

CLIENT ADVISORY

Independent Directors' Liability Insurance: An Overview

The U.S. Securities and Exchange Commission recently made headlines by filing lawsuits against six former directors and officers of Fannie Mae and Freddie Mac. This widely-reported move by the S.E.C. may cause independent corporate board members of publicly traded companies to question whether they need an additional insurance policy – separate from the traditional Directors' and Officers' Liability Insurance (D&O) policy that's protecting the entire board – to cover themselves for board-related liabilities. Just to be clear, independent directors are simply those who are not also employees of the company on whose board they sit. This term is more fully defined in [Rule 16b-3 of the Securities Exchange Act of 1934](#).

A client's interest level is raised by clients with their insurance brokers most frequently following media coverage of high-profile securities lawsuits resulting in payments directly from the pockets of individual director and/or officer defendants. A number of well-publicized lawsuits have required individual defendants to make payments from their personal assets. Included on this list are matters involving [Enron](#), [WorldCom](#), Xerox, [Global Crossing](#), HealthSouth and Lucent. Reading about settlements or judgments funded to any extent with personal assets can, understandably, cause concern for independent or "outside" directors. It should be noted, however, that the insurability of personal contributions will depend upon the specific facts of each lawsuit and the applicable law.

"When independent directors undertake an assessment of the insurance protection provided to them by companies for serving on their boards, it's usually prudent to examine Independent Directors' Liability coverage as part of that process. In many instances, it can augment existing insurance policies in a meaningful way," says Richard Fernandez, National Financial Services Practice Co-Leader and Executive Vice President of AmWINS' Atlanta brokerage office.

The current legal environment encourages independent board members to closely examine, or reexamine, the adequacy of existing D&O coverage. A record number of securities-related lawsuits (1,293 according to insurance information services company Advisen) were filed in the United States in 2010. This increase was partly attributable to the credit crisis and related financial scandals. While final figures for 2011 were not available as of 1/4/2011, Advisen is projecting that 2011 will surpass 2010 with more than 1,400 securities-related lawsuits being filed.

With all of this litigation, and with well-publicized instances of defendants dipping into their pockets to make payments, it's only natural that independent directors would consider increasing their insurance protection. Plus, independent directors, not being employees, may also feel that they need an additional layer of protection that isn't shared with inside insured persons or the corporation. The independent directors are not able to regularly monitor and influence company activities like "insider" employee/directors which may be the source of the litigation.

It's critical that professional lines insurance brokers understand some basic facts to help clients who are independent directors determine if they want to buy (or request that a company purchase) the additional protection afforded by an Independent Directors' Liability (IDL) insurance policy. As Mr. Fernandez of AmWINS points out, *"IDL is one of those products that isn't called upon all that often to respond, but when it is, it's the most important insurance policy in the world to that particular director defendant."*

One of the first things worth knowing about IDL insurance is that it kicks in only after the board's traditional D&O insurance coverage is exhausted or otherwise fails to respond to a claim. Thus, it's basically an excess "A-Side" D&O policy strictly for the use and benefit of independent directors. The A-Side of a traditional D&O policy responds to pay an insured individual's losses directly when the insured company either can't reimburse him (because, for example, the company is bankrupt) or it won't reimburse him (because, for example, of legal prohibitions).

The Basic Types of IDL Policies

There are two basic types of IDL policies. The first, which is sometimes referred to as a "portable" policy, covers only one individual director for his service on one or more boards. Generally this premium is paid by the insured director himself, although there's nothing to stop a company from paying this premium in order to attract or retain high quality outside directors. A portable IDL policy provides a separate limit of liability in addition to whatever insurance is in place to protect the entire board. If the insured director purchasing the portable coverage is on more than one board, the carrier would most likely consider extending the portable IDL policy to cover activities in connection with other boards too, but only after the appropriate underwriting and, possibly, payment of an additional premium. The alternative would be for each separate

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company to buy policies for this one person. The benefit for a portable policy is the security felt by this insured that he or she has consistent broad coverage for his or her personal interests.

The carrier may also impose some changes to the terms and conditions of the policy for coverage following any additional programs depending upon the specifics of the situation. For example, if the original portable IDL policy covered service on a non-profit charitable board and then the independent director joined the board of a community bank, it is likely that the insurer will change some of the policy's provisions and charge an additional premium. And, of course, just as with any other policy, one must consider the wisdom of potentially diluting available limits by extending coverage over the insured's activities for multiple entities. Some independent directors prefer a separate IDL policy for each board on which they serve.

