

Chapter 7

Protection of Directors and Officers from Liability: Exculpation, Indemnification, and Insurance

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§ 7:1 Overview

While the risks of liability for directors and officers may be significant, directors and officers have a number of tools to protect themselves. The three primary defensive tools are exculpation, indemnification, and insurance. A person considering taking on the role of corporate director or officer—particularly in a public company—and the lawyers advising such persons, should fully understand and carefully consider both the protections afforded by these approaches as well as the limitations inherent in each.

In general, exculpation provisions seek to prevent liability attaching to directors in the first instance, while indemnification and D&O insurance seek to compensate and hold directors and officers harmless when they have incurred liability or are faced with defending liability claims.

Plaintiffs and their lawyers seeking to establish liability of corporate officers and directors also need to have a solid grasp of these protective devices so as to avoid pleading and proving a case that, in the end, may lead to a victory in the battle but, as a practical matter, a loss in the overall effort.

This chapter has three basic parts. The first part examines the very useful and protective device of exculpation provisions in a corporation's certificate (or articles) of incorporation. The second part surveys

the rights of officers and directors to be indemnified by their corporation for costs and liabilities. This survey examines the indemnification statutes, which provide for both mandatory and permissive indemnification by the corporation and for judicially ordered indemnification. This examination highlights the coverage of these statutes, as well as their exclusions. It also discusses customary contractual indemnification rights that a director or officer may negotiate with the company in addition to the statutory coverage. The third part reviews the related topic of insurance protection for directors and officers. This review discusses the power of corporations under corporate law to purchase insurance coverage for their officers and directors. More importantly, it highlights the standard features and exclusions of the typical directors' and officers' liability insurance policy (the "D&O policy" or "D&O insurance") and discusses the interaction between the protections offered by indemnification and this insurance. It also reviews key court jurisprudence on D&O policies.

§ 7:2 Magnitude of Claims

In recent statistics, securities class action claims and settlements continue to be in the multimillion-dollar range. The statistics on size of damages claims and settlement tend to vary year to year but these cases always have the potential of large exposure. In 2015, for example, total settlements for securities class actions in the United States exceeded \$3 billion.¹ In 2015, there were eight "mega" settlements of such lawsuits—meaning securities class actions in which the settlement amount exceeded \$100 million. The median settlement, however, was just over \$6 million. In many cases, the alleged damages are in the hundreds of millions of dollars and it is not unusual for alleged damages to exceed \$1 billion. Thus, while securities class actions continue to settle well below the amount of alleged damages, settlements still are substantial and pose significant risks to companies and their directors and officers, making the three levels of protection for directors and officers critical. In addition, costs of defense of such claims easily range in the millions of dollars.

Examples of the liability exposure of individual officers and directors, including outside directors, drive home the point about the risks of liability. The outside directors of Enron Corporation agreed to a \$168 million settlement for their liability for securities law claims, with \$13 million not covered by insurance and thus coming out of

1. This number and the ones that follow are taken from a Cornerstone Research Report of March 29, 2016, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2015 REVIEW AND ANALYSIS (Mar. 29, 2016).

their own pockets.² A similar kind of settlement for securities law claims was agreed upon by the parties for the liability of WorldCom's outside directors, requiring them to pay \$54 million (\$18 million of their own funds, which is reported to represent 20% of their personal assets).³ Former WorldCom chairman and CEO Bernie Ebbers, who was convicted of, among other things, securities fraud, agreed to place essentially all of his remaining assets in a liquidation trust for defrauded investors. In his \$81 million settlement with the SEC, Richard Scrushy, former CEO of HealthSouth, agreed not to seek indemnification or reimbursement for any part of this disgorgement and civil penalties.⁴ Shortly after these settlements occurred, these examples of substantial personal contributions by directors and officers were thought to possibly presage a new era in which individual directors and officers would be required to contribute personally to settlement of securities class action and derivative settlements. However, this has not proven to be the case and in the more routine claims that make up the overwhelming majority of claims against public company directors and officers settlements have not included personal contributions.

§ 7:3 Exculpation of Corporate Directors

§ 7:3.1 Exculpation Clauses in Corporate Charter Documents and the Delaware Approach

The Delaware Supreme Court decision in *Smith v. Van Gorkom*⁵ created great anxiety in the corporate director community by demonstrating that corporate directors could face very substantial personal monetary liability for actions taken in their directorial capacity. In that case, a corporate board approved a proposed merger in a manner that the court found to have been grossly negligent based upon the board members' failure to make adequate inquiry, failure to obtain expert advice, and general failure to be sufficiently informed about the merger they were approving. The allegations in *Van Gorkom* read like a textbook for board disregard of duties and what not to do, and have been used as a teaching tool for directors ever since. The result was the

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2. See Catherine Tomasko, *Enron Directors to Pay \$168 Million to Investors*, Corp. Officers & Directors Liability Litig. Rep., Jan. 24, 2005.
 3. See ELAINE BUCKBERG ET AL., RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: ARE WORLD COM AND ENRON THE NEW STANDARD? 1 (NERA July 11, 2005); see also *In re WorldCom, Inc. Sec. Litig.*, 388 F. Supp. 2d 319 (S.D.N.Y. 2005).
 4. See SEC v. Richard M. Scrushy, Litigation Release No. 20,084 (Apr. 23, 2007).
 5. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

imposition of substantial financial liability on the board. Following this decision, there was great concern that the now-clear risk of personal financial liability would make it difficult for corporations to recruit directors.

In response, Delaware enacted legislation allowing corporations to exculpate directors from certain liabilities. Delaware General Corporation Law §102(b)(7) permits Delaware corporations to adopt charter provisions that limit the liability of directors for personal monetary damages for breaches of the duty of care. These provisions do not purport to eliminate liability on the part of directors for violations of other fiduciary duties, such as the duty of loyalty, or for bad faith misconduct. The statute provides that a Delaware corporation may include an exculpation clause in its certificate of incorporation

eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [involving unlawful dividends]; or (iv) for any transaction from which the director derived an improper personal benefit.⁶

This exculpation provision is most commonly invoked to protect directors against monetary claims that are brought as derivative claims by shareholders for the benefit of the corporation.

At the present time, these exculpation (or "raincoat") provisions are clearly "state of the art," and it is necessary to have such a provision in order to attract talented directors.⁷

It is important to note that this provision—and comparable provisions under other state corporate statutes—only apply to monetary damages. These provisions do not limit equitable or injunctive actions against directors.

6. DEL. CODE ANN. tit. 8, § 102(b)(7).
7. Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 793 (Del. Ch. 2004) (noting that the Delaware legislature's enactment of section 102(b)(7) "is an important public policy statement by the General Assembly, which has the intended purpose of encouraging capable persons to serve as directors of corporations by providing them with the freedom to make risky, good faith business decisions without fear of personal liability").

§ 7:3.2 **Exculpation Provisions in the Model Business Corporation Act**

A majority of states have adopted corporate law provisions which permit exculpation of directors similar to that adopted by Delaware.⁸ The Model Business Corporation Act (MBCA) section 2.02(b)(4)⁹ provides that a corporation's certificate of incorporation may contain a provision

eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of financial benefit received by a director to which the director is not entitled; (B) an intentional infliction of harm on the corporation or its shareholders; (C) a violation of Section 8.33 [providing director's liability for unlawful distributions]; or (D) an intentional violation of criminal law.¹⁰

It can be argued that the MBCA formulation of permissible director exculpation is somewhat broader and more protective than the formulation under the Delaware corporate statute. The MBCA formulation uses clearer and more well-defined terms to describe the required exceptions to director exculpation than the less well-defined and, potentially, broader and more ambiguous language of "loyalty" or "good faith."

§ 7:3.3 **Exculpation of Officers**

Unfortunately for officers, the statutory exculpation provisions in both Delaware and in the statutes of the various other states which have corporate statutes allowing for exculpation only provide for exculpation of directors, not officers.¹¹ *Gantler v. Stephens* was a

8. *In re Avado Brands, Inc.*, 358 B.R. 868, 880 (Bankr. N.D. Tex. 2006) (noting that thirty-six states have adopted exculpatory clauses like Delaware's).

9. MODEL BUS. CORP. ACT § 2.02(b)(4) (2008).

10. *Id.*

11. In a sense, in very practical terms there may be something of a "silver lining" in the absence of exculpation for officers. While officers can be found liable under a much lower standard than the heightened standards required to sustain a non-exculpated claim against directors, if these officers are found liable, it is much more likely that they will still be indemnifiable and insurable. For directors, since they can only be found liable for the relatively more egregious non-exculpated conduct, if, in fact, such conduct is shown, insurance and indemnification may be at risk. For this reason, some of the same dynamics as in securities class actions may apply in suits alleging directors' breach of duties; *i.e.*, that such directors may be faced with essentially a "use it or lose it" issue for insurance and indemnification in deciding on a pretrial settlement or trial.

case in which the shareholders of a bank holding company sued the bank's directors and officers, alleging breach of fiduciary duty.¹² While the court noted—explicitly for the first time under Delaware law—that the fiduciary duties of officers and directors are the same, the court noted that section 102(b)(7)¹³ only allows a corporation's certificate of incorporation to exculpate a director from personal liability for money damages in a breach of fiduciary duty case and that there is no equivalent statutory provision authorizing the exculpation of corporate officers.

§ 7:3.4 Interplay of Exculpation with Demand Futility Issues in Derivative Litigation

As noted earlier in the discussion of derivative litigation,¹⁴ one of the most important early issues in derivative litigation is whether a shareholder/plaintiff may proceed directly to a derivative suit or must make a demand on the board for the desired relief. Very often a shareholder seeks to bring a derivative claim in the name of the corporation against the entire board. In such situations, it is often the centerpiece of the plaintiff's argument that pre-suit demand on the board for the relief requested is excused because a majority of the board faces a strong likelihood of liability and is, thus, too interested to fairly consider such a demand.¹⁵ Exculpation issues become critical in this context as the plaintiff will need to allege facts showing that a majority of the board faces a strong likelihood of liability on a non-exculpated claim—a typically much more difficult showing.

§ 7:4 Indemnification

§ 7:4.1 Indemnification Statutes

Arguably, under the common law a corporation did not have the power to indemnify its directors or officers for any dereliction of their duties, for their inappropriate actions would in no way have benefited the corporation.¹⁶ As a policy matter, it would be inappropriate to allow officers and directors to use corporate funds to protect them from their own misdeeds. Indemnification was allowed, then, only when a director or officer was found in the litigation or other proceedings against him or her to have acted properly in the performance of his or her duties. In time, however, an alternative view

12. Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

13. DEL. CODE ANN. tit. 8, § 102(b)(7).

14. See *supra* section 5:2.

15. See *supra* section 5:2.7.

16. See, e.g., N.Y. Dock Co. v. McCollum, 16 N.Y.S.2d 844 (Sup. Ct. 1939); Kan. City Operating Corp. v. Durwood, 278 F.2d 354, 357 (8th Cir. 1960).

prevailed, which was solidified through the adoption of indemnification statutes in all the states, usually in their corporate law. Indemnification was allowed because it was necessary to encourage individuals to accept the director and officer position despite potentially significant liabilities. Directors and officers also needed to perform their tasks knowing that they were protected from baseless lawsuits.¹⁷ These statutes generally distinguish among different kinds of indemnification. Thus, there are situations where a company must indemnify its officers or directors (mandatory indemnification, such as where an officer or director has prevailed in a lawsuit), others where the company has the discretion to indemnify (permissive indemnification, such as where an officer or director has been found liable, but has otherwise satisfied certain basic standards of conduct), and still others where a court may order the indemnification. These kinds of indemnification will be discussed further below in this chapter, particularly in reference to the indemnification provisions of the Model Business Corporation Act, the American Law Institute's Principles of Corporate Governance and representative statutes, such as Delaware's. This indemnification section will also consider such matters as the advancement of expenses, the procedures for indemnification and the availability of non-statutory indemnification.

