The rest of the story: directors and officers coverage for independents

Brokers can help clients greatly mitigate the personal, unlimited liability that comes with being an independent director

By Priya Huskins

The historic out-of-pocket payments made in recent years by independent directors of publicly traded firms are enough to instill fear in board members everywhere, not to mention their insurance brokers. But is the fear well-founded? Is more liability insurance for directors and officers the only solution? Or even the best one? What can brokers do to better serve their clients and help them protect their corporate and personal assets?

For starters, consider the facts. Although the historic Enron and WorldCom settlements in 2005 grabbed headlines, in the end the incidents are just anecdotal. A broader look at data suggests that the rate of securities class-action lawsuits — the type of lawsuits that pose the largest exposure for directors of public companies — has actually dropped.

According to the Woodruff-Sawyer & Co. Securities Class Action Litigation Database, the number of securities fraud class actions filed in 2006 was the lowest ever recorded in a calendar year since the adoption of the Private Securities Litigation Reform Act of 1995. The number of such actions in 2006 — 107, to be exact — was 34 percent lower than the previous year, and 41 percent below the 10-year historical average of 181.

Even more comforting to independent directors should be the search conducted jointly by University of Texas law professor Bernard Black, Cambridge University law professor Brian Cheffins, and Stanford law professor Michael Klausner. This research shows independent directors paid out of pocket only 13 times between 1980 and 2005.

Recognize context

Experience shows that most suits brought against independent directors have either failed or have settled for less than the limit on the applicable D&O insurance policy. Where insurance limits are inadequate, independent directors are usually indemnified by the companies on whose boards they serve. Thus, the main problems faced by independent directors are the time, aggravation and reputational harm such lawsuits carry with them, and not direct financial loss.

Does this research mean independent directors do not need to worry about exposing their personal assets to the risk of class-action suits? Of course not. But what it does mean is that it is helpful for them to recognize the risk in context. This will allow them to focus appropriate attention on non-insurance risk management solutions, as well as insurance-related protection. Sophisticated insurance brokers can advise them along these lines, and recommend smart steps along the way.

Protection beyond insurance

Perhaps the best advice brokers can give independent directors is to take their independence seriously. Outside directors who work diligently to protect their independence and who are attentive to the details — they read what they are asked to read, they ask pointed questions, and they refrain from ignoring warning signs — fulfill the duties the law places on independent directors. By and large, this diligence offers them protections within the same legal system that would penalize them if they indulged in conflicts of loyalty or failed in their duty of care.

Although a company cannot have complete control over whether and when it will be sued, independent directors can take steps to reduce the risks and enhance the likelihood that a suit will be dismissed. Corporate governance, properly executed, is the advance planning that prevents events from overwhelming the company.

For instance, consider the current options-backdating scandal. Those companies with strong internal controls are not the ones being scrutinized for improper granting practices.

Another way that independent directors can protect themselves is by entering into pro-director indemnification agreements that obligate the company to pay for legal expenses, settlements and sometimes even judgments on their behalf. These agreements generally provide for far broader coverage than that granted by D&O policies. Independent directors should tap outside counsel and a knowledgeable broker to make sure they maximize company-provided protection.

Insurance protection

Of course, insurance is crucial. So is policy language. The D&O policy is a highly-

negotiable contract, so not all policies are created equal. Given the technical intricacies of policies, only a specialist who constantly works with D&O policies has the expertise required to make sure a policy is well written. It is advisable to seek review by a knowledgeable counsel or have another set of eyes — perhaps a risk management consultant or an independent insurance broker who specializes in D&O insurance — analyze the coverage. Companies seek outside advice for other large dollar transactions. Insurance should be no different.

A key consideration in any coverage discussion is policy limits. An interesting dynamic comes into play in the D&O market. Typically, companies look at how much others are buying. It is called "peer data benchmarking." But consider this: rarely do directors look at benchmarking and then say they would like to be in the bottom quartile. This leads to an escalation of insurance limits over time as everyone seeks to be at or above average.

A more systematic way to arrive at a figure for policy limits is to weigh three empirically verified observations.

First, securities class-action lawsuits are generally the largest claims made against independent directors. Second, these suits almost never go to trial. And third, the ratio of the settlement to the loss claimed depends largely on a company's market capitalization. An informed insurance broker should use this information as the basis to recommend limits that more closely track a company's risk profile than the peer data benchmarking method would.

There may also be an insurance solution other than a company's corporate D&O insurance policy. For some time, some independent directors have wanted to purchase a personal D&O insurance policy. Such a policy would pay on behalf of an independent director when both the director's company and the company's regular D&O insurance failed to do so. Often referred to as a "wealth security policy" this type of policy has not been available economically. Given the demand that exists for economical wealth security policies, however, the future is likely to bring broader availability and better pricing of such policies. Though not necessary for everyone, having a wealth security policy surely will become another often used tool for independent director protection.

Conclusion

By helping independent directors understand and manage risks, and by putting in place appropriate corporate and individual protection, brokers can help clients greatly mitigate the personal, unlimited liability that comes with being an independent director of a public company.

Conventional wisdom says clients should simply buy more insurance and pay ever-increasing premiums. Instead, by implementing these recommendations, brokers can help independent directors and their companies uncover cost-effective and sensible alternatives.

Although the historic Enron and WorldCom settlements in 2005 grabbed headlines, in the end the incidents are just anecdotal. A broader look at data suggests that the rate of securities class-action lawsuits — the type of lawsuits that pose the largest exposure for directors of public companies — has actually dropped.

Priya Cherian Huskins is an attorney and partner at San Francisco-based Woodruff-Sawyer & Co., a full-service commercial insurance brokerage and member of Assurex Global, the international broker network. She specializes in D&O liability insurance and can be reached at phuskins@woodruff-sawyer.com or 415-402-6527.