Key Concerns for Individuals Considering Becoming Directors of Private Companies

and a Review of Indemnification and D&O Insurance

Introduction

An invitation to serve on a board of directors (the "Board") of a private corporation can be an interesting, even flattering opportunity. One may be asked to join a Board because a corporation is impressed with the potential director's business acumen, demeanor, insight into the industry, or a host of other reasons.

However, before accepting an appointment to a Board, a potential director should engage in an in depth review of the corporation and ask pointed questions of management of the corporation and the other directors on the Board to obtain a complete picture of state of business and operations, including any potential legal and business risks that may expose the director to unwanted liabilities. By failing to ask the right questions and reviewing certain key documents before joining a Board, one may risk being exposed to legal and business, as well as financial, harms which may have significant consequences to the director. Even with extensive diligence, however, one must prepare for the possibility of litigation associated with service on a Board.

This article first provides a brief overview of certain key questions and documents that are prudent to review prior to joining a Board. The article then explores in some detail indemnification and directors & officers' liability insurance, which together act as a backstop in protecting a director when litigation arises.

Due Diligence

Before joining a Board, it is important to understand the business and operations of the corporation at hand. Potential directors may take the first step in understanding these items by engaging in general discussions with other Board members, such as by asking them what their responsibilities are, how often the Board meets, and what direction they see the corporation going in over the coming months and years, their views of (and concerns about) management and financial reporting, what connection other directors have with the corporation, management and shareholders, the quality of information and legal and accounting advice to which directors generally have access and what types of issues the Board regularly addresses at meetings and the depth of consideration they have given to those issues. Potential directors may also want to search the internet for material about the corporation, its officers and directors, and the industry that the corporation is engaged in, to obtain a basic understanding of the landscape that the corporation is a part of.

However, there are many risks that may be lurking behind the scenes that would not be uncovered by these general inquiries and searches. Potential directors should not shy away from asking pointed questions about financial stability, adequacy of working capital, pending or threatened litigation and other risks that may affect the corporation directly, as well as potential issues that may impact the industry in which the corporation is engaged. Below is a brief list of questions that potential directors may want to ask and materials they may want to review in order to obtain a deeper understanding of the corporation. Without delving into these items, a potential director may inadvertently become entangled with the time-consuming problems of a corporation faced with serious creditor, supplier or customer disputes, financial distress, crippling shareholder disagreements or inadequate management. Any or all of these may embroil the prospective board member in litigation and other potential exposure.

- <u>Why is there an Open Seat on the Board?</u> Was the size of the Board increased or is there a current vacancy? If the latter, why did the former director leave the corporation? How long is the standard tenure for a member of the Board?

- <u>Existing Conflicts?</u> Are there any areas of conflict or disagreement among the controlling or major shareholders, the directors or between the Board and the senior executives? If there have been any such conflicts or disagreements, how have they been resolved? Do these conflicts relate to a systemic issue or does it appear as though the conflicts have been addressed and will not arise again going forward?

- <u>What is the Financial Condition of the Corporation?</u> Have there been, or are there expected to be, any significant changes in the finances of the corporation? If so, why? How often does the Board receive information relating to the finances of the corporation? Does the Board have a meaningful opportunity to review and ask questions about those materials? Has the corporation lost any key customers recently or does the corporation expect any key customer to materially reduce its spend with the corporation? Have there been, or are there expected to be, any changes in the industry in which the corporation operates that may negatively impact the corporation (such as a new regulation that may impact how the corporation's products are manufactured)? In addition to asking questions about current and potential financial concerns, one should ask to review the financial statements of the corporation (including audited financial statements, if any, and budgets) and ensure that he or she closely reviews the footnotes thereto, as those footnotes may describe liabilities (such as lawsuits) that the corporation faces. A corporation with cash flow or other balance sheet issues requires detailed analyses to determine solvency risk.

- <u>Is there a Succession Plan in Place?</u> What is the plan for dealing with a corporation's loss of a key member of the Board or a senior executive?

- <u>What is the Corporation's Ability to Indemnify its Directors and what is the strength of its D&O Coverage?</u> You should consider the corporation's financial ability and legal commitment to indemnify the directors, and advance expenses for defending litigation. Adequate directors and officers insurance coverage can fill the gap left by a corporation's legal or financial inability to protect directors from litigation (For further details about indemnification, advancement of expenses, and directors and officers insurance policies, please see below).