[A] Coverage

The indemnification statutes identify corporate personnel who are eligible for coverage and protection. Coverage typically reaches directors and officers,¹⁸ although it may extend to all employees and agents of the corporation, as well as to former officers and directors.¹⁹²⁰ It may also reach an officer or director who is requested by the corporation to serve in a position of authority in another firm or as a trustee in the firm's employee benefit plan.²¹ The indemnification rights generally continue even after a director or officer has left office and pass to

17. See *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 561 (Del. 2002).

18. See MODEL BUS. CORP. ACT, §§ 8.51, 8.52, 8.54, 8.56; 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.20(a)(1), at 261 (1994) [hereinafter ALI, PRINCIPLES OF CORPORATE GOVERNANCE].

19. See MODEL BUS. CORP. ACT, § 8.56 Official Comment (discussing coverage for employees and agents); DEL. CODE ANN. tit. 8, § 145 (2005).

20. In modern corporations, many employees have titles suggesting that they are corporate officers when, under ordinary circumstances, one would not consider them to be officers as intended by these statutes. For an interesting discussion of several recent cases that have dealt with the issue of who is actually a corporate officer despite titles. Kevin LaCroix, *A Particular Vice: Job Titles, Indemnification, and Insurance*, THE D&O DIARY (Aug. 9, 2016).

21. See, e.g., MODEL BUS. CORP. ACT, § 8.50(2).

the benefit of the heirs, executors, and administrators of the person's estate.²² Coverage is generally limited to proceedings instituted against a director or officer because of his or her corporate role. This means proceedings arising from actions in an official capacity or service in another firm at the corporation's request, or from status as a director or officer even if the actions or conduct that give rise to the proceedings were not done for the corporation.²³

[B] Proceedings

The reach of the indemnification statutes with respect to proceedings is broad. The purpose of the broad coverage is to ensure that directors and officers are protected in all kinds of litigation, both the typical and the new or unexpected. The statutes typically cover civil, criminal, administrative, and investigative proceedings and may extend to arbitration as well.²⁴ They reach actions that are threatened, pending, or completed, as well as all appeals and requests to review decisions.

[C] Covered Liabilities

Covered liabilities for indemnification generally include attorneys' fees and other defense costs, money judgments, penalties, fines and amounts paid in settlement, although, as discussed below, this coverage may be limited in certain kinds of lawsuits.²⁵ The purpose here is again to make the coverage as broad as possible to reach any amounts assessed against a director or officer (including penalties and restitution). However, there may be fines and civil penalties pursuant to laws that prohibit indemnification, in order to focus the punishment upon the wrongdoer, and these would not be covered.²⁶ Notable in this regard are the federal securities laws: The SEC has for a

22. See DEL. CODE ANN. tit. 8, § 145(j) (2005).

23. See *Heffernan v. Pac. Dunlop GNB Corp.*, 965 F.2d 369, 375 (7th Cir. 1992) (interpreting Delaware law on indemnification to include lawsuits against the director by reason of his or her role, position or status). The key here is a "nexus" between the officer's or director's activity and the matter for which indemnification is sought.

24. See MODEL BUS. CORP. ACT, § 8.50(6) (defining proceeding to mean "any threatened, pending or completed action, suit, or proceeding, whether civil, criminal, administrative, arbitral, or investigative and whether formal or informal"); 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(a)(1) ("any threatened, pending, or completed action, suit, or other proceeding, whether civil, criminal, administrative, or investigative and whether formal or informal"); DEL. CODE ANN. tit. 8, § 145(a) (2005); N.Y. BUS. CORP. LAW § 722(a) (McKinney 2005).

25. See, e.g., MODEL BUS. CORP. ACT, 8.50(3); N.Y. BUS. CORP. LAW § 722(a) (McKinney 2005) ("judgments, fines, amounts paid in settlement").

26. See, e.g., 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(b)(1)(2).

long time taken the position that the indemnification of directors and officers for violations of federal anti-fraud laws is against their policy.²⁷ Reasonable expenses, including attorneys' fees, are included in the indemnification, even where the fine or civil penalty might be excluded.²⁸ The qualification of "reasonableness," which generally applies only to expenses, is designed to protect the corporation from having to pay excessive defense costs incurred by the director or officer.²⁹

[D] Permissive Indemnification

As discussed above, indemnification statutes make a distinction between mandatory and permissive indemnification, with the former generally dealing with situations where the officer or director has prevailed in the litigation. As to the latter form of indemnification, where the opposite result has occurred, further distinctions are made as to the identity of the party pursuing a suit against the director or officer, and the nature of the claim or claims made against him or her. Given, moreover, that in this case indemnification is permissive, the statutes often specify the procedures that the corporation must follow to authorize it.

[D][1] Third-Party Actions

Indemnification statutes permit a corporation to indemnify a director or officer in cases where a third party (including a government agency) brings a civil suit against him or her, and even prevails in it, provided that, with respect to the action that is the subject of the lawsuit, the director or officer acted in good faith and reasonably believed that the conduct was in, or at least not opposed to, the best interests of the corporation.³⁰ The implication here is that a director or

27. See, e.g., 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20 Reporter's Note 7 (describing the SEC's position and courts' reaction to it, as well as providing other examples). It is established that amounts paid in settlement of securities claims may be indemnified. See, e.g., *Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170 (N.D. Cal. 1994). It has been recommended that the SEC discontinue this policy against outside directors, provided that they have acted in good faith, particularly since the policy was adopted at a time when most directors were also employees of the company and since it was thus intended to encourage them to manage well the offering process. See INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 91 (Nov. 30, 2006).

28. See, e.g., 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(a)(1).

29. But see DEL. CODE ANN. tit. 8, § 145(a) (2005) ("[E]xpenses (including attorney's fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action . . .").

30. This is the formulation in Delaware and New York. See DEL. CODE ANN. tit. 8, § 145(a) (2005); N.Y. BUS. CORP. LAW § 722(a) (McKinney 2005). It is

officer may fail to meet the appropriate standard of behavior, such as a director's duty of care as to a particular decision or a duty arising under laws other than corporate law; indeed, without this failure, there would be no liability and thus no reason for indemnification. However, it is subsequently determined that this failure was not caused by the director's bad faith (that is, a willful recklessness) or the pursuit of other interests, such as his or her own. A director or officer may also be indemnified with respect to criminal proceedings if he or she had "no reasonable cause" to believe that the conduct was unlawful.³¹ Another way of putting this is that a corporation may indemnify a director or officer for criminal penalties or fines so long as his or her conduct does not involve "a knowing and culpable" violation of the law.³² This would appear to exclude indemnification for crimes where a guilty mind (*mens rea*) is an element of the offense but to include indemnification for criminal offenses that are regulatory in nature (that is, do not involve a knowing state of mind, but mere negligence).

Indemnification statutes make clear that any termination of the proceeding by judgment, order, settlement, conviction, or plea of no contest is not by itself a determination that the director or officer has not met the standard of conduct required for indemnification.³³ Indeed, the statutes generally stipulate that this termination does not create a presumption as to this issue of the director's good faith, reasonable belief, or reasonable cause.³⁴ Certainly, this effect makes sense with respect to a settlement or a plea of no contest, which could be made for many reasons unrelated to the merits of the claim against the director or officer.³⁵ On the other hand, a judicial determination as

also that recommended by the MODEL BUS. CORP. ACT. *See, e.g.*, MODEL BUS. CORP. ACT, § 8.51(a)(1)(i), (ii). The MBCA provides the further specification that in some cases the conduct of the director or officer "was at least not opposed to the best interests of the corporation" (for example, where the director or officer was acting on another firm at the corporation's request). *See, e.g., In re UnitedHealth Grp., Inc. S'holder Derivative Litig.*, Nos. 06-CV-1216, 06-CV-1691, 2007 WL 4571127, at *3 (D. Minn. Dec. 26, 2007) (suggesting that former Chair/CEO of UnitedHealth, Dr. William McGuire, might not be entitled to indemnification from his company if it were shown that he did not meet the appropriate standard of conduct in his participation in stock option backdating at the company).

31. *See* DEL. CODE ANN. tit. 8, § 145(a) (2005); N.Y. BUS. CORP. LAW § 722(a) (McKinney 2005); *see also* MODEL BUS. CORP. ACT, § 8.51(a)(1)(iii).

32. This is the ALI's formulation. *See, e.g.*, 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(b)(1)(A).

33. *See* MODEL BUS. CORP. ACT, § 8.51(c).

34. *See* DEL. CODE ANN. tit. 8, § 145(a) (2005); N.Y. BUS. CORP. LAW § 722(b) (McKinney 2005).

35. This is the explanation offered by the MBCA. *See* MODEL BUS. CORP. ACT, § 8.51 Official Comment No. 3.

to the issue of good faith, best interests of the corporation or guilty mind should certainly carry much weight.³⁶ Nevertheless, the statutes delegate the ultimate determination on permissible indemnification for third-party lawsuits to the corporate decision-maker, as discussed further below.

[D][2] Corporate Actions

The indemnification situation is very different when the person bringing the lawsuit against the director or officer is not a third party, but the corporation itself, either directly or through a derivative lawsuit. It is inappropriate for a director or officer to receive indemnification in circumstances in which the corporation has determined that his or her behavior violated legal duties to it, unless he or she is exonerated in this litigation. If the corporation prevails in the litigation, it would end up handing the recovery it receives from the director or officer right back to him or her.³⁷ Accordingly, indemnification statutes restrict indemnification in these circumstances by barring indemnification of damages or settlement amounts where the corporation is the plaintiff. They generally permit the corporation to indemnify the director or officer only for reasonable expenses (including attorneys' fees) incurred in connection with the defense or settlement of the lawsuit, provided that there is a corporate determination that he or she met the good-faith and "best interests of the corporation" standards.³⁸ Some statutes, however, provide for additional coverage: they allow for indemnification of expenses incurred in these proceedings where there is a final adjudication of the director's or officer's liability or for amounts paid in settlement, although in these cases indemnification requires court approval.³⁹

The limitation on corporate indemnification in derivative suits leaves a hole in director and officer protections that is frequently filled by director and officer liability insurance.

36. *See id.*

37. *See* MODEL BUS. CORP. ACT, § 8.51 Official Comment No. 4.

38. *See* MODEL BUS. CORP. ACT, § 8.51(d)(1); DEL. CODE ANN. tit. 8, § 145(b) (2005).

39. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(b) (2005) (court may allow for indemnification of expenses regarding claims for which the director has been found liable if it finds "that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses"; no allowance for amounts paid in settlement); N.Y. BUS. CORP. LAW § 722(c) (McKinney 2005) (allowing for indemnification of settlement amounts as well as expenses incurred in a litigation with an adverse final decision, but, again, only with court approval in both cases).

