EXECUTIVE SUMMARY

Today’s corporations need law departments to provide legal support that enables them to maximize their competitive advantage, while at the same time safeguarding the organization against unnecessary risk. Over the last decade, the focus to become ever more efficient while still delivering on these primary objectives has been a heavy burden for many law department leaders — especially given the resistance of their traditional outside counsel to reduce their costs. However, this report suggests that in order to maximize the value delivered, it’s time to pay as much attention to improving the impact of legal services the corporate law departments are delivering as it is to reducing the cost of those services.

Indeed, today’s legal problems are dynamic and wide-ranging, and the solutions require a highly diverse set of skills and capabilities. Teams of lawyers alone are no longer enough to solve problems in optimal ways. All types of professional need to work together collaboratively, often from different organizations, and they need the support of modern working processes and systems.

Innovative law departments and innovative law firms score significantly higher across all key performance areas, including the ultimate measures of quality and value.

Innovation incorporates a whole host of different areas, such as embracing legal technologies, utilizing expert professionals holistically with lawyers, overhauling work processes and pricing models, and building collaborative partnerships between in-house teams and their outside law firms and alternative legal services suppliers.

To that end, the report identified a number of key levers that corporate law departments can use to create a higher performing legal function and enhance the impact that their departments makes on the overall success of the organization.

For example, recent research by Acritas showed that many corporate law departments would benefit most from enhancing the project management capabilities among their teams. The lack of this capability was the number one criticism made by law firm partners when reviewing their corporate clients’ performance. While some departments can justify professional project managers, others enhance their existing teams’ project management skills through training. Both groups benefited from leveraging project management systems, the research showed. And asking for feedback will help to assess whether your team has room for improvement.

Another key lever was increasing the demographic diversity of your legal teams — both in-house and in supporting teams. Greater diversity led to greater results, and yet the proportion of women in the most senior roles plummets in comparison to their number at the start of their legal careers. The interim results of recent research by the International Bar Association (IBA) showed that sexual harassment and bullying is commonplace in both law departments and law firms. Law departments have a role to play in ensuring their departments are a safe and inclusive place to work and one that offers equal opportunity. At the same time, law departments can push their external legal providers to ensure that they are fielding diverse teams, allowing them to reap better performance results as well.
Further, for law departments to prove their full value beyond simple cost savings, they need to find ways to measure the value they deliver in terms of business benefit and averted risk — and to show that they are delivering this quicker and better each year. Metrics play a key role in this, particularly when aligned to the strategic direction of the organization.

Finally, law departments are being forced to innovate in order to deal with the new age perils of cybersecurity and data privacy. More than half of US corporate law departments feel they are failing to meet new data privacy regulations. The solution to this challenge reinforces the key findings of this report as a whole — the need to tap into a diverse range of skills beyond legal expertise, to access new technologies, and to report on the progress made.

**DATA CREDENTIALS**

Acritas helps law departments and firms to improve performance through its research and benchmarking services. In addition to customized surveys to collect business stakeholder feedback and external law firm feedback, Acritas conducts an ongoing global research study of senior in-house counsel, called Sharplegal, which started in 2007. More than 2,000 interviews are conducted by telephone each year exploring the approach of in-house counsel to buying legal services, their spend level, their experiences with law firms, and their team size. This report draws on the 600 interviews conducted with U.S.-based respondents each year. Additionally, Acritas conducts two annual surveys with partners at law firms who have been nominated as stand-out by senior in-house counsel. In the Stand-Out Talent survey, these attorneys are asked about what it takes to deliver superior client satisfaction and how the legal industry can develop stand-out talent. In the Appraising Clients survey, the external lawyers evaluate their corporate clients’ performance in managing their input and delivering for their organizations.

Thomson Reuters provides industry-leading solutions to Corporate Law Departments. Legal Tracker is the industry-leading e-billing, matter management, analytics, and reporting platform used by more than 1,300 of the world’s best corporate law departments. With more than $87 billion in approved legal spend data, Legal Tracker provides pricing and benchmarking information that allows law departments to make more-informed business decisions and improve their bottom line. In 2018, Thomson Reuters published several reports and white papers focused on trends in corporate law departments, including the LDO Index, a combination of quantitative benchmarking from the Legal Tracker product and qualitative survey responses published annually; the Survey on Data Privacy Compliance, including results from 1,000 data privacy professionals at organizations (corporations, private companies, government organizations, and NGO charities) in nine countries or jurisdictions; and the Efficiency Study, based on a survey of 462 attorneys and decision-makers working in law departments across the globe.

Corporate Legal Operations Consortium (CLOC) is an organization of corporate legal operations leaders who aim to optimize legal service delivery models and share knowledge. The group’s work has helped define what skills and focuses are needed for law departments to make legal operations work and enabled a community of professionals to form around operations. CLOC conducts regular pulse surveys with its memberships.

The IBA, in collaboration with Acritas, has led a global survey to understand the nature, prevalence and impact of bullying and sexual harassment across the world within law departments, law firms, and other areas of the legal ecosystem. This report shares some of the interim global results. The full report will be issued in May 2019 but preliminary analysis indicates that the US has a higher incidence of bullying and harassment than the global average.
SECTION 1
Creating a high-performing legal function

In order to create a high-performing legal function, corporate law departments must deliver quality legal solutions that maximize their organization’s success and provide long-term shareholder value. Much of the recent focus of law departments, however, has been to drive down the cost of their legal spend through greater efficiency and lower cost services. This still remains the number one focus area in terms of the desired improvements law departments want to see in their external law firms. However, Acritas’ research over the last decade has uncovered specific levers that enable law departments to offer a more business-optimizing service, creating even greater value than trimming away at cost can provide.

This report suggests that departments that focus on improving the legal solutions they deliver, in addition to remaining vigilant on cost efficiency, are likely to offer significantly more value to their organizations and ultimate shareholders.

Figure 1 – Legal function goals

<table>
<thead>
<tr>
<th>Assessment</th>
<th>Develop solution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Understand business need</td>
<td>Source work appropriately</td>
</tr>
<tr>
<td>Assess legal requirements</td>
<td>Work quickly and efficiently</td>
</tr>
<tr>
<td></td>
<td>Collaborate and manage expectations</td>
</tr>
<tr>
<td></td>
<td>Embed data-driven processes</td>
</tr>
<tr>
<td></td>
<td>Deliver results</td>
</tr>
<tr>
<td>Maximize commercial gain</td>
<td>Minimize organizational risk</td>
</tr>
<tr>
<td>Evidence value creation</td>
<td>Evidence losses mitigated</td>
</tr>
</tbody>
</table>

Over the next few pages, we will highlight five levers which, when leveraged correctly, enable corporate law departments to reach higher levels of performance and provide significantly higher value.

IMPROVEMENT LEVER 1 – CREATE HIGH-PERFORMING TEAMS WITH DIVERSE SKILLSETS

Within Acritas’ research, we see time and time again that bringing together diverse experience and skillsets delivers an uplift in performance. This goes beyond just different areas of legal expertise and experience and into the broader skillsets that legal teams need to draw on. Through analyzing the qualities recognized in more than 10,000 stand-out lawyers, we were able to identify 23 distinct skills. These skills clustered around three different lawyer types — the “specialist expert” lawyer, the “practical service” lawyer and the “business relationship” lawyer.

Business relationship lawyers are effective at working with internal clients. They build rapport, work hard to understand the organization’s business goals, are proactive, and deliver solutions. Practical service lawyers are effective project managers. They ensure matters are appropriately resourced, are responsive, and ensure a fast turnaround. Specialist expert lawyers focus more on the legal work itself, bringing to bear their specialist knowledge and superior legal capability as well as their business sense.
While it is rare to find an individual lawyer that can deliver all three skill types, the highest performing teams brought together the three different lawyer types and allowed them to work together in a complementary way.

It is worth considering how other professionals can complement these legal teams. For example, legal operations professionals, professional project managers, account managers, and technology/data experts could be enlisted to support the legal team. While many lawyers have learned these broader skills, they aren’t always the most skilled at these non-legal tasks nor are a cost-effective resource.

**Figure 2 – Collaborative team utilizing different skillsets with clear responsibilities**

**TAKE-AWAY**

Within your law department, think about the lawyers you have and which profile they fit. Are you missing any of the three skill types? Given the make-up of your work portfolio and the size of your team, would you benefit from specialist professional experts such as legal operations or technology managers?

**IMPROVEMENT LEVER 2 – DEVELOPING PROFESSIONAL PROJECT MANAGEMENT SKILLS**

41% of outside lawyers felt their clients could benefit from effective project management training.

High-performing law departments appear to be doing one thing in particular better than the rest — project management.

Project management incorporates a range of activities and skills; notably, internal organization, coordination, and efficiency — which, not incidentally, are the qualities most frequently cited by private practice lawyers of clients they regard as “stand-out.” Other strong features of great project management include active engagement with the work, proactivity, and appropriate focus throughout. Project management at the initial engagement stage specifically should focus on clarity of communication. Indeed, stand-out clients provide their law firms with comprehensive briefings that include clear objectives, including scope and establish expectations.

Figure 3 picks out the traits that the most effective in-house counsel excel, from external lawyers’ perspective.
Figure 3 – Top five traits of stand-out in-house counsel

<table>
<thead>
<tr>
<th>Trait</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well-organized</td>
<td>27%</td>
</tr>
<tr>
<td>Required legal knowledge</td>
<td>21%</td>
</tr>
<tr>
<td>Understanding the business need</td>
<td>19%</td>
</tr>
<tr>
<td>Clear communication</td>
<td>17%</td>
</tr>
<tr>
<td>Collaborating as equal partners</td>
<td>16%</td>
</tr>
</tbody>
</table>

Source: Acritas Stars - Appraising Clients Survey, September 2018

TAKE-AWAY

Would your people benefit from project management training and qualifications? Would a professional project manager add value to your legal function? Do you have a project management system to help you manage and report on your legal work? Are you working with project managers at the external legal service providers you deal with?

IMPROVEMENT LEVER 3 – BUILD COLLABORATIVE PARTNERSHIPS WITH EXTERNAL LEGAL SUPPLIERS

Most legal functions rely on external legal support to deliver services, either to access additional capacity or provide special expertise. The way external and internal teams work together has a dramatic effect on the quality of the final legal outcome.

After analyzing thousands of interviews from both in-house and private practice lawyers, Acritas found that there is room for improvement on both sides. If the in-house counsel does not manage their external counsel effectively, they are unlikely to get the best outcome. Through working together in a respectful, collaborative partnership, where objectives and incentives are aligned, the outcome is likely to be optimized. This research identified a number of areas which are critical to get right in order to manage external counsel effectively, including attitude, skills, and taking action.

Figure 4 – Areas critical to managing outside counsel

<table>
<thead>
<tr>
<th>Experience</th>
<th>Mindset</th>
<th>Actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Understand legal issues</td>
<td>Trusting</td>
<td>Set direction and expectations</td>
</tr>
<tr>
<td>Understand business drivers and risks</td>
<td>Respectful</td>
<td>Take control and manage all parties</td>
</tr>
<tr>
<td>Realistic expectations on timeframes and costs</td>
<td>Appreciative</td>
<td>Bring in external lawyers at the right time</td>
</tr>
<tr>
<td>Focus on big issues, not minor distractions</td>
<td>Collaborative</td>
<td>Respond quickly</td>
</tr>
<tr>
<td>Cool under pressure</td>
<td>Open</td>
<td>Provide complete information</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Allow access to stakeholders</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Act on advice</td>
</tr>
</tbody>
</table>

Source: Acritas Stars - Appraising Clients Survey, September 2018
Law departments striving to get the most out of their external advisors need to ensure that their internal teams are built around these attributes and establish working practices that best demonstrate these attributes. This starts with ensuring a suitable balance of commercial and legal experience across the department. In areas of work which require external support, the focus of the internal team should perhaps be more on the commercial side because, according to our research, external lawyers feel at least half of the time that they are not given adequate background information and clarity on the client’s goals.

High-performing law departments take the lead in connecting external advisors to the organization, through such venues as vendor conferences or vendor orientations that include items like sharing the organization’s priorities and goals, reviewing internal language and acronyms, and connecting external advisors to the organizational leadership. When external advisors know the business they are serving, they deliver stronger outcomes.

Creating a successful panel

Law departments are increasingly seeking out external advisors who proactively show their value. A recent CLOC pulse survey showed that 50 percent of law departments have a preferred provider program, resulting in an average 23 percent cost saving. And yet only 12 percent of law departments gave all their work to those preferred providers.

Panels, in theory, should be the perfect foundation for implementing business partner relationships between in-house and external lawyers which deliver optimal value. In reality, the mismanagement of panels results in weaker relationships in one-third of cases. External lawyers are willing to put in the effort to apply for panels, but it is frustrating if insufficient work comes in return. Often there is little transparency around how work is distributed; and at worst, panels are used as a tool to keep procurement teams happy. Indeed, this frustration can grow when external legal teams see most of the work going to firms that aren't even in the panel and aren't making the same investment in the relationship. To get the best from a panel, law departments need to be open, fair, and transparent, treating the external lawyers as part of the same team.

