Director & Officer Liability Newsletter

Message from the Chair

Our committee has been active since we last met. Ongoing projects include planning, under Jim Wing's leadership, a CLE-eligible program at the Business Law Section's Spring meeting in Los Angeles, sending out alerts of recent cases and other developments, updating our checklist for D&O insurance and publishing this newsletter. A podcast on the attorney-client privilege as it relates to directors and officers is also in the works. Our committee will meet in Los Angeles from 10:00 to 11:30 a.m. on Friday, April 11, 2014 in Plaza 3, Third level, at the JW Marriott Hotel. Our CLE, which is co-sponsored by the Business and Corporate Litigation, Corporate Governance and Private Equity and Venture Capital Committees, is scheduled for 2:30 to 4:30 p.m. on Saturday, April 12 in the Gold Ballroom, Salon 1, First Level, of the JW Marriott. Perhaps due to this level of activity and content-generation, I am pleased to report that our committee is one of the fastest-growing committees of the Business Law Section. Thanks once again to our subcommittee chairs -- Frances Goins, Michaela Sozio and James Wing -- and the newsletter committee of Frances, Michaela and Corinne Amato, for their efforts in in keeping you up to date on topics relevant to director and officer liability. I look forward to seeing you in Los Angeles.

Business Law Section Spring Meeting Information

The Director and Officer Liability Committee Meeting will be held on Friday, April 11, 2014 from 10:00 a.m. to 11:30 a.m. at the JW Marriott, Plaza 3, Third Level.

The dial-in information is as follows:

- Toll-free dial-in number (U.S. and Canada): (866) 646-6488
- International dial-in number: (707) 287-9583
- Conference code: 7465900121

Spring Meeting CLE: Directors, Officers and In-House Counsel: You Think You're Covered, But You're Not (And What To Do About It)
April 12, 2014 at 2:30 p.m. to 4:30 p.m., Gold Ballroom, Salon 1, First Level, JW Marriott

This CLE is unique both in its focus and its panelists. The title is descriptive: "Directors, Officers and In-House Counsel: You Think You're Covered, But You're Not (And What To Do About It)." It summarizes the results of the D&O Liability Committee's two-year exploration of the law and practice relating to the advancement of defense costs to innocent executives and their counsel when they become, as a U.S. Supreme Court case put it, "ensnared in ambiguous circumstances" that have criminal law implications. Experience
teaches that these are the most stressful and potentially catastrophic claims that executives and their counsel can face, and they are not prepared for the damage that frequently follows to their health, family relationships, career and finances -- even if they are vindicated or not even charged.

The program will show how the common law of advancement has grown in a piecemeal fashion and remains fractured and complex. It will also demonstrate how insurance coverage is only beginning to catch up. It will then suggest means to limit the possible damage.

The panelists have been selected to cover the waterfront. Francis Pileggi, a noted practitioner and Delaware law legal blogger from Eckert Seamans in Wilmington, Delaware, will speak to the pitfalls and advantages of Delaware law and the twelve U.S. jurisdictions that are viewed as following it. Nancy Adams of Mintz Levin in Boston, Massachusetts, a noted insurance practitioner, will illustrate the problems inherent in the laws of the 40+ Model Act jurisdictions that require an executive seeking advancement to either waive critical Fifth Amendment rights as a condition to advancement or forfeit both his or her job and right to advancement. She will also link those issues to cooperation clauses in D&O policies. James Wing of Holland & Knight in Miami, Florida and Chicago, Illinois has defended executives caught in parallel civil and criminal proceedings and litigated advancement cases in which Fifth Amendment concerns were paramount. He will provide attendees with a Fifth Amendment primer directed to executive risks in internal investigations. He will also introduce our committee's current corporate counsel checklist as well as a 52 jurisdiction summary and analysis of advancement law as it relates to the Fifth Amendment and other means by which executives’ rights to advancement can be compromised.

In addition, Leslie Kurshan, chief executive of the management liability division of Marsh London, a major international insurance broker, will link these points to current developments in both U.S. and international D&O insurance markets. Finally, Kara Altenbaumer-Price, management liability counsel for USL Dallas, a major broker for in-house counsel, will explore how these issues impact "employed lawyers" (the insurance-industry term) and discuss particular issues unique to their protection when they are accused of aiding alleged miscreant executives.

