

CLIENT ADVISORY

Excess Follow Form D&O Coverage: Does It Really Follow Form?

Excess Follow Form D&O insurance sounds straightforward. Based on the name, it's simply a policy that provides an additional layer of coverage and merely follows the terms and conditions for the underlying policy(ies). Unfortunately, this is not necessarily the case. If the proper attention to detail is not applied to the excess D&O policy language, you could have a large E&O claim against you waiting to happen. As you will read below, there is no standard wording and the potential for coverage gaps in a layered program is significant.

There are two main ways to create an Excess Follow Form layer of coverage.

THE EXCESS FOLLOW FORM POLICY First, you can simply use what's called an Excess Follow Form Policy, which essentially states that it mirrors the coverage terms of the policy below it, except for the limits and attachment point. To broaden or restrict coverage, the Excess Follow Form Policy may also declare that it's not following one or more specific provisions of the coverage below it.

THE STAND ALONE EXCESS FOLLOW FORM POLICY The second method involves what's called a Stand Alone Excess Follow Form Policy. In this case, the follow form coverage is created by using a self-contained policy with its own coverage grant, definitions, exclusions and other essential elements. It creates coverage by its own terms, and not merely by mimicking the coverage below. From the insured's viewpoint, this is not the preferred method of creating an Excess Follow Form layer because it requires an exhaustive (and sometimes exhausting) analysis of the excess policy to make sure that the coverage matches up as intended. And even where the analysis is exacting, the slightest variation in wording between the policies can have a dramatic impact.

It is advisable to request an "at least as broad as the underlying coverage" endorsement to the Excess Follow Form policy. If the insurer won't provide this endorsement, the language may be put into a letter of intent. Although helpful, a letter of intent still isn't the preferred method of establishing this language.

WHICH LAYER IS FOLLOWED? What does it really mean that the Excess Follow Form follows "the coverage below it"? To which layer does that refer? Determining which layer represents "the coverage below it" is a crucial element of Excess Follow Form insurance. Insureds can elect to have Excess Follow Form coverage directly mirror the primary policy, which is the norm. Or in a program with three or more layers, the insured may want the form to mirror another layer that's above the primary. For example, let's assume that there's a five-layer D&O program, with each layer consisting of a \$10 million limit of liability. If the primary insurer declines to provide A-Side (non-indemnifiable) coverage, but all of the other layers do, then the insured would want layers 3, 4 and 5 to follow the first excess (or layer 2) with respect to the A-Side coverage. Otherwise, if they all followed just the primary policy, there only would be A-Side coverage for the single layer of \$10 million in excess of the primary \$10 million. In this instance, if an A-Side claim came in, the insured will not be sufficiently covered.

WILL THE POLICY RESPOND? There are a number of factors that may cause an Excess Follow Form Policy to not respond to an underlying loss. This is why it's important to carefully negotiate, and then review, your Excess Follow Form coverage during the placement process. Many insureds and brokers have been burned by placing their sole focus on the primary terms and conditions at the expense of the excess terms. Great danger lies in the assumption that the excess will automatically provide the proper Follow Form coverage. One reason a Follow Form Excess Policy may not respond to a loss is that one or more of the policies below it are improperly identified.

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Such a simple mistake can be costly. Sometimes a list of underlying policies to be followed may include two or more policies with conflicting provisions, which can cause confusion and lead to delayed payment – or no payment at all. For example, if the policy at Layer 4 says it follows both Layer 3 and Layer 2 and those policies differ on how (or whether) they provide a particular coverage, which underlying policy would control how Layer 4 responds? A mistake like this can cause distracting coverage litigation at a time when all efforts should be focused on defending the claim.

Another type of Excess Follow Form Policy is called a Difference in Conditions or DIC policy. Usually, a DIC policy *expands upon* the coverage grant in the layer(s) below by virtue of having fewer exclusions, but this is not always the case. For example, the layer beneath the DIC policy may cover civil fines and penalties (where insurable) but the excess DIC policy may specifically say that civil fines and penalties are *excluded*. Again, a careful and thorough negotiation of coverage is necessary to guard against simple mistakes. This is just another example of how an excess policy may not respond as intended.

WHICH LAYERS HAVE RESTRICTIVE EXCLUSIONS? Some Excess Follow Form policies will state that they follow any “additional terms” or the “most restrictive terms” of underlying layers. This is problematic for the insured when one of the underlying excess layers includes an exclusion not found in the primary policy and/or other underlying excess policies. Using our previous example of a five-layer, \$50 million D&O tower, if Layer 4 has an exclusion and Layer 5 has a “most restrictive terms” provision, the insured would only have \$30 million of coverage for a loss falling within that exclusion.

WHEN WILL THE EXCESS INSURER PAY? Excess Follow Form policies also usually contain a provision stating that the insured must maintain the underlying limits during the policy period, and that the Excess Follow Form insurer will not pay a claim until all of the underlying insurers have exhausted their limits. This can cause a problem in some circumstances, such as when an underlying insurer becomes insolvent and is unable to pay or if there is a coverage dispute over covered and uncovered matters.

Does it make a difference whether an underlying layer of liability is paid by the originally-obligated insurer or by the insured itself? Some excess insurers will say that it does and won't allow the insured to pay the insolvent insurer's limit of liability to satisfy the provision requiring the originally-obligated (now insolvent) insurer to pay its limit. Experienced brokers will negotiate a provision called a “shaving of limits” endorsement that requires the Follow Form Excess insurer to respond whenever a covered loss payment reaches its layer regardless of who pays the underlying amounts. Another problem arises when the primary insurer pays its limits fully, but the insurer on the first excess layer refuses to pay because it believes that the primary insurer misinterpreted the policy and paid its limit without justification, despite the fact that the excess policy is supposed to follow the primary exactly. So the question on the next layer(s) of Excess Follow Form would be which form do they follow, the primary insurer's payment or the first excess insurer's declination? The specific wording in this instance is crucial to determining whether the next layers kick in.

CONCLUSION When negotiating and placing Excess Follow Form coverage, wording is crucial. Consider the examples in this article as demonstrations of how a coverage situation can become extremely complex when dealing with multiple layers in a tower of insurance. Make sure you know which layers to follow and what specific wording to use, or find a coverage expert who can offer proper guidance.

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