# THE DIRECTOR'S GUIDE

# To Liability

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NACD Directorship

# Risks Rising

## An overview of the increasingly contentious climate for D&O liability

By Lawrence Fine and Mark Curley

Directors and officers of American public companies face many substantial risks, not just the risk of their companies' success or failure in the marketplace. Every year, hundreds of directors and officers are sued, most notably in securities-fraud class actions filed by professional plaintiff law firms. For decades, it has seemed every time a company's stock price drops by more than 10 percent in a two-day period, one or more plaintiff firms are likely to bring an action.

For a corporate director or officer, worrying about one's own prospective liability can create an unfortunate distraction from the primary goal of delivering shareholder value. Executives can be further confused and distracted if they pay too much attention each year, when noted consultants and commentators release statistical studies examining fluctuations in filing volume during the previous year, and offering sweeping opinions as to the causes, historical and social significance, and consequences of such statistical fluctuations, however great or small they may be.

### Comfort from Commentators?

For example, commentators famously opined in 2007 that "increased enforcement activity" by the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) resulted not only in "less fraud," but that this downward movement was in fact a "permanent shift." Notwithstanding these optimistic projections, in 2008 the number of securities-fraud class-action filings increased by almost 28 percent to 224, which tied 2002 for a 10-year high. In 2009, the number of discrete filings went back down somewhat to 178, which is still higher than the average volume for the previous five years (174), and once again, commentators seem to be rushing to say that the corporate waters are evidently safe again.

Experience, however, suggests otherwise. Indeed, the only consistent identifiable trend in filing volume over the last couple of decades appears to be that, in general, years in which securities class-action filing volume went down have been followed by years in which the number of filings increased again. As Grace Lamont, the U.S. securities litigation and investigations practice leader for Pricewaterhouse-Coopers, said in an April 1, 2010 press release: "Although 2009 saw a decline in the total number of federal securities class-action lawsuits, neither financial-services firms nor companies in other sectors

should take this as license to drop their guard. Far from being a trend, the decline may simply be a lull as the plaintiffs' bar refocuses following two years of intense financial-crisis-related filings."

More importantly for an individual director or officer, the number of securities-fraud class-action filings in a given year has no logical or identifiable link to the likelihood that a particular company will suffer a securities-fraud class action. If the company experiences a sudden drop in stock price, then the company is likely to be sued.

And not even the most optimistic commentator is predicting that plaintiff lawyers are ever simply going to stop filing cases. To the contrary, in recent years the statistical studies of securities class-action filings, while still important, have become progressively less relevant as a measure of the broadening risks that are being faced by corporate directors and officers today.

### Risk: Competition Among Plaintiffs

The conviction and imprisonment of several of the key leaders of the securities plaintiffs' bar several years ago created a vacuum into which numerous enterprising attorneys have attempted to leap. Plaintiff firms and especially institutional plaintiffs have become more aggressive than ever, making cases harder to settle. Defendants paid $3.8 billion in settlements in 2009, which was up 35 percent from 2008. Plaintiff firms out to make a reputation have proven to be more willing than ever before to call defendants' bluffs and take cases to trial. Unfortunately, plaintiffs have been persistent and had considerable success tapping into current anti-corporate sentiment and winning verdicts in cases against Vivendi, Household Finance, Apollo Group (jury verdict, later reversed on appeal), Charles Conaway, formerly of Kmart (in a suit by the SEC, even though Conaway had previously won a bankruptcy-related arbitration), Gregory Reyes, former CEO of Brocade (convicted for the second time, after his prior conviction was overturned) and Richard Scrushy, formerly of Healthsouth ($2.9-billion judgment in a corporate derivative suit, even though Scrushy had previously won a criminal trial in 2005). With stakes that can run into the billions, a company's only viable strategy may be to pursue settlement and hope its insurers will assist and not impede the process.

### Risk: The Credit Crisis

Although many optimists now speak of the "credit crisis" as if it was a thing of the past, it is important to bear in mind that about 80 percent of the subprime and credit-crisis cases are still pending. About 15 percent of the cases have been dismissed, many without prejudice to re-filing by plaintiffs, and only about 5 percent of the cases have been settled (11 credit-crisis securities class actions have settled for a total of $858.5 million).

