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The Wealth Security Policy: Personal Protection for Independent Directors

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Can an independent director purchase insurance coverage that goes beyond the insurance his or her corporation purchases through a traditional D&O insurance program?

Yes. “Wealth Security Policies” are designed to protect the personal assets of an independent director when the director’s company and the company’s own insurance cannot.

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³ See Black, Cheffins & Klausner, “Outside Director Liability,” 58 Stan. L. Rev. 1055 (2006).

⁴ Special thanks to Boris Feldman, Esq. a partner specializing in securities class action litigation at Wilson Sonsini Goodrich & Rosati

The Problem

What would happen if a company’s director and officer insurance proves to be inadequate or is otherwise unavailable to settle a claim alleging wrongful acts by independent directors? Or what would happen if the company lacked the resources to meet its obligations to indemnify its independent directors from such a claim? In such instances, how might an independent director nevertheless protect his or her personal assets?

When independent directors are sued they usually rely on their company to indemnify them for both their legal fees and any settlement. Take for example a securities class action suit, the largest potential exposure a public company independent director faces as measured by historical settlement amounts. When independent directors are named as defendants in securities class action suits, their personal assets are potentially at risk. Ordinarily though, in these types of cases and the company — or more accurately the company’s insurer — pays the bill for the costs of defense and the settlement. It is thus still relatively rare for directors to be out-of-pocket as the result of a securities class action.³

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Notwithstanding the typical case, an individual independent director might find himself or herself having to make a personal, out-of-pocket payment to pay defense costs, or even to settle a claim, if his or her company were insolvent and the company's D&O insurance were either inadequate or unavailable. It is easy to understand how coverage would be unavailable if the claim exceeded the resources of the company and the limits of the insurance policy. A more subtle point is that the D&O insurance itself could be unavailable if, for example, a bankruptcy court were to seize the policy as an asset of the company, or the policy were rescinded by the company's insurance carrier because the carrier felt that it had been misled at the time of the formation of the insurance contract.

Without company D&O insurance coverage, the independent director might have to go into his or her own pocket to pay the cost of his or her defense and any settlement. Moreover, given the cost of a good legal defense, an independent director might have to settle the case prematurely to avoid personal bankruptcy.

Because of this serious risk to the security of the personal wealth a given independent director may have amassed over years of work, independent directors often ask about the availability of a personal D&O insurance policy that they could purchase for themselves. The value of having a personal D&O policy would be its ability to respond in situations where the company's D&O insurance is unavailable.

Although there have been carriers in the past who were willing to consider issuing personal D&O insurance policies, the cost of these policies has been so prohibitive, and the underwriting process so arduous, that these old-style personal policies have not been seen as a viable solution.

Would a Wealth Security Policy Solve the WorldCom/Enron Problem?

Beyond the concern that a company's D&O insurance might be inadequate or unavailable, another circumstance that has worried directors is the "WorldCom/Enron Problem."

In January 2005, several of the defendant independent directors in the WorldCom and Enron securities class action suits agreed to pay large settlements out of their own pockets as a condition of the settlement. The settlement agreements specifically included promises that the defendants would not look to their companies' D&O insurance policies for reimbursement, even though insurance was seemingly available. Although the rationale for requiring the directors to make personal payments has never been fully disclosed, these settlements were widely seen as a punitive.

After the historic settlements in WorldCom and Enron, directors and others began asking whether they themselves could personally purchase a cost-effective D&O insurance policy that could be used to defend themselves if a corporate D&O policy could not. Such a personal D&O policy — also known as a "Wealth Security" Policy — would clearly be useful whenever a company becomes insolvent and its insurance program is exhausted or otherwise unavailable. With respect to the WorldCom/Enron Problem, many have concluded that the proceeds of a wealth security policy could be used to pay such a settlement.

This conclusion, however, has never been tested. On the one hand, since a wealth security policy would truly be a personal asset of a defendant director, payment by the insurer would certainly constitute the use of personal assets to settle a claim. This is particularly the case if an individual director paid for the wealth security policy out of his or her own pocket. On the other hand, if the motivation for a WorldCom/Enron-style settlement were overwhelmingly punitive, it is unclear whether a plaintiff would settle for payments made by any insurer. The actual outcome in the next "WorldCom-Enron"-style case will, of course, inevitably depend on the facts and circumstances of the individual case and perhaps the reasonableness of a plaintiff.

The Solution – A Wealth Security Policy

Woodruff-Sawyer & Co. took this independent director need for a personal D&O policy seriously and has been working with insurance carriers and securities class action litigators to craft a solution.⁴

In our view, a personal independent director liability policy cannot be a truly viable “wealth security policy” unless the insurance policy can answer “yes” to all of the following questions:

- Is the policy cost-effective given the level of risk?
- Is the underwriting process simple, straightforward and fast?
- Does the policy have minimal exclusions?
- Is the policy backed by an insurance carrier of unquestionable financial strength?
- Is the policy an asset of the individual director that has been purchased by the individual director?

Woodruff-Sawyer is proud to introduce to the insurance marketplace a type of wealth security policy designed to answer “yes” to each of the critical questions posed above. There are many steps — insurance and otherwise — that you can take to protect your personal assets when you are an independent director of a company.

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