Directors and Officers Liability Loss Prevention

Prepared by: Dan A. Bailey, Esq.
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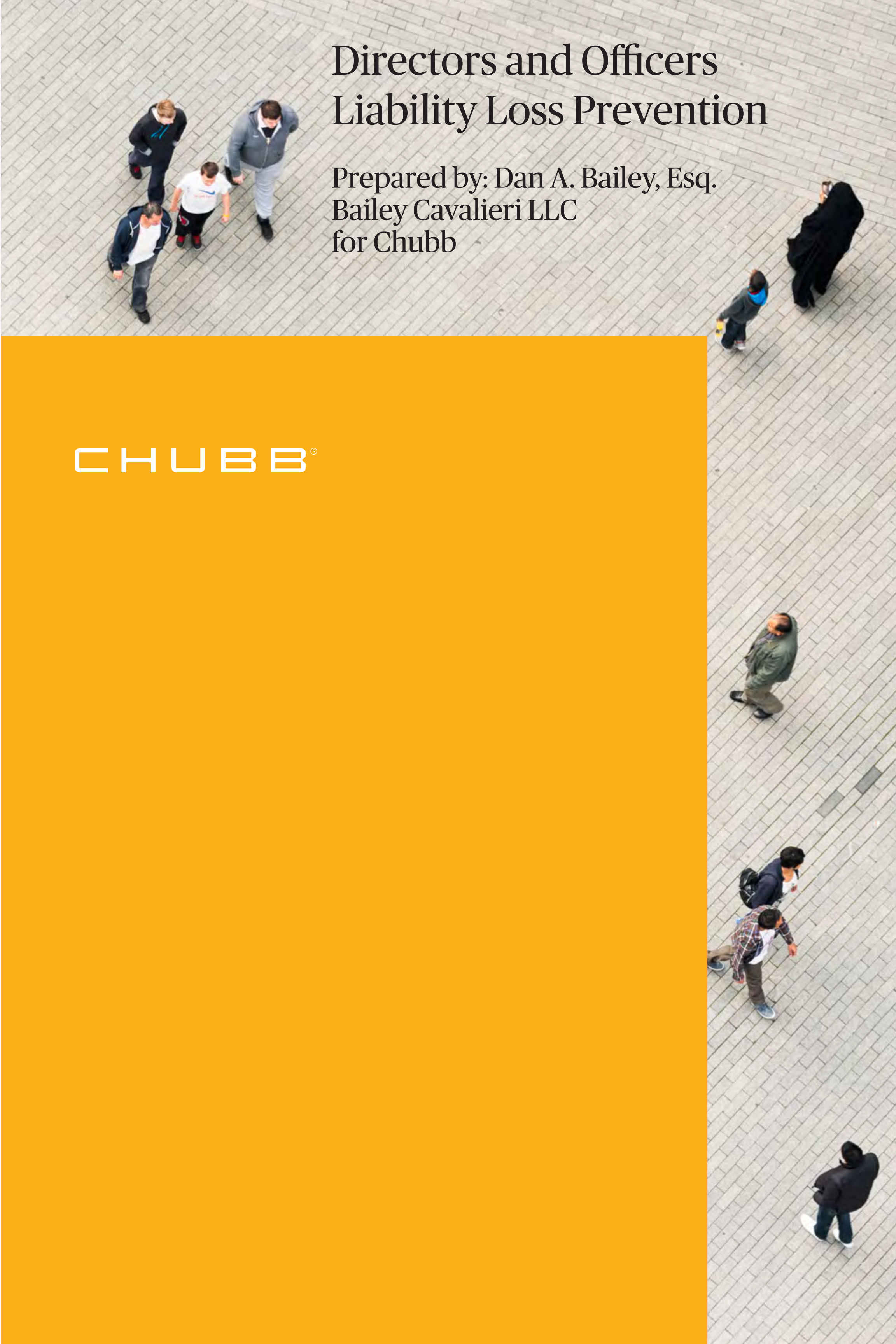
for Chubb



CHUBB®

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Note: The views, information and content expressed herein are those of the author and do not necessarily represent the views of Chubb.

Foreword

Executive liability is a perennial threat for corporations, large and small. In addition to potentially huge litigation damages, expenses, and distractions, exposure fears can inhibit decision-making and result in the loss of significant corporate opportunities. Although a comprehensive executive liability insurance policy will go a long way toward reducing these exposures, today's directors and officers face risks greater than insurance coverage alone can address.