Throughout 2009 and into 2010, the effects of the credit crisis spread far beyond the financial sector, and cash flow problems have led to increased bankruptcy filings and related securities-fraud suits. Business bankruptcy filings were up 52 percent for 2009 over 2008. One example of what seems like a knee-jerk response from the plaintiffs' bar involves a company called Idearc. When, arguably as a result of the economic downturn, the company had to write off $47 million in receivables, it filed for bankruptcy protection and experienced a 10b-5 suit for allegedly misrepresenting its credit policies. Other non-financial companies that have recently entered Chapter 11 bankruptcies and seen their directors and officers sued under Rule 10b-5 include MRU, Charter Communications and Nortel Networks. Of course, bankruptcy situations can lead to many other types of claims, including claims by bankruptcy trustees and creditors, as well as suits by laid-off employees.

### Risk: New Suits on Older Stock-Price Drops

Another significant development has been the growing number of recently filed suits against non-financial companies where the proposed class period ended in 2007 and 2008 (e.g., Nokia, CRM Holdings, Stryker Corp., Bidz.com, Liz Claiborne, Coach, Rackable Systems and Sprint Nextel). These cases, which take advantage of the lengthened limitation periods granted by the Sarbanes-Oxley Act of 2002 (SOX), should remind companies that experienced bad news within the last two years that they can't afford to ignore the ongoing potential exposure.

### Risk: Diversity of Securities Litigation

Apart from securities class actions themselves, directors and officers may be faced with other increasingly expensive (and increasingly common) securities-

## D&O Glossary

A.M. BEST RATING
An evaluation published by A.M. Best Co. of all life, property and casualty insurers domiciled in the United States and U.S. branches of foreign property insurer groups active in the United States. The ratings are often used to determine the claims-paying ability, suitability, service record and financial stability of insurance companies. Other rating agencies include Standard & Poor's, Conning & Co., Fitch and Moody's.

COOPERATION CLAUSE
A policy provision compelling the insured to assist an insurer in defending claims under a policy. The rationale behind this provision is that the insured, rather than the insurer, is in a much better position to ascertain certain information about claims that are critical to the defense process.

related litigations, such as corporate derivative suits, merger and acquisition challenges and securities-fraud suits brought individually by large institutional plaintiffs. These actions do not fit directly within the rubric of "securities-fraud class actions," and are thus frequently omitted from the annual reviews and commentary, but they may present significant problems for directors and officers nonetheless.

### Risk: Legislative Efforts

Following the 2008 elections, Congress has been considering legislation that could greatly expand potential liability for companies doing business in the United States, including measures that would override recent specific Supreme Court decisions. One bill would lower pleading standards for all civil litigation, so plaintiffs could more easily survive motions to dismiss and then bludgeon corporate defendants with onerous discovery demands. Another proposed bill would create a civil cause of action for aiding and abetting securities fraud, thus undoing the Supreme Court's *Stoneridge* decision. Each of these measures could drastically increase exposure to directors and officers.

> Although many optimists now speak of the crisis as if it were in the past, 80 percent of subprime cases are still pending.

### Risk: More Vigorous Enforcement

The risks are not limited to private litigation. Directors and officers also must not ignore the recent increases in government enforcement activity at the state and federal levels. This is particularly true as costs involved in responding to government inquiries and proceedings are skyrocketing, partly because the government's efforts can be more unpredictable than private plaintiffs and are not motivated purely by economic incentives.

Areas in which the government has become demonstrably more active over the last year or two include the pursuit of SOX 304 compensation "clawback" claims by the SEC and Foreign Corrupt Practices Act-related enforcements being pushed by the SEC and the DOJ. The SEC's use of SOX 304 (separate and apart from its increased insider trading enforcement efforts) in 2009 included two highly publicized instances in which they sought the return of compensation from executives against whom they had not alleged any personal wrongdoing. Having stepped up their enforcement of SOX 304 in recent years against individuals who were alleged to have been at the heart of stock-options backdating schemes (in suits relating to UnitedHealth, Mercury Interactive, Broadcom, Maxim and others), in 2009 the SEC surprised many observers by suing the CEOs of CSK Auto and Beazer Homes USA, respectively, without even alleging these individuals were aware that the financials they certified had been incorrect.

