

SPECIALIZED POLICIES FOR RETIRED DIRECTORS: WHY THEY ARE NEEDED AND WHAT THEY COVER

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Directors of public companies are exposed to claims long after their tenure on a board has ended. (In fact, the statute of limitations under the Sarbanes–Oxley Act of 2002 is 5 years.) If you doubt this, just ask former directors of Enron, WorldCom, and Just for Feet. Directors who sat on the boards at these companies share a dubious distinction—they were required to use their *personal assets* to settle lawsuits filed against them because the corporations they served were unable to provide indemnification. Most recently, five former directors of Just for Feet paid a total of \$41.5 million in conjunction with their service at the company, an amount that exceeded the combined Enron and WorldCom director-funded settlements. But even if a claim situation stops far short of these worst-case scenarios, retired directors still face considerable hurdles in obtaining optimal protection.

Recognizing that the D&O policies currently available in the marketplace do not adequately address the unique exposures of retired directors, ACE Westchester, through Retired Directors Assurance Underwriting Services (RDAUS), their program agent, recently introduced a specialized policy to cover these individuals. This article explores the need for retired directors coverage and analyzes the key provisions in the Retired Directors Assurance policy.

The Liability Exposure of Retired Directors: An Example

Persons who serve on a board of directors are exposed to liability claims long after their tenure has concluded. Consider a director who sat on a board for 10 years, from January 1, 1995 to January 1, 2005. On July 1, 2006, 1 years after retiring, the director is sued for alleged wrongful acts he committed during this 10-year period. The fact that the director is no longer a board member does not absolve him from liability. Now, in response to the claim, the retired director must provide a defense to these allegations and perhaps pay a settlement or judgment in conjunction with the lawsuit.

Gaps in Coverage for Retired Directors in Standard D&O Programs

In theory, coverage under a corporate (or nonprofit) entity's D&O program would be available to defend and indemnify the retired director in the above example. This is because the "insured" definitions under virtually all standard D&O policy forms state that "...coverage applies to *past*, present, and future directors for claims made against them *during the term of the policy*." (Emphasis added.)

Given the claims-made nature of D&O forms, coverage is triggered by the making of a claim against an insured. As long as a D&O policy is in force on the date the claim is made (July 1, 2006), coverage should be available to the retired director under the corporation's current D&O policy. There are, however, a number of reasons why this may not be the case.

A Policy Is No Longer in Force

The company may not have a policy in place on July 1, 2006. If the organization is in poor financial condition, it may not have had the funds to buy coverage or it may be forced to reduce limits. Or, even if the firm attempted to purchase a policy, the premium, given the

organization's difficulties, might have been unaffordable. Since, as already noted, coverage under a claims-made policy is triggered by the date on which *claim is made*—rather than the date on which the *wrongful act was committed*—the fact that coverage was in place during the time the alleged wrongful acts took place (i.e., from January 1, 1995 through January 1, 2005), does not trigger coverage for a claim made on July 1, 2006.

No Limits Remain

But perhaps a policy was in place at the time a claim is made against the retired director. Under such conditions, other directors and officers, as well as the organization, are also likely to have been named in the lawsuit (or in other lawsuits). Consequently, the policy's limits may already have been exhausted by indemnity payments and/or defense costs in conjunction with such claims.

Various Restrictions Preclude Coverage

A number of restrictions within the policy, most likely exclusions, may allow the insurer to deny coverage for a claim against the retired director. The fact that these restrictions or exclusions were not contained within the policy that covered the retired director at the time he/she left the organization is of no consequence in determining whether coverage is available. Rather, the policy in effect at the time a claim is made is what controls the trigger of coverage. The key point to recognize is this: policies renewed subsequent to a director's retirement may contain much more restrictive terms and conditions compared to the coverage that was in place during the director's tenure with the company.

A Bankruptcy Trustee Claims Ownership of Policy Proceeds

In recent years, bankruptcy trustees have frequently claimed primary ownership of D&O policy proceeds, asserting that their interests supersede those of the insured directors, officers, and the corporate organization. Although this contention is not yet a matter of settled law, bankruptcy trustees represent still another potential impediment to coverage for retired directors.

The Policy Has Been Rescinded

The policy may have been rescinded by the insurer, most often, based upon a material representation contained within the application for coverage. And for various reasons, the severability provision in the policy or in the application, may not preserve coverage for the retired director in this situation.

The Need for Separate, Retired Directors Coverage

Many of the coverage gaps noted above, stem from three major sources. These sources provide the rationale as to why directors require separate coverage after they leave a corporate board.

