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Insurance and Good Corporate Governance: A Modest Proposal

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Insurance is not often discussed as an element of good corporate governance. It should be. Broadly understood, good governance is the maintenance of an appropriate level of accountability for directors and managers so that there is both transparent decision-making and an effective means to take action for poor performance or decisions. Much of the discussion about corporate governance centers on structural safeguards (for example, that board committees tasked with important decisions contain a majority of independent directors; that there are guidelines for the timing and substance of the information provided to directors in advance of meetings; and that directors are able to obtain independent advice when appropriate). These safeguards are intended to create a system of checks and balances that lead to conflict-free decisions that are in the best interests of an organization's stakeholders. After learning that the risks of a bubble economy cannot be avoided by opaque financial engineering, it is appealing to believe that transparency in decision-making and strict rules regarding conflicts of interest will limit risky corporate behavior.

Such institutional safeguards are valuable and are an appropriate focal point for legislative and regulatory reform, but they will never eliminate the risk that bad decisions might be made or that improper conduct might take place. When shareholders and other stakeholders suffer losses resulting from alleged errors or breaches of duty on the part of directors and officers, it is accountability that matters most to those aggrieved parties—not procedural and structural safeguards. In this context, accountability really means the ability to obtain compensation from the allegedly responsible parties.

This is where the role of insurance in good governance comes to the forefront. In general, management liability insurance (including D&O, E&O and fiduciary liability insurance) covers insureds for claims for loss allegedly caused by their acts, errors, omissions, misstatements or misleading statements. In other words, management liability insurance covers alleged breakdowns in some of the safeguards equated with good governance.

But how can insurance for claims that allege breakdowns in good governance itself be an element of good governance? Despite all the best intentions and structural safeguards, mistakes will happen, bad decisions will be made and unforeseen contingencies will disrupt business plans that seemed wise at the time. Responsible planning for the risks inherent in running a business dictates that provisions be made for these contingencies. Management liability insurance can be an effective way of providing for these risks and, hence, an expression of good corporate stewardship. (For a more thorough discussion of the interplay between insurance and prudent planning, please see the three-part series titled "The Devil Is in the Details," as well as "D&O Insurance: Why on Earth Would a Private Company Need It?").

Management liability insurance also should be an integral component of the due diligence concerning prospective business relationships. For example, gaining an understanding of a prospective business partner's management liability insurance can reveal how that party understands and values its business risks and can provide insight into that party's adherence to best practices. Moreover, gaps in coverage may raise important questions about a prospective business partner's financial accountability.

The following examples illustrate some of the material information a business might hope to attain through comprehensive insurance due diligence, as well as some of the questions that can arise.

Always Ask What Is in the Bag before You Agree to Hold It

FirstNat's trust department provides trustee and/or fiduciary services for employee stock ownership plans (ESOPs). Before agreeing to become an ESOP trustee, FirstNat requires that a company have fiduciary liability insurance placed with an A-rated insurer, that FirstNat be identified as a named insured and that the fiduciary liability policy cover ESOP-related claims. In this scenario, MillCo is preparing to be sold to its employees by its current owner, DarthCo, and FirstNat is asked to become the trustee for MillCo's proposed ESOP plan. The market for MillCo's core product is in long-term decline, and the company has sizeable legacy pension obligations. The proposed transaction is highly leveraged, contains aggressive stock valuations and is partly financed by DarthCo. The projections supporting the transaction assume that growth in some of MillCo's newer units will offset the problems in its core unit.

Within two years of the sale, MillCo is unable to service its debt because the intervening recession has stunted the projected growth and exacerbated the decline of its core business. MillCo declares bankruptcy and DarthCo now holds a majority of the senior debt. Employees and pensioners commence litigation against DarthCo, MillCo, FirstNat and the other transaction advisors alleging, among other things, that DarthCo structured the transaction with the connivance of MillCo's entrenched management so that MillCo would inevitability declare bankruptcy, thus allowing DarthCo to re-take control unburdened by MillCo's pension liabilities. When FirstNat seeks coverage from MillCo's fiduciary liability insurer, it soon learns that the policy's "continuity date" is also the date of the closing of the ESOP transaction and that claims relating to or arising in whole or in part out of actual or alleged conduct that took place prior to the "continuity date" are excluded.

