



# Loss Prevention Guidelines for Independent Directors

*from Chubb*





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## **LOSS PREVENTION GUIDELINES FOR INDEPENDENT DIRECTORS**

*This discussion of possible loss prevention strategies is presented for general information only and does not constitute legal advice or opinions. This booklet should not be used as a substitute for legal advice from qualified experts. In many respects, use of and reliance upon qualified legal counsel can be the single most important loss prevention practice in this area.*

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## INTRODUCTION

Now more than ever, companies are demanding strong leadership from qualified, intelligent, and dedicated “independent” or “outside” directors. In today’s post-Enron era, independent directors are expected to diligently perform a wide variety of tasks, including strategic planning, CEO nurturing, financial and operations oversight, and legal compliance. The Sarbanes-Oxley Act of 2002 and the continuing stream of increasingly expensive shareholder claims against directors and officers confirm that the financial and reputational risks to independent directors have never been greater.

As a result, individuals who contemplate service as independent directors for publicly traded and privately held companies, as well as not-for-profit organizations, are insisting on information concerning preventive measures, defensive tactics, and financial protection. This booklet provides some perspectives on the expanding roles and increasing importance of independent directors and provides guidance on good corporate governance and best practices.

Although most of the content of this booklet focuses on independent directors who serve on the boards of publicly owned companies, much of the material is equally applicable to independent directors of privately held companies and not-for-profit organizations. It is important to understand that independent directors of all types of organizations face numerous liability exposures, any of which can threaten their personal assets.

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## ROLE OF THE INDEPENDENT DIRECTOR

The major securities markets require that a majority of the directors of all listed companies be independent and require that key oversight committees (such as audit, compensation, and nomination/governance committees) be composed solely of independent directors.

The underlying rationale behind the use of independent directors is that including outsiders in corporate decision making provides an effective mechanism to monitor the actions of management, to prevent abuses of power, and to provide a more balanced perspective on important corporate issues. The use of independent directors also broadens the experience base of a company's governing body.

These benefits can be achieved in a number of ways.

### *Providing a Different Perspective*

Independent directors often bring a fresh perspective to issues and are able to identify problems and suggest solutions that management might simply be too close to see. This works especially well when a company is able to retain an expert in a field that complements the business of the company or otherwise augments the level of industry experience available to the company. Quality independent directors will, the theory goes, be free to bring this perspective to bear on the issues of the company without the inherent taint of personal interests, especially with regard to financial matters between inside directors and the company.

### *Monitoring Management Activities*

For public companies, shareholders rely on independent directors to watch out for their interests. Although this responsibility does not necessarily mean that independent directors must be hostile toward management, it can result in friction between the independent directors and management. This may occur in a variety of contexts, ranging from situations in which management resists action that, in the opinion of the independent director, would be

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beneficial to the company, to events in which the independent director questions the judgment or integrity of the company's management.

### *Independently Approving Certain Board Actions*

Under general corporate law principles, a company's directors owe a duty of loyalty. This duty requires directors to conduct themselves for the benefit of the company and its stockholders. The converse of this principle is that directors may not take actions that would be detrimental to the company for the purpose of conferring a personal benefit on themselves, their family members, or their business associates. This does not, however, mean that directors can never have any direct business dealings with the companies they serve. It does mean that such related-party transactions should not be approved by a director who stands on both sides of the transaction. Even if the director is of such high character as to negotiate on behalf of the company against his or her own personal interests, such a situation would be too susceptible to question and almost certain to be challenged. In these sensitive situations, independent directors can perform an important role. A special committee of independent directors can negotiate and approve such transactions on behalf of the company, provided that its members are sufficiently independent from the directors whose interests are adverse to the company. A benefit to following this process is that it raises the confidence level of shareholders and outside constituents if impartial persons approve the transaction. Certain beneficial presumptions are also available under state law when such a process is followed.

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## SELECTION OF INDEPENDENT DIRECTORS

The desired benefits of including independent directors on a board of directors will be realized only if truly independent, committed, and appropriately experienced individuals are selected.

### *Qualitative Independence*

Independent directors should be free of perceived impediments to independent thought and action. The types of relationships identified by the major securities markets as being presumptively inconsistent with a director's independence include those in which:

- The director has a material business or professional relationship with the company or one of its affiliates.
- An executive officer of the company serves on the compensation committee of another company that employs the director.
- The director has a current or recent affiliation with the company's external auditor.
- An immediate family member of the director has any of the foregoing relationships.

Courts frequently apply even harsher standards to determine a director's independence, frequently examining not only business but also social and personal relationships.

Avoid appointing directors who have prior personal relationships—as well as direct or indirect business, financial, and family connections—with management.