No Control over D&O Program

After a director has retired from a board, he or she has no control over the nature of the D&O coverage the organization buys. This is especially true if a company is taken over by a leveraged buy-out firm or even if one company is purchased by another. In these situations,

the new organization's management has no loyalty to retired directors. In fact, current management may have completely replaced the board that was sitting at the time the company was acquired. Since the retired director now has no voice regarding the details of coverage purchased by the organization, he or she requires a policy suited to his or her own needs and legal interests.

Conflicting Legal Interests

When a director retires from a board, he or she may have different, if not conflicting, legal interests, compared to current directors or to the organization's operating executives. The Enron case provides a good example of this concept. Here, the outside directors were merely negligent in fulfilling their duties. Conversely, a number of the company's operating officers were either convicted of or pleaded guilty to criminal wrongdoing. These types of situations, in which there are obvious conflicting legal interests, underscore the need for retired directors to have separate defense coverage.

Shared Policy Limits

Even when legal interests of the various insureds under a D&O policy are not in conflict, there remains the problem of shared policy limits, whereby multiple individual insureds, including the corporation itself (for securities claims), must "compete" for coverage limits under a D&O policy. As pointed out by nationally-recognized D&O attorney Dan A. Bailey in an article titled "D&O Liability: Now It's Personal," there have been a number of recent cases in which some, but not all, of the insureds under a D&O policy participated in claim settlements that consumed the remaining policy limits, effectively leaving the nonsettling directors/officers uninsured. "The notion that some insureds can consume all of the D&O proceeds to the detriment of other insureds is a shocking revelation to many directors and officers," he commented. Adding to this problem is the fact that in recent years, the trend is toward expanding the number of insured persons within D&O coverage forms. Since the Sarbanes-Oxley Act imposed substantial legal liabilities on corporate auditors and in-house legal staff, underwriters responded by adding these and other nondirectors/nonofficers as insureds under D&O policies; the effect of which is to heighten the competition for policy limits.

"Final Adjudication" Wording: Yet Another Minefield for Outside Directors

Conduct exclusions in directors and officers policies generally state that defense coverage applies until either (1) it has been established "in fact" that the insured committed the wrongful conduct precluded by the exclusion or (2) until the insured's responsibility for committing the wrongful conduct has been subject to a "final adjudication." This second wording makes it more likely that bad actors will exhaust policy limits required by their defense.

Traditionally, "final adjudication" wording is considered preferable for the insured. This is because under "in fact" wording, an insurer might, for example, appoint its own expert who concludes that the insured "in fact" committed the wrongful act noted within a conduct exclusion. In turn, the insurer could use this finding to bar additional defense coverage. On the other hand, under "final adjudication" language, which is much more common than "in fact" wording, directors and officers continue to receive defense coverage until such wrongful conduct has been established by a court of law. Recognize too that since 98

percent of claims are settled rather than tried to a verdict, the likelihood of ever reaching final adjudication in any single case is remote. So in reality, the supposedly insured-friendly "final adjudication" wording works to the detriment of both current and former outside directors.

But in recent years, the supposedly insured-friendly "final adjudication" wording has, in some cases, had the opposite effect, especially for retired directors. Former Enron CFO Andrew Fastow pleaded guilty in criminal proceedings associated with Enron's bankruptcy. Yet since the Enron D&O policy forms were written on a "final adjudication" basis, the insurer was obligated to continue defending Mr. Fastow against civil lawsuits because his conduct still had not been subject to "final adjudication." Although Mr. Fastow had already pleaded guilty to criminal charges, he had not yet been sentenced and until that time could still change his plea. But by continuing to defend Mr. Fastow, other far less culpable directors and officers—including retired directors—had their remaining policy limits depleted.

Retired Directors Policies versus Independent Directors and Side A-IDL Policies: There Is a Difference

A number of observers have questioned the need for separate retired directors coverage. This is because policies already exist to cover: (1) independent directors and (2) independent directors on a Side-A basis. Although these forms serve important purposes, they do not adequately address the coverage needs of retired directors.

Independent Directors Policies

These forms are written to cover individuals who are *currently* serving as independent directors on one or more corporate boards. The policies are usually purchased by the independent directors themselves, rather than by the corporations on whose boards they serve. One drawback of such forms is that they must be renewed each year, which can be a problem, especially if the company(ies) on which the independent director is serving encounters financial difficulties. In these instances, underwriters may be unwilling to provide coverage at an affordable premium.