Figure 5 – Most suggested improvements for panel management

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>More transparency/openness</td>
<td>22%</td>
</tr>
<tr>
<td>Clarity on work opportunities</td>
<td>21%</td>
</tr>
<tr>
<td>Stronger communication</td>
<td>15%</td>
</tr>
<tr>
<td>Clearer criteria for selection/assessment</td>
<td>13%</td>
</tr>
<tr>
<td>Provide feedback</td>
<td>6%</td>
</tr>
<tr>
<td>Innovative approach to fees</td>
<td>6%</td>
</tr>
</tbody>
</table>

Source: Acritas Stars - Appraising Clients Survey, September 2018

The more sophisticated law departments are able to optimize the outcomes on legal matters and ensure panel success with a highly collaborative relationship between in-house attorneys, external lawyers, and legal operations professionals. Sharing scorecards on law firm performance and collaborating for improvement ensures realization of greater value.
IMPROVEMENT LEVER 4 – GENDER DIVERSITY ENHANCES THE QUALITY OF A LEGAL FUNCTION

After reviewing thousands of performance scores that rated legal teams, Acritas found that gender diverse teams achieved significantly higher performance ratings. And yet, both law firms and in-house teams continue to lose female talent at the most senior levels.

There are many reasons why women leave the legal profession. Recent research by the IBA found that half of women lawyers had been bullied and one-third had been sexually harassed, both significantly higher ratios than for their male counterparts. Findings were similar both in-house and in private practice. Most often these incidents were ongoing rather than one-off events and were rarely reported. In addition to the hostile work environment, many women feel a lack of fairness in terms of opportunity, reward, and career progression — factors, unfortunately which are borne out with statistics. Less than 20 percent of law firm equity partners are women and only 25 percent of general counsel are women. And for those women who do get to the top, there is a significant pay gap, both at in-house departments and law firms.

Acritas’ research has found that male in-house counsel are biased in favor of selecting male external advisors and pick women as lead partner in just 17 percent of cases. In-house counsel can play an important role in increasing diversity at their outside law firms as well as on their own teams. Requesting diverse teams on the law firm side, looking to female lead partners in at least one in every three matters, and ensuring equal pay and promotional opportunity within their own teams are important ways to start. Many law firms are adhering to the “Mansfield Rule”, as a public declaration of their commitment to achieving higher levels of diversity.

Named after the first women admitted to a U.S. bar, the Mansfield Rule asks law firms to consider women and minority lawyers for at least 30 percent of their candidate pool for leadership and governance roles, equity partner promotions, and lateral hiring. More than 50 law departments — including 3M, Workday, PNC, PepsiCo, Gap, Target, VMware, Facebook, Abercrombie & Fitch, Mastercard, American Express, Ford Motor Company, BASF, Salesforce, Google, Hewlett Packard Enterprise, and Charles Schwab — have agreed to support the law firms that meet or exceed the Mansfield Rule requirements by meeting and getting to know their newly promoted diverse partners.1

Overall, only 29 percent of law departments require diversity information from their law firms; however, for law departments with annual legal spending in excess of $50 million, that percentage grows to 62 percent that require diversity information. High-performing law departments don’t just ask for law firm demographics but

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1 For more, see data provided by Diversity Lab, at https://www.diversitylab.com/knowledge-sharing/clients-push-for-diversity/.
Two of the inhibitors of innovation are a lack of time and a risk-averse mindset. Most in-house lawyers are very
time-strapped and risk-averse by nature. Creating a role on the team for someone who can be given the time
and budget to create and pilot innovative solutions is likely to deliver real dividends. It is not surprising that we
now see 50 percent of law departments with legal operations professionals. Many legal ops roles carry the
responsibility for driving innovation in the legal function, and larger organizations are starting to have legal
technology managers within legal operations looking to automate manual processes with technology.

**TAKE-AWAY**

Are you paying enough attention to the diversity of your internal and external legal teams? Are you
ensuring fairness of opportunity and a safe working environment for your people and your advisors? Are
you measuring the make-up of teams who work on your matters and offering recognition or reward?

**IMPROVEMENT LEVER 5 – CREATING AN ENVIRONMENT FOR SUCCESSFUL INNOVATION**

Law departments who embrace innovation are seen as 10 percent more effective by external lawyers; and
equally, in-house counsel who recognize their law firms as innovative also awarded 5 percent higher ratings
across all key performance areas.

Examples of innovation given by in-house counsel mostly focused on technology. Other examples included
alternative pricing models, new ways of resourcing such as contract attorneys or legal managed services, and
value-added services such as training and sharing knowledge. What is innovative to one department is fully
established to another.

Thomson Reuters research showed that both small and large law departments alike are increasing their use of
legal technology.

**Figure 7 – Legal departments with increasing use of legal technology**

Source: Acritas Stars – 2018 Thomson Reuters LDO Report

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time-strapped and risk-averse by nature. Creating a role on the team for someone who can be given the time
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now see 50 percent of law departments with legal operations professionals. Many legal ops roles carry the
responsibility for driving innovation in the legal function, and larger organizations are starting to have legal
technology managers within legal operations looking to automate manual processes with technology.
Most law firms also now have specialists who are responsible for driving innovation within the firm. By engaging in dialogue with those people at your external law firms, you can see what the firm has to offer and how you can benefit as a client. Learn from the firm and its other clients.

**Figure 8 – Technologies used by legal departments**

Most law firms also now have specialists who are responsible for driving innovation within the firm. By engaging in dialogue with those people at your external law firms, you can see what the firm has to offer and how you can benefit as a client. Learn from the firm and its other clients.

**TAKE-AWAY**

Have you innovated the way you work in the past year? Do you have in place the right team members with expertise in process improvement and supporting technologies? Are you having open dialogues with your external legal service providers about how you can improve the way you work together?

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2 Rogers, Everett M. (1962). *Diffusion of Innovations*, Glencoe: Free Press. Copyright license – [https://creativecommons.org/licenses/by/2.5/legalcode](https://creativecommons.org/licenses/by/2.5/legalcode)
SECTION 2
Measuring value creation and improvement over time

Alongside the legal issues confronting companies, in-house teams continued to deal with the challenges of providing legal services while measuring and then demonstrating the value of the legal department to the organization at large. Educating internal stakeholders to the value of the contribution of the legal team remained one of the top frustrations cited by respondents in the 2018 Thomson Reuters Efficiency Survey.

As high-performing law departments are making decisions using data, analytics, and benchmarking — all optimized by the professional lens of legal operations — law departments can share this information to build greater credibility internally with sourcing, finance, and other key divisions.

When it comes to use of data and performance analytics, legal is often looked at as behind other divisions of the organization; however high-performing law departments effectively use data alongside the delivery of legal services — improving law firm value and delivering higher quality outcomes.

By implementing data-driven solutions that are technology enabled, law departments are more able to show value and demonstrate how efficiency and effectiveness are helping to not only minimize risk but maximize commercial gain.

It is also worth considering using surveys to collect feedback from stakeholders that really matter, including your internal business clients, your in-house team, and your external partners. Indeed, the use of these survey tools and rating scales can then be shown as an independent and objective exercise, which in itself acts as a vehicle to direct efforts and track progress.

TAKE-AWAY
Have you shared data around efficiency gains? Have you used benchmarking data to differentiate your department’s performance against that of your peers? Have you connected your department’s use of technology and automation of manual processes to the ROI it provides?

CREATING METRICS THAT MEASURE QUALITY AS WELL AS COST

Returning to the legal function goals outlined at the start of this report, we can see that only one area relates to cost, whereas most law departments focus purely on cost-related metrics. Cost metrics are critical to measure, of course, but much of that data should stay within the department or be shared with external providers rather than being shared upwards to the C-suite. The higher-level metrics that more closely relate to higher-level strategic goals — although more difficult to measure — should be shared upwards. Some examples are shown in Figure 9.
Figure 9 – Cost-related metrics

<table>
<thead>
<tr>
<th>Goal</th>
<th>Metrics</th>
<th>Tools to Collect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Understanding the business need</td>
<td>Understanding the business objective (score out of 10)</td>
<td>Business stakeholder feedback</td>
</tr>
<tr>
<td>Assessing the legal requirements</td>
<td>Setting expectations and giving clear instructions (score out of 10)</td>
<td>External lawyer feedback</td>
</tr>
<tr>
<td>Working quickly and efficiently</td>
<td>Cost per matter ($)</td>
<td>Spend and matter management</td>
</tr>
<tr>
<td></td>
<td>Hours per matter (volume)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Turnaround time (number of days)</td>
<td></td>
</tr>
<tr>
<td>Communicating and managing expectations</td>
<td>Communicating effectively (score out 10)</td>
<td>Business stakeholder feedback</td>
</tr>
<tr>
<td></td>
<td></td>
<td>External lawyer feedback</td>
</tr>
<tr>
<td>Maximizing commercial gain</td>
<td>Additional value added ($)</td>
<td></td>
</tr>
<tr>
<td>Minimizing commercial risk</td>
<td>Value of exposure avoided or mitigated ($)</td>
<td></td>
</tr>
<tr>
<td>Building an effective team</td>
<td>Team engagement (score out of 10)</td>
<td>Internal engagement feedback</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters

It is important to make sure that your reporting is framed with business-friendly language, reinforcing the idea that the law department is accessible and aligned to the organization’s corporate objectives.

TAKE-AWAY

Do you have metrics that go beyond spend? Can you find a way of valuing your function’s contribution to the organization? Are you spending time reviewing progress on your metrics and comparing your performance to industry benchmarks? Are you asking for feedback from your internal customers and external suppliers?
SECTION 3
Dealing with new age perils

Cybersecurity and data privacy are two related issues that have become growing areas of great concern for in-house counsel. Protecting internal and client information has long been an in-house priority, given the substantial repercussions of a data breach or data privacy lapse. As threats evolve and companies look to mitigate risks as much as possible, “in-house counsel is facing growing responsibility to minimize damage to the corporate reputation, loss of key data, and legal and regulatory penalties.”

According to the Thomson Reuters Survey on Data Privacy Compliance, many organizations are struggling to comply and stay current with the data privacy regulations that are both in effect and evolving wherever they operate around the globe. The U.S. showed the highest level of failure in meeting data privacy regulations among the countries surveyed.

Figure 10 – Failing to adhere to data privacy regulations

Source: Thomson Reuters Survey on Data Privacy Compliance

TAKE-AWAY
Do you review the security profile of your software providers? Do you conduct security assessments of your external law firms and other service providers? Are you accessing up-to-date expertise to ensure you are doing all you can to protect your organization against this hugely dynamic and unfamiliar threat?

DEVELOPING THE HALLMARKS OF A MODERN LEGAL DEPARTMENT

The modern corporate law department faces complex challenges in 2019, and is increasing under growing pressure to demonstrate clear contribution to shareholder value. We predict that the law departments most successful in delivering on this as we move into the next decade will be those that relentlessly focus on forward momentum in four key areas as shown in Figure 11.

Figure 11 – Key areas law departments will focus on in 2019

<table>
<thead>
<tr>
<th>Modern team</th>
<th>Modern support</th>
<th>Modern systems</th>
<th>Modern metrics</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Diversity of skillsets</td>
<td>• Collaborative external partnerships</td>
<td>• Project management</td>
<td>• Quality</td>
</tr>
<tr>
<td>• Demographic diversity</td>
<td>• 360° feedback</td>
<td>• Legal tech</td>
<td>• Cost</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Continual innovation and an eye on new age perils</td>
<td>• Progress</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Benchmarking</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• 360° feedback</td>
</tr>
</tbody>
</table>

And it does makes sense to address each of these areas in the order they have been laid out – starting with the internal team, then the external partnerships, and then getting systems in place before measuring. In reality, we observe that many law departments have focused their modernization efforts in a different order. Whichever the order, however, a balance of initiatives across all four areas ultimately will generate the synergistic impact needed to deliver optimal return on effort.

Let’s assume, for example, you are experiencing frustrations in getting commercially practical advice from your external lawyers and need to drive better value from them. Ensuring your internal team combines all key skill sets is a great start, which enables you to leverage the skills of individuals with collaborative and communication strengths to manage external law firm relationships more effectively. Support this with fit-for-purpose project management technology, on which all parties are trained and incentivized to use, and you will also benefit from efficiency gains and reduced scope for error. Finally, measure and report your enhanced outcomes to gain organizational support for further improvement and resources. In this way, you’ve effectively shifted the focus of your law department from reducing cost to improving the impact of the legal services provided.

The above framework for developing your department can be applied to a host of other challenges. For example, if you are struggling to keep up with fast-paced regulatory changes, then draw on strong relationships with external law firms and online compliance resources. If you need to reduce costs on commoditized work, then consider whether you need to develop relationships with alternative legal service providers and who on your team should manage these new relationships. And when under pressure to further reduce internal costs, you can demonstrate value with robust, benchmarked data.

While this report provides an optimal model to aim for in the long term, there are a multitude of quick wins available to all law departments, regardless of size or budget, including:
- Draw on the diverse skills of your colleagues in other business units;
- Take a more organized approach to project management;
- Invest time in getting the most out of the existing technologies you already have in place; and
- Spend the time to make open and honest communication a two-way street with your external advisors.

Most importantly, remember that collaboration is most successful when everyone is rowing in the same direction.
FINAL NOTE

The contributors to this report – Acritas, Thomson Reuters, CLOC and the IBA all provide support to law departments in the form of conferences, best practice guides, research services, consulting, and legal technologies. Please get in touch to find out more.

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Insurance Proceeds To The Rescue - Will Insurance Pay For Some Of The Biggest Public Health And Welfare Issues Of Today And Tomorrow?

