Global FINEX - Directors & Officers Insurance

Considerations for D&O Insurance in Captives

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Willis Towers Watson

Introduction

In the context of an increasingly challenging Directors and Officers ("D&O") liability insurance market, we are being asked by clients for other options to placing the whole of their D&O program with traditional insurers. One such option which is often raised is whether some or all of a D&O program could be satisfied by use of a captive insurance arrangement. Please note that this article was originally produced for the London insurance market. We have updated it for our North American audience.

Sides A, B & C

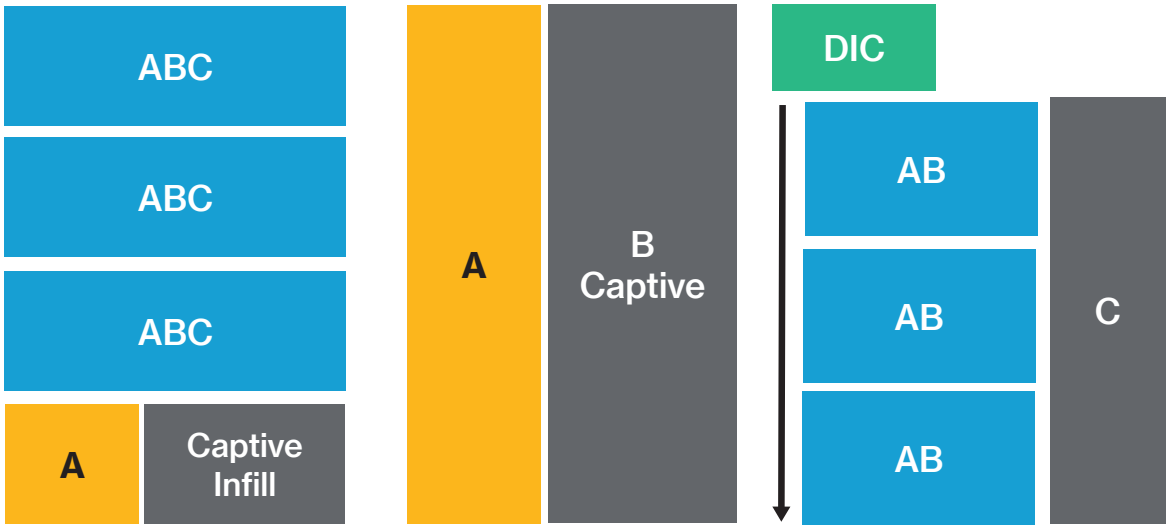
Traditionally, D&O liability is written on the basis of three types of cover:

- Side A – covers for liabilities incurred by an individual in their capacity as a director or officer
- Side B – covers for corporate reimbursement of liabilities to a director or officer by the company for which they serve as a director or officer
- Side C – covers for securities claims against the company for public companies, and for private and not-for-profit companies, far broader coverage may be available.

The use of a captive for Sides B & C is well aligned to captive participation with sufficient prudent consideration to risk appetite and loss control and can readily be accomplished. Side A, however, has a number of complications that are considered within this document.

There are a number of ways in which a captive can become involved:

Figure 1: **Sides A, B & C**



Captive infill for Sides B and C on the lower layers

Captive replacement for Side B

Captive replacement for Side C

Side A captive issues

There are three principle issues with the use of a captive insurance vehicle to provide Side A D&O insurance coverage:

1. **Ring-fencing of Assets.** The purpose of Side A D&O insurance coverage is to indemnify directors when the company is unable or, in some cases, unwilling to do so. One of the main situations in which the company will be unable to indemnify its directors is when the company is insolvent. In a traditional captive insurance arrangement, the captive insurance is provided by a subsidiary of the company purchasing the insurance and the assets of the captive may be vulnerable to attack by creditors of the company. It may be argued that the assets of the captive are additional/other assets of the parent company and should be made available to meet the company's liabilities, rather than being kept available to meet the insurance claims of the directors and officers. While this risk may be relatively remote, it is something the company (and its directors and officers) will wish to avoid given that the insurance is provided for the benefit of individual directors and officers.

2. **Circularity of Funding.** One of the other situations when a company is unable to indemnify its directors is when the company is legally prohibited from doing so. The situations which are legally prohibited vary across different jurisdictions. Where this indemnity is being replaced by captive insurance, the risk is that this arrangement falls foul of any prohibition on the company indemnifying its directors. This is because the prohibition extends to other companies within the policyholder's group, i.e. including the captive if it is a subsidiary. For many years, it has been assumed that this inability to corporately indemnify Directors & Officers renders a captive solution tenuous at best. There is nothing particularly to stop the captive issuing a policy, but the payment of claims may not be possible in certain circumstances. Non-executive directors, in particular, may be uncomfortable with this situation.

