SEYFARTH SHAW
MANAGEMENT ALERT

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Is It Still Safe To Be An Independent Director?

At Seyfarth Shaw LLP, we pay particular attention to legal developments affecting corporate Board members. Of particular interest is a recent Delaware appellate court decision involving the Walt Disney Company. Independent directors have always taken comfort in the "business judgment rule" which says that if directors were loyal, careful, well informed and made decisions based on advice from legal counsel, investment bankers and other experts, they would be protected from liability. The Delaware court in *Disney* may have raised the bar by implying that its board could not rely on the business judgment rule if the directors exercised "no judgment" or if they failed to make a good faith attempt to fulfill their fiduciary duties. The directors in *Disney* had relied on a compensation expert who later admitted that he had failed to calculate the cost of a severance package. The Disney directors are still on trial.

You may have read recently about 11 former WorldCom directors personally agreeing to settle a case against them and others and to contribute $20 million out of their own pockets to settle a case against the bankrupt WorldCom and its directors. In addition, the last former WorldCom member recently agreed to pay $4.5 million out of his own pocket to settle the same claim. One of the plaintiffs, a New York state pension fund, had wanted the directors to be held accountable personally. In the *Enron* case, ten of Enron's former directors have agreed to personally pay a total of $13 million to the plaintiffs to settle the securities class action. Those headlines have gotten the attention of independent directors everywhere.

The *WorldCom* and *Enron* cases were based on unusual facts involving allegations of fraud and bankrupt companies. However, many companies are facing accounting restatements or other issues which lead to shareholder lawsuits against companies and their boards and denials by insurance companies of D&O insurance coverage because of fraudulent applications or for other reasons. Prior to the *WorldCom* and *Enron* cases, most directors only wanted to know if they were indemnified, if their company had appropriate D&O insurance and the limits of that coverage. Now, they must know new concepts like "incontestability", "noncancelable", "Side A coverage" and "severability."

Over the past three years, insurance companies have sharply increased premiums for traditional D&O insurance, which typically insures officers and directors as well as the company itself. This increase has caused a number of public companies to provide less than adequate liability insurance for its directors. Management at some companies have decided they simply cannot afford to insure directors at levels that would protect them from liability likely to be assessed in the event of a successful shareholders' lawsuit. As a result, a number of large public companies have had independent board members resign because the companies had failed to provide them with adequate liability insurance. Increasingly anxious board members have also seen insurers narrow the scope of coverage of D&O insurance policies by limiting the types of insured events, removing entity coverage for the corporation, lowering total coverage amounts and increasing retentions.

While it is still safe to serve on a corporate Board, it is now critical for directors to exercise good business judgment, be active, thorough and attentive, and seek out and base decisions on the advice of the outside experts. Do not be shy about retaining outside experts when you deem it to be appropriate. The Sarbanes-Oxley Act permits independent directors to hire outside experts at company expense.

In addition, appreciating the changed landscape for independent directors, insurance companies are responding with new insurance products designed to protect the independent director even when exclusions or competing claims under the company's traditional D&O policy would curtail coverage or make it unavailable. These policies are designed to protect the individual board member as an excess policy over the company's existing D&O coverage. Depending on the policy structure purchased, the policy would "drop down" and go into effect if the company's D&O coverage becomes unavailable for one or more of the following reasons:

- The company's D&O coverage has been rescinded for all directors and officers by virtue of the conduct of one or a few individual directors or officers, including conduct warranting a rescission or the breach of a non-severable warranty;
- The company's D&O policy was rescinded because of a restatement of earnings;
- The company's D&O policy was declared part of the bankruptcy estate of a bankrupt corporation;

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- The company's D&O coverage limits have been exhausted;
- The company's underlying D&O policy is subject to a specific exclusion;
- The D&O insurance company is financially unable to pay.

These policies are designed to provide independent directors with extra protection from the substantial personal risk they face in connection with their current independent board responsibilities. Typically, the policy is purchased by the company on behalf of its independent board members, and the policy pays defense costs, settlements and judgments in connection with indemnifiable and non-indemnifiable claims. A typical independent director policy also includes excess coverage, which provides additional protection for independent directors in non-indemnifiable claims, and drops down to provide first-dollar coverage for non-indemnifiable losses when the traditional D&O policy is not available. The policies also contain no retention amount, and thus do not require the independent director to "buy in" to the policy once a claim arises, before coverage is triggered.

Independent directors should insist that the company have best-in-class governance practices, that there is adequate D&O coverage, that the company's D&O policy is non-cancelable, and that the directors have separate coverage so that a claim against the company and the officers or directors accused of wrongdoing won't exhaust the limits available for those Board members who are not culpable. These new, separate policies for directors are designed to provide independent directors with extra protection from the substantial personal risk they face in connection with their current independent board responsibilities. Doing so may cost the company additional premiums, but most likely will assure the company has on its board qualified independent directors. Without it many qualified candidates may decline board positions.

We have condensed these complicated issues to keep this memo brief but at the same time to call these important developments to your attention. Your Seyfarth Shaw corporate attorneys are available to talk about any of these issues in more detail.

This memo has been written by several Seyfarth Shaw attorneys, one of whom is also a director of a NYSE company and an active member of the National Association of Corporate Directors ("NACD"), and two of whom defend corporate directors and officers in complex securities litigation throughout the country.

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