

# Acredula

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**A**credula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

## Practical Advice for Buying D&O Insurance, Preparing for Merger or Acquisition

**T**his month's issue of *Acredula* completes a series of articles on D&O insurance and begins a series on preparing your company for a merger or acquisition.

The featured article of our January 2001 issue of *Acredula* addressed an officer's responsibility to require a review of the organization's D&O insurance. Although directors of corporations are entitled to certain defenses and protections against potential liability, such as the "business judgment rule," these defenses and protections in no way limit potential liability for actions taken by officers and employees. As a result, officers and employees need the protection of indemnification provisions and D&O insurance.

This month's lead article, by Thomas W. Harvey, focuses on what to look for in purchasing D&O insurance, including 15 buying tips. Mr. Harvey is president and CEO of Assurex International, which, as part of its relationship with Assurex Synergy Group

### Editor's Note

Partners, has agents on six continents who can deliver insurance and risk management services globally wherever clients have assets at risk. Mr. Harvey's article also emphasizes the importance of employment practices liability coverage that is too often overlooked when considering D&O insurance.

The second and third articles of this month's *Acredula* begin a series of articles on preparing for a merger or acquisition. One is by Michael F. Sullivan, senior partner of Bricker & Eckler LLP's corporate department. His article focuses on some simple, but often overlooked, steps to increase profits to owners when selling a company. The last article is on preparing governing boards to participate in the process.



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## D&O Insurance:

### Battling Managerial Malpractice Exposures with Insurance Protections



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**W**hen disgruntled shareholders, employees, customers, or competitors cry foul, alleging financial mismanagement, discrimination, or other wrongful acts, blame often lands at the feet of corporate directors and officers. Claims of *managerial malpractice* definitely are on the rise today, along with the costs—legal fees, settlements, and judgments—associated with them. In fact, according to the most recent *Directors and Officers Liability Survey* prepared by Tillinghast-Towers Perrin, the average shareholder claim

rose \$1.51 million to \$8.67 million in 1999, the highest ever recorded by the annual survey. During the same period, the average employee claim climbed to \$306,000, up from \$287,000 in 1998.

That fact is, the threat of lawsuits and litigation costs is a basic risk of corporate directorship. Because directors' and officers' services are considered fiduciary, requiring decision-makers to exercise their powers in good faith and with prudent judgment, directors and officers risk what essentially are managerial malpractice claims.

Typically, directors and officers claims result from disputes over financial or accounting irregularities or company decisions alleged to adversely affect shareholders' return on investment. For public companies, shareholder complaints are the most frequent sources of D&O claims. The *1999 Directors and Officers Liability Survey* found claims relating to financial disclosure to be the most common complaint brought by shareholders. Other common shareholder complaints revolve around

breach of fiduciary duty and fraud, as well as mergers and acquisitions, stock offerings, and spin-off-related issues.

Discrimination is the number-one employee complaint, followed by wrongful termination, harassment, and breach of contract.

Clients and customer groups also cite discrimination more often than any other type of complaint. Business interference tops the list of competitors' claims. For both clients and competitors, contract disputes come in second on the list of typical grievances.

Fortunately, directors and officers (D&O) insurance can help mitigate losses when an organization and its directors and/or officers are slapped with a legal claim. For responsible organizations operating in the age of workplace lawsuits, D&O insurance is a must.

### *Understanding D&O Coverage*

Insurance buyers often misunderstand the exposures facing

corporate directors and officers. Indeed, the complexities of D&O exposures and insurance coverages can confuse not only buyers, but inexperienced insurance agents and brokers as well. When shopping for D&O coverage, it is particularly important to seek the counsel of an experienced risk management and commercial insurance brokerage firm. Working with an insurance broker who is familiar with your company and its executive liabilities, and is experienced negotiating D&O policies with underwriters, likely will result in more comprehensive coverage and lower premiums.

Most D&O insurance policies contain two inseparable coverages. The policy reimburses the corporation for indemnifiable losses. In addition, the policy directly protects directors and officers from losses that are not covered by the corporation's indemnification agreement.

### *The Purpose of D&O Insurance is Four-Fold*

Available for non-profit and for-profit organizations, public and private companies, D&O insurance serves four basic purposes. Specifically, D&O insurance:

1. Protects directors and officers with an insurance contract covering matters for which they might not be indemnified by the corporate by-laws language, assuming the matters are not illegal in conduct, motivation, or execution.
2. Reimburses the organization after it has indemnified directors and officers in accordance with the corporate by-laws provisions. However, this does not include protection for allegations of liability against the organization or the organization as an entity.
3. Motivates the organization to attract quality outside persons to serve as directors or executive managers. The organization must be sure prospective directors/officers understand they expose their personal assets in exchange for making discretionary business judgments.
4. Reassures inside directors and officers. This is particularly important should the organization face a difficult financial situation.