Thursday, May 2, 2019
TIPS Section Conference
New York, New York
Public Health Crisis -- the Opioid Epidemic
Opioid Crisis – How It Happened

A Multi-Layered Problem in Three Distinct Waves

351,000 people died from an opioid overdose (1999–2016)

1990s
mark a rise in prescription opioid overdose deaths

2010
marks a rise in heroin overdose deaths

2013
marks a rise in synthetic opioid overdose deaths

Rx OPIOIDS
Include natural, semi-synthetic, and methadone and can be prescribed by doctors

HEROIN
An illegal opioid

SYNTHETIC OPIOIDS
Such as fentanyl and tramadol are very powerful and can be illegally made
Opioid Prescribing Rates by State

Map shows the geographic distribution in the US of retail opioid prescriptions dispensed per 100 persons. (2016)
Rise in Opioid Overdose Deaths by Year

Chart shows age-adjusted rates of drug overdose deaths and drug overdose deaths involving any opioid for all intents and for unintentional intent by year. (US 1999-2016)
Facing Lawsuits Over Opioid Epidemic, Purdue Pharma Considers Bankruptcy

March 15, 2019 - 5:03 AM ET
Heard on Morning Edition

Purdue Pharma agrees to $270 million settlement in Oklahoma opioid case

NY Attorney General sues opioid distributors, makers, including Purdue Pharma, Sackler family

David Robinson and Matt Spillane, Rockland/Westchester Journal News
Published 10:32 a.m. ET March 28, 2019 | Updated 1:52 p.m. ET March 28, 2019

53 medical professionals indicted in federal opioid bust: Here's who they are

Alia Paavola - Thursday, April 18th, 2019 Print | Email
# Litigation Environment - Overview

## Plaintiffs
- State and local municipalities
- Indian tribes
- Hospitals
- Third-party payors
- Patients
- Insurance Consumers

## Defendants
- Manufacturers
- Distributors
- Dispensers/pharmacies
- PBMs
- Individuals: Physicians/Pharma Sales Reps

## Ohio MDL Litigation
- Over 1100 cases
- First trial scheduled for Oct. 2019

## Oklahoma AG suit
- Trial scheduled for May 2019
- Recently settled for $270M

## What’s next?
- Who else will join? Sue?
- Length of time?
- Result?
- Bankruptcies?
Litigation Environment-Causes of Action

- Public Nuisance
- Negligence
- Negligence Per Se
- Violations of Racketeer Influenced and Corrupt Organizations Act
- Violations of State Statutory Codes
Litigation Environment-The Damages

- **Public Services**: Lawsuits seeking restitution, injunctive & equitable relief in connection with increased costs of healthcare, drug treatment programs, law enforcement, social services & lost productivity

- **Cost Recoupment**: Seeking recoupment for costs of unnecessary prescriptions or uninsured services

- **Property Damage**: Lawsuits seeking damages for affected property and public utilities, including litter, clogged water and sewer lines

- **Disclaimers of Damages**: Lawsuits expressly disclaiming damages for bodily injury or property damage

- **Bodily Injury**: Lawsuits seeking compensation for individuals on their own behalf and/or on behalf of drug-addicted babies

- **Fines and Penalties**: Lawsuits seeking fines and penalties and disgorgement of profits
Coverage Environment

- “Bodily Injury” Damages
- Occurrence
- Product Exclusions
- Drug-Specific Exclusions
- Controlled Substance Act Exclusions
- Known Loss
- Damages Exclusions:
  - Equitable/Injunctive Relief
  - Restitution/Disgorgement
  - Punitive Damages
  - Penalties
Public Safety

Public safety / health issues leading to BI or nuisance

a. Lead paint
b. Clean drinking water (e.g., Flint Michigan); farm waste contamination of water (in Midwest)
c. Food contamination – salmonella and e-coli
d. Claims brought by / on behalf of governmental entities and institutions?
e. Fires
f. For individual claims, is there a government component, as in failure of pipes, lead paint at military installations, or even failure to properly inspect buildings and impose proper standards.
Public Safety / Health Issues

• Lead Paint at University in California

• Background
  a. Claim is now due to “Atmospheric River”
  b. Building not able to dry out between rain storms
  c. Lead leached into the soft building materials

• Issues
  a. Covered cause of loss?
  b. Time period allowed for repairs?
  c. Exclusions?
Public Safety / Health Issues

• Water Contamination – Paradise, California

• Background
  a. Wildfire in Paradise
  b. Benzene released into public water system
  c. Paradise Irrigation District has 2 year plan to rebuild infrastructure

• Issues
  a. Some insureds are able to make repairs before two-year period
  b. Of these insureds, some have a 12-month limit on insurance
  c. Water filtration systems are available – who will pay?
Public Safety / Health Issues

• Food Contamination – Chipotle

• Background
  a. E. coli outbreak in Oregon & Washington stores
  b. Insured did not know origination of contamination
  c. Closed 40+ locations
  d. Improved quality control in regards to handling of food

• Issues
  a. Covered time period for closures?
  b. Investigation costs?
Public Safety / Health Issues

• Food Contamination - Amy’s
  a. Contaminated spinach in frozen foods
  b. If cooked according to directions it would kill the E. coli
  c. Some people don’t cook according to directions...
14 different natural disasters in 2018 (hurricanes, winter storms and wild fires) cost the country $91 billion

Who pays for $91 billion of damages?

National Oceanic and Atmospheric Administration data
Climate Change

Property Insurance Policies

Property Damage  Business Interruption  Extra Expense

Exclusions
– Flood
– Storm Surge
– Volcano
Climate Change

Underinsured, Uninsured or Denial of Coverage

a. File suit against the broker/agent who placed insurance

b. File suit against the design professionals

Now **E&O insurance** is at issue

Stephen G. Aquilina et al. v. Certain Underwriters at Lloyd’s, London et al., case no 1:18-cv-00496 (D.C. HI) (class action against brokers who encouraged the purchase of property insurance policies with lava exclusions).

Multiple lawsuits by 400 homeowners in Riverstone Development in Fort Bend County TX against engineering firm Costello, Inc. flawed design in levee (District 19)
CGL Insurance

- Early nuisance claims against oil and gas companies did not get off the ground – nor did the coverage suit that followed
  - BI/PD; Occurrence

- *Lliuya v. RWE AG*, a farmer in Peru sued RWE for its emission of GHG, leading to glacial melt and flooding based on a nuisance theory under German law
CGL Insurance

*Lliuya v. RWE AG*

- liable for its contribution to the total GHGs
- using a market share theory of liability
- BI/PD or Occurrence?

Market share theory in product liability
MTBE and Lead Paint
Climate Change

CGL Insurance

• Negligence actions (secondary suits)
  – Extreme weather overloads Milwaukee’s sewer system causing significant damage to 8,000 homes (*Steadfast Ins. Co. v. Greenwich Ins. Co.*, 380 908 N.W.2d 502 (2019))

• Loss of Use of Property
• Invasion of Right of Occupancy
Climate Change

D&O Insurance

- NYAG suits against Exxon for securities fraud
- SEC Climate Change Disclosure Requirement

Event Cancellation Insurance
Travel Insurance
Comprehensive or Collision Auto Insurance
Other, Similar Type Claims

Other, similar type claims in this space

a. Silent cyber – Where is their coverage?

b. Related vein – risk to power grid/utilities/water supplies

c. Hacks leading to bodily injury – e.g., hospital hacks, medical devices

d. Event-driven D&O & E&O
The Developing Role of Corporate Counsel in the Company, and Its Evolving Effects on the Outside Counsel Relationship

ABA TIPS SECTION CONFERENCE – NY 2019

► Marcy Cohen, Chief Legal Officer & Managing Director, ING Americas, New York, NY
► Melanie D Margolin, SVP, General Counsel & Corporate Secretary, Wabash National Corporation, Lafayette IN
► Shruti Krishnan, Associate Legal Counsel, Tabletop Media, LLC d/b/a Ziosk LLC, Dallas, TX
► Catherine Kunz, Senior Counsel, Raytheon Company, Sterling VA
► Moderated by William Kruse, Vice President & Counsel, Gallup, Washington, DC

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Practical Tips for New In-House Counsel
by Practical Law

This Practice Note discusses practical tips and strategies for counsel to consider when transitioning from private practice to an in-house position. Topics covered include key differences between law firm and in-house practice, steps to understanding the company and its business, operations, risk profile, people, culture, and law department, and ways to manage work efficiently, communicate effectively, and become a problem-solver, generalist, and business partner.

Many companies today are launching internal legal functions or growing their corporate legal teams as a way to decrease and manage their external counsel spend. Lawyers who transition from private practice to in-house positions must adapt their skills and mindsets so they can be effective in their dual roles as legal counsel and business partner.

This Note summarizes some of the key differences between law firm and in-house practice and discusses practical suggestions to help lawyers successfully transition to in-house counsel positions, including how to:

- Establish credibility within the company.
- Set and meet expectations with internal clients.
- Use effective communication strategies.
- Develop as a trusted legal advisor and valued business partner.

While this Note focuses on transitioning lawyers who are new to in-house practice, many of the tips and strategies discussed also apply to lawyers with prior in-house experience who are new to their companies.

While this Note can be useful to in-house counsel at all levels, it does not specifically address the additional considerations that are unique to new general counsel. For strategies and tips to help counsel transition to a general counsel position, see Practice Note, Practical Tips for New General Counsel.

Key Differences Between Law Firm and In-House Practice

Lawyers go in-house for a variety of reasons ranging from the appeal of a better work-life balance to fatigue with having to bill time or develop business, an interest in a specific industry, and a desire to delve into the business and focus on one client. In addition to these changes, counsel should be prepared to adjust to other key differences between law firm and in-house practice. Depending on the size of the firm, counsel's years of experience, the type of company and nature of its business, the size and structure of the corporate legal department, and counsel's in-house role, the differences can be significant or subtle. For example, in-house counsel may have to deal with:

- **A higher volume of projects.** Law firm lawyers may have three or four large matters that are active at any given point in time (though more experienced lawyers may have more matters and clients). In-house counsel, in contrast, generally have to juggle many active matters (both small and large) at once and often maintain a backlog of projects.

- **A larger client base.** Law firm lawyers may only deal with three or four clients at once (though experienced lawyers may have more active clients, and junior or mid-level lawyers may not deal directly with clients at all). In-house counsel, in comparison, may deal simultaneously with multiple business people, all of whom are their internal clients (though the company is the only actual client).

- **Varying levels of client sophistication.** Lawyers from larger firms tend to deal with sophisticated clients such as general counsel, chief executive officers, and chief financial officers, who usually have experience dealing with lawyers and legal
matters (though smaller firms often also represent and deal with the business owner who may not be sophisticated). In-house counsel frequently work with personnel across the company with varying levels of sophistication about the legal framework and the issues that need to be covered (see Understand Internal Clients).

- **Extended involvement in projects.** When projects are completed, law firm lawyers can often walk away without further thought to the deal, including where they may have fallen short on particular deal points or language. In contrast, in-house counsel are frequently involved in project implementation and have to live with the results of the deal every day, including the strengths and shortcomings of the company’s decisions.

- **A broader scope of work.** While law firm lawyers tend to specialize and develop an expertise in an area of law, in-house counsel typically need to be generalists who can handle the broad range of legal issues that affect the company, even if they have no background, experience, or training in the area (see Develop As a Generalist).

- **New client expectations.** Unlike the law firm lawyer who may only have an incomplete knowledge of the business and its daily operations, in-house counsel are expected to:
  - thoroughly know the business;
  - understand the underlying business issues in detail; and
  - thoughtfully address those issues in the final work product.

    (See Know the Company.)

- **Different goals.** The law firm lawyer is trained to conduct precise, detailed (and often long-drawn) analyses of the law and aspires to achieve transactional perfection. In contrast, the in-house counsel’s goal is “progress over perfection,” which is to offer quick solutions to immediate problems so the business can move forward (see Deliver Appropriate Work Product).

- **More limited staffing.** While law firms often have available attorneys at all levels to staff a project, in-house counsel are usually limited to themselves and their existing staff members. As a result, in-house counsel may not have other lawyers in their legal departments to cover absences or provide extra staffing during busy seasons.

- **Less formal training.** Law firm lawyers are given more training and increasing responsibility as they advance in a firm, and usually have senior associates or partners to review their work. In-house counsel, in comparison, are expected to jump in and do the work when they are hired, sometimes with limited guidance.

- **Potential conflicts in their roles.** In-house counsel often assume executive or business roles in the company, which can directly conflict with their role as the lawyer when they have to both give the advice and make the decision (for example, see Practice Note, Serving as Corporate Secretary: Considerations for In-House Counsel).

Despite the many differences, private and in-house practice also share similarities in key areas. Both law firm lawyers and in-house counsel have demanding workloads and face substantial work pressures. In-house counsel are usually just as busy as law firm lawyers, often with many different internal clients vying for their time. Law firm lawyers are pressured to bill more, and similarly, in-house counsel are challenged to do more of the work themselves to prove their value as a cost center and because they frequently do not have a budget to outsource the work.

**Know the Company**

In-house counsel’s first step toward building credibility within a company is thoroughly understanding all aspects of the company and its business, including:

- The business structure and type of entity.
- The size of its operations and the number and type of people it employs.
- The industry and the nature of its goods and services.
- The locations of its operations, both domestically and internationally.
- The business’s approach to taking risks (see Determine the Company’s Risk Profile).
• The governance and decision-making processes, including the legal department’s role in making business decisions (see Build Relationships).

