

Preventing and Managing Directors and Officers Liability Risks

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D&O Protection – When It Really Matters



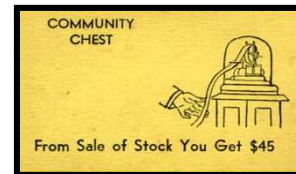
Getting the call
from the
CEO



Top 10 Ways Directors and Officers Get In Trouble



1. Corporate Governance



6. Corporate Change/ Merger & Acquisition



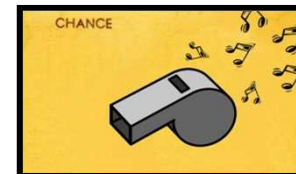
2. Finance-Related Risks



7. Employment Risk



3. Conflicts of Interest & Self Dealing



8. Internal Dissent/ Whistleblower



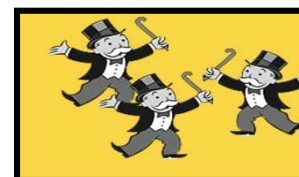
4. Failure to Report



9. Financial Distress Situations



5. Fraud and Misrepresentation



10. Industry Association Risks



Typical Board Committees

- ◆ **Executive Committee**: Often has the full authority of board to act generally or on specific matters
- ◆ **Audit Committee**: Tasked with hiring auditors and review of financial statements
- ◆ **Compensation Committee**: Tasked with establishing the compensation of officers
- ◆ **Governance Committee**: Tasked with establishing governance procedures, finding director candidates, settling committee assignments and rotation of managers.
- ◆ **Advisory Committees**: Do not wield the power of the board but are advisory only – study or review a particular issue and report findings back to the board. No corporate authority to take any action.



Liability Basics – Fiduciary Duties

“A director shall perform the duties of a director...in **good faith**, in a manner such director believes to be in the **best interests of the corporation**, and with such **care**, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.” RCW 24.03.127

- ◆ 6 basic duties:
 - ◆ Good Faith
 - ◆ Duty of Care
 - ◆ Duty of Loyalty
 - ◆ Duty of Disclosure
 - ◆ Duty of Confidentiality
 - ◆ Risk Management & Compliance Oversight





Liability Basics – Fiduciary Duties

- ◆ Good Faith
 - ◆ Honesty in purpose and honesty in fact.
What was directors' intent?
- ◆ Duty of Care
 - ◆ Stay informed
 - ◆ Show careful investigation
 - ◆ Show thoughtful consideration
- ◆ Duty of Loyalty
 - ◆ Act in best interest of corporation
 - ◆ Avoid conflict of interest and self-dealing





Liability Basics – Fiduciary Duties

- ◆ **Duty of Disclosure**
 - ◆ Directors must ensure shareholders have all relevant information on matters requiring a shareholder vote or when an investment decision is to be made
 - ◆ Keeping other Directors informed about relevant information
- ◆ **Duty of Confidentiality**
 - ◆ Matters not yet disclosed to the public
 - ◆ Insider trading, confidentiality and disclosure policies
- ◆ **Risk Management & Compliance Oversight**
 - ◆ Assess whether corporation has programs to minimize and properly insure for business risk
 - ◆ Compliance with law and corporate policy
 - ◆ Need for Public Relations or other specialists in crisis



Consequences of Breaches of Fiduciary Duty

- ◆ Individual personal liability to the director or officer
- ◆ Attorneys' fees
- ◆ Financial harm to the corporation
- ◆ Loss of shareholder and customer value and confidence
- ◆ Loss of community goodwill
- ◆ If the corporation is an exempt organization, there can be a loss of tax-exempt status and the imposition of Intermediate Sanctions



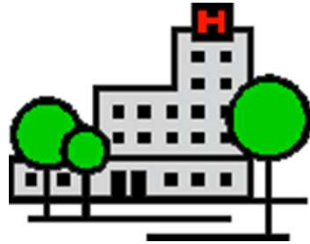


Protections (In Order of Strength)

- ◆ Contractual indemnification rights
- ◆ D&O insurance
- ◆ Indemnification in organizational documents
- ◆ Business Judgment Rule – in absence of self-dealing, actions will be judged by a gross negligence standard



D&O Protection – the Broad Context



Indemnifies



Statutorily mandated if successful defense*

Permitted by Articles of Incorporation?

