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Director and Officer Liability Insurance: Analysis of Survey Results

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Executive Summary

The CIBC Centre for Corporate Governance and Risk Management undertook a survey of Boards of Directors of TSX listed companies regarding their attitudes towards risk, the nature of risks they face, and their practices regarding risk management and insurance. The study was financed by Bishop Phillips Consulting Canada. The survey results indicate that respondents feel that the risk of potential claims against Directors and Officers is currently high, and is likely to increase in the future. The most likely causes of claims are identified as arising from financial and accounting disclosure and fraud, and the likely source of claims is identified as large shareholders and institutional investors. Respondents tend to agree quite strongly that D&O insurance is important for the recruitment and retention of qualified directors, that directors should be informed about insurance coverage when they are appointed and that incumbent directors are interested in reviewing insurance coverage policies. Almost all respondents currently have insurance, but the amounts, the annual premiums, and the deductibles differ considerably. The majority of D&O coverage is provided by four providers, and many companies use more than one insurer. Actual or threatened claims appear to be quite rare, and most companies are comfortable with current levels of coverage. When claims occur, they are likely to be settled by the insurance company. Nevertheless, one third of claims were disputed, but the number of such cases was small. Most respondents feel that standards of corporate governance in Canada are high, but expect them to rise, and most are taking measures to improve corporate governance.

Nature of Respondents

In February of 2006, survey questionnaires were mailed to Chairs of Boards of all TSX-listed companies in Canada for which addresses were available. Responses were received from 70 companies, a response rate of 6.4% for the just over 1,100 delivered questionnaires. Although the response rate is low, nearly 70% of the respondents were the Board Chair, the CEO, or both. The remainder was comprised of company secretaries, legal counsels, or CFOs. Thus, respondents were typically senior members of the board or officers of the company.

Company size varied considerably, with a range of less than 50 employees to more than 10,000, and annual sales of less than $1 million to annual sales of more than $5 billion. The majority of reporting firms had less than 999 employees and less than $100 million in sales. Unless otherwise noted, firm size had little impact on the response of firms.

Just over 40% of the sample firms were in resource industries (agriculture, forestry, mining, and oil and gas). The second largest category (30%) was accounted for by firms in various service industries (transportation, communications, finance, hospitality), while the remaining firms were in manufacturing and various high technology industries. Over one-third of the responding firms were located in Ontario, and the rest were mainly distributed among Alberta, B.C. and Quebec (in that order). The majority of respondents (59%) had operations outside of Canada, with most of those being active in the U.S. On average, those companies that operated abroad were active in just over 7 countries, but the dispersion was very large.

The majority of respondents were listed only on the TSX (70%). Of those that were dual-listed, the majority were listed in the U.S., mainly on the NYSE. On average, the companies had 8 directors, a number remarkably close to that identified as “optimal” in some academic studies. Most of the companies (75%) had boards with a majority of outside directors. Perhaps not surprisingly, and consistent with academic evidence, board size and board compositions were both positively related to firm size. Large firms tended to have larger boards, and were more likely to have a majority of external members on those boards.

Assessment of Risk of Potential Claims

When asked to assess the *current* degree of risk of potential claims against Directors and Officers on a 5 point scale (5 being very high), the mean response we 3.92, suggesting that most respondents perceived a high level of current risk. However, when asked about potential *future* risks, the mean response rose to 4.55.

Respondents see current risks as high, and expect them to rise.

The correlation between current and future perceptions was positive, so that firms which perceived higher risk today were more likely to expect it to rise in the future. The perception of risk was not affected by firm size. Firms of all size categories tended to share the same views with respect to current and future risk. Interestingly, however, firms with international operations tended to perceive less current risk, but had the same perception of future risk as other firms. An explanation for this consensus regarding future risks can be found in respondents' comments in the survey. For example, one respondent wrote: "D&O Liability insurance in Canada is becoming increasingly important because of trading and working with US companies". Other respondents similarly anticipate changes in the Canadian business environment that will result in more litigation and mounting legal fees.

