

Independent Directorship: Is It Worth The Risk?



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Never has the need within corporate America been as great as it is now for the sage guidance, objective perspective, and ethical leadership of independent directors. Unfortunately, the “need” comes at a time when the risk of acting in that role has never been greater. While we do not intend to dwell in depth on each factor that has contributed to this high-risk period for directors, it is important to understand the major factors, and the magnitude of the risk which they have created. Consider the following facts of life in present-day corporate America:

- Bankruptcies are at a 50-year high.
- Litigation against boards and the individuals serving on them continues its upward trend.
- Derivative actions against BOD members are at an all time high.
- The most important SEC regulation (the Sarbanes-Oxley Act) since 1934 has established new, elevated benchmarks for acceptable corporate practices and behavior.
- Our socio-political climate has gone from lionizing to scapegoating corporate titans and entrepreneurs alike.

Add to this an insurance marketplace in which insurers are significantly reducing the standard of coverage to which individual directors (and the companies on whose boards they serve) have become accustomed, and you arrive at our topic “*Independent Directorship – Is it Worth The Risk?*” Fortunately, with proper due diligence, such as that discussed in the body of this work, we believe that the answer is “yes” – the rewards of serving as an independent director can continue to outweigh the risks.

Many executives sitting on boards of companies as independent directors often overlook their participation as a source of potential personal financial exposure. Too often, executives assume that their personal liability for serving on any board is insured via their personal insurance (e.g. Homeowners; Umbrella). While their personal insurance **may** provide some coverage for their roles as directors of non-profit organizations, there is **NO COVERAGE** afforded for their roles as directors of for-profit corporations.

According to a recent Korn/Ferry International/Corporate Board Member Magazine study, 48% of the participating respondents indicated that they had turned down a board position because they felt the risk of being sued was too great. And 49% of the respondents said that D&O insurance was a very important factor in their decision to join a particular board. It is clear that the perception of risk is evident, but the reality of the exposure vs. proper coverage continues to be ambiguous.

Nearly half of the 908 board members surveyed were concerned about D&O coverage. In light of the significant changes to the corporate Directors’ & Officers’ Liability Insurance product, these board members have every right to be concerned. As a potential independent director, your best-practice approach should include due diligence for any board on which you plan to participate.

William Gallagher Associates (WGA) is a leading independent commercial broker, specializing in providing risk management, employee and executive benefits services to companies with difficult and complex risks. These include a focus on Life Sciences, Technology, Energy, Healthcare, Financial Risks, Environmental and other industry groups. WGA has offices throughout North America and Europe, including Boston, MA; Princeton, NJ; Columbia, MD; Atlanta, GA; and Paris, France.

While we recommend that directors consult with their attorneys to ensure that their due diligence approach provides them with the maximum protection available, there are a few basic steps that can readily be incorporated: 1) review the corporate by-laws to ascertain the degree to which you will be indemnified; 2) consider an individual indemnification contract between you and the company; 3) meet with the CEO, CFO and key members of the BOD and senior management - establish a level of comfort since the actions of any one of them can become your responsibility; 4) review the financials (including Risk Factors) and request the opportunity to speak with the firm's auditors and counsel; 5) review the company's corporate governance policies and practices which should include compliance with Sarbanes-Oxley; 6) review a schedule outlining the firm's entire insurance program to ascertain both adequacy and company's attitude toward risk; and 7) review the D&O program in place with a focus on – stability of insurers, adequacy of limits, scope of terms and conditions (e.g. is there coverage for “innocent” directors?), and any past claims. Finally, considering a new BOD opportunity is also a natural time to re-assess the adequacy of your personal risk management. Are your personal assets as legally protected as possible from a piercing of the corporate veil? Is your personal insurance affording you the utmost protection? In conjunction with the latter question, you need to have a working knowledge of Directors' & Officers' Liability insurance—what it does, and what it does not, cover.

Traditional corporate D&O insurance policies provide coverage under three insuring agreements. While each of these agreements is subject to the specific terms and conditions of each policy; the coverage granted is typically as follows:

- **“Side A” is for the benefit of individual directors/ officers.** Its purpose is to insure individuals when the company cannot indemnify them. Derivative actions and bankruptcy are two good examples of when this can happen.
- **“Side B” is typically known as “Company Reimbursement”.** This agreement is a risk transfer vehicle for the company to meet its obligations to indemnify its directors/officers, i.e. it's the insurance that pays defense costs and settlements for individual directors/officers when the actions against them are indemnifiable by the company.
- **“Side C” is typically known as “Entity Coverage”** and provides coverage for claims made against the company itself.