### *What Type of D&O Insurance Is Right for You?*

Your organization's structure will determine the type of D&O coverage application form used by the underwriter. Insurance companies that underwrite D&O policies distinguish between for-profit and non-profit organizations, as well as publicly held and private companies, when preparing D&O quotes and policies.

*Seeking the counsel of an experienced risk management and commercial insurance brokerage firm likely will result in more comprehensive coverage and lower premiums.*

The good news for non-profits: D&O coverage is both broad and reasonably priced for non-profit organizations. Minimum premiums begin well under \$1,000. Directors/officers of non-profit organizations can obtain coverage aspects and extensions not available to the directors and officers of for-profit organizations. Non-profit organizations' coverage provisions might include full coverage for the organization, employment practices liability, an affirmative coverage grant for punitive damages (unless prohibited by law), defense expenses payable beyond policy limits, and in some cases no per-claim deductible.

Unfortunately, underwriters are not as liberal in allowing coverage breadth, less costly premiums, and small deductible amounts for directors and officers of for-profit organizations. A distinction does exist, however, between private and public companies. Specifically, the scope of coverage allowed for private corporation directors and officers generally is broader and less costly than for their contemporaries at publicly held organizations.

When it comes to private versus public company D&O insurance, a major distinction concerns the scope of coverage available for the organization as an entity. Most publicly held organizations are able to purchase coverage for the organization's liability only for shareholder claims in connection with Securities and Exchange (SEC) Liability. Since this exposure is not faced by private organizations (even those with shareholders), underwriters generally exclude the SEC exposure from private companies' D&O policies. However, it is nonetheless important that private organization D&O coverage not exclude claims brought by shareholders, as many private organizations do indeed have shareholders.

Underwriters of private company D&O insurance offer several coverage forms to cover the organization's liability to the same extent as the liability coverage provided to directors and officers. However, since for-profit D&O insurance policy limits are provided on an aggregate limit basis, payment of covered claims made against the organization erodes the coverage limit available for directors and officers.

*The scope of coverage allowed for private corporation directors and officers is generally broader and less costly than for their contemporaries at publicly held organizations.*

### *Don't Forget Employment Practices Liability Coverage*

A benefit of covering private organizations as an entity on a D&O policy, in addition to protecting the directors and officers, is the ready availability of Employment Practices Liability (EPL) coverage. EPL insurance protects employers from workers' claims of discrimination or wrongful termination based on race, sex, age, or disability. EPL insurance also protects organizations from third-party liability claims filed by customers and outsiders.

It is important to note, however, that there are good reasons to opt for a separate EPL policy, rather than a D&O policy that includes EPL coverage. Specifically:

- Separate EPL policies generally feature lower deductible amounts.
- An EPL policy offers a broader scope of coverages with respect to employees, independent contractors, and third parties.

- Separate EPL policies sometimes allow a broader scope of coverage for perils.
- Loss is generally more broadly defined under a separately written EPL policy.
- Many EPL policies cover prior acts with no retroactive or continuity date.

A final word of caution for publicly held and private companies shopping for D&O coverage: Some underwriters provide coverage for directors/officers and the organization on a co-defendant basis. The problem: For the organization to be covered for direct liability claims, both the directors/officers and the organization must be named in covered allegations and remain as

defendants in the litigation. The co-defendant approach opens the insurance agent to errors and omissions exposure. That's another reason why it is so important for buyers to work with an insurance broker with comprehensive D&O experience.

### *How to Maximize Your D&O Coverage—15 Buying Tips*

It is important to note that D&O insurance coverages are highly negotiable. Your insurance agent should make every effort to customize D&O coverage to meet the unique needs

of your organization and its management structure. Market conditions should be taken into account as well.

Assurex International—the world's largest independent commercial insurance brokerage group—is owned by more than 65 of North America's leading independent insurance brokers, called Partners. Recognized as a collective D&O insurance powerhouse throughout North America and Canada, Assurex Partners have extensive experience negotiating and writing D&O insurance policies for non-profit organizations and for-profit companies. Assurex's Broker Partners offer 15 tips to maximize your organization's D&O insurance coverage.