By having a complete picture of and insight into the business and operations, counsel can:

• Structure agreements, transaction strategies, settlement negotiations, litigation tactics, and other business advice to be more tailored and capable of achieving the financial goals and business objectives of a transaction, litigation, or other project.

• Understand the effect of the legal department’s actions and decisions on the business (see Deliver Appropriate Work Product).

• More effectively prioritize time to reflect business priorities.

• Demonstrate that counsel cares about the success of the business. By persuading the business team that counsel is trying to achieve the same goals, counsel:
  • can be more influential when giving advice, even when counsel needs to contradict what the business team believes is the best course of action;
  • is more likely to be invited to contribute at the early stages of a project and during the decision-making process; and
  • may have better access to project information and be able to address issues before they become serious problems (see Practice Note, Contract Management: Overview: Contract Initiation).

Learn the Business and Operations
Counsel can learn about the company’s business and operations by:

• Studying its business plan and financial reports. This material helps counsel understand the company’s goals and the financial metrics imposed on the business teams. For an overview and discussion of financial reporting concepts, see Practice Notes:
  • Accounting, Auditing and Financial Reporting in the US: Governing Authorities;
  • Financial Reporting in the US: Basic Concepts;
  • Financial Reporting in the US: Key Topics for Corporate Counsel; and
  • Internal Control Over Financial Reporting for Counsel: Why Should You Care?.

• Reviewing its SEC filings. If the company is a public company, read the company’s Form 10-K, proxy statement, annual report to stockholders and other filings with the Securities and Exchange Commission (SEC) (see Annual Report on Form 10-K Toolkit and Proxy Statement and Annual Meeting Toolkit).

• Reading its offering documents. If the company is privately held, read any offering documents used to raise capital, such as the private placement memorandum (see Practice Note, Conducting an Unregistered Offering: Overview: Documents Involved in an Unregistered Offering).

• Spending time with internal clients. To understand commercial basics, priorities, and challenges, spend time with internal clients, including:
  • a senior business manager who can provide a high level overview of the corporate strategy;
  • a finance professional who can explain how and where the company makes and spends money;
  • a colleague in product development who can discuss the company’s long-term direction for future products and services;
  • a sales team member who can describe the company’s current products and services; and
• an operations professional who can explain how the company ensures the delivery of products and services.

• (See Understand Internal Clients.)

• **Experiencing its products and services.** Consider being imbedded in or shadowing the business units for a specified period of time to understand the operational and technical details of the business. For example, if the company is a:

  • retail business, spend time and assist on the sales floor and in the back inventory room;
  
  • technology company, sit in the call center to learn how it operates, help take calls, and understand how the technology works; or
  
  • service company, accompany technicians on service visits and in training sessions.

• **Building a detailed understanding of its industries and markets.** Understand the business environment in which the company operates, including its:

  • legal and regulatory requirements (for example, the anti-bribery laws governing its sales agents outside the US (see Bribery and Corruption Toolkit), or regulations limiting its online advertising (see Practice Note, Online Advertising and Marketing));
  
  • competitors, partners, and customers in these industries; and
  
  • reputation and place within that ecosystem.

• **Becoming familiar with its core processes.** In-house counsel are often tasked with not only advising on a project, but also helping to implement that advice. To provide practical advice that can be readily implemented, counsel should understand the company’s procedures (such as hiring, budgeting, procurement, and project approvals).

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### Determine the Company’s Risk Profile

Public scrutiny of corporate risk management and risk oversight has intensified as a result of the recent financial crisis and the ensuing parade of corporate scandals. While the senior leadership is responsible for risk management and the board of directors is responsible for risk oversight, in-house counsel play an increasingly important role in a company’s efforts to manage risk.

For more information on corporate risk management, see Practice Note, Corporate Governance Practices: Commentary: Risk Management and Article, Enterprise Risk Management.

### Identify the Universe of Risk

Counsel should build an understanding of the company’s risks by:

• Reviewing the corporate risk profile that was prepared for management (if one exists) and the underlying risk assessments.

• Meeting with internal audit, risk management, and legal department personnel to discuss the company’s:

  • key strategic, operational, and project risks;
  
  • strengths and weaknesses, including major opportunities and threats, by business unit and subsidiary and affiliate (if applicable);
  
  • appetite and tolerance for risk (see Gauge the Tolerance for Risk); and
  
  • training and risk management tools.

• Considering the industries and locations in which the company operates to identify the most common risks in those areas.
For a discussion of risk assessments and common risk areas, see Practice Note, Developing a Legal Compliance Program: Conduct an Initial Risk Assessment and Address Key Risks.

Gauge the Tolerance for Risk
Companies accept different levels of risk in their daily operations depending on factors such as management personality, market share, anticipated revenue, litigation history, and cost of compliance. Counsel should gauge the company’s tolerance for risk by:

- Consulting with the legal, risk management, and internal audit departments.
- To the extent accessible, getting feedback from the board, senior management, and relevant corporate team leaders about the risks they prioritize.
- Reviewing historic documents, such as contracts, playbooks, meeting notes, and internal memos to identify risk allocation patterns.
- Reading the company’s policies, procedures, and public statements to see how the company reflects and embodies its risk tolerance and understanding of applicable laws and industry standards.

By understanding the company’s risk tolerance level and the driving factors, counsel can better:

- Get comfortable with those risks while still setting appropriate legal and ethical boundaries (see Practice Note, Ethical Issues for In-House Counsel).
- Strike a balance between supporting corporate growth and protecting the company from criminal penalties, civil damages, and litigation.
- Suggest mitigation strategies and creative solutions to allocate and manage risk when faced with a specific problem.
- Strategize to get ahead of certain risks by putting in place appropriate policies and procedures.
- Train managers and employees so they:
  - understand the degree of risk that is acceptable to the company;
  - have practical guidance to make risk-intelligent decisions; and
  - can identify and report behavior that is non-compliant or activities that exceed the company’s risk tolerance level.

- For resources to use in educating company personnel on key areas of legal risk, see Business Briefings Toolkit.
- For a collection of presentation materials that counsel can customize and use to generally train the company’s board of directors, business management, or other employees, see In-House Training and Guidance Center.

Understand Internal Clients
In-house counsel frequently advise and collaborate with internal clients from diverse areas such as sales, product development, human resources, accounting, and marketing. Counsel should consider that:

- Many internal clients may have little comprehension of what lawyers do and may have worked with lawyers only infrequently.
- Counsel’s relationships with internal clients may often be different from the relationships they developed in private practice with clients who were lawyers and understood counsel’s work.
- Internal clients may require more support and guidance from in-house counsel than they would request of external counsel who bill at hourly rates. Counsel should schedule appropriate follow-ups with internal clients to review legal options, discuss action items, and provide other project assistance as needed (see Be More Than the Lawyer).
- Conflicts may arise. Counsel represents the company, not its constituents, and must avoid creating the impression that counsel
represents an internal client in the client’s individual capacity (see Practice Note, Ethical Issues for In-House Counsel: Identifying the Corporate Client).

Build Relationships
Counsel should take the time to meet with different groups within the company to understand their needs, build relationships, and develop allies. In particular, counsel should create a plan to:

- **Meet with the groups supported by counsel.** Counsel may support a particular division or group within the company (such as human resources, marketing, quality control, or information technology) or handle legal matters across the company. Counsel should meet with the supported groups to hear about:
  - what these groups do and how they work;
  - which activities impact the company, generate revenue, and drive the profit margin and how;
  - when the busy and slow seasons occur;
  - how counsel can support these groups and help them deliver on their goals; and
  - what expectations these groups have for counsel, and then address those expectations, such as what counsel can practically deliver and when (see Deliver Appropriate Work Product).

- **Develop relationships with internal clients.** After the initial internal client meetings, counsel should continue to cultivate these relationships, build allies, and stay current on upcoming projects and activities. Counsel should proactively:
  - reach out to internal clients to schedule lunches and participate in meetings;
  - train internal clients on how to use the legal department efficiently; and
  - generally be a visible part of the corporate community outside the legal department.

- **Build rapport with legal department colleagues.** If counsel is part of an in-house team:
  - approach senior lawyers with questions and plumb their institutional knowledge;
  - identify one or more legal team members who can be a mentor;
  - shadow other in-house counsel to observe how they handle internal clients and projects and what makes them successful; and
  - become involved in legal team activities.

- **Learn the formal (and informal) decision-making process at the company.** Steps to take may include:
  - studying an organizational chart to understand the company’s hierarchy, reporting relationships, and dotted-line responsibilities;
  - reviewing the delegated authorities or signature authorities policy, if one exists; and
  - asking questions to find out who the key decision-makers are and how business decisions are made.

- **Discern the relationships within the company.** Counsel can better prioritize the multitude of questions and matters they manage if they understand the internal politics and the different personalities, roles, and relationships within the company. Matters assigned by influential people in the company (or personnel acting on behalf of those influential people) may be more important to the company or may become top priorities because key individuals consider them important. Counsel should identify the individuals who:
• wield authority and get things done within the company, regardless of title, department, or pay grade;

• have the strongest relationships with the general counsel (and counsel’s manager, if not the general counsel); and

• are most likely to complain to senior management if dissatisfied with counsel’s performance.

• **Find one or more informal mentors outside the legal department.** Mentors from different teams can:

  • share how the company works from different business perspectives;
  
  • teach the technical ins and outs of the business; and
  
  • provide insight into navigating corporate bureaucracy and politics.

• **Be accessible.** Company personnel should feel comfortable discussing important matters with counsel and asking questions. To be accessible to personnel and minimize disruptions during consultations, counsel should consider creating an open door policy or setting aside office hours that:

  • set guidelines so personnel are aware of when counsel is available and unavailable (for example, post a door sign with open office hours); and
  
  • incorporate uninterrupted time for counsel to focus on drafting or problem solving.

### Adapt to the Corporate Culture

Corporate culture is the personality of an organization, including its values, behaviors, beliefs, and norms, which is demonstrated through how things are done there. Many factors can shape this culture, such as the company’s:

• Management profile and the tone set from the top.

• History and development (such as when and how the company was founded and the original values it espoused).

• Industry.

• Size.

• Organizational structure (for example, whether management and administration are centralized or decentralized within individual territories, functions, or business units).

• Status as a privately held or publicly traded company.

• Ownership as a domestic or foreign-owned company.

• Development stage as a start-up or mature company.

### Learn the Culture

Successful in-house counsel know the corporate culture, adapt to it as appropriate, and use their understanding to strategically implement necessary changes. To learn about the culture, counsel should:

• Review the company’s written cultural values and mission statement.

• Identify the ideals and standards that the company values and demonstrates in practice, including:

  • the values and behaviors modeled by the company’s senior leadership and mid-level managers;

  • the activities and achievements that are encouraged and rewarded at the company; and
• the policies and procedures that are overlooked and not enforced.
• Speak with colleagues about the culture (see Build Relationships).
• Observe the company’s visible characteristics. For example, note if:
  • employees dress formally or casually;
  • the floor plan promotes or discourages interaction between departments; and
  • posters or other public messages advertise components of the culture, such as a compliance program or team-building activities.

Promote the Value of In-House Services

The biggest adjustments for in-house counsel transitioning from private practice often are:

• Moving from their role as revenue generator to a new role as cost center.
• Having more limited resources in the corporate environment (for example, having less administrative and peer support and fewer systems, precedents, and general know-how at counsel’s disposal).
• Providing legal advice that minimizes risk sufficiently to enable the business to succeed (see Become a Problem Solver).

Consider How the Legal Department Is Viewed

New in-house counsel should learn how the legal department views its role within the company and aligns its priorities with the company’s vision and strategy. Counsel should also understand how the company views the legal department. Depending on a company’s corporate culture and past experience, the legal department may be viewed either positively or negatively as:

• A trusted advisor.
• A valuable business partner.
• A gatekeeper to information and authorizations.
• An obstacle to getting the deal done.
• A clerk to rubber stamp transactions.
• An unnecessary cost to the business.

Understanding how the legal department is perceived within the company can help counsel:

• Create a strategy for interacting with internal clients.
• Anticipate and address any problems before they arise.
• Change any misconceptions or negative perceptions.

For a resource to help counsel gather feedback from internal clients on the quality of the law department’s legal services, see Standard Document, Law Department Client Satisfaction Survey.

For information on using metrics to demonstrate a law department’s value to the company, see Using Metrics to Measure Law Department Performance Checklist.

Draw on Available Resources to Deliver Value

At the outset of counsel’s transition, taking the following steps can help counsel deliver more value and create or reinforce positive views of the legal department:
• **Locate and create contract templates.** Templates and other frequently used documents may be saved on a legal department shared drive or stored on a colleague’s desktop. Understand the extent to which templates exist, and if not already in existence, create form contracts for key deal types. For a discussion on building contract templates, see Practice Note, Contract Management: Overview: Build a Contract Template and Clause Library.

• **Review contract playbooks.** Become familiar with any contract playbooks to understand the rationale for using different standard clauses. Discuss these clauses with knowledgeable legal and business department personnel for additional insights. Having this information can help counsel:

  • be more efficient in negotiating and preparing contracts;
  
  • determine the company’s tolerance for risk (see Determine the Company’s Risk Profile); and
  
  • resolve more quickly the issues that have been previously addressed by the company.

• For information on contract playbooks, see Practice Note, Contract Management: Overview: Prepare Contract Playbooks.