In the event that there is no coverage available under the corporate D&O policy or the limits are simply insufficient, then the directors and officers can become personally liable for damages. Unfortunately, insurers have just recently made significant changes to the terms and conditions of their corporate D&O policies which greatly restrict the insurance available for innocent directors when the company's officers commit fraud or other “*wrongful*” acts. In response to this greatly increased risk of personal exposure for independent directors, the insurance industry has developed a new coverage. Its intent is to provide directors, either individually or collectively, with a last line of defense in the event that the corporate D&O insurance is not “*there*”, either on a total or partial basis, when needed. This new coverage is currently being offered by several of the D&O industry leaders in two very different structures.

The first type of structure is a “*corporate*” driven product, whereby a corporation will purchase additional coverage over (and “*beside*”) the existing traditional D&O program providing insurance solely for the benefit of the corporation's independent directors. AIG, a leader in providing management liability products, is the first to introduce this structure. At the present time, limits up to \$25MM should be available subject to underwriting and aggregation exposure restrictions.

The other structure is a “*portable*” approach, and is tailored to provide coverage for an individual sitting on one or more boards. Chubb, also an industry leader in the area of executive risk, has embraced the “*portable*” concept. This product

differs from AIG's approach in that the targeted holder of this policy is the individual director as opposed to the corporate entity. In other words, this differs from the AIG product since the limits are not shared with other directors.

One similarity is that both products will act as primary coverage in the event that the underlying coverage is rescinded or a U.S. Bankruptcy Court has ruled that the underlying policies are assets of a bankruptcy estate and, therefore, unavailable to pay any covered loss.

In the final analysis, America has responded to the crisis of confidence in our public markets by instituting the most meaningful new SEC legislation since 1934. While D&O insurers have been hit hard by the pre-Sarbanes-Oxley corporate scandals and bull-to-bear market, they too are instituting change to ensure that there will be both a viable market for corporate Directors' & Officers' Liability insurance and insurance for independent directors so that they can continue to serve in their role as guardians of corporate America. Independent Directorship – Is It Worth The Risk? Definitely, but directors need to stay abreast of the changing landscape so that the rewards can continue to outweigh the risks.

To learn more about your options for Independent Directorship Liability Coverage, talk with your WGA Account Executive, or email us at info@WGAins.com.

The white paper was prepared by WGA's Management Liability Practice and Private Client Group.

| | AIG's IDL | Chubb's PDL |
|---|--|--|
| Designed to insure... | The independent directors of one BOD. | An independent director serving on one or more BODs. |
| Roles above can be insured at: <ul style="list-style-type: none"> • Corporations <ul style="list-style-type: none"> ○ For-profit ○ Not-for-profit • Partnerships | Yes No No | Yes Yes Maybe |
| Coverage can be triggered by these events: <ul style="list-style-type: none"> • Company's D&O limits are exhausted and IDL/PDL drops down to provide Side A for Independent Directors • Rescission of a company's D&O program • Company's D&O program deemed an asset by bankruptcy court • Litigation against an individual which a company cannot indemnify • Breach of non-severable warranty • Claim excluded due to restatement exclusion • Financial impairment of the underlying issuer | Yes Yes Yes Yes Yes Yes No | Yes Yes Yes Yes Yes Yes Yes |
| Policy can be positioned as follows with respect to existing D&O programs: <ul style="list-style-type: none"> • Beside an existing program on a Difference in Conditions (DIC) basis • On a SIDE A excess over D&O program basis | Yes Yes | Yes Yes |
| Limits Available | \$25MM maximum \$10MM Average | Up to \$10M |

| | AIG's IDL | Chubb's PDL |
|---|--|--|
| Retentions | None | None |
| Coverage provided for: <ul style="list-style-type: none"> • Defense Costs for litigation • Settlements • Judgments • SEC Investigations | Yes Yes Yes Sublimited on a case by case basis | Yes Yes Yes No |
| Can policy be rescinded? | No | Yes, if written for one individual who makes a material misrepresentation on the PDL application. |
| What information is needed in order to obtain a proposal for coverage? | Contact WGA. In addition to an application, further information about the company and individual directors will be required. | Contact WGA. In addition to an application, further information about the company and the individual will be required. |
| How do I get started? | Contact WGA. | Contact WGA. |

