Outside Directors' Liability in Private Equity—Deploying Sponsor's Insurance Where the Portfolio Company Cannot Indemnify

Management Liability

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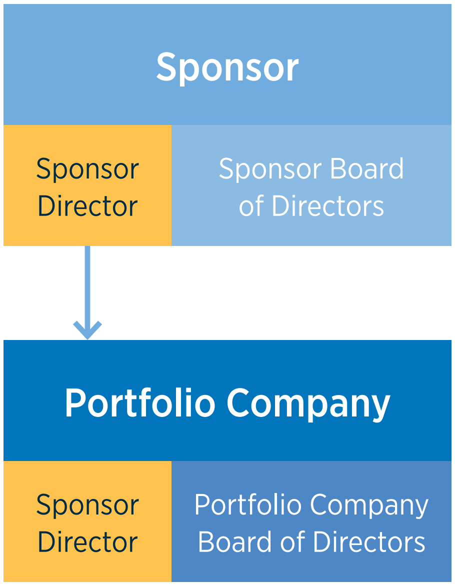


Private equity sponsors often appoint employees to serve as Outside Directors of portfolio companies (also referred to herein as Outside Entities) at the direction of the entity.[1] In such cases, the sponsor's Directors & Officers (D&O) policy should specifically address coverage of the Outside Director, typically excess of the portfolio company's D&O policy and excess of the portfolio company's own indemnification. This paper addresses how the sponsor's D&O insurance limits may deploy for a claim against an insolvent portfolio company and the questions that may arise.

Overview: The Excess Insurance Clause in the Sponsor's D&O Policy

The sponsor should ensure that its D&O wording is up to par with the marketplace. The D&O policy[2] should specifically contemplate the possibility of the sponsor's director serving on outside boards. D&O policies may address this in number of different provisions; we will focus on the excess insurance clause.

The excess insurance clause should specify that the sponsor's D&O policy will cover the Outside Director for his activities on the board of the portfolio company, albeit with a number of important caveats. The sponsor's policy typically applies excess insurance, as discussed more fully below. Consider the following specimen language:

> Any coverage afforded under this Directors & Officers policy for a Claim in connection with an Insured Person serving in an Outside Director's Capacity shall be specifically excess of any indemnification provided by the Outside Entity and any insurance available to such Insured Person by reason of serving in such Outside Capacity. Any coverage under this policy shall apply only once the underlying insurance has been paid in full. This coverage shall apply regardless whether under Insuring Clause (A) Insured Person Coverage or under Insuring Clause (B) the Indemnification of Insured Person Coverage.

This specimen language brings to the fore a number of points. First, the specimen language clarifies that the policy will indemnify the Outside Director excess of the indemnity provided by the entity. Therefore, it behooves the sponsor to work with its outside attorneys and the Outside Entity to confirm that the appropriate measures are in place to ensure indemnification of the Outside Director by the Outside Entity.[3]

Second, the sponsor's D&O insurance also applies excess of indemnification by the portfolio company's insurance. Again, the sponsor should work with counsel and the Outside Entity to ensure full understanding of the Outside Entity's insurance. For example, the sponsor may ask counsel to confirm that the Outside Entity maintains its own D&O insurance to a specified limit, and that adequate reporting protocols are in place to ensure that the Outside Entity is able to avail itself of the D&O policy. As referenced in the above sample language, the policy may specify whether the entity is required to indemnify the Outside Director.

Some insurers deem the sponsor's insurance to apply as double excess insurance—i.e., only after indemnification of both the Outside Entity and the exhaustion of its insurance.[4] What this means in practice is that the double excess limits could deploy under the following scenario: The claimant in a D&O action may name the Outside Director individually or the board of directors as a whole. If the claim or prior claims against the portfolio company fully exhaust the portfolio company's underlying limits (i.e., by full payment thereof), the Outside Entity should indemnify the individual directors.

In two specific circumstances, however, the Outside Entity may be unable to indemnify the individual—namely, (1) in cases of financial insolvency and (2) in cases of derivative claims, as corporate bylaws and state statutes forbid indemnifying the named individuals in derivative claims. In either case, the claimant may continue to pursue the liability claim against the Outside Director. In this situation, the sponsor's limits may deploy excess of the Outside Entity's insurance and indemnification requirements of the Outside Director.

