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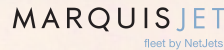

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Retired Directors Face Continuing Legal Exposures

By David Lupica and Steve Wilson

Board members often fail to recognize that their personal exposure lasts long after their final term ends.

In April of 2007, five former directors of Just for Feet paid $41.5 million of their own money to settle litigation. The failed shoe retailer, who had filed for bankruptcy in 1999, had exhausted its D&O insurance and was financially unable to meet its indemnification obligation to its directors at the time of settlement.

The statute of limitations imposed on directors under the Sarbanes-Oxley Act of 2002 is five years. In addition, the time it takes to resolve securities litigation has grown over the last decade so that the average case now takes five years to resolve. When you combine the Sarbanes statute and the length of time it takes to resolve a case, a director's personal liability can extend for a long period of time.

Clearly, a unique exposure exists for directors when they retire or resign from service. Unfortunately, the protection typically afforded retired directors through traditional D&O insurance and corporate indemnity may not be sufficient to cover the long-term exposure imposed under Sarbanes-Oxley. To adequately protect themselves, retired directors must stay abreast of the corporation's activities and insurance renewals from year-to-year or consider an option for individual coverage that protects them beyond the statute.

In the case of Just for Feet, The Wall Street Journal reported that after corporate officers had settled the shareholder lawsuit, only $100,000 in insurance remained to cover the bankruptcy trustee's suit against the former outside directors.

Insurance considerations for a retired director

Typically, D&O policies are one-year contracts with no guarantee of renewal. This is a big concern for a retired director—there is no guarantee the company will continue to purchase coverage at similar limits, terms and conditions after the director leaves the board. Should a company's financial condition or litigation history change, terms and conditions could become more restrictive or coverage could become cost prohibitive. The cyclical nature of the D&O 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 decision to maintain D&O insurance. Continuity of coverage is critical because D&O policies are claims-made contracts. Therefore, the coverage that applies to a claim is the coverage that is in place at the time the claim is made against the insured, not the coverage that was in place at the time the alleged wrongdoing occurred.

Coverage gaps and shortfalls

Traditional D&O policies also contain a number of exclusions as well as severability and warranty language that could exclude coverage altogether. Attempts by the insurance carriers to rescind coverage for alleged material misrepresentations have also become more common in recent years. Another frequently overlooked aspect of coverage is that D&O limits are shared by a multitude of people. Typical D&O polices cover past, present and future directors and officers, non-officer employees and the corporation itself. In addition, policies can be expanded to cover officers sitting on outside boards and in some cases, third parties such as underwriters or lawyers. In the event of litigation, there simply may not be enough insurance to go around,

especially if various parties all retain separate counsel. Also, polices today are very broad in scope and are designed to maximize coverage for the corporation and the corporate insiders whose legal interests, most likely, will not be aligned with the legal interests of a retired director. In the event of complex, problematic litigation, the limits can easily be exhausted by one group of insureds to the detriment of the remaining insureds. In the case of Just for Feet, *The Wall Street Journal* reported that after corporate officers had settled the shareholder lawsuit, only $100,000 in insurance remained to cover the bankruptcy trustee's suit against the former outside directors.

Why indemnity may not be enough

When D&O coverage is denied or the settlement exceeds the available limit of insurance, directors have traditionally been able to rely on the indemnity of the company to cover their personal exposure. However, there is no guarantee that the company will be legally or financially able to indemnify its former directors. Recently, institutional lead plaintiffs and regulators have demanded personal contributions from directors without the indemnity of the corporation, to settle certain large D&O claims. In the WorldCom case, for instance, the lead plaintiff, the New York State Common Retirement Fund, required the former directors to contribute $18 million of their own money as a condition of a proposed settlement. That represented about one-fifth of their total assets, excluding retirement accounts and their primary homes. For a number of reasons, a settlement was ultimately reached in which the directors contributed $20.25 million of their personal assets.

With such easy access to capital, mergers and acquisitions are occurring more frequently than ever before. Most of these transactions involve a recapitalization which can change a company's balance sheet overnight. So while a company's ability to indemnify may have been rock solid at the time a director retires or resigns, it may become questionable over time or when the retired director actually needs the indemnity protection in future years.

Personal coverage for retired directors

Companies can now provide their directors with an individual policy when they retire or resign from the board. An individual policy provides a retired director personal long-term protection that traditional sources are unable to provide. An individual policy covers only the retired director named on the policy and it cannot not be rescinded or cancelled, except for non-payment of premium. In contrast to traditional D&O insurance, an individual policy can be written for a six-year term that goes beyond the statute of limitations imposed under Sarbanes-Oxley. With an individual policy a retired director does not have to worry about changing terms and conditions in his or her former company's policy or whether they reduce limits or non-renew coverage. Another important advantage of an individual policy is the ability of the insured to select their own personal counsel. Many corporate D&O polices require the insured to select from a list of firms, known as panel counsel firms. In complex litigation and with personal assets potentially at stake, selection of counsel is very important. Not only is it preferable that the retired director selects his or her own lawyer, it also avoids any potential conflict of interest. Lastly, some individual policy providers offer other value added services that help a retired director stay abreast of current issues affecting directors and boards and the company he or she served.

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, all of which can lead to an increased risk of litigation in an environment that has become increasing hostile. As a result, directors are more concerned about their personal exposure than ever before and are looking at alternatives to traditional sources of protection when they leave the board. Unless companies can provide retired directors with adequate personal protection, fewer qualified directors will serve and 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.

Steve Wilson is co-founder and president of Retired Directors Assurance Underwriting Services (RDAUS). Prior to starting RDAUS, Wilson was a managing director for RLI Insurance in the Executive Products Group. He previously held various senior level positions with Chubb in the Executive Products Division. Wilson has 25 years of experience in the insurance industry and a solid understanding of D&O insurance, underwriting and the unique exposures of retired directors and is a graduate of Texas Christian University where he received his BBA in 1982. David Lupica is president, ACE Westchester Professional Risk Division, a position he has held since May 2004. With more than 21 years in the insurance arena, Lupica joined ACE in November 2000 as executive vice president, ACE USA Professional Risk. Prior to his tenure with ACE, he held various senior underwriting positions, including most recently serving as president, Starr Excess Liability Insurance Company Inc. of Bermuda. He previously held various senior underwriting roles at Alexander & Alexander (now Aon). He began his insurance career as an underwriter within National Union Fire Insurance Company, part of American International Group (AIG).