• **Contribute to a collaborative law department culture.** Look for opportunities to be a team player so the legal department can more effectively and efficiently provide services to internal clients. Volunteer for committees, take on special projects, and offer to help other lawyers in the department.

• **Make use of other valuable resources.** Counsel should identify other available resources, such as:

  • colleagues in legal and other departments who can answer questions and assist with projects;
  
  • IT systems, databases, and other technology tools (see Practice Note, Using Technology to Increase Law Department Efficiency);
  
  • online subscriptions and other reference materials; and
  
  • professional networks (including trade associations, legal networks, and in-house counsel from other organizations and industries).

• **Evaluate external service providers.** Counsel should set up no-charge, introductory meetings with outside counsel, external auditors, and other relevant service providers to understand:

  • the relationships between the legal department and the providers (including any long-standing personal or professional relationships between the providers and key personnel within the company);
  
  • the nature of the services provided; and
  
  • the expectations for how counsel and the providers should work together (including counsel’s expectations for deliverables) (for example, see Working Effectively with Outside Counsel Checklist, Standard Documents, Outside Counsel Guidelines and Use of Outside Counsel Policy, and Practice Note, Auditing: An Overview).

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**Become a Problem Solver**

Internal clients may propose potentially lucrative projects that fail to properly account for risk. Counsel’s initial reaction to protect the company may be to say “no.” However, while outside counsel are often in a position to just give advice (which may just be “no”), the role of in-house counsel is not only to give advice but also to support business growth and profitability. Repeatedly giving a negative response, without more, can lead to conflict with the client and counsel’s reputation as a naysayer and obstacle to the business. Counsel should consider the following strategies to overcome that negative perception:
• **Adopt a mindset of mitigating risk rather than eliminating it.** Be prepared to assume some risk to give practical advice and solve problems. Risk management (rather than risk avoidance) based on the company’s tolerance for risk can make the company more competitive (see *Gauge the Tolerance for Risk*).

• **Suggest alternatives.** Simply prohibiting a problematic business proposal does not help the company achieve its business objectives. Provide suggestions for minimizing the risk through alternative approaches. Engage with the internal client in a collaborative process to determine what legally and ethically can and cannot be done. Offering mitigation strategies, even if ultimately cost prohibitive or not viable, can:

  - demonstrate counsel’s diligence and creativity in attempting to find ways to achieve business objectives;

  - help the internal client view counsel as a valuable contributor and problem solver; and

  - stimulate the brainstorming and discussion of other possible solutions.

• **Say “no” with credibility.** When a negative answer is the appropriate response to a particular situation, say “no” to internal clients in a manner they can understand and accept. Counsel should:

  - credibly back up the position while demonstrating a firm grasp of how the business works;

  - categorize the risks and clearly explain their consequences (see *Communicate Effectively*); and

  - explain why a conservative legal position is necessary and appropriate.

• **Build relationships with internal clients.** By building solid relationships with internal clients and consistently supporting them in positive ways, counsel can develop trust, value, and influence, even when counsel’s advice is “no” (see *Build Relationships*).

### Manage Work Efficiently

Competent in-house counsel are expected to be responsive to queries, deliver timely and appropriate work product to internal clients, and reduce legal costs. This efficient time and project management are central to helping counsel:

- Create positive impressions within the company.
- Maintain the good will of internal clients.
- Eliminate waste (see *Lean for Law: Legal Process Improvement Checklist*) and legal spend (see *Practice Note, Saving Costs by Bringing More Legal Work In-House*).

### Be Responsive

Not responding to communications in a timely manner can lead internal clients to view the legal department as a black hole and wonder if counsel is ignoring or has even received their requests. To be a trusted business partner and advisor, counsel should:

- **Respond to emails and telephone calls promptly.** Be courteous and acknowledge requests, even if only to convey that counsel is not able to substantively respond until a later date due to other priorities.

- **Set a personal goal for sending timely responses.** For example, counsel can aim to respond by the end of the day for any communications received before noon, and by the next morning for any communications received after noon.

- **Delegate responsibility when necessary.** If counsel is unavailable because of vacation or other priorities, counsel should:

  - alert internal clients with whom counsel is currently working so clients can plan accordingly;

  - forward emails to other legal department members or provide an alternate contact so internal clients can receive timely responses; and
• delegate responsibilities to other legal department members so internal clients have support during counsel’s absence.

**Deliver Appropriate Work Product**

Companies require their in-house counsel to provide advice and work product that are commercially sensitive, pragmatic, and timely. To meet these needs, counsel should:

• **Set reasonable expectations for deliverables.** By clearly communicating what will be delivered when, counsel can align performance with expectations and avoid negative feedback from internal clients. For a sample policy and a sample form to help counsel manage internal client requests and expectations for contract preparation, see Standard Documents, Contract Review and Approval Policy and Contract Review or Preparation Request Form.

• **Tackle issues in a practical and timely manner.** In-house counsel often find it more important to provide a quick, generally correct answer that can timely inform a pending business decision than to reach a detailed, strictly correct answer that is delivered after the decision was made. This requires counsel to:
  
  • weigh the costs and benefits of taking more time to thoroughly research the answer to a legal question; and

  • sometimes take a more pragmatic approach to legal issues that may be less precise, while still providing quality advice.

• **Consider operational effects.** Carefully consider the operational effects of specific legal advice on the business. For example:
  
  • in advising an internal client about new regulations, consider how the client can continue to do business while being compliant; and

  • when drafting a new internal policy, consider any additional administrative steps required by the policy and how those steps may affect cycle times and operational costs for the business.

• **Prioritize matters.** When faced with a multitude of projects from various internal clients, counsel should be nimble and consider:
  
  • focusing on the projects that have the greatest potential to affect revenue growth and are important to key business leaders within the company;

  • shifting priorities based on business needs and deadlines; and

  • delegating non-essential, highly specialized, and other appropriate matters to outside counsel and other service providers.

• **Manage outside counsel representation.** When engaging outside counsel, in-house counsel should:
  
  • have clear conversations about the level of representation needed in a particular matter, the size of services requested, and the company’s budget;

  • define the company’s objectives. For example, in a litigation it may be more important for the company to reach an early conclusion than to win the case at all costs; and

  • negotiate billing rates, set billing guidelines, require estimates of project costs, fees, and other expenses, and monitor outside counsel spend for cost-effectiveness and compliance with the company’s expectations.

• For resources to assist in-house counsel in engaging and managing outside counsel, see Engaging and Managing Outside Counsel Toolkit.

**Communicate Effectively**

In-house counsel add value to the business when they can:
• Quickly digest a lot of information.
• Explain key points and complex concepts in a clear, concise, and non-technical manner.
• Enable management and other corporate leaders to make informed business decisions.

Counsel should consider the following steps to communicate effectively with internal clients and external business partners:

• **Speak the common language.** Facilitate understanding by:
  • using plain English and avoiding legal jargon, difficult legal terms, and acronyms;
  • illustrating points with descriptions, examples, and analogies that the audience can understand; and
  • learning the company lingo, including the acronyms and terminology that internal clients speak.

• **Listen carefully.** Counsel should pay close attention during internal meetings and discussions to:
  • determine what internal clients are asking;
  • proactively determine if counsel needs to be involved in a matter, even if internal clients are not requesting or even aware of the need for counsel; and
  • flag issues and raise questions as appropriate, particularly if internal clients are unaware of the issue or have not considered counsel’s perspective.

• **Tailor communications to the audience.** Counsel should consider if they are conveying relevant information in a useful format that is appropriate to the specific audience, many of whom are non-lawyers. For example, it may be more helpful for counsel to:
  • provide clear and concise guidance up front, targeting advice to the current issues, and reserve any broader legal analysis for later discussion if requested; and
  • summarize the contents of a court notice and highlight its key deadlines and action items, rather than just forwarding a copy to a business manager.

• **Explain risks coherently.** When evaluating a project for an internal client, clearly:
  • categorize the risks (for example, operational, accounting, corruption, or security risk);
  • explain their potential consequences (such as worst case scenarios, financial, operational, and reputational impact, and administrative burden);
  • advise on the probability of those risks actually materializing; and
  • prioritize them for internal clients so if time is limited, they can focus on the risks that have the biggest effects on the business.

  (See [Determine the Company’s Risk Profile](#).)

• **Communicate frequently.** Keep relevant legal department personnel (including counsel’s manager), management team members, and internal clients updated on the status of matters so they can:
  • report appropriate information to their superiors;
  • make informed decisions about the business; and
• be prepared to handle issues that arise.

• **Consider privilege issues.** Because in-house counsel often function as both legal advisors and business partners, application of the **attorney-client privilege** and **work product protection** to in-house counsel's communications depends on context. Counsel should avoid mixing business and legal advice when advising company personnel. For sensitive matters, counsel should also consider having discussions in person or by phone. For more information on:

  • determining whether these privileges apply to in-house counsel's communications, see *Practice Note, Ethical Issues for In-House Counsel: In-House Counsel's Dual Role*;

  • unique issues that arise when applying these privileges to corporations, see *Practice Note, Attorney-Client Privilege: Identifying the Attorney and the Client: Corporate Clients*; and

  • the attorney-client privilege and work product doctrine generally, see *Attorney-Client Privilege and Work Product Doctrine Toolkit*.

For a discussion of communication skills that can help counsel interact effectively with others inside and outside the company, see *Practice Note, Soft Skills for In-House Counsel: Communication Skills*.

**Develop As a Generalist**

New in-house counsel may be surprised at the broad range of legal questions raised by internal clients. If not specializing in a particular practice area within a large legal department, in-house counsel are usually expected to be generalists. Counsel should consider the following strategies to develop and succeed as a generalist:

• **Candidly admit not knowing an answer on the spot.** In addition:

  • explain counsel's area of expertise, if appropriate;

  • offer to research the question or seek out an expert on the matter; and

  • ask when an answer is needed.

• **Use good judgment and instinct to provide initial guidance.** Counsel should be willing to step out of their comfort zones to advise on an unfamiliar area of law. This approach gives practical direction on a matter to help the business move forward. Counsel should also make sure that internal clients understand that the advice is tentative and not a final answer.

• **Embrace new challenges.** When a big project presents itself (such as a big litigation, large acquisition, or new compliance initiative), volunteer to manage it and deliver quality work product.

• **Be deliberate about professional development.** While many in-house counsel find it difficult to allocate time for professional development, it is essential for expanding their practice area knowledge. Counsel should know their areas of responsibility at the company, learn the applicable laws and regulations, and keep up-to-date on the changes and trends in those areas (including general issues affecting in-house practice) by:

  • networking through corporate counsel groups and industry trade associations;

  • subscribing to distribution lists for law firm and consultant newsletters covering counsel's areas of responsibility;

  • attending relevant training programs offered by law firms, bar associations, and other professional and industry trade associations; and

  • when faced with budget constraints, being resourceful in finding learning opportunities (for example, by agreeing to present on a conference panel in exchange for a waiver of registration fees).
For a selection of resources covering many key issues and legal matters that in-house counsel commonly handle, see In-House Generalist Resource Center.

For a selection of resources that can help counsel negotiate, draft, or review contracts and other documentation for a wide range of business transactions, see In-House Business Transactions Center.

**Be More Than the Lawyer**

In addition to traditional legal responsibilities, in-house counsel often assume ancillary responsibilities that include areas such as corporate governance, compliance, human resources, and risk management. Counsel should consider the following approaches to manage these roles:

- **Be an active business partner.** Be willing to weigh in on the business merits of an issue. To become knowledgeable as a business leader, participate in committees within the company that are focused on the business, such as an integration team or a transaction review or strategy committee.

- **Be a team leader.** Counsel often work with cross-functional teams from different areas of the company (such as sales, logistics, public relations, strategy, and research and development). Bridge communication gaps and build consensus among team members so they are willing to share information more freely and cooperate more frequently. Be prepared to step into leadership to guide the team and assign tasks so team members can execute on the project.

- **Develop business skills.** Focus on professional development in areas such as:
  - project management;
  - strategic planning; and
  - business plan development.

- **Understand financial concepts.** Counsel should:
  - learn about finance and accounting and develop business fluency. For example, counsel should know how to read a balance sheet, income statement, and cash flow statement (see Practice Note, Financial Reporting in the US: Basic Concepts); and
  - know the budget for their legal matters, manage legal expenses, and be prepared to explain those expenses (such as why outside counsel selections were made).

- **Acquire knowledge that adds value to the company.** Stay current on business and legal news and follow issues related to the company and its competitors and industry.

- **Go above and beyond to complete a project.** Be willing to:
  - perform any tasks required to complete a project, including more basic tasks that in a law firm environment might be delegated to others (such as paralegals or junior associates); and
  - tackle different types of problems, even if not obviously legal problems. Counsel’s willingness to add value at all levels helps to build good will among internal clients.

For a discussion of leadership, business, and other skills that can help in-house counsel succeed in their roles, see Practice Note, Soft Skills for In-House Counsel.

**Keep Your Lawyers in Shape: A Professional Development Strategy for In-house Talent**
The takeaways from a panel session at the Association of Corporate Counsel’s Annual Meeting on October 27, 2010 on creating effective professional development programs for in-house counsel.

The session Keep Your Lawyers in Shape: A Professional Development Strategy for In-house Talent brought together thought leaders from the in-house legal community to explore the challenges and rewards of creating effective professional development programs.

The panel discussed many different aspects of effective training, including the necessary elements of a comprehensive program, the importance of developing both substantive legal skills and business acumen, using performance assessments and reviews as a professional development tool, effective use of knowledge management systems and new approaches to in-house hiring.