### *Commitment*

To be effective, an independent director should have sufficient time and a genuine interest in serving a company. A person who serves on an excessive number of boards, particularly if he or she also serves in a senior

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management position with a company, will be unable to fully perform the duties and provide the benefits expected of independent directors.

### *Experience*

Selection of independent directors should be based in part on needed skills—skills that best complement the qualifications of other directors in light of the company’s current challenges and strategic vision. A diverse board composed of people with different backgrounds, education, experiences, and perspectives is far more effective than a homogenous board. Each director position constitutes a valuable asset of the company, so the director selection process should seek to maximize the value of that asset.

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## INDEPENDENT DIRECTOR SERVICE ON BOARD COMMITTEES

Independent directors play important roles on many board committees, particularly those that have a direct effect on the company's management. Use of these committees, though, does not relieve other directors from their general oversight responsibilities for the issues addressed by the committees. It is important to know that even directors who are not members of a committee have general oversight responsibilities for issues addressed by the committee. Non-committee members of the board can rely on committee recommendations only if that reliance is reasonable under the circumstances (after appropriate inquiry) and in good faith. Following is a discussion of certain board committees on which independent director participation is essential and, depending on applicable statutory or stock exchange requirements, may be mandatory.

### *Audit Committee*

The audit committee is specifically charged with overseeing the process by which a public company prepares and publishes its financial reports. This includes monitoring the firm's financial disclosure controls and auditing processes, as well as actively reviewing its financial statements. At least annually, the audit committee is required to prepare a written report describing its responsibilities and performance. For publicly traded companies, this report must be submitted to the entire board and included in the company's annual report filed with the Securities and Exchange Commission (SEC).

Audit committee members should discuss a variety of issues with the independent auditors, including use of off-balance-sheet transactions, application of the company's critical accounting policies, adequacy of the company's internal controls and accounting systems, and whether the financial statements present a true and complete picture of the company's financial condition. The audit committee must focus not only on the company's financial and accounting functions but also on the qualities

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and conduct of the independent auditors. The audit committee must be confident that the auditors have the independence and the professional competence to handle the responsibilities of being the company's independent auditors.

The Sarbanes-Oxley Act placed new responsibilities on public company audit committees. The audit committee must be composed solely of independent directors and is responsible for appointing the company's certified public accountants, compensating them, and overseeing their work. It must also establish procedures for receiving, processing, and retaining complaints received by the company concerning accounting controls or auditing issues and provide for the confidential submission of complaints by the company's employees. To help meet these responsibilities, the committee must also have the authority to engage independent advisors, such as legal counsel and accounting advisors, and the resources to pay for them.

The audit committee also has primary responsibility for oversight of the internal audit function. The committee should ensure that: qualified and independent-minded persons serve as internal auditors; the internal audit process is structured to promote operational independence; appropriate lines of communication exist between the internal auditors, management, and audit committee; and an environment exists in which internal auditors can express concerns to the audit committee without fear of management retribution.

### *Nominating Committee*

The nominating committee has the responsibility to nominate qualified individuals for board service and to appoint members and chairpersons of the various committees of the board. Members should review the performance of incumbent directors to determine whether their service justifies their renomination for continued service. They should also conduct searches and evaluations for potential new directors. To prevent inside directors from "stacking the deck" with outside directors favorable to them, the nominating committee should be composed entirely of independent

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directors.

Some of the more important functions of the nominating committee include the following:

- Establish or recommend to the board criteria for identifying appropriate director candidates.
- Periodically identify skills and experiences that the board possesses, lacks, or needs to strengthen in light of the company's circumstances at that time.
- Consider the desirability of term limits or a mandatory retirement age.
- Recruit, evaluate, and approve/recommend director nominees, including both re-electing incumbents and identifying new candidates.
- Recommend board committee chairs and members.

### *Compensation Committee*

Executive compensation is critical to a company's success because it plays a central role in attracting, retaining, and motivating management. Perceived abuses and excesses in executive compensation in recent years have resulted in unprecedented focus on and disclosure of compensation issues.

Through the compensation committee, independent directors must balance the competing interests of executives and shareholders by establishing an executive compensation program that is both fair and appropriate in light of the company's economics, and also sufficient to attract, retain, and motivate quality managers. Frequently, the committee should utilize compensation consultants and other experts to assist in understanding market conditions and evaluating compensation alternatives. In addition to establishing the compensation and benefits for the CEO and other senior executives, the

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compensation committee should oversee the company's overall compensation structure, philosophy, and programs.

### *Qualified Legal Compliance Committee*

Some public companies may choose to establish a qualified legal compliance committee in accordance with new SEC rules. This committee must include at least one member of a company's audit committee and at least two other independent directors. The committee should be charged, among other things, with the responsibility to receive, evaluate, and, if necessary, investigate allegations of material violations reported to the committee by the company's outside legal counsel or any of its directors, officers, or employees.