- <u>Does the Corporation Comply with its Corporate Governance and other Policies?</u> Do any shareholder(s) have significant influence over the decisions of the Board or does the Board have independence with respect to its decision-making? Are any shareholder(s) (such as preferred stockholders) entitled to appoint a designated director? Are there any agreements among some or all of the shareholders, such as voting agreements? What is the relationship between the Board and the senior management of the corporation? Does the Board have the ability to ask appropriate questions of management in order to feel fully informed before making significant decisions? Does the corporation have effective corporate governance and compliance procedures? What types of committees does the corporation have (e.g., audit committee, compensation committee, and compliance committee)? Do the committees have, and comply with, guidelines for handling the types of issues that are within their purview? How are potential related party or interested director transactions handled? Senior management's attitude toward corporate governance and compliance can significantly influence both the information that flows to the directors as well as the ability of the directors to make informed decisions that affect both the corporation and its shareholders. Without the ability to make informed decisions and ask the right questions of management, directors may be exposed to claims that they breached their fiduciary duties to the corporation. Further, the proper use of independent committees can be beneficial in insulating the Board from attack with respect to certain decisions involving related parties.

- Are there any Pending or Threatened Claims against the Corporation or any Directors? If so, what is the nature of the claims? What was the outcome of any past claims? Did the corporation fully indemnify the directors for such claim and advance expenses to the directors on a "pay as you go" basis? Was insurance available to defend this claim?

- Has the corporation adopted exculpatory provisions permitted by statute? Both New York and Delaware permit a corporation to adopt provisions in its certificate of incorporation limiting the ability to sue directors for certain actions or omissions that would otherwise constitute a breach of duty on the part of a director. These "opt-in" provisions generally prohibit suits based on acts or omissions that would constitute negligence, but would not protect against claims based on breach of the duty of loyalty, intentional misconduct or bad faith.[1]

Indemnification and Advancement of Expenses

General Concepts

One way to mitigate the exposure that a director or officer may have in his or her capacity as such is to ensure that the corporation adequately indemnifies the directors and officers for claims made against them and advances expenses to directors and officers for payments made by them in defending any such claims. This article focuses primarily on statutory provisions under Delaware's corporate statute,[2] and where relevant, the article also provides footnotes comparing certain provisions in the New York and Delaware statutes.

Statutory Indemnification and Advancement of Expenses

Section 145 of the Delaware General Corporation Law (the "DGCL") provides for "permissive indemnification" and "mandatory indemnification."

In brief, Section 145(a) provides that a corporation may indemnify its current and former directors and officers from third party claims "by reason of the fact that the person is or was a director [or] officer" against "expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding…",[3] while Section 145(b) of the DGCL provides that a corporation may indemnify its current or former directors and officers from actions brought by or in the right of the corporation (the latter being styled a derivative action) "by reason of the fact that the person is

[1] See DGCL Section 102(b)(7) and NYBCL 402(b).

[2] In the authors' experience, it is common practice for corporations to incorporate in Delaware.

[3] Similarly, Sections 722(a) and 722(b) of the New York Business Corporation Law (the "BCL") provide that a corporation may indemnify directors and officers from third party claims. Certain differences between the permissive third party indemnification provisions in Delaware (Section 145(a) of the DGCL) and New York (Sections 722(a) and (b) of the BCL) include: (i) Section 722(a) of the BCL references indemnification for an "action or proceeding" (whereas Section 145(a) of the DGCL specifically includes any "threatened, pending or completed action, suit or proceeding"), (ii) Section 722(a) of the BCL clarifies that it addresses such actions, "whether civil or criminal" (where as Section 145(a) of the DGCL also addresses "administrative or investigative" actions or proceedings), and (iii) Section 145(a) of the DGCL provides that that the termination of "any action" shall not create a presumption that the person did not act in good faith (whereas Section 722(b) of the BCL narrows the scope of that provision to apply to "any civil or criminal action").

