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Training for Tomorrow:

Corporate Counsel Checklist for Supervising Creation/Renewal of D&O Protection Program

To obtain and retain effective directors and officers (executives), corporations employ risk managers, outside counsel, and insurance brokers to protect them from personal financial and criminal liability. Their task is to create a comprehensive program to protect them from claims that they have been guilty of wrongful acts or omissions while serving the corporation. The protection consists of four elements: (1) legal immunity from claims for damages resulting from directors' failure to exercise due care; (2) advancement to selected executives of defense costs and expenses until any claim is resolved and then relieving them from any duty to repay the amounts advanced; (3) indemnifying them for any additional amount they may agree to pay in settlement of such a claim or that they may be compelled to pay by judgment; and (4) a credible program of D&O insurance coverage.

The first element, statutory exculpation, is simply a matter of verifying whether the correct language appears in the corporation's certificate or articles of incorporation.

The second, third, and fourth elements—rights to advancement of defense costs, relief from the duty to repay the advances, and indemnity against settlements and judgments—is found usually in corporate by-laws. By-laws frequently state that some number of executives will be advanced defense costs and indemnified "to the fullest extent permitted by law." While this phrase is facially expansive, it is in fact a limitation, because no corporate statute permits indemnity for all conceivable claims against executives. Further, developing case law and prosecutorial techniques create significant hurdles to realizing the goal implicit in that phrase: making sure that the entity's by-laws actually provide the maximum rights to advancement and indemnity that the law permits.

Directors' and Officers' (D&O) liability insurance is the fourth element of a protection program and is intimately related to the issues of advancement and indemnity. Indeed, the corporation's obligation to indemnify its executives "to the fullest extent permitted by law" is these days written into most D&O insurance policies as a de facto covenant of the corporation procuring the coverage for them.

What follows is a checklist intended to guide an attorney serving as counsel to a corporation tasked with overseeing specialists in risk management and insurance who recommend an executive protection program:

I. Director Exculpation under Certificate/Articles of Incorporation

Under most states' corporation laws, directors may be exculpated in advance from civil liability for damages for breach of the fiduciary duty of due care. This is a corporate articles/certificate of incorporation matter that requires no further checklist. Volunteers for not-for-profit corporations may be entitled to exculpation or immunity from suit under federal and state laws. Taking the legal steps necessary to allow directors to avail themselves of these exculpatory provisions contained in governing law is an important component of any comprehensive director protection program.

II. Advancement and Indemnity

Executives may be given a right to advancement of reasonable defense costs for all claims against them arising from their service, and a mandatory right to be relieved from repaying these advances. They may also be indemnified for any ultimate settlement or judgment against them under corporate by-laws or formal indemnification agreements. In all cases, however, these rights exist only if and to the extent that advancement and indemnity is permitted by governing law.

Checklist issues are:

A. Are the advancement and indemnity rights contractually mandatory, or are they only to be conferred by separate action of the board on a discretionary basis after a claim arises?

B. If granted in by-laws, is the board prohibited from amending the by-laws to eliminate protection for circumstances that accrue during the executive's tenure but before a claim is made?

C. Does the right to advancement accrue at a sufficiently early stage to protect the executive without causing premature "lawyering up" that is detrimental to corporate collegiality and informal communication?

D. Does the right to advancement cover derivative demand, special litigation committee, and corporate internal investigations?

E. If the corporation has foreign subsidiaries on whose boards executives are expected to serve or if they are expected to otherwise supervise foreign operations, is the corporation obligated to post bonds or otherwise pay to secure the release of the executive's person from physical arrest and the executive's personal assets from sequestration orders issued by a foreign court or governmental agency?