### *Corporate Governance Committee*

A growing number of boards are forming corporate governance committees to address and oversee corporate governance issues. Responsibilities can include creating and periodically reviewing a formal governance policy that defines the framework for the company's governance (including the responsibilities of the board, management, directors, and committees; director selection criteria; meeting procedures; independence requirements and the like); arranging director orientation and training; conducting board, committee, and director evaluations; and overseeing CEO and senior management succession planning.

### *Special Committees*

From time to time, a company may wish to establish a special committee for a specific purpose. In some instances, a special committee may be charged with negotiating a transaction on behalf of the company in which one or more officers or other directors have a material interest. In other situations, the special committee may be responsible for approving a business combination, such as a merger or other change of control, in order to avoid the appearance that management is putting its own interests above the

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company's. The actions of and the approval by such a committee can have significant advantages to the company, as well as to the board of directors.

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## THE INCREASING IMPORTANCE OF INDEPENDENT DIRECTORS

Over the past 30 years, companies have significantly increased the number and improved the quality and role of independent directors. That trend is likely to continue because the focus on independent directors has never been greater. In addition to statutory and regulatory requirements for independent directors, several rating services and publications now rank the quality of corporate boards based in large part on the number and quality of independent directors. Clearly, legislatures, regulators, courts, shareholders, and the public at large all expect independent directors to play an important role in establishing trust and confidence in the quality and credibility of corporate governance.

In response to these heightened expectations, some of the most important board responsibilities today include:

- Monitoring the company's performance in light of its operating, financial, and other significant corporate plans, strategies, and objectives, and approving major changes in plans and strategies.
- Selecting the CEO, setting goals for the CEO and other senior executives, evaluating and establishing their compensation, and making changes when appropriate.
- Developing, approving, and implementing succession plans for the CEO and top senior executives.
- Understanding the company's risk profile and reviewing and overseeing risk management programs.
- Understanding the company's financial statements and monitoring the adequacy of its financial and other internal controls as well as its disclosure controls and procedures.
- Establishing and monitoring effective compliance systems and policies for ethical conduct.

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## RECRUITING AND RETAINING INDEPENDENT DIRECTORS

Although the presence of independent directors can enhance the overall performance of any company, both public and private, America's public companies in particular must find ways to address the increased need for independent directors along with the increased responsibilities and risks that go hand in hand with such service.

First and foremost, companies should nominate only top-quality individuals for director service. Independent directors should have relevant industry or other business experience, and they should serve on public boards for the *right* reasons. They should understand the important role they play in the governance of the company and be committed to spending the time and attention necessary to faithfully discharge those obligations.

To incentivize qualified persons to serve in this important but potentially dangerous role, companies should evaluate and, if necessary, revise their practices in the following areas:

- Implementing corporate governance best practices.
- Providing equitable compensation for outside director services.
- Maximizing financial protections for independent directors.

Working together, independent directors and companies can take steps (many of which are summarized on the following pages) to create a climate that invites top-notch business leaders to serve as independent directors. In pursuit of this goal, companies can, of course, take advantage of expert advice available from attorneys, accountants, and consultants with experience in corporate governance matters.

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## **CORPORATE GOVERNANCE BEST PRACTICES**

The best way to reduce risk exposure is to ensure consistently high-quality performance. Many available resources recommend various corporate governance “best practices.” However, the individual circumstances of a particular company will define which practices are best for that company. A company should consider using a qualified consultant or legal counsel to bring fresh ideas and an independent perspective to the task of tailoring a corporate governance policy that is most appropriate for that company. Some companies now have a chief governance officer (CGO), whose responsibilities include evaluating and implementing governance “best practices” and educating directors about governance issues.

### *Educate Directors*

Directors should be sufficiently knowledgeable to properly discharge their duties to the company and its shareholders. Formal education programs should not be limited merely to specific issues under consideration by the board. A comprehensive director orientation program should include factual, legal, and financial information concerning the company, as well as the company’s industry and market. Ongoing educational programs should offer insight into current developments in all those areas and constantly sensitize directors to potential conflicts between the interests of directors on one hand and of shareholders on the other. Methods for dealing with and resolving conflicts should be agreed upon and understood by both the board and senior management.