or was a director [or] officer" against "expenses (including attorneys' fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action or suit…."[4] As can be seen by the foregoing language, subsection (a) provides for permissive indemnification in third party claims against expenses, judgments, fines and amount paid in settlement, whereas subsection (b) only provides for permissive indemnification in actions by the corporation and derivative claims against expenses and not against judgments, fines or amounts paid in settlement (this narrowed provision in subsection (b) is intended to address the fact that in actions by the corporation and derivative actions, unlike third party claims, the suit is brought by or on behalf the corporation against the director or officer (for example, alleging that the director or officer breached his or her fiduciary duty to the corporation) and, hence, it would leave the corporation without a recovery to indemnify the director or office for judgements, fines, or settlements paid in connection with such actions).[5]

In order to fall within subsections (a) and (b), (i) the action must have been brought "by reason of the fact that the person is or was a director [or] officer" of the corporation, and (ii) such person must have "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation."[6] However, the subsections also diverge. For example, subsection (a) requires that an additional test must be met in criminal proceedings, whereby the director or officer also must have had no "reasonable cause to believe that [his or her] conduct was unlawful." Additionally, unlike subsection (a), subsection (b) provides that a corporation shall not be permitted to indemnify (again here limited to expenses) any director or officer in respect of any claim if he or she has been found liable to the corporation, unless the court otherwise determines that such person would be "fairly and reasonably" entitled to indemnification.[7]

A corporation is <u>required</u> to indemnify a current or former director or officer of the corporation "against expenses (including attorneys' fees) actually and reasonably incurred by such person"[8] if he or she "has been

[4] Similarly, Section 722(c) of the BCL provides that a corporation may indemnify directors and officers from derivative claims. Some of the most significant differences, however, between the permissive third party indemnification provisions in Delaware (Section 145(b) of the DGCL) and New York (Section 722(c) the BCL) include: (i) Section 722(c) of the BCL permits indemnification for "amounts paid in settlement" with court approval (whereas Section 145(b) of the DGCL does not expressly permit indemnification for settlement payments) and (ii) Section 722(c) of the BCL only refers to indemnification of a director or officer (whereas Section 145(b) of the DGCL also refers to employees or agents). . Note BCL Section 725(f) purports to apply New York's indemnification statute to foreign corporations deriving at least 50% of their revenue from New York.

[5] Accordingly, as Section 145(b) of the DGCL does not expressly permit a corporation to indemnify its directors and officers with respect to settlement amounts in derivative actions, it is imperative that a potential director review the corporation's D&O policies (as defined and described below) to see whether such policies, instead, would provide coverage for such amounts.

[6] Additionally, Section 145(d) of the DGCL states that permissive indemnification under subsections (a) and (b) (unless ordered by a court) may only be made by the corporation to the extent that the corporation determines that indemnification of the current or former director or officer is "proper under the circumstances because the person has met the applicable standard of conduct set forth in subsections (a) and (b) of this section." Such determination may only be made by (i) a majority vote of the directors who are not party to such action, (ii) a committee of such directors designated by majority vote of such directors, (iii) if there are no such directors or if such directors so direct, an independent legal counsel pursuant to a written opinion, or (iv) the stockholders. Section 723(b) of the BCL includes similar provisions.

[7] Section 145(c) of the DGCL. Indemnification may not be made with respect to any claim as to which such person shall have been adjudged to be liable to the corporation unless the court determines upon application that, "despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper." Section 722(c) of the BCL contains a similar provision, but also provides that this provision shall not only apply to a claim as to which such person shall have been adjudged to be liable to the corporation, but also to a "threatened action, or pending action which is settled or otherwise disposed of" (and, additionally, could potentially permit indemnity for "such portion of the settlement amount" (and expenses) as the court deems proper). However, under Section 721 of the BCL, a director or officer may not be indemnified 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."

[8] Section 145(c) of the DGCL.

successful on the merits or otherwise in defense of any action, suit or proceeding" referred to in subsections (a) and (b) of Section 145 of the DGCL. This is generally referred to as "mandatory indemnification."