F. If the executive is in any way implicated in a matter that creates potential personal criminal exposure, does the executive:

i. have access to (but not possession, custody, or control over) all relevant corporate documents useful to the executive's defense?

ii. have the express right to assert Fifth Amendment privileges (and his or her lawyer the right to assert work product privileges) without jeopardizing the executive's advancement and indemnity rights or limiting the amount of defense costs for which the executive is entitled to advancement? Does the by-law specify a mechanism for resolving privilege disputes?

iii. have the right to receive advancement of defense costs until at least the first "final adjudication" (i.e., after appeal) of facts that forbid the corporation from indemnifying the executive under the relevant corporate law, provided these facts are found in a criminal case against the executive or in a U.S. civil case in which the executive has participated without asserting Fifth Amendment rights? Is the corporation prohibited from instituting or continuing any civil case against the executive that requires the executive to assert Fifth Amendment rights before final adjudication of any actual or threatened claim that gives rise to the right to advancement?

iv. have the right to subrogate to the corporation's Side B coverage should the corporation refuse to advance defense costs and the D&O pay such a cost directly?

v. have the right to judicially compel advancement at the corporation's expense without making any assertions of fact, good faith, or innocence? If the governing corporate law requires such an assertion as a condition to advancement, is the executive protected by insurance? (See next section in respect of DIC cover.)

G. If the executives' advancement and indemnity rights cover claims that are broad in scope, does the board understand that the broad definition may include a duty to advance reasonable defense costs in an unlimited amount in respect of claims for insider trading, embezzlement of the corporation's assets, or allegedly criminal conduct against third parties, leaving the corporation in a delicate public relations situation should such a claim occur and uninsured defense costs rise to a substantial level? If the corporation elects not to advance or indemnify for claims in which an executive is accused of obtaining an improper personal benefit, is that intention adequately expressed in the bylaws and is it consistent with similar exclusionary language contained in the corporation's D&O insurance policies?

III. D&O Insurance

A corporation typically obtains what is called "Side A and B" or "Side ABC" insurance to backstop its advancement and indemnity obligations and to provide its executives direct coverage for certain defined claims. It may then expand protection to particular executives for certain matters for which the corporation may not legally indemnify, financially cannot indemnify, or for which the corporation refuses to indemnify. This type of cover is excess over both the corporation's duty to advance and indemnify under the corporation's by-laws and the Side A and B cover. This type of insurance is called "Side A-Only Difference-in-Conditions" (DIC) cover. To the extent any refusal by the corporation or the Side A and B insurer to advance or indemnify the executive is unlawful, the DIC carrier is subrogated to the executive's rights against them.

Checklist issues are:

A. Are all individuals that the board wishes to insure in fact covered? Are those it does not wish to cover excluded from the policy definition of insured?

B. Has the board made a reasoned and appropriate decision on policy limits, particularly given that under its Side B coverage, it seeks to cover its complete advancement and indemnity exposure to all covered executives beyond its agreed retention? Are all parties cognizant of the phenomenon of competition among insureds for access to policy limits and the accepted means for reducing such competition?

C. Does the policy cover defense costs within overall limits or through sublimits for matters such as derivative investigations (both those that arise immediately after demand and those that arise after the creation of a special litigation committee) and corporate internal investigations, even though there is no definition of any charge or claim nor assertion that the executive may be personally implicated in misconduct, which facts may not otherwise constitute a defined "claim" subject to policy coverage?

D. Where advancement coverage incepts under "C" above before a defined "claim" under the corporation's ABC policy arises, does the policy contain a provision that gives the insured the option of not treating an event less than a defined "claim" as a reportable claim or mandatorily-reportable circumstance?

E. Does the policy cover employment practice claims, crisis management costs, and claims against employed lawyers? If the latter have separate professional liability cover, is it clear which cover is primary?

F. Is the policy definition of "wrongful act" sufficiently expansive so that "all risk" coverage is obtained, assuming such is the desire?

G. Does advancement coverage expressly continue until there has been a final adjudication of facts in the underlying proceeding for which advancement is given that permits the application of the "willful or intentional act" policy exception, and is the insurer prohibited from bringing any suit to accelerate that process?

H. Is the insurer prohibited from recovering its advances should the conduct fall within the "willful or intentional act" exclusion?

I. Is the definition of "loss" sufficiently expansive? Does it exclude the types of claims for which the board may not wish to grant advancement and indemnification rights such as insider trading, embezzlement, and money laundering?

