

Ask the Lawyer

DIRECTOR and OFFICER INSURANCE

by Chaim J. Jaffe

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My two previous articles discussed issues related to confidentiality agreements and covenants not to compete. Another important issue for small-business owners to consider is the need for director and officer insurance, commonly referred to as "D&O insurance."

As its name suggests, D&O insurance provides liability coverage for the directors and officers of a corporation. D&O insurance is available through your property and casualty insurance broker for both not-for-profit and for-profit corporations. The officers and directors of both for-profit and not-for-profit corporations have a fiduciary duty to their shareholders and related membership. Before you agree to become an officer or director of a corporation, the first question you should ask is whether the corporation has D&O insurance as well as the scope of the coverage.

The Business Corporation Law (BCL) of New York State provides officers and directors with the right to seek indemnification from the corporation in the event that an action is initiated against that individual arising from that individual's involvement with the corporation. Sections 722-724 go into specific details about the scope of the right to seek indemnification. Section 722(a) of the BCL provides that indemnification is to encompass reimbursement "against the reasonable expenses, including reasonable attorneys' fees, actually and necessarily incurred. . . in connection with the defense of such action, or proceeding or any appeal." The right to indemnification exists if at the time of the alleged wrong, the officer or director was acting in "good faith." Section 722(b) provides that the termination of a civil or criminal proceeding by virtue of a judgment, settlement, conviction or a plea of *nolo contendere* (no contest) does not presume that the officer or director did not act in good faith.

New York State's highest court, the Court of Appeals, most recently discussed BCL Section 722 in *Baker v. Health Management Systems, Inc.*, 98 N.Y. 80 (2002). In *Baker*, the chief financial officer (CFO) of the corporation was named as a defendant in several securities' fraud class actions. All claims against the CFO were dismissed by stipulation of the parties. However, the corporation refused the CFO's request for reimbursement of his attorneys' fees and expenses.

The Court of Appeals denied the CFO's application for reimbursement, holding that Section 722 required a "reasonably substantial nexus between the expenditures and underlying suit." (*Baker*, 98 N.Y.2d at 85.) The majority held that corporations are free to provide for reimbursement of "fees on fees" in their by-laws, employment agreements or through insurance.

The dissenting opinion in *Baker* argued that the plain language of the statute required that the CFO be reimbursed for legal fees incurred in connection with seeking statutory indemnification.

If you don't already have D&O insurance, consult your legal counsel to see if you should be carrying such coverage. □

Please remember that nothing contained in this article is to be construed as a legal opinion or the creation of an attorney-client relationship.

Small-Biz Snapshot

To underline the importance of entrepreneurs and small business to the economic well-being of the nation, the Small Business Survival Committee came up with the following list of the "Top 10 Benefits from Small Business."

1. Create the bulk of new jobs, on average accounting for 75% of net job creation each year.
2. Employ 51% of private-sector workers.
3. Produce twice as many product and significant innovations as large firms, and obtain more patents per sales dollar than large business.
4. Produce 55% of innovations.
5. Generate 51% of all U.S. private sector output.
6. Account for 47% of sales in the nation.
7. Accounted for 98% of the growth in the number of U.S. exporters between 1992 and '98.
8. Accounted for 96.5% of all U.S. exporters in 1998.
9. Increased ownership opportunities among women and minorities. Minority-owned small businesses (excluding "C" corporations) grew from 6.8% of businesses in 1982 to 14.6% in 1997. Women made up 38% of self-employed individuals in 2000 compared to 22% in 1976.
10. Firms with fewer than 500 employees account for more than 99% of all employers.

Source: Small Business Survival Committee □

