

WHEN THE COMPANY DOESN'T PAY

By Geoffrey Fallon

INDIVIDUAL LIABILITY OF DIRECTORS & OFFICERS WHEN THE CORPORATION IS UNABLE TO PROVIDE INDEMNIFICATION

The most serious financial risk faced by directors and officers is a claim where their corporation, for various reasons, does not pay their defense costs and/or any settlement or judgment. These so-called non-indemnifiable claims often are ignored or given only scant attention when an individual considers serving on a board or when the corporation considers Directors and officers liability insurance (D&O).

While huge settlements in shareholder class actions receive the lion's share of media visibility when it comes to directors and officers liability, the corporation can usually indemnify for this risk. Hence, for these claims directors and officers have two lines of defense before their personal assets are at risk: (1) corporate indemnification; and (2) D&O insurance.

Furthermore, D&O insurance typically reimburses the corporation for amounts it pays to indemnify the directors and officers (known as "Side B" coverage), and also often pays the direct liability of the corporation for shareholder class actions (called "Side C" coverage). But, when faced with a non-indemnifiable claim, the only thing standing between a director's or officer's personal assets and personal liability is D&O insurance.

D&O insurance typically covers individual directors and offi-

cers when the corporation does not provide indemnification. Virtually all D&O insurance policies contain Side A coverage that provides insurance directly to individual directors and officers, usually with no deductible, for non-indemnifiable claims. Side A coverage is triggered when the corporation is financially unable to provide indemnification or is legally prohibited from doing so.

Before proceeding to discuss non-indemnifiable claims, it will be helpful to describe briefly the practical and legal basis for corporate indemnification.

INDEMNIFICATION

A corporation's ability to indemnify its directors and officers is determined in the first instance by state law. All states recognize the need for indemnification, but each state legislature must strike a balance between two competing public policy goals. On one hand, it is good policy to provide personal liability for individuals who abuse the trust placed in them as corporate leaders responsible for the assets of the public (i.e. their investment in the corporation's securities) as well as the livelihood of the corporation's employees and other corporate stakeholders.

On the other hand, if personal liability is triggered at too low a threshold or simply by a valid business decision that does not pan out, qualified individuals will be less inclined to serve as directors and officers, and the prospect of personal liability may prevent the board and the corporation from taking growth-oriented business risks.

Delaware, by far, is the most popular state for companies to incorporate and it permits corporations to indemnify directors and officers, generally, when the act for which indemnification is sought was in good faith and in, or not opposed to, the best interests of the corporation.

This Delaware standard has been followed by many other states and at first blush appears to be quite reasonable and, some might argue, balances more toward protection for directors and officers than toward liability for wrongdoers. However, despite this broad grant of authority for corporations to provide indemnification, there are several situations where indemnification is not permitted or available to directors and officers.

SITUATIONS WHERE INDEMNIFICATION ISN'T AVAILABLE OR LEGALLY PERMITTED

Corporation Lacks the Funds to Indemnify

As a practical matter, a corporation's legal authority to indemnify is meaningless if it does not have the money to pay the indemnification. Over the years there have been several unfortunate situations where corporations appeared to have adequate funds, but when the "cooked books" were exposed, the company had little or no cash.

Corporation Files Bankruptcy

Bankruptcy is a fairly common occurrence in corporate life and a Chapter 11 filing does not mean the corporation is devoid of

cash. Bankruptcy is so common that the stock price tables in newspapers often have a specific footnote to indicate that a company is in bankruptcy. Many companies throw off substantial cash flow in Chapter 11 because they are temporarily relieved of the obligation to pay interest on their debt.

Even where a company has substantial cash flow, bankruptcy law may prohibit indemnification. Bankruptcy prioritizes a corporation's creditors such that certain debts are paid first (e.g. administrative expenses of the bankruptcy), while debts to general unsecured creditors are paid last and only after senior creditors have been paid in full.

The right of directors or officers to indemnification is usually classified as general unsecured, so if they get anything at all it may only be cents on the dollar and will be paid only at the conclusion of the bankruptcy proceedings. But if the directors and officers are defendants in a lawsuit, they need to have their defense costs paid on a current basis and in full. However, despite broad indemnification and substantial cash flow, a corporation in bankruptcy most likely will not be able to provide indemnification for the directors and officers.

