

FEBRUARY 23, 2006

## The soaring cost of a boardroom safety net

Once oblivious to their liability coverage, directors are coping with a steep rise in premiums, JANET MCFARLAND writes

Canada's small community of corporate directors was shocked to hear last year that the insurance provider for Nortel Networks Corp. had rescinded part of the company's directors' and officers' liability policy following news of earnings restatements. More bad news came later in the spring when Nortel issued its shareholders proxy circular, revealing it had paid a whopping \$13.6-million (U.S.) for its coverage in 2003 -- up from \$1.1-million two years earlier.

Insurers and brokers say the news from Nortel jolted Canadian boardrooms, sending many directors scrambling to understand the previously overlooked or technical details of their own directors' and officers' (D&O) insurance policies -- the coverage intended to protect them from personal liability at times of trouble.



Elan Pratzter, chief executive officer of Executive Risk Services Ltd., urges directors to learn about features they could add to their policies, such as clauses that prohibit the insurer from cancelling coverage.

"It had a big effect," says Elan Pratzter, chief executive officer of Executive Risk Services Ltd., a Toronto-based insurance company specializing in directors' and officers' insurance policies. "Look who was on that [Nortel] board -- you have some of the titans of board members," Mr. Pratzter says. "It was certainly a wake-up call for other directors across the rest of Canada to be concerned about their rights."

Nortel's insurance woes came to light after three years of steady price increases for D&O insurance and after a host of other high-profile liability cases hit the news. In 2004, directors of both WorldCom Inc. and Enron Corp. agreed to make large payments out of their own pockets to cover settlements with shareholders. The result is that directors have never been more motivated to examine their insurance policies and shop for more coverage with better terms and conditions.

**Companies need not be in a crisis to see their insurance rates soar. Even low-risk organizations have faced increases.**

"Directors have become much more informed about the liabilities and risk exposures . . . and are much more engaged in making sure they're getting proper product," says David Griffiths, senior vice-president at insurance broker AON Reed Stenhouse Inc.

Lawyer Carol Hansell, who advises boards of directors on legal and governance matters, says her clients are now keen to know the details of their liability insurance. Even three years ago, few directors knew anything about their insurance limits, terms or conditions. "You just could not get people to get interested in this," she recalls.

If nothing else, a series of sharp price increases over the past three years have focused directors' attention on their D&O coverage. For many public companies, premiums have at least tripled since 2002. A governance survey released in January by executive search firm Spencer Stuart found D&O insurance premiums rose 26 per cent from 2003 to 2004 for Canada's 100 largest public companies. The price changes varied widely among the companies. Some saw their premiums drop during the year, while others reported huge increases.

FEBRUARY 23, 2006

---

Enbridge Inc., for example, said its D&O premium climbed to \$1.9-million (U.S.) in 2004 from just \$266,000 in 2003. Canadian National Railway Co. said its premiums jumped 455 per cent to \$2.9-million (Canadian) from \$521,000 a year earlier. And Magna International Inc. said its D&O insurance cost rose 447 per cent to \$5.1-million in 2004, up from \$939,349 in 2003.

Enbridge's 610-per-cent premium increase came about after the company's previous contract expired, spokesman Jim Rennie said. "We were exempt from pretty large increases for a couple of years, and this was totally a catch-up when the three-year term expired last year," he said.

Magna and CN Rail also said they had been insulated from price increases with three-year insurance contracts, which have since been replaced by one-year contracts. CN spokesman Mark Hallman said the railway had previously renewed its insurance in September, 2001. "That was just before Enron and the other D&O policy increases," he said.

Still, directors facing big new insurance bills can always comfort themselves with the realization that it could be worse: They could have no insurance at all. Toronto-based Hollinger Inc. reported last year that its insurance had expired and couldn't be renewed following a protracted board battle with former CEO Conrad Black. Hollinger ended up setting aside millions of dollars in a trust fund for directors. The company finally got a new D&O policy but only after it replaced its entire board last summer with new directors.

Mr. Griffiths says it's rare for a company to be unable to get any coverage at all. But sometimes insurance is so expensive that it's essentially unattainable. "If the cost to buy D&O insurance ever gets to the point where it's going to have a material impact on your operating capital, then you're getting pretty close to being uninsurable," he says.

Companies need not be in a crisis to see their insurance rates soar. Even low-risk organizations have faced increases, largely because of the growing number and cost of shareholder lawsuits being filed in the United States. A U.S. study by Cornerstone Research found the total value of securities class action lawsuit settlements reached a record high \$3.5-billion (U.S.) in 2005, up 17 per cent over 2004.

For that reason, Canadian companies with U.S. stock listings routinely pay far higher D&O rates than companies whose shares trade only in Canada. And while D&O premium increases levelled off in 2005, industry officials say they are expecting more increases in the future because claims costs are still climbing.

Mr. Griffiths says prices in Canada are being held down due to an influx of new companies entering the D&O market. "D&O premiums should be increasing, absolutely," he said. "But premium levels are being somewhat held down by the competition."

Despite the rising costs, Mr. Pratzer advises companies not to buy coverage based solely on price. He says it is more important to have adequate insurance to cover not only legal settlements but also legal bills that companies can incur when fighting lawsuits. He urges directors to take the time to learn about features they could add to their policies to protect themselves, notably clauses that prohibit the insurer from cancelling or rescinding coverage. He also recommends a feature that allows the insurer to "sever" any directors involved in wrongdoing while continuing to provide coverage to the rest of the board.

Many directors also protect themselves further by shifting their assets out of their names to ensure they are not at risk from a devastating legal claim, Ms. Hansell says. Directors have often been shy about insisting on more and better D&O insurance because they feel it is a delicate proposition to ask the company to spend huge sums on insurance to protect them against a remote risk, she says. But the risks can be hard to assess, and problems often come out of the blue, she says. "If you talk to directors while they're going through it, they always say, 'If I'd known this, I never would have gone on the board.'"