### *Adopt Procedures for Effective Meetings*

Meeting procedures should ensure that the board and its committees address the appropriate topics, conduct an open dialogue, make informed decisions, and appropriately document discrepancies and the outcomes of meetings. Independent directors should be allowed to set the schedules, frequency, duration, and locations of meetings; amend meeting agendas; determine the type, quality, and format of information provided to the

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board and committee before and at meetings; and invite appropriate senior management to meetings. During meetings, directors should resist the temptation to promptly move through agenda items and instead take sufficient time to thoroughly discuss, debate, and challenge submitted recommendations. To help accomplish these goals, the board should consider the election of an independent director as chairperson, or at least the designation of a lead independent director. Such a separation of responsibilities between the CEO and independent directors can enhance the objectivity and functionality of the board.

### *Hold Executive Sessions without Management Present*

Independent directors should regularly meet without management present. The major securities markets require periodic executive sessions, and many boards now include time for an executive session at every board meeting. Management should support and encourage such meetings as a means to attain a high-quality governance process.

These sessions can provide a forum for non-management directors to raise ideas or issues they may otherwise be reluctant to bring up with management present, to share candid views about management's performance, to discuss whether board operations are satisfactory, and to raise potentially sensitive issues regarding specific executives. Following each session, the director who leads the session should brief the CEO on the discussion and any requested action. Detailed minutes of the executive session are typically not kept because formal action is usually not taken and such minutes may discourage a candid discussion.

### *Become Informed*

Directors should be provided with detailed materials before board and committee meetings. Although all directors should spend the necessary time to review and study these materials, it is vitally important for independent directors to do so. Independent directors do not have the day-to-day knowledge of the workings of the company that insiders have. Independents need to be prepared to actively engage in a discussion of

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the issues surrounding board proposals. They should not merely listen passively to reports and meekly approve management initiatives. A director most effectively contributes to the governance of a company when he or she is informed and can engage in debates, exchange ideas, and suggest alternatives. Both formal and informal information channels should exist among directors and between the directors and management. To be most effective, this process needs to be openly embraced and fully supported by the CEO. When information is lacking, directors should insist on additional information and delay any decisions until the directors are fully informed. If repeated requests by a director for information are ignored, the director should consider resigning.

### *Play the Skeptic*

One of the primary roles of a director is to exercise healthy skepticism toward management reports and recommendations. A director should challenge management and be willing to disagree. If answers are not sufficiently complete or satisfactory, the director should push for more information. If the director does not understand something, he or she needs to investigate.

### *Investigate Warning Signs*

In many instances, alarming company disclosures are preceded by warning signs visible to senior management and directors. Independent directors should be especially vigilant in looking for and addressing warning signs. Investigating troubling reports or inconsistent information is vitally important, and independent directors should demand adequate responses to their inquiries on a timely basis. For example, independent directors should be wary if the company appears to be entering into a number of transactions merely to gain advantages in its financial reports. Of course, related-party transactions should always be carefully scrutinized. However, if there appears to be a sharp increase or unusual frequency in such transactions, then the independent directors should inquire whether this is indicative of larger troubles at the company. Likewise, directors should be vigilant if members

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of management propose a number of highly complex transactions in which the structure, purpose, terms, and effect are not easily explained nor clearly understood by management or the board. Such activities should be thoroughly investigated, and these transactions should be approved, if at all, only by knowledgeable, informed, and truly independent directors who have received an accurate presentation of the information and the advice, when available and appropriate, of qualified outside advisers.

Even absent red flags, directors should be sure the company maintains procedures that are appropriately designed to identify and manage business risks and comply with laws and corporate policies.

When a significant problem is identified, the independent directors should make certain that the board as a whole promptly addresses the problem through a comprehensive investigation and analysis, with candid communications during and after the investigation. If necessary, the board should take decisive action that addresses the matter head-on. If possible, timely and meaningful explanations should be made to investors, employees, other constituents, and the public regarding the source and consequences of the problem and the plans to address the problem. Facts and evidence relating to the problem should be preserved for later reference, particularly if an investigation or a lawsuit seems likely or is pending. In addition, directors and officers should avoid the appearance of receiving special treatment, either before or after the matter is disclosed. For this reason, it may be easier for the independents on the board to determine when board action appears unduly favorable to the company's management and to suggest alternatives to avoid such perceptions.

### *Take Advantage of Advisors*

Directors can and should rely on the advice of qualified advisors when making decisions. That reliance is strong evidence of a careful and thorough decision-making process. However, directors have the ultimate responsibility for their decisions and should not blindly follow advice without probing its veracity.

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A company's board of directors, as well as its individual committees, should have the authority and the resources to retain outside advisors when necessary to provide advice regarding legal, accounting, industry, or other matters. In fact, public companies must provide this authority to their audit committees under the provisions of the Sarbanes-Oxley Act. Even if separate advisors are not necessary, almost all public companies have established relationships with professionals who routinely provide advice. When evaluating the company's performance or considering proposed board action, directors should take full advantage of the expert advice available from these sources. Independent directors should especially take notice of the views of these professionals, who can provide a perspective on issues separate from that held by the company's insiders. Particular notice should be taken in the event these views differ significantly from those of the company's management. Furthermore, independent directors should take notice of and document the advice given by these special advisors, especially if the board takes action in reliance upon their recommendations.

