NINE QUESTIONS TO ASK YOUR ATTORNEY NOW

Pandemic-induced financial repercussions, environmental disasters, #MeToo scandals and cyber events are all factors in today's more complicated and risky D&O liability landscape. Here's how to gauge your risk of exposure. BY RUSS BANHAM

IT'S A PERILOUS TIME TO BE A BOARD member of a public company. The uncertainty surrounding the pandemic's impact on present and future business has made advising on a proper course an act of sheer courage. Even companies currently seeing spikes in revenues and profits are unsure if it's a short-lived respite, courtesy of the federal relief policies, or an actual harbinger of growth.

Meanwhile, bankruptcy lawyers are predicting a tidal wave of Covid-19 filings involving companies in embattled industries like hotels, restaurants, retail, oil production and fitness centers, to scratch the surface. At the same time, the U.S. economy remains on shaky footing, contracting at a record rate in the second quarter, with so many Americans still on unemployment.

In addition to environmental, social and governance (ESG) risks, board members are subject to being dragged into court to explain why the company they serve did this or didn't do that. The volume of shareholder class action litigation and derivative lawsuits targeting board members is nearing all-time highs, and recent judgments like the Blue Bell Creameries decision appear to widen director liability for compliance.

Making sense of such fast-moving liabilities is not a task for the fainthearted. As every board member knows, shareholder litigation puts their personal assets at risk along with their reputations. Absorbing the brunt of the financial losses is D&O liability insurance, assuming the company has indemnified the directors and the insurer does not deny the claim. Though rare, claim denials do occur, largely because of non-indemnified losses and insurance coverage gaps.

That's just one reason anyone on a public company board should retain personal legal representation before and after taking a seat. While the general counsel and outside corporate law firms *do* protect the interests of board members, there are occasions when they *don't*—as the case with derivative actions filed by shareholders on behalf of the company.

"It's vitally important to discuss with your personal attorney a wide range of issues before joining a board and on a routine basis afterwards," says Donald Mrozek, former chairman of Hinshaw & Culbertson, which grew under his leadership from a small Chicago law firm to a national firm with 25 offices and 500 attorneys today. "The risks are too big to take lightly."

Here are nine points to consider in discussing current events with an independent attorney now:

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—Donald Mrozek, Former Chairman, Hinshaw & Culbertson

ONE

TO WHAT EXTENT DOES THE COMPANY INDEMNIFY ME FOR LIABILITY?

It is an honor for anyone to be asked to join a board, a testament to the person's integrity, experience and reputation. Before saying yes, two formal documents must be scrutinized—the corporate bylaws and articles of incorporation. And the best person for this task is the individual's personal attorney, given the independent, objective opinion offered.

As directors know, the bylaws outline the basic rules and duties of board membership, and the articles of incorporation address corporate governance. Both documents are filed by a corporation's founders in the state in which the business is domiciled. "These documents are the first source of protection for board members," says Mrozek.

Within the documents are the corporation's indemnification provisions—the specific situations in which the company will indemnify board members for their actions or inactions. Although nearly all bylaws and articles of incorporation on a state-by-state basis follow the template set by the General Corporation Law of Delaware, the state in which many companies are incorporated, dissimilarities exist.

These differences are particularly worrisome when they involve shareholder class action lawsuits and derivative actions. "The first questions directors ought to explore with personal counsel is the scope of their protections under the bylaws, their indemnification rights with respect to third-party actions," Mrozek says. "Counsel should verify the scope of indemnification, particularly now that derivative actions seem to be on the increase."

In this litigation, the board is sued for failing to disclose to shareholders an adverse event that could affect the company's performance, as well as for not advising management to put sufficient controls in place to prevent the event or mitigate the outcome. In recent years, derivative actions have been filed by shareholders against board members at Wells Fargo, PG&E, Wynn Resorts, Oracle, 21st Century Fox, Yahoo! and Nike, among others.

"While the company generally will indemnify board members' legal expenses in these cases, it generally does indemnify the judgment, as it would be illogical and inappropriate for a company to indemnify something that causes it a loss," Mrozek explains. The area that is in flux legally is whether or not a settlement in such cases is indemnifiable. "Delaware law appears to allow this, and we've seen a move by companies to put it in the bylaws. Nevertheless, it is certainly sensible to ask independent outside counsel to analyze the bylaws and articles of incorporation to illuminate sources of potential board member exposure."

TWO

ARE THERE SITUATIONS WHERE I COULD BE HELD LIABLE FOR ACTIONS THAT THE COMPANY DOES NOT INDEMNIFY?

Since companies have the option to indemnify or not indemnify directors, a scrupulous reading by an attorney of the corporation's bylaws and articles of incorporation is in order. The governing documents should spell out the indemnifications—the specific situations in which the corporation will pay to defend directors against certain lawsuits and absorb the costs of judgments and settlements, subject to certain limits.

