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Underwriters of D & O and Professional Liability Insurance

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In this issue... March is National Ethics-Awareness Month, a fact which may have escaped many readers, and so it is probably an appropriate time to take a very general look at ethics.

[[Ethics-Awareness Month](#) was initiated in 1990 by a group of organizations including the American College, the American Institute for Chartered Property-Casualty Underwriters (AICPCU), the Chartered Property-Casualty Underwriters (CPCU) Society, and the Society of Financial Services Professionals. It has been observed by insurance and finance professionals each year in March ever since then.]

SOME COMMENTS ON ETHICS

Legislating For Ethics

Most people would agree that ethical behavior in business is a good thing, but it was the Enron case and the subsequent Sarbanes-Oxley legislation which could be said to have changed the ethical landscape by incorporating ethical behavior at public companies into federal law. One of the many questionable events that came to light in the Enron affair was the revelation that the board of directors had [specifically waived](#) provisions from the company's code of ethics in order to permit its CFO to benefit from internal transactions.

The Sarbanes-Oxley Act took aim at that incident in Section 406 b.:

Changes in Codes of Ethics.—The [Securities and Exchange] Commission shall revise its regulations concerning matters requiring prompt disclosure on Form 8-K (or any successor thereto) to require the immediate disclosure, by means of the filing of such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers.

The rest of [section 406](#) both defines a Code of Ethics geared towards the public companies which are governed by the act, and requires public companies to publish or make available either their own code of ethics or an explanation of why they choose not to publish one.

How far Sarbanes-Oxley affected corporate behavior remains the subject of speculation. The number of [securities class action filings](#) certainly dipped in the years following the 2002 passage, and the tightening of internal corporate controls mandated by the act probably discouraged some would-be transgressors. Yet there are many elements which impact securities class action activity: increased enforcement by the SEC and the steady procession of executives to federal prison may also have played a part in limiting corporate shenanigans.

Rules Are Easier To Change Than Behavior

Regardless of federal legislation, the conditions which can nurture unethical behavior that may become fraud are almost timeless: a combination of motive and opportunity.

Motivators of unethical actions can include: **greed**, a consistent and relentless driving force; **addiction** which can lead people to take desperate measures to help feed the addiction; **insufficient earnings** can result in individuals never having enough money, the corollary of which is **living beyond ones means**, creating a constant need for more funds; and **outside pressure**, which can be intense enough to push someone into making bad decisions.

By themselves the motivators can certainly result in unethical actions, but when coupled with what seems to be an ideal opportunity to satisfy those demands, those motivators are often triggered into action, causing otherwise law-abiding individuals to commit breaches of ethical standards, and then the law.

Motivators and D&O Liability

Part of any Directors & Officers liability underwriting assessment is to get a sense of a company's vulnerability to unethical behavior, though this is not easy. On a corporate level, a weak cash flow, high leverage and excessive executive compensation can be leading indicators. Less quantifiable are pressures on management which can come from many sources and could include: market and investor expectations, a fiercely competitive business sector, internal compensation levels triggered by sales or stock performance, or regulatory considerations—especially for a life-science company anxious for approval of its product from the federal Food and Drug Administration (FDA).

Crossing a Line

No one expects codes of conduct or legislation to eliminate unethical behavior. Perhaps the best that can be hoped for is that some people will be given pause before they cross a line that might lead to fraudulent actions and criminal prosecution. Certainly, the press continues to carry stories alleging such behavior. Earlier this month a former top official at the New York state pension fund [pleaded guilty](#) to a felony under the Martin Act, admitting his role in a “pay-to-play” scheme, whereby investment decisions were made based upon payments made to pension fund executives. The on-going [Galleon hedge-fund case](#) includes allegations of wrongful insider trading; meanwhile outside the financial sector, the *New York Times* reported on a [network of bribery](#) in the food industry.

Summary

Ethical standards in life and in business are a delicate issue which are not always objective. The traditional but informal standard of doing only what you would not mind seeing reported in the newspaper still holds some validity, but has been refined by carefully written corporate codes of conduct, spurred by legislation and tailored to the specific demands of each organization. Ethical standards for corporate executives underlie the world of Directors & Officers liability—perhaps more so than in any other segment of the insurance industry. ❖

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