Delaware also provides for the possibility for a corporation to advance fees to directors and officers incurred in defending certain actions. Subsection (e) provides that expenses (including attorneys' fees) may be paid by the corporation in advance of the final disposition of such action "upon receipt an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation as authorized in this section."[9] It is important to note that this section allows – but does not require – a corporation to advance expenses in connection with a covered proceeding. Additionally, directors or officers seeking or receiving any advanced expenses under this subsection should be aware of the potential for clawback of such amounts if it is ultimately determined that such director or officer is not entitled to indemnification as authorized by Section 145 of the DGCL. Note that this clawback would generally not apply for expenses covered by a directors and officers insurance policy.

Materials to Review

The DGCL states that a director's or officer's rights to indemnification are not exclusively found within the statute, but rather the provisions of Section 145 of the DGCL shall not be deemed exclusive of any other "rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise."[10] Accordingly, it is imperative that an individual and his or her attorneys, before joining a Board, review the corporation's charter, bylaws, indemnification agreements, if any, and directors and officer's insurance policy (as described in greater detail below) to understand what rights may or, importantly, may not, be afforded to him or her in the unfortunate event that he or she needs to seek indemnification or advancement of expenses.

Individuals seeking to join a Board should strongly consider requiring that the corporation enter into an indemnification agreement between the director and the corporation. Among other things, indemnification agreements may be more easily enforced as they – unlike the corporation's certificate of incorporation or bylaws – are bilateral contracts agreed to by the parties. Additionally, depending on the leverage that a potential director or officer has, one may be able to obtain expanded or more favorable indemnification protections in an indemnification agreement (such as expanding the scope of what types of "claims," "proceedings," and "expenses" are covered, as applicable) and timeframes relating to any indemnification proceedings and advancement of expenses. In addition, an indemnification agreement will have detailed procedural issues covered such as the time required for the corporation to respond to a claim for advancement of expenses and provisions that cover attorneys' fees incurred to enforce an indemnification claim (as further discussed below). An indemnification agreement can also have provisions requiring the maintenance of directors and officers insurance.

[9] Notably, this Section does not reference a standard of conduct that must be met in order for the director or officer to receive advancement. Similarly, Section 723(c) of the BCL permits the corporation to pay the expenses of a director or officer incurred in defending any action or proceeding under Section 722 of the BCL in advance of the final disposition upon receipt of an undertaking by or on behalf of the director or officer to repay such amount as required by Section 725(a). Unlike Section 145(e) of the DGCL, Section 725(b) of the BCL sets forth various circumstances in which no indemnification, advancement or allowance shall be made, including where it appears: (i) that indemnification would be inconsistent of the law of the jurisdiction of a foreign corporation, (ii) that indemnification would be inconsistent with a provision in the certificate of incorporation, bylaws, or agreement which was in effect at the time of the accrual of the alleged cause of action, which prohibits or otherwise limits indemnification, or (iii) "if there has been a settlement approved by the court, that the indemnification would be inconsistent with any condition with respect to indemnification expressly imposed by the court in approving the settlement." Sections 725 also contains various notice requirements that must be met in connection with indemnification and advancement of expenses.

[10] Section 145(f) of the DGCL. Similarly, Section 721 of the BCL provides that the indemnification and advancement provided by Article VII of the BCL are nonexclusive of any other rights to indemnification a director or officer may have and that the corporation may grant additional indemnification rights in the certificate or bylaws, resolutions of the shareholders or by contract.

Certain Vulnerabilities and Protective Steps

When reviewing the corporation's existing documents that contain indemnification and/or advancement of expenses provisions or when negotiating indemnification agreements, one should ensure, among other considerations, that the below items are addressed prior to joining the Board:

- "Fees on Fees." Are attorney's fees covered under the indemnification provisions? A potential director should require that the corporation indemnify him or her for what is commonly referred to as "fees on fees," which would require that the director be indemnified not only for the covered actions noted above, but also for attorney's fees incurred by the director or officer in connection with enforcing his or her indemnification rights. As these fees can be significant, one would be remiss not to require that the corporation cover these expenses.

- Timing of Advancement. Are expenses advanced immediately upon request by the director or officer or are they advanced at other intervals (e.g., only at month end or quarterly) or upon the satisfaction of other milestones? If possible, a director should require that advancement of expenses is made immediately upon his or her request and on a "pay as you go" basis, as opposed to waiting for extended periods or for other milestones. Otherwise, a director or officer could be required to fund – out of his or her own pocket – the costs of litigation. Such financial exposure can be crippling to a director or officer and it is imperative to negotiate for protection from this exposure.

