

Acredula

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

D&O Coverage Benefits Officers, Non-Profit Corporation Laws Mirror For-Profit Laws

This issue of *Acredula* focuses on officers' responsibilities and their need for errors and omissions insurance (D&O coverage) and the recent changes to Ohio's non-profit corporation law.

Prior to 1955, directors and officers of non-profit corporations under most states' laws, including Ohio, were held to a higher standard of responsibilities than those of for-profit corporations. That difference has narrowed since 1955. Today, most states' non-profit corporation laws mirror their for-profit laws regarding director and officer responsibilities. Effective April 9, 2001, Ohio takes its final step by changing the statutory term for members of governing boards from "trustees" to "directors."

Editor's Note

A common misperception about D&O coverage is that it only benefits directors. In today's litigious culture, officers receive the most value from D&O coverage, as they are not entitled to the same defenses and protections as directors. Under most states' statutory laws, liabilities for mistakes of the entity may reach officers personally, even though they do not reach directors. A future issue of *Acredula* will focus on what to look for when reviewing D&O coverage.



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Ohio Modifies Its Non-Profit Corporation Law

Alexander M. Brown

The differences between Ohio's statutory framework governing non-profit corporations and their for-profit brethren have continually narrowed since 1955. Ohio Governor Robert Taft recently signed House Bill

597, which modifies Ohio's Non-Profit Corporation Law (*See Ohio Revised Code Chapter 1702*). Effective April 9, 2001, this bill takes the final step in eliminating any remaining differences between the statutory fiduciary duties of a non-profit

corporation's governing board and those of a for-profit corporation's board. In addition, the bill makes some other changes that distinguish non-profit corporations from for-profit corporations.

Trustees

Perhaps the most noticeable change is that the term "directors" will replace "trustees." The initial use of the term "trustees" in Ohio's non-profit corporation law traditionally meant that members of a non-profit corporation's board had greater fiduciary duties than members of a for-profit corporation's board. However, changes over the years since 1955 in Ohio's non-profit corporation law have continually narrowed any differences. Since 1967, the statutory fiduciary duties of a non-profit corporation's governing board have mirrored those of a for-profit governing board. It is interesting to note that the bill also replaces "for-profit corporations" with the term "business corporations." The change in term from "trustees" to "directors" is the final step in eliminating any differences.



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Like their for-profit brethren, non-profit corporation's boards will be comprised of "directors" beginning April 9, 2001. Non-profit corporations already in existence need take no action to effect this change in terminology, and directors shall have the same rights, privileges and responsibilities as had trustees.

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Members

A limited liability company is now eligible to become a member of a non-profit corporation, if the corporation's organizational documents permit such a membership. All members shall have the same membership rights and privileges unless the organizational documents provide otherwise. If the non-profit has fewer than three members,

it can have the same number of directors. It is no longer required to maintain a "membership book," instead it must "maintain a record of its members."

Notice

The bill clarifies that notice must be given in writing and can be either personally delivered or sent by U.S. mail, express mail, courier, telegram, telecopy or electronic mail. If delivery is personal or electronic, notice is deemed given *when delivered*; if notice is sent via mail or courier, the notice is deemed given *when deposited* in the mail or with the courier service. Under the bill, most corporate actions now only require notice be given to members entitled to vote, as opposed to providing notice to all members, even non-voting members.

Voting by limited liability members may be accomplished by any manager or member of the limited liability company, unless certain actions are taken. Corporate members of the non-profit may vote through persons exercising authority as the corporation's officer, representative or other person entitled to so vote, and such persons shall be assumed to have the requisite corporate authority to represent the corporate member.

Types of Non-Profit Corporations

The bill removes the term "charitable corporation," replacing it with a new type of non-profit corporation, designated a "public benefit corporation." To be a public benefit corporation, the corporation:

- (i) must be exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code or be organized for a public or charitable purpose; and
- (ii) upon dissolution must distribute its assets to another public benefit corporation, to the federal, state or local government, or to another 501(c)(3) corporation.

All non-profit corporations other than public benefit corporations fall into the category of "mutual benefit corporations."

Sale or Disposition of Assets

Mutual benefit corporations must adhere to the current law with respect to a sale or other disposition of all or substantially all of the corporation's assets (the voting members

must authorize such a disposition). However, the bill prohibits a public benefit corporation from disposing of more than 50 percent of its assets, including through a series of transactions in any 36-month period, unless such disposition is in the ordinary course of business and it is in accordance with the corporation's purposes, otherwise the disposition must meet specific exceptions, such as having received prior approval from a court of common pleas or having the acquiescence of both the Attorney General's Charitable Law Section and a majority of the voting members. The Attorney General has expanded powers to review such dispositions, including the ability to institute a civil action seeking to rescind the disposition. An action to set aside a conveyance may now be brought one year after the conveyance occurred. Furthermore, if given the power to do so in the agreement concerning or by the same resolution authorizing a disposition, the directors of any non-profit corporation may abandon the proposed disposition, and this power is no longer limited to dispositions of "all or substantially all" the assets of a corporation.

