Message from the Chair

The Director and Officer Liability Committee has had an active year. Thanks to the hard work of former co-chairs Matt Boos and John Grossbauer, the ABA published this summer our model indemnification agreement. Under the leadership of Fran Goins, we have regularly sent "Alerts" to our members apprising them of significant developments affecting director and officer liability. Our insurance sub-committee under the leadership of Jim Wing has been actively participating in discussions among market participants around the globe regarding insurance for directors and officers facing a corporate internal investigation where Fifth Amendment issues may be implicated. The leadership team of Corinne Elise Amato, Frances Floriano Goins, and Michaela L. Sozio published three newsletters bringing together our alerts and summarizing recent developments. In the coming year we anticipate providing podcasts or webinars on topics germane to our members regarding director and officer liability. We invite all who are present in Washington for the Business Law Section to join us at our meeting on Friday, November 22 at 9:00 a.m., in the Jefferson Room, at the Ritz-Carlton Hotel. I look forward to seeing you.

Lewis H. Lazarus  
Morris James LLP  
Chair, Directors and Officers Liability Committee  
ABA Business Law Section

Featured Articles

Update: 2013 Checklist for Corporate Counsel Supervising the Creation or Renewal of an Executive Protection Program

By The ABA

The ABA Director & Officer Liability Committee is pleased to announce the recent publication of its 2013 Checklist for Corporate Counsel Supervising the Creation or Renewal of an Executive Protection Program described in Business Law Today. The comprehensive Checklist covers a broad range of vehicles for creating protections for directors under corporate Articles of Incorporation and bylaws, as well as critical considerations for advancement of attorney fees and indemnification of directors in litigation, and the process of obtaining appropriate D&O insurance. Kudos to Jim Wing and Bill Johnston, chairs of the D&O Insurance and Indemnity Subcommittees, respectively, for their excellent work on this project.

The Checklist is an outgrowth of a joint presentation by the Director & Officer Liability Committee and the Corporate Governance Committee at the Business Law Section Spring Meeting in March 2012, titled Protecting the Corporate Director. The program was so well received that this Committee
decided to expand upon the presentation through a practical, working document that provides important and critical information to corporate counsel who are charged with protecting corporate directors.

Consistent with the Checklist, the Director & Officer Liability Committee has also recently published its annotated Model Indemnification Agreement, now available for purchase in downloadable form from the ABA website.

More Uncertainty and Confusion for In-House Attorney Would-Be Whistleblowers

By Richard T. Hamilton, Jr., Ulmer & Berne LLP

If you are an in-house attorney contemplating disclosing internal company information with the idea of becoming a whistleblower and potential bounty recipient, depending on your state of licensure, you’d better think twice.

On October 7, 2013, the NYCLA Committee on Professional Ethics issued a formal opinion driving a further wedge between the application of SEC Rule 205 and state ethics rules for purposes of reporting certain violations outside the company. NYCLA Committee on Professional Ethics, Formal Opinion 746 (October 7, 2013)
http://www.nycla.org/siteFiles/Publications/Publications1647_0.pdf
This ethics opinion, though limited to New York lawyers, reinforces the notion that the SEC’s rules governing attorney conduct and whistleblowing differ sharply from controlling ethics rules and fiduciary duty principles applicable in several states. This ethics opinion also quashed, at least presumptively, the notion that an in-house lawyer can collect a bounty in exchange for disclosing confidential information about a corporate client under the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. (Section 922 of Dodd-Frank provides that whistleblowers whose “original information” results in successful SEC-related prosecutions are entitled, with some exceptions, to bounties of 10-30% of the amount recovered by the government in excess of $1 million.)