J. Does the policy contain an exclusion for claims against executives that seek to recover amounts that the corporation should have paid in addition to amounts it did pay in a merger, share exchange, or sale transaction? If so, are executives entitled to advancement and indemnity if personally sued in such a case without being required to allocate their defense costs between other covered claims and the claims seeking an increase in consideration? Generally, are executives permitted to be advanced and indemnified against all legal costs in any matter that also includes uncovered claims or parties so long as the facts or issues relevant to the covered and uncovered claims overlap?

K. Are the exclusions for illegal conduct, "other insurance," and timing of claims (including the provisions relating to giving of notice of claim or circumstance), reasonable and readily understandable? Are the "notice of circumstance" provisions objective, subjective, or both; mandatory or permissive?

L. Is there an "insured-versus-insured" exclusion and, if so, is it phrased narrowly to exclude only truly collusive claims?

M. Does the insured entity have in place reporting mechanisms to ensure that the risk manager is kept fully informed of any potential claim or circumstance requiring notice to the insurer? Does the insurer bear the burden of establishing prejudice from late notice and is its remedy for late notice limited to the actual damage it sustains as a result?

N. Does the policy permit an executive subject to potential or actual criminal charges to assert Fifth Amendment rights, and his or her counsel assert work product privileges, without violating the policy's cooperation clause or limiting the executive's recovery of defense costs due to a claim by the insurer that the executive's counsel has provided insufficient descriptions of services rendered in billings or otherwise? Is there a severability clause that protects "cooperating" executives should "non-cooperating" executives be held to violate a cooperation clause

O. Is the policy's definition of "application" reasonably narrow and understandable? Are the covenants and representations made by the corporation and any insureds in either the application or the policy reasonable and understandable?

P. Is there an application severability provision that insulates innocent executives from a claim of application fraud due to the guilty knowledge of less than all of their number?

Q. Are there appropriate limits on the insurer's right to rescind a policy, such as an incontestability clause? Is the insurer's right to cancel the policy appropriately limited?

R. Is there a settlement "hammer" clause and has it been appropriately drafted to avoid unfair and unintended results?

S. Does the policy sufficiently define the parameters of the consent-to-settlement clause and the clause permitting the insurer to associate counsel to eliminate micro-management of the defense?

T. Is there an "order of payments" provision sufficient to reasonably mitigate the effects of a corporate insolvency?

U. Are the claim reporting time limits reasonable? Does a broad definition of "claim" result in an undesirable expansion of the insureds' duties to give notice of claims or circumstance?

V. Have the implications of "DIC" or "dedicated limits" coverage for directors as a group, or outside directors only, been appropriately vetted and explored to provide advancement and indemnity coverage (1) for claims that the corporation's by-laws and the underlying ABC policy does not cover, (2) where the corporation refuses or is unable to advance defense costs and indemnify, and (3) to mitigate the risk of program failure due to competition among competing insureds for policy limits?

W. Does the policy insure executives for costs of obtaining release from incarceration and release of sequestered personal assets if they act as directors or agents of a foreign subsidiary or act for the parent corporation in a foreign country?

X. Does the carrier selected have a reasonable financial rating and a good reputation for claims handling and payment?

Y. Do the insureds have the right to recover their attorneys' fees under applicable law should they be required to litigate coverage with the insurer?

Z. Are there to be one or more excess policies above the negotiated first-tier policy that do not "follow the form" of the first-tier policy, and, if so, have questions "B" through "Y" above been asked in respect of each of the excess policies? Has there been separate consideration of the effects of arbitration and choice of law clauses in these policies as potentially derogating from the executives' contemplated protection, particularly if they mandate arbitration in jurisdictions unfamiliar with U.S. plea bargaining? Do these policies have appropriate provisions relating to when each layer of excess coverage attaches so as to avoid gaps in protection, including provisions requiring that upper tiers "drop down" should insureds reach a settlement with the lower-tier carrier below its policy limits?

AA. Have the appropriate locally issued D&O policies been obtained in respect of foreign subsidiaries and operations?