How Not to Be a Victim of the Intricacies of Corporate Insurance

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It's pretty much all the same, right?

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If you're a small to medium-sized firm, responsibility for insurance will often reside within the C-Suite or with the owner. As they will readily admit, however, rarely do any of these executives or the owner of the business have any meaningful experience with corporate insurance, other than possibly knowing someone who sells it.

If you're a large enterprise without a formal risk management function, the responsibility for insurance likely is with the Assistant Treasurer. Why? Nobody really wants the job since most know they don't have the skills necessary to do it well, few have the time to obtain the required knowledge, and more often than not, it's also because there's no "Assistant, Assistant Treasurer".

So, what happens when you've been designated as the internal person in charge of insurance and you don't have much or any insurance experience? Who do you call for advice? The insurance agent or broker? Your peers? Outside legal counsel?

In order to address this knowledge gap, you may conclude that you'll need to hire a full-time Risk Manager and start investing the time and resources required to develop an effective insurance and risk management function internally.

But, what if there were a source of expert knowledge, objective insurance advice and succinct risk strategies? What if engaging this source would likely lead to better coverage (protecting your Balance Sheet), lower premiums (improve your P&L) and simplified administration (fewer insurance-related headaches)? In that case, shouldn't you just bring in the outside experts to help you identify the critical decision points, navigate the insurance process and help you with your day-to-day risk management needs?

Not convinced? Still think you can D-I-Y? Here's a simple self-assessment to illustrate just a few of the many intricacies that must be understood and addressed in order for your insurance program to work correctly.

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Policy Language – It's pretty much all the same, right?

Crime policies generally cover the direct theft loss of your, and potentially your clients', tangible property (including money and securities) due to your employee(s) acting alone or in collusion with others.

As with every insurance contract, the effectiveness of Crime coverage usually hinges on a single word or two. One of the critical words you must make sure is in your Crime policy is "discovered", as in Loss Discovered. This is because most Crime coverage sold in the United States is Loss Sustained rather than the preferable Loss Discovered. Let's take a look at why the word discovered is so important in a Crime policy.

Employee theft can be categorized into two basic buckets: fast and slow. The fast bucket contains the one-and-done thefts – your employee steals $160,000 of inventory over a long weekend. The slow bucket, which is more often than not where the biggest losses occur – the employee sets up a system (dummy vendors or employees, for instance) to which they redirect relatively small amounts of funds repeatedly over an extended period of time (think years).

If you have the typical Loss Sustained Crime policy, when it's time to collect on a "slow bucket" loss from your insurer, you'll be surprised to find out that you're only covered for the theft amount that you *sustained* during the policy period, rather than the amount of loss you *discovered* during the policy period. Said another way, the Loss Sustained policy form is designed to cover only the fast theft losses, whereas Loss Discovered can cover both fast and slow employee theft losses.

The irony, from the buyer's perspective, is there's no cost difference to have Loss Discovered. You just need to know to ask for it and make sure the policy wording conversion is implemented correctly.

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Claims Often Involve Multiple Policies - Do You Know How Yours Interact?

- Do you know how well your Crime and Cyber policies work together if a third party uses a computer to steal your money?
- Under your current group of insurance policies, which policy would you turn to, to pay the cost to replace computers if, after the introduction of malicious code into your computer network (cybercrime loss), the digital forensic investigation determines the hardware is not worth saving and needs to be replaced? **Hint:** it's not your Crime policy.
- To what extent, if at all, will your Cyber and Crime policies respond to a voluntary parting of money or securities under false pretense or so-called "social engineering" schemes?

Contractual Insurance Obligations... Whose Balance Sheet Holds the Risk?

One of the recurring problems we come across in our new engagements is how often the insurance broker-issued Certificates of Insurance (COI) do not reflect the actual coverage in place or that is required by the contract between you and a third party. If you haven't had a thorough review of both your inbound and outbound contractual insurance requirements as compared to what the insurance policies actually insure, we conservatively estimate that one in every five Certificates of Insurance issued to you or on your behalf is done incorrectly.