A key theme that emerged from the session was the belief that the best way to develop in-house lawyers is to ensure they are exposed to a wide variety of experiences and many different cycles of learning. The panelists stressed that, even with the best training programs, there is no substitute for gaining first-hand experience in different capacities. This approach benefits both the individual lawyers and also their clients, who receive deeper, broader and more creative counsel and support.

In addition, the panelists agreed that individual lawyers must take responsibility for their own careers. Regardless of the size of their legal department or the effectiveness of their internal review processes or formal training programs, the individual is in the best position to ensure his or her own professional development. If the in-house environment is not providing a lawyer the training he or she needs, the lawyer must explore other avenues — through external legal education, trade associations and individual mentoring. An individual’s professional development should be an ongoing, lifelong pursuit.

Panelists Brad Smith, General Counsel of Microsoft, Mark Roellig, General Counsel of MassMutual and Gabriel Buigas, Deputy General Counsel of Hewlett-Packard, each share some of their views below.

On Using Assessments and Reviews as a Professional Development Tool

Brad Smith, Senior Vice President and General Counsel, Microsoft

Assessments are crucial to helping lawyers grow in their career. We have a formal review once each year, and, mid-year, we have a structured conversation for people to sit down with their manager to think about and discuss next steps in developing their individual skills. We also sometimes use this conversation to determine when is the right time for the employee’s next step in the company.

For some, we also do 360 degree reviews every few years. We also have found an online tool to be incredibly useful across the company to provide a vehicle for employees to give feedback on their manager and their manager’s manager (“skip-level manager”). This includes a short quantitative survey followed by a section for comments. The questions we ask include:

- What is this person doing that you really like and want more of?
- What is this person doing that is ineffective and needs to focus on?
- Is there anything else you would like to say?

With at least four to five responses from direct reports and 15 to 20 skip-level responses, we usually start to see a pattern. We can use...
this to start a dialogue with the person being reviewed, and take them through three steps. First, we communicate the symptoms (for example, “You don’t communicate well”). Then we have a discussion as to the underlying causes of the problem. From there, we can discuss steps we can take to address the issue, including through formal or informal training. We have found that this approach can unearth issues and lead to real improvement through a personalized plan.

On Elements of an Effective Training Program

Mark Roellig, Executive Vice President and General Counsel, MassMutual

Our training program for lawyers joining the company falls into five categories:

- On-boarding.
- How to practice in-house.
  - Learning general business and the company’s business.
- Personal development.
- Substantive legal education.

Before lawyers even arrive for their first day, we send them materials on how to think strategically and the difference between working in-house versus working at a law firm. From day one, we assign both a peer mentor and a leadership mentor to help them navigate their new environment.

We spend a lot of time trying to teach new lawyers skills they may not have received at a law firm. For example, many lawyers think they are great communicators, but in reality that is often not the case when it comes to communicating with business professionals. Accordingly, we periodically bring in experts on legal writing and presentation skills. One skill we have them focus on is how to think and write in bullet points, something most lawyers have trouble doing but which is a way of life for business people. We also use outside trainers for negotiation skills and emphasize litigation risk analysis for all lawyers, so our legal team can understand how we and our business clients think about litigation from a probability point of view rather than from a law firm perspective.

With respect to learning the business, I am a big believer in mini-MBAs (or actual MBAs) and often send members of my legal team to these programs. While there is debate on whether business judgment can be learned, I believe it can. In fact, I have brought in an outside professor to focus on this issue with my team. Our goal is to help lawyers learn to be strategic, add value and become members of the team. Lawyers should not talk in the third person with the business people: it’s not “what you can do,” it is “what we should do.” We also make sure that we teach cost consciousness, especially in terms of how to manage vendors (including outside counsel).

In terms of personal development, we have found assessments to be critical and beneficial, particularly when we focus on areas in which the individual excels and areas in which they need to improve. This helps us create customized plans for each individual going forward.

In terms of substantive knowledge, we benefit from “all you can eat” offerings of CLE providers and take full advantage of outside counsel, who typically provide a menu of free offerings to their clients.

On New Approaches to In-house Hiring

Gabriel Buigas, Vice President and Deputy General Counsel, Hewlett-Packard

HP received some publicity recently because we started hiring first-year lawyers. It is important to explain the context of HP to see why this makes sense, as this has been the subject of much debate.

Over the past three years, we have moved a significant amount of our work in-house. We do much of our own patent applications, much of the diligence in M&A and are very hands on in terms of litigation management. We also do almost all commercial transactional work in-house as well, both in-bound and out-bound (some work is outsourced to a lower cost LPO). So we have a lot of work first-year lawyers can do. In addition, there have been changes in the legal services industry and to the law firm model that have made us competitive in terms of salary, allowing us to recruit great candidates from top schools. And, based on our internal strengths, we think we can develop lawyers just as well, if not better, than law firms.

Our training program for these new lawyers is divided into three pillars. First, we focus on substantive knowledge — that is, what do all
young lawyers need to know generally? We build on top of that the specific content they need for their assigned practice area (in this first
year of the program, we have one first-year in each IP, corporate M&A, commercial and litigation).

The second pillar focuses on practical experiences. We asked ourselves what experiences a new lawyer should have. For example, we
discussed how many depositions they should attend, whether they should shadow a sales person and whether they should work on a
trial. We strive to give the lawyers a set of practical experiences that will round out their practical education over the first year or so.

Finally, we focus on the soft skills, giving them tools to draft, communicate, write and present well — not only in terms of legal
information but specifically for the business environment in which they are working. Even more important, however, is that they develop
a “solution orientation,” which requires business acumen and judgment. We think we can do a better job of teaching this than a law firm
can, which is one of the reasons we are excited about our new program.
OUTSIDE COUNSEL EVALUATION FORM

Thank you for providing feedback on your experience working with outside counsel for [ORGANIZATION NAME] ("[ORGANIZATION]"). Your response will help us evaluate the effectiveness and efficiency of our outside counsel. It also provides important information to help us improve the quality and value of legal services to [ORGANIZATION].

We have asked you to identify yourself for follow-up purposes. However, your specific ratings and comments will generally be known only to members of the Law Department. Please answer all questions based on your personal experience with the outside counsel listed below ("Outside Counsel") and provide additional comments to the extent possible.

Please return this evaluation form by [DATE] to [CONTACT PERSON].

Date of Evaluation: ____________________________________________
Name of Evaluator: ____________________________________________
Title: _________________________________________________________
Department: ___________________________________________________

Name of Outside Counsel (law firm): ______________________________
Name(s) of Outside Counsel Attorney(s): __________________________
Nature of Interaction with Outside Counsel (e.g., project or case name, general consultation): ________________
________________________________________________________________________
Rating Scale

1 = Excellent performance (exceeds expectations overall)
2 = Very good performance (sometimes exceeds expectations)
3 = Good performance (satisfactorily meets expectations)
4 = Mediocre performance (acceptable, but there is room for improvement)
5 = Poor performance (failed to meet expectations in a significant way)
N/A = The question is not applicable to you, or you have no experience working with Outside Counsel in that capacity.

Please rate Outside Counsel's performance by placing a rating (1-5 or N/A) next to each category below.

A. Legal Knowledge and Performance
1. Has expertise in substantive and procedural legal areas that are important to [ORGANIZATION] and its legal matters.
2. Possesses strong, practical knowledge of opposing counsel, judges, venues, local juries, and experts.
3. Has credibility with opposing counsel, judges, local juries, and experts.
4. Delivers quality work product (e.g., contracts, memos, reports, and briefs).
5. Accurately assesses the degree of legal risk in a given situation or case.
6. Provides clear, practical, and complete advice, including options.
7. Negotiates effectively with other parties.
8. Achieves desired outcomes for [ORGANIZATION].

B. Business and Solution Orientation
1. Understands [ORGANIZATION]'s business and its priorities and objectives.
2. Understands the industry issues affecting [ORGANIZATION] and its business.
3. Understands the objectives and milestones of the legal engagement.
5. Proactively anticipates legal issues and risks relevant to [ORGANIZATION] and works with you to address them.
6. Offers strategic and creative solutions.
7. Focuses on risk management rather than risk avoidance (e.g., distinguishes between "must do" versus "good idea").
8. Contributes to the Law Department's efforts to improve its operations.

C. Budgeting and Fiscal Accountability
1. Accurately predicts costs and manages the case or matter within budget.
2. Submits budgets in a timely manner.
3. Demonstrates concern for cost containment.
4. Suggests ways to maximize work efficiency.
5. Hourly rates are in line with other providers.
6. Is reasonable about billing for time (e.g., avoids unnecessary internal firm meetings or does not bill for them).
7. Delivers work product that is good value relative to the amount of time spent or amount of money billed.

D. Project and Time Management
1. Demonstrates good organization and planning.
2. Keeps legal matters on track.
3. Delivers answers and work product in a timely manner.
4. Gives sufficient lead time for the Law Department to review and comment on documents.
5. Effectively manages [ORGANIZATION]'s disputes and litigation.
6. Staffs matters with professionals who are appropriately qualified to handle them in a cost-effective manner.
7. Uses current technology to handle [ORGANIZATION]'s legal matters in a cost-effective way.
8. Manages vendors (e.g., discovery, experts, and local counsel) effectively and efficiently.
E. Communication and Responsiveness
1. Communicates clearly and effectively (orally and in writing).
2. Keeps you up-to-date on the status of your legal matters.
3. Informs you of new legal developments important to your work.
4. Returns phone calls and emails promptly.
5. Is readily available when needed.

F. Values and Relationship
1. Demonstrates a high standard of ethics and integrity.
2. Is professional and respectful of others.
3. Treats you like a valued client and colleague.
4. Demonstrates that your legal issue is important.
5. Promotes diversity (e.g., staffs matters with women and minority attorneys).
6. Adheres to [ORGANIZATION]'s policies and procedures (e.g., outside counsel guidelines and billing requirements).
7. Promptly notifies you of significant events or changes.
8. Secures [ORGANIZATION]'s approval when appropriate or required (e.g., regarding budget overruns, conflict of interest issues).

G. Overall Satisfaction
1. Please rate the overall performance level of Outside Counsel in providing legal services.

H. Additional Questions
1. Taking all of the performance items (A-F) into account, would you recommend we hire this Outside Counsel again? (Please check yes or no.) ___ Yes ___ No
   Please explain: ____________________________

2. Please rank the importance of each of the performance categories (A-F) to you when working with Outside Counsel.

<table>
<thead>
<tr>
<th>Category</th>
<th>Rank</th>
<th>Ranking Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Legal Knowledge and Performance</td>
<td></td>
<td>Please use a scale of 1-5.</td>
</tr>
<tr>
<td>B. Business and Solution Orientation</td>
<td></td>
<td>1 = Most important.</td>
</tr>
<tr>
<td>C. Budget and Fiscal Accountability</td>
<td></td>
<td>5 = Least important.</td>
</tr>
<tr>
<td>D. Project and Time Management</td>
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<tr>
<td>E. Communication and Responsiveness</td>
<td></td>
<td></td>
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<tr>
<td>F. Values and Relationship</td>
<td></td>
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</tr>
</tbody>
</table>

3. What, if anything, do you find most valuable and helpful about Outside Counsel's performance and services?

4. What can Outside Counsel do to increase your level of satisfaction with its performance and services?

5. Do you have any feedback or comments you would like to provide about specific Outside Counsel individuals?

6. Please share any additional observations and comments that will help improve the quality and value of [ORGANIZATION]'s engagement of Outside Counsel.
“Good Faith”: The Current Landscape of Claims Handling and Policyholder Expectations

Links to Articles:


The Changing Shape of Bad Faith under the Restatement: What Are the Consequences When an Insurer Breaches Its Duty to Settle or Defend?

By Craig E. Stewart

If you’re a coverage geek, or just someone who enjoys a good academic brawl, you already know that the ALI’s draft Restatement of the Law of Liability Insurance has come under fire from insurance industry lawyers who see many of the proposed rules as stating what the reporters believe the law ought to be, rather than a distillation of the common law into a set of rules that accurately states what the law is. Policyholder lawyers have fired back, reminding their brothers and sisters at the insurance bar that a restatement is not limited simply to identifying the majority
rule, but also considers many other factors: “the nature of the majority rule,” what specific rule will best fit with the other rules, trends in the law, and the “relative desirability” of competing rules.

This academic brouhaha is an important backdrop to understanding (1) how and why the Restatement defines “bad faith”; (2) why a finding of bad faith is no longer required to impose severe penalties on an insurer who breaches its duty to make reasonable settlement decisions under Section 27; and (3) how the Restatement reporters were persuaded to revise Section 19 (Consequences of Breach of Duty to Defend) so that a finding of bad faith will be required before an insurer can be stripped of its coverage defenses.

