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Proceed With Caution:

Understanding how Delaware's new D&O captive statute can leave executives vulnerable.

Section 145(g) of the Delaware General Corporation Law is a longstanding statute permitting corporations to purchase insurance for directors and officers regardless of whether the corporation is permitted to indemnify them for losses covered under the policy. This statute was recently amended to expand the definition of insurance to include D&O insurance provided by or through a captive, fronting, or reinsurance arrangement.

While the new legislation is being heralded by some as a positive development for companies navigating challenging D&O insurance markets, a closer assessment reveals there actually may be less to celebrate. Several D&O exposures typically covered under commercial D&O insurance programs cannot be included in the captive programs or fronting arrangements allowed by this new legislation. Any D&O insurance buyer considering such a captive program should understand the potential ramifications and shortfalls for its directors and officers.

Several D&O exposures covered under commercial D&O insurance programs likely cannot be covered by the captive or fronting arrangements allowed by this new legislation.

Noteworthy Conditions

The newly amended statute imposes four conditions on a captive or fronting/reinsurance arrangement for D&O insurance:

1. The captive must be licensed in any jurisdiction.
2. The policy issued by the captive or fronting arrangement must include a conduct exclusion.
3. Covered losses paid through the captive or fronting arrangement must be approved by an independent claims administrator, a majority of disinterested directors of the corporation, or special outside counsel.
4. If a derivative lawsuit settlement is to be funded in whole or in part by the captive or fronting arrangement, the legally required notice to shareholders disclosing the proposed settlement must specify the portion of the settlement to be funded by the arrangement.

How Directors & Officers Are at Risk

The following D&O exposures, which are typically within the scope of most commercial D&O insurance policies, likely will not be able to be covered by the kind of D&O captive or fronting arrangement authorized by this new legislation.

Non-Indemnifiable Loss Under Federal Law

The new law allows a captive or fronting arrangement to cover D&O losses that are not indemnifiable under Delaware law.[1] However, the new law likely is not applicable to losses that are not indemnifiable under federal laws and regulations. In contrast, a commercial D&O insurance policy can, and routinely does, apply to such exposures.

The most important non-indemnifiable losses arise from actual violations of federal securities laws. Both the SEC and the courts consider such indemnification to be against public policy and therefore prohibited. Even though federal securities class action lawsuits are almost always settled without a finding of an actual violation, SEC proceedings and opt-out or other single-plaintiff securities lawsuits are more likely to result in such a finding. In that event, any D&O losses resulting from that proceeding or lawsuit, or from any related securities class action lawsuit alleging the same wrongdoing, likely are not indemnifiable under federal law. Thus, without commercial D&O insurance, directors and officers will likely be without financial protection for those losses.

There are several other examples of losses that are likely not indemnifiable under federal law (and thus would require a separate commercial D&O insurance to provide the most protection for directors and officers), including:

- Fines and penalties under the Foreign Corrupt Practices Act (FCPA)
- Losses arising from the gross negligence of investment company directors and officers under the Investment Company Act of 1940
- Losses arising from violations of RICO or antitrust statutes
- Losses in sex discrimination claims under Title VII
- Certain losses incurred by directors and officers of financial institutions

[1]Although this new Delaware legislation has received a lot of publicity, at least a dozen other states have enacted similar legislation over the last 35 years, including California, Texas, Ohio, and New Jersey.

Bankruptcy

Directors and officers should consider the effect of a parent company's bankruptcy on the coverage offered by a captive program. In a bankruptcy proceeding, a bankruptcy trustee may assume control of the captive, including the captive's claims payment decisions or capitalization. In addition, a bankruptcy court may order the captive's assets to be equitably consolidated with the parent company's assets. Any transfer of assets from the parent company to the captive may be challenged later by creditors. These factors may reduce or prevent the directors and officers of the bankrupt company from accessing coverage under the captive program.

Capitalization Complications

To ensure that a captive will remain a reliable source of financial protection for executives, the captive will require substantial capitalization over a long period of time. Adequate capitalization is particularly important in light of the potential severity and long-tail nature of D&O claims. If capitalization is inadequate or eroded, the parent's directors and officers may be left without sufficient coverage for a claim. Also, using a captive in this way could result in tying up a large amount of the parent's capital, and if the captive's large capitalization is perceived to hinder the business operations or opportunities of the parent company, directors and officers who approved the capitalization could face criticism.

Derivative Settlements

The new law requires a notice to shareholders stating that a derivative settlement will be funded by a captive or fronting/reinsurance arrangement. However, this notice requirement could itself jeopardize final approval of any such settlement. The court and shareholders could object to a proposed settlement on the basis that using the captive for this insurance is simply moving corporate assets from one pocket to another. If the settlement is not approved by the court, or is successfully attacked by shareholders, the defendant directors and officers could find themselves without financial protection to resolve the derivative suit, unless they had a separate commercial D&O insurance program that could apply.

No Conduct Exclusion Carve-outs

The new law requires a conduct exclusion, which is comparable to the standard conduct exclusion in most D&O policies. However, there is one pivotal difference: exceptions or "carve-outs" to that exclusion. It is now common, particularly with Side A D&O policies, for the conduct exclusion to contain various carve-outs to the exclusion, such as for defense costs, independent directors, employment claims, and Sections 11, 12, and 15 claims under the Securities Act of 1933. However, none of those carve-outs are permitted in policies issued by a captive or fronting arrangement under the new law. Directors and officers will forfeit this potential coverage if commercial D&O insurance is not maintained.

Proceed With Caution

Before going without commercial D&O insurance, risk managers and board members must understand these gaps and shortcomings in a potential captive program. D&O buyers should also understand that under a captive or fronting program, the decision to pay or not pay non-indemnifiable losses may be influenced by the interests of the company. Thus, any D&O buyer and insured should meticulously analyze and assess their exposures under these newly permitted arrangements.

For most companies and boards, the risks of abandoning commercial D&O insurance in favor of these limited alternative arrangements is likely to be unacceptable. For some companies, a hybrid D&O program consisting of a combination of a captive policy with a commercial D&O policy to fill these critical gaps could be a viable option.

As always, Chubb is committed to helping our clients navigate new and changing rules, regulations, and market conditions. To understand more about this new law's implications for your D&O program, contact us.

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