Of course, independent directors should be particularly mindful when it appears that experts who serve at the will of, or who have special relationships with, the company's management may be providing advice that is perceived to affect management. There may also be situations in which the advisor is clearly representing the interests of the company as a whole rather than, for example, the audit committee in particular. In some circumstances, it will be advisable for the independent directors to have separate advisors precisely because these interests diverge. For example, when approving the annual audit of the company's financial statements, it may be important to obtain advice from a financial advisor different from the company's regular auditors. Separate representation is also important if the liability of independent directors is different from or greater than the liability of the other directors, such as when the independents are being asked to approve a transaction between the company and one of its executive officers. In these situations, it may be crucial for independent directors to have their own advisors to protect their interests and to provide a truly unbiased perspective on the matter at hand.

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## *Create a Record*

In the event an action of the board is challenged, the records kept by the board and by individual directors could become very important. The official minutes of meetings and a director's personal notes are potentially discoverable during the course of litigation. For this reason, each director should carefully review the minutes of meetings before approving them. All reports and records the board reviews during meetings should be noted, as well as the nature of the debate and discussion of corporate proposals. Board action is often challenged based on the allegation that the directors did not fulfill their "duty of care." Directors fulfill this duty by taking the time and devoting the attention to compile and review the information necessary to make informed decisions. Carelessly rubber-stamping bare-bone minutes that merely set forth the resolutions the board approved will be of little help if the board is called on to demonstrate that it fulfilled this duty of care.

Of course, any record can be used against a company and its directors in the context of a lawsuit. So although it is important to create a clear and informative record, minutes should not attempt to capture verbatim the entire discussions of the board nor should they randomly capture comments from directors during the course of debate. Instead, they should generally reflect the subjects discussed at the meeting and any information provided to the directors for review (whether provided before or at the time of the meeting), as well as indicate the general nature of the discussion and analysis of the board leading up to the action ultimately taken by the directors.

Likewise, director notes can demonstrate how an individual director met his or her individual duty of care by evidencing the effort the director took in reviewing information, preparing for meetings, and participating in discussions. Although personal notes can be useful in some instances, they can be problematic if they contain comments that could be construed to support a plaintiff's claim. Unless the notes are carefully drafted, the potential harm from their retention frequently outweighs the potential benefits.

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The company's general counsel or outside counsel can provide assistance in how to prepare comprehensive minutes or keep appropriate notes. This issue also can be addressed in the company's formal director education programs.

### *Demand Integrity*

The board should insist on the highest level of ethical behavior throughout the company. Directors and senior management should demonstrate 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. One person's illegal conduct can cause enormous harm to a company and expose otherwise innocent directors and officers to potential litigation.

If an independent director is not confident in the integrity of senior executives, either the director or the executives should leave the company. A policy of zero tolerance for questionable behavior should be implemented and enforced at all levels of the company. For example, in many of the most highly publicized corporate scandals, officers routinely participated in company transactions with seemingly little regard for its best interests. Independent directors must implement sufficient policies and procedures to prevent officers from misdirecting corporate funds and resources for their own personal benefit, to the detriment of the company and its true owners, the stockholders. The board should develop and oversee the implementation and enforcement of the company's code of business conduct and ethics, as well as "whistleblower" procedures. The code or similar policies should address, among other things, particularly sensitive topics that present challenges in light of the company's unique circumstances.

### *Manage Risks*

The board or an appropriate committee should oversee the company's risk management function and should establish parameters for the company's risk/reward decisions. For example, directors should receive periodic reports describing and assessing the company's financial, industry, and other

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important risks, as well as the company's program for managing those risks. Areas that frequently have specific risk management programs include crisis management, information technology security, insurance arrangements, compliance programs, plant security, confidential information protection, and intellectual property.

### *Ensure Legal Compliance*

Directors should periodically satisfy themselves that an appropriate process is in place to encourage compliance with legal requirements and to detect material legal deficiencies. Formal written policies approved by the board should be distributed to employees, enforced, and monitored for effectiveness.

Examples of corporate compliance policies relate to: anti-discrimination and employment laws; environmental, health, and safety laws; anti-bribery laws; antitrust and competition laws; securities laws, including insider trading laws; and business conduct codes.

An effective legal compliance program includes whistleblower or hotline policies that encourage employees to report questionable conduct to an independent person or committee without fear of retaliation. A robust legal compliance program not only reduces the chance of having legal violations, but also may reduce the consequences to the company in the event of a violation.