DOUBLE EXCESS INDEMNIFICATION

Applies Last*	SPONSOR'S INSURANCE
Applies Next	PORTFOLIO COMPANY'S INSURANCE
Applies First	PORTFOLIO COMPANY INDEMNIFICATION

***Sponsor's insurance often requires exhaustion by payment of the portfolio company's insurance.**

Sponsor's D&O Policy Not a Substitute for the Outside Entity's D&O Policy

While the sponsor's insurance may provide double excess coverage to the Outside Director for certain D&O claims against him as part of the Outside Entity's board, the sponsor and the Outside Entity should not consider the sponsor's insurance a substitute for the portfolio company's insurance. As mentioned above, the double excess coverage would only apply where the Outside Entity is unable to indemnify the Outside Director.

The prospect of having the Outside Entity enter into insolvency in particular may be considered a viable way to access the sponsor's limits. Depending on the industry, insolvency maintains a recognized, if somewhat debated, presence in the context of private equity.[5] Insolvency is part and parcel of the private equity landscape, and therefore the sponsor or the portfolio company may be tempted to utilize insolvency to place an undue reliance on the insurance of the sponsor to cover the claims against the portfolio company's board of directors.

Specifically, the fact of the sponsor's insurance may tempt the Outside Entity to remain underinsured so that, in the event of a claim, it need merely enter into insolvency proceedings. The entity would do so in hope that the sponsor's excess coverage may be available through the involvement of the Outside Director, who could be held jointly and severely liable due to his participation in the Outside Entity's board. It would be a mistake for the Outside Entity to take this approach.

As a preliminary matter, the Outside Entity should be protecting each of its directors, officers and employees, along with the entity itself, by purchasing its own adequate limits, separate and apart from the limits of the double excess insurance available through the Outside Director. Moreover, the sponsor's insurer has specifically underwritten the sponsor, based on its financials and its operations—not the Outside Entity. The two entities in the current scenario typically maintain independent operations and independent finances, and purchase separate towers of D&O insurance, often through separate brokers.[6] It would not be advisable for the Outside Entity to rely upon the double excess coverage of its Outside Directors.

Examples Wherein Sponsor's Insurance May Be Required to Drop Down

Despite the above, it may be possible for double excess insurance limits to deploy prior to the full exhaustion by payment of the Outside Entity's insurance. There are at least two commonly recognized ways in which this may occur, depending on the language in the excess policies[7] and the jurisdiction: (1) insolvency of an insurer of the portfolio company and (2) the portfolio company's settlement with its insurers for less than the total limits, where the liability exceeds the portfolio company's total limits. Following is a very brief discussion of these two scenarios, along with a third scenario.

A. Insolvency of an Outside Entity's Insurer

The first example is the specific circumstance in which an entity's primary insurer is insolvent. There is conflicting case law regarding whether excess insurance may be required to drop down to a lower attachment point in the absence of specific drop-down language.

There is some California case law that favors excess insurers dropping down where excess policy language fails to specify that underlying policy limits must be exhausted by payment of the full underlying limit.[8] Specifically, California case law holds that where terms such as "exhausted" or "reduced" are not defined in the excess policy, the policy may be required to drop down in cases of insolvency of the underlying insurer.

Wisconsin case law allowed for a similar outcome, where the excess insurance policy fails to specify that the underlying policy must be fully exhausted by payment.[9] Where the excess policy stated it shall be excess of the "amount recoverable," the Wisconsin appellate court required the excess insurer to drop down due to underlying insurer insolvency.[10]

Case law in a number of other states, however, holds that absent explicit drop-down language, the excess carrier will not be required to drop down due to an underlying carrier's insolvency. For example, case law in New York,[11] Connecticut,[12] Pennsylvania,[13] Texas[14] and Illinois[15] has not required excess carriers to drop down in case of an underlying insurer's insolvency.