In implementing parts of the Sarbanes-Oxley Act of 2002, the SEC adopted Rule 205 as an attorney conduct regulation. Rule 205 is much more aggressive than state ethics laws in pushing attorneys to disclose possible violations of securities laws both within and outside the corporate client. Rule 205 requires attorneys practicing before the SEC to report serious corporate wrongdoing “up the corporate ladder.” Rule 205.3(b)(1). Reporting material wrongdoing to the company’s chief legal counsel is thus mandatory. Rule 205 also permits (but does not require) attorneys appearing and practicing before the SEC in the representation of an issuer to reveal to the SEC, without the issuer’s consent, confidential information related to the representation to the extent the attorney reasonably believes necessary (1) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (2) to prevent the issuer from committing perjury, suborning perjury, or making false statements in connection with an agency proceeding; or (3) to rectify the consequences of a material violation by the issuer that causes, or may cause, substantial injury to the financial interest or property of the issuer or investors in furtherance of which the attorney’s services were used. Rule 205.3(d)(2).

Pursuant to Rule 205, an in-house attorney is permitted, under the right circumstances and when the attorney reasonably believes necessary, to report material misdeeds of the corporation outside the corporate chain, right? Not so fast. In its opinion, the New York ethics committee looked to its own Rules of Professional Conduct (“RPC”) for guidance and answers. In particular, the committee focused on RPC 1.6(b)(2) (allowing disclosure of confidential information to prevent a crime); RPC 1.6(b)(3) (allowing disclosure of confidential information where the attorney’s services have been used to perpetrate a crime or fraud); and RPC 1.6(b)(6) (allowing disclosure of confidential information when permitted or required under the rules or to comply with other law or court order). In the end, however, the committee found none of these state ethics rules, standing alone, sufficient to warrant allowing an attorney to use Rule 205 to report confidential
information outside the corporate client.

Moreover, the New York ethics committee opined that “disclosure of confidential information in order to collect a whistleblower bounty is unlikely, in most instances, to be ethically justifiable.” Thus, disclosure of confidential information in order to collect whistleblower bounty under Dodd-Frank is not permitted, even if it complies with the SEC rules, unless that disclosure fits within an exception under the state’s RPC. Additionally, the committee expressed its view that whistleblower bounties for attorneys raise the specter of divided loyalties and may breach fiduciary obligations.

In view of the recent New York ethics opinion, what is the take away for lawyers practicing outside of New York? One, notwithstanding Rule 205, before an in-house attorney reports confidential information outside the corporate client, he or she should be familiar with all applicable state ethics rules and federal legal principles. Guess wrong and you may lose your law license. Two, do not rely on the SEC’s claim that its rules preempt state ethics rules. Maybe they do; maybe they don’t. What is known is this: The New York ethics opinion expresses skepticism about federal preemption. And other states - California, for example - have flatly rejected federal preemption as basis for providing an attorney who discloses confidential information with a safe harbor for a “good faith” defense.

By Corinne Elise Amato, Esquire, Morris James LLP

In a case which arose in an unusual context, the Delaware Court of Chancery recently dismissed as inequitable and premature a claim for indemnification by two directors. The case may be found at http://courts.state.de.us/opinions/download.aspx?ID=193300. The directors, William Huff and Richard D'Angelo, sought indemnification from the defendant, Longview Energy Company (“Longview”), after a Texas court entered judgment against them. The Texas court found that they had breached their fiduciary duties by usurping a corporate opportunity from Longview. In addition, the jury imposed a constructive trust in favor of Longview on profits earned by the directors, and also awarded the company damages of $95 million. As of the date of the Court's letter opinion, Huff and D'Angelo were appealing the adjudication that they had breached their fiduciary duties of loyalty.

Although under Delaware law indemnification claims do not typically ripen until after the merits of an action have been decided and all appeals have been resolved, the directors brought this action claiming that they were successful within the meaning of 8 Del. C. § 145(c). They reasoned that they had achieved partial success because Longview had originally asserted eight counts against them, but ultimately presented only one breach of fiduciary duty claim at trial. The directors analogized their claim to cases in which a corporate fiduciary sought indemnification because specific criminal counts were dismissed even though the fiduciary was found guilty on other charges.

