Client Alert: International Directors' & Officers' Liability Insurance

Introduction

Directors' & Officers' Liability ("D&O") insurance typically provides worldwide coverage. Even so, the majority of U.S. multi-national parent companies also purchase admitted D&O insurance in some or all countries where their foreign subsidiaries are incorporated.

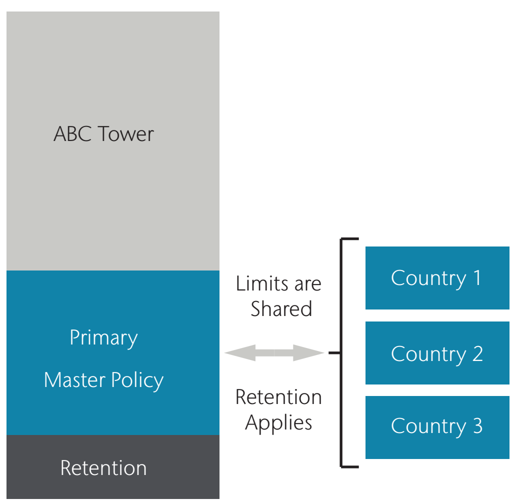
The reasons for choosing to purchase locally admitted country D&O policies, in addition to a U.S. Master, vary by company. Some parent companies purchase locally admitted country policies to ensure tax and/or legal/regulatory compliance. Other companies purchase locally admitted country policies to provide coverage for directors and officers in countries where admitted insurance is required and corporate indemnification is limited, questionable or not permitted. Still others choose to purchase admitted county policies to attract foreign subsidiary board members; guarantee local claims management; address concerns regarding depletion of the parent company's D&O limits; comply with a demand by a foreign subsidiary board member; provide for coverage not otherwise available under the parent company policy; and a host of other reasons.

Depending on the concerns, the due diligence process likely includes reviewing some or all of the following: country specific insurance regulations; insurance premium tax and parafiscal issues; D&O liability and claims activity in specific countries; and permissibility of corporate indemnification.

Whatever the reason or reasons for purchasing locally admitted country D&O insurance, a U.S. multi-national parent company must decide on a structure that best meets its needs. Historically, a parent company had limited options when structuring a D&O program with admitted insurance for its foreign subsidiaries. A company either purchased separate D&O policies, with separate limits for each country, or it purchased locally admitted country policies with limits that were shared with the U.S. Master primary policy. Now, a multitude of options exist, each with pros and cons.

Option 1 – Traditional Approach

The traditional approach is to structure a program where locally admitted country D&O policies share all or a portion of the U.S. company's Master primary policy limits. The locally admitted country policies provide coverage for both Side A and B claims, on a DIC basis, in most countries. The retention on the locally admitted country policies typically mirrors that of the Master primary policy. On a rare occasion, the locally admitted country policies will have a lower retention than the Master primary policy, at a significantly increased cost. A U.S. parent company concerned about its non-U.S. Side A risk, may confine its locally admitted country policy coverage to Side A only. Regardless of whether an insured chooses to insure its Side A and B risk or just its Side A risk, this structure is sometimes supplemented by the purchase of locally admitted country D&O policies that do not share the limits of the U.S. Master primary policy.



While the traditional approach has its advantages, it also has its shortcomings. Today, one of the most significant flaws with this structure relates to the near record pace of securities class action suits in recent years. Exhaustion of the U.S. parent company's Master primary policy limits by a securities class action claim leaves the locally admitted country policies limits exhausted. So, even when a U.S.

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parent company diligently identifies its non-U.S. D&O concerns, assesses its foreign subsidiary D&O risk, and expends the significant time and energy required to purchase locally admitted country D&O policies, the local policy limit likely will be exhausted if the parent company has a securities class action filed against it.

Of course, it also is possible that in the event of limits loss on an admitted country policy, the U.S. parent Company primary limits also can be exhausted. This scenario is rarely contemplated when the parent company is deciding on its D&O limits. Likewise, a limits loss on an admitted country shared limits policy may exhaust the limits of all the admitted country policies purchased.

Less obvious, but important, is that most foreign Side B D&O claims will rarely exceed the retention of the Master primary limits. This leaves the foreign insured subsidiary company or parent Company without reimbursement from the insurer on most foreign Side B claims.

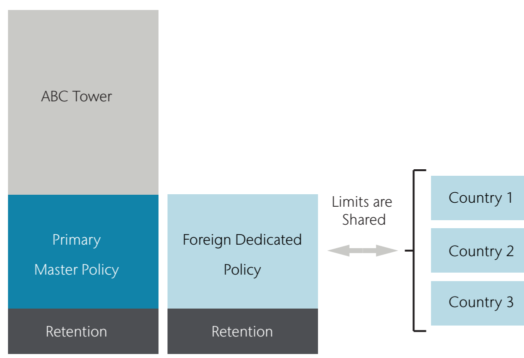
Of course, if a U.S. parent's primary D&O policy is with an insurer that does not have a global footprint or does not partner with a third party or friendly fronts, the traditional structure will not work.