When a public benefit corporation dissolves, however, it will be allowed to distribute its assets not only towards its charitable purposes, but also towards its public purposes.

Mergers and Consolidations

Mutual benefit corporations may merge and consolidate with other entities, including business corporations, in the same

manner as general non-profit corporations under the current law. Public benefit corporations, however, have strict conditions imposed in order to merge with other entities. Any merger or consolidation of a public benefit corporation requires the involvement of the Attorney General's Charitable Law Section. Merging with a mutual benefit corporation or a business corporation is subject to additional restrictions and qualifications, particularly if the surviving entity is not a public benefit corporation.

Dissolution

The bill makes minor changes to the dissolution procedures among non-profit corporations. Generally, the rules applicable to charitable corporations will apply to public benefit corporations, and the rules applicable to general non-profit corporations will apply to mutual benefit corporations. When a public benefit corporation dissolves, however, it will be allowed to distribute its assets not only towards its charitable purposes, but also towards its public purposes.

Your Responsibilities as an Officer Require Review of the Organization's D&O Insurance

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An abundance of information exists on directors' and officers' (D&O) liability. Publications have increased exponentially, as have headline news about the FBI raiding the offices of Archer Daniels Midland and the former directors and officers of Medical Mutual personally repaying \$6.8 million to policyholders. Directors of corporations are entitled to certain defenses and protections against potential liability, such as the "business judgment rule." However, these defenses and protections in no way limit potential liability for actions

taken by officers and employees. So, what about officers and employees?

Statutory Scheme

Under most corporate statutes, directors are entitled to rely upon officers and, if they do so properly, may escape liability. The statutory laws in Delaware and Ohio protect directors from liability when relying upon information, opinions, reports, or statements presented by any of the corporation's directors, officers, or employees who are believed to be

reliable and competent in the matters presented.¹ Yet, if officers were entitled to the same defenses and protections as directors, no one would be responsible to shareholders. Most states' corporate statutes do not entitle officers or employees, including directors who are also officers or employees, to the same defenses and protections that directors enjoy. Neither Delaware nor Ohio law contains a provision entitling an officer to rely upon information presented by other officers or employees, or professionals such as legal counsel or public accountants.²

Common Law Duties

Some states' corporate statutes define the duties of a director, and do so to provide some protection. Ohio statutory law provides that a director shall perform his duties in good faith, in a manner he reasonably believes to be in or not opposed to the best interests of the corporation, with reasonable care.³ A director is protected from liability unless it can be proven by clear and convincing evidence that he or she failed to act in the best interests of the company and failed to act with reasonable care.⁴ Any plaintiff seeking monetary damages has the additional burden of proving that the director's action or failure to act involved an act or omission undertaken with "deliberate intent to cause injury to the corporation" or with "reckless disregard for the best interests of the corporation."⁵

Most states' statutes do not directly define the duties of officers or employees.⁶ These duties are left to judicially-made common law. They include the fiduciary duties of care and loyalty. The duty of care requires an officer to exercise the care that an ordinarily prudent person in a like position would exercise under similar circumstances. The duty of loyalty requires an officer not to misuse a corporate asset, including misappropriating a corporate opportunity, for a personal benefit. Furthermore, some states' common laws, like those of Delaware, require officers to disclose all material information to the board of directors in order to enhance the directors' ability to make informed decisions.

Contractual Duties

In addition, officers and, often, employees may have contractual duties that exceed common law duties. These duties could include employment responsibilities and performance standards in employment agreements, restrictive covenants in

noncompetition agreements, secrecy requirements in confidentiality agreements, and disclosure requirements in expense reimbursement agreements. These duties can also include those responsibilities set forth in employment policies that are incorporated as part of the employment agreements.

Negligence Standard

Officers and employees are generally held to a negligence standard of culpability based upon a prudent person in a like position under similar circumstances.

Although a director's duty of care is similarly based upon a prudent person in a like position under similar circumstances, directors are afforded the protection of the so called "business judgment rule." Under this rule, courts do not question the wisdom of directors' decisions unless there is proof of a breach of fiduciary duties, such as fraud, bad faith, or abuse of discretion. Therefore, directors are not liable for a business decision simply because it proves to be bad. This protection is not routinely afforded officers or employees.