### *Measure Company Performance*

The board, and particularly independent directors, should devise ways to monitor the company's financial and nonfinancial performance, particularly in comparison to stated goals. Directors need to resist the temptation to primarily evaluate company performance by artificial external indicators, such as stock price performance or securities analysts' ratings. Various nonfinancial criteria—such as quality improvements, intellectual capital, customer satisfaction, and the like—can be vitally important to a company's

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progress. The board should agree on and monitor certain critical metrics to measure progress and identify areas that may need improvement.

### *Preserve One's Independence*

Directors are labeled “independent” under many different standards, including standards set by the SEC, the New York Stock Exchange, the NASD, and even state corporation laws. A comparison of these standards reveals a variety of actions that may be permitted under one set of rules while prohibited under another. Given these inconsistencies, independent directors should avoid any situation that may suggest the director has stronger loyalties to an individual officer than to the company and its stockholders.

Once a director has been identified as “independent,” he or she is likely to be placed in situations in which losing that status could have serious consequences. For example, if the independence of a director serving on a public company’s audit committee is challenged, the company may inadvertently violate the federal securities laws because the audit committee was not composed entirely of independent directors. Similarly, under state law, a company may lose the protections it wanted to achieve if a transaction that it thought was approved by a group of independent directors is tainted because a director’s independence is called into question.

In general, independent directors should take great care to remain strictly disinterested and removed from any direct or indirect dealings with the company and its executive officers, their related business affiliates, and their friends and family members. Although taking the high road may not be strictly required by law or regulation, independent directors and the companies they serve will benefit from preserving and protecting the independent status of the men and women who serve on the board.

### *Evaluate the Company's Document Retention Program*

As a result of the Sarbanes-Oxley Act, which impacts publicly held companies, the federal government now specifically prohibits the intentional

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destruction of documents or other records in an effort to prevent, obstruct, or otherwise interfere with a government investigation or other official proceeding. Compliance with a preestablished document retention plan may be useful evidence to support an affirmative defense against a charge of document destruction. Directors should review their company's current document retention program or, if none exists, push for the creation of one. The following key points should be kept in mind when creating and maintaining a records retention policy:

- The policy should be applied uniformly.
- There must be legitimate reasons for the policy and a rationale for the way documents are slated for destruction.
- The policy should take into account any administrative or regulatory record-keeping requirements.
- The policy should not be adopted in bad faith or with the primary purpose to avoid preserving potential evidence.
- If a document is slated for destruction in accordance with company policy at a time when litigation related to the subject of the document is reasonably foreseeable, the document should be preserved. Adequate safeguards should be in place so that an executive or general counsel can quickly notify the department or individual overseeing the records retention policy of the need to preserve records that may otherwise be slated for the shredder.

### *Review the Company's Internal Control Procedures*

A company's internal accounting controls should operate to ensure that financial transactions are executed in accordance with company policy and by individuals with the requisite authority to enter into such transactions. They should occur in such a way as to provide the proper documentation to account for the company's assets and to permit preparation of financial statements in accordance with generally accepted accounting principles. The Sarbanes-Oxley Act requires quarterly review of a company's internal control

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procedures. In fact, the CEO and CFO must certify to this fact every time the company files an annual or quarterly report with the SEC. Accordingly, independent directors may wish to retain the services of an outside auditor to perform an audit of the company's specific controls. An audit would provide the CEO and CFO with an extra level of comfort as they certify to the adequacy of these internal controls, and obtaining an audit demonstrates the board's involvement in and commitment to sound financial accounting procedures. However, once the board has received the audit report, it will be difficult for the board to ignore any suggestions contained in the report, no matter how onerous, time-consuming, or expensive those recommendations may be.

### *Conduct Periodic Board Evaluation*

Directors of public companies are required by the major securities markets to evaluate the effectiveness of boards and each of their committees at least annually. Many boards use a written questionnaire, the responses to which can serve as the basis for a discussion. For example, board and committee meeting procedures should be evaluated regularly, and specific suggestions for improvement should be made. The frequency and duration of meetings, the timeliness and quality of information available to directors, and the depth of board discussions should be considered to ensure that adequate and timely attention is being given to the company's affairs.

The evaluation of each director's performance is not required but can be equally valuable. In most companies, almost every employee is reviewed at least annually, but that evaluation exercise is frequently not extended to members of the company's board of directors. Directors should consider conducting regular evaluations of the performance of individual directors. It is not realistic to expect improved director performance unless areas of improvement are identified through critical self-assessment. Although the nominating committee should evaluate a director's performance before nominating the director for reelection, more frequent evaluations can address performance concerns in a more timely manner.