[D][3] Exclusions

In addition to a corporation's being prohibited from indemnifying a director or officer who has been found to have knowingly violated the law, indemnification statutes also prohibit a corporation from indemnifying him or her if the director or officer has been found to have received an impermissible financial benefit.⁴⁰ Many of these cases would involve the violation of the duty of loyalty by the director or officer, for example, engaging in an unfair transaction with the corporation, or making use of corporate assets or property, or competing with the corporation. Again, it would be absurd to have the director or officer be penalized for a conflict-of-interest violation by disgorging profits to the corporation, and then to have the corporation turn around and indemnify him or her for the lost profits. This exclusion applies even if the director or officer engaged in action that, while it benefited him or her, arguably did not directly harm the corporation, such as in the case of insider trading.⁴¹

[D][4] Corporate Determination

As noted above, permissible indemnification requires a corporate determination that the director or officer satisfied the standards for indemnification for the civil or criminal proceeding and a corporate authorization of payment of the indemnity. The determination is made in the same manner as when a corporation must evaluate other matters involving its directors or officers: it must be done by directors who are not the subject of the legal proceeding and who do not otherwise have disabling relationships with the director(s) or officer(s) who are the subject of the proceeding.⁴² As in other similar cases, the determination must be made by a majority vote of the disinterested directors, or by a majority vote of a committee of these directors.⁴³ Indemnification statutes also provide that, in the absence of disinterested or qualified directors, the determination of satisfaction of the standards may be made by a special legal counsel, who would be

40. See MODEL BUS. CORP. ACT, § 8.51(d)(2); 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(b)(1)(A).

41. See MODEL BUS. CORP. ACT, § 8.51 Official Comment No. 4.

42. These directors are generally referred to as "disinterested," or, in the new parlance of the ABA Committee on Corporate Laws, as "qualified." See *Changes in the Model Business Corporation Act—Proposed Amendments Relating to Chapters 1, 7, and 8*, 60 BUS. LAW 341 (2004); see also MODEL BUS. CORP. ACT, § 1.43(a)(2). The other circumstances would involve a pre-approval of a conflict-of-interest transaction between a board member and the corporation, or the decision of the board whether to recommend the pursuit of a derivative lawsuit. See *supra* sections 4:3, 5:7.

43. See MODEL BUS. CORP. ACT, § 8.55(b)(1), DEL. CODE ANN. tit. 8, § 145(d) (2005); N.Y. BUS. CORP. LAW § 723(b)(1) (McKinney 2005).

appointed only for this matter and who would not have a relationship with the involved directors or officers, or by the shareholders (excluding the vote of the shares of the director(s) or officer(s) involved).⁴⁴ The determination does not suffice, however; there must also be a corporate authorization of the indemnification payment. Again, this may be done in the same manner as the determination, except that the special legal counsel cannot by law authorize a corporate payment, which is a board function.⁴⁵ In this case, in the absence of disinterested directors, the interested board must make the authorization.⁴⁶ That it is making this authorization upon the special legal counsel's determination may help insulate the board from a subsequent shareholder challenge that the indemnification payment violated the board's fiduciary duties.

[D][5] Shareholder Disclosure

The ALI recommends that an actual indemnification of a director or officer (as well as an advancement of expenses, as discussed below) should be reported to the corporation's shareholders.⁴⁷ SEC rules also provide that, when engaged in a public capital raising, a corporation must disclose the "general effect" of any indemnification rights of its directors or officers, among others.⁴⁸ In addition, if these indemnification rights include indemnification for liabilities under the Securities Act, the company must disclose the SEC's view that this indemnification is against public policy.⁴⁹

[E] Mandatory Indemnification

Indemnification statutes also provide for mandatory indemnification of directors and officers: In certain circumstances, the company is obligated to indemnify them for litigation expenses. The Model Act and the ALI provide that an officer or director be "wholly successful" in the lawsuit in order to be entitled to this indemnification.⁵⁰ This

44. See MODEL BUS. CORP. ACT, § 8.55(b)(2), (3), DEL. CODE ANN. tit. 8, § 145 (d) (2005); N.Y. BUS. CORP. LAW § 723(b)(2) (McKinney 2005).

45. It would also appear that the shareholders cannot authorize a corporate payment, although they could ratify a board's authorization.

46. See MODEL BUS. CORP. ACT, § 8.55(c). The MBCA explains that this kind of authorization is a legal necessity. See MODEL BUS. CORP. ACT § 8.55 Official Comment.

47. See 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(d). See also N.Y. BUS. CORP. LAW § 725(c) (McKinney 2005) (requiring disclosure to shareholders).

48. See 17 C.F.R. § 229.702 (2005). This is a disclosure item in the SEC's capital raising forms, such as Form S-1 and Form S-3.

49. See *id.* § 229.510.

50. See MODEL BUS. CORP. ACT, § 8.52; 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(a)(3)(A).

approach would exclude situations where the officer or director has bargained with the opposing party, such as a prosecutor, to obtain a plea on a lesser charge and/or to have certain claims or counts dropped.⁵¹ Mandatory indemnification also demands that the litigation be finally resolved, with all appeals exhausted. The phrasing in the model acts is that the officer or director need be “wholly successful, on the merits or otherwise.” This suggests that he or she is entitled to indemnification even if the lawsuit is finally disposed of on a procedural issue, such as the statute of limitations.

Actual indemnification statutes, and the jurisprudence on them, are more liberal than the model acts with respect to mandatory indemnification. Delaware law provides this kind of indemnification to any “present or former director or officer” who has been “successful on the merits or otherwise” in any action or “in defense of any claim, issue or matter therein.”⁵² The implication of this language is that an officer or director is entitled to indemnification as to individual claims or issues, even those dismissed or bargained away; he or she need not be “wholly successful” in the entire action or proceeding.⁵³ This would require apportionment of indemnification as to the claims on which the director or officer has prevailed. Indemnification may also be mandated in cases where the lawsuit alleging claims against the officer or director has been settled, provided that he or she makes no admission of liability.⁵⁴ In addition, mandatory indemnification is not exclusive. An officer or director is always eligible for permissive indemnification if he or she is not entitled to mandatory indemnification and satisfies the conditions for permissive indemnification.

A recent decision involving both permissive and mandatory indemnification is *Hermelin v. K-V Pharmaceutical Co.*⁵⁵ There the CEO of K-V Pharmaceutical, Hermelin, and the company itself faced numerous civil and criminal actions because of its marketing of “oversized” pills. Hermelin claimed that he was entitled to mandatory or

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51. See MODEL BUS. CORP. ACT, § 8.52 Official Comment.
 52. See DEL. CODE ANN. tit. 8, § 145(c) (2005); see also N.Y. BUS. CORP. LAW § 723(a) (McKinney 2005) (referring to “successful”).
 53. See *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138 (Del. Sup. Ct. 1974); see also *In re Adelpia Commc’ns Corp.*, 323 B.R. 345, 380–83 (Bankr. S.D.N.Y. 2005) (finding that mandatory indemnification is allowed under Delaware law even if an officer is partially successful, and that “wholly successful” means, in relevant jurisdictions, that an officer has not been convicted or pled guilty to any criminal offense).
 54. This is an area of the law that is subject to the jurisprudence of individual jurisdictions. See, e.g., *Wisener v. Air Exp. Int’l Corp.*, 583 F.2d 579 (2d Cir. 1978) (interpreting Illinois law to allow indemnification in settlement); *Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87 (2d Cir. 1996) (same for Delaware law).
 55. *Hermelin v. K-V Pharm. Co.*, 54 A.3d 1093 (Del. Ch. 2012).

permissive indemnification with respect to his costs and penalties associated with all of the proceedings. Vice Chancellor Glasscock only partly agreed with his contentions. He first summarily dismissed Hermelin's argument that he was entitled to indemnification for Hermelin's legal action to prevent a reporter from obtaining records of Hermelin's time in a county jail (part of his punishment for a criminal violation to be discussed below), since such actions were explicitly excluded by the indemnification contract. Thus, Hermelin had to repay to the company any amounts advanced to him for legal fees on this matter. The vice chancellor then considered whether Hermelin was entitled to mandatory indemnification with respect to three criminal and civil matters, which turned on whether he was "successful on the merits or otherwise" in them. In the court's view, this determination turned entirely on the outcome of the proceeding, that is, whether an indemnitee like Hermelin avoided a bad result. He concluded that Hermelin was not entitled to mandatory indemnification on the criminal charges against him, to which he had pled guilty and received a fine and a thirty-day jail sentence. That Hermelin avoided expense by pleading guilty did not alter the fact that the outcome of the criminal proceeding was not a success. Similarly, the court reasoned that Hermelin was unsuccessful in a Health and Human Services' proceeding to determine whether he should be excluded from future participation in federal healthcare programs (he was so excluded for twenty years). The court found irrelevant that Hermelin was not fined by the agency or that he helped his company avoid its own exclusion. By contrast, Vice Chancellor Glasscock found Hermelin entitled to mandatory indemnification with respect to a Food and Drug Administration consent decree relating to him, among other parties, since that decree literally imposed no restrictions on him.

The court then had to consider whether Hermelin was entitled to permissive indemnification for his expenses in the criminal action and the Department of Health and Human Services (HHS) proceeding, which would turn on whether, despite the adverse outcomes noted above, he had acted in good faith. The Vice Chancellor noted that the outcome of a trial or proceeding was not determinative of this issue unless the trial or proceeding had explicitly dealt with this matter (such as by a finding that the defendant had acted with scienter). But neither the criminal action (Hermelin pled guilty to a misdemeanor imposing strict liability upon a responsible corporate officer) nor the HHS proceeding addressed the good faith matter. Thus, Vice Chancellor Glasscock ordered trial on this issue of good faith for the purpose of determining Hermelin's eligibility for permissive indemnification and limited discovery in preparation for the trial to the evidence relating to it.

[F] Advancement of Defense Costs to Directors and Officers

Expenses, particularly attorneys' fees, incurred by a director or officer in defending against lawsuits can be significant and can impose a financial burden on all but the wealthiest of individuals. If a director or officer has to pay them himself or herself and then seek indemnification from the corporation upon the final resolution of the action, which might take years, this could prove ruinous wholly apart from whether the director or officer is ultimately found to have engaged in wrongdoing. This would certainly have a chilling effect on corporations' ability to attract good directors and officers. To encourage competent persons to direct enterprises and to take risks and therefore corporate statutes authorize, but do not require, corporations to finance the defense of directors and officers and, for that purpose, to pay in advance their defense expenses.

Indemnification statutes provide for the advance payment of defense expenses.⁵⁶ Generally, this advancement is subject to conditions. The basic condition is that the director or officer undertake⁵⁷ to

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56. See *Envirokare Tech, Inc. v. Pappas*, 420 F. Supp. 2d 291, 293–94 (S.D.N.Y. 2006) (holding that Sarbanes-Oxley's prohibition on a public company's making personal loans to executives does not bar a company's advancement for litigation expenses).
57. These "undertakings" are frequently an evergreen provision in a director's or officer's indemnification agreement with the company. These provisions state that the director or officer in signing the agreement agrees to undertake to pay advanced fees and costs if he or she ultimately is not indemnified. For instances in which the director or officer does not have an indemnification agreement or does not have such a provision in their indemnification agreement, company counsel will provide the director or officer with a short "undertaking" in connection with any litigation or other proceeding against the director or officer. An example of the language used in these undertakings is as follows:

This Undertaking is given by the undersigned to [Company], a Delaware corporation, in his capacity as a current or former officer of the Company in connection with the advancement of attorneys' fees, costs, and expenses incurred by the undersigned in connection with the following lawsuits [Captions] (the "Action"). The undersigned has become involved in the Action arising out of his executive position with the Company. The undersigned hereby affirms that, with respect to the facts and circumstances related to the Action, he acted in good faith and in a manner he believed was in or not opposed to the best interests of the Company. The undersigned agrees that, if it is ultimately and finally determined that he is not entitled to be indemnified, he will reimburse the Company for all fees, costs and expenses advanced on behalf of the undersigned in connection with the Action to the extent required by his Indemnification Agreement, the Company's Articles and Bylaws, and the law of the State of Delaware.

