

Risk Monitor



Sarbanes-Oxley Act Changes Rules for Privately-Owned Businesses

Responding to a number of scandals involving fraud at publicly owned companies, the U.S. Congress in 2002 enacted a new law intended to make undetected fraud less likely to occur. The law applies only to public companies, mainly those whose securities are registered in accordance with the Securities Exchange Act. Even so, experts predict that it will have an enormous impact on private companies as well.

Among the changes many businesses, public and private, will undergo are creating mechanisms for fraud whistle blowing by employees, adapting to a different relationship with their external auditors, upgrading internal financial controls, becoming much more aggressive at preventing fraud, and improving audit committee accountability. This magnitude of change is why the Sarbanes-Oxley Act has been variously described as “a paradigm shift” in how companies do business and “a whole new way of thinking about corporate governance.”

Some of the most notable of the act's requirements include:

- Management must certify the accuracy of their companies' financial statements.
- Management must attest to the effectiveness of their internal financial controls.
- Outside auditors must attest to the accuracy of management reports.
- The internal audit committee must have independence and must include financial experts.
- Steps must be taken to improve fraud detection and prevention (e.g., an employee hot line for reporting fraud, training about fraud, a written corporate anti-fraud policy).

- Auditors must proactively look for material misstatements in financial reports, evaluate opportunities to commit fraud, and maintain a skeptical attitude to the company's reports.

Some experts predict that more private companies will fall under new rules similar to or the same as Sarbanes-Oxley as states enact new laws and apply them to private companies doing business in the state.

Many banks and insurance companies are demanding a higher standard of action to prevent fraud and are closely examining a borrower or insured's fraud prevention efforts. Private companies that deal regularly with banks and insurance companies, and those that are potential acquisition targets, might find that they must comply with new rules even though they are not required to do so by law. While previously a banker's only concern was whether they would get paid, now they are more likely to be concerned with whether management has done enough to avoid the risk of financial mismanagement.

Insurers, too, are engaging in increased oversight. Prices are going up on coverage in every area of financial fraud and mismanagement risk. Underwriters are reviewing private companies' financial statements much more carefully and sometimes require interviews to obtain additional explanations.

Customers, clients, professional services providers, and business partners of privately held companies want to avoid the spotlight of scandal and may insist on adherence to the principles of Sarbanes-Oxley.

Private company directors are also likely to push for stricter fraud-prevention efforts in light of a recent federal court decision that will hold them responsible for fiscal misconduct by company

continued on page 2

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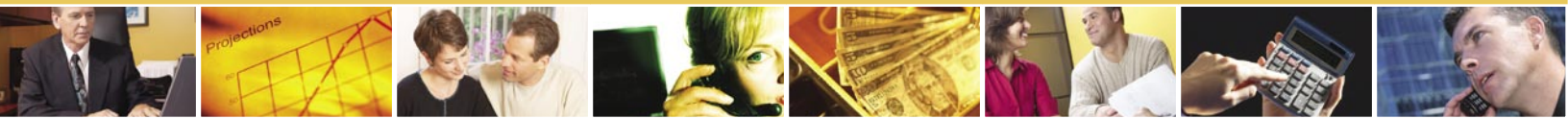
We will be sure to keep you updated with its official launch.

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Cut-Throughs to the Rescue

Whenever A.M. Best, Standard & Poor's, Moody's or Fitch drop an insurance company's rating below an A, businesses become worried that an insurance company might not have enough capital to pay their claims. To reassure the risk managers of these businesses, insurers often seek cut-throughs from their reinsurers.

A cut-through is an endorsement to a reinsurance agreement that requires the reinsurer, in the event of the ceding company's insolvency, to pay a loss covered under the reinsurance agreement directly to the insured or its beneficiary. The endorsement gets its name because reinsurance claim payments "cut through" the usual route of payment from reinsured company-to-policyholder, substituting instead payment of reinsurer-to-policyholder. A cut-through affects the payment only, and does not increase the risk to the reinsurer. Most cut-throughs are provided only for property, almost never for casualty, unless the cut-through can be limited to claims on a yearly basis.

Those insurance companies that get a cut-through from reinsurers, are borrowing the size and rating of their reinsurers. A cut-through permits the insured or its beneficiary to collect insurance proceeds directly from the reinsurer if the insurer becomes insolvent. The insured does not have to wait for the liquidator of the insolvent insurer to pay claims, usually paid at a discount, which could take years.