- Procedure for Indemnification. Does the indemnification agreement set forth a procedure with respect to proceedings for which indemnification is sought? For example, is the corporation entitled to assume the defense of such proceeding? If so, does the director or officer have the right to approve the counsel retained by the corporation? Under what circumstances would the director be entitled to separate counsel even if the corporation assumes the defense of a proceeding?

- Insurance. Do the documents require that the corporation maintain insurance that would cover the potential director or officer and, if so, for how long? If possible, one should require the corporation to maintain its directors and officers insurance policies ("D&O policies") in reasonable amounts (or, alternatively, amounts that are customary in that industry for similarly situated companies) from reputable insurers. Additionally, one should require that such insurance be maintained for so long as the director or officer serves as an agent of the corporation and for a period thereafter that would cover any time periods in which a claim could be filed against the director or officer by reason of the fact that he or she was an agent of the corporation. Also, as further discussed below, not all D&O policies provide adequate coverage so specificity on the scope of D&O coverage is critical.

Directors and Officers (D&O) Insurance

General Concepts and Terminology

One of the key purposes of D&O policies is to protect directors and officers of a corporation from personal liability for losses they may incur related to their service to the corporation. Unlike statutory indemnification, coverage is not restricted by prohibitions in corporate statutes governing indemnification. Rather, coverage is a matter of contract. Typically, D&O policies are comprised of:

Side A Coverage: Side A coverage is intended to provide coverage for a director's or officer's losses in situations in which the corporation is unable to indemnify him or her. Such situations include where the corporation in financially unable to indemnify the directors and officers (such as because the corporation is insolvent) or where it is restricted or otherwise prohibited from doing so (such as because the applicable corporate statute or the charter, bylaws or indemnification agreement do not permit indemnification in a specific instance).

Side B Coverage: Side B coverage is intended to reimburse the corporation for the payments it made with respect to its indemnification obligations to, or its advancement of expenses on behalf of, the directors and officers.

Side C Coverage: Side C coverage, also commonly referred to as "entity coverage," is intended to provide coverage for the corporation's losses for claims made against the corporation.

Certain Items to be Aware of when Reviewing D&O Policies

In order to understand the full scope of exposure – or protection – that one may have under a D&O policy, a director or officer and his or her attorneys should consider asking the questions below when reviewing the corporation's D&O policy. These questions are not an all-inclusive list of items to be addressed when conducting such review, but provide a starting point for the discussion and analysis of these policies.

- What are the policy limits? Are there any retentions or deductibles? What is the total amount of losses that the insurance carrier will cover? Are there any reductions or deductibles that have to be satisfied? Typically, there is a single aggregate policy limit for the Side A, B, and C policies. As such, a third party claim under the Side C policy, for example, would erode the overall coverage under the policy and, accordingly, could deplete the remaining limit left for the directors and officers under the Side A policy. Accordingly, it is imperative that the potential director engage counsel to carefully analyze key terms in the policy, as slight tweaks in the definitions of these terms could significantly impact the breadth of these terms and, accordingly, how quickly the limit can be eroded. Additionally, the potentially director should understand whether the policy has a deductible or a self-insured retention (also known as a SIR). One of the main differences between those items is that with a SIR, typically that amount must be satisfied by the insured person before the insurance carrier will contribute to the loss, whereas with a deductible, typically the insurance carrier will cover the entire loss (to the extent it deems appropriate within the terms of the policy) and then seek reimbursement from the insured person equal to the amount of the deductible.

- Are the size of the limits and self-insured retentions or deductibles, if any, standard and customary for the industry in which the corporation operates? Has the corporation asked its insurance broker to benchmark the overall policy limits and deductibles or self-insured retentions, if any, against other similarly situated corporations? If so, are there any significant differences between those policies (including any differences in the amount of the coverage and variations in key terms)? While this analysis will help a potential director obtain a general understanding as to whether the corporation's D&O policy is reasonable or customary in its industry, one must also be aware of any facts and circumstances that are specific to the corporation and how those may impact the analysis of the policy and its limits as well.