repay the advance if it is ultimately determined that he or she is not entitled to indemnification, whether mandatory or permissible, under the indemnification statutes or otherwise.⁵⁸ The MBCA adds several other conditions for the advance, only some of which are reflected in actual statutes or in the jurisprudence interpreting them. It provides that the director or officer must affirm in writing his or her “good faith belief” that he or she has met the “relevant standard of conduct” for permissible indemnification or for exculpation from liability under a charter provision.⁵⁹ It also stipulates that the advance must be authorized by disinterested (or in the new parlance “qualified”) directors or by the shareholders (excluding the votes of any interested directors)—a requirement not generally seen in the statutes.⁶⁰ It explains, however, that the directors or shareholders authorizing the advance are under no obligation to inquire into the merits of the claims asserted against the director or officer, although they may condition the advance as they see fit.⁶¹ Indeed, courts emphasize that advancement and indemnification are two separate issues, and the former is not contingent upon the latter.⁶² It also provides that the advance need not be secured nor be based upon the ability of the director to repay it, with the policy being that no distinction must be made among directors that would discourage the less affluent from serving on boards—a position generally reflected in the cases on advances.⁶³

As discussed further below, the advance may be provided pursuant to a separate agreement between directors and officers and the

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58. See, e.g., DEL. CODE ANN. tit. 8, § 145(e) (2005); N.Y. BUS. CORP. LAW §§ 723(c), 725(a) (McKinney 2005); see also 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(a)(2). For an interesting story on potential payback of advancement by Rajat Gupta, a former Goldman Sachs director convicted of insider trading, see Peter Lattman, *Goldman Stuck with a Defense Tab, and Awaiting a Payback*, N.Y. TIMES: DEALBOOK (June 18, 2012).
59. See MODEL BUS. CORP. ACT, § 8.53(a)(1). This written affirmation requirement has been adopted by a number of states.
60. See *id.* § 8.53(c). The MBCA allows for a vote of interested directors where there are fewer than two disinterested directors. See *In re Adelpia Commc'ns Corp.*, 323 B.R. 345, 384–86 (Bankr. S.D.N.Y. 2005) (finding that in jurisdictions, like Delaware, where advancement is not mandatory, directors must evaluate whether it can be done in the best interests of the corporation, and their decision must be scrutinized for entire fairness if they are interested in the advancement).
61. See *id.* § 8.53 Official Comment.
62. See, e.g., *Brady v. i2 Techs. Inc.*, No. Civ. A. 1543-N, 2005 WL 3691286 (Del. Ch. Dec. 14, 2005) (holding that an agreement executed at the time of CEO's resignation that dealt with, among other things, indemnification did not affect CEO's advancement rights under prior agreement, because second agreement did not specifically address advancement).
63. See MODEL BUS. CORP. ACT, § 8.53(b) & Official Comment.

corporation, or pursuant to a bylaw or charter provision, which may be broader or narrower than the applicable statute.⁶⁴ A complete understanding of a director's or officer's right to advancement requires an evaluation of any such provision.

A Delaware Supreme Court case highlights issues raised in the advancement context, where a company resisted giving an officer an advance. In *Homestore, Inc. v. Tafeen*,⁶⁵ Peter Tafeen, a former officer of Homestore, applied for advancement of expenses relating to investigations, civil proceedings, and criminal actions in which he was a defendant because of his alleged role in Homestore's accounting fraud. Homestore's bylaws provided for a mandatory advancement of expenses, without any conditions, for present and former directors and officers, who, under the bylaws, would be indemnified to the fullest extent of Delaware law.⁶⁶ Homestore would make the advance, but only if Tafeen agreed to a list of conditions, which he refused to do. The Court of Chancery directed Homestore to make the advancement, but Homestore appealed this decision.

In considering Homestore's defenses, the Delaware Supreme Court noted the importance of advancement:

Advancement is an especially important corollary to indemnification as an inducement for attracting capable individuals into corporate service. Advancement provides corporate officials with immediate interim relief from the personal out-of-pocket financial burden of paying the significant on-going expenses inevitably involved with investigations and legal proceedings.⁶⁷

The court observed that section 145(e) of the Delaware Code did not require any specific undertaking or condition for an advancement to former officers or directors, although a corporation would be free to add conditions in its certificate or bylaws. In this case, Homestore had made advancement unconditional. The court also observed that indemnification and advancement were separate and distinct: the right to an advancement was not dependent upon a director's or officer's right to indemnification (although an officer or director would

64. See, e.g., *Underbrink v. Warrior Energy Servs. Corp.*, C.A. No. 2982-VCP, 2008 WL 2262316 (Del. Ch. May 30, 2008) (applying business judgment review to adoption of an advancement bylaw by written consent of the board, where bylaw would have retroactive effect with respect to adopting directors).

65. *Homestore, Inc. v. Tafeen*, 888 A.2d 204 (Del. 2005).

66. Delaware law imposes no condition on the advancement of expenses for former officers or directors, although it does require an undertaking for a present officer or director to repay the advance if it is later found that he or she was not entitled to it. See DEL. CODE ANN. tit. 8, § 145(e) (2006).

67. *Homestore*, 888 A.2d at 211 (footnote omitted).

have to repay the advance if it were later found that he or she was not entitled to indemnification).⁶⁸ Accordingly, any proceeding involving an advancement was generally summary in nature.⁶⁹

The court then disposed of Homestore's objections to making the advancement. Homestore had argued that Tafeen was not entitled to advancement, because the proceedings for which he sought advancement dealt with conduct in which he allegedly enriched himself, which would take him out of the indemnification's requirement that they be based upon his official capacity. The court, however, rejected the alleged motivation of an officer or director as a justification for denying the advancement. As it noted:

Accordingly, we hold that if there is a nexus or causal connection between any of the underlying proceedings contemplated by section 145(e) and one's official corporate capacity, those proceedings are "by reason of the fact" that one was a corporate officer, without regard to one's motivation for engaging in that conduct.⁷⁰

It also rejected Homestore's defense, on equitable grounds, that Tafeen had "unclean hands" in asking for the advancement when he was attempting to make himself judgment-proof by placing his assets in his Florida home, which, under Florida law, could not be attached if it were later found that he was not entitled to indemnification and if he refused to repay the advancement. The court did not dispute that this defense was valid, but agreed with the Court of Chancery that the facts in this case did not support it.

In *Sun-Times Media Group, Inc. v. Black*,⁷¹ Vice Chancellor Strine considered the question of what constituted a "final disposition" of a

68. *See id.* at 212–13.

69. *See also* *Kaung v. Cole Nat'l Corp.*, 884 A.2d 500, 508–10 (Del. 2005) (ruling that Court of Chancery erred when, in a proceeding to determine an officer's right to an advancement of expenses, it resolved the issue of the corporation's recoupment of previous advancements, and pointing out that this proceeding is a summary one); 2005 WL 3462250 (Del. Ch. Dec. 13, 2005) (after remand from Delaware Supreme Court, Court of Chancery denying request for attorney fees for lawsuit seeking advancement because officer had not prevailed in his seeking of advancement, but only as to the denial of recoupment of former advances).

70. *See Homestore*, 888 A.2d at 214 (footnote omitted); *see also* *Brown v. LiveOps, Inc.*, 903 A.2d 324 (Del. Ch. 2006) (following *Homestore* and requiring that advancement be enforced where former director and officer was sued by company for, among other things, misusing its proprietary information, because there was a nexus between the claims against him and his former positions; decision came despite company's effort to remove any mention of officer's former position with it in the company's amended complaint).

71. *Sun-Times Media Grp., Inc. v. Black*, 954 A.2d 380 (Del. Ch. 2008).

criminal action for advancement purposes. The case concerned the obligation of the *Sun-Times* to continue to advance defense expenses to Conrad Black and others after they had been convicted of criminal offenses at the trial court level, with the *Sun-Times* taking the position that its advancement obligations were at an end. Finding the Delaware case law on this point to be inconclusive (but law from other jurisdictions to be supportive of his conclusion), the Vice Chancellor read the words “final disposition” in the context of section 145(e) to mean “the final, non-appealable conclusion of a proceeding.”⁷² He also observed that policy reasons of encouraging individuals to serve as directors and officers supported his perspective:

Here, in interpreting final disposition, I have already found that the most common and natural usage of that term is the final, non-appealable conclusion of a proceeding. Applying the policy gloss in favor of advancement to corporate officials only strengthens the view that a final disposition is not reached until there is a final, non-appealable conclusion to a proceeding. To find otherwise would be to interpret § 145(e) as creating a patchwork system of advancement that fails to provide advancement to officials for the appeal of an adverse trial court judgment. Moreover, doing so would contradict Delaware’s policy of encouraging officials to resist unjustified lawsuits by discouraging them from appealing adverse trial court judgments. In turn, that might discourage qualified individuals from serving at Delaware corporations.⁷³

Thus, under this decision there must be advancement of defense expenses until a director’s rights of appeal have been exhausted.⁷⁴

72. *Id.* at 397.

73. *Id.* at 404–05 (footnote omitted).

74. *See also* Barrett v. Am. Country Holdings, Inc., 951 A.2d 735 (Del. Ch. 2008). In this odd case, the directors had almost used up D&O coverage for advancement of expenses and thus sought statutory advancement from their company, which was suing them. The company conditioned the advancement on the directors’ confessing judgment and assigning any of their rights under the D&O policy to the company (which was in a dispute with the D&O insurer). Vice Chancellor Strine found that the directors were unconditionally entitled to advancement. For a discussion of this and other recent Delaware D&O cases, see Joseph M. McLaughlin, *Directors’ and Officers’ Liability*, N.Y.L.J., Oct. 9, 2008. *See also* Westar Energy, Inc. v. Lake, 552 F.3d 1215 (10th Cir. 2009) (upholding preliminary injunction directing corporation (incorporated under Kansas law) to advance to former director and officer attorney fees for his defense expenses in criminal proceedings). *But see In re HealthSouth Corp. Sec. Litig.*, 572 F.3d 854 (11th Cir. 2009) (upholding a settlement’s bar order that extinguished corporation’s contractual obligation to advance legal fees to Richard Scrusby, the former CEO and a non-settling defendant in the action).

Directors and officers are not always so successful in advancement litigation, however. In *Happ v. Corning, Inc.*,⁷⁵ Robert Happ served as a director of Galileo, a Delaware corporation, which provided indemnification by bylaw and contract and advancement if a director supplied an undertaking that he or she would repay the advance if it were later determined that he or she was not entitled to indemnification. The indemnification and advancement rights were basically in line with Delaware law. When the SEC brought a civil lawsuit against Happ for a violation of federal insider trading law in his sale of his company's shares, Corning (which had acquired Galileo) insisted that his undertaking of repayment state that Happ would repay the advance "if it were 'finally determined' that he 'wrongfully used material non-public information of Galileo Corp . . . for personal gain, either with intent or recklessly, in selling shares of Galileo stock.'"⁷⁶ Happ was found guilty of insider trading, and in a separate trial over the amount of the advancement he was ordered to repay it pursuant to his undertaking.

The Court of Appeals for the First Circuit upheld the order of repayment. The court first rejected Happ's argument that the undertaking, which was more specific than what was provided under Delaware law (which requires repayment if it is found that the director or officer is not entitled to indemnification), was procured by duress. It found that it was not unlawful or wrongful for Corning to insist upon the specific wording of the undertaking, and Happ had recourse at that time if he disagreed with it.⁷⁷ The court next observed that even if Happ's entitlement to the advancement were judged by the Delaware law standard (not by the undertaking), which requires indemnification where the director acted in good faith and with a reasonable belief that his or her actions were in the best interests of the company, he would likely not satisfy it and would have to repay the advance.⁷⁸

In an interesting decision, *Schoon v. Troy Corp.*,⁷⁹ Vice Chancellor Lamb of the Delaware Court of Chancery determined that a former director was not entitled to advancement, because the corporation had changed its bylaw to eliminate this right before the corporation itself brought suit against the former director for breach of his fiduciary duty. The corporation, Troy Corp., had previously provided indemnification and advancement rights to existing and former directors, but removed the latter from the advancement (but not indemnification) coverage a little over a month before bringing the fiduciary duty claims. The claims were based upon allegations that the former

75. *Happ v. Corning, Inc.*, 466 F.3d 41 (1st Cir. 2006).