As one of the world's leading writers of directors and officers (D&O) liability insurance, Chubb believes the best risk management strategy combines several techniques, including quality D&O liability insurance, sound corporate governance practices, and expert legal assistance. Chubb asked Dan A. Bailey, Esq., a nationally recognized authority on D&O issues, to prepare this exclusive D&O loss prevention booklet to help business leaders protect themselves and their corporations against claims and litigation. In the pages that follow, Mr. Bailey reviews the basic duties of directors and officers and summarizes many D&O loss control procedures.

We at Chubb hope this book will begin a process of education and guidance for the executives within your organization. It is our intent to help your company develop effective loss prevention strategies, but no booklet is a substitute for expert legal advice. We strongly encourage you to seek competent counsel for specific issues when they arise as you design and implement your organization's loss control procedures.

Introduction

Risk management, or loss control, is a concept well-known to modern corporate management. Most businesses take precautionary measures to minimize the risks associated with fire, theft, product liability, work-related injury, and other common business exposures. Over the past decade, the benefits of a well-designed executive protection risk management plan, once recognized only by larger corporations, have become increasingly apparent to business entities of all types and sizes. In addition to the clear risk reduction benefits, proactive management of D&O exposures can improve a company's ability to recruit talented management, enhance the quality of corporate decision-making, and contain the cost of D&O liability insurance premiums. Occasionally, proven risk reduction techniques may be inconsistent with past corporate procedures, and resistance to implementation can occur. In such cases, outside consultants are available to assist management in evaluating, structuring, or implementing D&O loss control programs specifically tailored to the particular corporation.

The fundamental goal of any D&O loss prevention program is to sensitize the company's executives to the fact that virtually everything they do creates the potential for second-guessing and perhaps for claims by persons adversely affected by the D&O's actions and decisions. Once that mindset exists, the executives will naturally apply commonsense caution, which is the single most important element of any loss control program.

Basic Executive Duties

A director's or officer's duty is to prudently represent the interests of the shareholders, as well as other corporate constituencies, in directing the business and affairs of the corporation within the law.

Corporate governance often requires executives to delicately balance the competing interests of various company constituents. Shareholder concerns need to be kept at the forefront, while the needs, desires, and requirements of employees, customers, lenders, regulators, community groups, and others should also be considered. Directors and officers need not be flawless in their decision-making, but they must fulfill three essential duties while performing their corporate functions:

- **Duty of diligence**—Also called the duty of care, this duty requires executives to act in good faith and consistent with what a reasonably prudent person in a comparable position would do under similar circumstances. Prior to making a business decision, directors and officers need to obtain and consider all material information reasonably available to them. In addition, they should make a reasonable effort to monitor corporate activities.
- **Duty of loyalty**—This duty precludes directors and officers from engaging in personal conduct that would injure or take advantage of the corporation. They should seek to avoid any appearance that they have misused their position of trust for their private interests. Examples of prohibited actions include:
  - Gaining a secret profit or unfair gain through personal transactions with the corporation.
  - Competing against the corporation to its detriment or usurping a corporate opportunity.

  - Profiting from the use of material, non-public corporate information.
  - Making decisions which uniquely benefit family members, friends and business associates.
- **Duty of obedience**—This duty requires directors and officers to conform both their own conduct and the corporation's activities to applicable statutes and the corporate charter. Directors and officers may be liable if they cause a corporate action that is either illegal or ultra vires (i.e., outside a company's authority).

Business Judgment Rule

Even for decisions that may later prove to be mistakes, directors and officers are presumed to have satisfied their basic duties if the Business Judgment Rule (BJR) applies. This important defense protects directors and officers who make informed and disinterested business decisions in good faith. If appropriate procedures are followed, courts will not second-guess the quality or wisdom of the decision. However, the BJR does not apply if no actual business judgment has been exercised, such as where a claim is based on a board of directors' failure to act.

Composition of Board of Directors

Each director should be selected for the sole purpose of maximizing benefit to the company. Where possible, the size and composition of the board of directors should be determined based upon the company's unique circumstances and the following considerations:

Director attributes
The qualities of an effective director include integrity, an inquiring mind, practicality, and mature judgment. A director should have sufficient time and interest to devote the necessary energies to the required job. Also, persons with differing expertise, experiences, backgrounds and perspectives provide valuable diversity to a board's deliberations. The number of other boards on which a prospective director serves should be considered to determine whether the director could realistically commit the necessary time for service on this board. Also, a prospective director's involvement with other companies that do or reasonably could compete with or transact business with the company should be considered to determine the likelihood of that involvement creating conflicts of interest with the company.

Independent directors
To be effective, a board must be independent from management and not merely a "rubber stamp" for officers. Courts frequently recognize a greater presumption of good faith when a majority–or at least a substantial percentage–of a board consists of independent, outside directors. Although various regulations define the characteristics of an independent director, companies should establish specific and conservative standards for determining a director's independence and should set a minimum number or

percentage of independent directors on the board and on certain key committees. For example, the major securities markets require listed companies to have a majority of independent directors on the board and to have only independent directors on key oversight committees such as audit, compensation and nominating/governance.