- Are there any ways to address the dilution of claims risk? In addition to narrowing the scope of certain key terms in the D&O policy (as described below) or increasing the overall policy limit, another way to address this concern would be for the corporation to obtain a standalone, non-rescindable Side A policy that provides coverage for the exclusive benefit of the directors and officers. First, as one can surmise from the use of the term "non-rescindable," one key advantage of this policy is that the insurance carrier would not be able to rescind this policy (or, if they could, it should be in a very limited, negotiated set of circumstances). Second, as also can be surmised from the use of the term "standalone," this policy would sit outside of the other coverages and would not be eroded by claims under those coverages (thus, for example, if a claim is made under the Side B policy, it would not erode the policy limit available under this standalone Side A policy). Third, the proceeds of a standalone Side A policy typically will not be considered corporation assets during bankruptcy proceedings because the corporation is not insured by the policy. In addition to additional Side A policies, independent directors may want to require that the corporation obtain separate independent directors' liability insurance for the exclusive benefit of the independent directors (as management directors who are involved in the day-to-day making of the corporation may be more likely to make claims under the standalone Side A policy and thus deplete the coverage under the Side A policy, this additional policy would provide a separate policy and policy limit for those independent directors). Another option would be to purchase a Side A policy with difference in conditions (also known as a Side A DIC policy). Unlike an excess Side A policy, which may provide additional coverage once the policy limit under the primary policy is exhausted, a Side A DIC policy typically provides coverage for claims that would not otherwise be covered under the primary policy.

- Certain terms that should be closely reviewed: In addition to the items noted above, the sections below provide a non-exhaustive set of initial questions that a director and his or her counsel may want to ask when reviewing terms in the corporation's D&O policy. However, one should be aware as in all aspects of negotiating such a policy, there is a delicate balance that must be struck, as on the one hand, a director typically wants the terms and coverage to be as expansive as possible so that he or she can be covered under the policy in as wide of an array of situations as possible and on the other hand, a director may be concerned that if these terms become too broad, the coverage may be quickly diluted by a wider scope of claims from a broader group of insured persons, which, in turn, would more quickly erode the overall policy limits and deplete the amount of coverage that would remain for the director if he or she subsequently wanted to make a claim under the policy.

  - Who qualifies as an "insured person"? Does it include the corporation only or does it extend to subsidiaries and/or affiliates? If it extends to subsidiaries and affiliates, the director may want to request that overall policy limit be increased to account for potential claims relating to these additional entities. Does it include directors and officers only or does it extend to certain employees and/or other personnel? Does it include directors and officers only if they were duly appointed? If so, the director should request that he or she be provided with evidence of his or her due appointment.

  - What constitutes a "claim"? Does it only cover formal proceedings (if so, does it require that a lawsuit be initiated) or should it be expanded to also include informal proceedings and investigations (such as governmental investigations)? A potential director should also understand whether this term only applies to formal document demands or whether it also includes informal document requests and subpoenas. Does it include proceedings in arbitration or mediation?

  - What constitutes a "loss"? What types of losses and expenses does it cover? Are there any items that are excluded from coverage, such as fines are penalties? Additionally, a potential director will want to ensure that the insurance carrier has an obligation to advance defense costs to insured persons (so that the insured person does not have to wait for final adjudication of a claim to receive defense costs under the policy).

  - What is a "wrongful act"? D&O insurance policies typically provide coverage for losses incurred by an insured person relating to wrongful acts. However, each policy may have its own unique definition for such term and exclusions thereto. As such, there are various questions that must be asked when reviewing this term, including: what types of actions constitute wrongful acts (e.g., breach of duty, misstatements, etc.)? Does it extend to related wrongful acts? Does it only cover acts by a director or officer acting in such capacity? If so, what would happen if the director were sued for actions he or she took in his capacity as a director and in another capacity?

- Does the D&O policy have a severability clause? Does the policy include a "full severability" or a "limited severability" provision? Among other things, a potential director would want to ensure that the misconduct of one director would not be imputed to all of the other directors or officers and, thereby, putting the innocent directors at risk of losing their coverage due to the acts of the wrongdoer. A director would also want to ensure that the severability provisions applies to the application itself, meaning that if, for example, an officer knowingly made a misstatement or provided false financial statements when submitting the corporation's application, it would not be imputed to any other innocent insured persons who did not have knowledge of such actions.