76. *Id.* at 43.

77. *See id.* at 45.

78. *See id.* at 46.

79. *Schoon v. Troy Corp.*, 948 A.2d 1157 (Del. Ch. 2008).

director had acted for the benefit of the controlling shareholder whom he represented on Troy's board, rather than for Troy. The Vice Chancellor rejected the former director's argument that the right to advancement "vests" when a director takes office with a bylaw in force granting him this right and concluded, instead, that it is triggered only by the onset of litigation against the director. Since, the court reasoned, Troy brought its fiduciary duty claims after the amendment to the bylaw, the former director no longer had any right to advancement. Practitioners were concerned that, in light of this decision, which could be read to extend to the indemnification right as well, directors and officers had to ensure that their contractual indemnification and advancement rights with the corporation were strong enough to withstand this kind of unilateral amendment by the corporation.⁸⁰ However, reversing the effect of the *Schoon* decision, the Delaware legislature amended section 145(f) to clarify that a director or officer is entitled to the indemnification and advancement rights existing at the time of the breach or other violation that is the basis for a later civil or criminal proceeding, unless the bylaws specifically provide otherwise.⁸¹

It may happen that the proceedings against the director or officer terminate without any determination as to his or her liability. In these circumstances, the board, the appropriate board committee, or the shareholders must make a determination whether the director or officer is entitled to permissible indemnification and thus need not repay the advance. The ALI observes that it is always in the board's

80. See, e.g., Andrew R. Brownstein et al., Indemnification and Expense Advancement Bylaws Should Be Reviewed in Light of Delaware Decision (Wachtell, Lipton, Rosen & Katz May 29, 2008); David A. Katz & Laura A. McIntosh, *Corporate Governance*, N.Y.L.J., July 24, 2008 (recommending, among other things, that bylaws state that indemnification rights vest when person becomes director, that they state that no amendment to them can adversely affect director, and that individual indemnification agreements cannot be amended without director's consent). A board may simply reserve to itself the decision to advance defense costs. Such a decision, if pursuant to the corporation's bylaws, will be upheld. See *Miller v. Palladium Indus., Inc.*, C.A. No. 7475-VCN, 2012 WL 6740254 (Del. Ch. Dec. 31, 2012), *aff'd*, 72 A.3d 502 (Del. Sup. 2013).

81. See DEL. CODE ANN. tit. 8, § 145(f) (2009) ("A right to indemnification or to advancement of expenses arising under a provision of the certificate of incorporation or a bylaw shall not be eliminated or impaired by an amendment to such provision after the occurrence of the act or omission that is the subject of the civil, criminal, administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred.")

business judgment to waive any claim that it might have against a director or officer for repayment of expenses (for example, where he or she is not entitled to mandatory or permissible indemnification), although any waiver as to advanced expenses for a derivative suit where the director or officer has been found liable demands court approval.⁸²

[G] Court-Ordered Indemnification

Indemnification statutes authorize a court to order indemnification, as well as advancement of expenses, in a number of cases upon the application of a director or officer. Most obviously, a court will order indemnification where the director or officer has satisfied the requirements for mandatory indemnification.⁸³ Where indemnification rights are provided for in a corporation's charter, bylaws, or in a separate indemnification contract, a court could be asked by a director or officer to interpret them, obviously in situations where the corporation has made an adverse determination that the applicable document does not protect the director or officer.⁸⁴

More significant is the power of the court to award indemnification and expenses even in circumstances where under the statutes or under a contract the director or officer is not entitled to them: for example, where a director or officer has been found to have committed a knowing violation of the law or to have benefited himself or herself, or for damages or a settlement in a derivative lawsuit. Reflecting the statutes of numerous states, the MBCA provides for this indemnification or expense reimbursement where the court determines "in view of all the relevant circumstances, that it is fair and reasonable" to make the indemnity or advance the expenses.⁸⁵ It explains that in deciding to make an award in these cases, a court would consider such factors as the view of the corporation's board, the financial impact on the corporation, the ability of a director to finance his or her defense, the position of the corporation as to the indemnification (for example, where under the law a corporation is itself prohibited from making the indemnification, but otherwise supports it) or the de minimis nature of the director's breach of fiduciary duties (for example, where a director has been found to have received an improper pecuniary benefit, but it was insubstantial).⁸⁶ There may in fact be statutory

82. See also 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(c)(1).

83. See MODEL BUS. CORP. ACT, § 8.54(a)(1).

84. See MODEL BUS. CORP. ACT, § 8.54(a)(2). See also 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE § 7.20(c)(1).

85. See MODEL BUS. CORP. ACT, § 8.54(a)(3). See also 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(c)(2).

86. See MODEL BUS. CORP. ACT, § 8.54 Official Comment.

limitations to this court power.⁸⁷ For example, under Delaware law a court cannot do more than order payment of expenses for a director or officer who has been found liable to the corporation in a derivative lawsuit.⁸⁸ Depending upon the jurisdiction, a court generally has the power to order payment of a director's or officer's expenses incurred in seeking the court-ordered indemnification, particularly in situations of mandatory indemnification or indemnification under charter or contract.⁸⁹

§ 7:4.2 Contractual Indemnification

The three kinds of indemnification, permissive, mandatory and court-ordered, are pursuant to corporate law statutes. A director or officer may have additional indemnification rights under the corporation's charter or bylaws, or under a contract with the corporation. The important question is whether the corporate law statutes of a particular state authorize a corporation to grant these additional rights or restrict indemnification to the three statutory forms.

[A] Exclusivity of Statutory Indemnification

The MBCA makes statutory indemnification and expense advancement exclusive,⁹⁰ and this approach is followed by a small number of states.⁹¹ Under this approach, there may be indemnification provisions in the charter or bylaws, or in an indemnification contract, but they would have to be consistent with statutory indemnification; they could not offer additional rights. The MBCA suggests that these contractual provisions might be procedural: for example, they might obligate a board of directors to act quickly upon a director's application for permissible indemnification or for advancement of expenses, or to cooperate in a request from an officer or director seeking the kind of indemnification that requires court approval.⁹² In addition, under this

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87. Even the MBCA limits this court-ordered indemnification: only reimbursement of expenses (that is, no indemnity) is allowed where a director or officer has been adjudged liable in a derivative proceeding or has been found to have received an improper financial benefit. *See id.* § 8.54(a)(3)(ii), at 8-90. The ALI proposes a similar restriction; *see also* 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(c)(2) (proposing a standard somewhat more restrictive on a court).
88. *See* DEL. CODE ANN. tit. 8, § 145(b) (2005). New York restricts the court's power to what the statute allows under permissible and mandatory indemnification; N.Y. BUS. CORP. LAW § 724 (McKinney 2005).
89. *See* MODEL BUS. CORP. ACT, § 8.54(b).
90. *See id.* § 8.59.
91. *See also* 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20 Reporter's Note 3.
92. *See* MODEL BUS. CORP. ACT, § 8.59 Official Comment.

approach a corporation could obligate itself in advance to make permissible indemnification and expense advancement mandatory. This means that indemnification and expense advancement are pre-authorized—a common approach in corporations.⁹³ The director or officer must still affirm his or her entitlement to the indemnification and commitment to repay the advanced expenses, if he or she is found not to be so entitled, and there must be a determination by the board, board committee, or special counsel that the director or officer has a right to the indemnity.⁹⁴ By contrast, it is also within a corporation's power to limit in its charter the permissible rights to indemnification and expense advancement.⁹⁵

[B] Non-Exclusivity

The vast majority of the indemnification statutes authorize indemnification beyond statutory indemnification; in other words, the statutes are non-exclusive.⁹⁶ The Delaware statute is exemplary in this respect as it provides that the statutory indemnification and expense advancement “shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors, or otherwise, both as to action in such person's official capacity and as to action in another capacity while holding such office.”⁹⁷

An important question thus becomes whether there is any limit on this contractual power to provide additional indemnification to directors or officers. New York, for example, provides one model by barring indemnification as to certain final judgments: that is, “if a judgment or other final adjudication adverse to the director or officer establishes that his acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled.”⁹⁸ Other state statutes bar contractual indemnification for

93. *See id.* § 8.58(a) & Official Comment. The Official Comment suggests that, when permissible indemnification has been pre-authorized, there should be a presumption that expense advancement is pre-authorized as well.

94. *See id.*

95. *See id.* § 8.58(c).

96. *See* 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20 Reporter's Note 3.

97. *See* DEL. CODE ANN. tit. 8, § 145(f) (2005).

98. *See* N.Y. BUS. CORP. LAW § 721 (McKinney 2005).

certain kinds of misconduct.⁹⁹ A more difficult question arises where, as in Delaware, there is no express limitation to the non-exclusivity provision: Does this mean that there are no limits to contractual or consensual indemnification? It would seem clear that indemnification is always subject to public policy limitations, which may bring a court back to the limitations.¹⁰⁰

[C] Safeguarding Indemnification Funds

Although directors and officers may have rights under indemnification statutes and contractual indemnification arrangements, they may experience problems in obtaining funds for expenses and indemnification at times when the funds are most needed. The corporation may not be in a financial position to advance any money. Possible solutions include placing funds for indemnification and expense advances in an irrevocable trust or in escrow with a third party, other than the corporation, acting as trustee or being in control of them.¹⁰¹ The corporation could also procure third-party support for the indemnification rights, for example, by a letter of credit. This kind of arrangement may be particularly valuable for the director or officer if he or she no longer occupies the position and/or his or her interests are at odds with those of the current management of the corporation (for example, there has been a change of control of the company). However, the arrangement must be established when the corporation is solvent, so as to avoid any claims that, in setting it up and providing the necessary funds, the corporation was defrauding its creditors. Any arrangement must also be structured so as not to be viewed as a self-interested benefit to directors and officers at the expense of the corporation and its shareholders.

§ 7:5 Directors' and Officers' Liability Insurance

§ 7:5.1 Background

A careful director or officer will want to understand D&O insurance and the policies in place for his or her corporation. D&O insurance plays a critical role in director and officer protection, sometimes providing comfort that there will be an entity with the financial

99. See, e.g., VA. CODE ANN. § 13.1-704(B) (2005) (barring additional indemnification for “willful misconduct” and a “knowing violation of the criminal law”).

100. Cases have interpreted contractual indemnification under Delaware law to have basically the same limitations as its statutory indemnification. See, e.g., *Cochran v. Stifel Fin. Corp.*, 2000 Del. Ch. LEXIS 58, at *65 (Del. Ch. 2000); *Waltuch*, 88 F.3d at 91–92. This is basically the ALI’s approach as well. See 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(e) & cmt. 1.

101. See 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20 cmt. 1.

capability to provide protection and at other times providing assurance that gaps in allowable indemnification will be able to be filled. The previous discussion underscores significant problems in indemnification's coverage. Permissible indemnification can be subject to exclusions, such as judgments and even settlement amounts for derivative lawsuits. Moreover, there is always the risk that the board may not authorize the indemnification or expense advancement under permissive statutes, particularly if there has been a change of control and the ousted directors and officers resisted it or if for another reason the new board wants to distance itself from or is even hostile to former management. Even if a director or officer has a contractual right to indemnification, there may be interpretative issues regarding the contract or the firm may have not enough resources to satisfy its contractual obligations. D&O insurance provides both a backstop to the firm's indemnification obligations to directors and officers, as well as additional coverage to them for liabilities and expenses not covered by indemnification. Historically, this insurance became critical in the last quarter of the twentieth century when liability for directors and officers, particularly from shareholder derivative and federal securities lawsuits, exploded.¹⁰² A D&O policy typically insures individual directors and officers and usually insures the corporation for any amounts it owes under indemnification statutes or arrangements. A third type of coverage is now very common, insuring the company itself for its own liability—often limited to securities liability. The discussion below discusses the law permitting corporations to purchase this kind of insurance, the basic coverage of D&O insurance and several related topical issues.