The second type of IDL coverage is normally bought by a *company* to protect *all of the independent directors* on its board. There are various reasons a company might choose to make this purchase. One main reason: An IDL policy can be a valuable tool in recruiting new board members – especially in current times, when lawsuits against board members are highly publicized and many prominent business leaders don't consider serving on a board and risking their personal assets to be worth the risk. In other instances, independent board members may simply demand the additional coverage. This is especially true when there are concerns about the terms and conditions of the current D&O program or the financial strength the participating carrier(s). Additionally the buyers will be motivated by any question about the solvency of the company on whose board the directors are serving.

Key Elements of IDL Policies

There are some key elements of most IDL policies that your client should understand when considering whether to pursue the coverage. Among the most important:

Non-Rescindable: One of the most comforting features for independent directors of an IDL policy is that the carrier usually agrees not to rescind the policy under any circumstance. This can be critical when an outside director doesn't feel that he has full confidence in the company's financial statements and other information that may have been disclosed to the insurer as part of the application process. In many traditional D&O policies, if the applicant company provides false information on the application, the entire policy can be rescinded, which is a concern alleviated by an IDL policy.

Full Severability: Don't confuse a policy that's non-rescindable with one that provides full coverage even to those applicants who lied. Full severability, with respect to the application, means that innocent directors who had no part in providing false information to the carrier will not have their coverage restricted or removed. Full severability also applies to the so-called personal conduct exclusions, which means the fraudulent behavior of one insured won't be imputed to any other insureds. For example, if the CEO committed fraud in making false statements to the media about the company's financials, innocent insureds won't lose coverage. This is not always the case with traditional D&O coverage.

Difference-in-Conditions (DIC) Coverage: While each IDL policy differs in its exact wording, they will generally provide broad DIC coverage above the underlying D&O program. This means that many of the exclusions (and other terms and provisions that serve to restrict coverage in the underlying D&O policy, not all of which are found in a policy's Exclusions Section) will be rendered inapplicable under the IDL policy. In other words, the IDL policy will not "follow form" of the underlying exclusions, and fewer exclusions means broader coverage. An allegation denied by the traditional D&O program due to an exclusion in that program may not prohibit protection being provided to the independent directors under their own IDL policy.

Narrower Exclusions for Fraud and Personal Profit: Traditional D&O policies do not provide coverage for allegations of fraud and receipt of illegal personal profit or gain (e.g. acceptance of bribes or insider trading profits) once such acts are proven in court or admitted to by the insured. IDL policies will typically cover defense costs for such allegations – even if they're proven. Primary D&O policies often have provisions requiring an insured to reimburse the insurer for defense expenses paid to defend fraud or personal profit claims that are later proven via a judgment or final adjudication.

Defense Cost Coverage for Insured vs. Insured Claims*: Carriers don't like paying legal fees on both sides of a dispute and, thus, D&O policies contain Insured vs. Insured exclusions so that the insurer is not funding lawyer costs for internal fights among board members. IDL policies eliminate this restriction and will generally pick up the legal fees in these matters. (*See our client advisory, ["How to Soften the Insured vs. Insured Exclusion in Your Client's D&O Policy"](#).)

No "Hammer" or Settlement Clause: Standard D&O policies often contain a provision that allows the carrier to cap their liability at the total costs that could have been expended to settle a matter (including defense costs) at a point where the plaintiff indicated, with certainty, that he would accept a specific amount to conclude a claim. Thus, any insured that elected to fight beyond that point would do so at his or her own expense. IDL policies don't contain this clause, thereby freeing up insureds to fight to protect their reputation and/or principles at the carrier's expense if they'd like.

The points listed above are some of the major benefits of purchasing IDL coverage, but as with all insurance products, each has its own specific terms and conditions and should be reviewed carefully in light of the particular needs of your client. The team of highly knowledgeable and experienced brokers at AmWINS offices nationwide stand ready to assist you with all of your IDL and other professional lines insurance product needs.

This article was prepared exclusively for AmWINS Group, Inc. by Larry Goanos, CEO of Andros Risk Services, an independent insurance consulting firm.