Respondents who see current risks as high are more likely to expect them to rise. Perception of future risk is the same, regardless of firm size or international exposure.

Nature of Potential Claims

Respondents were asked to assess the degree of risk associated with claims of various kinds, ranging from inadequate disclosures to overseas risks. Twelve potential risk sources were listed. In addition, respondents could indicate that they saw no potential risk from any particular source.

The single greatest type of potential claims identified by respondents was risk associated with inadequate or inaccurate disclosures.

This variable was statistically different from all other responses. However, further statistical analysis revealed that the sources of potential claims could in fact be grouped into three broad categories: financial and regulatory; ethical; and strategic. These three categories accounted for almost all of the variation in sources of risk.

Financial and regulatory risk was comprised of three factors: inadequate/inaccurate disclosure; accounting fraud; and failures in regulatory compliance. This broad factor was statistically the most important of the three identified. Ethical issues included claims arising from interested party transactions, conflicts of interest and insider trading. Some of these may also be related to regulatory compliance, but from a statistical perspective they appeared as a distinct group. Strategic issues were comprised of risks arising from overseas operations, human resources policies and merger activity.

Three broad forms of potential claims were identified as arising from financial and regulatory disclosure and compliance; ethical issues related to various forms of conflicts of interest; and strategic issues arising from human resource policy, mergers, and international operations.

For the most part these factors were common to all respondents. One exception was the second factor (ethical practices) which was not as important to large firms.

Sources of Potential Claims

Respondents were asked to identify potential sources of claims against Directors and Officers. Ten possible sources were listed, including the company itself, its competitors, and a variety of stakeholders including various classes of shareholders, creditors and customers.

The two most widely perceived sources of claims were large shareholders and institutional investors. These variables were statistically different from all others, but not from each other. Together, they were considered the greatest potential sources of claims.

The two most important sources of potential claims identified by respondents were from large shareholders and institutional shareholders.

The least important sources of potential claims were identified as those arising from employees, customers, competitors, the company itself, and creditors. These variables were not statistically different from each other, but were statistically significantly lower than scores for the potential claims arising from large and institutional shareholders.

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An intermediate level of risk was identified as arising from claims by small and minority shareholders, and regulatory and government agencies. These two factors were not statistically different from each other, but were statistically different from other variables.

Intermediate sources of potential claims were identified as those arising from small and minority shareholders and government and regulatory agencies

For the most part, these results were common across size categories. An important exception is that smaller firms tended to perceive creditors and receivers/liquidators as greater sources of potential claims**.**

Attitudes Toward D&O Insurance

Respondents were asked to what extent they agreed or disagreed with a variety of statements regarding their attitudes toward D&O Insurance. These statements ranged from those regarding *practices* (should companies inform independent directors of their liability coverage; are directors involved in reviews of insurance coverage) to those regarding potential *benefits* (insurance helps to recruit and retain qualified directors; insurance is an important component of good corporate governance) to those regarding the *nature of policies* (do they provide good value for money; are they restrictive with too many exclusions). The increasing importance of D&O liability insurance for director recruitment was emphasized by one respondent as follows: “10 years ago we said ‘if you conduct yourself in a prudent manner you don’t need D&O insurance’. The outside environment has changed. You will not attract good directors without D&O.”

The results indicate that respondents tend to agree quite strongly that D&O insurance is important for the recruitment and retention of qualified directors, that directors should be informed about insurance coverage when they are appointed and that incumbent directors are interested in reviewing insurance coverage policies.

In general, respondents tend to believe that D&O coverage is beneficial in terms of its contribution to good corporate governance, and that directors should be actively involved in reviewing the terms of the policies. However, they are less certain that existing policies are good value for money. The average response to the question of whether existing insurance policies provide good value for money is 3.29 (with 5 indicating strong agreement, and 1 indicating strong disagreement), while the average response to the question of whether insurance is likely to *decrease* claims is 3.30. In both cases, the standard deviation exceeds one which means relatively high variability in respondents’ views. In contrast, the average response to the question of whether insurance is essential for good corporate governance is 4.07, with a standard deviation less than one. Finally, the results also suggest that on average respondents do not feel that current policies are overly restrictive and contain too many exclusions.