On the FCPA front, enforcement has reached record levels against both individuals and corporations (40 in 2009: 26 DOJ actions and 14 brought by the SEC; these numbers are up from 2 and 3 respectively in 2004). The SEC is in the process of forming a separate unit dedicated solely to FCPA enforcement. Last year saw three criminal trials against four individuals, all of whom were convicted. This increased governmental enforcement has also resulted in a growing number of related securities-fraud class actions and corporate derivative suits against large multinational companies, including Siemens and Baker Hughes.

### Increased Litigation Risk Abroad

U.S. companies and their foreign divisions and subsidiaries are more exposed than ever abroad, as more and more countries beef up regulation and add class and collective-action litigation statutes. In addition to increased securities regulation exposure, companies and their directors and officers are increasingly exposed to liability and criminal charges from a variety of other types of statutes. This point was recently driven home when the Criminal Court of Milan on February 24, 2010 sentenced three officers of Google to six months in prison for violating Italy's privacy laws. Google's chief legal officer, chief privacy counsel and former CFO were each found guilty of violating Italy's Personal Data Protection Code by allowing the posting of a video showing high school students bullying another student with Down syndrome. In today's "small" world of global commerce and communication, executives in particular need

to be sure that their policies are sufficient to fully protect them from the laws of all potentially relevant jurisdictions. In some countries, effective protection can only be accomplished by locally admitted policies, but fortunately some carriers have practical solutions available.

### Managing Risk

So what should companies, and the management liability insurance-buyers' market in general, take from all of this? First, they should not allow themselves to be complacent where their D&O insurance coverage is concerned. Any D&O policyholder needs to understand the ins-and-outs of their coverage, both the primary policy and any and all excess policies, and especially the potential differences among the terms of these policies. Additionally, and at least as importantly, insureds need to reassure themselves (gathering information from reliable sources with actual relevant experience) that they will be fairly treated by the claims departments of the insurers into whose hands they are entrusting themselves.

As exposures proliferate and potential liabilities continue to grow, it will be more important than ever to have state-of-the-art policies and claims handling. Pursuing commercially sensible resolutions to potential disputes whenever possible is a must—until the rest of the D&O market is up to speed, it's up to the client and the brokers to understand the terms of their policies and to know what to expect from their coverage and their claims service in the event that a significant claim occurs.

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## D&O Glossary

SIDE A COVERAGE
The section of coverage affording "direct" coverage of an organization's directors and officers. This portion of the policy provides direct indemnification to the directors and officers for acts that the corporate organization is not legally required to indemnify the directors and officers.

SIDE A ONLY COVERAGE
A directors and officers liability policy that provides only "direct" coverage of the directors and officers, but does not cover the corporation's legal obligation to indemnify the directors and officers. Side A-only forms are written on either an excess or umbrella basis over a primary D&O policy. When written on an excess basis, they provide additional limits if a claim exhausts the coverage available under the primary form. When written on an umbrella basis, Side A-only policies afford broader coverage than the underlying, primary D&O policy, as well as additional limits.

# Litigation 101: You've Been Sued. Now What?

By Douglas H. Flaum and David Hennes

While serving on a board of directors can be at times prestigious and rewarding, board service is not without potential pitfalls: unanticipated demands on your time; fractious, intractable colleagues; and the possibility–or rather, the likelihood–that you may be named as a defendant in a lawsuit filed by a company shareholder, competitor or acquisition target. In today's litigious climate, these suits are an all-too-common occurrence, and if mismanaged, the financial and reputational consequences can be severe. It is important that directors facing allegations of wrongdoing fight the understandable urge to panic and concentrate instead on formulating a considered and appropriate response, which often begins before the litigation is even filed.

### Preventative Measures

Directors need not, and should not, wait until they are served with a complaint to take steps to mitigate the potential consequences of lawsuits. At a minimum, directors should work with in-house counsel to ensure that corporate matters likely to generate litigation, such as mergers and divestitures, or the sale of stock by corporate insiders, are conducted in a way that limits the ability of potential plaintiffs to assert credible claims. By expressing their views—setting the "tone at the top"—directors can make it known that litigation prevention is an important corporate goal that will, in the long run, save the company expense and reputational damage.