Applying the above to our double excess Outside Director's liability scenario, the sponsor's insurance will not drop down to a lower attachment point to cover the Outside Director, unless a number of conditions are met—the inability for the underlying insurer to indemnify the Outside Director, and the inability for the portfolio company to cover the Outside Director (again, either due to financial insolvency or because the claim is derivative in nature). Thereafter, the language of the excess policy must be sufficiently ambiguous for certain jurisdictions to hold that the excess insurer must drop down in case of underlying insurer insolvency.

B. The Prospect of Settling With Underlying Insurers for Less Than the Underlying Limits, Where the Loss Exceeds Underlying Limits

The second scenario we address is one in which a claim exceeds the primary (or underlying) insurance limits, but the insured settles for less than the limits, because of coverage issues or other reasons. In such instances, the sponsor policy acts as excess

and may (or may not) drop down to provide coverage. The case law generally falls into the following three categories: (1) cases that require the excess insurance to drop down[16]; (2) cases that allow for excess insurance to apply, but only after the insured fills the gap between the settlement and underlying limits[17]; and (3) cases that hold the excess insurance will never be reached, because the limits of underlying insurers were never exhausted by payout.[18]

Once again applying this principle to the Outside Director's liability in the context of the sponsor's insurance, the sponsor's insurance will only drop down if (1) the portfolio company settles with its insurers for less than the total limits, and then (2) the portfolio company subsequently becomes unable to indemnify the Outside Director. Thereafter, in certain jurisdictions, the sponsor's insurance will be required to drop down without requiring that the gap be filled.[19]

Other jurisdictions[20] will require that the gap be filled before the sponsor's insurance limits deploy. In our scenario, however, the portfolio company does not have the ability to indemnify the outside director (once again, either due to financial insolvency or because the claim is derivative in nature). Therefore in this situation, if the portfolio company is unable to fill the gap between its settlement and the full limits of its insurance, the excess insurance will never be reached.

The third group of jurisdictions holds that regardless of whether the portfolio company could fill the gap, excess insurance would never be reached. These cases argue that underlying limits must be exhausted by payment of the underlying insurers only, and not by settling with the underlying insurers for an amount lower than the underlying limits—even if the portfolio company were somehow able to fill the gap.[21] Critics have argued this constitutes a windfall for the excess insurers,[22] but ultimately these cases disincentivize settling with underlying insurers for an amount less than underlying limits, if the excess insurance is to apply.

Applying this to the example at hand, the portfolio company is unable to indemnify the Outside Director, and therefore cannot fill the gap upon settling for a lower amount. Even if it could, however, these cases would hold that the excess insurance would never be reached because the underlying limits have not been exhausted by underlying insurer payment.

C. The Unsettled Case of Failure to Provide Notice to Underlying Insurer

Where the sponsor and Outside Entity purchase insurance through different brokers, the sponsor's brokers may not have knowledge of the claims notification process to the Outside Entity's insurers. In one such example, the Outside Entity's brokers noticed the claim only to the Outside Entity's primary carrier, but not its excess carriers. The claim was severe enough that insolvency proceedings were considered, meaning it was possible that the Outside Entity would be unable to indemnify its Outside Director.

The question arose as to whether the sponsor's insurance would drop down to apply once the portfolio company's primary insurance is exhausted by payment. Unlike the exceptions discussed above, the Outside Entity's excess insurers remained solvent, and they did not participate in a settlement wherein the portfolio company faced a prospect of filling the gap. The Outside Entity's excess carriers simply were never put on notice, and therefore argued they had no duty to respond.[23]

The sponsor's insurers may resist dropping down in this situation, arguing the underlying limits have not been exhausted via payment. They may point out that there is no factor prejudicing the insured portfolio company, such as bankruptcy of an underlying insurer. They may also argue that agreeing to drop down in this scenario would in effect be letting the portfolio company and its insurers off the hook, and could even create a perverse incentive. By agreeing to drop down, the sponsor's insurer may be sending a message that the portfolio company can take a careless approach to notification on the expectation that the sponsor's insurer will drop down. The sponsor's insurance may even contend that its limits will never deploy when the underlying has not been notified.