Option 2 – Stand-Alone Local Policies

To overcome some of the limitations noted with the traditional structure, a U.S. parent company may choose to simply purchase locally admitted D&O policies that do not share limits with the parent. Alternatively, a U.S. parent may decide that locally admitted country policies that neither share the limit of the U.S. primary policy nor the limits of other locally admitted country D&O policies is the best option. These solutions can be accomplished in a variety of ways. The most basic approach is to purchase individual locally admitted country D&O policies with separate limits. This approach ring fences the individual locally admitted foreign policy limits from depletion or exhaustion by both the U.S. parent and foreign subsidiary D&O risks in other countries. However, this approach is burdensome. Full underwriting of the D&O risk in each country where a policy is being purchased, including the submission of separate applications and disclosure of the most recently audited financials, is required. Of note, the valuable difference in conditions ("DIC") with the Master policy becomes unavailable with this option.

Option 3 – Foreign Dedicated Policy

To avoid a full underwriting exercise in each country and still ring fence the locally admitted country policy limits from the U.S. parent, a dedicated standalone international D&O program is a viable option. A separate dedicated Foreign Dedicated Policy ("FDP") is put in place outside the U.S. to insure all or a portion of the parent Company's foreign subsidiary D&O risk. This policy excludes coverage for both the U.S. parent company and U.S. subsidiaries. Then, just as with the traditional structure, locally admitted D&O policies are put into place that share all or a portion of the FDP limits. The local policies can provide coverage for both Side A and B, or Side A claims on a DIC basis, in most countries. The retention on the locally admitted policies typically mirrors that of the FDP. However, the retention of the FDP is typically lower than the retention on the U.S. Master. This is significant because foreign private company D&O claims rarely rise to the level of the U.S. primary policy's retention.



While the structure comes at an additional premium, it is only a fraction of the U.S. Master because the U.S. is excluded from cover.

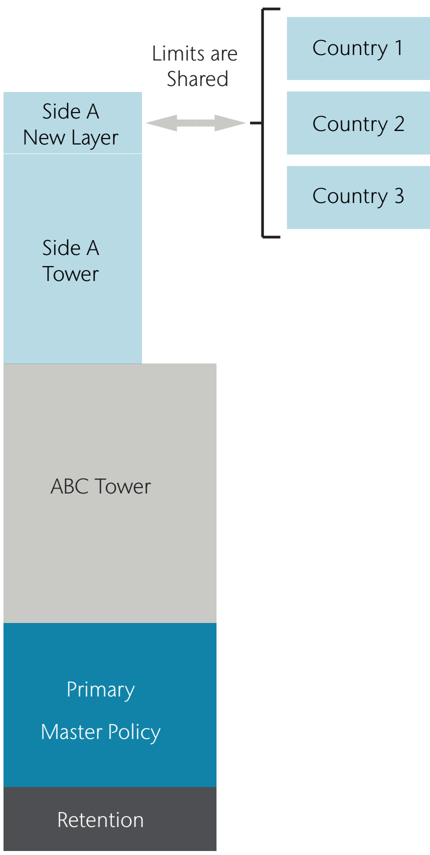
Option 4 – London Side A

In the event an insured is only concerned with its Side A foreign subsidiary D&O exposure, there are additional structures to consider. One approach is the placement of a Side A DIC D&O product through London. For example, the Aon A+ Protect is a Side A DIC policy underwritten and placed with a Lloyd's syndicate. This product offers a single D&O policy that will respond in countries where Lloyd's is licensed to place D&O insurance. The policy includes three (3) reinstatements, including full-limits for 'compensation claw-back'; affirmative coverage for fines; and limited exclusions for fraud/

improper conduct. For those countries where Lloyd's is licensed, this option eliminates the chance that a claim on the primary layer of the U.S. Master D&O policy will exhaust the D&O policy limits. Insureds who purchase this option and have D&O risk in countries where Lloyd's is not licensed, often purchase additional locally admitted country policies with a different insurer.

Option 5 – Excess Side A

Another Side A approach is to purchase an additional Side A layer at the top of a parent company's U.S. Master tower, with an insurer that has a global footprint, or partners with a third party that has a global footprint. Locally admitted country policies can then be purchased that share the limits with the new Side A layer. This approach contains DIC wording and requires drop down wording to trigger coverage of the locally admitted country policies.



This structure minimizes the likelihood that a U.S. claim will exhaust the limits of the locally admitted country policies due to the placement of the placement of the foreign policies on the U.S. D&O program.

Conclusion

As can be seen, one size does not fit all Insureds. So, it is important to consider options carefully when selecting a structure to insure a U.S. parent company's foreign subsidiary D&O risk.

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