Directors should be advised of the status of the liability insurance (often referred to as a D&O policy) purchased for their benefit and ensure state-of-the-art coverage for the directors is secured. Directors should, at a minimum, insist that their company purchase insurance that provides them with direct coverage for any losses they incur as a result of litigation.

Directors should also review their company's charter and corporate bylaws to ensure that the provisions providing for the indemnification and advancement of legal fees are sufficiently robust. In particular, directors should satisfy themselves that the company's indemnification and advancement provisions are broad and mandatory (to the extent allowed by the law of the state in which their company is incorporated) rather than narrow and permissive: i.e., that they require the company to cover directors' litigation expenses in the widest possible range of circumstances and from an early stage of the suit. This will minimize, and in many cases eliminate, the financial burden directors may otherwise need to bear if they are sued personally.

### When the Lawsuit is Served

The first step directors should take upon finding out that they have been sued is a basic one: notify the appropriate parties. Directors should notify senior management at their company, including the general counsel, so the company can begin planning its response to the lawsuit and make any public disclosure that is required. In order to invoke D&O insurance coverage, directors should ensure that the insurance carrier is notified promptly. It is also important to know whom not to tell: directors should refrain from discussing the suit itself or the claims at issue with anyone other than their counsel. Barring exceptional circumstances, any conversations with non-lawyers about the litigation will not be protected by the attorney-client privilege. Venting to friends or colleagues about the underlying facts can potentially create witnesses who may ultimately be called to testify about the conversation.

A few other basic steps are also in order. First, directors should ask for a detailed memo outlining the pertinent provisions of the applicable D&O insurance and indemnification policies—although directors should already be generally familiar with their terms. Second, directors, working with company counsel, should ensure that they and the company preserve all documents (including emails) that

relate to issues raised in the lawsuit (including copies of documents that they possess personally). Third, depending on the nature of the lawsuit, directors should consider informing any other companies on whose boards they sit. These companies may also need to disclose the lawsuit publicly.

### Obtaining Counsel

The directors' next task is to obtain appropriate legal representation. In most instances, directors will not need to retain counsel independent of the company. The company's outside counsel will be able to represent both the directors and the company, as long as this dual representation does not create a conflict of interest. When there is a conflict—such as when the case is brought derivatively on the company's behalf against the directors—separate counsel may be necessary. If that occurs, the company can assist or even spearhead the directors' search for their own independent counsel, but directors can and should suggest potential candidates and participate actively in the process, including reviewing the backgrounds of potential candidates and participating in interviews.

It will often be in a director's best interest to share representation (and therefore conserve corporate resources) with other director (or officer) defendants, but this depends on the role the director played in the events that gave rise to the litigation and whether the director has defenses that are unique or unavailable to co-defendants. For example, a director may not have attended the board meeting at which the challenged conduct took place, or a co-director may be accused of having a unique pecuniary interest in the challenged conduct; in such circumstances, it might be in the director's interest to be distanced from those directors who were at that meeting or are benefiting from the conduct. Because lawyers cannot pursue a defense strategy on behalf of one client that implicates another client, directors facing such a situation should think seriously about securing independent representation for themselves or for a similarly situated group of defendants.

### Assessing the Claims

Directors should also make sure that they thoroughly understand the nature of the claims so that they can respond to them appropriately. The most common form of claim filed against a director is a suit by a shareholder, and such claims fall into one of two broad categories. Either they are "direct" claims, brought by a group of shareholders who allege that director misconduct has injured them uniquely; or they are "derivative" claims, mentioned previously, such as a claim that directors have wasted or misappropriated corporate assets and thus harmed the company itself. Certain kinds of alleged wrongdoing often generate both direct and derivative lawsuits (such as at companies alleged to have improperly backdated stock options). Shareholders, however, do not determine whether a particular claim is direct or derivative. This question is objective, fact-sensitive and governed by state law.

A fundamental precept of corporate law is that the decision whether to pursue derivative litigation on behalf of a company is a business judgment belonging to the board. This has created a unique set of legal rules and responsibilities for directors. For example, where the claims at issue are derivative, directors may need to investigate and then decide whether the company should pursue the case, or where certain directors may lack independence, directors may need to create a special committee to make this determination. In this situation, the directors as a whole or the special committee will need independent counsel to guide them through this process.