Size of board

Surveys indicate the average board size of publicly held companies is 9 to 13 members. It is questionable whether larger boards are the most desirable in fulfilling directorial responsibilities in light of the inevitable reluctance that members will have to participate fully in board discussions. Board size should reflect a balance between active engagement by all directors, on one hand, and sufficient diversification and committee staffing, on the other hand.

Self-evaluation

Most boards now conduct periodic self-evaluations, pursuant to which they analyze the overall operation and performance of the board. In addition, many boards also evaluate the performance of individual directors, either periodically or in the context of nominating the director for re-election. Topics addressed by an evaluation of individual directors can include attendance, participation in discussions, quality of contribution and preparedness. Evaluation results should be reviewed by the nominating committee when considering whether to nominate a director for re-election.

Board leadership

Whether designated the board chair or the lead director, an independent director should be selected to provide certain board leadership independent from company management and to facilitate the board's independent

oversight and governance function. For example, this independent director can determine in consultation with the CEO both the agenda for board meetings and appropriate board initiatives, and can serve as a liaison between the board and the CEO.

Education

A company should develop a thorough orientation for new directors and officers and an ongoing education program for all directors and officers.

Directors and officers should be well informed about the company's business lines, its competitive and regulatory environment, and the legal arena in which it operates. Because the factual and legal conditions affecting the company constantly change, the need for education is continual.

Factual education

An orientation as to the facts and operations of the company is particularly important for new directors and officers. Directors and officers may be personally liable for wrongful conduct regardless of how new they are to their positions; therefore, directors and officers should become fully informed, contributing executives as quickly as possible. New directors should become familiar with corporate disclosure documents, such as recent Securities and Exchange Commission (SEC) filings, shareholder reports, and proxy statements. Also helpful in the education process are written descriptions of board committees, biographies of the current directors, management letters from independent auditors, information concerning corporate facilities (including a tour when possible), and a review of the company's outlook with respect to current prospects and problems, critical issues, and long-range objectives.

Legal education

The initial and ongoing education of directors and officers with respect to legal principles must be tailored to the unique set of legal standards applicable to the particular company. Among other things, the standards depend on the type of business, state of incorporation, other locations where it does business, industry in which it competes, and the articles of incorporation and bylaws.

Internal guidelines

The board should ensure proper education of officers and employees. Among other things, directors should develop, publicize, maintain, and enforce appropriate management policy statements defining ethical standards and legal guidelines with respect to various potentially sensitive or misunderstood areas, including:

- Conflicts of interest
- Securities trading, including insider trading and blackout periods
- Antitrust compliance
- Proper accounting and financial integrity
- Bribes and kickbacks
- Political contributions
- Harassment and discrimination
- Misappropriation of corporate assets or opportunity
- Confidentiality of corporate information

The board should develop, with the assistance of legal experts, corporate policy guidelines for these areas. The guidelines should then be circulated to all employees and reinforced through periodic training programs, reminders and informative communications. Senior management should be fully committed to enforcing the corporate policy, regardless of any violator's rank. Each employee, including all new employees, should sign a statement acknowledging and agreeing to the corporate policy. The company should periodically review and update its policy in view of new regulatory developments. Updated material should be redistributed to and recertified by each employee. Such practices may not stop intentional wrongdoers, but they will educate and guide employees on avoiding illegal conduct, and they may prevent the corporation and its directors and officers from being charged with wrongdoing (or at least mitigate the severity of sanctions imposed) when a subordinate employee violates the guidelines.

Board Meetings

Any action taken by directors must be an informed decision based on a thorough, well-documented investigation of all relevant facts reasonably available and applicable law.

The board (not just senior management) should periodically review various procedural practices relating to board meetings, including:

Schedules
Regular attendance at meetings is imperative to keep directors informed and to provide the opportunity for meaningful input into the decision-making process. A

regular meeting schedule, preferably on a yearly basis, should be established, with dates communicated to the directors well in advance. Special meetings should be scheduled to maximize attendance to the extent possible.

Attendance by non-directors
Only directors have a legal right to attend board meetings, but officers, counsel, and others who have been involved in or are knowledgeable about particular matters being considered should also either attend meetings or remain available as needed.

Duration of meetings
Time spent deliberating a decision does not always equate to quality decision-making. Yet time spent in deliberation is an indication of the degree of care exercised by the board, and a full analysis and discussion, particularly for a complex corporate transaction, requires adequate time. Every director should have the full opportunity to question any aspect of an item under consideration.

