Lawsuits & Board Liability

Company policies to cover related costs can curb the hit to directors' wallets.

BY DOUG RAYMOND

Directors — and particularly directors of public companies — are frequently sued. When misfortune strikes, the directors typically are the first targets of the ensuing investigations and lawsuits. In the past year, lawsuits against directors and officers have been based on a number of claims, including such familiar topics as conflicts of interest and self-dealing, as well as more topical issues like failure to prevent data breaches or tolerance of illegal discrimination or sexual harassment.

The board of directors is responsible for the oversight of the management of the corporation, so the proverbial buck stops with them.

Even when the board is not aware of a particular problem, the directors are often sued for allegedly having turned a blind eye to the issue, failing to ensure that the company had in place sufficient procedures to prevent the trouble. The claims brought against directors often relate to asserted violations of their fiduciary duties to stockholders or of a specific law, such as certain provisions of the federal securities laws (which can subject directors to personal liability).

But company policies that cover upfront litigation costs, known as advancement, could help directors cover some of the lawsuit expenses.

Why is this so important?

Many corporations have included provisions in their articles of incorporation and bylaws that can limit directors' potential liability. The risk of liability, and of significant and expensive litigation, however, cannot be entirely eliminated.

If a director incurs legal or other fees, or has to pay damages related to legal or administrative proceedings arising out of actions in their corporate capacity, he or she has certain rights to be reimbursed by the company. For example, a Delaware corporation is permitted to indemnify its directors and officers against losses incurred by them as long as they had acted in good faith and in a manner they reasonably believed to be in the best interests of the corporation.

On the other hand, a Delaware corporation ***must*** indemnify directors if a court has ruled in their favor based on the facts presented and the applicable law. However, such indemnification rights can be cold comfort to a director who has to pay substantial ongoing defense fees for months or years before there is a final determination justifying indemnification.

Fortunately, the corporate law of most states al-

lows a corporation to cover in advance the legal and other expenses incurred by directors who have been sued or become involved in a government investigation. Advancement, unlike indemnification, gives a director an immediate source to pay these ongoing expenses as incurred with one important caveat. The director must agree to repay amounts advanced if a court ultimately determines that he or she is not entitled to indemnification. In practice, because most of these cases are settled before a court determines whether indemnification is allowed, the corporation's rules on advancement are most important for whether directors may have their expenses covered.

When the board reviews its rights to indemnification, it should therefore begin with the directors' advancement rights, especially for expenses incurred in an investigation or other less formal contexts, such as appearing as a witness.

As more directors find themselves involved in investigations into what the board knew regarding alleged wrongdoing, boards:

- Should be sure that their advancement policies cover these less formal actions.
- Should make sure that their right to advancement cannot be limited by possible concerns about their ability to reimburse the company if there is an adverse determination.
- Should consider whether they should be able to make any required reimbursement over time, in installments.
- Should consider whether to enter into separate indemnification agreements with the company, so they are not relying principally on the articles and bylaws.
- Should think carefully about advancement and indemnification rights for former directors and whether to require former directors to repay advancement amounts if it is determined that they are not entitled to indemnification, as the law is not clear on this point in many jurisdictions.

When the board reviews its rights to indemnification, it should therefore begin with the directors' advancement rights, especially for expenses incurred in an investigation or other less formal contexts, such as appearing as a witness.

Unlike the company's organizational documents, an indemnification agreement cannot be changed to limit prospective indemnity rights without the director's consent. These agreements also can provide for a strong presumption in favor of a director's right to indemnification unless proven otherwise. Additionally, these agreements can require the company to pay the director's legal and other expenses if he or she has to sue to enforce his or her indemnification rights.

Boards should also carefully consider whether and in what circumstances to exclude indemnification and advancement if litigation is initiated by a director against the company and the rest of the board chooses to bring counterclaims for wrongdoing by that director. A common exception to this exclusion would be for suits to enforce indemnification and advancement rights.

Finally, boards should also revisit their insurance for directors. Often, separate indemnification agreements obligate the company to obtain a certain level of insurance for its directors, which otherwise is subject to majority approval. With varying types of coverage available, it is important to have sophisticated advisors in crafting a policy.

As consumers, stockholders and government agencies seek to press claims against directors for corporate misfortune, boards should periodically consider the protections available to the directors if there is litigation or a significant investigation. In order to attract and retain top talent on boards, meaningful indemnification and advancement protections are indeed a necessity. ■

Doug Raymond is a partner in the law firm Drinker Biddle & Reath LLP (www.drinkerbiddle.com).

The author can be contacted at douglas.raymond@dbr.com. *Ashlee Paxton-Turner assisted with preparation of this column.*