### Stay Involved

Regardless of the type of claim alleged, directors should remain personally involved in the litigation. Directors should not wait passively for infrequent or ad hoc updates on litigation strategy and factual development. Rather, directors should stay abreast of the progress of the litigation and receive regular updates from counsel to ensure that the claims are being dealt with in a way that is measured, minimally disruptive and most likely to achieve a successful result.

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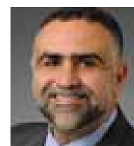

## D&O Glossary

**SIDE B COVERAGE**
Another term for what is known as the "Corporate Reimbursement Coverage" section of a directors and officers liability policy.

**SIDE C COVERAGE**
Another term for what is known as the "Entity Securities Coverage" section of a directors and officers liability policy.

**NOSE COVERAGE**
Claims-made liability policies typically include a retroactive date, and the policy will not cover claims arising from covered occurrences, acts or omissions committed prior to that date. It gets its name from its attachment to the "front" of the policy term, as opposed to its "tail."

**POLICYHOLDER SURPLUS**
The difference between an insurer's admitted assets and liabilities, i.e., its net worth. This figure is used in determining the insurer's financial strength and capacity.

## D&O Glossary

RESERVATION OF RIGHTS
An insurer's notification to an insured that coverage for a claim may not apply. Such notification allows an insurer to investigate (or even defend) a claim to determine if coverage applies (in whole or in part) without waiving its right to later deny coverage based on information revealed by the investigation. Although a reservation of rights protects an insurer's interests, it also alerts an insured to the fact that some elements of a claim may not be covered, thereby allowing the insured to take necessary steps to protect its potentially uninsured interests.

RUNOFF
A provision in a reinsurance contract stating that the reinsurer remains liable for losses under reinsured policies in force on the termination date, that result from occurrences taking place after the termination date.

# The Ultimate Insurance Check List

## Protecting your assets requires prudent questioning

*J. Thomas Presby has done your homework for you. The former chairman of Deloitte & Touche USA compiled this list based on his deep boardroom experience.*

### Strategic

❑ Do I belong on this board?
❑ Do I really want to be associated with this company/management?
❑ Is the company's indemnification clause as good as it can be?
❑ Am I doing everything that a good, diligent director should be doing?
❑ How much D&O is the right amount for this company?
❑ Will asking questions about D&O be considered hostile?

### Technical

❑ Under what circumstances are personal assets exposed?
❑ Are there other "bundled" covers that could drain the D&O coverage away from the directors?
❑ Do I lose coverage when accused of a bad act or only when convicted of a bad act?
❑ Does the Side A coverage include a DIC provision?
❑ When does my D&O policy get triggered?
❑ Will a financial restatement impact the coverage in any way?
❑ Will the coverage be available to the directors in the event of bankruptcy?
❑ What is the quality of the underwriting carriers?
❑ What is my exposure if another director or an officer of the company is accused or convicted of fraud? Is there a severability provision?
❑ What changes in coverage take place when a company files an IPO? Is new coverage required at that time?
❑ Is there coverage for foreign operations?
❑ What is the right deductible?
❑ Does the cover include the right to buy a "tail" if the policy is not renewed?

# The Response to Presby's Questions

Should a director consider board service for a company that does not provide insurance coverage? Most would not consider it for fear that their personal assets would be put at risk. Some believe that the existence of insurance attracts litigation—a subject for a different story—but most directors of public companies today are simply not willing to accept that chance.

To take some of the guesswork out of how the questions developed by J. Thomas Presby should be answered, *NACD Directorship* sat down with Louis Lucullo, an executive vice president in the Executive Liability division at Chartis, for a fast-paced game akin to "Twenty Questions."

Lucullo recommends that before an executive considers joining a board, he or she should review the company's bylaws and an insurance provider should be analyzed for its ability to pay claims.

To assess the quality of the insurance carrier, the best measurable for directors is the policyholder surplus, which for an insurance company is its assets minus liabilities. What needs to be determined is whether the insurer has the wherewithal to sustain future catastrophic losses.