Presentation of information
Information concerning important matters should be distributed to directors well in advance of the meeting. A detailed agenda, background information, committee minutes, and minutes of the previous board meeting should be distributed one to two weeks in advance. If special circumstances do not permit advance notice, time should be set aside at the meeting for directors to review and understand the information presented.

Preparation for meeting
Each director should critically analyze all available information before a meeting to maximize the time that can be spent on discussing the issues. As a rule, directors should plan on devoting at least two hours of preparation

for each hour of a board meeting.

Conduct of meeting
Board meetings should be conducted in an unbiased manner, encouraging candor, open discussion, and active questioning of management and outside advisors. The goal of board discussion is not simply to reach consensus, but rather to exercise a healthy skepticism and to air different viewpoints. Insiders should never stifle open discussion among the board, since unchallenged reliance upon management's recommendations circumvents the primary purpose of the board. Inevitably, not all directors will agree with all board decisions. In that case, a dissenting director should actually vote against the proposal if he or she wishes to establish a legal defense based on the dissent. Mere abstention is typically viewed by courts as tantamount to approval.

Executive sessions
It is appropriate for the independent directors to meet periodically in executive sessions without officers present to consider sensitive matters which uniquely affect the officers (e.g., performance evaluations; litigation against officers; major change in management; proposed change of control; etc.). To avoid unnecessary concern by management, these executive sessions can be regularly scheduled throughout the year and can be called by the chair or other directors more frequently if needed. Many stock exchanges now require boards of listed companies to have at least one such session each year.

Minutes
An accurate set of minutes of board and committee deliberations is one of the most important (and most frequently neglected) areas of D&O liability loss control. Board minutes should clearly set forth what occurred at

the meeting, including limitations placed on any action taken or authority granted and identification of any conscious decision not to act. Although specific comments or questions typically are not included, the minutes should reflect the topics discussed and evidence a fulsome discussion of each topic. Documents incorporated or attached to the minutes should be clearly identified in the minutes themselves. Each vote's results and the name of any dissenting director should be recorded. Each director should review all minutes to ensure that they accurately document the meeting, including the individual's participation. A director should also review minutes of any meeting not attended. If an absent director subsequently disagrees with actions taken at a meeting, the objection should be put in writing and submitted to the board for the information of the other directors and for filing in the corporate minutes book.

All documents prepared by or relating to directors and officers should be prepared with the expectation that they will be closely scrutinized in the future for evidence of wrongdoing. Imprecise wording, inflammatory or vulgar phrases, and ambiguous language should be avoided. Wording that seems innocent when written may be interpreted quite differently when considered in a different context at a later date.

Delegation of Certain Functions

Although directors may not abrogate their duties, they may rely in good faith on advice or input from board committees, officers, employees, or outside experts.

Board committees
Board committees permit a small number of directors

to perform deeper analysis of a subject that would be impractical for the entire board. Committee appointments should take into account a director's talents or expertise. Rotating directors among committees is an increasingly popular practice and may be advisable. The board should periodically evaluate what committees it should have. Common committees include executive, audit, compensation, and nominating committees. Other possibilities include planning, finance, governance, technology, conflict of interest, and social responsibility committees. The audit committee is the most scrutinized of any board committee, with the SEC and the major stock exchanges now viewing an independent and active audit committee as critical to accurate financial reporting. Key committees, such as audit, compensation and nominating/governance committees, should be composed solely of independent directors.

Management

The board should not engage in direct management of the company. However, the board is responsible for monitoring corporate conduct by ensuring that competent management and adequate policies are in place. Key board functions include evaluating executive management (particularly the Chief Executive Ovfficer) and assuring that clear decision-making procedures are in place. Officers, in turn, have similar responsibilities with respect to their subordinates. Well-defined job descriptions should be approved and then disseminated to all management personnel. The authority and responsibilities of the board and management with regard to each other should be clearly documented and understood.

Reliance
Directors are entitled to rely in good faith upon experts, officers, committees, or agents of the corporation when making board decisions. Several guidelines should be applied when the board relies on experts:

- **Competence**—The expert should be reasonably competent and reputable in the area of advice.
- **Scope**—The advice must be within the scope of expertise.
- **Disinterest**—The expert should not have an interest or stake in the decision being considered by the board.
- **Full disclosure**—All relevant facts known to the directors should be disclosed to the expert.
- **Nature of reliance**—Directors must follow the rendered advice in good faith and with due care.

Legal counsel
The most important risk management advice to directors is rendered by legal counsel. Qualified counsel should be consulted frequently. Advice of counsel not only helps guide directors toward acceptable conduct, but it can also improve the ability to defend their conduct when they act in reliance upon the advice. The board should not feel compelled to use the same counsel for all legal issues, but should seek the most competent counsel reasonably available for the issue under consideration.

