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**RETURN TO BASICS: D&O LESSONS FROM RECENT
CLAIMS**

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The material in this outline is not intended to provide legal advise as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.

A number of recent large and highly publicized claims against directors and officers provide valuable lessons for others who wish to avoid being subjected to similar claims and the adverse publicity, embarrassment and potentially catastrophic financial consequences resulting therefrom. Ironically, the underlying causes of these claims are not new or exotic. Rather, almost without exception, the subject directors and officers strayed from simple and basic concepts of fiduciary duties, prudent management processes and common sense. It may be tempting to rationalize that in today's highly competitive and sophisticated environment, equally sophisticated new rules of corporate governance should apply. However, just the opposite is true: as a company's affairs become more complex, basic fiduciary duties and corporate governance principles do not change but simply become more important.

The following summarizes numerous D&O lessons which can be gleaned from the recent corporate debacles.

I. D&O LESSONS

- A. Don't Ignore Basic Fiduciary Duties. Directors and officers owe to their company and its shareholders basic fiduciary duties of care and loyalty. Several recent claims primarily involve alleged breaches of the duty of loyalty, which generally precludes directors and officers from engaging in personal conduct that would injure or take advantage of the company. In some instances, officers routinely participated in transactions with the company and otherwise created blatant conflicts of interest with seemingly little regard for their fiduciary duty of loyalty. D&Os should make a renewed commitment to avoid even the appearance of conflicts of interest whenever possible, and should fully disclose and recuse themselves from any truly unavoidable conflicts. In addition, in some cases directors failed to appreciate and respond to the risks and dangers faced by the company (many of which resulted from officer decisions). In fulfillment of their duty of care, directors should thoroughly understand the basic operations and economics of the company and periodically assess the company's strategy and key performance indicators. Management should encourage and directors should raise challenging questions, and directors should insist upon satisfactory answers. The primary responsibility of directors is not to simply approve Board resolutions, but to effectively oversee the business and affairs of the company by probing into all aspects of the company and by exercising healthy skepticism about what is presented.
- B. Investigate Warning Signs. In most instances of corporate financial or operational problems, warning signs are visible to senior management and directors long before the problem fully develops. D&Os should be vigilant in identifying those warning signs and should adequately respond thereto on a timely basis. For example, some of the recent claims involve the company entering into numerous transactions designed for financial reporting purposes rather than economic substance; an excessive number of related-party transactions; and highly complex transactions in which the structure, purpose, terms and effect of the transactions were not understood by some senior managers and the directors. Such activity should be thoroughly investigated and the

transactions should be approved by knowledgeable, informed and truly independent persons based on the advice of qualified outside advisors where appropriate.

- C. Don't Manage to Artificial Indicators. Public companies routinely focus on meeting analysts' expectations and private companies often focus on meeting internal budgets and goals. Meeting these expectations, budgets and goals can become an obsession. As a result, an environment can be created in which personnel at all levels of the company are pressured to do whatever it takes to meet these artificial indicators. Such a mindset unduly emphasizes short-term performance and may encourage deceptive disclosures. Instead, companies should strive to build long-term credibility, and should seek to avoid unreasonable expectations by company constituents.
- D. Don't be Arrogant. Successful managers are frequently tempted to believe they have all the answers and can ignore the input of others. Such arrogance typically leads to disaster sooner or later. Instead, directors and officers should recognize that others may have helpful ideas, perspectives and suggestions and may raise legitimate concerns. An atmosphere of candid and open exchange of views should be fostered. Senior executives should encourage and carefully consider concerns and criticisms expressed by subordinates and should meaningfully respond to inquiries. Directors and officers should not surround themselves with "yes" employees and advisors who are either unwilling or incapable of challenging faulty reasoning or decision-making.
- E. Maintain Reasonable Leverage. Many companies are utilizing ever more complex methods to obtain leverage, including use of various types of complicated derivative instruments and off-balance-sheet financing arrangements. These arrangements present a variety of potentially enormous risk, including credit risk (in the event the other party to the transaction is financially unable or unwilling to honor its obligations), market risk (in the event the price or value of the underlying asset moves in an unexpected direction), valuation risk (in the event the instrument is not properly valued at inception or during the term of the contract), operations risk (caused by inadequate internal controls, deficient procedures, human error, system failure or fraud), and inadequate disclosures (typically resulting in a surprising disclosure to investors and others of large, unexpected losses). Directors and officers should establish policies and limitations on such leveraged transactions and should assure that a specific individual or department within the company (independent from the persons creating or administering the leveraged transactions) is responsible for measuring and reporting risk exposures and compliance with those policies and limitations. "Worst case" scenarios should be anticipated, and decisions to accept leveraged risks should be made with a view towards various possible stress conditions.
- F. Avoid Vague, Confusing or Exaggerated Disclosures. Directors and officers should insist upon full and meaningful disclosures to regulators and company constituents which are truthful and forthright. Clever "spin" or other vague or

