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MINIMIZING EXPOSURE: CORPORATE FORMALITIES AND INSURANCE COVERAGE

by
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1. INTRODUCTIONa,

Americans like to sue. Businesses get tangled in costly litigation, often not by choice. Once your business grows beyond a certain threshold size, it is imperative to limit liability through the use of the corporate business form. However, as explained below, in order to maintain limited liability for the shareholders, it is necessary that the participants (shareholders, directors and officers of the corporation) maintain meticulous corporate formalities. In the alternative, you may use the Close Corporation provisions of the California Corporate statutes, to dispense with certain corporate formality requirements.

Most Intellectual Property litigation is complicated factually, and can be very costly. Availability of funds for defense against claims often dictates the success or failure of such a defense. Moreover, in the Intellectual Property arena, the corporate form does not always provide protection against personal liability, as least for those who are actively managing the business. The risks involved are very real. This risk should be covered by insurance. As explained herein, Intellectual Property coverage is often available under the Advertising Injury clause of the Commercial General Liability policies, offered by many insurance carriers. It is absolutely necessary for the executive to periodically review the adequacy of his Intellectual Property insurance coverage, especially at time of renewal.

2. CORPORATE FORMALITIES

In order to maintain the limited liability status for your corporation, it is most important that you observe these formalities.

1. Corporate Meetings

A Corporation is a fictitious legal person. It can only operate pursuant to the terms of its Articles of Incorporation and Bylaws. Such Bylaws generally require that all major decisions require a resolution of the directors and/or shareholders, either at noticed meetings or by unanimous written consent of the directors and/or shareholders. Such resolutions must be recorded and kept as part of the corporate records. An inadequate corporate record is often raised as grounds for "piercing the corporate veil", i.e. for holding shareholders liable corporate liabilities.

Examples of major corporate decisions requiring meetings or unanimous written consent include:

1. Directors Consent is necessary for at least the following:
 1. major business transactions, important contracts, leases, etc.
 2. major loans and obligations of the corporation;
 3. hiring and termination of officers (president, V.P., secretary, and treasurer);
 4. capital restructuring for the corporation; and
 5. anything that might materially affect the well being of the corporation.
2. Shareholders Consent is necessary for at least the following:
 1. rmination of directors; and
 2. pital restructuring of the corporation.

Please review your corporate records. Were there any unrecorded corporate

transactions? If you need help in completing your corporate records, go see your attorney.

5. Annual Meetings

Your corporate Bylaws usually provide for annual meetings of the Shareholders and Directors. It is important that you observe this annual requirement, and keep proper records of any resolutions made at the meeting.

6. Close Corporation and Dispensing With Meeting Formalities

For a California corporation with 35 shareholders or less, the corporation may be formed as, or be converted into, a statutory close corporation. This confers upon the shareholders much greater power and flexibility in managing the business. The shareholders could function pretty much as owners of the business - like partners, while retaining corporate limited liability protection.

In other corporations, the failure to observe corporate procedures and formalities (e.g., re holding meetings of shareholders and Board of Directors) may result in the shareholders being held personally liable for the debts and liabilities of the corporation. The failure to observe such formalities in a close corporation cannot be considered as tending to establish shareholder liability for corporate debts, if there is a properly drafted Shareholders Agreement in place [California Corporations Code Section 300(e)].

The reality of running a busy business sometimes dictates the unwitting neglect of meetings, minutes, notices, etc., and other record keeping duties for maintaining the corporate formalities. The Close Corporation is an advantageous vehicle for limiting your liability by dispensing with such formalities as much as possible.

However, there are limitations and contravening considerations in deciding whether to go the close corporation route. Consult your attorney before you make the conversion.

7. Other Corporate Formalities

Other common caveats in maintaining corporate separateness, and limited liabilities for the shareholders, include at least the following:

1. The corporation must be adequately capitalized when it is formed; the capitalization must be commensurate with the risk being undertaken by the new venture. Insurance could count towards taking care of risks.
2. Don't forget to issue shares.
3. You must segregate corporate and personal funds.
4. Do not use corporate funds for personal purposes.
5. Do represent to the outside world that the company is a corporation, and you are acting on behalf of the corporation.

3. INSURANCE COVERAGE FOR INTELLECTUAL PROPERTY CLAIMS

Insurance agents do not know much about it, insurance carriers are strenuously fighting against the suggestion: but yes, there can be coverage for Intellectual Property claims in your Broad Form Comprehensive General Liability ("CGL") insurance policy, and corresponding "Umbrella" or Excess Liability Policies.

1. Get The Right Policies

1. Advertising Injury Coverage

The following are two common coverage forms for Advertising Injury coverage, found in Broad Form CGL policies:

1. Pre-1986 ISO Form

This coverage form, which is currently used only by a few major insurance

carriers (either in a special endorsement, or as part of the broad form CGL policy), defines "Advertising Injury" to mean "injury arising out of an offense committed during the policy period occurring in the course of the insured's advertising activities, if such an injury arises out of libel, slander, defamation, violation of right of privacy, piracy, unfair competition, or infringement of copyright, title or slogan".