A cut-through can be written on a blanket basis, where the reinsurer assumes liability for a complete line, or for specific policies. The fee or surcharge paid to the reinsurer can vary considerably, depending on how urgent the primary insurance company needs the cut-through and how willing the reinsurer is to consent to the plea.

Because of the continuing hard insurance market, obtaining a cut-through is difficult for a downgraded insurer. One reason

for the difficulty is in the event of an insurer insolvency, the reinsurer has to become involved with adjusting claims. Because reinsurers don't handle claims directly, they would have to hire a third party.

Further complicating the cut-through provision is determining which policies have the cut-through and which do not in the event of insolvency. Sometimes, records of the insolvent insurer can be incomplete or missing, and the reinsurer has to spend considerable expense to determine which claims are to be paid to the receiver and which to the beneficiary of a cut-through. If the accounting is not carefully fulfilled, the reinsurer may pay the same claim twice.

State insurance regulators are opposed to cut-throughs, arguing they give an unfair preference to sophisticated insurers and third parties at the expense of consumers and should not be enforced. The officials contend that reinsurers have a statutory obligation to pay reinsurance proceeds to the receiver of an insolvent insurance company.

Almost every state requires that reinsurance contracts contain an "insolvency clause" if the cedent is to receive financial statement credit for the reinsurance. An insolvency clause obligates the reinsurer to pay claims to the receiver of the cedent without diminution due to the insolvency of the cedent. A guiding principle of receiverships of insolvent insurers is that all creditors of the same class are treated equally. Ordinarily, this means all policyholders and loss payees would be paid the same proportion of their allowed losses.

But in some states, the "insolvency clause" contains language allowing payment of reinsurance proceeds directly to the insured if there are cut-through provisions. This difference can cause conflicts between contractual cut-throughs and receivership policy and case law on the other.

continued from page 1...Sarbanes-Oxley Act Changes Rules for Privately-Owned Businesses

management under a standard of due care and loyalty just as directors of public companies are. In *Pereira v. Cogan, et al.* (294 B.R. 449, S.D.N.Y. 2003) the judge ruled that directors at bankrupt Trace International Holdings Inc. failed in their responsibilities by allowing Marshall Cogan, Trace's chairman and controlling shareholder, to drain company funds by drawing excessive compensation, loans, and dividends. Significantly, the Trace directors were found to have violated their fiduciary duties irrespective of whether Mr. Cogan's self-dealing actions were the result of, or enabled by, board action.

The court noted that, during the period in question, the Trace board held no meetings and that, when it acted, it did so by written consent. The directors argued that they should

not be liable, since they had not taken any action nor played any part in the improper transactions. But the court rejected this idea, noting that directors have a duty to be informed of significant corporate expenditures and to disapprove of those that are not in the best interest of the corporation or its shareholders.

It will be years before the full effects of this new climate of corporate financial accountability will be realized. For many private companies, as for public ones, the likelihood is that there will be little choice but to change some of their practices and to spend more to prevent fraud and other financial mismanagement.



Terrorism Is Real:

Your Need for Terrorist Insurance in the Wake of 9/11

Terrorist insurance premiums skyrocketed after Sept. 11, 2001, leaving many businesses scrambling for coverage. But what, and how much, does terrorist insurance cover, and is it worth the escalating premiums?

Considered a property/casualty insurance, terrorist insurers will generally pay the claims of those covered as long as the incident causing the damage is not deemed an act of war, which is specifically excluded in most property/casualty policies. But before purchasing terrorist insurance coverage for your business, consider the insurance ramifications of the Sept. 11, 2001, attack on the World Trade Center in New York that include:

- Property and liability losses of the insurers of airlines;
- Property and liability losses of the insurers of the World Trade Center and surrounding buildings;
- Life insurance claims;
- Workers compensation coverage for injuries sustained by workers in the World Trade Center, the Pentagon, surrounding buildings, and by on-the-scene emergency personnel;
- Auto insurance losses for cars damaged by falling debris and those destroyed in underground parking garages;
- Business interruption losses covered by insurers from the businesses in the World Trade Center;
- Property losses for computers, furniture, and other contents of the businesses in the World Trade Center and surrounding buildings.