Acting in good faith,
best interests of corporation?



*

- RCW 23B.08.520 and .570
- RCW 23B.17.030 and RCW 24.03.043



Impermissible Indemnifications

- ◆ Conduct Not in Good Faith
- ◆ Knowing Violation of Law
- ◆ Breach of Duty of Loyalty
- ◆ Unlawful Payment of Dividends
- ◆ Situations in Which the Director is Found Liable to the Corporation (e.g., taking a corporate opportunity)
- ◆ Situation in Which the Director is Found Liable on the Basis of Improper Personal Benefit (e.g., taking too much salary or inflated expense reimbursements)

RCW 23B.08.510
RCW 24.03.043



Mandatory Indemnifications

- ◆ Unless limited by its articles of incorporation, a corporation shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which the director was a party because of being a director of the corporation against reasonable expenses incurred by the director in connection with the proceeding.
RCW 23B.08.520



The Basic D&O Set-Up – Not Standard Form



Side A – Individual Directors and Officers
Direct Cover



Side B – Corporation Reimbursement for
Indemnifying Directors and Officers



Side C – Direct Corporation Liability



Key Elements of D&O Policy

- ◆ Coverage grant
 - ◆ Typically claims-made
 - ◆ Alleged “wrongful act”
 - ◆ During coverage period
 - ◆ In insured capacity
 - ◆ Claims first made during policy
- ◆ Exclusions
- ◆ Definitions
- ◆ Conditions





Getting What You Paid For – General Issues



Who is covered?

- Broad v. narrow
- Spouses / domestic partners
- Former Directors and Officers



Actions covered?

- “wrongful acts”
- working for whom?

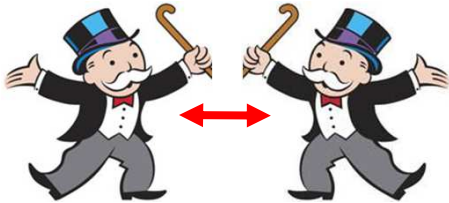


Defense costs and indemnity

- type of defense
- covered “loss”

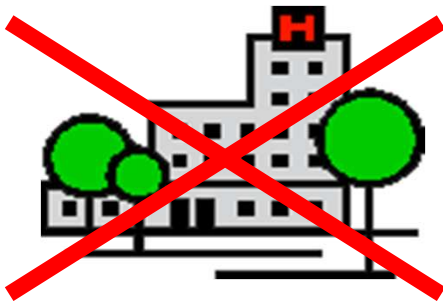


Getting What You Paid For – General Issues (cont.)



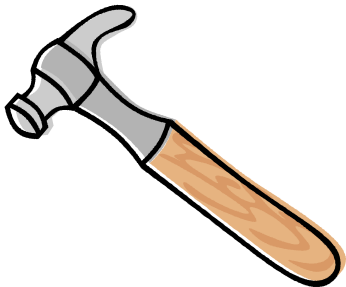
Severability

- avoiding rescission
- avoiding imputed knowledge



Impaired Companies

- whose asset is policy?
- Directors & Officers
- Corporate estate



Hammer Clause

- penalties for rejecting settlement



Getting What You Paid For – Specific Risks



1. Corporate Governance



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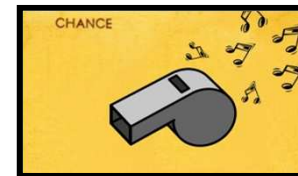
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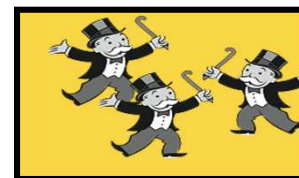
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A Bad Day



- ◆ Whistleblower alerts Board Chair to:
 - ◆ Misrepresentations to lenders
 - ◆ Undisclosed setbacks in key product development
 - ◆ Sales by insiders after setbacks identified
- ◆ Board requires company to quietly investigate
- ◆ D&O insurance renewed
- ◆ Investigation finds serious problems
- ◆ Risk Manager **gets the call**
- ◆ CEO and CFO dismissed; Audit Committee Chair and 2 others resign
- ◆ SEC commences investigation
- ◆ Lenders, investors sue
- ◆ Who will be defended?
- ◆ Who will be indemnified?
- ◆ Who has priority?



Questions?

Please contact us any time with additional questions.

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