The program promises to be both interesting and educational. The D&O Liability Committee encourages your attendance.

Lewis H. Lazarus
Morris James LLP
Chair, Directors and Officers Liability Committee
ABA Business Law Section
breaches after the fact, resulting in serious reputational, brand, and goodwill damage, depression of the company's stock price, exposure to costly customer class action litigation and regulatory investigations, and other costs incurred by Target as a result of the breaches, including notifying and dealing with customers. Based on early reports, such damages are likely to be in the hundreds of millions of dollars. More...

**D&O - Failed Bank Coverage Litigation - Insured v. Insured Exclusion - 1st Circuit Finds Duty To Pay Defense Costs**
*By Joseph Monteleone, Tressler LLP*

In a somewhat folksy Opinion by Judge O. Rogeriee Thompson, the First Circuit affirmed an Order of the District Court for the District of Puerto Rico holding that an insurer had an obligation to advance defense costs in underlying litigation brought by the Federal Deposit Insurance Corporation (FDIC) against directors and officers of a failed bank. *W. Holding Co., Inc. v. AIG Ins. Co.* - Puerto Rico, No. 12-2008, (1st Cir. March 31, 2014). More...

*By Morris James LLP, Corporate and Fiduciary Litigation Group*

In this transcript opinion, Vice Chancellor Glasscock of the Delaware Court of Chancery highlighted the need for mandatory advancement provisions and the consequences if directors are sued and attempt unilaterally to amend by-laws to advance funds. The Court granted the petitioners' motion to compel reimbursement of legal fees that were advanced to two directors without express authorization of the company and absent a bylaw provision allowing for advancement of legal fees to directors. The Court rejected the respondents' attempt to retroactively amend the company's bylaws to adopt an advancement provision. The conflicted directors' appropriation of company funds was an *ultra vires* act, and the Court enjoined further disbursements of company funds to the conflicted directors absent Court order. More...
In the ever-expanding world of risk management, corporate directors and officers may find themselves facing potential liability for failing to adequately oversee and supervise cyber risk. Recently, at least two shareholder derivative complaints were filed against the directors and certain executive officers of Target, based on their alleged failure to prevent and subsequently manage massive data breaches at the company resulting from the activity of hackers in the pre-holiday retail season. In the wake of what has been termed the “worst data breach” in American retail history, these complaints allege Target’s directors and officers breached duties of loyalty and good faith to the company by failing to implement preventive practices and procedures. Plaintiffs also claim the defendants allowed Target to release false and misleading statements about the scope and the extent of the breaches after the fact, resulting in serious reputational, brand, and goodwill damage, depression of the company’s stock price, exposure to costly customer class action litigation and regulatory investigations, and other costs incurred by Target as a result of the breaches, including notifying and dealing with customers. Based on early reports, such damages are likely to be in the hundreds of millions of dollars.

The underlying theory of director and officer liability articulated in the Target complaints dates back to the 1996 Caremark decision. In re Caremark Int’l, Inc. Derivative Litig., 698 A2d 959 (Del. Ch. 1996). In Caremark, the Delaware Chancery Court noted, “it is important that the board exercise a good faith judgment that the corporation’s information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility. . . .” However, the Chancellor was careful to note that,
“only a sustained or systemic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability. Such a test of liability – lack of good faith as evidenced by sustained or systemic failure of a director to exercise reasonable oversight – is quite high.” *Id.* at 970-71 (emphasis added). *See also Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (“We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.”). This “quite high” bar, however, does not make plaintiffs’ lawyers shy about filing such complaints. The good news for directors and officers is that the *Caremark* standard continues to result in the early dismissal of many such cases. The minority that have survived a motion to dismiss allege specific facts indicating prior board knowledge and warnings about the precise problem and activity at issue, coupled with a failure to act. *See, e.g.*, *La. Muni. Police Employees’ Retirement Sys. v. Pyott*, 46 A. 3d 313 (Del. Ch. 2012); *rev’d on other grounds*, No. 380, 2012 (Del. April 4, 2013).