- Does the D&O policy have a non-rescission clause? In what instances can the insurer rescind the D&O policy? Is it only in extreme cases? If the insurance carrier has the ability to rescind the policy, the director should negotiate this term to provide a defined, limited set of circumstances whereby this provision can be triggered.

- What is the "Priority of Payment" for Claims? D&O policies typically have layers of coverage, under which the primary carrier provides coverage from the first dollar after the retention is satisfied up to a limit and additional carriers provide coverage for losses in excess of that initial amount (with each additional carrier's coverage only being triggered once the limits of the underlying carriers' coverage have been exhausted). A potential director should review the "Priority of Payments" provision to ensure that the first payments of insurance proceeds are applied to claims under the Side A policy, before being applied to claims under the Side B and C policies.

- What is the Interplay between the Primary Carrier and any Excess Carriers? Another risk associated with having multiple layers of coverage is that higher level carriers are usually only required to make payments under their policies after the lower level carriers have paid for claims that exhaust the limits of their lower level coverage. Does the excess policy state that it will only be payable after the lower level policy pays its claim in full? If so, what happens if the lower level policy does not pay the claim in full (such as, because the insurance carrier issuing such lower level policy became insolvent)? A potential director should review any excess policies closely to ensure that such policies become active in those situations.

- Does the Policy provide for any exceptions and, if so, should those exceptions be narrowed in scope? There are a variety of potential exclusions that may be incorporated into insurance policies, including the Insured v. Insured exclusion (also known as the I v. I exclusion). Directors and officers may be surprised by the breadth of this exclusion and should pay close attention as to whether the D&O policy includes such an exclusion and, if so, what exceptions there may be to such exclusion.

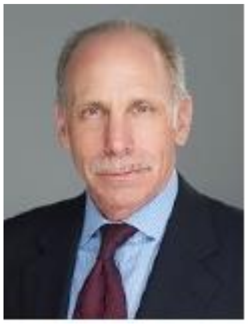
  As one can assume by its name, the I v. I exclusion excludes claims by one insured against another insured. The principal rationale for this exclusion is that carriers want to protect themselves against collusive suits among those insured (for example, if a corporation (an "insured person") sues a director (another "insured person") in order to recoup certain operating losses of the corporation that were allegedly caused by a poor business decision by such director). While that concept may seem logical at first, there are certain circumstances where the I v. I exclusion should not apply. For example, one may want to ensure that the exclusion does not apply to (i) whistleblower actions, (ii) lawsuits that are brought on behalf of a liquidator or bankruptcy trustee or other successor-in-interest type claims, and (iii) certain non-collusive derivative claims (e.g., derivative claims when no insured person instigated or participated in the claim). One should also be aware that an "insured" is typically defined to include both current and former directors and officers of the corporation. As such, it is important to require that claims by former insureds (such as a director who has ceased serving in that capacity for a specified amount of time) are not excluded by the I v. I exclusion.

From the corporation's perspective, there may be gaps in coverage relating to any entities that have been acquired by, or merged into, the corporation. As such, the corporation would want to ensure that the I v. I exclusion does not prevent coverage for certain claims that it may want to make as the surviving corporation against the directors and officers of the acquired corporation (for example, if those directors and officers made misrepresentations about the affairs of the corporation prior to such merger or acquisition).

In addition to the items noted above, a potential director should ask certain diligence questions with respect to the policy, including: Have there been any claims made against the policy? If so, what were they for? How were they handled? Were they covered in full? If not, why not?

Conclusion

The decision to join a Board is one that should not be made lightly. While there are certainly potential advantages to joining a Board, one must also be aware of the potential liabilities that he or she may be exposed to once they become a director or officer of a corporation. As such, it would be prudent to engage an attorney who is experienced in these areas to help navigate the complicated and highly nuanced waters of this area. An attorney can assist in the technical and detailed review that one must undertake when reviewing the corporation's charter documents, bylaws, indemnification agreements, and D&O policies, so that prospective directors can feel comfortable with their understanding of their rights and protections prior to joining a Board. An attorney can also assist with negotiating additional or modified protections. An agreement with the prospective corporation can be entered into to pay counsel fees for the prospective director in this review and negotiation.



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