1. Make sure the policy is non-cancelable, except for the non-payment of premium. Require the insurer to give a minimum of 90 days written notice of non-renewal.
2. Strive for an affirmative coverage statement regarding punitive damages.
3. Be clear on the extent of entity coverage afforded, both for settlements, judgments, and defense expenses. As an alternative, pre-set an allocation percentage (ideally 100 percent) for the entity. Generally, for publicly held entities, the only entity coverage available is for SEC-related claims. While broader entity coverage is available, D&O entity coverage is still evolving.
4. Is the policy endorsed to extend to EPL claims? This extension is valuable only if the entity is specifically covered for EPL claims.
5. If your organization is publicly held, have your agent investigate a coverage *carve out* in the exclusionary language for pollution-related claims, covering shareholder suits against directors and officers.
6. Generally, exclusionary language for Professional Services or Errors or Omissions is too broad. Request coverage *carve out* for failure to supervise, if the exclusion cannot be removed entirely.
7. Secure a written commitment from the insurer for multiple-year pricing, or language that restricts possible premium increases to significant financial changes, a major acquisition, or significant claims activity.
8. Seek automatic coverage for newly acquired or created organizations, with no additional premium payable with policy renewal or anniversary.

9. Make sure there is a specific provision for the insurer to advance defense costs to the insured.
10. Arrange for pre-approval of the insurer's choice of defense counsel.
11. Secure coverage for non-officer employees named in a covered suit with officers and/or directors.
12. Be sure a minimum of 12 months is allowed for the Extended Reporting period (Discovery Clause).
13. Have legal counsel review D&O policy application forms before submitting them.
14. Extend coverage to include outside directorships.
15. Have your insurance broker obtain a *carve out* from the usual *insured versus insured* exclusion to cover claims brought by bankruptcy trustees, federal or statutory receivers, and debtors-in-possession. Valuable in situations involving the bankruptcy of the insured organization.

D&O insurance will not necessarily protect your organization against intentional wrongdoing such as fraud, theft, or blatant disregard for employees' rights. However, whether your organization is private, public, or non-profit, D&O insurance should be a component of your overall insurance and risk management program.

You'll never know just how valuable D&O insurance is until the day you need it. For help assessing your organization's executive liability risks and designing a customized D&O insurance program, contact your local Assurex International Partner. Visit [www.assurex.com](http://www.assurex.com) for a listing of Assurex's 65-plus North American Partners.

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*Thomas W. Harvey is President and CEO of Columbus, Ohio-based Assurex International. This article contains material excerpted from *The Three Faces of Executive Liability* by Richard G. Clarke, a Senior Vice President with Palmer & Cay, Assurex's Georgia Partner. In addition to its 65-plus North American Partner-owners, Assurex maintains affiliate relationships through Assurex Synergy Group Partners in more than 65 foreign countries. With local brokers in every major city of the world, Assurex is positioned to deliver seamless global insurance and risk management services wherever clients have assets at risk. Assurex and Assurex Synergy Group Partners employ more than 12,000 professionals on six continents and generate annual premiums in excess of \$14 billion. Additional information about Assurex International is available online at [www.assurex.com](http://www.assurex.com).*

# Acquisition Pre-Planning:

## Simple Steps To Increase Profits When Selling A Company

**M**any business owners have been grossly underpaid for businesses they have spent years building because a sudden reverse, a liquidity crunch or health problems triggered a need to sell quickly. To protect your business from being bought out at fire sale prices, you should shape your business to be salable at a maximum price well before the need to sell arises. This article provides some practical guidelines for acquisition pre-planning gathered from mergers and acquisitions professionals who have spent years observing sales from the viewpoints of both buyers and sellers. These recommendations are most effective when adopted one or more years prior to the first negotiation session. By pre-planning, you can ensure that your business will be sold profitably.



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### *Culling Your Assets*

Most businesspeople do not realize, until they approach the end of an acquisition process, that they have left money on the table by not removing assets that are not valued in the acquisition process. Most acquirers base their purchase price on some multiple of earnings or cash flow. Only in fire sale situations is the book value or appraised value of an asset a prime determinant (or even a component) of a business valuation. Rarely, if ever, will an acquirer add a “bonus” for any asset other than cash on hand.

However, an acquirer will absolutely prohibit any transfer of assets outside of the ordinary course of business during the acquisition and will require proof that such a transfer has not occurred since the date of the last balance sheet.