Conflict of Interest

Even the appearance of a conflict of interest should be avoided if possible, and disclosed if unavoidable. Directors and officers should avoid situations where their personal interest may, or appears to, conflict with the best interest of the company.

This rule applies both to obvious situations, where the individual has interests on both sides of a transaction, and to more subtle situations. If a director has a close personal, family or business relationship with someone dealing with the company, the director could be challenged on conflict-of-interest grounds. Because conflicts preclude the benefit of the BJR and create fertile ground for liability, directors and officers must remain sensitive towards conflict of interest issues. Identification and treatment of potential conflicts should be incorporated into various corporate procedures.

When a potential conflict exists, that person should fully disclose to vdecision makers all material information regarding the conflict and then remove himself or herself from any discussion and vote on the issue. For example, only outside directors should act on items affecting the inside directors, such as compensation arrangements and employment contracts. Having directors or officers also serving as plan fiduciaries of company employee benefit plans is another potentially dangerous conflict of interest situation. Inherent conflicts of interest can arise when balancing the sometimes-competing interests of the company and plan participants.

Board approval of particularly sensitive transactions which may involve conflicts should be delegated to a special committee of the board composed only of independent and disinterested directors. The committee should have full authority to retain its own advisors and experts and should conduct its investigation and analysis without any involvement or input from officers.

When in doubt as to whether a conflict exists, advice from legal counsel should be obtained.

Special D&O Risks

Securities Law Compliance

Claims under the federal securities laws present the greatest exposure for directors and officers of public companies. If a material upward or downward movement in the company's stock price is perceived to be caused by surprising disclosures, litigation will likely be filed alleging that the company and the responsible directors and officers misled the investing public. Investors who traded in the company's stock during the period the information was allegedly withheld or misrepresented may claim they suffered financial damage to the extent the stock price was different when they traded than what it would have been if proper disclosure of the information had been made.

The goal of the federal securities laws, and thus the goal of a securities law loss prevention program, is to ensure the full, accurate, and timely disclosure of material information. A separate Chubb publication entitled *Directors and Officers Securities Litigation Loss Prevention* identifies in detail various loss prevention concepts in this area, including:

- **Telling the truth**—Although telling the truth appears to be a foregone conclusion, doing so may not be as easy as it sounds. Senior management must establish a corporate culture that clearly and unequivocally mandates only truthful and forthright communication both internally and externally. Communication should be plain, easy to understand, and convey the whole truth, not just a half-truth. Both sophisticated and unsophisticated investors should be able to readily understand the disclosed information.

- **Coordinated team approach**—No one person or department can fully satisfy the securities law disclosure requirements. Rather, an integrated team of outside professionals and representatives from various segments of the company must work together, with each having clearly defined and understood responsibilities regarding when, how, and who identifies and discloses material information. Inadequate internal communication frequently leads to inadequate disclosures to the investing public.
- **Delegation of responsibility**—Although many aspects of the disclosure process are typically delegated to lower management or outside professionals, senior management and, where appropriate, directors should personally review all important securities law filings and disclosure statements and assure themselves that the company has taken reasonable steps to accurately and completely disclose all relevant material information.
- **Detailed disclosures**—The more specific and detailed a disclosure, the more likely it will satisfy investors and the courts. Vague or veiled references to negative information invite false expectations by investors and therefore serve little benefit.
- **Exaggerated disclosures**—Companies should not overly tout good news, nor downplay negative news. The company should resist the temptation to maintain or unduly increase investor confidence at the risk of disclosing misleading information. Appropriate restraint in disclosing good news and openness in

disclosing negative news builds long-term credibility and helps prevent unreasonable expectations.

- **Company spokespersons**—SEC rules against "selective disclosure" (Regulation FD) make it imperative that disclosures be communicated through a relatively small number of clearly identified company spokespersons who are experienced and schooled in investor relations issues. The more people talking on behalf of a company, the greater the chances that important information will be improperly (i.e., selectively) disclosed or that disclosures will be inconsistent or inaccurate. Similarly, the chain of command for approval of written or oral disclosures should be well-defined and relatively short so that decisions can be made quickly if necessary.
- **Listening to internal skeptics**—The disclosure decision makers should not casually ignore skeptics within the company who warn management of actual or potential problems. Their warnings may be correct. In a culture where people are writing memos designed to cover themselves because management refuses to listen, potential "smoking guns" are created for discovery in future litigation.
- **Monitor investment expectations**—A company's disclosures should be based, in part, upon the expectations of investors. If the company detects that those expectations are diverging from reality, appropriate corrective disclosure may be appropriate even if such disclosure is not otherwise required. Timely advance disclosure of potentially troubling information or trends, thus resulting in a gradual decline in stock price, makes the company unattractive as a target of shareholder litigation.
- **Dealing with analysts**—Dealing properly with analysts is one of the most difficult issues under the federal

securities laws. No one set of rules is clearly correct or preferred over another. Therefore, a company, working closely with qualified securities counsel, should devote considerable time and thought to a desirable program for that company under the circumstances and then aggressively implement, monitor, and enforce that program.