§ 7:5.2 Insurance Statutes

Corporate law statutes generally authorize corporations to purchase insurance on behalf of directors and officers. In line with the MBCA and the ALI,¹⁰³ Delaware law provides that the insurance may be “against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the corporation would have the power to indemnify such person against such liability under this section.”¹⁰⁴

Thus, these statutes specifically authorize corporations to fill the gaps in protection left by indemnification through the purchase of D&O insurance. Some state statutes impose public policy limitations

102. See TY R. SAGALOW, *DIRECTORS AND OFFICERS LIABILITY INSURANCE: A DIRECTOR'S GUIDE* 2–3 (Nat'l Ass'n of Corp. Dirs. 2000).

103. See MODEL BUS. CORP. ACT, § 8.57; 2 ALI, *PRINCIPLES OF CORPORATE GOVERNANCE*, § 7.20(a)(4).

104. See DEL. CODE ANN. tit. 8, § 145(g) (2005).

upon this insurance coverage. For example, New York bars insurance payments, other than defense costs, “if a judgment or other final adjudication adverse to the insured director or officer establishes that his acts of active and deliberate dishonesty were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled”¹⁰⁵ This latter approach is echoed by the ALI, which prohibits insurance “against liability for conduct directly involving a knowing and culpable violation of law or involving a significant pecuniary benefit obtained by an insured person to which the person is not legally entitled.”¹⁰⁶ As discussed below, and more directly pertinent, insurance policies have their own sets of contractual exclusions, which reach many of the same liabilities excluded by indemnification.

§ 7:5.3 Insurance Policies

It is important that a director and officer understand in some detail the terms of his or her company’s insurance policy, for these policies play a critical role in protection against liability. Unfortunately, it is not uncommon for these policies to not be well understood by covered directors and officers.

Most modern D&O policies have at least two basic insuring promises or clauses. One clause is called Coverage A, or Side A, or “individual coverage,” under which the insurance company agrees to pay for losses incurred by directors and officers for which they are not indemnified by their company.¹⁰⁷ It is possible to obtain a Side A-only policy and this has been done when companies are trying to minimize their expenditures on insurance but want to have at least the bare baseline coverage of their officers and directors for situations where the companies either may not or cannot indemnify them. More typically these separate policies sit on top of all other D&O policies, providing both excess and umbrella coverage for directors and officers in the event of really difficult situations. These policies cannot be rescinded, have broader coverage than the underlying policies, and drop down to provide coverage for directors or officers when the company is unable to pay the deductible/retention due to bankruptcy, the company

105. See N.Y. BUS. CORP. LAW § 726(b)(1) (McKinney 2005). This statute also prohibits insurance coverage that would be contrary to New York insurance law.

106. See 2 ALI, PRINCIPLES OF CORPORATE GOVERNANCE, § 7.20(b)(2).

107. For background to this discussion, see SAGALOW, *supra* note 102, at 9–10. Part of Coverage A may be payment directly to directors and officers when the company is financially unable to indemnify them, even though it is legally obligated to do so.

cannot or refuses to pay, or another insurer in the insurance tower is unable or unwilling to pay.

The second typical insuring clause is called Coverage B, or Side B, or “company reimbursement coverage.” This insuring clause reimburses the company for amounts that it has had to pay its directors and officers under its indemnification obligations. When a public company can afford it, modern D&O insurance policies typically contain a third coverage called “entity coverage” (or Coverage C or Side C), which provides protection for claims made directly against the corporation, such as securities law claims. The standard D&O policy specifies the total amount of coverage with respect to all claims for the policy period (and any extended period). Claims are subject to deductibles, which are amounts that the company, directors, and officers must contribute with respect to each loss. The policy period is generally one year, although policies for multiple years are available.

[A] Claims

D&O insurance is for “claims made” during the policy period, as opposed to “occurrence” policies that would cover events of liability that occur during the policy period regardless of when a claim is made.¹⁰⁸ Thus, for D&O insurance, if a claim is made during the policy year it would be covered by the policy in effect at that time regardless of when the underlying alleged wrongful conduct took place. For an additional premium, a company can purchase coverage for an extension period following the policy period in order to protect itself for claims made after the policy period (but only for wrongful acts occurring before the end of the policy period), which coverage is required under the laws of many states (or is part of the contract) either where the insurance company does not renew the policy or when the company changes insurers. Claims must be reported to the insurance company during the policy or extension period.

108. A claim in a “claims made” policy may be broadly interpreted so that one claim is presumed to be related and therefore subsumed within a prior claim. Thus, the later claim applies to an earlier policy and is subject to its exclusions. *See* *Highwoods Props. Inc. v. Exec. Risk Indem., Inc.*, 407 F.3d 917, 921–23 (8th Cir. 2005) (finding that securities fraud class action was a claim related to breach of fiduciary claim against the corporation filed prior to insurance’s coverage period and was thus excluded from policy’s coverage (prior claim had not been covered by preceding policy that excluded entity claims)); *see also* *Fed. Ins. Co. v. Raytheon*, 426 F.3d 491, 499 (1st Cir. 2005) (finding that ERISA claim against a corporation and its officers was encompassed within an earlier securities law complaint filed before date of policy and thus excluded on the basis of a claim relating to “prior and pending litigation” because “the allegations of the second complaint substantially overlap those of the first”).

The claim here refers to an action or other demand against the insured, that is, against the officer, director, or company. In order to avoid interpretive disputes about the nature of the third-party action and the relief it seeks (for example, is it the kind of monetary relief covered by the policy?), it is important that the D&O policy have a precise definition of a claim. As explained in a guidebook on D&O insurance, the definition should include the following:

- a written demand for monetary or nonmonetary relief; or
- a civil, criminal, or administrative proceeding for monetary or nonmonetary relief that begins with:
 - service of a complaint or similar pleading,
 - return of an indictment (in the case of a criminal proceeding), or
 - receipt or filing of a notice of charges.¹⁰⁹

The claim must be made against an “insured,” which, as discussed above, includes directors, officers, and possibly the corporation itself. There is generally blanket coverage for all directors and officers elected or appointed during the policy period, as well as past directors and officers, although care must be taken to understand which officers are covered.

The claim must be made with respect to a “wrongful act” of the insured.¹¹⁰ Care must be taken for the protection of directors and officers that the definition of “wrongful act” is not overly restrictive: for example, that it does not exclude some misconduct, such as gross negligence and intentional wrongs. Moreover, it is recommended that it be defined to include “status” claims, which are claims that

109. See SAGALOW, *supra* note 102, at 13 (footnote omitted); see also Randy Paer, *Directors and Officers Insurance*, in *D&O LIABILITY & INSURANCE 2004*, at 13, 42–43 (PLI Commercial Law & Practice, Course Handbook Ser. No. 865, 2004) (adding a written demand or notice describing circumstances likely to give rise to a legal proceeding).

110. The D&O policy is meant to protect directors, officers, and (secondarily) corporations against claims made against the directors and officers; it is not a liability policy for the corporation with respect to claims made by directors and officers against it. In *Med. Mut. Ins. Co. of Me. v. Indian Harbor Ins. Co.*, 583 F.3d 57 (1st Cir. 2009), a corporation sought recovery on a D&O policy for a settlement entered into between it and a former CEO, who brought an administrative action and a court proceeding for discrimination when the firm terminated him after he had a stroke. The appellate court agreed with the lower court’s dismissal of the lawsuit seeking this recovery on the grounds that no claim had been made with respect to any director or officer of the corporation for his or her wrongful actions.

do not allege misconduct by a director or officer, but that are filed against them solely by reason of their status.¹¹¹ Coverage is restricted to wrongful acts done in their capacity as directors and officers of the company. It may not reach, therefore, acts done in service to the corporation, such as being a director in another corporation or non-profit firm at the corporation's request or providing consulting services to the firm, unless specifically included by an endorsement to the policy or in a separate policy—which is typical. Unless the policy has entity coverage (Coverage C), claims are restricted to wrongful actions by the officers or directors, not the corporation.

In the real world of director and officer liability, the limitation of insurance coverage to situations in which there is a “claim” can have serious, and sometimes financially dramatic, consequences. Often an SEC investigation commences as an “informal” investigation. In those situations the SEC explicitly notes that the request for voluntary discovery should not be construed as an allegation by the SEC that there has been any wrongful conduct and it is further clear that at that point there is not yet any “claim.” However, companies and their officers and directors are typically—and properly—advised in most instances to fully cooperate with the informal investigation. It is not uncommon for this informal investigation to last for months or even years and to cause the involved companies to incur millions of dollars of legal fees and costs on their own behalf and for the benefit of the directors and officers involved in the investigation. Since this all takes place before there is any claim, insurers will frequently deny coverage for these large expenses based upon the “claim” language in the insurance policy. Nor has it typically been a successful argument that the expenses may ultimately be necessary in defense of a parallel—but much slower paced—securities class action or that ultimately the SEC's informal inquiry has ripened into a formal proceeding. Although some insurers have taken steps to deal in some way with this set of circumstances, it remains true to the present that this presents a huge and costly problem for companies and their directors and officers—in large part, also, an unintended consequence of the extended timelines for securities class action litigation under the PSLRA compared to the relative speediness of SEC actions.

[B] Losses

D&O policies cover losses incurred by the insured, including directors and officers, for which the insured is liable and that arise out of a claim for a wrongful act. A typical policy provides that a “loss” means “damages, judgments, settlements and Defense Costs,” with the latter term meaning “reasonable and necessary fees, costs and

111. See SAGALOW, *supra* note 102, at 15.

expenses consented to by the Insurer . . . resulting solely from the investigation, adjustment, defense and appeal of a Claim.”¹¹² There are exclusions to the loss definition. For example, some policies exclude “civil or criminal fines or penalties imposed by law, punitive or exemplary damages, the multiplied portion of multiplied damages, taxes, any amount for which the Insureds are not financially liable or which are without legal recourse to the Insureds, or matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed.”¹¹³ The exclusions are based upon the view that insurance should not, as a matter of public policy, protect directors and officers against punitive measures against them, such as fines and punitive damages.¹¹⁴ Since most claims against directors and officers are settled if not previously dismissed, these exclusions are rarely at issue.