Chancellor Leo E. Strine, Jr. granted Longview's Motion to Dismiss and found that the directors were pursuing a claim for unfair indemnification. The Chancellor reasoned that it was not a foregone conclusion that Longview had forever waived any right to press its other seven theories of liability because the record was not complete and the matter was pending on appeal. Moreover, the Chancellor held: “Corporate fiduciaries who, unless they overturn a jury verdict, owe the corporation nearly $100 million and must yield to the company's substantial property rights, because they have been adjudicated to have breached their fiduciary duties, are not in an equitable position to ask this court to allow them to prematurely seek a money damages claim from the corporation to which they owed a duty of loyalty.” The Chancellor concluded that it would be inequitable to accelerate the directors' right to indemnification by expanding existing law.

http://apps.americanbar.org/buslaw/committees/CL996000pub/newsletter/201311/home.shtml
This case is a reminder to practitioners that claims for indemnification do not ripen until a matter has been finally adjudicated, including appeals. Also, as a court of equity, the Delaware Court of Chancery will not lightly expand settled law to enable directors who have been adjudicated by a trial court to have breached their duties of loyalty to accelerate claims to indemnification.

**SEC Enforcement Policy Changes May Impact Directors' and Officers' Insurance**

By Eric G. Barber and Charles Mulaney

In recent months, the Securities and Exchange Commission (SEC) has announced and implemented policy shifts that could compromise the availability of directors' and officers' (D&O) insurance coverage for entities and individuals.

- After years of not requiring admissions of wrongdoing unless there was an underlying criminal conviction, the SEC will no longer agree to "no admit, no deny" settlements in cases involving "widespread harm to investors" or "egregious intentional misconduct."
- The SEC is pursuing more enforcement actions against individuals in an effort to increase deterrence. While the SEC has long prevented insureds from accessing insurance proceeds for penalties and disagreements in settlements, these two policy shifts may seriously impact companies' and individuals' ability to tap into their D&O insurance policies for the defense of enforcement actions and in connection with coverage for civil litigation based on related facts. In light of this shift, policyholders should examine key D&O insurance provisions during policy renewal and before settling an enforcement action where an admission of wrongdoing is sought.

**Recent Settlements of SEC Enforcement Actions**

In two high-profile cases, the SEC has required admissions of wrongdoing as a condition of settling enforcement actions. In both cases, the defendants included provisions that appear to mitigate the impact of the admissions on insurance coverage.

"London Whale" Enforcement Actions. In its $900 million settlement of several "London Whale" enforcement actions, JPMorgan admitted wrongdoing in connection with its SEC settlement. But the admissions were not made on behalf of any single individual, and court approval was not needed because the settlement negotiations took place in an administrative proceeding. Therefore, JPMorgan was allowed to avoid the specific and direct admissions of wrongdoing that are more likely to trigger D&O coverage exclusions regarding conduct.

Philip Falcone and Harbinger Capital Partners Enforcement Actions. The other noteworthy settlement with the SEC involved two enforcement actions against billionaire Philip Falcone and his hedge fund, Harbinger Capital Partners. The SEC alleged that Falcone improperly used $113.2 million of investors' funds to pay his own taxes, favored some investors' redemption requests over those of others and improperly traded in bonds. The SEC required Falcone to admit wrongdoing in addition to paying an $18 million penalty after the SEC commissioners rejected an earlier settlement that did not contain an admission of wrongdoing. But the settlement does not prohibit Falcone and Harbinger from taking legal and factual positions in subsequent cases not involving the SEC, which will allow them room to maneuver in related civil suits.

Enforcement Actions Not Involving "Widespread Investor Harm." While the SEC has demonstrated its policy shift in these two recent cases, enforcement actions that do not appear on their face to involve "widespread investor harm" continue to be resolved without an admission of wrongdoing. As SEC enforcement co-directors Andrew Ceresney and George Canellos have recently clarified, admissions will be considered in the public interest:

- when misconduct has harmed large numbers of investors or placed...
investors or the market at risk of potentially serious harm;
• when admissions might safeguard against risks posed by the defendant to the investing public, particularly when the defendant engaged in egregious intentional misconduct; or
• when the defendant engaged in unlawful obstruction of the SEC's investigative processes.