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For a review process to be successful, the independent directors should control it, the board should embrace it in a collegial manner, and the results should be confidential within the board. The precise methodology can vary depending on the personalities and unique circumstances of each board, but a few resistant directors should not be allowed to veto the use of an effective evaluation process.

### *Plan for CEO Succession and Senior Management Development*

Independent directors should have primary responsibility for instituting a CEO succession plan and management development guidelines. One of the most vulnerable times for a company is when the CEO position is vacant for an extended period. A preapproved plan by the board that can easily be executed in the event of a CEO's sudden departure can greatly minimize any risk. In addition, such a plan can allow the board to discharge the CEO when necessary without the fear that the company could temporarily be without effective leadership.

In addition, the development of talented managers at lower levels is critically important and should be reviewed periodically by the independent directors. Both succession planning and management development should be continuous processes, designed to reflect the changing needs of the company.

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## FAIRLY COMPENSATE OUTSIDE DIRECTORS

Outside directors need to be fairly compensated for the time and attention they devote to the company, particularly in light of the increased responsibilities these individuals bear when serving on a publicly traded company board. SEC rules specifically allow companies to compensate directors not only for general board service, but also for specific service as members or chairs of board committees, without compromising their independent status.

As the risks for independent directors increase, the rewards for such service should also increase. The preferred form of director compensation (that is, securities rather than money) can be fairly debated. Equity compensation better aligns the directors' interests with shareholders' and the long-term interests of the company, but it also allows plaintiffs in litigation to allege the directors manipulated the stock price for personal gain. To better incentivize good director behavior through economic risks, some companies also require directors to purchase a minimum amount of company stock in the open market.

Regardless of the form of compensation, it is clear that in today's climate, more than ever, directors should be meaningfully paid in proportion to their contribution to the company. For example, independent directors serving on a company's audit committee almost inevitably end up putting in greater amounts of time and attention, as well as being exposed to greater risks of claims, than directors who do not have demanding committee responsibilities. As a result, these directors should receive compensation commensurate with the level of their service.

Directors have an unavoidable conflict of interest in setting their own compensation. But that conflict does not necessarily mean directors act improperly when determining their compensation. Directors should be informed when making that decision and should approve compensation arrangements that are fair and reasonable in light of what peer companies have and what the company's unique circumstances are.

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## MAXIMIZE FINANCIAL PROTECTIONS FOR INDEPENDENT DIRECTORS

### *Indemnification Protection*

The first line of financial protection for independent directors is indemnification from their companies. Although all companies are permitted to indemnify their directors and officers for certain types of loss, companies are generally required to indemnify their directors and officers only as provided in bylaws or certificates of incorporation. Therefore, a company's internal indemnification provisions should be periodically reviewed in the light of applicable state law to assure that they provide the maximum protection permitted by law. Suggested provisions to maximize a director's indemnification rights include the following:

- The certificate of incorporation or bylaws should require indemnification rather than merely permit the company to indemnify.
- The provisions should provide for indemnification to the full extent permitted by law.
- The provisions should require the advancement of defense expenses, subject only to an unsecured obligation to repay the expenses if a court subsequently does not permit indemnification.
- In the event of a dispute regarding indemnification, the provisions may shift the burden to the company to prove that the director is not entitled to the requested indemnification.
- The provisions may require the company to reimburse the director for any expenses incurred in a claim by the director against the company to enforce his or her indemnification rights if the director is successful in recovering indemnification in whole or in part from the company.
- The provisions may provide that, if the company denies indemnification, the director has a right to an appeal or an independent *de novo* determination as to indemnification entitlement.

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- The provisions may expressly state that the indemnification rights constitute a contract, are intended to be retroactive to events occurring prior to their adoption, and shall continue to exist after the rescission or restrictive modification of the provisions with respect to events occurring prior to that rescission or modification. Alternatively, a separate indemnification contract could be executed by the company and the director.
  
  - The provisions may state that any director who serves a subsidiary of the company, or any employee benefit plan of the company or such subsidiary, is deemed to be providing that service at the request of the company, thereby allowing the company to indemnify the director for service with the subsidiary or employee benefit plan.

To ensure adequate funding for any indemnification claim, the company may secure its indemnification obligation by establishing a reserve fund or trust or by purchasing a surety bond, a letter of credit, or another similar financial instrument.

### *Quality Directors and Officers (D&O) Liability Insurance Coverage*

It is more critical than ever that companies maintain adequate insurance for its officers and, more important, for its independent directors. It is difficult to imagine why a sophisticated businessperson would be willing to assume the escalating risks inherent in being a director today without such insurance protection.