Many governing documents, for instance, exclude indemnification for "extreme misconduct," such as a breach of the board member's fiduciary duty of loyalty. On the other hand, indemnification typically is provided for simple negligence, such as a breach in the director's duty of care.

"The more protective the indemnification provisions, the greater the liability for the company, as it will be bearing the judgment, settlement and legal costs," says Dan Bailey, chair of the directors and officers liability practice group at law firm Bailey Cavalieri. "Every company is different. Obviously, you want to be sure the indemnifications are as protective as possible. To do that, directors ought to obtain the views of independent counsel not loyal to the company."

Careful reading of the company's D&O policy by a personal attorney also is advised. As mentioned earlier, many D&O policies exclude coverage for shareholder derivative actions brought against directors on behalf of the company. However, Mrozek

says if the company is deemed a solid risk by insurance markets, "insurers may modify or even delete the exclusion. This would be an important line of inquiry for board members and their outside counsel."

In situations where the company does not indemnify directors, they need to purchase so-called Side A D&O insurance. The Side A insuring agreement covers individual directors against losses the company does not indemnify, whereas Sides B and C provide coverage for indemnified losses. Side A also pays board member legal defense expenses as they occur, as opposed to after the case has closed. Again, it is sensible for outside legal eyes to give the entire D&O program the once-over.

THREE

AM I INDEMNIFIED IN SITUATIONS INVOLVING THE COMPANY'S CODE OF CONDUCT?

Both the bylaws and the articles of incorporation address the standards of conduct guiding board members' performance of duties, which are typically wrapped together in a code of conduct. Depending on the bylaws and articles of incorporation, directors are expected to adhere to standards of ethical conduct, integrity, loyalty, care, confidentiality and legal/regulatory compliance, among others. They must also avoid conflicts of interest and opportunities for personal enrichment related to the entity's business.

"There are situations in which the company may be looking to sell a part of the business, which may be of interest to one or more board members to buy it," says Doug Raymond, a partner at Faegre Drinker Biddle & Reath. "This could create a conflict of interest."

Many board directors come from adjacent industries, such as a supplier to the company. This makes sense since the director will bring experience and expertise in the organization's business. The problem is when they perceive an opportunity to enrich themselves, such as acquiring a subsidiary or a division of the company. That leaves other board members in a quandary about their fiduciary duties of care and loyalty. "I would advise the directors not looking to buy the entity to reach out to personal counsel on their potential for a conflict of interest claim breaching the standards of conduct," Raymond says.

If the entire company is put up for auction, outside counsel should be retained to advise directors on the proper course of action. Selling the company to a private equity buyer may be in the best interests of management, since they are more than likely to retain their jobs, whereas selling to a strategic buyer will likely result in them losing their jobs. Moreover, if the company is acquired in a private equity transaction, the board members will be jettisoned.

"In such change-of-control situations, directors absolutely should have their personal attorneys advise on what is an inherent conflict of interest," Raymond says.

Bailey echoes this opinion. "It makes sense for the directors to form an independent committee of board members to do a deep dive into potential wrongdoings by the acquiring entity," he says. Such actions cropping up post-transaction can tarnish the combined organization's reputation and cause its stock to swoon. To assist the independent committee in its investigation, "the board should hire independent experienced outside counsel," he says.

Another reason to reach out to outside counsel for legal advice is when buying another company. Board members essentially become quasi-directors of the acquired entity," says Kevin Taylor, partner at Zukerman Gore Brandeis & Crossman, and author of the book, *FinTech Law.* "While management is expected to do thorough due diligence into the target entity's financial condition and growth opportunities, less evaluation may be given the company's liabilities, past and present,"

Such liabilities can crop up post-transaction to make the acquisition less valuable than originally portrayed to shareholders. For instance, an unknown tax exposure may result from the acquired entity's past tax treatment. Environmental exposures, intellectual property claims, employment disputes and accounting errors are other liabilities that can crop up years later to take the bloom off the rose. "If you're brought into this liability net, have your attorney make sure the corporation's governance documents address these legal possibilities from an indemnification standpoint," Taylor says.

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—Doug Raymond, Partner, Faegre Drinker Biddle & Reath

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—Craig Martin, Former Chair, Jenner & Block

FOUR

SHOULD I BE CONCERNED ABOUT THE BOARD'S LEADERSHIP AND SKILL SETS?

Each company across its history will endure a set of challenges that is unique to its business, from product recalls to environmental exposure liabilities. An airplane manufacturer, for instance, is going to have a different set of exposures than a chemical company or a provider of services to children. Understanding in advance what these risks are and how board members reacted to them in the past should factor into a decision to join the board.