D&O Insurance Provisions Implicated by the SEC's Shift

The full effect of the SEC's policy shift remains to be seen, but thus far it implicates several different provisions in D&O insurance policies:

• so-called "conduct exclusions;"
• the severability provisions in the policy, including with respect to the application for insurance; and
• possible repayment of previously advanced defense costs.

Conduct Exclusions

All D&O insurance policies contain what are referred to as "conduct exclusions." These exclusions are meant to carve out from coverage those claims that involve deliberate fraudulent or criminal conduct or the gaining of profit or advantage that is illegal. Under some policies, insurers might argue that admissions in an SEC settlement are sufficient to trigger the conduct exclusion and thus bar coverage in a civil lawsuit arising out of the same set of facts.

• Avoiding Conduct Exclusions. The first line of defense against this argument is to negotiate a settlement with the SEC that, like the JP Morgan settlement, keeps vague who did what wrong and avoids any mention of intent. And like in the Harbinger/Falcone case, the settlement must allow the defendant leeway to deny allegations in lawsuits arising out of the same conduct.

A conduct exclusion may also be avoided if insureds insist that the exclusion can be triggered only when the deliberately fraudulent conduct is established by a "final adjudication." If the settlement is in the context of an administrative proceeding, like the JP Morgan settlement, an insured may be able to argue that, absent court approval, the conduct exclusions have not been implicated. Insureds will also be in a better position if the conduct exclusion is triggered only when the finding of fact or admission occurs in the "underlying action," as opposed to the broader "underlying claim" language found in some policies.

Severability Provisions

D&O insurance policies also often contain what are referred to as "severability provisions," which prevent one individual insured's knowledge or wrongful acts to be imputed to another, or a director's or officer's knowledge or acts to be imputed to the entity itself, which would eviscerate coverage for that individual or entity. Generally, these provisions come into play only when specific individuals are established to have facts or knowledge that would trigger one of the conduct exclusions discussed above.

• Rescission Based on Representations in the Application. Another type of severability provision relates to the application for D&O insurance and can be implicated even when the admissions do not rise to the level of triggering a conduct exclusion. As part of that application process, an insurer may insist on certain representations and warranties regarding facts or circumstances that may later give rise to a claim, including documents filed with the SEC. These application severability provisions can differ from policy to policy, but well-drafted ones limit relevant knowledge to certain defined individuals, sometimes including only the signer of the application. If it turns out that one of the defined individuals knew material facts before the signing of the application, and admits this in an SEC
settlement, there is an increased risk that a D&O insurer might make a rescission argument with respect to coverage for that individual, the entity or others, depending on the insurance policy's language.

**Repayment of Previously Advanced Defense Costs**

Finally, insurers may argue that they are entitled to repayment of previously advanced defense costs if a settlement with the SEC contains specific allegations sufficient to trigger one or more conduct exclusions. Insurers have met with mixed success on this issue, but they were often denied an opportunity to establish a lack of coverage where insureds settle civil cases and regulatory actions without admissions of wrongdoing. While the likelihood that insurers will pursue previously advanced defense costs remains low, the risk increases in larger cases where millions of dollars have been spent. Insureds should pay careful attention to

- whether the D&O insurance policy explicitly grants the right to recoupment of previously paid defense costs, and
- whether an insurer explicitly reserves this right when it starts making defense cost payments.

**Conclusion**

Although the SEC's policy shift has just begun, and has so far been limited to headline-grabbing cases, policyholders should keep in mind its potential impact on the above provisions when negotiating D&O insurance policies and before beginning serious settlement discussions in regulatory enforcement actions.