Considering the complexity of the situation makes it easier to understand that other combined insurance coverage's are available to cover damages and/or losses sustained as the result of an act of terrorism. These options are worth looking into when exploring coverage for acts of terrorism; combining alternative policies may save your business a great deal of money in the long

run, while offering you the protection you want and need.

It is also important to understand that insurance companies shy away from large risks if the amount of risk is uncertain. The ongoing threats of terrorism and the current war in Iraq explain why terrorist insurance is now so costly and why the costs continue to rise.

Keep in mind that catastrophic event insurance premiums, such as those for terrorist insurance, generally jump in cost following a catastrophic event, such as the attack on the World Trade Center. In most cases, such costs dissipate over time if no further events occur. However, because the threat of additional attacks looms, insurance experts do not anticipate a lowering of terrorist insurance premiums anytime soon.

In fact, many insurance experts are now calling for government support of the market for terrorist insurance, hoping that the government will bridge the coverage disruptions seen after catastrophic events occur.

Such intervention could come in the form of direct government insurance, making the government the insurer of last resort (offering guaranteed catastrophic bonds, for example), or making the government the lender of last resort. The U.S. Senate and House of Representatives have passed separate bills in an effort to support the market for terrorist insurance.

In the meantime, it is advisable to work hand-in-hand with your business' insurance representative to insure you have adequate coverage in the event of a catastrophic event, such as the terrorist attack of September 11, 2001. Your agent will be able to assist you in covering your employees, your physical office space, your business property (furniture, computers, and other contents), and any other collateral damages including damaged cars and damaged property.

continued from page 4...Managing Diversity - What An Employer Needs To Know

The national jury-award median for employment-practice liability cases, which includes discrimination and retaliation claims, rose 44% in one year - from \$151,000 in 1999 to \$218,000 in 2000 - according to Jury Verdict Research's® report, Employment Practice Liability: Jury Award Trends and Statistics - 2001 Edition.

Though these facts and statistics point to the growing need for employers of all sizes to carry Employment Practices Liability Insurance (EPLI), the news is not entirely negative.

According to Risk and Insurance (online at www.riskandinsurance.com) there are more than 70 insurers providing EPLI coverage and companies with fewer than 50 employees can expect to pay as little as \$5,000 to \$10,000 annually for the coverage. Also, many EPLI policies come with pre-arranged legal services such as hot lines for attorneys versed in employment practices law, often at no additional charge. Contact us to explore your EPLI options and to find out more about managing diversity in your workplace.

Managing Diversity – What An Employer Needs To Know

“Managing Diversity” is a critical human resources function for organizations large and small. All too often, though, executives and managers lose sight of what diversity means from a legal and moral perspective, and the message then gets lost in the translation when it comes to the rank and file employee.

In 1997 the Department of the Interior identified diversity for its workforce as a crucial issue and provided the following definition of diversity for its own management purposes:

“The term “diversity” is used broadly to refer to many demographic variables, including, but not limited to, racial, religious, color, gender, national origin, disability, sexual orientation, age, education, geographic origin, and skill characteristics... Managing diversity is a comprehensive process for developing a workplace environment that is productive for all employees... The term “diversity” is also used narrowly in employment recruiting and retention efforts to refer to race/ national origin, gender, or disability...”

The EEOC (US Equal Employment Opportunity Commission) is the federal watchdog that oversees compliance for legislation such as Title VII of the Civil Rights Act of 1964, which prohibits discrimination on the basis of race, color, religion, sex and national origin. Discrimination complaints

filed with the EEOC have been on the upswing over the past four years, going from 77,444 in 1999 up to 84,442 complaints in 2002. Small businesses with as few as fifteen employees are subject to Title VII, but determining who qualifies as an employee for the purposes of Title VII and other federal legislation is a tricky proposition and should be determined through consultation with an attorney or by researching the legislation directly.

Title VII is not the only federal law that applies to employment discrimination cases. For example, the Immigration Reform and Control Act of 1986, the law that created the I-9 requirements for employers, also furnishes protection against discrimination because of national origin or U.S. citizenship. It applies to any employer with at least four (4) employees. The Civil Rights Act of 1866 (42 U.S.C. 1981) forbids employment discrimination because of race or color and applies to any employer, even if there is only one employee.

State laws such as the Texas Commission on Human Rights Act of 1983 (Texas Labor Code, Chapter 21) also apply to employment matters, so it is important to be aware of the complex patchwork of laws that may or may not apply to any employment situation.

continued on page 3

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