A Special Reprint of RRG BOARDS' BEST PRACTICES from

The
Risk Retention
Reporter

D&O–Yes You Need It

By Gary H. Osborne, President, USA Risk Group, Inc.

As a manager of over 30 risk retention groups and another 200 captive programs, I am often questioned by board members, owners, and risk managers whether they "really" need to spend the money on Directors & Officers insurance. My answer, based partially on my own unfortunate history of involvement with legal actions, as well as seeing other captive failures, is an unequivocal, YES!

The need for D&O varies depending on the form of the captive, so let us review the exposure for the three most common captive types.

Single Parent Captives–coverage for these entities can usually be extended from the parent company and it is probably not necessary for additional stand alone coverage to be sought. However, it is important to check whether all board members and officers of the captives are officers of the parent company, and the parent level policy may have to be endorsed or amended to include the directors and officers of all subsidiaries.

Group Captives–I would strongly recommend that boards and officers consider D&O and possibly errors and omissions (unless all services are provided by vendors and they have adequate professional coverage). The excitement of forming a new company often convinces members that everything is great and all the members are on the same page so nothing could possibly go wrong. After 25 years, I can promise you there are many, many, things that can and will go wrong, for example: (1) membership disputes, (2) collateral disputes, (3) investment problems, (4) dividend and distribution policy disagreements, (5) original member preferred terms, (5) capital repayment and forfeiture terms, (6) regulatory disputes, (7) coverage disputes, (8) expansion plans . . . and the list goes on. This can also be very problematic as founders leave and are replaced by new representatives for their company who may not have a thorough knowledge of the history of the company and an understanding of "why things have always been done this way."

Risk Retention Groups–I come close to stating that D&O coverage should be mandatory for risk retention groups. The only mitigating factor is that many RRGs are effectively controlled by a single entity (hospitals being the most obvious example), and coverage may be afforded by the controlling entity. The larger concern for a RRG is that its footprint is much closer to the "public" than any other form of captive and is also subject to much more regulatory scrutiny, not just from the domiciliary state but from all states in which it is doing business. The likelihood of members taking legal action against a board is greatly enhanced when there is a large diverse ownership and, accordingly, a smaller percentage of the total shareholdings is represented by board members.

The "History" Warning

I was recently involved in a contentious failure of a risk retention group. I had also served as a member of the board. There were eight board members and, at our recommendation, the controlling entity had purchased a $1 million D&O policy covering the boards of the controlling entity and covering the RRG. The controlling entity failed, and its failure had a domino effect in bringing down its related risk retention group. Suffice it to say that a $1 million limit did not go far when the failures resulted in legal actions against the two companies in three different states. Indeed, there was also a question of coverage in that most D&O and E&O polices do not provide coverage for government/regulatory actions. Our insurer took the position that a receiver was a function of government and disputed the claim.

The point of this history lesson is not to pore over details, but to highlight an actual example of what specifics a board needs to pay attention to when it has decided (and it should) to purchase Directors & Officers coverage.

Policy Limit. How many members are on the board and in how many states is your risk retention group operating? If every board member has to retain an attorney, how quickly can/will your limit be eroded? If there is a deductible, how will the funding of it be addressed? If you have a "hold harmless" or indemnification clause, how do you expect that to function?

Coverage exclusions. Look for regulatory exclusions. The RRG industry has a history of regulatory disputes and receiverships. If a receiver pursues the board members, is there coverage for the board?

Allocation of Limits. This may not be in the policy, but what will happen if there is an unequal cost between board members–how will the allocation of limits be addressed both by the policy and by the board?

Board Behavior

Obviously the best way to deal with the D&O coverage issue is not to have a claim. What steps can the board take to avoid some of the problems potentially involved in their board function?

1. **Do not be a rubber stamp.** Board members need to take their role seriously, ask questions, and vote no or abstain when they perceive there is an issue they feel they cannot or should not support.
2. **Audit Committee.** Members need to pay attention to any audit letter recommendations and/or any state examination questions.
3. **Investments.** The board needs to ensure there is an investment policy in place and should review compliance with said policy on a quarterly basis.
4. **Member rotation.** It is not good policy to have the same board members serve for extended periods–there should be a rotation of the key functions to reduce the possibility of complacency. New members will question the functioning of a group and look more carefully at practices and procedures.
5. **Conflicts of Interest.** The board needs to recognize they can be conflicted between their role as a policyholder and their role as a steward of the insurance company.

The potential personal liability involved with being on a board was brought home to me in the failed RRG situation. It is imperative for board members that they seek, at a minimum, indemnification for their actions, and secondly, cost effective insurance for protection of their personal assets.

Gary Osborne is president of USA Risk Group and is responsible for developing innovative alternative and traditional risk strategies and programs for clients and prospects of USA Risk Group. He is also responsible for oversight of the captive and alternative market divisions of USA Risk Group. Gary has been working in the alternative market for twenty years, having held positions in Bermuda, Hawaii, and Vermont. He has also been involved in the establishment of numerous captives, risk retention groups, and traditional group insurance programs. He is a frequent speaker on insurance and captive topics. He has served as treasurer of the Hawaii Captive Insurance Council and as the Chairman of the Legislative Committee of the Vermont Captive Insurance Association. He currently serves as a director of the National Risk Retention Association where he is also the chairman of the membership committee. He is also a faculty member for the International Center for Captive Education.

Reprinted from the August 2011 Risk Retention Reporter – Volume 25, Number 8

RISK RETENTION REPORTER — Published by INSURANCE COMMUNICATIONS, P.O. Box 50147, Pasadena, California 91115. (626)796-4972, fax: (626) 796-2363; e-mail: info@rrr.com; URL - http://www.rrr.com © Copyright 2011 *Risk Retention Reporter*. The *Risk Retention Reporter* is published 12 times a year. Subscription Rates: One year: $455; Outside U.S.: $485.