"Boards don't matter until they matter, and that's during a crisis," says Craig Martin, former chair of Jenner & Block. "That's when experience and expertise are tested. How the board members responded (during a crisis) speaks volumes about their ability and integrity. To unearth the issues that came before the board and how they responded to them requires an independent investigation, which can be performed by outside independent counsel."

A personal attorney's investigation into past board actions may indicate a significant time lag between management's delivery of worrisome information to the board and when the directors responded. "Such institutional lags suggest that a board tends to act slowly to a crisis, letting the situation fester," Martin says.

When "situations fester," the risk of a shareholder derivative action increases. The board of Wynn Resorts, sued in this type of litigation, is a case in point. The lawsuit filed by shareholders on behalf of the company against the board directors alleges they knew that sexual misconduct allegations about former CEO and namesake Steve Wynn had been made by several women through the years but had failed to act on the information. The litigation was settled in 2019 for $90 million.

A personal attorney also can conduct a deep background check on current board members to discern their capabilities and integrity. "You might find out that one board member is there to represent activist shareholders and another has an interest in purchasing part of the company, creating potential conflicts of interest," says Martin.

A similar investigation should be conducted on all members of the company's senior management. "One of the executive officers might be under investigation by the SEC," he explains. "Outside eyes (from a personal attorney) can see what's really going on with both management and the board."

FIVE

SHOULD I BE CONCERNED ABOUT THE RISK OF LITIGATION STEMMING FROM A POSSIBLE BANKRUPTCY SITUATION BROUGHT ABOUT BY THE PANDEMIC?

Yes, you should be worried, says Bailey. "Board directors need to be extra cautious when there is a risk of company bankruptcy, since a company's bankruptcy eliminates a director's indemnification protection from the company," he explains.

Even the whiff of a possible bankruptcy can alter the duties of the board, making it incumbent on members to reach out for advice from an independent attorney. "Seeking legal advice from counsel who represents the interests of you. as a director. is certainly prudent in this situation," Bailey says, adding that one should not rely exclusively on the organization's general counsel.

Mrozek concurs with this approach. "Directors have a fiduciary duty to act with reasonable care in the exercise of their oversight duties, which includes proper oversight of the company's efforts to identify and mitigate risks," he says. "For example, third parties who sustain Covid-19 injuries could bring claims against the company alleging that its failure to act with the appropriate standard of care caused their injuries."

While the board's fiduciary duties ordinarily do not extend to third parties, a bankruptcy scenario alters the status quo. "The bankruptcy trustee could make a claim against the directors on behalf of the company and, ultimately, for the benefit of the creditors and others that have made claims against it," Mrozek says.

The trustee's claim would be based upon the board's alleged breach of its fiduciary duty to act with reasonable care with regard to the oversight of the company's risk management efforts to protect against Covid-19-related injuries.

"In this situation, my advice to directors to protect their interests would be to retain

personal counsel," Mrozek says. "Depending on the terms of the D&O policy, the insurer may deny coverage to the director. Were this the case, the personal attorney would advise on a proper course of action to ensure the director received the full benefits available under the D&O policy."

SIX

SHOULD I HAVE ANY ADDITIONAL CONCERNS ABOUT THE COMPANY'S D&O INSURANCE POLICY?

The answer is yes and not just because every company's D&O policy has complex contract language. The D&O insurance market is hardening at the moment, with premiums rising 20 percent and more over the past year. The reason is the spike in insurer losses due to shareholder litigation settlements.

As prices rise, coverage limits are falling. An insurance broker commented that the financial limits available from different insurers combining to provide coverage are down from $25 million per insurer two years ago to $10 million at present, with a few insurers unwilling to put up more than $5 million in coverage. To retain higher limits adds to the overall cost of the product. The question is whether or not buyers will reduce their limits to save on premium. "If the market hardens further, some companies may pinch pennies and decrease the amount of insurance or the scope of the coverage terms and conditions," says Bailey.

That's not good news for board members covered by D&O insurance. Bailey advises members to ask the general counsel and external corporate counsel if the annual D&O insurance policy has changed upon its renewal. If corporate counsel is slow to respond, the board should ask an independent outside attorney to audit the current D&O insurance policy, comparing it to previous policies. "With shareholder litigation rising, directors can't afford to take any chances," he says.

Board members also should ask corporate counsel to conduct an independent review of the types of claims considered most likely to be filed against them, based on the company's unique risk characteristics. "I'd request that they match up these exposures with the D&O insurance to see just how the program responds," he says. Again, if the inside lawyers are slow to respond, a second opinion from personal counsel is always a prudent backup.

