



Protecting Directors— A Change Is Needed

By Bill Pollock

It's harder to attract qualified candidates to serve on a public company board today than it was just two years ago. This has been true for the past several years. While there are a variety of reasons for this trend, most would agree that in order to attract qualified people to serve as directors on corporate boards, they must be protected from personal liability.

Fear of personal liability, founded or not, has increased as the result of the well-publicized corporate meltdowns at Enron and WorldCom, where class action settlements were predicated on cash payments from directors' personal bank accounts. Another bomb was dropped in the director protection arena recently when outside directors in the Just for Feet, Inc., case had to personally pay over \$40 million in the settlement of that case. Some might argue that these were aberrations, but few would argue with the proposition that directors currently serving are subject to new laws, rules, and regulations and are under much greater scrutiny than ever before.

Directors need protection, and that protection is composed of three important elements: being informed and educated about their fiduciary duties and the business judgment rule; indemnification; and directors & officers (D&O) liability insurance. This article will look at the last of these elements.

Director Summary: Protection from personal liability comes in the form of informed judgment, indemnification, and D&O insurance. The author examines the last of these issues, noting the conflicting interests of the company and management arranging D&O coverage, and of the directors who are under its protection. He advocates for a separation of policies covering directors and policies protecting the company, and he encourages directors to become more informed about and involved in the insurance negotiation process.

From a director's point of view, most indemnification language could be improved. Regardless, the most important point that can be made about indemnification is that there are a number of situations in which it does not protect the director. While being fully informed about important issues inside the company is probably a director's best protection, even the most diligent director may not find out everything he or she needs to know—there have been several recent cases where very capable directors and boards were misled by management. That leaves the director's D&O insurance coverage as a critical part of the protection plan.

D&O Insurance

From a director's perspective, just having a D&O policy is not enough. Understanding the terms, coverage limits, exclusions, indemnification provisions, and who else could become a claimant under the policy, is key to ensuring directors will be protected should something go wrong. Directors should seek the broadest coverage available that closes all coverage gaps and has sufficient limits to adequately protect their personal assets. Some of the well-known coverage gaps that directors have had to endure are as follows:

- **Lack of full severability.** Misconduct of a company officer could cause denial of coverage for all.
- **Rescission.** Restatements of financials have led to claims of fraud in the application by insurers.
- **"Insured vs. insured" exclusion.** This is particularly important today in light of the growing wedge between management and directors.
- **Insolvency.** D&O insurance proceeds could be the property of the estate.
- **Exhaustion of policy.** Claims other than those against directors can exhaust policy limits.
- **Others.** Additionally, there may be lack of coverage for ERISA, failure to maintain insurance, pollution, libel/slander, and defamation.



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These are just a few examples. And, no doubt, other gaps will arise in the future. So, what should directors do? It would seem to be pretty straightforward to create a policy for directors which fits the definition of state-of-the-art—a policy with all gaps covered and no negotiations needed. Then, we could eliminate the concern over the gaps in coverage that we know about today, and over new ones that could arise in the future.

Anticipating this need, the major insurers introduced such a policy a few years ago—the Independent Director Liability Policy, or IDL. This is similar to “Side A-DIC” coverage in insurance jargon, but it has really failed to catch on. The policy serves as an umbrella—triggering when the company’s primary policy fails for some reason. An Independent Director Liability Policy is purchased by the directors themselves in addition to the company’s primary policy. However, it is not portable. If you serve on more than one board, you’d have to purchase coverage for each board you serve on—which can get expensive.

A Flawed System

The distribution system for D&O insurance is inherently flawed. Brokers are selling D&O insurance primarily to companies, which have to decide how much to spend on D&O insurance, how much to allocate to directors, and how much—if any—to allocate to protecting the company’s own balance sheet, though a few *Fortune* 500 companies are no longer buying balance sheet coverage. D&O insurance allocation is a management decision, and normally there is no input from directors or their representatives. Consequently, directors may never have the protection they need and deserve until the insurance industry addresses this flaw. Consider the following:

- Lawyers who are asked to review a company’s D&O coverage are careful to point out who they represent (most often it is the company) because of the potential for conflict of interest between the directors and the company with regard to the limits and some of the terms of coverage.
- Some gaps in coverage for directors can be negotiated away for a price. But who represents the directors in

this negotiation, if it takes place at all? What gaps still exist? Are the directors aware of the gaps?

- What is the appropriate amount of the coverage limits—for the company? For the directors? More limits cost more money, and often directors do not have a voice on the issue of how much is enough.

Herein lies the problem. The boards of directors in this country, composed of some of the most powerful, intelligent, wealthy, and successful people in the world, are delegating a critically important issue to people who do not report to them and who do not have reason to worry about protecting them. Does a new CEO leave the terms of his employment up to the treasurer or controller of the company? I don’t think so—he probably pays pretty close personal attention to it and has very qualified talent representing him.

Separate Interests, Separate Policies

The interests of the company and the directors are simply not aligned in the process of procuring D&O insurance. Is there a solution that will serve all interests? Yes. The D&O insurance policy should be separated—one policy should be purchased for the directors and one for the company. In that way, directors will be able to pay closer attention to the terms of their D&O insurance and secure the coverage they need.

Companies can decide if they want balance sheet protection, and if so how much, without that decision affecting the director’s coverage as to terms or as to limits. Similarly, the directors can procure their own coverage without the worry of how it might be affected by the actions of the insiders or how well the terms were negotiated in the first place by their broker and risk manager. Given the conflict in terms and limits of coverage facing the various officers inside the company involved in the procurement process, such inside parties should be greatly relieved to see this change made.

There is a way to successfully market D&O insurance directly to directors, and at the end of the day, those directors who have been worried about their protection can go back to worrying about making the important decisions that keep our corporations competitive. It will also enable companies to recruit the best talent for board positions. It will remove numerous conflicts of interest that exist in the current system of buying and selling D&O insurance and allow for the proper alignment of interests in the process. ■

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