[C] Exclusions

In obtaining a D&O insurance policy, it is very important to pay particular attention to the exclusions under the policy. One class of exclusion deals with the conduct of the insured. Typical conduct exclusions refuse coverage for any losses arising from claims based upon illegal personal gain, illegal remuneration, short-swing profits under section 16(b) of the Exchange Act, or criminal or deliberately fraudulent or dishonest actions.¹¹⁵ These exclusions typically, but not always, require a final judicial adjudication or finding of fact to apply, so that, again, they may have little effect if the case settles and, indeed,

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112. See *id.* at 100–01 (reproducing American International Companies’ basic policy); see also *Enterasys Networks, Inc. v. Gulf Ins. Co.*, 364 F. Supp. 2d 28, 30 (D.N.H. 2005) (holding that company suffered no recoverable loss under D&O policy when it delivered shares of its stock in a settlement of a securities class action; because the assets of the corporation were in no way diminished and only shareholders, who are distinct from the corporation, suffered harm in the dilution of their shares). “Loss” has been read to cover plaintiff attorney’s fee, where assessed against the corporation in the underlying action. See Joseph M. McLaughlin, *Insurance for Attorney’s Fees in Derivative and Class Actions*, N.Y.L.J., Apr. 14, 2011 (discussing the issue and identifying recent cases).
113. See SAGALOW, *supra* note 102, at 101; see also *Serio v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa.*, 18 A.D.3d 319, 320, 795 N.Y.S.2d 529, 530 (2005), *appeal denied*, 6 N.Y.3d 703, 844 N.E.2d 790, 811 N.Y.S.2d 335 (2006) (excluding coverage for dishonesty of insured CEO).
114. See SAGALOW, *supra* note 109, at 17.
115. See *id.* at 19–20; Paer, *supra* note 104, at 44. Commentators have warned that D&O insurers will likely apply exclusions to directors and officers who are sued regarding stock options backdating (for a description of this, see *supra* section 2:3.4[C][1]). Possible exclusions would include several of those mentioned in the text, such as illegal personal gain and illegal remuneration. The same commentators warn that insurers may use other

may prove to be the driver in causing the case to settle. Also important in this regard is a severability clause in the policy, which provides that the wrongful act of one insured should not be imputed to another. Thus, that a director has been criminally convicted should not affect coverage for other directors not criminally liable, for their losses that are not otherwise excluded.¹¹⁶

Another class of exclusions deals with claims that are or should be covered by other insurance policies, such as prior D&O policies, fiduciary liability policies (for ERISA claims), and general liability policies, or cover other standard matters (for example, pending litigation or failure to maintain insurance).¹¹⁷ Claims for violations of the environmental laws are generally excluded, although some policies cover securities law claims based upon problems with environmental disclosure. Another exclusion, known as the “insured vs. insured” exclusion, was originally designed to address collusive suits by one insured against another (for example, a company suing its officers for their negligence in order to obtain funds under the D&O policy) or family disputes involving present directors or officers against past directors or officers after a change in control. The problem with earlier versions of this exclusion is that they could be read to exclude coverage of losses in connection with shareholder derivative lawsuits, a main reason for D&O insurance in the first place.¹¹⁸ (Such “insured vs. insured” exclusions is frequently cited by derivative plaintiffs as a reason why a board would never bring suit against other officers or directors as is frequently demanded in a shareholder demand letter.) Similarly, it was argued (and sometimes accepted) that claims by a trustee in bankruptcy, or by a federal receiver of a failed financial institution, against the firm’s directors or officers were excluded from

contract language to deny the claims (e.g., argue that the option backdating occurred before the D&O coverage retroactive date). See generally Blair G. Connelly & Peter K. Rosen, *Will D&O Carriers Step Up to the Plate on Stock Options?*, N.Y.L.J., Sept. 26, 2006.

116. See SAGALOW, *supra* note 102, at 19–20. An insurer could raise this issue, however, depending upon the contract. See, e.g., *XL Specialty Ins. Co. v. Level Glob. Inv’rs L.P.*, 874 F. Supp. 2d 263 (S.D.N.Y. 2012) (unsuccessful effort by insurance company to use prior knowledge of illegality by one insured to deny coverage to other insureds).

117. See SAGALOW, *supra* note 102, at 20–21.

118. See *id.* at 21–22; see also *Sphinx Int’l, Inc. v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa.*, 412 F.3d 1224, 1229–30 (11th Cir. 2005) (affirming exclusion of securities class action lawsuit under “insured vs. insured” exclusion in D&O policy governed by Florida law where named plaintiff was a former director and officer of the insured company, even where there was no showing of “collusion” between the former director and the company, but noting disagreement on this issue of the requirement of collusion in other jurisdictions).

coverage by this provision. Current versions of the exclusion carve out exceptions for shareholder lawsuits conducted independently of the company or another insured for claims brought by a bankruptcy trustee and for such other matters as claims for wrongful termination of employment brought by an officer.¹¹⁹

Another exclusion, the so-called regulatory exclusion, grew out of the situation of failed financial institutions, when in the 1980s federal banking agencies brought claims against officers and directors of failed banks. This exclusion (which is generally used in a D&O policy for a financial institution) barred any payment for losses in connection with a claim made by these agencies, whether as a receiver, conservator, or otherwise. The logic of the exclusion was that the insurance industry never contemplated underwriting the government's losses for the failure of the banking industry. The case law on the exclusion is mixed, with some courts refusing to enforce it on public policy or other grounds and others allowing it to apply.¹²⁰

A D&O policy can be a highly negotiated contract. Accordingly, exclusions, other than a few of the standard ones, are generally tailored to the company and its directors and officers.¹²¹

[D] Notice

Notice of a claim is particularly important under D&O insurance since it is a "claims made" policy that provides coverage only for claims made during the policy period or extension period. Thus, D&O policies generally provide that the insured give notice to the insurer "as soon as practicable" of any claim or circumstances likely to give rise to a claim. Giving notice during the policy period about the circumstances likely to give rise to a claim could protect the director or officer if a claim based on these circumstances surfaces subsequent to the period, although there are some complex coverage issues that can be implicated or when notice is given before a claim is actually made when

119. See SAGALOW, *supra* note 102, at 22–23; see also Paer, *supra* note 109, at 59–60; *Rigby v. Underwriters at Lloyd's, London*, 907 So. 2d 1187 (Fla. App.) (when former CEO and director sought recovery under D&O policy for claims brought by bankruptcy trustee, insurer asserted "insured vs. insured" exclusion because trustee was specifically listed as an insured under the policy; appellate court held that exclusion did not apply since trustee's lawsuit was not brought as a director or officer, but on behalf of creditors).

120. See, e.g., Paer, *supra* note 109, at 63–64.

121. Another exclusion, which is related to a grounds for cancellation discussed elsewhere, is one for any act, events, etc., about which the insured has knowledge. See *Rivelli v. Twin City Fire Ins. Co.*, C.A. No. 08-cv-01225-RPM, 2008 WL 5054568 (D. Colo. Nov. 21, 2008) (allowing for an exclusion for excess D&O coverage because of officers' existing knowledge about fraudulent practices), *aff'd*, 359 F. App'x 1 (10th Cir. 2009).

the claim is subsequently made in a later policy year that must be carefully considered.

[E] Defense of Litigation

A D&O policy generally does not provide that the insurance company has a duty to defend claims made under the policy. Corporations, directors, and officers prefer to structure and manage their own defense and control the litigation against them, rather than have the defense subject to the insurer's preferences.¹²² Defense costs, as noted earlier, are covered losses under a typical policy and they count against liability limits. As a result, in typical securities and derivative litigation in which costs of defense can be very high, these defense costs can seriously erode the amount of insurance coverage left for settlement or to pay a judgment.

Coverage of defense costs, particularly those incurred in response to government inquiries and investigations, is subject to the D&O policy's terms. In *Office Depot, Inc. v. National Union Fire Insurance Co. of Pittsburgh, Pa.*,¹²³ Office Depot sought recovery under several D&O policies for \$20 million of legal fees that it incurred in responding to SEC inquiries, prior to the agency's commencing a formal investigation of the company's accounting practices.

The Eleventh Circuit upheld the district court's denial of coverage under the policy for such legal expenses. It observed that the definition of a covered claim explicitly excluded any administrative or regulatory proceedings or investigations of the organization, except for a proceeding against both an organization and a covered person. Thus, voluntary cooperation by Office Depot with the SEC's inquiries was not covered by the policy. The court rejected Office Depot's argument that the policy included the legal fees because the company made available individuals for testimony to the SEC, reasoning that such coverage was triggered only when individuals in Office Depot were explicitly targeted for enforcement by the SEC. Similarly, the court rejected Office Depot's argument that its contractual notice to the insurers that a claim might be made once it had received an inquiry letter from the SEC, justified coverage. In the court's view, this provision dealt only with the terms of the notice, not with coverage.

By contrast, in *MBIA Inc. v. Federal Insurance Co.*,¹²⁴ the Second Circuit upheld the district court's ruling that MBIA was entitled to coverage for defense costs relating to its response to investigations by the SEC and the New York Attorney General (NYAG). Coverage in the

122. See SAGALOW, *supra* note 102, at 34.

123. *Office Depot, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 453 F. App'x 871 (11th Cir. 2011).

124. *MBIA Inc. v. Fed. Ins. Co.*, 652 F.3d 152 (2d Cir. 2011).

D&O policies in question was triggered by administrative or regulatory proceedings begun by a formal or informal order or investigative document. The court found this contractual requirement satisfied here: it interpreted the NYAG's investigation as commenced by the issuance of a subpoena, while the SEC had issued a formal order authorizing it to investigate numerous insurance companies, which in turn led to its inquiries relating to MBIA. In this case, unlike in *Office Depot*, MBIA incurred its defense costs with respect to regulatory investigations that followed, rather than preceded, an official commencement by government agencies. Both cases indicate how important the specific contractual language on the coverage of defense costs can be, particularly in this era where internal investigations in response to, and in anticipation of, regulatory inquiries are common.¹²⁵

[E][1] Defense Counsel

While the directors, officers, and corporation control their own defense, the insurer typically covers only "reasonable and necessary" defense costs consented to by the insurer. This means that the insurer will be involved in defense strategy, particularly in the selection of defense counsel for the director or officer. Some of the larger D&O insurers include a list of pre-approved "panel" law firms that an insured may use for defense purposes, sometimes receiving a discount on their deductible/retention for doing so.¹²⁶ Of course, if the case involves conflicting interests among defendants (for example, between inside and outside directors), it may be advisable and will usually be acceptable to have multiple counsel.¹²⁷ A typical D&O policy will also provide the insurer the right to associate with the company, directors, and officers in defense and settlement of the claims.

[E][2] Allocation Issues

D&O insurance covers only defined losses, which include defense costs associated with covered claims. Historically, coverage did not reach claims made against the corporation itself, and disputes arose as to what portion of the damages or settlement was a covered loss and what defense costs were attributable to a covered claim. The generally

125. For a discussion of these cases and the lesson to be drawn from them, see Nancy D. Adams & Kristen S. Scamm, *Navigating a Mine Field: Governmental Investigations, Cooperation, and D&O Insurance*, BUS. L. TODAY (Jan. 2012).

126. See *id.* at 35; see also Paer, *supra* note 109, at 55.

127. The issue of multiple counsel was more problematic when insurance companies did not offer entity coverage (that is, Coverage C).

accepted jurisprudence on defense costs is that all costs should be paid if they are “reasonably related” to the defense of the directors or officers with respect to covered claims, even if costs are also attributable to non-covered claims.¹²⁸ Since coverage for claims involving federal securities law violations against the corporation (Coverage C) is increasingly the norm, allocation issues as to losses and costs for covered and non-covered claims have become less significant. Where a company does not have entity coverage, it may establish in the contract an allocation formula or pre-set allocation percentage. Even where there is entity coverage, moreover, the contract may have to deal with allocation issues as to priority of payment, that is, whether losses attributable to directors or officers are paid before those of the corporation (an “order of payments” provision).¹²⁹ In complex cases, priority-of-payment issues may have to be resolved during litigation: A good example is the *Enron* case, where a court-approved settlement allocated remaining amounts available under Enron’s D&O insurance among settling and non-settling defendant directors and officers.¹³⁰

[E][3] Settlements

A D&O policy will provide that the insurance company must consent to any settlement, a provision designed to prevent collusion among plaintiffs and defendants seeking to maximize payment from the insurer. This consent cannot be unreasonably withheld. A more significant issue regarding settlement is the payment of all the funds available for coverage to certain settling defendants, which leaves other insured, but non-settling, directors, and officers without any protection. As in the case of *Enron*, in these complex liability situations an insurance company may find it advisable to participate in settlement discussions with plaintiffs and the different directors, or to become an

128. *See id.* at 40; Paer, *supra* note 109, at 53–54.

129. *See id.* at 43.

