Directors & Boards
www.directorsandboards.com
SPRING 2007

Boardroom Briefing

A publication of Directors & Boards magazine and GRID Media LLC

D&O Insurance

With the support of

AlixPartners

Pitney Bowes

HEIDRICK & STRUGGLES

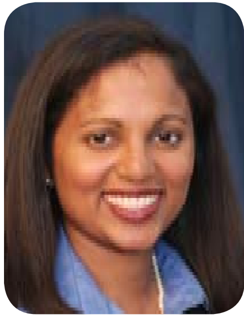
HARVARD | BUSINESS | SCHOOL
Executive Education

Exclusive New Research on D&O Insurance

Six Ways to Protect Independent Directors

By Priya Cherian Huskins

Alternatives to buying ever-larger D&O policies


Priya Cherian Huskins

The second anniversary of the historic out-of-pocket payments by the independent directors of WorldCom and Enron is a good time to re-examine conventional wisdom. Many believe that independent directors of public companies put their personal assets at great risk when they agree to serve. Moreover, independent directors have been told that the best way to protect their personal assets is to have their companies purchase ever-larger amounts of director and officer liability insurance. That advice seems unassailable, but more than one independent director has winced at the cost. Are there alternatives to buying ever-larger D&O insurance policies? Here are six ideas:

1. Don't believe the hype. The rate of securities class action law suits—historically the largest exposure for directors of public companies—has decreased dramatically. In 2005, there were about 162 securities class action suits. In 2006, there were only 106, a 35% decline.

Most suits brought against independent directors have either failed on the merits or have settled for less than the limit on the applicable D&O insurance policy. In contrast to conventional wisdom, this suggests that it is actually difficult to win suits against independent directors and the limits on D&O insurance policies are already adequate.

> *It is actually difficult to win suits against independent directors and the limits on D&O insurance policies are already adequate.*

2. Embrace the Law. "Personal, unlimited liability" is the ominous phrase that correctly describes the exposure that independent directors face. And yet independent directors do not typically pay out of pocket when they are sued. One reason for this outcome is a legal framework that is ultimately protective of independent directors.

Directors who avoid any action that would compromise their independence and who are diligent on the most basic level—they read what they are asked to read, ask pointed questions, and refrain from ignoring warning signs—do what the law requires. Consequently, they are generally protected by the same legal system that would penalize them if they indulged in conflicts of loyalty or failed in their duty of care.

3. Install fire sprinklers. A company cannot have complete control over whether and when it will be sued, but independent directors can take steps to reduce their risk and enhance the possibility that a suit will be dismissed. Corporate governance, when properly executed, is the equivalent of fire sprinklers in a factory. If the unexpected event occurs, the advance planning of corporate governance prevents events from overwhelming the company. Consider, for example, the options backdating scandal. Companies with strong internal controls are not the companies being scrutinized for improper granting practices.

4. Look first to the company. Independent directors can protect themselves by entering into pro-director indemnification agreements. These agreements obligate the company to pay for legal expenses and damages on behalf of independent directors. Indeed, most director indemnification agreements provide coverage that is far broader than that granted by D&O policies. Independent directors should work with outside counsel and a knowledgeable insurance broker to ensure that they are maximizing the protection provided by the company.

5. Straighten up and buy right. "What limits should we buy?" is the most frequently posed question about D&O insurance. Typically, companies look to how much others are buying. It's called "peer data benchmarking," and as a methodology surely has a place. But rarely do directors look at

> *Rarely do directors look at D&O benchmarking data and then declare that they would like to be in the bottom quartile.*

benchmarking and then declare that they would like to be in the bottom quartile. The result is an escalation of insurance limits over time.

Another, more systematic way to calibrate limits is to take advantage of three empirically verified observations: (1) securities class action law suits are generally the largest claims made against independent directors; (2) these suits almost always settle instead of going to trial; and (3) the ratio of the settlement to the loss claimed depends largely on a company's market capitalization. An informed insurance broker can use this information to recommend limits that more closely track a company's risk profile.

Then there is the matter of policy language. The D&O policy is a highly-negotiable contract. Companies looking only for the lowest price possible are asking for trouble. Consider having outside counsel review the policy or having another broker review what your regular broker is doing from time to time.

The policies are extremely technical, and anyone without technical expertise will find it almost impossible to tell if a policy has been well written. Companies that would otherwise routinely hire outside experts for other large dollar transactions are well-advised to do the same for their insurance policies.

6. Personally protect. Some independent directors have long wanted to purchase a personal D&O insurance policy for themselves. This type of policy, known as a "wealth security policy," is not yet available in the market on a cost-effective basis. However, we are likely to soon see the emergence of such policies.

Wealth security policies are designed to pay on behalf of an independent director when both a director's company and the company's regular D&O insurance fail to do so. Though not necessary for everyone, having a wealth security policy will surely become another often-used tool for independent director protection.

By implementing these six measures, independent directors will protect themselves from the personal, unlimited liability that can result from being on the board of a public company. The combination of these measures represents a more intelligent and cost-effective way to protect directors than the conventional wisdom of simply buying more insurance and paying ever-larger premiums.

Priya Cherian Huskin is a partner at Woodruff-Sawyer & Co., a full-service commercial insurance brokerage headquartered in San Francisco. She specializes in D&O liability insurance and can be reached at phuskins@woodruff-sawyer.com or 415.402.6527.