When possible, the company should refuse to review draft reports from analysts. If the company feels compelled to review draft reports, the company should standardize the review process to minimize the risk that the company will be seen as "ratifying" the report. It is particularly helpful to avoid contact with analysts shortly before a material announcement by the company. In any event, all communications should be carefully documented.

- **Insider trading**—The corporation should distribute to all appropriate employees a policy statement informing employees of their obligation to safeguard information and instructing them not to trade on the basis of material, non-public information. Many companies also implement a "blackout" period—usually immediately preceding the quarterly earnings announcement or other important disclosure—during which a defined group of insiders may not buy or sell company securities. Even if all blacked-out executives are not aware of the soon-to-be-released information, such a policy avoids transactions that create an appearance of insider trading.

Employment Practices

Employment-related claims represent a high-visibility, fast-growing area of D&O liability. The rules in this area are not always intuitive and are sometimes contrary to how some companies historically would have liked to handle employment-related matters. A separate

Chubb publication entitled Employment Practices Loss Prevention Guidelines summarizes various specific loss prevention concepts in this area.

As a general rule, senior management has two key roles in connection with employment practices liability issues:

1. It must set the tone of an enlightened employer by establishing and enforcing guidelines and policies to protect against all forms of discrimination, including harassment, by retaining well-informed human resources professionals and by conducting regular educational programs designed to sensitize all supervisors to the rules that govern hiring, firing, and coexisting in today's workplace environment.
2. Having set the tone, senior management must personally comply with the established standards and should monitor policy compliance, authorize vigorous investigations where necessary, make accommodations where appropriate, and take meaningful remedial steps, even if senior officers are involved.

The most important deterrent to employment claims is a proactive, well- staffed, quality human resources department. The primary responsibility of that department should be to create and maintain legally sufficient and consistent practices with respect to every aspect of the employment relationship.

Mergers and Acquisitions
Directors of a company that becomes a target of an actual or proposed merger or acquisition are especially vulnerable to claims of wrongdoing whether they approve or reject the transaction. Effective loss control practices can reduce the potential exposure to those claims, but will not prevent the claims from being made.

A separate Chubb publication entitled *Director Liability Loss Prevention in Mergers and Acquisitions* identifies various loss prevention concepts for directors of a target company when evaluating, negotiating, approving, rejecting or disclosing a proposed M&A transaction. The following summarizes some of the more important concepts.

- **Informed decision**—Directors should create a record demonstrating that they carefully and thoroughly considered relevant information regarding the proposed transaction and then made an informed decision.
- **Reliance on experts**—Directors should obtain and document advice from experienced, qualified and independent experts regarding the relevant legal and financial issues.
- **Independent directors**—To avoid the appearance of conflicts of interests, only independent and disinterested outside directors should investigate, evaluate, negotiate and approve the transaction.
- **Strategic alignment**—Directors should evaluate the extent to which the transaction is consistent with the company's defined long-term strategic plan and creates value for the company's constituents.
- **Seek best value**—Directors should confirm that any recommended transaction creates the best value reasonably available for the company, taking into consideration for example other actual or potential bids, the financial and no-financial terms of the transaction, the likely impact of the transaction on the company and its various constituents, and relevant information about the acquirer. Conducting a market check to determine if another preferred transaction is available can be helpful protection for directors, but may not be necessary in all circumstances.

- **Disclosures**—Directors should understand and approve the timing and content of public disclosures relating to a potential acquisition. Either premature or delinquent public disclosures, or inadequate or misleading disclosures, can create significant liability exposures.

Cyber Risks
As with any other major risk exposure, directors should confirm that reasonable steps are taken to identify, prevent, mitigate, and respond to cyber-related problems when they arise. However, because of the potentially severe nature of this risk, the directors' oversight role in this area should be particularly robust and is far from easy. A separate Chubb publication entitled *Cyber Loss Mitigation for Directors* identifies a number of specific practices and strategies that directors can follow to manage cyber risk.

There are two distinct timeframes that should be considered when identifying directors' loss prevention practices in this context.

- First, prior to a cyber incident occurring, directors should implement and oversee various initiatives that can reduce the likelihood of a cyber incident and the harm it may cause.
- Second, directors should understand and approve a comprehensive response plan for the company in the

event a cyber incident occurs.