130. *See* Motion for Settlement, *In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y. Jan. 26, 2005). A similar situation occurred in the Lehman Brothers’ bankruptcy with respect to insurance funds available from the D&O policy. There the court approved a \$90 million settlement coming exclusively from the D&O policy in a securities class action against Lehman directors and officers. Plaintiffs’ counsel was concerned that, if it did not take these insurance funds, they would be used up in the litigation and plaintiffs would be left with the uncertainty of direct recovery from the defendants. *See In re Lehman Bros. Sec. & ERISA Litig.*, No. 09 MD 2017 (LAK), 2012 WL 1920543 (S.D.N.Y. May 24, 2012). Before approving the settlement, however, Judge Kaplan reviewed the amount of assets owned by the defendants. The use of the D&O policy for this purpose of course threatened its availability for other lower-level Lehman executives. *See Eric Morath, Lower Level Lehman Managers Scramble for Piece of Insurance Pie*, WALL ST. J. (Sept. 9, 2011).

indirect participant in the litigation with respect to the claimed funds (an “interpleader action”).¹³¹

An order-of-payments provision in the D&O policy would give some comfort to the defendant director or officer, at least as to the priority between himself or herself and the company, even if it may not resolve issues among directors and officers themselves.¹³²

[F] Outside Directors

Outside directors may be the most concerned by the protections offered by D&O insurance and particularly by situations where protection is exhausted or where there is a dispute about allocation of remaining insurance assets. They could request that their company purchase excess Coverage A for them that comes into force whenever the primary policy is exhausted or otherwise does not protect them, or, for whatever reason, the company does not indemnify them.¹³³

Indeed, since in situations involving complex fraud authorities will proceed first against those most responsible for the fraud, who are generally insiders, D&O coverage may be exhausted by the insiders before claims against outside directors are litigated.¹³⁴

[G] Change of Control

In a change of control, such as a merger or acquisition, most directors and many officers of the target firm find their appointment or employment at an end. They are thus concerned about D&O insurance coverage for claims that are based on their alleged wrongful acts during their service, but that have not yet been made. As a covenant in the merger or acquisition agreement, the acquiring firm typically agrees to purchase for them a multi-year D&O policy for a period equal to the statute of limitations for possible claims against

131. For such a case, see *In re Enron Corp. Sec., Derivative & ERISA Litig.*, No. MDL-1446, Civ. A. H-01-3624, 2004 WL 2889891 (S.D. Tex. Dec. 9, 2004) (insurers tender proceeds of policies, whose distribution the court determines).

132. For complete protection, a director or officer may need to have his or her own policy, or personal coverage within a policy. See Paer, *supra* note 109, at 41.

133. See *id.* at 75.

134. See Symposium on Director Liability, (Harvard John M. Olin Center for Law, Economics and Business, Discussion Paper No. 547, Mar. 2006) (numerous participants in the symposium, particularly Vice Chancellor Leo Strine of the Delaware Court of Chancery, attribute settlements by outside directors to concern over exhaustion of D&O insurance). See, e.g., Peter Lattman, *Settlement in Just for Feet Case May Fan Board Fears*, WALL ST. J., Apr. 23, 2007, at B3 (discussing case where five outside directors paid \$41 million to settle a lawsuit where only \$100,000 remained from the D&O insurance, which was used by the company’s officers).

them, on terms at least equal to those of the policy formerly provided to them by the target corporation.¹³⁵ A hostile acquisition presents a slightly different problem, for the acquirer may not be inclined to provide the outgoing directors and officers with any protection, or may terminate the existing policy once it takes control. To protect directors and officers in these circumstances, a D&O policy should have a change-of-control provision that, at a minimum, continues coverage of the policy until its termination date (with an extension period), but only for claims based on wrongful actions occurring prior to the acquisition (so as not to reach wrongful acts of new directors and officers).¹³⁶ The policy may have a multi-year extension option, as discussed above, that a hostile change of control triggers.

[H] Cancellation

Typically, a D&O policy may be cancelled by either the corporation or by the insurance company, at the option of each. In canceling the policy, the insurance company must of course act equitably. Bankruptcy of the firm may prevent an insurance company from canceling the policy, which may or may not affect the directors or officers (that is, it may depend upon how protective of their interests is their Coverage A). An insurance company may also cancel, or rescind, a policy for misrepresentations made by the company or by a director or officer in the insurance application or renewal application, which cancellation often occurs after a significant fraud is revealed in a public company. The basic problem here is that a misrepresentation by one director or officer may affect coverage for all, particularly a misrepresentation, usually made by a company insider, as to the absence of knowledge about facts or circumstances that could give rise to a claim.¹³⁷ A key way to address this problem, particularly for outside directors, is to have a policy that provides for severability as to

135. In the friendly negotiated merger context, officers and directors of the acquired company should pay careful attention to any indemnification provision in the merger agreement providing indemnification to them from the buyer.

136. See SAGALOW, *supra* note 102, at 49–51.

137. See, e.g., *Shapiro v. Am. Home Assurance Co.*, 584 F. Supp. 1245 (D. Mass. 1984). For a discussion of relevant cases, see SAGALOW, *supra* note 102, at 54–57. See also *Fed. Ins. Co. v. Homestore, Inc.*, 144 F. App'x 641, 646–47 (9th Cir. 2005) (allowing rescission of policy where former CFO made material misrepresentation in SEC filing and in signing D&O policy, and policy allowed rescission as to all insureds if an individual signing application for policy had knowledge of misrepresentations). A possible protection is for the company to limit the number of officers or directors whose misrepresentations can be grounds for policy rescission.

innocent directors not involved in the misrepresentation¹³⁸ or, as mentioned earlier, to have a non-rescindable excess policy for these directors. In addition, even if the policy can ultimately be rescinded as to directors or officers, the insurance company may be required to pay defense costs (if they are provided for in the policy) until the issue of rescission has been adjudicated, if directors or officers challenge that action.¹³⁹ Accordingly, directors and officers should pay attention to the individual or group nature of the protection offered by their D&O policy.

[I] Effect of the Bankruptcy of the Company

This issue has been mentioned in preceding sections and is of concern to directors and officers with respect to their coverage under the D&O policy. The basic worry of directors and officers is that the bankruptcy of the company will remove some or all of their protection under the policy. One concern would be that the bankrupt company would prefer to have any insurance proceeds paid to it for any claims made against it, as opposed to its being paid for losses incurred by its directors and officers. They might also worry that the insurance company would cancel the policy when the company fell into financial trouble or when it announced its bankruptcy. Because bankruptcy is a

138. See SAGALOW, *supra* note 102, at 170 (reproducing Aetna policy's severability clause); see, e.g., *In re HealthSouth Corp.*, 308 F. Supp. 2d 1253, 1285 (N.D. Ala. 2004) (holding that the severability clause bars rescission of D&O policy as to directors and officers under both Coverage A and Coverage B simply because of allegation that misleading statements were made in HealthSouth's disclosure documents).

139. For cases supporting payment of defense costs, see *In re WorldCom, Inc. Sec. Litig.*, 354 F. Supp. 2d 455, 466–67 (S.D.N.Y. 2005) (requiring this payment prior to determination of insurer's ability to rescind, with respect to former WorldCom chairman); *Fed. Ins. Co. v. Kozlowski*, 792 N.Y.S.2d 397 (App. Div. 2005) (requiring payment of defense costs, and undertaking defense, of former Tyco CEO Dennis Kozlowski, subject to later apportionment of costs between those permissibly covered and those excluded by coverage). By contrast, the insurance company may claim that, since the D&O policy is void as a result of the misrepresentation, it is under no obligation to advance defense costs before the contract dispute is resolved. See, e.g., *ClearOne Commc'ns, Inc. v. Lumbermens Mut. Cas. Co.*, No. 2:04-CV-00119 TC, 2005 WL 2716297 (D. Utah Oct. 21, 2005) (allowing rescission of D&O policy under Utah law on the basis of materially false financial statements for two-year period that were supplied by company in the application for the policy, relied upon by insurer and later restated; insurer refused to advance defense funds to company). Practitioners recommend limiting the financial statements that are part of the D&O insurance application (that is, for the company to supply only the most recent). See William Kapell, *Directors and Officers Securities Coverage, Insurer Rescission Claims*, N.Y.L.J., June 22, 2006.

specialized area of the law, only the following general comments will be made on these subjects.

When a company files for bankruptcy, its insurance policies, such as the D&O policy, become the property of the bankruptcy "estate" and any payments under it are subject to bankruptcy's automatic stay to prevent the dissipation of the estate's assets.¹⁴⁰ It has been held, however, that proceeds of the D&O policy are not assets of the estate when the policy offers only Coverage A, that is, for directors and officers for claims that the corporation cannot indemnify.¹⁴¹ In such Side A-only policies the policies' beneficiaries did not include the corporation. The situation is different for a policy with Coverage B (reimbursement of the corporation for indemnified amounts) and especially with Coverage C (entity coverage for claims against the corporation itself), for then the corporation is a direct beneficiary under the policy. Even in these circumstances, the corporation may not lay claim to the proceeds of the policy, however, if it cannot be shown that it incurred an insurable loss (that is, made a reimbursable payment or has a loss under a claim against it).¹⁴² Where there is entity coverage and an automatic stay bars payment of proceeds under the policy, the directors and officers can ask for relief from the automatic stay, even if to a limited extent.¹⁴³ A priority-of-payments provision in the policy may help in this regard in justifying the lifting of the stay, because it shows that the corporation has a claim to the proceeds of the policy only following any necessary distribution to directors and officers.

Generally, the insurance company may not cancel a D&O policy of a bankrupt company (or in anticipation, or as a result, of a firm's bankruptcy).¹⁴⁴

140. See, e.g., *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89 (2d Cir. 1988).

141. See Dan A. Bailey, *D&O Insurance Coverage and Indemnification Issues Relating to Bankruptcy*, D&O LIABILITY & INS. 2004, at 693, 699–701 (PLI Commercial Law & Practice, Course Handbook Ser. No. 865, 2004) (citing cases).

142. See, e.g., *In re Adelpia Commc'ns Corp.*, 298 B.R. 49, 53 (S.D.N.Y. 2003); *In re Adelpia Commc'ns Corp.*, 302 B.R. 439 (Bankr. S.D.N.Y. 2003).

143. See, e.g., *In re Adelpia Commc'ns Corp.*, 285 B.R. 580, 600 (Bankr. S.D.N.Y. 2002); *In re Enron Corp.*, No. 01-16034 (AJG), 2002 WL 1008240 (Bankr. S.D.N.Y. May 17, 2002).

144. For a discussion of these and other D&O issues relating to bankruptcy, see Thomas H. Bentz, Jr., *Subprime Credit Crisis: Changes to Your D&O Insurance Policy That You Should Negotiate Now to Protect Your Personal Assets*, 6 Corp. Accountability Rep. (BNA) 1041 (Sept. 26, 2008).

[J] Disclosure of D&O Insurance

The SEC requires no detailed disclosure of a company's D&O policy. It demands only that the existence and "general effect" of a D&O policy be disclosed.¹⁴⁵ To satisfy this disclosure requirement, companies make a brief statement about the policy and usually provide only few details about it.¹⁴⁶ Unlike the case of indemnification, the SEC does not consider the existence of a D&O policy to be a reason not to accelerate the effectiveness of a company's registration statement for an offering of its securities.¹⁴⁷

One question that is often asked by directors and officers when they are obtaining D&O insurance is whether a large policy can serve to attract shareholder lawsuits. Generally the answer is in the negative. Companies very infrequently publicly disclose the dollar amount of their D&O insurance. While plaintiffs are entitled to discovery of such amounts after the filing of litigation—and in securities class actions only after the complaint has withstood a motion to dismiss—at the time lawsuits are filed plaintiffs typically do not know how much D&O insurance a particular company carries.

145. See 17 C.F.R. § 229.702 (2005).

146. See Sean J. Griffith, *Unleashing a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U. PA. L. REV. 1147, 1196–1200 (2006). Professor Griffith argues that the SEC should require more disclosure in order to enlist insurance companies to review the corporate governance of public companies.

147. See 17 C.F.R. § 230.461(c) (2005).

