

April 2004

## The Continuing Need for D&O Insurance— Outside Directors Shouldn't "Fuhgedaboutit"

Much bemused attention has been paid to a lively interview in the March/April edition of *Corporate Board Member* magazine entitled: "Worried About Shareholder Suits? Fuhgedaboutit!" The authors describe the results of a study on the outcome of D&O securities suits for outside or independent directors. They conclude that absent active participation in the fraud, these individuals were not held personally liable. They also imply that if personal liability is not a concern, D&O insurance should not be either. This second point is revised in the latter half of the article where D&O insurance is praised for its role in facilitating the settlement of D&O claims prior to trial and for bailing out the executives where a corporate bankruptcy has occurred.

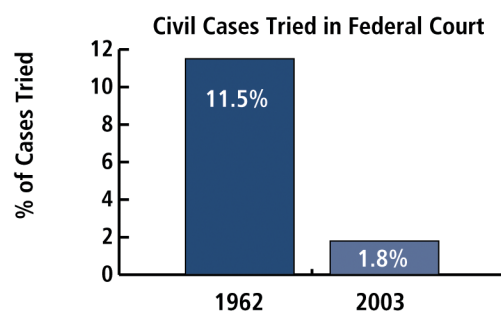
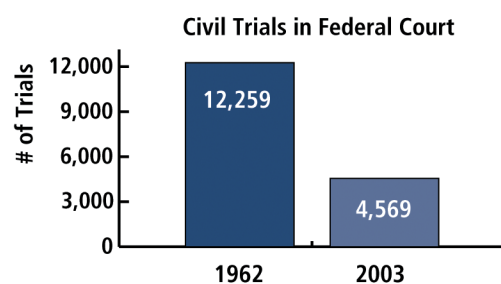
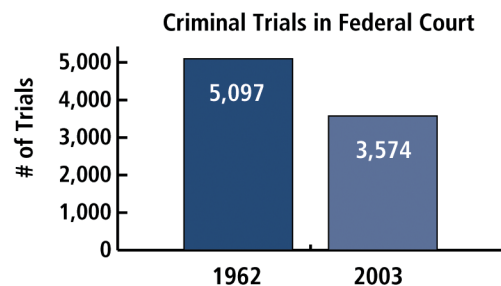
Willis believes that this latter advice is more reflective of the liability environment faced by today's independent director.

### Few Cases Adjudicated

The authors do good work with the data they examine, but the study relies on an increasingly small percentage of all suits: those that go to final adjudication.

Data compiled on the federal court system by Marc Galanter (who teaches law at the University of Wisconsin and the London School of Economics) for the American Bar Association reveals that while in 1962, 11.5 percent of all civil cases in federal court went to trial, by last year that number had dropped to 1.8 percent. Even with five times as many lawsuits today, the raw number of civil trials has also dropped, with a mere 4,569 civil cases tried last year in federal court.

The percentage of federal criminal prosecutions resolved by trial has also declined, to less than five percent last year from 15 percent in 1962. Although the number of prosecutions more than doubled in the last four decades, the number of criminal trials fell by 30 percent over that span. The declining number of trials in the federal courts can largely be attributed to revisions in sentencing laws. With the increased minimum sentencing guidelines now in place for corporate fraud cases, defendants who insist on a trial may face much longer sentences than those who accept a plea bargain. This point was made dramatically last month with the sentencing of a Dynegy financial officer to 24 years in jail.



**Most suits are being settled out of court, often bringing adverse outcomes for the individual outside director—outcomes that can be protected by D&O insurance.**

Data from the state courts, which handle most lawsuits, is broadly consistent with that in the federal courts, according to legal experts at the National Center for State Courts.

*All of this leads to the undeniable conclusion that more suits are being settled, a finding that underscores the need for D&O coverage for the simple reason that suits settled out of court often bring adverse outcomes for the individual outside director – outcomes that can be protected by D&O insurance.*

Further supporting the point are the limits placed by many states on a company's ability to indemnify its directors and officers for certain settlements.

## Outcomes Changing

Almost all of the decisions reviewed in the authors' study were brought in a pre-Sarbanes-Oxley world, before the recent string of corporate fraud cases, prior to the zero-tolerance sentiments for allegedly poor corporate decisions, and before the prevailing collective public skepticism about executives. We have yet to see the outcome of the recent crop of securities suits against outside directors. Of keen interest is whether they will be held liable for procedural lapses that allegedly allowed the illegal schemes that defrauded companies' stakeholders. At the top of this list is the Enron litigation involving its independent directors.

*Currently, there is no certainty as to the outcome of future independent director liability cases.*

## Recent Lessons from the *Disney* Decision

A recent decision that provides some predictive insight to independent directors (also mentioned by the authors) is last year's *Disney* decision by the influential Delaware Chancery Court. The suit against the Disney Compensation Committee (all outside board members) alleges that they breached their fiduciary duty in agreeing to a compensation package without thorough review of its merits. After granting the plaintiffs access to relevant company documents to form their case, the court is allowing the claim to proceed to trial. The allegations are strikingly similar to those of a number of other pending and likely suits.

Whatever the ultimate outcome, the Chancery Court has already determined that the company will not be permitted to indemnify the board member defendants. In the absence of D&O insurance, the personal net worth of each individual would be called into play.

The judge who issued the decisions in *Disney* as well as the recent *Oracle* case, has provided informal advice to corporate board members on how to avoid personal liability: if board members can demonstrate that they attended and actively participated in board meetings, reviewed the relevant issues, asked for reasonable information and generally acted in good faith, they will not, in hindsight, be held personally liable for poor decisions.

*To paraphrase this advice: independent directors will not be held strictly liable if they can demonstrate that they attempted to exercise prudent judgment. We are in an exceedingly tough environment if this cold comfort can be thought of as "consoling advice" for independent directors.*

## Conclusion

The authors reach thought-provoking conclusions about the possible personal legal liability of independent directors based on historical data that appears to be statistically insignificant, and therefore inconclusive.

With increasingly heightened legal standards and requirements for independent directors, these conclusions are likely to be even less relevant for current and coming claims against outside directors.

We agree with the authors that independent directors will not be held strictly liable for arguably poor decisions if they can demonstrate that they acted prudently. However, some recent case law casts some doubt on the applicability of the business judgment rule.

For more information, see the January 2004 Executive Risks *Alert* on management liability cases, available at [www.willis.com](http://www.willis.com).

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