



INDEPENDENTS' DAY: WHY A GROWING NUMBER OF DIRECTORS ARE SEEKING A DEDICATED LINE OF COVERAGE

By David M. Finz and Jack Flug

We live in an era of unprecedented shareholder litigation and regulatory scrutiny. Some directors are wondering whether service on a company's board is worth the increased risks they now face. Audit committee members of public companies feel particularly vulnerable, since they are now legally responsible for the selection, compensation and oversight of the accounting firms conducting outside audits of the company's internal controls.

Many directors presume that a company's "package" D&O policy will cover them in the event that plaintiffs or regulators pursue the personal assets of board members. Unfortunately, that is not always the case. A policy that is written to cover the corporate entity as well as the directors could be rescinded in the face of an earnings restatement, should the carrier find that the financials submitted with the application contained a material misrepresentation. Equally troubling would be the case where an earnings restatement lands a company in bankruptcy. In such a case, the trustee could argue that the D&O policy should be treated as part of the debtor's estate, thus putting it out of the reach of individual board members because the corporate entity is a named insured.

Consider the following recent cases in which board members were required to tap their personal assets to settle claims:

- ➔ In the settlement of the WorldCom securities litigation, independent directors paid out a total of \$18 million from their personal assets in damages.
- ➔ As part of another high-profile settlement, former Enron directors were compelled to disgorge \$13 million in profits from the sale of stock prior to the company's collapse.

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It bears noting that, in both of these cases, the company's D&O insurance had *not* been exhausted. Nevertheless, directors were made to contribute out of pocket toward settlement. Moreover, in other cases, the financial losses claimed by shareholders have exceeded the limits of the corporation's coverage, putting the personal assets of directors at risk.

Side "A" Coverage – Devil is in the Details

One way to reduce this exposure is for board members to have a dedicated line of liability coverage that is not shared

with the corporate entity, and is non-rescindable in the event of an earnings restatement. This type of policy is commonly known as “Side A” coverage. Even within Side A coverage, however, there are variations in the wording of policies. Directors should check their current policy to see whether it contains a severability clause. This protects innocent directors from liability for the misrepresentations of others in the application for the policy. Otherwise, the director is unprotected if the insurer rescinds the policy. This can happen, for example, in the face of an earnings restatement which calls into question the figures the insurer relied upon when writing the policy.

Another variation is when coverage may attach. Some policies state that coverage attaches to the director any time a company refuses to honor its indemnification commitments (this is a “broad-form/difference in conditions” policy); another, more restrictive version provides that attachment only occurs when there is a court order barring indemnification (for example, in a shareholder derivative suit). One should also consider how many directors are entitled to protection, and the likelihood that multiple claims by directors and officers will exhaust the “aggregate limit” of coverage. Additionally, directors should check to see if the policy’s definition of “claim” includes regulatory and criminal investigations, and whether “loss” includes fines, penalties and punitive damages.

The Case for Independent Director Liability Coverage

An even more specialized policy, sometimes referred to as Independent Director Liability (or “IDL”) coverage,

is gaining popularity as a tool to help audit committee members and other directors manage risk in light of Sarbanes-Oxley and shareholder litigation. Where permissible by law, IDL policies can even be crafted to provide first-dollar coverage, with no retention of risk by the board member. They also typically advance payments to cover costs associated with mounting a director’s legal defense.

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Getting Off on the Right Foot

If your company is undergoing (or recently underwent) an Initial Public Offering (“IPO,”), check whether the D&O Insurance carrier considers damages under Section 11 of the Securities Act of 1933 (which prohibits material misrepresentations within the offering documents), to be a covered loss. Some carriers have asserted that these damages are a form of “restitution” and thus outside the scope of coverage. Nevertheless, there are policies available that are specifically tailored to provide coverage for the risks associated with the IPO process. Depending upon the policy selected, such coverage can be extended to the corporate entity, its directors, officers and even current shareholders who may be selling their interest in the company when it goes public.

Not for Profit, Not to be Overlooked

Directors who serve on the boards of nonprofits need to be certain their policies will cover this activity as well. Do not assume that these boards are safe

havens from litigation and controversy; The Wall Street Journal reported on June 21, 2005 that, while Sarbanes-Oxley does not apply to nonprofits, auditors for these organizations are “clamoring” for use of the same accounting standards in this context. What’s more, Citigroup CEO Charles Prince, who himself serves on the board of a nonprofit, believes officers at nonprofits carry “even more of a burden of responsibility” than corporate executives, since they don’t have shareholders to serve as a “check and balance.”¹

Conclusion

Although today’s business environment does require a heightened state of vigilance, help is available. Board members should avail themselves of independent counsel and other advisers in order to better equip themselves for the role they have undertaken. Audit committee members are specifically entitled to such resources under Sarbanes-Oxley, but all independent directors should consider using them. Together with a comprehensive risk management strategy that puts the needs of the independent director first, board members can continue to focus on serving the companies that appointed them, rather than worrying that in accepting an appointment they have put their own financial well-being at risk.

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¹ Hymowitz, Carol, “In Sarbanes-Oxley Era, Running a Nonprofit Is Only Getting Harder.” The Wall Street Journal, June 21, 2005, at B1.

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