An astute business owner can “work the system” by initiating a thoughtful program of asset culling while a potential acquisition is still on the distant horizon. Consider implementing the following steps:

1. Take artwork that does not generate earnings and sell it or distribute it out to the owners. Replace it with prints.
2. Take any empty lots that were purchased for expansion, but never used, and sell them or distribute them out.
3. Take any vehicles, machinery or equipment that have been depreciated down to zero and distribute or lease them out. If they are not needed in the operation, distribute them out. If they are essential, but have a long-term residual value, lease them back at a low rate (so as not to affect earnings per share), with the opportunity to recover those residual values in the future.
4. Take one or more of the company’s facilities and distribute them out through a sale or leaseback. Set the rental payments to correspond with existing expenses with respect to that property (interest, taxes, utilities, etc.). You may have to extend the lease at the time of acquisition, but there is a good chance you will begin to realize residual values after five to 10 years.

Once you begin to think of your business in this way, other examples are going to come to mind. Unleash your accountant on the problem to find even more ways to harvest your assets.

### *Upgrading Your Income Statement*

What multiples are companies selling for in your industry? Six times earnings? Eight times earnings? Ten times earnings? That is the measure of how much you have to gain by taking a sharp pencil to your accounting practices. Consider the following:

1. Many owners, particularly those of smaller businesses, use the company as their personal wallet, taking aggressive positions with respect to whether an expenditure is proper for business purposes. Now those owners must pay a penalty of six to 10 times the annual cost of that motor van, that Florida condominium, those sporting tickets and those business meals at which operations

were discussed. Sometimes an acquirer will make a *pro forma* adjustment for such “business/personal” expenditures. But why take the risk? Cut questionable tax deductions to a minimum when an acquisition is on the far horizon.

2. There are often numerous alternative accounting practices that are perfectly acceptable, such as FIFO or LIFO inventory valuations. Privately held companies’ decisions regarding which accounting principle to apply may be driven by tax considerations rather than earnings-per-share considerations. Consult with your accountants on issues such as inventory valuation, bad debt reserves, “useful life” determinations and similar matters. Look at the financial statements of some of the publicly held companies in your industry to determine what choices they are making in the preparation of their financial statements.

### *Formalizing Compensation Arrangements*

Signing lucrative employment contracts on the eve of an acquisition will not sit well with an acquirer. Reasonable employment agreements that have been in place for a year prior to the time when discussions were initiated, however, will not cause alarm. Owners of closely held businesses often have certain reasonable expectations as to the continuity of compensation, retirement expectations, vacation entitlement and perquisites, but have had no need to formalize these arrangements. If you see an acquisition in your

*With an acquisition on the horizon, you should not underestimate the impression you will make if you have orderly files, documented relationships and detailed records of liabilities and potential assets.*

future, you should waste no time in formalizing those arrangements. This is also true for those loyal employees who rely on your personal generosity, but cannot rely on the generosity of a stranger. Be aware that, to the extent that future payments are susceptible to valuation and exceed industry norms, you may get a purchase price cut, no matter when they are initiated.

### *Committing Business Relationships to Paper*

Many businesses operate very successfully on trust and

familiarity with the people with whom they are dealing. In an acquisition, the acquirer will lack both of these components. Instead, the acquirer will have paper assurances of the continuation of the various factors that have made your business successful. If the acquirer does not have these assurances, you can expect a discount. Accordingly, well in advance of the acquisition, you should begin the process of committing your relationships to paper. Here are several examples of relationships that should be defined on paper:

1. Even though your old business associate will renew your lease forever, you should get a transferable option to renew reflecting your understanding.
2. Since your customers are going to stay with whoever owns the business, consider whether you should start changing your standard form purchase orders to reference you or a successor entity or assignee.
3. Although you have used that shortcut across your neighbor’s property for years with your neighbor’s consent, now is the time to get an easement.
4. Even though you have been using certain product names for years without receiving any complaints, this would be a good time to see if someone might have a reason to complain.
5. Although that branch office over in Indiana hasn’t been a large part of your operation and you haven’t wasted a lot of money “administering it,” you should make sure that you are qualified under Indiana law and have filed all your tax returns properly.
6. Since you are probably using dozens of software programs in your operations, this would be a good time to collect all of the license agreements in one place and make sure that no one is using unlicensed software.

With an acquisition on the horizon, you should not underestimate the impression you will make if you have orderly files, documented relationships and detailed records of liabilities and potential assets. Nor should you underestimate the potential for derailing or devaluing an acquisition because you cannot offer assurances that the acquirer will be obtaining the business relationships and governmental clearances necessary for the business’ successful operation.