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Standard of Proof

As a standard of proof, most states require that a preponderance of the evidence show negligence by an officer or employee (a showing that more likely than not a breach of duty or misconduct occurred). This is a lesser standard of proof than is required for actions against directors in states where clear and convincing evidence that a breach of duty or misconduct occurred is necessary.⁷

Indemnification

Under most states' laws, corporations may indemnify, or agree to indemnify, directors and officers against liabilities, and directors and officers may, in certain circumstances, be entitled to indemnification. The statutory laws of Delaware and Ohio allow corporations to indemnify

directors, officers, employees, and agents and, under certain circumstances, entitle directors, officers, employees, and agents, as a matter of right, to indemnification.⁸ However, many states place limits on indemnification. For example, in most states, indemnification is precluded if a court finds a director did not act in good faith or in a manner reasonably believed to be in the best interests of the corporation.⁹ Some states preclude indemnification in a derivative action if the liability involves negligence or misconduct by the director in the performance of a duty to the corporation.¹⁰

D&O Insurance

For officers, errors and omissions insurance is important. Most states' laws do not prohibit insurance giving broader coverage of officer liability than permitted by indemnification. By reviewing and comparing coverages of the insurance products of different insurers, officers can usually find this broader coverage at reasonable rates. There are many reasons why senior management, as well as directors, should have the protection of D&O insurance, including:

- Most states' laws permit broader protection by insurance than by corporate indemnification. In Delaware and Ohio, directors, officers, employees, and agents of the corporation are entitled to receive full benefit of whatever protection is offered by whatever insurance is purchased and maintained by the corporation, even if such protection is in addition to, or broader than that, of the indemnification statute.¹¹
- Insurance will provide greater protection in derivative actions brought by or in the name of the corporation. Delaware and Ohio generally deny indemnification if the director, officer, employee, or agent seeking indemnification is "adjudged to be liable" to the corporation unless a court finds the person is "fairly and reasonably entitled" to indemnification.¹²
- The Securities and Exchange Commission has not found D&O insurance protection of directors, officers,

employees, and agents of a corporation to be against public policy, as it has found indemnification for registration and disclosure violations under federal securities laws.¹³

- Unless protection is provided by D&O insurance, or a separate contract protecting a director, officer, employee, or other agent of the corporation, indemnification under most states' statutes is left to the discretion of others and there can be no assurance that indemnification will in fact be made available. In Delaware and Ohio, indemnification after the fact can only be made by majority vote of disinterested directors of the board, upon written legal opinion of independent legal counsel, by majority vote of stockholders, or by a court of competent jurisdiction.¹⁴ If not funded by D&O insurance, there can be no

assurance that the corporation will have sufficient assets or other financial means to pay anything even if indemnification is permitted and determined appropriate.¹⁵

Many boards, as well as members of senior management, are not aware that the business judgment rule under most state corporate statutes does not protect officers.

Contract, Insurance, and Indemnification Review

Many boards, as well as members of senior management, are *not* aware that the business judgment rule under most state corporate statutes does not protect officers. Boards and senior management may not be aware that protection may not exist when needed if there is not a separate contractual or D&O insurance protection. Unless their employment agreements otherwise provide, officers are

liable for negligence directly to their corporate employers as well as derivatively to their shareholders. Most boards should have an interest in offering senior management protective clauses in their employment agreements, adequate D&O coverage, and express corporate indemnification. We believe that boards would serve the best interests of their corporations and shareholders by authorizing a review of employment agreements, D&O coverage, and corporate indemnification to find out if senior management is adequately protected.

Footnotes

¹ See 8 Delaware Laws Annotated §142(e) and Ohio Revised Code §1701.59(B).

² See 8 Delaware Laws Annotated §142(e) and Ohio Revised Code §1701.59(B).

³ See Ohio Revised Code §1701.59(B).

⁴ See Ohio Revised Code §1701.59(C).

⁵ See Ohio Revised Code §1701.59(D).

⁶ See Delaware general corporation law under 8 Delaware Laws Annotated Chapter 5 and Ohio corporation law under Ohio Revised Code Chapter 1701.

⁷ See Ohio Revised Code §1701.59(C) and (D).

⁸ See 8 Delaware Laws Annotated §145 and Ohio Revised Code §1701.13(E).

⁹ See 8 Delaware Laws Annotated §145(b) and Ohio Revised Code §1701.13(E).

¹⁰ See 8 Delaware Laws Annotated §145(b) and Ohio Revised Code §1701.13(E)(2) which provide that “no indemnification shall be made in respect of any claim, issue, or matter as to which such person shall have been adjudged to be liable to the

corporation unless and only to the extent that . . . the court in which such action or suit was brought shall determine 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.”

¹¹ See 8 Delaware Law Annotated §145(f) and (g) and Ohio Revised Code §1701.13(E)(6) and (7).

¹² See 8 Delaware Laws Annotated §145(b) and Ohio Revised Code §1701.13(E)(2)(a).

¹³ See Rule 461(c) as contrasted with Rules 510 and 512 of Regulation C under the Securities Act of 1933 as amended.

¹⁴ See 8 Delaware Laws Annotated §145(d) and Ohio Revised Code §1701.13(E)(4).

¹⁵ If resources are limited, a board or its shareholders will have to choose between alternative uses for those resources in determining whether to allow indemnification. Solvency limitations may prevent corporations from using resources for indemnification. Limitations on corporations in regulated industries may preclude indemnification based on the financial condition and operations of the corporation at that time.

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