Since issuing insurance certificates is something that every organization must do, here's a basic Additional Insured (AI) primer that you can use to benchmark how well your risk management program is meeting some of your contractual needs:

(1) Do your contracts make 100% clear that you are not agreeing to make a third party a Named Insured or Additional Named Insured? If not, you've just agreed to hand over the full policy and its limits to the third party, rather than just providing Additional Insured status for their vicarious liability that emanates from your actions/products.

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Unfortunately though, we have never seen an insurer willing to agree to do the same, but we have seen this error occur, on various coverages, in twenty percent of our new client base.

(2) There are dozens of Additional Insured endorsements currently in circulation, so determining which one fits a particular situation can be perplexing. Furthermore, in many situations you'll need more than one AI endorsement (for example, one for your ongoing operations and another for your completed operations) to meet the exposure and contractual obligations. How do you check to see if your broker is obtaining and evidencing the correct AI endorsement(s) for the particular situation?

(3) Most so-called "blanket" Additional Insured clauses/endorsements require there to be a written contract between the parties requiring AI status prior to the loss occurring. Even when your broker issues a Certificate of Insurance ostensibly conferring AI status, if there's not a written contract in place with the party being made Additional Insured, the COI alone will likely not trigger the insurer's obligation (defense/indemnity) to the Additional Insured. Regardless of whether you intended to provide the counterparty with AI status, failure to comply with the policy's written contract requirement could expose you to a lawsuit by your counterparty and/or their insurers. Who confirms, you or your insurance broker, whether there's a written requirement for Additional Insured status before issuing the Certificate of Insurance that indicates AI status?

(4) Many third parties who require Additional Insured status will also want such coverage to be primary to and not contribute together with any other insurance available to the Additional Insured – – so-called primary and non-contributory coverage. In most cases, your policies will need to be modified (which can be done) to provide these, as liability policies generally contain an "other insurance" (who's paying first) clause which states that if there's any other available insurance that the other insurance will be primary and the insurer will waive its right to seek equitable contribution (who's sharing in the payment) from the other insurer(s). If this is not done correctly, when the time comes for you to make a claim, you can imagine how the insurers would point fingers at each other and say that the other insurer should pay the claim – with you caught in the middle – and the claim sitting unpaid.

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(5) If you need to use your Umbrella or Excess Liability policy to fulfill the limits required by the Additional Insured, have you made sure the policy(s) also addresses the underlying (Automobile Liability, Commercial General Liability, etc.) Additional Insured and modification of the Other Insurance clauses, including any primary and non-contributory requirement? Don't be lulled into a false sense of security by the most common, but incorrect, response we hear from both insurance intermediaries and underwriters, which is that the Umbrella/Excess policy is "following form" of the underlying policies. While it's true that follow-form policies follow the terms of the scheduled underlying policies, that is only true to the extent that the Umbrella/Excess Liability policy's terms do not differ from or conflict with the underlying policy terms (*see Insituform Techs. Inc. v. American Home Assur. Co., 566 F.3d 274 (1 st Cir. Mass. [May 22, 2009]*)). One of the serious consequences of not appropriately modifying the Umbrella/ Excess Liability policy(s) is the circularity of risk. To illustrate the issue, follow the scenario where you have made a counterparty an Additional Insured on your $1,000,000 Commercial General Liability (CGL) and $5,000,000 Umbrella Liability (Umbrella) policies, but neither the Other Insurance clause nor the primary and non-contributory wording were amended in the Umbrella policy. A serious covered claim occurs and the AI counterparty seeks protection under your CGL and Umbrella policies. The claim is adjudicated quickly with the court awarding the claimant $4,000,000 with liability being split 60/40 between you, the Named Insured and your Additional Insured counterparty. Your CGL carrier will pay its policy limit, however your Umbrella Liability insurer will require the Additional Insured's CGL insurer to pay its limit before they will afford coverage to your counterparty AI since there is other insurance (their policy in which they are the Named Insured) available to the Additional Insured. Depending on the contract and jurisdictional law, the Additional Insured's CGL insurer will likely seek contribution and possibly subrogate its loss bringing the financial loss back to you (Named Insured that granted faulty AI status), for which you will likely be uninsured.