Corporate indemnification is generally considered, by itself, inadequate protection against director liability because, among other reasons, indemnification may not be available for the following reasons:

- The company may become insolvent or may not have sufficient cash flow to pay the liability losses and defense expenses incurred by the directors. This gap in indemnification protection can arise not only with respect to a parent company that files bankruptcy or incurs financial hardship, but also with respect to an insolvent subsidiary of a healthy

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parent company. When evaluating this risk, one needs to assess the company's likely financial strength for five to six years in the future because the ability to indemnify is based on the financial condition of the company at the time the loss is incurred and a lawsuit may not be settled for several years.

- Because of public policy considerations and statutory limitations, some claims may be insurable but not indemnifiable. For example, settlements and judgments in shareholder derivative suits are not indemnifiable in many states, and loss arising from an actual violation of federal securities laws (as well as certain other laws intended to deter wrongdoing) may not be indemnifiable, although such items may be insured.
- A defendant director's conduct may not satisfy the indemnification standards but may be covered by insurance.
- The composition or attitude of the company's board of directors may change so that the board is no longer sympathetic to a prior director and thus does not make the necessary determinations to authorize the indemnification.
- Either the applicable law or the company's internal indemnification provisions may be modified to limit or prohibit the expected indemnification.

D&O liability insurance from a financially secure insurer typically responds to each of these non-indemnified situations, thereby providing financial protection for directors. Historically, D&O liability insurance policies covered directors and officers for non-indemnified losses as well as the company, to the extent that it indemnifies its directors and officers for losses incurred as a result of claims against those directors and officers. Beginning in the mid-1990s, D&O liability insurance policies began adding a third type of coverage, which insures securities claims made against the company itself.

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In response to the need to maximize quality insurance coverage for directors and officers, several insurance companies offer a “Side A” D&O liability insurance policy, which insures only director and officer losses that are not indemnified by the company. The limits of liability under such a policy are not eroded by losses incurred or indemnified by the company. A Side A policy frequently provides much broader coverage than a standard D&O liability policy and, unlike many standard D&O policies, will likely be accessible even if the company files bankruptcy.

To provide even greater insurance protection for independent directors, several insurers now offer a Side A policy that insures only outside directors (not officers or other employees) for non-indemnified loss. This type of policy typically contains even more coverage enhancements than a standard Side A policy. In addition, by insuring only independent directors, coverage under the policy is not diluted by losses incurred by officers or the company. This type of policy can be structured to insure only one individual for his or her service on multiple boards, or it can insure all of one company’s independent directors.

Yet another type of Side A policy now available from some insurers is a retired director policy, which covers non-indemnified claims made against a retired director for up to six years after the director leaves office. This type of policy affords protection to the retired director regardless of what type of D&O liability insurance program the company maintains after the director retires, regardless of subsequent developments in the D&O insurance market and the company’s future financial stability or insurability.

A Side A policy typically is in excess of the company’s standard D&O liability insurance program and contains a “difference-in-conditions” (DIC) feature that requires the Side A policy to drop down and fill any gaps in coverage in the underlying standard D&O insurance program to the extent the Side A policy affords broader coverage than the underlying policies.

One or a combination of these different types of D&O liability insurance policies, together with a broad company indemnification provision, can give

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outside directors reasonable confidence that the risk to their personal assets is minimized, thereby inducing the best available people to serve in the important role of independent director.

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## CONCLUSION

Independent directors today operate under a microscope. More is expected of them than ever before, and shareholders, employees, competitors, the government, the media, and others are watching them and their decisions closely under the light of the Sarbanes-Oxley Act. Understanding the scrutiny under which they work, independent directors must take every precaution to protect themselves. Two of the most important steps they can take are to follow principles of good corporate governance and ensure broad financial protection through comprehensive internal indemnification provisions and solid D&O liability insurance coverage. By not taking these steps and otherwise following the guidelines presented in this booklet, an independent director may be inviting financial and reputational disaster. On the other hand, putting this booklet's suggestions into practice can go a long way toward safeguarding an independent director from calamity, allowing him or her to concentrate on the important job of overseeing the business of the organization.

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## ABOUT THE AUTHOR

Dan A. Bailey, Esq., a member of the Columbus, Ohio, law firm Bailey Cavalieri LLC, 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 consultant to a wide variety of directors and officers, companies, insurance companies, insurance brokers, and law firms around the country regarding D&O matters.

A frequent speaker at seminars regarding D&O liability and insurance, Mr. Bailey is also the coauthor (with William E. Knepper) of *Liability of Corporate Officers and Directors* (7th edition, 2002), and he has written dozens of articles on the subject.

Mr. Bailey received his B.S. degree in business administration cum laude from Bowling Green State University in 1975 and was awarded a Juris Doctor degree with honors from the Ohio State University College 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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