

Retired Directors Face Continuing Legal Exposures

Shareholder and regulatory litigation are an acknowledged risk of serving as a director of a public company, but board members often fail to recognize that their personal exposure lasts long after their final term ends.

By Steve Wilson

In today's post-Enron environment, the personal liability for directors of public companies has never been greater. Directors are being held to a higher standard of conduct than ever before and are being aggressively pursued by shareholders and regulators when that conduct is perceived as improper. In several recent cases, directors have even been forced to settle litigation with money out of their own pockets. For example, in April 2007, five former directors of *Just for Feet* personally paid \$41.5 million to settle litigation by the company's bankruptcy trustee. The company's D&O insurance was exhausted in prior litigation against only the officers, and no indemnification from the company was available because of its insolvency.

This liability exposure does not stop when a director leaves office. Claims can be made years after the alleged wrongdoing occurs. In addition, the time it takes to resolve litigation against directors has grown over the last decade. On average, securities class actions now take five years to resolve. As a result, a director's liability for alleged wrongdoing while in office may not be known for 10 years or more after the director leaves office.

The cost to resolve securities litigation has also grown. Excluding settlements over \$1 billion, the average settlement in securities litigation grew from \$20 million in 2004 to an extrapolated \$30 million in 2007, according to a recent NERA survey. Plus, defense costs have grown dramatically, with mid to high seven figures the norm for "average" securities cases and much larger defense costs for the larger cases.

Unfortunately, the financial protection typically afforded directors through traditional D&O insurance and corporate indemnity does not adequately protect retired directors,

who have unique concerns once they leave office. D&O insurance affords “claims made” coverage, which means coverage is determined based on the insurance policy in force when the claim is made, not when the alleged wrongdoing occurs. In addition, the availability of corporate indemnification is determined when the loss is incurred, not when the alleged wrongdoing occurred or when the claim is made. In other words, events can occur and decisions can be made after a director leaves office that can reduce or eliminate the retired director’s financial protection.

Why is Traditional D&O Insurance Not Enough?

Typically, D&O insurance policies are one year contracts with no guarantee of renewal. This is a major concern for a retired director. A director’s personal liability is long term, yet there is no long term guarantee the company can or will continue to purchase coverage for the retired director with adequate limits, terms and conditions. In fact, there is no guarantee the company can or will purchase the coverage at all. Should the D&O insurance marketplace or the company’s financial condition change, coverage terms and conditions could become more restrictive or the insurance could become cost prohibitive. The cyclical nature of the D&O insurance marketplace could also affect future coverage. Regardless, once a director leaves the board, he or she no longer has a voice in the company’s decisions regarding future D&O insurance for the retired director’s past conduct.

In addition, traditional D&O insurance policies contain numerous gaps in coverage for directors. For example, various conduct exclusions, the so-called insured vs. insured exclusion, the pollution exclusion, the somewhat limiting definitions of “Claim” and “Loss” and the presumptive indemnification provision (which requires directors to personally pay the large corporate deductible if the company wrongfully fails to indemnify the director) can leave directors with little or no insurance for a particular claim. Also, directors may lose coverage under some D&O policies if the insurance application contains material misrepresentations.

Finally, even if the traditional D&O insurance policy covers the director’s loss, the limit of liability under the policy may be significantly eroded or exhausted by other Insureds. Most D&O policies today cover not only directors and officers, but other employees and

the company, as well as persons serving in various positions with certain outside entities. The more insureds who are covered, the greater the chance other Insureds will dilute the coverage available for the directors. Plus, directors and officers may be legally prohibited from accessing the policy if the company files bankruptcy.

Why is Indemnification Not Enough?

In today's world, it is virtually impossible to predict with certainty what a company's financial condition will be 5 to 10 years from now. Any number of global, national, industry or company-specific events can dramatically change a company's financial profile overnight. Given the magnitude of D&O losses, even companies that are relatively solvent may be unable to fund all of the Director's liability.

Other factors can also jeopardize indemnification from the company. If a company is acquired (which is an increasingly common event), indemnification from the surviving company is less predictable. Also, a director of a subsidiary may have indemnification rights only from that subsidiary, not the parent company, which again lowers the chances of getting the indemnification.

If any one of these risks occurs prior to resolution of a future claim against a retired director, the director may have little or no protection from the company. Because that claim may not be resolved for many years after the director retires, one cannot count on indemnification being available when needed.

What Should a Retired Director Do?

All of these concerns can be addressed with a newly-available retired director insurance policy, which insures only non-indemnified loss incurred by a specific retired director. Like other so-called non-indemnifiable loss policies, the retired director policy affords extraordinarily broad coverage without many of the troubling limitations contained in a traditional D&O policy. Plus, the limit of liability under the policy cannot be diluted by others since the only person covered is the specific retired director named in the policy.

Finally, the policy is fully paid for by the company when purchased and remains in effect for six years. Neither the insurer nor the company can cancel or rescind the policy.

In short, the retired director policy eliminates all of the risks identified above, and allows a retired director to lock in maximum protection for many years. Because no one else can change, revoke or dilute that protection, this type of policy is truly “sleep insurance” for the retired director and affords invaluable protection for the director’s personal assets.

Conclusion

Serving as a director on the board of a public company can be a very rewarding experience. However, directors continue to face increased scrutiny and lower investor tolerance for performance and governance failures. In this somewhat hostile environment for directors, there is understandably more concern about protecting the personal assets of directors. This concern is particularly acute for retired directors, who can no longer impact insurance or indemnification decisions by the company but who remain potentially liable for many years after they retire. Unless companies can provide retired directors with adequate and reliable personal protection, fewer qualified directors may be willing to serve, in which case the overall quality of corporate governance will ultimately suffer. A retired directors policy provides each director with individual, long-term protection so he or she can leave the board without having to worry about their personal exposure.

About the Author:

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To learn more about RDAUS, please visit: www.retireddirectors.com.

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