Copyright infringement is expressly covered. Unfair competition, which typically is undefined in the policy, has been held by the Courts to have the broad statutory meaning set forth in California Business and Professions Code Section 17200. Under this interpretation, unfair competition could cover most Intellectual Property claim. Further, at least some California Courts have ruled that the term "piracy" covers patent infringement.

Most carriers who currently use this pre-1986 ISO form, also include exclusionary clauses purporting to exclude trademark and trade name cases. However, it is questionable whether such exclusion is effective, if the term "unfair competition" still remains.

Sometimes an "Umbrella" or Excess Liability Policy, having this broad pre-1986 ISO form language, could be purchased over a more restrictive underlying policy.

2. 1986 ISO Form

A substantial number of insurance carriers have now adopted the new ISO form, where "Advertising Injury" is defined as follows:

"Advertising Injury" means injury arising out of one or more of the following offenses:

1. Oral or written publication of material that slanders or libels a person or organization or disparages a person's or organization's goods, products or services;
2. Oral or written publication of material that violates a person's right of privacy.
3. Misappropriation of advertising ideas or style of doing business; or
4. Infringement of copyright, title or slogan.

Copyright infringement is covered. It could also be argued (although the success could not be predicted) that both paragraphs 1.a and 1.c both cover trademark and trade name infringement. This coverage form also does not have coverage for unfair competition, and/or piracy. Moreover, some commercial general liability policies based on this ISO form, also carries a specific exclusion of trademark and trade name cases. Some carriers have recently modified their 1986 ISO form based policy, to further restrict the Copyright coverage to "advertising activities" only.

It is therefore apparent that not all policies are the same: some are more favorable than others.

2. Other Policy Provisions Relating to I.P. Coverage

The insurance policy should also be examined with respect to "Property Damage", and "Contractual Liability" coverage, for application towards Intellectual Property claims.

4. Getting What You Bargained For from the Carrier

Insurance coverage law is contract law. At least in California, contract law favors the "unsophisticated" insured, vis-a-vis a sophisticated entity such as an insurance carrier, when the carrier sells the insured a standard, pre-printed policy, on a "take it or leave it", and non-negotiable basis.

1. If You Ask, You Lose

Under this scenario, whenever there is ambiguity in the insurance policy, the policy language would be interpreted in a way most favorable to the "unsophisticated" insured.

This premise dictates special caution when dealing with the insurance companies, and its agents and representatives. Ignorance could indeed be bliss in some cases. Get help if you do not know what you are doing.

2. Shop, and Shop and Shop

Not all policies are the same: often one with better coverage can be purchased for a lower premium. Carriers adjust their premiums in part based on historical experience. Get quotes, ask for sample policies and compare them before you buy.

3. Read Everything Your Carrier Sends You

Carriers could, and do, change their coverage forms over time. It is up to the insureds to remain vigilant, and review all riders and notices received from the carrier. At least one local insurance carrier that we know of has attempted to remove "Advertising Injury" coverage by a disclaimer in the form of a rider.

4. Duty to Defend

Most policies provide that the carrier also has a duty to defend. The California Courts have generally ruled that the duty to defend is very broad. Whenever there is a possibility for coverage, the carrier will need to tender a defense for the entire case, at least until it has been determined that there is no coverage (e.g. in a Declaratory Judgment action by the carrier).

5. Coverage for Willful Conduct Maybe Questioned

In general, insurance covers "occurrences", where the harm caused is unintended. The law is unsettled in this area. Please beware that the policy may not ultimately cover all claims, especially those related to willful infringement.

6. Settlement Value

Insurance carriers are sensitive to the fact that Intellectual Property litigation could get very expensive. They will at times agree to "buy out" a policy, by payment to the insured.

7. The "Damage" Trigger

The duty to defend is usually triggered only if the opponent asks for damages in the Complaint. It could be argued that demand for attorney fees (typical boiler-plate language in most complaint and counterclaims include such a demand) is a demand for damages. On the offensive end, if an injunction alone would serve the interest of the plaintiff, you may wish to narrowly tailor the claim, so as to avoid triggering insurance coverage for your opponent.

8. Choice of Counsel

Under the CUMIS decision in California, the insured has the right to select his own counsel, whenever there is a potential conflict of interest between the carrier and the insured. As an oversimplification, such potential for conflict exists whenever the carrier is providing the defense under a "reservation of rights" (where they send you a letter saying that the defense is provided only on a conditional basis). This is an important right: it is your case, and you need to be comfortable working with your own attorney, whose competence you know about, instead of some faceless lawyer assigned by the insurance company.

Some carriers are fighting this interpretation. The insurance lobby has also successfully caused the enactment of California Civil Code § 2860, which in certain cases allow the carrier to pay for only a portion of what the insured's counsel charges. The application of §2860 is still an unsettled area of the law.

6. Conclusion

You can buy the appropriate insurance or go bare. In the latter case, the net effect is that you are

insuring yourself. Availability of appropriate coverage allows much more flexibility in planning the business, and in remaining competitive.

It is an easy choice.

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