

Directors and Officers: Questions to Ask When the CFO says, “We Have You Covered With D&O Insurance.”

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Right or wrong, in much of my work, directors and officers eventually get sued, fired and thrown under the bus.

Sometimes its creditors seeking recovery. Sometimes it’s an investor or other directors(s) looking for political cover with their own investors after making a bad decision to back a given company. Sometimes it’s the result of the director or officer in question doing something shady.

To make matters worse, these days, public relations firms and attorneys advise Boards to single out the now ex-CEO as a way to protect their own or the company’s reputation. In addition, under what is known as the Yates memo — a Justice Department policy that essentially trades company-provided information and cooperation regarding individual misdoings in exchange for leniency on fines and penalties — individuals at the top have become prime legal targets.

You May be More Vulnerable Than You Realize

Step one in avoiding legal problems down the road, of course, is to act in an ethical manner. But being ethical is not enough. First, because what is considered ethical or standard practice today may no longer be so tomorrow.

Second, because as noted above, though you may not be at fault, there will be plenty of people looking in your direction when things go bad. Even if you have what you believe are good corporate legal documents and D&O insurance, plaintiffs like to charge former CEOs with claims that aren’t typically indemnified by the company or these instruments, such as fraud. If this occurs, you may not have access to company funds or protection. That is why plaintiffs make such charges.

With all this in mind, what follows are precautions that, when taken, put yourself in the best position possible when the wolves are at your door.

Have strong and well written legal documents.

There are several types of documents to consider. Most obvious are corporate documents that spell out the company's commitment to indemnify directors and officers — *and pay for their defense*. To defend yourself properly, your attorney will need access to documents in the company's possession; these agreements should explicitly provide for that.

Another set of documents that can be important are those related to the financing of the company, be it debt or equity. Litigators want to side-step corporate indemnification, so they will look to these types of transactions for claims that aren't usually indemnified. If you limit what you represent as true in financing documents, that can make suing you harder.

The third set of important documents, particularly for officers, is the employment agreement.

Do You Have Side "A" Coverage?

In particular, you'll want something called "A" side coverage. ("B" side coverage insures the company for its costs in defending and indemnifying directors and officers. "A" side coverage *directly insures* the directors and officers.) "A" side coverage is important if the company refuses to indemnify and/or defend you or there are no funds to do so.

Good "A" side coverage will cover events that the corporate documents don't — things like criminal misconduct, fraud and so forth. The wolves will be looking for vulnerabilities, so they will try and allege non-indemnifiable acts. "A" side coverage that only mimics the corporate indemnification agreements leaves open a time-proven path of attack.

Also, look for "insured vs insured defense costs." This kicks in if an existing director, officer or the company itself sues you (most policies deliberately exclude such coverage). This is particularly important where your equity ownership is minor or you are just an employee.

Another key element for "A" side coverage is a low bar for events that trigger a claim. If you must wait for a formal law suit to be filed, for example, you won't be covered for the legal expense in protracted negotiations, threats and so forth. A good policy will kick in after an e-mail exchange.

Finally, consider umbrella coverage. Besides adding another layer of coverage, some foreign D&O carriers offer umbrellas that “drop down” when US Courts bar the coverage from the US insurance company.

The Landscape is Always Changing

The political and legal landscape is full of land mines and booby traps — and it’s constantly changing. A few more pointers on how to navigate it...

Use qualified legal counsel. I look for lawyers that specialize in the particular type of matter as spelled out above and who do so in the state with governing law.

I have had several liquidation clients, for example, where the opportunity to reorganize or sell was long gone. For some of these situations I have been blessed with a tag team from the governing state — a litigator and an entity expert. These tag teams have sliced up corporate documents drafted by big name (read: very expensive) attorneys that don’t practice locally. Even if all you need is someone to review the documents before you come on board, consider a litigator that is well versed in the relevant state’s law.

Purchase insurance through a broker with a department dedicated to D&O insurance. Not only should they know the ins and outs of coverage, they should have the in-house expertise to advise you on filing a claim, etc. For example, the ex-CEO of one of my clients that went out of business was able to use the very experienced team from the insurance broker to advise his attorneys on how to best draft his claim.

Take time and care to properly complete renewal forms. If potential claims are not disclosed at renewal, this is often a basis for an insurance carrier to later deny the claim. Don’t let a minion in the organization blindly fill out the annual renewal paperwork. If you are on the Board, make sure you understand your policy, particularly the section about when the carrier must be advised about a potential claim.

Make sure your D&O policy has priced in “tail insurance.” D&O insurance is on a claims made basis — it only covers claims made during the policy year. If your company goes out of business it needs “tail insurance” that covers claims made in the future. A three-year tail is a minimum, a six-year tail is ideal.

Upgrade counsel and insurance brokers as your company grows. Make sure the upgraded team reviews important past transactions and corporate documents. Same for the officer that keeps getting promoted and eventually lands the brass ring.

When bad things do happen, get legal counsel ASAP, contact your insurance broker, and be prepared to switch legal counsel to one for which the insurance carrier will pay. That usually means an attorney on the carrier's "list."

Conclusion

Being an officer and/or director sounds — and is — cool. Until it isn't. With those added responsibilities and rewards come risks, some of which may not be properly protected when the attack comes.

Get adequate protection before you dive in and monitor things as time marches on.

*Goodrich & Associates helps businesses solve urgent liquidity problems: insolvency & bankruptcy, loan financing, transaction facilitation, and distressed investing.