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We often hear from our new client-partners that they're not sure why they should care if the COI is correct when the other party has accepted it. While an incorrect COI certainly may keep the other party satisfied in the short term, if they ever do call upon the Additional Insured status and your insurer declines to afford their defense, you could be found in breach of contract. Furthermore, if the other party was smart enough to have insurance requirements, you can be assured they also have an indemnification clause that favors them, to buttress their position in case their Additional Insured status on your insurance doesn't work as planned. If you had the appropriate AI endorsements for the situation, this financial risk would likely be on your insurer's dime, rather than your Balance Sheet being exposed to the AI's defense expenses and possible indemnity.

Certificates of Insurance From Basic to Complicated Real Quick

- The issuance of a Certificates of Insurance does not change the terms and conditions of an insurance policy.
- If you have agreed to make non-vehicle finance/leasing organizations Additional Insured on your Automobile Liability policy, we suggest you double check your policy. **Hint:** Designated Insured does not provide Additional Insured status.
- Have you agreed to provide Additional Insured status in jurisdictions (such as NY) where such status may not be enforced with a party where there's no privity of contract (*see Gilbane Bldg. Co./TDX Const. Corp. v. St. Paul Fire & Marine Ins. Co., No. 653199/11, [2016 WL 4837454]*)?

Global Insurance Portfolio Structure – the Admitted vs. Non-Admitted Quandary

Unfortunately for multinational organizations, jurisdictional laws around the globe make it virtually impossible to have true worldwide coverage. If your organization is based in the United States and you do business beyond its borders, you likely purchase an International Package (foreign General Liability, Automobile Liability, Employers' Liability, etc.) policy.

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If you review that policy closely, you'll see that the insurer is acutely aware of the jurisdictional insurance laws regarding the use of non-admitted insurance. That's not to say that your current insurer hasn't provided a policy with a worldwide territory, but the real question you should be asking is whether your insurer is legally able to provide insurance that's recognized in your relevant jurisdictions around the globe.

Let's take a closer look.

From the corporate buyers' side, there are typically two schools of thought when it comes to purchasing locally admitted or licensed policies, whether they be independent or part of a master-controlled program.

The first school asks: If the policies we already purchased provide global coverage, why would we spend money on individual policies in various countries around the world?

The second school says: Even though we purchase a global master policy, we realize that there are indigenous country coverage nuances, contractual obligations and legal requirements around the world, so we also want to have local policies where it makes sense.

While we have seen both approaches used in practice, for sake of illustration, here we will highlight some of the reasons you may want to consider purchasing locally admitted policies in certain foreign jurisdictions, even if you have a global policy with "worldwide" coverage.

When an insurer is "admitted" in a certain jurisdiction, they hold a government issued license, which enables them to sell coverage in that jurisdiction. Even if they are headquartered outside the jurisdiction, for most intents and purposes, they are licensed like a local insurer and are therefore able to sell licensed or admitted coverage. When an insurer is "non-admitted", they are not regulated or licensed in the jurisdiction and are likely not paying Insurance Premium Taxes (IPT) the way a licensed insurer in a particular jurisdiction would.

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In certain jurisdictions, non-admitted insurance is permitted for non-compulsory insurances. In others, non-admitted insurance is not permitted at all. In the jurisdictions where non-admitted insurance is not permitted, you can face several challenges when trying to have a claim paid by your U.S. insurer that has provided "worldwide" coverage. Take, for example, a claim against your in-country Directors and Officers where you are expecting your "worldwide" insurer to pay on your behalf legal defense costs in a jurisdiction where non-admitted insurance is prohibited. In such a scenario, you will likely run into one or more difficulties.

First, you'll need to check your policy to see if the insurer has a duty to defend the company, its directors, and/or officers. Even if your insurer has the obligation to defend, they may still be legally prohibited from advancing defense costs to your local subsidiary or the affected in-country director(s). This is particularly relevant when local country laws require that some number of the foreign subsidiary directors be local nationals. Your "worldwide" D&O insurer will likely reimburse you (the parent company) elsewhere, then it will be your responsibility to get the money into the subsidiary and/or to the director(s). In doing so, you may cause unanticipated changes to the local subsidiary's capitalization table and/or create personal tax consequences for the affected directors/officers. These challenges may be further exacerbated if the relevant jurisdiction has currency controls, such as exist in Brazil and China.