On balance, respondents feel that current policies are for the most part good value for money, are likely to reduce future claims, and are not overly restrictive. However, there is considerable variation across responses.

D&O Insurance Coverage and Policies

The vast majority (93%) of surveyed companies did have D&O liability insurance, but the amount of coverage varied considerably. About half of the companies that did have insurance held coverage of less than $20m. At the other end, nearly one-third of companies held coverage in excess of $50m. Only 4 respondents did not carry insurance, and the reasons given were related to costs and the existence of indemnity benefits in existing contracts. For the total sample there was a statistically significant positive correlation between measures of firm size, and the amount of coverage. However, the correlation was strongest for resource companies and financial institutions.

The vast majority of surveyed companies carry D&O liability insurance, but the amount of coverage varies considerably. In general, larger firms carry higher coverage, but this varies among industries.

Similarly, the annual premiums and basic deductibles also vary considerably by company. Over half of the surveyed companies pay premiums that are less than $150,000 per annum; nearly 15% of companies pay more than $1m per annum. Over half of the companies have deductibles that are less than $250,000; 10% of companies have deductibles that exceed $2m. There is a positive and statistically significant correlation between the amount of coverage, and both the size of the basic deductible and the amount of the premium.

Of the companies that carry D&O liability insurance, the annual premium and basic deductible varies considerably. Most companies pay annual premiums that are less than $150,000 per year and have deductibles that are less than $250,000. Companies with higher coverage pay higher premiums and have higher deductibles.

The majority of D&O coverage is provided by four providers: Chubb, AIG, Liberty International and Ace INA. The numbers suggest that many companies use more than one provider, likely because they use different providers in different countries. In addition, 63% of respondents indicated that they felt that most policies sold in Canada were similar.

Although four companies dominate in terms of provision, many companies use multiple providers, in part because they operate in different countries and in part because they believe that most policies sold are similar.

Most companies (68%) engage an external consultant with expertise in D&O insurance, and about the same number (62%) have corporate legal counsel review the annual application and policy. A minority of firms (42%) has external legal counsel perform this review. Independent directors are less likely to engage an external consultant (25%), and in most firms do not request any change to the policy (39%).

The process of reviewing D&O insurance polices rests more with external consultants and internal legal counsel than with independent directors.

Most companies (84%) do not report either an actual or threatened claim in the previous three years. Perhaps as a consequence nearly 80% of respondents reported being very comfortable or comfortable with current levels of coverage. Of the ten companies that reported a claim, 33% indicated that the insurer disputed whether the policy would cover the claim. While this percentage is large relative to that reported in U.S. surveys, the number of respondents to this question is low and so the result must be approached with caution.

Over the past three years, 14% of respondents reported actual or threatened claims. When claims occur, they are likely to be settled by the insurance company. Nevertheless, one third of claims were disputed, but the number of such cases was small. Most companies are comfortable with current levels of coverage.

Attitudes Towards Corporate Governance

Respondents were also asked about their attitudes towards corporate governance in general. Most agreed that standards of corporate governance in Canada are higher, and comparable to those in the U.S., and that yet higher standards would likely be required in future.

Corporate governance standards are high in Canada, and similar to those in the U.S., but are expected to become higher.

Respondents also indicated that standards of corporate governance differ greatly across companies. Most companies were engaged in various measures to improve corporate governance. Among the actions taken, over 80% of companies reported taking measures to strengthen the role of independent directors, to improve transparency in reporting, and to strengthen audit and risk management committees. Less than half (46%) reported engaging in training of directors, but 37% indicated that they would do so in the near future.

Most companies are taking measures to improve corporate governance, primarily by strengthening the role of independent directors, improving reporting mechanisms, and improving audit and risk management capabilities.