ANDERSON KILL & OLICK, P.C.

EXECUTIVE INSURANCE ADVISOR

www.andersonkill.com Summer 2005

A Delicate Balance: Guiding Class Actions, Derivative Suits and S.E.C. Investigations to Acceptable Resolution Without Giving D&O Insurers an Excuse to Deny Coverage

By Finley Harckham

The only thing worse for a risk manager or corporate counsel than hearing that the directors and officers, and the company, face class and derivative actions by shareholders ("shareholder suits") and an SEC investigation, is the realization that the insurance companies have fully reserved their rights and are looking for ways to deny coverage. Those insurers are likely to oppose settling the shareholder suits and will attempt to develop arguments to bolster a coverage denial. Those arguments often focus on the policyholder's duty to cooperate with the insurers' investigation of the coverage claim, or by asserting that the policyholder has deprived them of their contractual right to associate in the defense and/or settlement of the shareholder suits, and that the policyholder has settled the cases without their consent.

The Duty to Cooperate

Like almost every type of insurance, D&O policies require the policyholder to cooperate with insurers in their investigation of the coverage claim. Typically, insurers will issue full reservations of rights when notified of a D&O claim, and then do little or nothing to investigate the claim for as long as possible.

Nonetheless, insurers argue that the policyholder has an affirmative duty to keep them informed of all developments concerning the shareholder lawsuits and point to policy language requiring "cooperation," and possibly a written request by them to be kept "informed."

To counter this argument, immediately after notifying the insurers of the claim policyholder's counsel should send the insurers all pleadings in the shareholder lawsuits and related SEC investigations as a matter of course, invite the insurers to meet periodically to discuss developments in the lawsuits and offer to make all non-privileged documents produced in the lawsuits available for their inspection. These efforts should be carefully documented in letters to the insurers to create a strong record of cooperation.

The policyholder may be rewarded for these efforts with seem-

"A Delicate Balance" continued page 2

New York Permits Broad Protection of Officers and Directors

By Isaac E. Druker and Jean M. Farrell

Whether D&O insurance coverage is available, and how much, in a particular matter may depend on whether indemnification by the corporation is mandatory or optional. The answer to that question can be found in the interplay between the language of the corporation's organizational documents and the corporate laws of the jurisdiction of incorporation.

When a corporation makes no provision with respect to indemnification of its officers and directors, one must look to the New York Business Corporation Law ("NYBCL") for guidance. Most states have statutes similar to the NYBCL which set forth the criteria for indemnification of directors and officers. Section 722(a) of the NYBCL states that, in general, a corporation *may* indemnify any director or officer, who is a target of proceeding because he served in such capacity. This section provides fairly rigorous criteria for indemnification: the director or officer should have acted (in good faith) for a purpose (reasonably believed by him) to be in the best interest of the corpo-

"Broad Protection" continued page 2

"Broad Protection" continued

ration, or, if the indemnitee also serves another corporation, for a purpose not opposed to the best interest of the indemnifying corporation:

> A corporation may indemnify any person, made, or threatened to be made, a party to an action or proceeding (other than one by or in the right of the corporation to procure a judgment in its favor), whether civil or criminal, including an action by or in the right of any other corporation of any type or kind, domestic or foreign, or any partnership, joint venture, trust, employee benefit plan or other enterprise, which any director or officer of the corporation serve in any capacity at the request of the corporation, *by reason of the fact that he*, his testator or intestate, was a director or officer of the corporation, or served such other corporation, partnership, joint venture, trust, employee benefit plan or other enterprise in any capacity against judgments, fines, amounts paid in settlement and reasonable expenses, including attorneys' fees actually and necessarily incurred as a result of such action or proceeding, or any appeal therein, *if such director* or officer *acted, in good faith, for a purpose which he reasonably believed to be in, or, in the case of service for any other corporation* or any partnership, joint venture, trust, employee benefit plan or other enterprise, *not opposed to, the best interest of the corporation* and, in criminal actions or proceedings, in addition, had no reasonable cause to believe that his conduct was unlawful

NYBCL § 722(a) (emphasis added).

