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How to Lose a Director in Ten Days

Sarbanes-Oxley. Shareholder derivative suits. Class actions. With all of the increased risks, it's a wonder more board members aren't jumping ship. Audit committee members on the boards of publicly traded companies are 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.

Still, there are a number of steps a prudent director can take to stay protected in the face of heightened enforcement and investor scrutiny:

Communication: board members need to feel comfortable confronting management when presented with information that calls the reliability of internal controls into question. The availability of independent counsel and other outside experts to audit committee members puts a powerful resource at their disposal, which, to the credit of Congress, is precisely what was contemplated by the Act.

Documentation: an important part of any internal control program is a system of document retention. This is not to suggest that documents should never be destroyed, only that a system that withstands regulatory and judicial review should be put into place. The decision-making process surrounding which types of documents to shred and when to shred them should be consistent, defensible and understandable. It may also be necessary to halt even regularly scheduled document destruction when the company is facing an investigation or lawsuit.

Indemnification, or more precisely, addressing the potential lack of indemnification. 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. However, a policy that is written to cover the corporate entity as well as the directors could be rescinded in the face of an earnings restatement, should the carrier find that the financials submitted with the application contained a material misrepresentation.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.

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. An even more specialized policy, sometimes referred to as “Independent Director Liability” 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.

Although today’s business environment does require a heightened state of vigilance, help is available. Audit committee members can and should avail themselves of the independent counsel and other advisers authorized to them under Sarbanes-Oxley in order to better equip themselves for the role they have undertaken. 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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