"Too often that's a forgotten analysis by directors," Lucullo says. One way to make such an assessment is to check with ratings agencies such as A.M. Best.

Also find out if the insurer has an effective claims process and a favorable approach to claims resolutions by asking other directors.

***How much D&O insurance is the right amount?*** Typically, either third-party consultants or the insurance broker should detail for the board what their peers typically buy.

The peer group can be based on a company's direct competitors, size of its employee base or market cap. This allows the board to assess its own purchase decision.

***Under what circumstances would a director's personal assets be exposed?*** This is why so-called Side A coverage has become so popular. A feature built into a new insurance product recently launched by Chartis called Executive Edge goes a step further by advancing

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# Avoiding The "F" Word

## How your external auditor can help you avoid internal fraud.

### By Robert Levine

The expression "tone at the top" is well established now and for good reason, as it neatly encapsulates a complex idea into a few common-sense words. In a business sense, tone at the top most often refers to how executive management comports itself with regard to behaviors that affect everything from human resources to marketing messages or from operations to the strategic plan. When it comes to financial reporting, the effect and importance of tone at the top only increases as the ramifications of errors in financial reporting become existential and certainly rise to the level of board issue.

Top management, starting with the CEO, sets the tone and establishes the financial reporting environment. Properly setting the tone at the top of a business sends a clear message, reinforcing management's commitment to integrity and ethical values. Usually these messages communicate downward throughout the enterprise whereas, in fact, when dealing with issues of financial reporting, the possibility of fraud or material misstatements, the messaging of strict adherence to accounting rules and regulations might also emanate directly from the audit committee or the entire board of directors.

There is no point in rehashing the well-known horror stories of Worldcom or Madoff. In fact, so infamous is the Enron case that it was the subject of a Tony Award-nominated musical on Broadway. And it doesn't make sense to explain the Sarbanes-Oxley Act of 2002 (SOX), except to say that SOX was passed to increase confidence in the public's ability to rely on audited financial statements; and that it has increased the audit committee's responsibilities.

Rather, what might be helpful is to take a basic look at the way in which an accounting firm views the meaning of financial fraud in its audits and, significantly, in training audit staff.

What is fraud? In criminal law, fraud is the crime or offense of deliberately deceiving another in order to damage them—usually, to obtain property or services from them unjustly. Fraud is intentional. There are two types of fraud that auditors consider that boards should be aware of: financial-reporting fraud and misappropriation of assets.

Misstatements arising from *fraudulent financial reporting* are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial-statement users. This may be accomplished by manipulation, falsification or alteration of accounting records; misrepresentation in or lack of disclosure of events, transactions or other significant information; or intentional misapplication of accounting principles.

Misstatements arising from *misappropriation of assets* involve the theft of an entity's assets, which impacts a company's financial condition and results of operations and may result in a misstatement in the financial statements. Misappropriation of assets can be accomplished in various ways—embezzling receipts, stealing assets, causing an entity to pay for goods or services that have not been received or causing an entity to make a payment based on conditions that were not truly met.

While it is the auditor's role to take fraud into consideration during the audit of financial statements, it is management's responsibility to design and implement programs and controls to prevent, deter and detect fraud. Understanding the fraud risk factors may be of most value to boards. Fraud risk factors, which are set forth in the Statement on Auditing Standards No. 99 (SAS 99), are conditions that may indicate a greater risk that fraud exists at a company.

Fraud risk factors include incentives and pressures, opportunities and rationalizations or attitudes. For instance, a CEO who owns stock or options and a CFO with a bonus tied to financial targets have *incentive* to help the stock price increase, so he or she can benefit financially. Poor internal controls, accounting subject to estimation and judgment, related-party transactions and financial reporting dominated by one individual create *opportunities* to commit fraud; borrowing revenue from next quarter or waiting until next

## D&O Glossary

SEVERABILITY OF EXCLUSIONS
A term stating that although an exclusion applies to one (or more) insured(s) under a policy, the exclusion does not necessarily apply, and therefore bar coverage, as respects other insureds. Assume that a directors & officers liability policy, excluding coverage for fraudulent and criminal acts, also contains a severability provision that applies to the policy's exclusions. Under these circumstances, the fraudulent actions of one director would not bar coverage for other directors who were not a party to these fraudulent acts (that bar coverage for the director who committed them).