Directors are not unaware of the growing risk. In the recent NYSE Governance Services, *What Directors Think 2014 Survey* ([https://www.spencerstuart.de/research-and-insight/what-directors-think-2014](https://www.spencerstuart.de/research-and-insight/what-directors-think-2014)), twenty percent of directors reported a lack of confidence in their board’s understanding of cyber risk, and cited a background in information technology as one of the top four attributes such directors would look for in a new board candidate. Directors
also identified IT strategy as one of the top five items they would choose if setting the agenda for their next meeting. These responses may reflect an awareness of not only growing litigation risk, but also increased regulatory attention to cyber security. The December 31, 2010 FTC “Red Flags Rule” (16 CFR § 681), for instance, addressed Identity Theft Protection Programs, and required their adoption by any company that is a financial institution or “creditor” – a term defined broadly to include any company that permits deferred payment. Guidance issued by the SEC’s Division of Corporation Finance in October 2011 (“CF Disclosure Guidance: Topic No. 2 - Cyber Security”) (http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm) summarizes the SEC’s views on public company disclosure obligations of cyber security risks and breach incidents. Recently, on February 12, 2014, the National Institute of Standards and Technology issued a Framework for Improving Critical Infrastructure Cyber Security, designed to provide a cost-effective mechanism for critical infrastructure companies, including energy, financial services, emergency services, health care and public health, and critical manufacturing to manage cyber security risk. (See http://www.ulmer.com/news-events/alerts/striving-for-security-understanding-the-new-cyber.)

In light of this burgeoning area of potential director and officer liability, companies must seriously address both the potential for and the risk of data breaches and other possible cyber risks. The team tasked with addressing cyber risks can no longer be limited to IT personnel, but must include senior management, legal, risk management, public relations, and compliance/audit. While this is an area where one size does not fit all, boards may consider designating oversight responsibility for cyber risk management to a particular board committee, with clear lines of reporting and authority, and at least annual review by the entire board. Cyber security risk assessments, either conducted internally, or utilizing the services of an outside
vendor, are becoming recognized as the logical starting point for addressing these matters. Regular education and training programs are essential, not only for personnel directly involved in data security, but also for supervisory management and for directors, who may not be as “tech-savy” as plaintiffs’ attorneys would argue they should be.

Lastly, a review of the company’s insurance coverage for cyber risk is essential. Existing D&O policies may provide coverage for such risk, absent a data breach claim exclusion. Commercial general liability policies may also provide limited coverage for the expense of compensating customers whose information is breached. Specialty privacy and data breach insurance policies are becoming more prevalent, and should be investigated if gaps appear in existing insurance.
In a somewhat folksy Opinion by Judge O. Rogeriee Thompson, the First Circuit affirmed an Order of the District Court for the District of Puerto Rico holding that an insurer had an obligation to advance defense costs in underlying litigation brought by the Federal Deposit Insurance Corporation (FDIC) against directors and officers of a failed bank. *W. Holding Co., Inc. v. AIG Ins. Co.* – Puerto Rico, No. 12-2008, (1st Cir. March 31, 2014). Click here for a link to the decision.

The exclusion at issue provided that the insurer:

Shall not be liable to make any payment for Loss in connection with any Claim made against an Insured . . . which is brought by, on behalf of or in the right of, an Organization or any Insured Person other than an Employee of an Organization, in any respect and whether or not collusive.[1]

The Court noted that “the policy neither mentions the FDIC nor bars coverage for suits by FDIC-type regulators like some policies do.” In fact, the Court observed that the District Court took judicial notice of the fact that other policies issued by the insurer expressly excluded coverage for claims brought by or on behalf of any State or Federal regulatory or administrative agency in its capacity as a receiver.

The District Court had found the insured vs. insured exclusion inapplicable because the FDIC was not only suing on behalf of insureds, but it was also suing on behalf of bank account holders, depositors and the FDIC’s insurance fund.

Key to the Court’s ruling that the insurer had to advance defense costs was Puerto Rico law holding that an insurer must pay such defense costs if a complaint alleges claims that create even a “remote possibility” of coverage. The Court further stated that the there only had to be a “likelihood” of a remote possibility of coverage.