This Section arguably requires the director or officer to meet the difficult burden of demonstrating that he or she consciously considered and reasonably believed his or her actions advanced the interests of the

"Broad Protection" continued page 3

"A Delicate Balance" continued

ingly endless unreasonable and burdensome demands for information. The natural reaction to such demands is to want to tell the insurers to take a hike. However, such a response may be what the insurers are hoping to elicit in order to create a record of non-cooperation and therefore, to the extent possible, should be avoided.

If the policyholder effectively has prevented the insurers from arguing that disclosure has been inadequate, the insurers may claim that they have actually been given too much information, and demand that the policyholder decide for them what the "important" or "hot" documents are that they should review. This is a potential trap. Any commitment to decide what information the insurers should focus on leaves the policyholder open to a claim that important information was withheld. A possible solution is to point the insurers to the transcripts and exhibits of depositions in the shareholder suits or SEC investigation and suggest that they contain the information that the opposing parties find important.

The Insurers' Right to "Associate" in the Defense or Settlement of the Investor Suits

D&O insurers also frequently seek to avoid coverage on the ground that the policyholder has deprived them of their right to "associate" in the defense or settlement of the investor suits, even when the insurers have reserved their right to deny coverage. The policyholder must be careful not to exclude the insurers from the defense and settlement of the underlying cases, to the extent they can be allowed to participate without jeopardizing the policyholder's ability to protect its rights vis-à-vis the plaintiffs.

The insurers' argument concerning the right to associate in the defense of shareholder suits typically arises in the context of an alleged failure of the policyholder to provide necessary information. In addition to providing information as outlined above, the policyholder can blunt, if not avoid, this argument by inviting the insurers to offer their views as to how the cases should be defended.

Claims that an insurer has been denied its right to associate in the settlement of an action can arise when that insurer has not participated in settlement discussions for whatever reason, and even where the insurer has participated, but nonetheless asserts that its involvement was limited by the policyholder. The policyholder should inform the insurers of any plans to mediate or otherwise attempt to settle a case, and should consider any requests made by the insurers to participate in that process. At the same time, the policyholder should ask for a clear statement on what role

"A Delicate Balance" continued

the insurers intend to play in the settlement process.

Settlement Without the Insurers' Consent

When a D&O insurer refuses to participate in a settlement, it will almost certainly later assert as a coverage defense its policy's provision that the policyholder may not settle any claim without its consent. However, this coverage requirement is not absolute, because the provisions also state that the insurer's consent cannot unreasonably be withheld.

Whether or not an insurer has unreasonably withheld consent to a settlement may depend upon a number of different factors, including the cooperation and right to associate issues discussed above. In addition, even if an insurer refused to participate in the settlement process, and never committed to providing coverage, it may devise some argument that it nonetheless had the right to accept or reject a settlement. Indeed, one court recently held that a "preliminary" denial of coverage did not relieve the policyholder from its obligation to obtain the insurer's consent to a settlement. This potential problem can be dealt with by conditioning a settlement upon insurer approval, while reserving the policyholder's right to waive that condition. If the plaintiffs will not accept a conditional settlement, the agreement should not be consummated without first presenting it to the insurers.

Conclusion: Caveat Emptor

No matter how unreasonable and annoying insurers' efforts to derail resolution of shareholder suits, they must be taken seriously and handled carefully in order to avoid saving the company and its Ds and Os from ruin at the hands of shareholders, only to find that the tower of insurance coverage needed to fund the settlements of these suits has evaporated.

Finley Harckham is a stockholder in Anderson Kill's New York office. Mr. Harckham regularly represents and advises corporate policyholders in insurance coverage matters. Mr. Harckham has successfully litigated, arbitrated and settled hundreds of complex coverage claims. His areas of particular expertise include property loss, business interruption and general liability claims. Mr. Harckham can be reached at (212) 278-1543 or fharckham@andersonkill.com.

"Broad Protection" continued

Corporation, or at the very least, were not antagonistic to them. Even if the criteria are met, indemnification is only optional, not mandatory, under § 722, which could have an impact on insurance coverage.