3. **Independence of Claims Handling.** Finally, a significant issue for many directors and officers is that they will not want decisions about whether their insurance should pay out to be made by a captive that is owned by the company for which they work or which they serve as a non-executive director. This is particularly a concern where the company is the one bringing the claim against the directors. However, it could also be a concern simply where a new regime is in place and the company no longer has the same relationship with the director. In any such situation, the directors and officers will want to be sure that any decisions regarding claims handling and control are objective and independent from the company.

There are a number of solutions which can be found for the issue of independence of claims handling, such as:

- Appointing an independent claims handling company or lawyer to manage claims; and/or
- Having the insurance fronted by an independent insurance company and then reinsured into the captive.

Figure 2: **Direct Insurance**

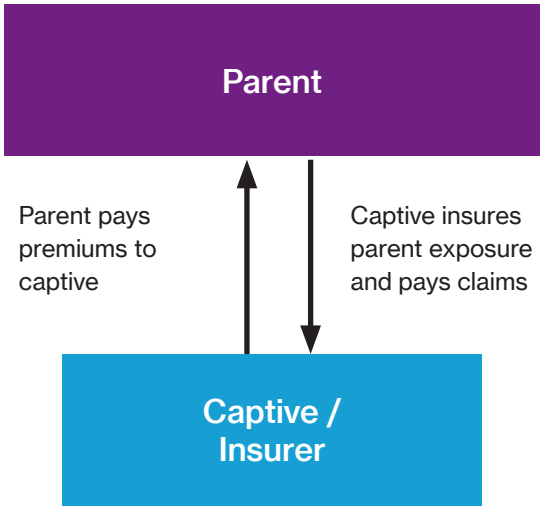
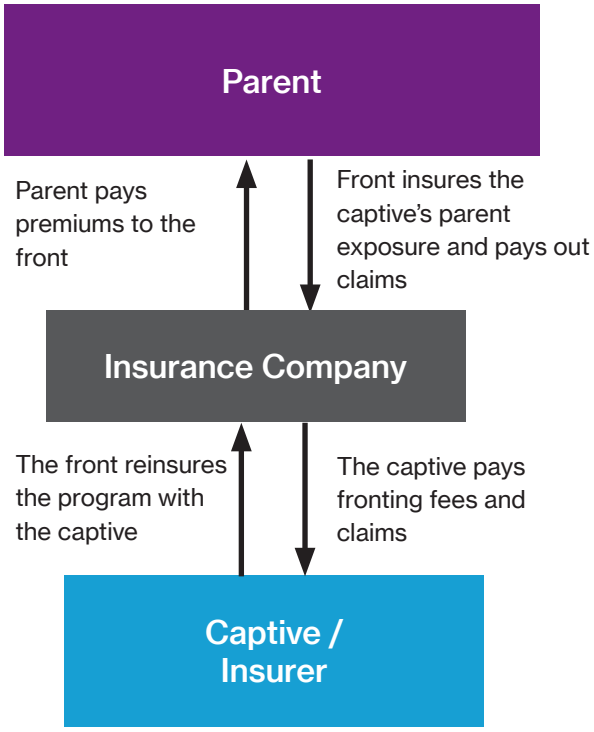


Figure 3: **Reinsurance**



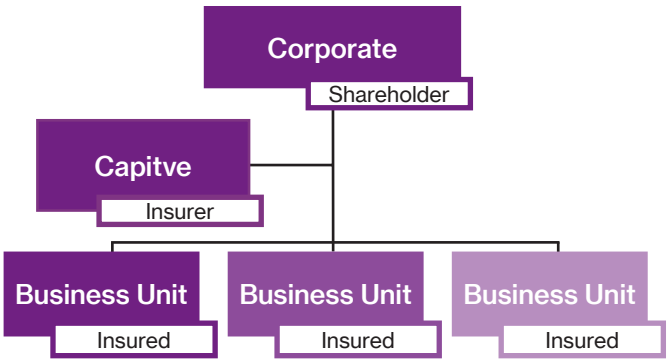
Of course, finding a solution and the directors and officers being satisfied that it is a better solution than simply paying the premium for independent insurance, are not the same thing! Nonetheless, these are possible solutions.

The first two issues of ring-fencing of assets and circularity of funding are less straightforward to resolve.

