Cooley

Delaware Expands Use of Directors and Officers Captive Insurance

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On February 7, 2022, Delaware Gov. John Carney signed into law a bill that **amends the Delaware General Corporation Law (DGCL) to expressly allow the use of captive insurance companies to fund a Delaware corporation's directors and officers insurance coverage**. The insurance business is historically cyclical in nature, and we're currently experiencing a particularly "hard" D&O insurance market, in which companies seeking D&O coverage face capacity and pricing challenges. This hardening of the market is especially pronounced for companies engaged in new and innovative sectors such as technology, crypto and the sharing economy.

Although many companies, in response to a hard market, turn to the use of captives to self-insure their own risks, certain ambiguities in the law have historically discouraged the use of captives in the D&O space, particularly for "Side A" coverage for "non-indemnifiable" loss.

This law intends to mitigate these legal impediments and opens the door for the increased use of captives to fund companies' D&O coverage.

A primary – though not the only – legal impediment to self-funding D&O coverage through a captive concerned whether Delaware corporations could or should use captives to fund "Side A" D&O coverage, which insures against the wrongful acts of directors and officers when a company is not permitted, as a matter of a law or pursuant to a company's governing documents, to indemnify these individuals.

Background

Section 145(a) of the DGCL allows a Delaware corporation to indemnify a director or officer "if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful." Separately, Section 145(g) of the DGCL permits Delaware corporations to purchase insurance protecting directors, officers and other indemnified persons "against any liability asserted against such person … whether or not the corporation would have the power to indemnify such person against such liability." Accordingly, to hedge its risk with respect to any non-indemnifiable acts (e.g., acts not taken "in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation"), a corporation could purchase insurance coverage. However, until this new legislation, there has been uncertainty whether or not risk captured by a captive should be treated, for purposes of the DGCL, as insurance or as indemnification. If captive insurance is treated as the latter, then it would be suspect to provide "Side A" coverage through this mechanism.

This law amends Section 145 of the DGCL to expressly permit Delaware corporations to utilize captives to provide coverage for D&O liability, as long as the program meets certain statutory safe harbors – including, most notably, requiring the exclusion of coverage associated with certain bad acts and the involvement of a third-party administrator in certain situations.

Looking forward

In light of this amendment to the DGCL, we anticipate more Delaware corporations will consider using captives to fund coverage of D&O risk. With a number of jurisdictions to choose from, companies will need to evaluate which jurisdiction is appropriate for their particular risk profile. Captive insurance can be offered through a wholly owned captive insurance subsidiary of the insured company or through a segregated cell captive where the insured will "rent" a separate cell of a standalone captive to self-insure their risk.

Although there are regulatory requirements and costs associated with forming and maintaining these types of entities, captives can generally be a great risk management tool for well-capitalized companies that have the capacity to think strategically over the long term about their risk profile and risk management. For example, captives may provide companies with greater flexibility in how they structure their insurance program and manage risk, allowing them to obtain broader coverage for more bespoke risks, and often at lower premiums, by being able to access the reinsurance markets.

Furthermore, if losses are less than anticipated, then captives – subject to applicable laws – may dividend excess premium back to the sponsor companies. Companies have long used captives to self-insure a wide variety of risk with low-value, high-frequency claims. However, with the hardening of the D&O market, companies have started to consider how to effectively and efficiently use captives to protect against their potential D&O liability. We expect the new law to accelerate this trend in the market.