The New York statutes and courts tend to favor expansive indemnification rights on behalf of independent directors and officers for reasons of public policy, applicable especially in the era of Sarbanes Oxley, so that corporations may attract the highest caliber independent directors. This public policy is reflected in NYCBL § 721, which permits corporations to provide broader protections than those set forth in § 722. Section 721 specifically provides that the indemnification rights set forth in "this article" are "not exclusive of the rights that a corporation" may provide. Because "this article" includes § 722, it is clear that § 722 was not intended to and does not limit the scope of a corporation's ability to provide indemnification rights. Indemnification cannot be granted under § 721, however, if the director or officer's liability arises as a result of "bad faith," or "active and deliberate dishonesty":

> [N]o indemnification may be made to or on behalf of any director or officer 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*.

NYBCL § 721 (emphasis added).[1]

Accordingly, if a corporation drafted a by-law provision which requires indemnification "to the full extent of the law," indemnification is mandatory, subject only to the implied condition that the director or officer's conduct not fall below the minimum standards set forth in § 721. Analyzing and updating existing indemnification provisions (or adding them if they do not exist) in company charter

"Broad Protection" continued page 4

"Broad Protection" continued

or by-laws, from the perspective of the current rules and case law, may be crucial — the result could be more predictable protection under a D&O policy, avoidance of costly litigation and more clarity in the response to prospective directors and officers' concerns about protection.

[1] Indemnification is prohibited under this section only if a final judgment or adjudication has established that the suspect conduct was both prohibited and was material to the cause of action brought, or that the trustee has realized an advantage to which he had no legal right. *NYBCL* § 721

Isaac E. Druker is the Chair of Anderson Kill's Corporate Department. With over thirty-five years experience, Mr. Druker has handled mergers and acquisitions, international and domestic business, investment and financial transactions, project finance, international and domestic joint ventures, and distribution, licensing and general commercial agreements. Mr. Druker can be reached at (212) 278-1475 or idruker@andersonkill.com.

Jean M. Farrell is a senior member of Anderson Kill's Insurance Recovery Group. Ms. Farrell has represented policyholders nationwide in highly complex actions seeking insurance coverage for product, environmental and employment discrimination liability. Ms. Farrell can be reached at (212) 278-1222 or jfarrell@andersonkill.com.

Mark Your Calendar

Anderson Kill & Olick, P.C. Presents the Third Annual D&O Conference

Safeguard Your Directors & Officers: Liability and Insurance in Troubled Waters

FREE Seminar

September 27, 2005

Time: 4:00 - 6:00 p.m.
(cocktails 6:00 - 7:30 pm)

Location: The Rainbow Room
30 Rockefeller Plaza, 65th Floor
New York City

Topics to be discussed include:

- Introduction: Overview of the Year in D&O Liability and Insurance
- Your Exposure in the Current Environment
- Navigating the Claims Environment and Avoiding Pitfalls
- D&O Insurance Claims and Coverage Traps

This presentation qualifies for 1.5 hours of New York Continuing Legal Education Requirement, including .5 of Ethics. For further information or to register, please visit our website at www.andersonkill.com or contact Michele Elie at (212) 278-1318.

The **Executive Insurance Advisor** is published bi-annually by Anderson Kill & Olick, P.C. to inform clients, friends, and fellow professionals of developments which affect Directors and Officers. The newsletter is available free of charge to interested parties. The articles appearing in the **Executive Insurance Advisor** do not constitute legal advice or opinions. Legal advice and opinions are provided by the Firm only upon engagement with respect to specific factual situations.

We hope that you have found this issue of the **Executive Insurance Advisor** informative. We invite you to contact the Group Chairs or Editor listed below with your questions and/or concerns.

William G. Passannante, Co-Chair
Insurance Recovery Group
Chair, D&O Group
wpassannante@andersonkill.com
(212) 278-1328

Isaac E. Druker, Chair
Corporate Department
idruker@andersonkill.com
(212) 278-1475

Alex D. Hardiman, Editor
ahardiman@andersonkill.com
(212) 278-1471