Lessons From Claims

The following summarizes various lessons that can be gleaned from recent D&O liability claims.

Measure company performance
Directors should agree on and monitor a limited number of key performance criteria which indicate not only the company's financial performance, but also its fulfillment of strategic goals. Because the selected metrics will heavily influence management's focus and performance, the board should carefully consider which metrics should and should not be included in the "dashboard" which is regularly presented to the board.

Investigate warning signs
Usually, financial or operational warning signs are visible to senior management and directors long before a problem fully develops. Directors and officers should be vigilant in identifying those warning signs and should adequately respond on a timely basis. Types of early warning signs include unrealistic strong company performance, unusual management turnover, 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 are not understood by some senior managers and the directors. Any "red-flag" should be thoroughly investigated, and directors should insist upon information and rational explanations for their concerns.

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 targets can become an obsession, and personnel at all levels of the company can feel pressured to do whatever it takes to create the desired performance. Such a mindset unduly emphasizes short-term performance and may encourage deceptive conduct.

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.

Manage risk
Some company risks are desirable because they enable profitable initiatives, but other risks are unnecessary and should be minimized. A comprehensive enterprise risk management (ERM) program should be maintained, which focuses on the company's financial, reputational, operational and strategic risks. Far more than purchasing insurance and implementing routine loss prevention, an ERM program should seek to identify, quantify and manage those risks and to align business decisions with

approved risk tolerances. The directors should approve and monitor the program, and a senior chief risk officer should implement and oversee the program.

Prepare for management succession
A company is most vulnerable immediately following an unexpected departure or loss of its CEO. One of the most important functions of the CEO and the board is to maintain an effective senior management succession plan which continually identifies, nurtures and evaluates new senior management candidates and which defines an interim leader if the CEO is suddenly no longer in office or capable of functioning. This succession planning not only protects against a leadership void, but also eliminates a possible barrier to the board removing the incumbent CEO.

Maintain effective internal controls
Although companies routinely have internal control procedures, those procedures are not necessarily effective. An internal control program should impose real constraints on employee behavior in appropriate areas and should be widely understood and enforced. The board's audit committee should receive regular reports regarding enforcement of the internal controls, including metrics reflecting the number and type of corrective actions taken in various areas, so that directors can monitor whether the internal controls are sufficiently robust and effective.

Maintain effective compliance program
A wide-ranging program which addresses compliance by the company and its employees with legal and regulatory requirements can reduce many of the company's greatest risks, reduce the severity of claims and penalties, and enhance company performance. Both directors and senior officers have important roles with respect to (i) establishing and approving a comprehensive compliance

program, (ii) providing and overseeing meaningful training and education for all employees, (iii) creating a simple internal reporting system which encourages employees to report inappropriate behavior, (iv) audit and monitor the program's effectiveness, and (v) respond to identified deficiencies in the program.

Work with people of high integrity
Directors and senior management should demonstrate and insist on 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 activity that 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.

Don't aggravate an 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, decisive action, and 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 plans to address the problem. Facts and evidence relating to the problem should be preserved for later reference, particularly if an investigation or litigation is 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.

Be prepared
No company is immune from crisis, so companies should adopt and implement, with the support of directors, crisis management programs designed to assure a coordinated and effective company-wide response to a crisis, such as a natural disaster, terrorist activities or other violent incident, cyber intrusion, discovery of fraud, major negative publicity situations or unexpected senior management absence. The program should describe communication and decision-making protocols, provide backup resources and procedures for continued business operations, and identify preferred external advisors for the crisis, among other things. The quality of a company's response to a crisis is directly related to the thoughtful preparation by directors and officers.

Maximize Legal Protections

Companies should take necessary steps to provide a legal environment consistent with maximizing protection to directors and officers.

Indemnification
The internal indemnification provisions of the company should be reviewed periodically to assure that they provide the maximum protection permitted by law. The articles of incorporation or bylaws should require (not just permit) the company to indemnify current and former directors and officers to the full extent permitted by law. The indemnification language should also require the advancement of defense expenses, subject only to an unsecured obligation to repay the expenses if a court subsequently determines that indemnification is not permitted. If a company has subsidiaries or employee benefit plans, the indemnification provision can state

that any person who serves as a director or officer of the subsidiary or as a trustee of the employee benefit plan is serving at the request of the parent company, thereby obligating the parent company to indemnify those persons in those outside positions. Various other provisions relating to contractual rights, burden of proof, appeal, and retroactivity can be included to provide extraordinary indemnification protection for the directors and officers.