Next, there are local exposure nuances. Across Europe, for instance, there are different approaches to corporate governance and notable variations in board structures that can be problematic for U.S.-based worldwide D&O insurance. Take for example the common two tiered Board structures in many European countries. With these structures there is usually an Executive or Management Board (MB) and a separate Supervisory Board (SB). The MB, which is led by the CEO, is responsible for day-to-day operations and the separate SB for all the non-executive directors is responsible for strategic oversight.

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In Germany, unlike the United States, there are more lawsuits against directors by their own company than due to shareholder litigation. This is a result of the two-tier board structure in Germany, which allows, and in some cases requires, the Supervisory Board to commence legal action against the Management Board. With this structural difference, there are several areas in your worldwide D&O policy that need to be amended to adequately protect your foreign directors and officers. The obvious one is how the Insured v. Insured exclusion is amended for two-tier boards, as both the MB and SB will be considered insureds under the policy.

On top of Board structure challenges to "worldwide" D&O insurance program, there are also indigenous coverages that need to be contemplated. In several jurisdictions, it is possible for corporate directors to be held liable for corporate pollution *(see Northstar Aerospace v Ministry of Environment Ontario Canada [2012]).* In Brazil, it is commonplace for the courts to freeze the assets *(so-called "Penhora Online")* of defendants involved in director litigation. When such an asset freeze occurs, the affected directors will likely need cash advances to simply pay their personal living expenses. If the D&O policy is not providing such advances, which is a common expectation for local Brazilian directors, then who is? Certainly check your policy, but it's likely not the European/North American based worldwide D&O insurance program.

If this wasn't complicated enough, even if no claim occurs, some countries are aggressive about non-admitted insurance being utilized in their jurisdiction, when such insurance is prohibited. Not surprisingly, part of this push for compliance has to do with collection of Insurance Premium Taxes (IPT) that would be collected if the insurance were procured "correctly" from licensed insurers. There are well known cases *(see Kvaerner P.L.C. vs. Staatssecretaris van Financien)* where regulatory authorities have come after companies (as well as their insurers) for such IPT and related non-compliance fines and penalties.

While it is certainly your choice how you approach procuring coverage for your operations around the globe, it's important that you make the decision with your eyes open to the potential consequences of not having locally admitted coverage.

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Even if you decide not to purchase local D&O (and other policies) in all jurisdictions in which your organization operates around the world, you may want to consider obtaining them where non-admitted insurance is prohibited, your company does significant business, and/or where there are local coverage nuances.

International Directors' & Officers' Liability Self-Check

- Has your worldwide D&O policy been modified to protect the Directors from personal liability for various foreign corporate tax liabilities (e.g. Canada, Italy, etc.)?
- If you choose to have your U.S. master D&O insurer arrange the locally admitted policies through its network, do you know what is considered a "good local standard" of coverage in each jurisdiction?
- If your U.S. Master Program has limits (excess layers) above the world wide primary policy, do you know if they'll recognize the limit erosion that occurs when the locally admitted policies pay claims?

Wrap Up

Hopefully you found this self-assessment valuable. If your firm is like most, this exercise helped you realize that corporate insurance is much more complex than you previously envisioned.

Without the involvement of an experienced, independent insurance advisor (NOT someone who sells insurance), it's easy to see how the intricacies of insurance can lead to an undesirable outcome. Your choice of from whom you obtain guidance and to whom you entrust the organization's insurance and risk management strategy is therefore of paramount importance.

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Sometimes, it's an acute situation or an uncovered loss that provides the impetus to seek specialized outside insurance advice. Other times, it's the Board of Directors or a new senior manager that suggests a review of the insurance and your risk management program.

Whatever the reason, as the saying goes, an ounce of prevention is worth a pound of cure. And with the right unconflicted advice from the outset, at claim time, your insurance program won't be what's in need of cure.

This article discusses certain insurance, legal, tax and related developments and should not be relied upon as insurance, tax or legal advice. Readers are cautioned against making any decisions based on this material alone. If you require insurance advice, we would be pleased to discuss the issues in this article with you, in the context of your particular situation.

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