Given the circumstances of this transaction, would knowledge of a "prior acts" exclusion have been relevant to a prospective trustee? If FirstNat had been aware of this issue when negotiating its role in the transaction, could it have demanded thatm either MillCo or DarthCo secure more favorable coverage terms?

Can I Really Trust You with My Client's Money?

AdvisCo counsels institutional pension funds on the selection of investments. On behalf of its clients, AdvisCo conducts extensive due diligence concerning the management and investment philosophy of the hedge funds and private equity companies in which its clients invest. That due diligence includes confirmation that the investment firms have suitable limits of D&O and E&O insurance. One of

AdvisCo's clients, EndowFund, invests with two funds, MadCo and StanCo. Shortly thereafter, both funds suffer massive losses when it is discovered that several of their traders had been manipulating earnings through the "sale" of assets to off-balance sheet entities. EndowFund joins litigation against MadCo, StanCo and the officers of both firms. Because the underlying investments lack a liquid market, the D&O and E&O insurance of both investment firms is their most accessible asset. MadCo's management liability programs do not contain severability provisions limiting the insurers' ability to rescind or to apply "conduct" exclusions as to "innocent" insured persons. The StanCo insurance program has significant limitations on the insurers' ability to rescind coverage and protects "innocent" insured persons against rescission and the application of the "conduct" exclusions.

Which company's management liability insurers are more likely to engage in substantive settlement discussions? Might a sophisticated institutional investor view the information that could have been obtained from closer insurance due diligence as relevant to its decision making? Can an investor reasonably expect its advisors to conduct this type of due diligence? Can an advisor differentiate itself from competitors by providing risk assessments that incorporate the information resulting from this due diligence?

What Did I Get Myself Into?

Holly Martins is asked to become an outside director on the board of LimeCo by Harry Lime, an old acquaintance and the company's president. Before agreeing, Martins confirms that the limits of LimeCo's management liability insurance program are consistent with its peer companies. However, Martins quickly becomes concerned that the board is a rubber stamp for questionable decisions by management. Rather than resign, Martins decides to work to improve LimeCo's governance. Shortly thereafter, the company's auditor informs the board that it has reservations with LimeCo's accounting procedures. As a result, LimeCo's relationships with its lenders deteriorate, the company declares bankruptcy and a receiver is appointed. The receiver sues the former officers and directors for alleged conflicts of interest. In addition, state securities regulators issue subpoenas to directors and officers concerning the marketing of fractional shares in a LimeCo real estate development. When Martins finally asks counsel to review LimeCo's management liability insurance policies, Martins learns that (1) a receiver falls within the definition of "insured company," (2) the policies do not contain a bankruptcy exception to the "insured vs. insured" exclusion, (3) "claims" do not include investigatory subpoenas and (4) the policies contain broad exclusions for claims by regulators.

Should a director agree to sit on a board without first asking to review the company's management liability insurance? What can a potential director learn about a how a company deals with its risk exposures based on a review of its management liability insurance?

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Insurance due diligence—if it is to be of real value—must go beyond a "checklist" approach of simply confirming the existence and limits of insurance. Management liability and other types of insurance are not one-size-fits-all products. In fact, there are significant differences in each business' risks and in the available policy forms and terms that can make a material difference in whether or not a particular claim will be covered. Understanding risk (both for your own business and for your prospective business partners) and making provisions that protect or enhance your ability to satisfy potential liabilities associated with those risks are signs of responsible planning. In the end, good corporate governance requires more than procedural safeguards. Smart businesses should also do the necessary due diligence to examine insurance policy terms that often are taken for granted (transparency) and assess the potential financial consequences of those terms (accountability).

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