SEVERAL LIABILITY
Liability that may be assigned or apportioned separately to each of a number of liable parties. Distinguishable from, but often paired with, joint liability.

TAIL
Claims from workers compensation and liability exposures in a given period can arise for many years thereafter. The aggregate of such incurred but not reported (IBNR) losses is often called tail liability.

year to write off bad account receivables, justified as "timing differences"is a *rationalization*. This is the way fraud happens—it starts small, with the intention of fixing it next period and it spirals out of control.

Board members today need to know and understand that their companies have effective internal controls in place to help prevent financial fraud from occurring, to identify suspicious reporting activity and to establish clear lines of communication with the firm's auditors and its office of general counsel. An important part of assessing a company's susceptibility to fraud is the consideration of the existence of fraud risk factors. Board members would be well advised to familiarize themselves with specific examples provided in the appendices to SAS 99 and consider them in light of their company's corporate policies, internal control processes, compensation arrangements and business relationships.

Following these simple steps sets a tone that will promote an environment in which accounting rules are followed and the chances of fraud are greatly reduced. D

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## D&O Glossary

TAIL COVERAGE
A claims-made liability policy covers claims made prior to the policy's expiration or cancellation that arise from covered occurrences, acts or omissions committed on or after their retroactive date, if any.

DIFFERENCE IN CONDITION (DIC) INSURANCE
An endorsement to a policy that fills the gaps between a policy provided by the corporation and the director's policy. A DIC endorsement typically states that, to the extent a loss is not covered under the corporation-provided policy, it would be covered under the director's policy on an excess basis.

SOURCE: INTERNATIONAL RISK MANAGEMENT ASSOCIATION (WWW.IRMI.COM)

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defense costs for covered loss when the company fails or refuses to indemnify the executive for any reason. It's important that directors review the order-of-payment clause in a policy to ensure that the corporation is paid *after* the officer and directors in the event of loss.

***Will coverage be available if the company is insolvent?*** " The filing of bankruptcy does not in itself trigger an end to coverage. In fact, the policy should contain as part of the definition of an insured 'the debtor in possession of the named corporation,' which is what the company becomes when bankruptcy protection is filed for," Lucullo explains.

Upon an emergence from bankruptcy, typically there's a change in control that ceases coverage and converts the policy into what is called "runoff" or "tail" and claims have to allege a wrongful act before that date to be considered for coverage.

***What is my exposure in the event another officer is convicted of fraud?*** This question introduces the concept of severability and whether the actions of one adversely affect the actions of another. The conduct exclusions in a D&O policy should be fully severable and should not have an impact on any executive who did not commit any fraud. Directors all share the limit, but new policies have gone out of the way to ensure that individuals are not adversely affecting other directors as much as they used to.

Another feature in Chartis' Executive Edge policy is a claim cooperation clause that also is fully severable. "Part of the requirement when there is a claim against you is that you cooperate," Lucullo says, "and if you didn't cooperate, we would have the right to deny the claim. Now, under this new policy, one's action in not cooperating with the claims investigation does not affect the coverage of others under that policy."

***Does Excess Side A coverage include a DIC provision?*** Excess Side A coverage should always include a Difference in Conditions (DIC) provision, Lucullo says. If the underlying primary policy does not pay the Side A loss, the Excess Side A policy with a DIC feature would, under certain circumstances, drop down and pay the loss.

***Will a financial restatement affect coverage?*** If fraud or criminal conduct is an element of the financial restatement, coverage could be at issue.

Directors should look for Side A non-rescindable coverage—the insurance company cannot rescind A-side coverage, Lucullo explains. It should be obtained on both the A, B, C tower as well as the A-side DIC tower. Directors should also review conduct exclusions, which prevent the insurer from providing coverage in the event of fraud or a criminal act. Those exclusions, he points out, should be fully severable.

If, for example, there is a financial restatement based on fraud, there's potential that a conduct exclusion is applied and insurance is knocked out for those individuals involved in the fraudulent activity. The corporation could also lose coverage based on the actions of certain individuals.

The bottom line is that it's important for directors to understand how their D&O policy works when the actions of another executive are at issue.