To our knowledge, there is no appellate case law addressing this specific scenario for Outside Director's liability and, in the absence of case law, the sponsor's insurer may select from a wide range of potential responses. In doing so, the insurer will likely take into account not only the language in the sponsor's policy, but also factors such as strength and depth of relationship among the sponsor, its broker and the insurer; rate and claims trends in the line of coverage; and loss history and other underwriting information pertaining to this insured. The role of Gallagher claims advocates is to ascertain potential grounds for coverage by reviewing the language of the policies at issue and argue coverage accordingly.

Sources and Notes

[1] The entity whose director, officer or employee will be serving on an outside board may be the sponsor or general partner of a private equity fund, but may also be a limited partner who is a significant investor in the private equity fund. For the sake of simplicity, this paper will address the private equity context and will refer to the originating entity using the term "sponsor." For the entity on whose outside board the director is serving, this paper will use the term "portfolio company" or "Outside Entity." The principles outlined in this paper are not limited to the private equity context—they will also apply to directors of a corporate parent serving on the boards of subsidiaries or affiliates within a larger corporate structure outside of the private equity context.

[2] Although this paper specifically references only D&O policies, similar principles can apply to other executive lines of coverage. As always, the specific language of the policies will control, and coverage should be analyzed on a case-by-case basis.

[3] We suggest these measures for illustrative purposes only—every situation is different. We defer to outside counsel in this regard, and Gallagher brokers are available to discuss further as needed.

[4] See, e.g., https://www.rlicorp.com/private-equity-investment-services-executive-liability-insurance; while beyond the scope of this paper, a less frequent additional requirement is for the sponsor to indemnify prior to the sponsor's insurer. This approach is sometimes known as triple excess indemnification. See https://baileycav.com/site/assets/files/1433/glossary.pdf under "Outside Positions"; https://studylib.net/doc/7487354/dando-policy-commentary---bailey-cavalieri-llc.

[5] https://www.institutionalinvestor.com/article/b1gfygl4r8661f/LBOs-Make-More-Companies-Go-Bankrupt-Research-Shows; https://www.retaildive.com/news/the-road-to-bankruptcy/540617/; https://srvhlaw.com/blog/role-of-private-equity-in-chapter-11-bankruptcies-debated/.

[6] Ideally, the sponsor and its portfolio companies should consider a comprehensive plan for coverage with their broker.

[7] These scenarios assume no other limiting language in the sponsor's policy precludes coverage.

[8] See *O'Reilly Auto Enterprises v. United States Fire Insurance Co.*, No. 6:17-03007-CV-RK, 2020 U.S. Dist. LEXIS 18422 (W.D. Mo. Jan. 31, 2020) (addressing general liability policies); but see *Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770 (2008) (addressing D&O liability policies with explicit language requiring exhaustion by payment in full by underlying insurance). The *Qualcomm* case demonstrates that coverage cases addressing executive liability policies often cite to other lines of coverage, such as general liability or crime.

[9] *Lechner v. Scharrer*, 145 Wis. 2d 667, 429 N.W.2d 491 (Ct. App. 1988) (automobile insurance).

[10] Id.

[11] *U.S. Fid. & Guar. Co. v. Treadwell Corp.*, 58 F. Supp. 2d 77, 88 n.11 (S.D.N.Y. 1999) (footnote addressing coverage over a number of lines of coverage, case addressing general liability insurance).

[12] *Dexter Corp. v. National Union Fire Insurance Co*., No. 3:95CV00702(WWE), 1997 U.S. Dist. LEXIS 7668 (D. Conn. Mar. 12, 1997) (general liability insurance).

[13] *Mountainside Holdings, LLC v. Am. Dynasty Surplus Lines Ins. Co.*, 2014 Pa. Dist. & Cnty. Dec. LEXIS 73 (D&O insurance).

[14] *Taylor Service Co. v. Texas Property & Casualty Insurance Guaranty Ass'n*, 918 S.W.2d 89 (Tex. App. 1996) (automobile insurance).

[15] *Home Insurance Co. v. Hooper*, 294 Ill. App. 3d 626, 691 N.E.2d 65 (1st Dist. 1998) (general liability insurance).