Protected cell company

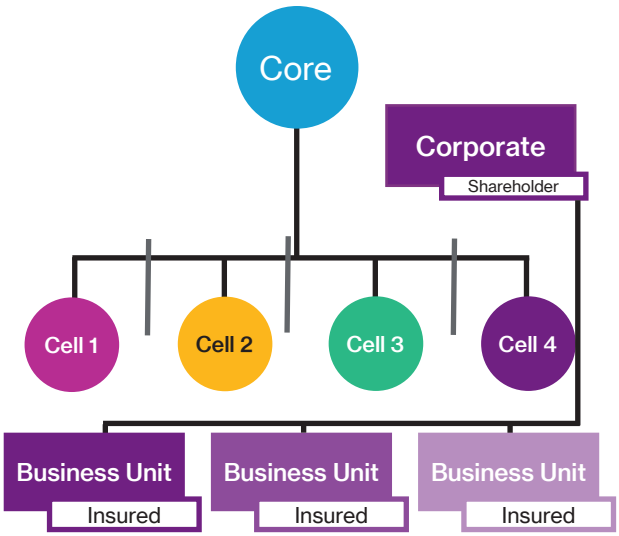
One structure which is adopted for some captive insurance arrangements is the use of a protected cell company ("PCC", and also known as Segregated Account/Portfolio Companies). This is a single company which can insure a number of different policyholders but offers segregation of the assets and liabilities of each policyholder by means of independent "cells" or "accounts" within a single legal entity. The company wishing to participate in the cell is issued a share variant, class or participation agreement to reflect their ownership of the benefits of the cell including the assets and liabilities contained therein. This is shown in the diagram below:

Figure 4: **Wholly Owned Captive**



- Insured - pays premiums and submits claims
- Captive - pays operational service providers, collect premiums, pays claims, dividends profits
- Shareholder - provides capital and surpluses and collects dividends

Figure 5: **Protected Cell Captive**



There are two core considerations regarding the utilization of a protected cell as it relates to control.

1. Mind and management

The protected cell may be considered to be under third party 'control' on the basis that:

- The cell is not an independent legal entity;
- Any issued cell shares or other participation instruments are non-voting; and
- The captive directors and officers are appointed by, and responsible to, the third party owners of the Protected Cell Company rather than the cell itself.

Additionally, well considered language in the governing documents of the relationship between the company and the PCC can help ensure that the PCC is given the independence to act with regards to any matters, including claims, relating to the cell, ensuring there is independence in both substance and form.

The PCC structure therefore may be considered to offer independence of claims handling and management from the insured/cell owner. This independence in decision making and governance may support the use of a protected cell for D&O risk in respect of the general control, and specific handling of claims.

2. Ownership

The company seeking insurance for its directors and officers may own shares in relation to the assets and liabilities of the cell and therefore there remains a concern that a liquidator or plaintiff/claimant will still argue that the value of those shares should be made available to meet the company's liabilities. We therefore have concerns about ring-fencing of assets in such a structure in respect of Side A.

However, Willis Towers Watson is exploring the possibility that there may be an opportunity to establish a cell in a manner which distances the cell ownership from the company for whose directors and officer coverage is issued, which may provide a solution to this key issue.

Given that the assets of the cell in such a structure may form an asset of the company or may have originated from the company for whose directors and officers coverage is purchased, consideration also should be given to the efficacy of coverage via a captive or cell in respect of financial restitution for shareholder actions as part of a Side A claim. A claim against the cell may not provide the intended financial benefit to the consolidated financial position of the company.

As matters stand, the use of a cell structure for Side A remains relatively untested. While there is demonstrable opportunity related to separation of control and potentially ownership, there are other potential issues to overcome in order for this to be an effective solution, not least the high degree of funding/capitalization required. Nonetheless, this may be an approach that companies may wish to consider and seek legal counsel about. Willis Towers Watson is here to assist you in these discussions and work towards a satisfactory outcome.

We believe that protected cells can provide a framework for managing governance issues related to Sides B and C, where prudently structured, enabling captive utilization.

