry for several years. What is not discussed as often is including a clause pertaining to a cyber breach or cybercrime. "Many captives have very little in the way of personal information that could be subject to breach and misuse," said Holahan. "But some types of captives—those covering health care providers, for example—may have quite a lot of personal information in their claims files. D&O policies do not necessarily cover Directors and officers if they are sued in connection with a data breach. Board members should be certain adequate coverage is provided."

Ingram said, "Captives are where the innovation lives in insurance and new risk financing vehicles. This is precisely what makes them exciting, appealing and profitable. With that comes new risk. So far I think D&O coverages I see are keeping up with this. The trick will be to constantly review and analyze your coverage to make sure your activity is not outrunning your comfort zone."

The amount of coverage should also be a major consideration for a D&O policy. Many prepackaged policies generally offer one million in coverage with a $50,000 deductible. Yet, according to Osborne, this might not be enough. "If you've got four or five Directors that's not such a big deal, but if you've got ten, it could be an internal fight as well and a million could go fast."

"We also recommend clients think about that because the Directors may not all have the same interests," continued Osborne. "My interest as the resident Director could be different than parent or the other insureds. You can sometimes have multiple lawyers fighting on behalf of different Directors, so if it's a big Board a million may not go very far."

Attracting and protecting the captive's Board is an important component for creating and running a healthy company. Making sure the Directors' have adequate coverage and keeping the policy up-to-date for emerging risks is as valuable as a fully functioning Board.

"The main responsibility resides with the Board member. Be involved, informed and active in your fiduciary duty to you company," advised Ingram. "Don't be afraid to question and vote your conscience. As an independent Director, my main goal in to keep my companies solvent and in regulatory compliance. That's why I advocate for at least one truly knowledgeable but independent member on every Board. That is your main insurance. D&O is a secondary, but necessary safeguard." ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.