"I don't think every board member has to bring in their personal attorney, but it makes sense to bring in at least one outsider's legal views," he explains. "Ask the attorney if the D&O insurance program is drafted well, the language in the policy is clear and concise, and the amount of insurance is appropriate given the organization's risks. Above all, you want to be sure the terms and conditions are consistent with market norms in the D&O marketplace."

SEVEN

MORE THAN 65 PERCENT OF JOBS IN THE U.S. CANNOT BE PERFORMED REMOTELY, MEANING THESE INDIVIDUALS HAVE TO WORK OR RISK JOB TERMINATION—COVID OR NO COVID. DOES THIS OPEN ME UP TO LITIGATION IF THESE EMPLOYEES CONTRACT THE CORONAVIRUS?

It's possible. Directors have a fiduciary duty to act with reasonable care with respect to their oversight of the company's efforts to identify and mitigate risks, including any health exposures presented to employees, customers and third parties. The challenge is that the processes and procedures that companies should follow in managing these risks are unclear. "The guidance from government on what constitutes a 'healthy' workplace are far from uniform and consistent," says Mrozek.

Nevertheless, regulators and the courts have been "particularly demanding" of directors in situations where the board's conduct affects the health and safety of others, says Bailey. "There are heightened expectations for deeper board involvement in health and safety matters," he explains. "This can conflict with management's desire to exclusively control company operations, creating tension."

In such cases, the directors should not rely solely on the advice of the company's counsel, but should seek advice from separate counsel, he says. Mrozek counsels the same approach. "Given this unclear and ambiguous landscape, if the director

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feels uncomfortable with measures taken by the company or the advice given by the company's counsel, independent advice provided by personal counsel would be the proper course of action."

EIGHT

THE COMPANY JUST INFORMED US THAT THEY HAVE FORMED A CAPTIVE INSURANCE MECHANISM TO ABSORB A PORTION OF OUR LIABILITY AS BOARD MEMBERS. SHOULD THIS BE A CAUSE OF CONCERN?

The action described is a response to the hardening D&O insurance market. Many companies form and own captive insurance mechanisms in several U.S. states and offshore locations like Bermuda and the Cayman Islands as a form of self-insurance for diverse property and liability risks. "Whenever the insurance cycle turns, we see a resurgence in captive activity," says Bailey. "The topic is again bubbling up."

The strategy is perceived as a cost-effective alternative to buying insurance exclusively from private insurers, as it can serve as a deductible, reducing the total amount of insurance purchased from traditional markets, reinsurers and excess insurers. Captives also present favorable tax-saving opportunities.

With regard to absorbing D&O exposures, Bailey says captives are being used primarily to address directors' non-indemnified losses, with traditional Side A insurance purchased on top of the self-insurance layer. "I'm also hearing that some companies are setting up trust funds in certain states to fund claims against directors and officers," he adds. "There's nothing inherently wrong with these alternatives, but in my view, there is no complete substitute for traditional D&O insurance."

If management is considering using a corporate-owned captive or trust fund for something as crucial to board members as Side A coverage, Bailey advises that directors ask corporate counsel if these alternative insurance mechanisms will erode their coverage limits for non-indemnified losses. "If you don't like the answer, then reach out to an outside attorney with expertise in D&O liability for their input," he adds.

NINE

SO, I SHOULD NEVER DEPEND ON THE COMPANY'S GENERAL COUNSEL TO ADVOCATE ON MY BEHALF?

Under most circumstances, the general counsel is not the lawyer for the directors, officers or even the CEO, as the individual represents a sole entity: the corporation. While board members can rely on the general counsel to advise them on the design of the corporation's procedures for their legal compliance, there are times when directors may not have confidence in the person to provide this advice, says Raymond.

A case in point is when the general counsel has close daily encounters with senior executives, which can cloud their perspectives. "I once was brought in by a board member who was worried that the CFO was doing something illegal," Raymond says. "The problem was that the CFO and the general counsel ate lunch together every day. That put the directors in a very awkward position. Even outside counsel employed by the company is subject to letting friendships affect their views."

If the judgment of internal legal counsel appears to be compromised by a relationship with senior management, Raymond advises board members to put the subject in front of their personal attorney. "This is especially the case if the company is discussing highly sensitive things like a change in strategy, executive compensation, a change at the top of the organization and anti-takeover provisions, where the risk of a conflict of interest is higher," he says.

If the board has serious questions about the integrity of a senior executive like the CFO he mentioned, Raymond says directors "absolutely need to reach out to an independent external attorney who has no relationship to the company. In such cases, I would request they conduct an independent investigation of potential wrongdoing."

As these nine questions underscore, it's not always wise to depend on the corporate counsel when personal assets are at risk. In today's increasingly uncertain economy and highly litigious climate, board members must take their own precautions. **CBM**

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