Side-A Independent Directors Liability (IDL) Policies

These forms are purchased by corporations to cover outside directors in situations where the corporation is either financially unable or not legally required to indemnify these outside directors. Such policies apply to claims on a DIC (difference-in-conditions), or occasionally on an excess basis, over the corporation's standard D&O program. But like independent directors forms, Side-A IDL policies must also be renewed each year and are not specifically designed to cover directors once their service on the entity's board has ended.

Unique Aspects of the Retired Directors Assurance Policy

There are several features of the RDA approach to providing retired directors coverage that are not found in standard D&O programs. These features eliminate the gaps in policies written for independent directors and under Side-A IDL policies.

Coverage Applies on a 6-Year Basis

The policy is written for a 6-year term, payable in a single premium. This has the effect of locking-in the same scope of coverage for the entire 6-year policy period and avoids the problem noted earlier in this article, whereby subsequent renewals may not provide coverage on as broad a basis as the policies that were in force while the now-retired director was serving the organization.

The rationale for this 6-year period is that a 5-year statute of limitations applies to claims made under the Sarbanes-Oxley Act. The additional year of coverage provides an extra margin of safety. In contrast, and as noted above, independent directors policies and Side-A IDL forms have only 1-year terms and therefore must be renewed annually, which cannot be guaranteed.

Insured Selects His/Her Own Defense Counsel

The policy allows the insured to select his/her own defense counsel (subject to insurer approval). This is especially important because, as noted above, various insureds under a corporate policy often have very different, if not conflicting, legal interests. Although insurers under standard D&O programs usually do approve requests for separate counsel, this is not a right that is contractually guaranteed by the policy. In contrast, under the RDAUS form, the right of the insured to select personal counsel is clearly stated within the policy.

No Severability Issues

Since the retired director is the only insured under the policy, misrepresentations within the application, made by another insured, cannot occur. This is a significant benefit, because severability issues are often involved in the D&O claims handling process and frequently defeat coverage for an otherwise innocent director.

No Requirement To Maintain Underlying Insurance/No Self-Insured Retention or Deductible

In the event of a claim against an insured retired director, coverage under the RDAUS policy applies excess of the organization's existing D&O insurance. However, unlike standard excess D&O forms, there is no requirement that such underlying coverage be maintained. Therefore, if the organization does not renew its policy, if its limits are exhausted, or if exclusions or other restrictions preclude coverage for a claim, the RDAUS policy applies without the application of a self-insured retention or deductible.

Fewer Exclusions Compared to Standard Policies

Unlike virtually all standard D&O forms, the Retired Directors Assurance policy does not contain exclusions for claims involving: pollution, bodily injury/property damage, or allegations pertaining to ERISA Act violations. Nor does the policy contain an insured versus insured exclusion.

Nonrescindable and Noncancelable Policy

Many, but not all, independent directors and Side-A IDL forms are both nonrescindable and noncancelable, as is the RDAUS policy.

Attracting Directorial Talent

Another key benefit of retired directors policies—from an organization's standpoint—is that the coverage assists in recruiting directorial talent. Given widespread publicity about director-funded settlements, such as those noted at the beginning of this article, increasingly, prospective board members are asking questions about an organization's D&O program. As Dan Bailey noted in the article referred to earlier, "... the D&O insurance product is now elevated to a far more important role in corporate America. Unless the product is perceived as affording comprehensive and predictable personal asset protection for outside directors, fewer qualified directors will agree to serve and the quality of corporate governance will suffer."

Case in point: this year's annual Towers Perrin D&O survey reported that 66 percent of potential public and 71 percent of potential private company directors posed questions regarding the nature of the company's D&O insurance programs. Interestingly, concerns regarding D&O coverage were consistent across companies of all asset sizes. Specifically, 75 percent of small-cap (up to \$300 million in assets to \$2 billion), 70 percent of mid-cap (\$2 billion to \$10 billion), and 69 percent of potential large-cap (over \$10 billion) directors asked about the firms' coverage arrangements.

Based on this data, it is apparent that a solid D&O program—including one that extends protection after retirement—is critical for both public and nonprofit companies, as a means of attracting directorial talent and experience. Accordingly, it is reasonable to expect that the companies on whose boards they serve will pay the premiums for retired directors coverage as an inducement to attract top-drawer board members.

Concluding Thoughts

Retired directors have liability coverage needs that differ significantly from directors who are currently serving on corporate boards. The RDA policy has been expressly designed to address these needs. For additional details, contact Steve Wilson, president of Retired Directors Assurance Underwriting Services, at 866-212-3030, or visit the firm's Web site at www.retiredirectors.com.

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