**Bad Faith under the Restatement**

Under the Restatement, what determines whether an insurer has acted in bad faith or just made a knuckle-head mistake? Section 49 sets out a two-part test: “objective” and “subjective.” An insurer is liable for bad faith when (1) it fails to perform under its policy without a reasonable basis for its conduct and (2) does so with knowledge of its obligation to perform or in reckless disregard of whether it has an obligation to perform. The Restatement calls such conduct “true bad faith.” For an insurer to be liable for true bad faith, the Restatement makes clear that both parts of the two-part test must be satisfied: no reasonable basis and knowledge or reckless disregard. This definition fits the law of most jurisdictions when it comes to insurers who are liable for first-party bad faith, i.e., when insurers wrongfully deny coverage for loss suffered by their own insureds (e.g., property damage or uninsured motorist (UM)/underinsured motorist (UIM) benefits). But this is not always the case when it comes to third-party bad faith, i.e., where the insured is looking for his insurer to cover a claim against him for damages he caused to others. For example, most jurisdictions do not require a showing of subjective knowledge or reckless disregard to find an insurer liable for bad faith when it fails to settle a claim brought against its insured when liability is reasonably clear and the damages are within policy limits. In most jurisdictions, only the objective prong of the two-prong test must be met: Did the insurer lack a reasonable basis for refusing to settle? More often than not, insurers who are found liable for “bad faith failure to settle” are required to pay the full amount of any judgment, covenant judgment, or settlement, regardless of policy limits.

**Rule 27: Damages for Failure to Make Reasonable Settlement Decisions**

Consistent with this common law, Rule 27 does not require a finding of bad faith. Rather it applies a “commercial reasonableness” standard to determine whether an insurer will be liable for breach
of its duty and obliged to pay the entire amount of the excess judgment. That is, an insurer will be liable if a judge or jury finds that its refusal to settle would not have been made by a reasonable insurer that bore “the sole financial responsibility for the full amount of the potential judgment.” The Restatement expressly does not use the term “bad faith” because: (a) it doesn’t fit with the definition of “true bad faith”; (b) the Restatement wants courts to be able to use “bad faith” and its two-prong test for insurers whose conduct goes beyond “unreasonableness”; and (c) it wants “to create an incentive for insurers to take into account the risk to insureds and excess carriers” from an excess verdict, without slapping the label of “bad faith” on the conduct of insurers who make a mistake. It also doesn’t use the term “bad faith” because (as set forth in the comments to §24) it wants to reduce “the likelihood that an inexperienced lawyer or judge will mistakenly conclude that the same legal standard applied in both categories.” Consequently, under Rule 27, an insurer who breaches its duty is “subject to liability for any foreseeable harm caused by the breach,” including the full amount of the damages assessed against the insured, regardless of the policy limits. No finding of bad faith is required.

**Rule 19: Consequences of Breach of Duty to Defend**

The final draft of Rule 19 that was presented to the ALI’s membership for approval in May 2017 came under withering fire. As it was then drafted, there were two consequences or penalties, set out in two paragraphs, that resulted from an insurer who breached its duty to defend. First, an insurer that breached its duty “lost the right to assert any control over the defense or settlement of the action.” Second, an insurer who breached its duty “without a reasonable basis” automatically forfeited all its coverage defenses to the action brought against the insured. This meant that not only was the insurer liable for all the insured's defense costs, it also was required to indemnify the insured for any damages awarded up to the policy limits, regardless of any coverage defenses it could have asserted. The first consequence was expected, because it is a common penalty in most jurisdictions. The second consequence drew outrage and protest from a number of insurance company coverage counsel, academics, and at least one judge who pointed out that (1) the proposed rule was not the majority rule in the United States (indeed, 28 states require a finding of bad faith before the penalty can be applied); (2) the reporters didn't cite to any “trends” that would support the adoption of the rule; and (3) there was no “social science evidence” that would support the claim that adopting the rule would incentivize insurers to “to fulfill their duty to defend.” As a result, the critics warned, the Restatement, and the ALI itself, risked losing the legitimacy and high regard for its pronouncements that come with a reputation for exacting and neutral scholarship.
Considering these protests, the ALI postponed the vote on approving the Restatement until its annual meeting in May 2018, and the reporters went to work answering the criticisms of Rule 19 and several other rules. The next iteration of Rule 19, released in August 2017 as part of “Preliminary Draft No. 4,” did nothing to assuage the criticism because the language of Rule 19 remained the same. The only difference was in the “Comment” section to the rule, where the reporters agreed that “the majority rule is that insurers that breach the duty to defend are generally permitted to contest coverage, subject to the risk of facing additional consequences for a bad faith breach.” While admitting that the proposed rule did not represent the current majority rule, the reporters argued that the change was warranted and necessary. First, the reporters pointed out that coverage for defense attorneys’ fees and costs was critical to policy holders. Insurance defense coverage provides “the access to civil justice for defendants that corresponds to the access to civil justice that contingent-fee arrangements provide for plaintiffs.” Without it, most individual consumers and small businesses “would be deprived of an adequate defense.”

Second, like Rule 27, the proposed Rule 19 aligns the insurer’s interests with those of the insured. If an insurer knows that it will forfeit its coverage defenses if it wrongfully denies a defense, it will be forced to make its decision by considering “full liability for the action,” not only the defense costs it will have to pay, but the full amount of any judgment (or settlement) up to its policy limits. Because the insured’s need for defense coverage, like the insured’s need for the insurer to make reasonable settlement decisions, are both recurring and critical, the reporters declined to require a two-part finding of bad faith. Instead, the reporters adopted half of the two-part bad faith standard, “reasonableness,” while imposing a penalty so severe that most jurisdictions currently require a finding of bad faith. Critics of the Restatement’s Rule 19 remained outraged.

**Rule 19 Revised**

The debate over Rule 19 and other sections of the Restatement continued through the fall of 2017 with the reporters continuing to meet with judges and receiving comments and suggestions from other members of the ALI as well as from other advisory bodies. In December 2017, the reporters submitted “Council Draft No. 4” that was approved by the ALI’s Council in January 2018. In that draft, the offending paragraph 2 of Rule 19 was deleted in its entirety. Rule 19 now reads:


An insurer that breaches the duty to defend a legal action loses the right to assert any control over the defense or settlement of the action.
The reason for the change was a newly acquired consensus by the reporters and their advisors that there was insufficient authority to support stripping an insurer of its coverage defenses for breach of its duty to defend without a finding of bad faith. Notwithstanding this retreat to the majority rule, the Comment to §50, Remedies for Liability for Bad Faith, makes clear that insurers risk forfeiting their coverage defenses if they are found to have acted in bad faith. But that “bad faith” must be determined by the two-prong test: a finding of no reasonable basis; and knowledge or reckless disregard that there was no reasonable basis.

At the ALI’s annual meeting in May 2018, Council Draft No. 4 was approved in its entirety by the ALI’s membership. It is now the ALI’s official Restatement of the Law of Liability Insurance. Time will tell whether the Restatement is accepted as articulating a broad consensus of what the law is, or whether it is viewed as advocating what the law should be. Either way, it undoubtedly will be a factor in how lawyers argue coverage cases and how courts decide them.
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Step 12: Celebrate D&I Successes

Overview

Creating and maintaining a sustainable culture of diversity and inclusion remains a challenge for many organizations, but the legal community seems to have more difficulty than most. Most efforts at building a diverse workforce focus on recruitment and hiring, and this is where law firms and corporate counsel departments excel. There is no shortage of legal talent among underrepresented communities and integrating efforts into the recruiting strategy is as simple as checking a box. But once these diverse individuals are in the door, they often find themselves in cultures where opportunities for interesting work and promotions are granted to those with informal relationships that have been forged over time, leaving them out in the cold.

Many if not most professional relationships operate outside of the normal chain of command, elevating the importance of interpersonal interactions within the context of work. As human beings, we naturally gravitate toward those who are like us. Yet it isn’t difficult to see how this natural affinity may disadvantage those who are not like those in positions of power and authority. Though most organizations have a public commitment to diversity in their workforces, and the legal community has myriad organizations and awards to elevate its importance, in practice diverse employees are frequently relegated to diversity initiatives specific to them that only contribute to feelings of isolation from the greater work community.

Our model for sustainable diversity and inclusion is much more expansive than the limited reach of most diversity initiatives. Here, the goal is to create a welcoming environment where opportunities are available to everyone, irrespective of race, ethnicity, religion, sexual orientation or gender, and the benefit of this approach is that it does not exclude white men. Everyone has the opportunity to succeed.

Studies have defined inclusive organizations as “characterized by effective management of people who are different, the ability to admit weakness and mistakes, heterogeneity at all levels, empowerment of people, recognition and utilization of people’s skills and abilities, an environment that fosters learning and exchanging of ideas, and flexibility.”

Others describe a learning and effectiveness paradigm in multicultural organizations that connects employees’ contributions and perspectives to the principal work of the organization. This can create openings to rethink the way things are done, who the clients are, and how services are utilized, not to mention an organization’s strategies, missions, business practices, and even cultures. In this type of
organization, there is equal opportunity for all, differences are recognized and valued, and most importantly, the organization is able to internalize differences among employees so that it learns and grows because of them. Indeed, members of these organization can say "we are all on the same team because of our differences, not [in] spite of them."2

Creating such an environment requires an intentional effort to identify the systems, processes, and mind sets that are obstacles to the true meritocracy we all strive for. In essence, it requires a comprehensive, well thought out diversity and inclusion (D& I) strategy. It may seem like an odd analogy, but it is not unlike helping someone conquer an addiction by methodically altering ingrained thinking and habits through a 12-step program. What follows is a 12-step strategy for sustainable diversity and inclusion.

**The 12-Step Strategic Plan to Sustainable Diversity and Inclusion**

With this D& I sustainability approach, behavior change is not the goal. Instead, changing systems and processes creates the conditions for the behavior we want to cultivate within organizations. This approach changes the way we require people to do things, as opposed to asking them to change their behaviors on their own. Step 1 is almost universally where D&I strategies run off the rails. This is particularly true in the legal community, because the systems and processes in place have worked very well for those in power, i.e., the partners and senior leadership. They will (and do) argue that systems and processes are by their nature unbiased – they’re simply ways of doing things. This resistance to systemic and process changes is natural, but healthy organizations have, or develop, a strong capacity to evolve to meet the challenges of the new workforce paradigm. What is the old adage? Insanity is doing the same thing over and over again and expecting a different result. If a firm or department is not achieving the diverse and inclusive workplace it wants, it must look within to discern why not.

**Step 1: Acceptance = Readiness**

Does your firm or department acknowledge and accept that its diversity and inclusion efforts are not achieving the desired outcomes, no matter how well-intentioned? The classic first step in any change effort is to plainly and accurately discern what is going on and to understand the drivers of the current state. A sustainable culture of diversity and inclusion is an organizational system like any other, and it must be engaged by everyone if the organization is to mature and thrive.

Once this reality is accepted, leaders must assess their own readiness to address the issue, including readiness to make the kinds of systemic and process changes that may disrupt the usual ways of doing business. This step is vital because the relative level of readiness will predict the potential for future success. If, for example, it is determined that the firm’s or department’s compensation system is inherently biased, the leadership team must not only be capable of accepting that this is factually the case, but also be willing to do the very hard work of adopting a system that is truly merit-based. And that is just one example of legacy systems that may be counterproductive to a sustainable culture of diversity and inclusion.

**Step 2: The D& I Officer Needs Help**

Those responsible for making diversity and inclusion a way of life cannot do it alone. They need the help of those in positions of power to drive change. The “higher power” needed to build sustainable diversity and inclusion in a workplace is the leadership team. Only the most senior leaders can set the vision and endorse systemic changes and processes essential for culture change. While consultants can be a vital resource, leadership of D&I efforts cannot be outsourced because outsiders simply do not have the organizational credibility necessary to achieve buy-in from the workforce. Nonetheless, outside professionals are an invaluable asset in analyzing the status quo, providing feedback about what works, and identifying obstacles that are standing in the way of a culture of diversity and inclusion. Consultants also have the expertise and objectivity to provide guidance throughout the change process, maintain
momentum, generate new ideas and strategies, and navigate the inevitable derailers and pushback along the way.

**Step 3: Commitment**

Be open-minded and decisive in setting a formal diversity and inclusion strategy for your organization. Recognize that the change needed to create impactful outcomes will require the firm or company to think, behave, and engage in systems differently. Change is hard, and it must be championed by the leadership team. The goal is to change behaviors not head on, but through the implementation of new systems and processes that will facilitate the adoption of new ways of being. Yet as anyone who has tried to break a habit knows, it takes a huge level of commitment and mindfulness to achieve the desired outcome.

Senior leaders have the greatest responsibility during this change, because while the spirit can be strong, the flesh is frequently weak. It is difficult to maintain the dedicated focus needed for this kind of wholesale change in the face of competing business challenges as well as real, sustained, and sometimes angry pushback. Yet leaders cannot back down, even in the face of resistance from power brokers within the organization—rainmakers, partners, executives, and others. Change can feel threatening, and there will be perceptions among some that they are “losing.” It will require inner strength to stick with the strategy, as well as a comprehensive strategic communications effort to help manage the uprisings that may occur.

**Step 4: Ground the Effort in Truth**

Be brutally honest in assessing your organization’s readiness. Which operational factors (people, processes/systems, and technology) support diversity and inclusion and which impede it? Who are your champions and who will be your resisters? What aspects of your operational practices are counterproductive to sustainable diversity and inclusion? This step will necessitate an inside-out view of what is actually happening on the ground. Use both quantitative and qualitative data gathering techniques: written surveys, focus groups, and one-on-one interviews to learn about how employees experience the workplace from a diversity and inclusion lens. Engage the organization’s leaders in this honest discussion to understand whether there is a shared perspective of the organization’s reality and to learn about the perhaps contradictory views of others. They must feel free to share their honest views for the effort to be an effective measure of the organization’s current state.

