



RISK MANAGEMENT

The problems with protecting corporate directors and officers when a company doesn't indemnify them

Limited defense

Directors and officers often wrongly assume that their company will indemnify them in all instances. However, a company in Chapter 11 typically will not pay indemnity – nor will new management quickly indemnify former officers and directors sued for allegedly willful misconduct or bad-faith breaches of their fiduciary duties.

Delaware mandates indemnification only for the successful defense of certain actions against directors and officers. Some companies have succeeded in delaying or denying the advancement of defense costs based on the assertion that the director or officer had 'unclean hands' or that advancement would fall outside the protective ambit of the 'business judgment rule.'

Although statutes vary from state to state, company charters, bylaws and indemnification agreements may provide mandatory cover, regardless of management decisions to the contrary. Litigation can sometimes enforce such indemnification, even by former directors and officers targeted by new management. A serious problem will persist, however, for any officer or director paying a settlement or judgment for claims brought by the company, especially those alleging willful or intentional misconduct. Most companies will not indemnify for such claims, especially without a bylaw expressly requiring indemnification.

Some state statutes allow companies to grant greater rights to indemnification than is required. For example, in some states, bylaws and corporate charters may provide for indemnification, even in derivative actions or actions by the corporation, if the individual did not engage in intentional wrongdoing. Bylaws, corporate charters and, in some states, indemnification agreements that provide for such indemnification, in effect, convert permissive indemnification into mandatory indemnification.

In addition, D&O insurance will not normally be available when a company sues its former directors or officers. Although this kind of

insurance typically pays for shareholder derivative actions, it will not indemnify a director or officer sued by the company for alleged neglect or malfeasance, due to the 'insured vs. insured' exclusion. For non-derivative claims, the only recourse for directors and officers is to seek indemnification from the company itself, which often necessitates hardball litigation with no guarantee of success.

Almost all D&O policies include an 'insured vs. insured' exclusion for suits brought by one insured against another. Although the form of these exclusions varies, they typically seek to preclude coverage for claims against any insured by the company or any of its directors or officers.

But what happens when a trustee in bankruptcy sues a former director or officer? Most courts have ruled that the 'insured vs. insured' exclusion does not preclude coverage, finding that the trustee's action does not really benefit the insured company, but rather its creditors. Other courts uphold coverage, relying on the exclusion's purpose, which is to prevent collusion against the insurer. However, some courts point to the 'plain meaning' of such exclusions to preclude coverage for directors and officers in any claim by or in the name of the company, another insured or a trustee in bankruptcy.

RISK MANAGEMENT

Derivative claims, special risks

By law, companies in many states cannot indemnify liability for judgments or settlements from shareholder derivative claims under most circumstances, making D&O insurance the only source of indemnification.

A derivative suit, in which a shareholder purports to sue 'by or in the right of the corporation,' typically asserts that director and officer defendants breached duties owed to the company. This differs from a shareholder's claim as the putative representative of a class, asserting that director and officer defendants breached duties owed to shareholders. Although complaining shareholders in derivative cases against officers and directors still face difficulty in overcoming the 'demand requirement' and the 'business judgment rule,' the burden is not insurmountable.

Company indemnification for derivative claims applies with few exceptions to advancement of defense costs. Delaware public policy, for example, prohibits indemnification for judgments, fines or settlements in shareholder derivative actions. Virginia law, however, permits indemnification for derivative settlements not involving willful or intentional misconduct. Logically, a company would receive no benefit if it reimbursed, in circular fashion, culpable directors and officers for money they paid as settlements, judgments or fines to the company.

Delaware law, however, expressly authorizes companies to buy D&O insurance to cover claims, such as shareholder derivative claims, for which indemnification is not permitted. Accordingly, in almost every instance, the availability of sufficient D&O insurance limits will be crucially important to directors and officers in shareholder derivative claims.

Competing for coverage

Most modern D&O policies provide three

SOLVING THE D&O PUZZLE

Deductibles: Ideally, deductibles or self-insured retentions (SIRs), which may be substantial, should not apply if the company is insolvent.

Entity coverage: Entity coverage should be evaluated in regard to its cost and proclivity to create competition for proceeds. Policyholders may wish to consider allocation formulas in D&O policies. Alternatively, insured directors and officers should seek 'priority of payment' provisions that allow directors and officers to access policy proceeds first.

Exclusions: Exclusions should be as narrow as possible. 'Insured vs. insured' exclusions should preserve coverage for derivative actions and should not apply if the company is insolvent or in proceedings. 'Conduct' exclusions should include severability provisions so that 'bad' conduct is not imputed to innocent directors and officers.

Non-rescindable: To protect against application defenses, policies should not be rescindable, except in extraordinary circumstances unrelated to securities fraud allegations. Alternatively, policies should guarantee severability of representations in the application so that they are not imputed to innocent or non-involved persons.

Policy definitions: Important policy terms should be suitably defined. For example, a broad definition of 'claim' will help ensure coverage for alternative dispute resolution (ADR) as well as for regulatory, civil and criminal proceedings, including investigations by the SEC or Department of Justice.

Side-A coverage: Traditional coverage can be supplemented by one or more additional policies, whose limits the company cannot access. Some companies purchase multiple layers (towers) of such policies to sit atop the traditional D&O tower, designed to be triggered when the combined underlying limits are exhausted. Policies can also feature a difference in conditions (DIC) clause, designed to respond when the underlying coverage does not respond for any reason.

types of coverage: side-A, for directors and officers when the company cannot or will not indemnify them; side-B, for the company for sums it pays to indemnify directors and officers; and side-C, or entity coverage, for the company's own liability for securities claims.

Because the payment of defense costs by an insurer 'erodes' the aggregate coverage limits under sides A, B and C, collectively, directors and officers often find themselves competing with the company for diminishing policy proceeds. This is a particularly important consideration for directors and officers when one or more securities class actions and derivative suits arise from the same transaction or set of circumstances. By agreement of the parties, courts often permit deferral of derivative suits until the companion securities class action litigation is resolved. CS

John H. Mathias Jr., Lorelie S. Masters, Christopher C. Dickinson and John E. Welch are all partners at Jenner & Block LLP.