Shareholder Derivative Actions

A realistic example illustrates this best. Assume a corporation is found liable for violation of government regulations and must pay a fine of \$5 million. The fine is not material enough to cause a stock price drop when it is announced, but one shareholder (not a class) sues the board. The shareholder sues on behalf of the corporation, i.e. derivatively, alleging that the board failed to institute adequate controls to prevent the violation, and failed to properly supervise management to prevent the violation.

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This derivative suit is filed on behalf of the corporation against the board, and any settlement or judgment will be paid from the directors to the corporation. It would be circular for the corporation to indemnify the board so that the funds indemnified could then be repaid to the board. Thus, in most states, including Delaware, any settlement or judgment in a derivative action is not indemnifiable.

INDEMNIFICATION IS A CASE-BY-CASE BUSINESS DECISION THAT IS NOT AUTOMATIC

Outside the bankruptcy context, many directors and officers have the misconception that indemnification is virtually automatic and that whenever they are named in a lawsuit the corporation will pay their defense costs and any settlement or judgment. This is a perilous assumption because there are several scenarios where a corporation may not provide indemnification even when it has the money and is not in bankruptcy.

The practicalities of indemnification are important. The business decision to indemnify or not is typically made by a subcommittee of the board comprised of independent directors not involved in the transaction at issue and is about the expenditure of corporate funds.

Those making the decision may be subject to liability for an unauthorized or improper use of such funds. A simple example makes this point starkly: Assume a corporate treasurer is found guilty of embezzling corporate funds and the corporation sues this former treasurer for disgorgement. Obviously, the corporation would not want to indemnify and may justifiably decide not to indemnify. The former treasurer would be left to use personal funds to defend the case and pay the damages. A similar result would likely ensue if a director or officer was fired for sexual harassment.

WHEN MAY A CORPORATION DECIDE NOT TO INDEMNIFY?

Beyond the obvious logic of these examples, there are other scenarios where a corporation may decide not to indemnify. Assume a director or officer makes a business decision or series of decisions that turn out so poorly that he or she is fired for cause. A committee of disinterested directors may readily decide that if the director or officer's job performance warranted termination, indemnification should not be available.

In a similar vein, indemnification may be denied even where there is no wrongdoing by the director or officer. Assume that the CEO and board are at loggerheads on a number of issues, and as sometimes happens, the dispute winds up in media reports. Assume further that the CEO-board dispute causes a sudden stock price drop; the shareholders sue; and the CEO

resigns. If the CEO is portrayed in the media as criticizing the board, particularly with personal attacks, the board committee making the indemnification decision may deny funds to the CEO.

AFTERMATH OF A HOSTILE TAKEOVER

Assume that all directors and officers of a corporation targeted in a hostile takeover make a rational business decision that it is in the best interests of the corporation, its shareholders and stakeholders to fight the hostile takeover. The target's directors and officers use all legal means to resist the takeover but in the end the "raider" succeeds, and its first corporate act is to replace the target's board and management.

Who makes the indemnification decision in this scenario? The raider's board. Clearly, the new board may see no benefit to their corporation in providing indemnification.

THE BYLAWS MAY BE CHANGED

It is likely the bylaws in effect at the time indemnification is sought will be the bylaws under which indemnification is determined. Changing the bylaws does not require shareholder approval and may be done by a vote of the board of directors. Accordingly, if there has been a change in the board, whether by hostile takeover or otherwise, the new board has the power to change the indemnification provisions of the bylaws in such a way as to deny indemnification to the former directors and officers.

STATUTORY LIMITATIONS TO INDEMNIFICATION

While beyond the purview of this article, is worth briefly noting that various laws limit a director or officer's right to indemnification. For example, there may be no indemnification for: (1) RICO anti-trust violations; (2) certain penalties under the Foreign Corrupt Practices Act; and (3) failure to pay payroll taxes.

CONCLUSION

While the huge settlements in shareholder class actions dominate the headlines, non-indemnifiable claims present the greatest risk to individual directors and officers. In addition to the Side A coverage provided in standard D&O insurance, there are a variety of specialized insurance products available that enhance and expand coverage for non-indemnifiable claims, and directors and officers are well-advised to consult knowledgeable advisers about the benefits of expanding their coverage for non-indemnifiable claims.