Statutory limitation of liability

Virtually all states have laws that permit the corporation to limit or eliminate certain types of director (and in some instances officer) liability. Many of these laws require amendment of the corporation's articles or bylaws to authorize the liability restriction. The charter amendment should limit liability to the full extent permitted by state law and provide that any repeal or modification of that amendment will not adversely affect the limitation of liability otherwise applicable to any conduct occurring prior to modification.

D&O liability insurance

A corporation is legally permitted to indemnify its directors and officers for certain liabilities arising out of their corporate activities. However, corporate indemnification is not, by itself, adequate financial protection for directors and officers because indemnification may not be available for the following reasons:

- The conduct of the director or officer may not satisfy the necessary statutory standard for indemnification.
- The corporation may not have sufficient available cash flow to pay the losses and expenses incurred by its directors and officers.

- Applicable law or the corporation's internal indemnification provisions may be modified to limit or prohibit the expected indemnification.
- The composition or attitude of the board may change so that it is no longer sympathetic to, and does not authorize indemnification for, a prior director or officer.
- Some claims may not be legally indemnifiable. For example, settlements and judgments in derivative suits are not indemnifiable in many states, and violations of the federal securities laws may not be indemnifiable under public policy.

D&O liability insurance responds in varying degrees to each of these non-indemnifiable exposures and therefore is an essential component of a company's financial protection program for directors and officers.

Standard D&O liability insurance policies serve two purposes. First, they protect directors and officers against non-indemnified loss, thereby protecting the personal assets of the directors and officers when no other financial protection is available. Second, they protect the company's balance sheet by insuring the company's obligation to indemnify its directors and officers and by insuring securities claims against publicly-held companies.

When structuring its D&O insurance program, a company should define the relative importance of these two purposes, which can conflict with each other. For example, broader coverage for the company can dilute the available coverage for the directors and officers. To maximize the scope, quality and amount of coverage for directors and officers, most companies purchase both standard D&O insurance policies described above and so-called Side A insurance policies which only cover D&O losses not indemnified by the company. Those Side A policies usually are excess of the company's standard D&O policies and provide valuable additional personal asset protection for directors and officers because the coverage is exceptionally broad, cannot be diluted by company losses, and drops down to fill coverage gaps in the underlying standard D&O policies. Side A policies can be purchased to protect all directors and officers of the company or only the independent directors.

D&O liability insurance policies are somewhat unique in nature and create complex legal, underwriting, and management issues, which are difficult to identify and analyze without the assistance of knowledgeable experts. That analysis should include not only the structure and terms of the insurance program, but also the financial strength, claims-handling reputation, experience and long-term commitment of the insurer to this product.

Document Control

Companies should adopt a thoughtful document control program in order to prevent the destruction of important documents or the retention of harmful documents. A document control program should define the procedures for retaining documents relating to the corporation and actions of the board, including financial and legal documents, personnel records, and other files of the corporation. Procedures for periodic review of documents to determine whether they are to be retained or destroyed should be established to conform to state laws and evidentiary rules.

Legal Audit
Some corporations use a “legal audit” to inspect and evaluate legal structure, litigation, potential claims, and internal policies and procedures. Risk management techniques, including indemnification provisions and D&O liability insurance, can be reviewed for scope and adequacy. In addition to identifying potential problem areas, a legal audit also emphasizes to all participants the necessity for compliance with all legal requirements at all times and the importance of preventive planning

Conclusion

Superior corporate governance occurs only if a company-wide commitment to excellence and discipline exists. Board members and senior officers must be ever mindful that their job is to serve the interests of the corporation and its various constituencies. Executive decisions should be thoughtful, informed, made by disinterested persons, and fully documented. When appropriate, outside expertise should be sought.

Good corporate governance is good business. Although an investment of time, energy, and resources is necessary to achieve an exemplary corporate governance program, the tangible and intangible rewards from a successful program will far exceed that modest investment.

About the Author

Dan A. Bailey, Esq., a partner in the Columbus, Ohio, office of the Bailey Cavalieri LLC law firm, is one of the nation's foremost experts on matters relating to D&O liability, litigation, and insurance. He and his firm have represented or served as a consultant to a wide variety of directors and officers, corporations, insurance companies, insurance brokers, and law firms around the country regarding D&O matters.

Mr. Bailey is the co-author (with William E. Knepper) of *Liability of Corporate Officers and Directors* (8th edition, 2015), which is a leading treatise on D&O liability and insurance, has authored dozens of articles and other publications on the subject, and is a frequent speaker at seminars throughout the country regarding governance issues.

Mr. Bailey received his B.S. degree in Business Administration cum laude from Bowling Green State University in 1975 and was awarded a Juris Doctorate degree with honors from the Ohio State University School of Law in 1978. He is a member of numerous honoraries and was selected for inclusion in *Who's Who in America*.


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