confusing communications should not be tolerated. Instead, communications should be plain, easy to understand, and convey the whole truth. Even unsophisticated constituents should be able to readily understand the disclosed information. Bad news should not be understated and good news should not be overstated.

G. Improve Audit Committee Functions. Despite increased accountability of audit committees in recent years, a widespread perception still exists that these committees remain ineffective in many situations. The Sarbanes-Oxley Act of 2002 imposes new requirements on audit committees of public companies. Directors of both public and private companies should consider implementing not just the minimum standards imposed by law. Some suggestions to enhance the committee's effectiveness include the following:

- Audit committees should be composed of only financially literate members who can fully understand and critique the company's financial statements and disclosures.
- Audit committee members should be truly independent from management and the auditors. Business, social or other relationships which may impede the independent thinking and decision-making of committee members should be considered when determining a member's qualifications for service on the audit committee.
- Audit committees should meet regularly and frequently, not just in connection with the annual audit.
- The audit committee, not the CFO, should have full responsibility for the selection, hiring and termination of outside auditors. A periodic turnover of auditors (or at least the partner in charge of the audit) is advisable.
- The audit committee should discuss annual and quarterly financial statements in one-on-one meetings with each of the company's auditors, management and internal accountants and should review any representation letter from management to the auditors and any management letter from the auditors to management.
- The audit committee should adopt and oversee the enforcement of revenue recognition policies within the company and should particularly examine very closely the financial reporting and accounting policies for significant transactions that can materially effect the company's earnings performance for a quarter or year.
- The audit committee should insist upon the highest quality accounting standards, which reflects the true economics of transactions and business operations.

- The audit committee should pre-approve any non-audit services to be performed by the outside auditor. Preferably, the only meaningful business relationship with the outside auditor is the audit.
 - The audit committee should establish procedures to receive, investigate and respond to complaints or confidential information from employees or others relating to the company's accounting or financial controls.
 - In recognition of the increasingly complex and comprehensive responsibilities for the committee, members should be appropriately compensated, which in many instances will require a significant increase in pay.
- H. Encourage Diversification of Employees' Investments. Consistent with sound investment concepts, management should encourage employees to diversify their investments and not include within their investment portfolio an unreasonably large percentage of company stock. Although employees should be encouraged to maintain an ownership interest in the company, thereby aligning their interests with outside investors, an excessive concentration of an employee's investment portfolio in company stock can not only create unnecessary investment risk, but may motivate employees to act inappropriately in order to artificially maintain or increase the company's stock price.
- I. Work with People of High Integrity. Directors and senior management should demonstrate and insist upon a strong commitment to the highest level of legal, moral and ethical conduct. A company's culture of integrity is established primarily through the actions of its leaders. Companies should not tolerate at any level activity which is perceived to be deceptive, manipulative, self-serving or otherwise improper. It only takes one person's illegal conduct to cause enormous harm to the company and to expose numerous other directors and officers to potentially dangerous litigation.
- J. Don't Aggravate Existing Problem. When a significant problem is identified either internally or externally, directors and officers should promptly address the problem through a comprehensive investigation and analysis, through decisive action and through forthright communications. If at all possible, timely and meaningful explanations should be made to investors, employees, other constituents and the public regarding the source and consequences of the problem and the plans to address the problem. Facts and evidence relating to the problem should be preserved for later reference, particularly if investigations or litigation are expected or pending. In addition, directors and officers should avoid the appearance of receiving special treatment either before or after the matter is disclosed. In any event, do not deny the truth, even if the truth seems harmful.