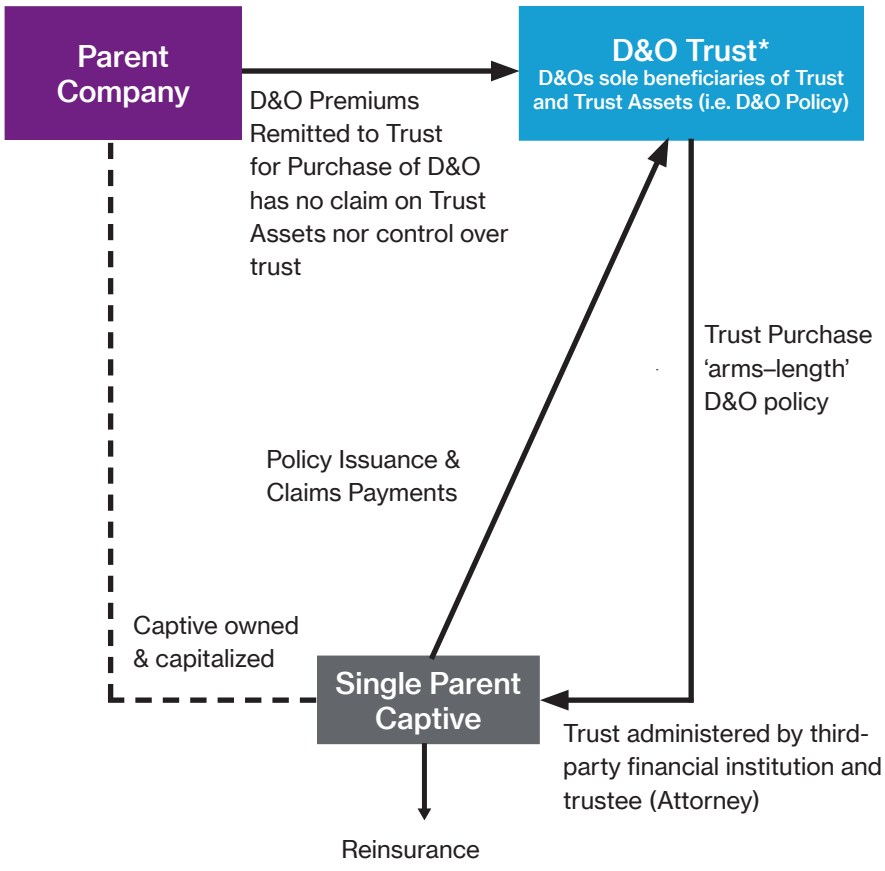
We additionally believe that cell structures have the potential provide an alternative for A side, subject to certain additional controls being assessed and embedded. However, given the issues outlined above, this is only likely to be a fallback solution for situations where the commercial insurance market is unable or unwilling to provide insurance at a capacity and premium acceptable to the policyholder.

Trust structures

A potential alternative to the PCC structure is to involve a trust arrangement, further seeking to divorce ownership of the premiums used to pay the captive from the company seeking to insure its directors' and officers' liabilities.

Under this structure, the premiums are remitted to a trust for which the directors and officers are the sole beneficiaries. The trust then purchases insurance from a captive insurance vehicle and payments made by the captive are paid to the trust, which then distributes those payments to the relevant directors and officers in accordance with its trust deed and rules.

Figure 6: **Trust/Captive Insurer D&O (Side A) Transaction**



While this structure has the potential to provide further weight to rebut the arguments around ring-fencing of assets and circularity of funding, its use for Side A is also as yet untested.

Other considerations for D&O in captives

Leaving aside the questions of whether Side A can be insured using a captive arrangement, the use of captives within D&O more generally raises questions for clients considering these alternatives to purchasing traditional insurance:

- The cost of establishing and running a captive. Captives are insurance vehicles and therefore will need to be regulated in the relevant jurisdictions.
- D&O liabilities can be very long tail risks. When considering the cost vs paying premium to a traditional insurer, clients will need to consider the cost of tying up capital aligned to legacy liabilities.
- D&O liabilities tend to be low frequency and high value. It will therefore be imperative to align assumed risk to risk appetite. If the company already has a captive in place for other risks, these may offset this D&O volatility.

Summary

Given the increasingly difficult market conditions it is entirely natural to consider captives, either as an alternative or alongside market placements, to offset these challenges. Serious consideration should however be given to the intricacies of captives for this purpose and look through to the intent of the coverage.

Side A presents specific challenges related to financial and governance circularity. We believe that there are viable solutions for Sides B & C, however, given the potential for significant loss volatility, this will require prior organization and predominantly be for well-funded stable captives.

Willis Towers Watson is here to support you:

Willis Towers Watson operates Protected Cell Companies in Europe, the USA, and Bermuda. Willis Towers Watson's captive teams are aligned with our client service teams, specialist brokers and dedicated analytics to support you in optimizing your D&O risk financing strategy.

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