Judge Thompson took great pains to emphasize that the Court’s decision applied only to defense costs and was based on the very easy burden on the insureds under Puerto Rico law to secure advancement. As she stated to conclude the Opinion,

But we add – lest anyone be confused – that having lost the likelihood-of-success skirmish, [the insurer] may still “win” the coverage “war at a succeeding trial on the merits.”

(citations omitted)

Thus, the “coverage war” continues between insurers and ultimately the FDIC over application of the insured vs. insured exclusionary language in the current aftermath of the bank failures of a few years ago.
[1] Contrast this language with that at issue in the very recent decision in Bancinsure, Inc. v. McCaffree, No. 12-2110, 2014 U.S. Dist. LEXIS 24941 (D. Kan. Feb. 27, 2014), where the court upheld an insured vs. insured exclusion that provided as follows:

[t]he Insurer shall not be liable . . . for Loss in connection with any Claim made against the Insured Persons based upon, arising out of, relating to, in consequence of, or in any way involving . . . a Claim by, or on behalf, or at the behest of any other Insured Person, the Company, or any successor, trustee, assignee or receiver of the Company.

(emphasis added)
In this transcript opinion, Vice Chancellor Glasscock of the Delaware Court of Chancery highlighted the need for mandatory advancement provisions and the consequences if directors are sued and attempt unilaterally to amend by-laws to advance funds. The Court granted the petitioners’ motion to compel reimbursement of legal fees that were advanced to two directors without express authorization of the company and absent a bylaw provision allowing for advancement of legal fees to directors. The Court rejected the respondents’ attempt to retroactively amend the company’s bylaws to adopt an advancement provision. The conflicted directors’ appropriation of company funds was an ultra vires act, and the Court enjoined further disbursements of company funds to the conflicted directors absent Court order.

By way of background, the petitioners, Thomas and Georgeann White (the “Petitioners”), owned one-third of the shares of A.E. Moore, Inc. (the “Company”). See *White v. Kern*: Delaware Court of Chancery Enjoins By-law for Advancement of Fees Under Entire Fairness Standard, Practical Law Corporate & Securities, Feb. 20, 2014 found at http://us.practicallaw.com/1-558-1465. The respondents, Steven Kern and David Wharton (collectively, the “Respondents”), each owned a one-third interest in the Company and held a seat on the Company’s board of directors. *Id*. Collectively, Respondents were the Company’s controlling stockholder and also held two-thirds of the Company’s seats on the board of directors. *Id*. Petitioners brought suit against Respondents, alleging breaches of fiduciary duties and that Respondents had engaged in self-dealing. Following the initiation of this litigation, Respondents caused the Company to advance their legal fees in defense of the claims brought by Petitioners. This particular ruling was intended to address Petitioners’ motion to compel reimbursement of the advanced fees.

The Court of Chancery initially noted that a decision to amend bylaws to provide for advancement of legal fees is subject to review by the Court to ensure satisfaction of a controlling stockholder’s and/or a board of directors’ fiduciary duties. The decision to amend a Company’s bylaws is typically afforded business judgment rule standard of review. However, where the controlling stockholder or a majority of the board of directors is conflicted at the time of the bylaw amendment, the amendment will be analyzed under the entire fairness standard of review.

The Court then held that because the Company’s bylaws did not provide for the advancement of legal fees, Respondents could only advance themselves Company funds by adopting a bylaw amendment through director or stockholder vote. Neither a stockholder or director vote would satisfy the entire fairness analysis, since Respondents were self-interested in having their legal fees advanced. The Court did allow the Company to hire independent counsel to review the appropriateness of the advancement pursuant to Section 145(d)(3) of Delaware’s General Corporation Law. The Court was skeptical, however, that the Company would find any independent counsel that would agree that advancement in this situation was in the best interests of the Company. Finally, the Court held that no future advancement of legal fees in this litigation could be made absent Court order.

Even bylaw amendments must satisfy the rigorous entire fairness review where a self-interested board or controlling stockholder approves the amendment for its own benefit. This decision emphasizes the need for companies to approve mandatory advancement provisions in their bylaws “on a clear day” before suit is filed. Such provisions take away board discretion in deciding whether to advance its own
members their legal fees, and thus avoid a self-interested decision subject to challenge under entire fairness review.