II. D&O INSURANCE IMPLICATIONS

The D&O insurance market is undergoing a significant transformation, largely as a result of the significant increase in large losses arising from problematic claims. The following summarizes some of the ways in which D&O underwriters are and will likely be responding to these recent claims and issues which Insureds should consider in light of recent claim experiences.

- A. Entity Coverage. D&O insurance policies which include coverage for certain claims against the company are more likely to be considered assets of the bankruptcy estate if the company subsequently files bankruptcy. As an asset of the estate, the policy and its proceeds are automatically frozen when the bankruptcy petition is filed. D&Os cannot then access the policy's proceeds to pay defense costs unless and until the bankruptcy court approves such payments. This can result in significant delay in paying defense counsel and necessary experts, thus potentially impeding the ability of the defendant directors and officers to properly defend claims against them. This risk is greatly reduced if the policy does not contain entity coverage. Predetermined allocation can accomplish many of the same benefits as entity coverage without creating this increased bankruptcy risk.
- B. Co-Insurance. In order to better align the interests of the Insureds and the Insurer in negotiating settlements and otherwise defending claims, many Insurers are now requesting co-insurance in the D&O policy, at least with respect to corporate reimbursement coverage. If the policy also contains a predetermined allocation provision, Insureds should fully understand the interrelationship and the cumulative effective of both a co-insurance and predetermined allocation provision in the policy.
- C. Application. Through much of the 1990's soft market, many D&O Insurers were willing to waive the necessity for an Application in the underwriting process, particularly at renewal. Several recent large cases have sensitized Insurers to the importance of meaningful Applications upon which underwriters can rely. As a result, it is likely that Applications will be more routinely required by Insurers in connection with underwriting both an initial and a renewal policy.
- D. Severability. Although severability of the Application has and will remain a common feature of most D&O policies, it is likely that a limited version of severability will become more common. Unlike a "full" severability provision which does not impute the knowledge of any Insured Person to any other Insured Person, more Insurers will likely be utilizing a "limited" severability provision which excepts the knowledge of the person signing the Application. Under such a provision, if the Application signer knows of information which is not truthfully disclosed in the Application, coverage may be lost for all Insureds. As demonstrated by several recent large claims, when the signer of the Application participates in the subject fraud, the D&O Insurer is as much a victim as

shareholders and other third parties, and therefore arguably should be entitled to full release of its obligations under the Policy.

- E. For-Profit Outside Position Coverage. As a consequence of some of the highly publicized recent corporate failings, D&O Insurers will likely be more conscientious about and less willing to afford for-profit outside position coverage. In some respects, this more conservative approach to outside position exposures is consistent with the interests of all Insureds, since this coverage can result in substantial dilution or exhaustion of the Policy's limits of liability due to the wrongdoing of an unrelated company in which an Insured Person serves in an outside position.
- F. Choice of Law Provision. Several recent large claims have demonstrated the significant disparity in relevant insurance law which exists among various states. As a result, many D&O Insurers are now more sensitive to which state law may apply in administering claims under the Policy. That heightened sensitivity may result in some carriers adding to the Policy a choice of law provision which seeks to apply the law of a favorable jurisdiction in connection with the interpretation and enforcement of the Policy.

The foregoing D&O insurance issues are in addition to numerous other policy form amendments which are likely to appear as a consequence of the general tightening of the D&O insurance market. Unlike other hard market terms and conditions, though, the coverage terms discussed above directly result from the recent large claim experience of D&O insurers. Although dramatic increases in D&O insurance premiums appear to be attracting more attention by Insureds, changes in coverage terms and conditions can be far more significant to an Insured in the event of a claim. Therefore, Insureds should understand the reason for and consequence of these changes at the time the policy is purchased.