[16] *HLTH Corp. v. Agricultural Excess & Surplus Insurance Co.*, No. 07C-09-102 RRC, 2008 Del. Super. LEXIS 280 (Super. Ct. July 31, 2008) (D&O insurance); *SI Industries v. American Motorists Insurance Co.*, 128 N.J. 188, 607 A.2d 1266 (1992) (employment practices liability insurance). Additionally, a long line of cases in the state of New York was in agreement, but has been abrogated on this point. See discussion of *Zeig v. Massachusetts Bonding & Insurance Co.*, 23 F.2d 665 (2d Cir. 1928) (crime insurance) at https://www.baileycav.com/site/assets/files/1453/excess_policy_attachment.pdf.

[17] *Forest Laboratories, Inc. v. Arch Insurance Co.*, 2012 NY Slip Op 22291, 38 Misc. 3d 260, 953 N.Y.S.2d 460 (Sup. Ct.) (D&O insurance); *Elliott Co. v. Liberty Mutual Ins. Co.*, 434 F. Supp. 2d 483 (N.D. Ohio 2006) (general liability insurance; portions vacated by *Elliott Co. v. Liberty Mutual Insurance Co.*, 239 F.R.D. 479 (N.D. Ohio 2006)).

[18] *Mehdi Ali v. Federal Insurance Co.*, 719 F.3d 83 (2d Cir. 2013) (interpreting New York and Pennsylvania law) (D&O insurance); *Hopeman Brothers, Inc. v. Continental Casualty Co.*, 307 F. Supp. 3d 433 (E.D. Va. 2018) (general liability insurance; interpreting New York law); *Federal Insurance Co. v. Estate of Irving Gould*, 2011 U.S. Dist. LEXIS 114000 (S.D.N.Y. Sep. 28, 2011) (D&O insurance; interpreting New York and Pennsylvania law); *Martin Resource Management Corp. v. Axis Insurance Co.*, 803 F.3d 766 (5th Cir. 2015) (D&O insurance; interpreting Texas law); *Great American Insurance Co. v. Bally Total Fitness Holding Corp.*, No. 06 C 4554, 2010 U.S. Dist. LEXIS 61553 (N.D. Ill. June 22, 2010) (D&O insurance); *Comerica Inc. v. Zurich Am. Ins. Co.*, 498 F. Supp. 2d 1019 (S. D. Mich. 2007) (D&O insurance); *Qualcomm, Inc.v. Certain Underwriters at Lloyd's, London*, 73 Cal. Rptr. 3d 770 (Ct. App. 2008) (D&O insurance).

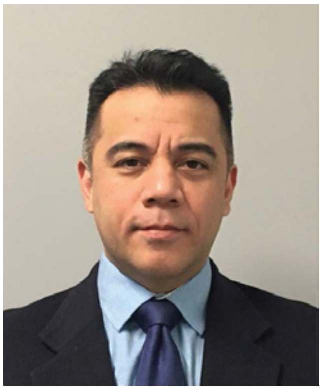
[19] See footnote 16, above.

[20] See footnote 17, above.

[21] See footnote 18, above.

[22] See *Pereira v. Cogan,* 2006 U.S. Dist. LEXIS 49263 (S.D.N.Y. July 12, 2006) (D&O insurance).

[23] Gallagher sometimes inherits claims situations such as this one, arising from pre-existing situations between non-clients using other brokers. In this case, defective notice by a non-client and its broker could not be cured, and the non-client opted against pursuing damages from its broker. This only further reinforces the point made above—that sponsors must attain detailed knowledge of, and comfort level with, the insurance and claims notifications processes of their portfolio companies.



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Adnan Arain fills a multifaceted role, specializing in D&O, cyber and professional liability lines of coverage. Deploying a skill set developed as a litigator, former head of claims and subject matter expert, Adnan excels at client advocacy and policy analysis. Prior to joining Gallagher, he served as senior broker in the professional liability space at a large national broker, leading underwriting meetings in the U.S., London and Bermuda. He then served as head of claims and subject matter expert, and led the management liability team of a smaller brokerage located in Chicago. Prior to joining the insurance brokerage industry, Adnan practiced law in Chicago, defending professionals who were sued for malpractice.

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