Personal Directorship Liability Insurance: Protecting the Independent Director

By Anthony Galban

Directors and officers (D&O) liability insurance can be one of the most confusing insurance products. Comprised of an array of different coverage offerings with nondescript names—"Side A, B and C" coverage—it may be easier to leave it to agents, brokers, risk managers and lawyers to recommend the best coverage for a company and its directors and officers. However, the recommendations of these experts regarding this purchasing decision may not necessarily be in the best interest of the independent director.

One of the challenges associated with the purchase of D&O liability insurance is the conflicting interests of the independent directors with the internal officers who are typically responsible for obtaining the coverage. Specifically, independent directors view themselves as being the primary focus and beneficiary of D&O liability policies, due to the significant liability exposures they incur through their fiduciary duties. On the other hand, the internal officers buying the coverage are employed by, and feel responsible for, the needs of the company.

Although the interests of the independent directors and the internal officers are not necessarily aligned, both have valid perspectives as to the purpose of the company's D&O liability policy.

While many independent directors may still cling to the notion that this is a "directors policy" purchased principally to help protect them from the significant *personal* liability they have at risk, internal officers seeking the best protection for the company may view a D&O liability policy in ways that may potentially dilute the protection available to the independent directors. For instance, internal officers might seek to cover **all** employees under the D&O liability policy—not just directors and officers—because they may view this as a better way to protect the company as a whole. Or they may seek to cover the corporate *entity itself* for corporate liabilities and other business risks. Or they might consider merging the D&O liability policy with other types of coverage such as employment practices liability insurance, in an effort to achieve a premium savings. All of these decisions may effectively result in the dilution of D&O liability protection for the independent directors.

A-side Protection

In the 2000s, corporate scandals such as Enron and Worldcom illustrated how quickly the insurance limits on a D&O liability policy could be eaten away by a corporation embroiled in a liability lawsuit—leaving little if anything to help protect the independent directors and internal officers. The D&O liability losses paid during that era demonstrated that directors and officers would need a discreet level of protection, as the corporate entity could consume virtually all of the insurance proceeds.

Today, a majority of publicly traded companies include A-side insurance coverage in their D&O liability insurance program; some privately held or nonprofit organizations may purchase this coverage as well. A-side D&O liability insurance was designed as excess insurance that sits over traditional D&O insurance protection available to **all** parties, including the corporate entity. However, the A-side insurance doesn't cover the corporation, either in its own right or for its indemnification of directors and officers. A-side insurance is dedicated to directors and officers for nonindemnifiable loss.

Most A-side coverage is shared by the independent directors and the internal officers. There are A-side products available for the exclusive benefit of independent directors, but they tend to be purchased infrequently. This low purchase rate may also be a reflection of the independent directors' lack of involvement in the purchasing process.

Directors versus Officers

The purchase of A-side insurance still doesn't solve for the disparity of D&O liability insurance protection that can exist *between* directors and officers. Officers, who run a company on a day-to-day basis, can have very different exposures to litigation than directors responsible for board oversight. And the order in which the policy responds to these two constituents can be critical.

Consider a criminal matter brought against the officers of a company. Defense costs for this type of litigation can be extremely expensive. According to Chubb's *2013 Private Company Survey*, the average total cost to a private company of a D&O event, including judgments, settlements, fines and legal fees, is $697,902. But, among the losses reported by survey participants were a $10 million loss by a large company, a $2.6 million loss by a midsized company and a $1 million loss by a small company. These are the types of situations that drain legal fees from the D&O liability insurance program, leaving little if any protection for independent directors needing legal defense in a typical claim against them for negligent oversight.

The challenge is that independent directors continue to be poorly represented in the D&O liability insurance purchasing process. Unless their role shifts towards a more "hands-on" risk management approach, they may continue to find themselves with gaps in protection in a D&O liability lawsuit.

Personal Directorship Liability Policies

Personal Directorship Liability (PDL) policies, issued in the name of individual independent directors, may offer a unique way for independent directors to obtain the liability protection they require. PDL policies are not new. These policies have historically been marketed through commercial agents and brokers focused on sales to corporate enterprises. Since the purchase of a PDL policy is a personal and an individual decision, independent directors need to initiate and drive the process.

A PDL policy is sold to an individual, similar to a homeowners policy, and provides tailored protection for individual exposures. The policy is intended strictly for the named individual—and, like A-side coverage, it offers no protection to the company. All types of entities can be scheduled on the policy—public companies, privately held companies, or nonprofits. Interestingly, it is not uncommon to see a PDL policy purchased by an affluent individual serving on the board of a philanthropic nonprofit, as these type of entities typically buy lower amounts of D&O insurance.

In addition, PDL policies are portable, designed to travel with the individual. Just as a homeowners policy can address a second home, a PDL can also address an individual's service on a second board —or more. The policy "sits" at the very top of the insurance tower, in excess of all other D&O insurance purchased through the company. This means that, when the insurance limits of the company's D&O insurance have been exhausted, the PDL policy is there to protect the independent director.

PDL can help solve a conundrum for independent directors. Independent directors have traditionally had limited involvement in the purchasing process for D&O liability coverage, which has led to a dilution in the protection the policy affords them. In addition, today's independent directors share the policy's protection with a large and varied group with diverse interests. Pursuing an option such as a PDL policy may be an attractive choice as it allows the independent director to control the purchase and the level of insurance protection required on his or her own individual behalf.

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