Executive Risks

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Presumptive Indemnification in Executive Liability Policies

What Is It?

"Presumptive indemnification" is a term you're likely to hear if you have an Executive Liability claim, but it's not actually defined in any Directors & Officers (D&O), Employment Practices or Fiduciary Liability insurance policy that we know of. The closest thing to a definition you will find reads something like this:

> "Indemnifiable Loss" means Loss for which an Organization has indemnified or is permitted or required to indemnify an Insured Person pursuant to law or contract or the charter, bylaws, operating agreement or similar documents of an Organization.

Some version of this language can be found in virtually every Canadian and US-based Executive Risks policy. Essentially, if a company is legally permitted to indemnify its directors, officers and employees embroiled in a claim, the insurance carrier will *presume* that it has done so to the fullest extent allowable by law. In fact, this presumption is usually made whether or not the company has actually elected to do so.

While in the past it may have seemed automatic for corporations to extend indemnification to executives, this is no longer the case. In the post-Enron, Sarbanes-Oxley world, companies may deny indemnification to some or all of its executives. Some observers believe that corporations are actually being encouraged to do just that. This is an issue that is finding its way into the US courts and the news media as we write. The potential repercussions for organizations and their directors and officers are significant.

The Significance of Presumptive Indemnification

Historically, Executive Liability insurance was intended to respond whether or not the corporation was legally or financially able to indemnify its executives. For the most part, the real significance of presumptive indemnification was its impact on the policy's deductible or self-insured retention (SIR). The deductible or SIR applies only to indemnifiable claims and is the financial responsibility of the corporation. Notably, if the deductible is not fully depleted, or exhausted, the carrier has no financial obligation for the claim, while non-indemnifiable claims instantly trigger coverage as there is typically a zero dollar deductible or SIR. Therefore, the insurance carrier, as well as the executive, has a financial stake in whether or not indemnification is legally permissible.

Under traditional insurance programs, indemnification serves to limit, eliminate and/or postpone the carrier's financial obligation to respond to Executive Risks claims. Now, however, there are additional coverage considerations. Since 2001, there has been a significant surge in the purchase of A-Side D&O coverage, which is intended to respond solely when the company is legally or financially unable to indemnify its executives. For A-Side D&O contracts, the determination as to whether a company is legally obligated to indemnify its executives must be made before the coverage can be applied.

Indemnification Rights

In Canada, the legal basis for a corporation to indemnify an executive or employee is typically founded in three sources:

1. Provisions in the corporate statutes under which the corporation was created
2. Provisions in the corporation's by-laws
3. Contractual indemnities between the corporation and the director or officer

Determining Indemnification: a Two-Part Test

Most provincial and federal business statutes *allow* (but do not mandate) a corporation to indemnify its directors and officers provided two standard

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prerequisites are met. The statutes require a determination that the individual:

- Acted honestly and in good faith with a view to the best interests of the corporation
- Had no reasonable grounds to believe his or her conduct was unlawful with respect to any criminal or administrative action or proceeding

Provided those two prerequisites are met, a corporation *must* indemnify a director or officer if the individual is substantially successful on the merits of the defence of the action. Often the timing of entitlement to indemnification is an issue. The determination of whether an individual with a right to potential indemnification is entitled to payment of ongoing defence costs rather than waiting for completion of all proceedings was recently considered by the Manitoba Court of Queen's Bench, which set out the following principles:

1. A court has discretion to determine the timing of indemnification.
2. A court should allow for indemnification on a concurrent basis, provided there is an absence of evidence showing the individuals failed to meet the two prerequisite criteria noted above; a mere allegation of bad faith or dishonesty will not forfeit the right to indemnity as good faith is assumed in the absence of evidence to the contrary.
3. A court may impose a cap limiting the amount to be paid in indemnification.
4. The existence of insurance is not relevant to the question of entitlement to indemnification.

Incentives in the US: The Carrot and the Stick

Under US Department of Justice rules of engagement known as the Principles of Federal Prosecution of Business Organizations, or the Thompson memo, prosecutors are encouraged to consider nine factors when deciding whether or not to indict (sue) the corporation rather than just its executives. One of these factors is whether or not the corporation extends indemnification to executives and others under suspicion of illegal conduct.

> [A] factor to be weighed by the prosecutor is whether the corporation appears to be protecting its culpable employees and agents. Thus, while cases will differ depending on the circumstances, a corporation's promise of support to culpable employees and agents, either through the advancing of attorneys fees, through retaining the employees without sanction for their misconduct, or through providing information to the employees about the government's investigation pursuant to a joint defense agreement, may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation.

In 2004, the Securities & Exchange Commission (SEC) assessed a $25 million fine against Lucent for failure to cooperate in an investigation, including what it viewed as improper indemnification of certain corporate executives.

More recently, in late 2005, the SEC issued guidance on penalties that effectively suggested that organizations that "cooperate" with the Commission would be treated favourably. One of the considerations in determining cooperation was, presumably, the decision to grant or deny indemnification to executives suspected of felonious behaviour.

What does all this mean? For one, it means that organizations often face a difficult choice on whether or not to indemnify their directors and officers. Protecting their executives may come into direct conflict with protecting the organization itself as organizations attempt to determine how prosecutors might perceive their choices.

High Stakes and Zealous Prosecutors

Arthur Andersen stands as a lesson to companies on what can happen to indicted corporations; they can disappear overnight. Companies do not, however, need to panic and circle their wagons – with directors and officers on the outside.

In June, a US federal judge ruled that prosecutors acted unconstitutionally when they pressured KPMG to stop paying legal fees for 16 of its former executives charged with setting up illegal tax shelters. The judge found that the government "let its zeal get in the way of its judgment" and "violated the Constitution it is sworn to defend." The judge held that prosecutors had violated the Fifth and Sixth Amendments by "causing KPMG to cut off legal fees and other defense costs upon indictment" and suggested that the company should consider paying the fees of former employees currently under indictment. Furthermore, he invited the former partners and employees of the accounting company to sue for fees if need be. While this closely watched decision leaves in place the two-part test for corporate indemnification, it creates uncertainty as to how these guidelines will be treated going forward, as well as its impact on cases recently closed where executives were denied this protection. As yet, we have not seen similar tactics in Canada.

Insider Information

Without a doubt, the rigorous internal investigations that companies undertake when they suspect (or are suspected of) illegal conduct may well turn up information that gives them pause when considering the prerequisites to corporate indemnification. Given the intense scrutiny and desire for full

disclosure surrounding corporate activities today, corporate indemnification may not be something that an executive can bank on.

Insurance to the Rescue

What should organizations with D&O exposures do? We suggest three responses.

1. Be sure a recently reviewed and well-drafted indemnification agreement is in place for executives, at both the parent and subsidiary levels.
2. Establish (or review) a properly designed and structured Executive Liability insurance program.
3. Partner with experienced Executive Risks claims advisors.

The insurance marketplace offers products that address these issues. For example, an excess A-Side D&O program may specifically state that it will respond if corporate indemnification is wrongfully denied or if an underlying insurance carrier wrongfully refuses to respond to a claim. Alternatively, it may be possible to negotiate removal of a presumptive indemnification provision in the policy. That may simplify matters, but will not, unfortunately, make this thorny issue go away.

Willis publishes a US and a Canadian Executive Risks Alert series; both are available at www.willis.com.

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