### *Creating Boundaries Between You and Your Business*

If you negotiate with a typically suspicious acquirer and ask what you can do post-acquisition that is related to the company’s business, the answer will be “nothing.” If you

act while an acquisition is still on the horizon, related endeavors will not encounter suspicion or, indeed, objection. Accordingly, do the following well before an acquisition arises:

1. If you wish to form a related business, you should have a specific waiver of corporate opportunity from the board. Incorporate into your employment agreement a non-compete that expressly makes exception for that potential business in the noncompetition clause.
2. If you are engaged in transactions with your company (leasing property, provision of accounting or management services from a related entity), that relationship should be documented with a contract. If that contract has been in place for one or two years before you are approached by a potential acquisition partner, it will not raise eyebrows. If the relationship has been in place, but has never been documented, you are either going to have to renegotiate from ground zero or risk a purchase price discount imposed by the suspicious acquirer because you have entered into an affiliated-party contract on the verge of an acquisition.

### Avoiding Being Unacquirable

As a closely held company, you may have saved some money by utilizing a bookkeeper rather than an accountant or by relying on unaudited or unreviewed financial statements. These may earn you a significant price cut when you begin acquisition discussions. Worse yet, it may make you unacquirable because the SEC or acquirer's lender won't

accept your financials as a basis for raising capital. The time to establish a base of credibility for your earnings is at least two years before you enter acquisition negotiations. Get an accountant with skills commensurate with the size of your company and pay him or her enough to produce financial statements which will be fully accepted by potential acquirers.

### Assembling Your Team

When you decide to sell or circumstances force you to sell, you are going to need the best possible team, consisting of an accountant, a lawyer and a business broker or investment banker. Most often, the accountant who is familiar with your finances has the inside track. With respect to other professionals, you should recognize that acquisition work is highly technical and specialized. Make a habit of striking up conversations with people in your industry who have been involved in acquisitions to find out who represented them and how satisfied they were with the services. Take notes. Hopefully, when you have to assemble a team, you will have several names collected and an idea of pricing for the services.

### Conclusion

By following the above suggestions, sellers can avoid unnecessary suspicion and loss of benefits, while maximizing the value of their business components that don't fit into the "valuation system" operating in this country today. By protecting your business' assets properly in the beginning, you can ensure that your business will be sold profitably, even if you are forced to sell quickly and unexpectedly.

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*A Bricker & Eckler Initiative*

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# Involving Boards in Strategic Direction Facilitates Making Changes

Involving boards in evaluating their own performance or composition is rarely successful unless the evaluation is structured as a component of a larger program focusing on the company as a whole. First, evaluating performance or composition on a standalone basis without any frame of reference typically results in directors' critiquing each other which is not only awkward, but also uncomfortable for those involved. Second, evaluating performance or composition focuses on the past, diverting attention away from the future. Third, without a larger program as a frame of reference, the process becomes purely subjective and too often is driven by personalities. And finally, the process often results in hard feelings.

Evaluating past performance, especially of individual directors, probably is not necessary. A better course is to determine competencies needed in the future and then address acquiring those competencies. This is best accomplished by first involving the board with management in developing the company's strategic direction. After the board and management determine a strategic direction, the board and management can then determine what competencies are needed among the board and management in the future to achieve the strategic direction. In this way, changes or additions can be made to the board as well as to management to reflect future strategic direction rather than as an evaluation of past performance or personalities.

Involving boards jointly with management in determining strategic direction generally results in stronger bonds between both groups. Disagreements between boards and CEOs over strategy often result in short tenure for the board or abrupt departures by the CEO.

Here are some steps to consider in involving boards in strategic direction that also includes determining competencies needed in the future:

- Explain to the board the need to be constructively



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involved in determining strategic direction. The goal is to build long-term stockholder value for the benefit of all stakeholders.

- Urge the board to do this as a whole rather than through a committee. Determining direction requires the view of every perspective available to the company.
- Clarify that the process is a joint role of both the board and management. Both should both participate jointly in establishing the process as well as determining the direction.
- Agree upon the elements that are going to be considered in the process. One of the key considerations is the background, experience and expertise needed among management and the board to achieve the strategic direction.
- Direct management to propose strategies for discussion. The board's function is to discuss and question management's proposals, requiring management where appropriate to reformulate strategy consistent with guidelines instructed by the board.
- Schedule as one of the later considerations the background, experience and expertise needed among management and the board to achieve the strategy.
- Require the board and management jointly to map out the changes or additions necessary to management and the board to acquire the needed background, experience and expertise.
- Direct a nominating or similar committee of the board to implement the change in composition.

Involving the board first in determining the strategic direction of the company as a whole facilitates a board's evaluation of its own composition. Doing so not only gives the board a frame of reference for evaluating its composition, but also focuses the board's attention on future needs rather than past performance, avoiding the hard feelings that may come if the evaluation is perceived as purely subjective or driven by personality.