Indemnification Holes After a Company is Sold

Can a buyer cancel insurance, or amend bylaws after a sale?

BY DOUG RAYMOND

A good directors & officers insurance policy frequently is the first and best line of defense. But what happens to these layered protections when the company is sold? Can the buyer cancel the insurance and amend the bylaws?

A recent Delaware case that deals with indemnification provisions for executives and board members when the company is sold highlights these issues.

ServiceMesh, Inc. had been sold to Computer Sciences Corporation (CSC), and following the sale, CSC brought an indemnity claim against the former CEO, alleging that he had taken actions that fraudulently inflated the amount CSC paid to the ServiceMesh shareholders. The CEO, pointing to the bylaw provisions in the ServiceMesh bylaws, demanded that ServiceMesh (now a CSC subsidiary) advance to him the fees and expenses he would incur in defending himself against the CSC lawsuit. Soon after, the CEO demanded advancement for expenses he would incur in a related federal criminal bribery investigation.

Despite objections from CSC in an earlier proceeding, the Delaware Court of Chancery largely granted the CEO's request, as many of the claims related to his position as an officer of ServiceMesh before the acquisition. While the federal investigation ultimately was dropped, the CEO incurred over $18 million in expenses defending himself from the numerous actions and investigations.

There are few events as significant for the board of directors as the decision to sell the company. Whether public, family-owned or PE-backed, the sale of control to a third party typically severs the long-standing ties of the directors to the company, turning over control and management to a new group of unfamiliar faces. Readers of this magazine have seen many discussions of the board's obligations to the shareholders when a sale of control becomes likely.

There are other consequences of the sale that are important for the directors. Before a sale, the directors and officers of a corporation enjoy overlapping layers of protection against challenges to their decisions. The corporation laws of every state mandate, or allow, indemnification of directors and officers who are brought into an actual or threatened suit, or other legal action as a director or officer. This protection is an essential protection for the board, and is at risk in a sale of control.

Corporations can adopt bylaws or other provisions that provide a broad indemnity so long as the director or officer satisfies a base level of care (e.g., in Delaware, that the director acted in good faith and in a manner they believed to be in, or at least not opposed to, the bests interest of the corporation). Most public and many other corporations have adopted such protections. It also is very common to establish indemnification agreements with the individual directors that establish presumptions and expense reimbursement and other provisions for the benefit of the board members.

Perhaps more important, these bylaw provisions and agreements generally require the corporation to pay the directors' costs of defense (and similar expenses) as they are incurred, so the individual directors do not have to incur out-of-pocket expenses to fund what can be a very expensive and protracted litigation defense.

After a sale, the buyers may want to cancel the insurance and amend the bylaws, so they do not have to pay for the litigation and other expenses of the legacy board. However, experienced deal professionals will recommend the company purchase (perhaps out of the sale proceeds) extended insurance coverage for the directors (a "tail policy") that they can access directly.

But how about the indemnification and advancement obligations of the company once it is in unfamiliar and, perhaps, unfriendly hands? On this issue, sellers seek to include in the transaction agreements a binding agreement by the buyer to not change these important provisions to the detriment of the directors, at least for a period of time when claims could be brought.

In the case of CSC and the CEO's expenses, CSC had agreed in the acquisition agreement to continue the bylaws' indemnity and advancement protections for the directors and officers. However, to avoid having to indemnify for claims that CSC itself might assert against the officers and directors, it had limited this obligation: CSC insisted on a separate payment obligation by the former ServiceMesh shareholders to reimburse CSC for any losses it might incur because of such provisions "to the extent such indemnification or advancement of expenses provisions relate to the authorization and approval of this agreement and the transactions contemplated hereby by the [ServiceMesh] board of directors."

So, if a claim was brought that the board, for example, had breached its fiduciary duties in approving the sale transaction, the ServiceMesh shareholders would effectively be responsible for these indemnification and advancement obligations. (The D&O insurer providing the tail coverage had denied coverage, a story for another day.)

CSC argued to the court that the CEO's fraud tainted the approval of the transaction by the ServiceMesh board, and therefore was covered by the reimbursement provision. The court disagreed and dismissed the request for reimbursement, acknowledging that there was no nexus between the fraud claims and the board action, and the board was apparently unaware of the alleged fraud and had never considered or authorized it.

While in this case the court approved the indemnity and advancement provisions, and did not require the advances to be reimbursed by the selling shareholders, it highlights important considerations for the board:

- First, the board should make sure that it has adequate D&O tail coverage and that their advisers have carefully analyzed the coverage and exclusions.
- Second, the board should insist on broad survival of their indemnity and advancement protections, including indemnification agreements if possible.
- And finally, it must make sure that the individual directors understand any limits that the buyer seeks to impose on those rights, whether by cross-claims against seller shareholders, or other exclusions. ■

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