**Step 5: Challenge Your Assumptions with Facts**

This step focuses on an outside-in view of how an organization stacks up against its peers. Use external benchmarks to understand how your firm or company compares in areas such as:

- diversity league tables,

- quantitative measures like “best places to work,”

- published employee engagement surveys,

- EEOC or state reports of number of complaints related to diversity and inclusion concerns,

- the number and titles of diverse senior leaders in competitors’ organizations, either geographically co-located or industry-based organizations, and

- public spotlights and acknowledgements such as Best Workplace for Working Moms that are available to the organization but are missed because of lackluster D&I performance.
Step 6: Be Open and Engaged

Design the D&I strategy with new pathways for building diversity and inclusion in your workplace. Be committed and ready to operate differently. Leaders must be “on board” if not in heart, then at least in their words and actions. We may not be able to change hearts and minds for others at work, but we can prescribe behavior that we feel is supportive of the organization’s goals and objectives. Leaders must both embrace D&I goals and objectives and model the behaviors required to support successful D&I strategies and outcomes. If there is demonstrated leadership commitment to change, the workers will absorb that lesson over time and make it a part of their own performance. If leaders merely pay lip service, workers will quickly realize this initiative has no real support and they will not bother to adapt.

Step 7: Lead with Honesty and Humility

Leaders must be honest and humble in engaging the organization in the change that will be needed. Senior leaders must publicly acknowledge what they have learned, and they must be willing to speak the truth about why diversity and inclusion programs have not worked in the past. This does not mean anyone is called out by name. Rather, it is a cleansing moment for the leaders on behalf of the organization. Admitting falling short and owning the failure smooths the path to engaging others in the collective change that must happen.

When leaders are vulnerable in this manner, it gives rank and file workers a reason to trust and to follow because they are being treated like adults and colleagues who are worthy of the truth. Ideally, this eases the realization that there will be new expectations and visions for each member of the organization to behave differently by:

- taking personal responsibility for achieving the firm’s/company’s diversity and inclusion goals,
- acting proactively and decisively to address behaviors and/or systems that disserve D&I goals, and
- communicating effectively with each other on matters related to ideas, perspectives, concerns, and disagreements.

The organization must engage in healthy dialogue and perhaps even conflict to get through the discomfort and disorder that inevitably accompanies any change process. To facilitate this, the leadership team should invest in ancillary organizational development support, training, and coaching to move through the change process successfully and collectively.

Step 8: Acknowledge Past Wrongs

Much like the AA program, the organization must make amends in order to start anew. This means taking responsibility for the organization’s past failures. As part of this process, the firm’s/company’s leaders should create a “to do” list based on the harms it has inflicted on its employees through ineffective and perhaps negligent inattention to diversity and inclusion matters over the years. For example, if women or minorities have been or are underpaid compared to similarly situated men, then the organization must commit to a plan to correct that inequity. This does not require public mea culpas, but it does require biting the bullet, owning the shortcomings, making systemic changes, and then taking decisive action to rectify individual circumstances.

Step 9: Replace Harm with Care

When making the changes identified in Step 8, it requires going deeper to understand what may have contributed to pervasive systemic inequities. These inequities frequently are the result of biases that are inherent in a system and include:
- job descriptions and associated compensation bands,
- organizational or cultural biases based upon the nature of the practice or the location,
- social or business systems like informal networking practices or activities that may leave some people out, or
- investments that must be changed or managed to ensure that past problems are not re-engaged.

Firms and companies must consider healthy ways to build sustainable support for historically marginalized people and begin thinking about how promotional opportunities are meted out. For example, if women and minorities have been historically underpaid, address the compensation issue but also think about instituting a program to provide greater professional development opportunities as a way of both making amends and initiating practices that will facilitate future professional opportunities.

**Step 10: Monitor and Measure**

Each day presents a chance to get it right or get it wrong in the process of effecting organizational change. Leaders must set serious goals for D&I outcomes and they must hold themselves and others accountable for achieving them. This means defining a rigorous yet simple set of qualitative and quantitative measurements of progress that are monitored regularly. Measuring the number of women or people of color in the organization alone is not terribly edifying. But a healthy number of women and people of color in executive, highly visible, highly impactful, and nontraditional roles is truly meaningful. The latter number reflects the impact that new systems, processes, and programs are having on people's career trajectories, their increased influence within the firm or company, and the outward message to potential hires that the organization is one where women and people of color can compete and thrive. These are the qualitative differences that matter. Numbers without this richer context are meaningless.

**Step 11: Reflection**

Leaders and managers should make it a best practice to spend time reflecting on their D&I strategy and outcomes on a semi-annual or annual basis. Are the strategies and tactics working? Does it feel authentic? Are people buying into the program and embracing the results? Are people generally feeling good about it? Are some feeling displaced? Do those who may feel displaced need support to manage their potential or perceived loss of status in light of the new organizational reality? Is there a need for course correction to ensure that near- and long-term goals will be met? The goal should not be to castigate those who are having a difficult time accepting the changes happening around them. Rather, support should be available for everyone involved, to meet them where they are and help them understand the process as part of a greater good in which they can be an integral part. Opportunities should not be finite unless that is what an individual chooses for him or herself.

**Step 12: Celebrate D&I Successes**

When the strategy is being implemented in a sustainable and authentic way it's time to celebrate. Any organizational change is hard and change that positively impacts diversity and inclusion is harder than most. It is important to remember in this context that success is not defined by, nor limited to, economic gain. Rather, a new client engagement or litigation victory that has been supported by the ideas of more than one group and/or individuals who have not been previously invited to the table is a win. Keeping true to the principles of sustainability and authenticity is cause for celebration. Meeting people where they are and bringing them along to new ways of doing things with new colleagues is truly reason to cheer.

**Footnotes**


About the Authors

Terri Hartwell Easter is the founder and principal of T. H. Easter Consulting with over 30 years of experience. Terri was the first African-American female chief operating officer of a top 100 national AmLaw legal practice and is a highly regarded organizational change strategist for leading utility companies, professional services firms, commercial banks, and the White House. Awarded the 2017 American Business Awards for Executive of the Year and Woman of the Year, Terri regularly presents to business executives and human resources professionals on topics including strategies for employee engagement, diversity & inclusion in leadership, succession planning, and recruitment, among many others. She is a Ph.D. candidate in Human and Organizational Development with Fielding Graduate University.

Susan Brooks is a principal with T. H. Easter Consulting. An attorney and management consultant, Susan has over twenty-five years of experience in law, human resources management, recruitment strategies, and communications for businesses, nonprofit organizations, and political advocacy groups. Susan's areas of expertise include human resources management with an emphasis on policy and process; employee relations including internal communications, investigations, and performance management; diversity recruitment and management; and attorney recruitment. Her writing on human resources issues can be found in the National Law Journal, Bloomberg Law, People + Strategy, and Training magazine. Susan received her law degree from the Paul M. Hebert Law Center at Louisiana State.

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Once this reality is accepted, leaders must assess their own readiness to address the issue, including readiness to make the kinds of systemic and process changes that may disrupt the usual ways of doing business. This step is vital because the relative level of readiness will predict the potential for future success. If, for example, it is determined that the firm’s or department’s compensation system is inherently biased, the leadership team must not only be capable of accepting that this is factually the case, but also be willing to do the very hard work of adopting a system that is truly merit-based. And that is just one example of legacy systems that may be counterproductive to a sustainable culture of diversity and inclusion.

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Firms and companies must consider healthy ways to build sustainable support for historically marginalized people and begin thinking about how promotional opportunities are meted out. For example, if women and minorities have been historically underpaid, address the compensation issue but also think about instituting a program to provide greater professional development opportunities as a way of both making amends and initiating practices that will facilitate future professional opportunities.

**Step 10: Monitor and Measure**

Each day presents a chance to get it right or get it wrong in the process of effecting organizational change. Leaders must set serious goals for D&I outcomes and they must hold themselves and others accountable for achieving them. This means defining a rigorous yet simple set of qualitative and quantitative measurements of progress that are monitored regularly. Measuring the number of women or people of color in the organization alone is not terribly edifying. But a healthy number of women and people of color in executive, highly visible, highly impactful, and nontraditional roles is truly meaningful. The latter number reflects the impact that new systems, processes, and programs are having on people's career trajectories, their increased influence within the firm or company, and the outward message to potential hires that the organization is one where women and people of color can compete and thrive. These are the qualitative differences that matter. Numbers without this richer context are meaningless.

**Step 11: Reflection**

Leaders and managers should make it a best practice to spend time reflecting on their D&I strategy and outcomes on a semi-annual or annual basis. Are the strategies and tactics working? Does it feel authentic? Are people buying into the program and embracing the results? Are people generally feeling good about it? Are some feeling displaced? Do those who may feel displaced need support to manage their potential or perceived loss of status in light of the new organizational reality? Is there a need for course correction to ensure that near- and long-term goals will be met? The goal should not be to castigate those who are having a difficult time accepting the changes happening around them. Rather, support should be available for everyone involved, to meet them where they are and help them understand the process as part of a greater good in which they can be an integral part. Opportunities should not be finite unless that is what an individual chooses for him or herself.

**Step 12: Celebrate D&I Successes**

When the strategy is being implemented in a sustainable and authentic way it's time to celebrate. Any organizational change is hard and change that positively impacts diversity and inclusion is harder than most. It is important to remember in this context that success is not defined by, nor limited to, economic gain. Rather, a new client engagement or litigation victory that has been supported by the ideas of more than one group and/or individuals who have not been previously invited to the table is a win. Keeping true to the principles of sustainability and authenticity is cause for celebration. Meeting people where they are and bringing them along to new ways of doing things with new colleagues is truly reason to cheer.

**Footnotes**


About the Authors

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Corporate D&O Liability and Sexual Harassment in the Workplace

By Peter J. Biging and Heather M. Zimmer

The #MeToo movement has spawned a new era for corporate America with regard to how we look at and what we do in response to allegations of sexual harassment. It has forced corporate America to give serious consideration to the manner in which to consider and manage the risks stemming from sexual harassment by corporate officers and directors.

While complaints of sexual harassment at work are not new, the revelation that the head of a film studio not only was permitted to pursue a decades-long career as a sexual predator but also, in fact, was enabled by corporate leadership to engage in such behavior has been met with a collective sense of horror. The practice of journalistic “catch and kill” to bury claims of sexual misconduct and grossly inappropriate behavior has drawn scrutiny, as well. And the spotlight is shining starkly on the manner in which corporations have placed a premium on “managing” the immediate financial risk presented by the claims and fallout from the allegations, and insulating individuals perceived to be key performers, rather than placing the focus on refusing to tolerate and taking aggressive action toward eradicating such behavior. All of this has revealed a corrosive culture that society at large now seems unwilling to tolerate.

Previously, ugly allegations might have been addressed quietly, settlement agreements might have been drawn up, and the individuals accused of such conduct might have been permitted to proceed in their leadership positions as if nothing had happened—with the excuse being that the individual’s value to the company justified dealing with the allegations in this manner. Times have changed. While a company’s stock price may not be impacted when allegations of sexual harassment first surface, a company has to consider the possibility that a serious financial risk can occur when a company does not deal with claims promptly, directly, and in a manner that evidences a corporate culture intolerant of such behavior.

An illustrative example can be seen in what happened when model Kate Upton accused the Guess cofounder of sexual harassment: shortly thereafter, the company’s shares dropped nearly 18 percent, shedding roughly $250 million in value. As another example, Twenty-First Century Fox paid out an eight-digit settlement in 2016 for its mishandling of sexual harassment claims against Roger Ailes and Bill O’Reilly. Still another cautionary tale is told in how the market reacted to the lawsuits against Steve Wynn, Wynn Resorts, and his board of directors.

Rise in Sexual Harassment Allegations

For years, companies and their boards were able to quietly settle and then sweep under the rug sexual harassment allegations as there was little financial incentive to address them in a more fulsome manner. Times have changed. While a company’s stock price may not be impacted when allegations of sexual harassment first surface, a company has to consider the possibility that a serious financial risk can occur when a company does not deal with claims promptly, directly, and in a manner that evidences a corporate culture intolerant of such behavior.

An illustrative example can be seen in what happened when model Kate Upton accused the Guess cofounder of sexual harassment: shortly thereafter, the company’s shares dropped nearly 18 percent, shedding roughly $250 million in value. As another example, Twenty-First Century Fox paid out an eight-digit settlement in 2016 for its mishandling of sexual harassment claims against Roger Ailes and Bill O’Reilly. Still another cautionary tale is told in how the market reacted to the lawsuits against Steve Wynn, Wynn Resorts, and his board of directors.
concerning Wynn’s alleged decades-long sexual misconduct.5 In the aftermath of these suits, the stock price of Wynn Resorts dipped nearly 20 percent.6 And the most telling example is that of the Weinstein Company: an entire brand has been eviscerated by the revelations of Weinstein’s enduring sexual misconduct and the failures of the Weinstein board to take effective measures to put a stop to it.7

**The Securities Exchange Act of 1934**
The Securities Exchange Act of 1934 (Exchange Act) regulates the secondary trading of securities and, under its antifraud provisions, makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange[,]...[t]o use or employ...any manipulative or deceptive device or contrivance [in selling securities].8 The purpose of the Act is to create a mandatory disclosure process designed to force companies to make public information that investors would find pertinent in making investment decisions, and to provide a means of punishing individuals and companies that either make false or misleading statements about the company or make use of information not available to the public to enrich themselves at the expense of other investors.

A plaintiff may bring an action against a public company for violations of the antifraud provisions of the Exchange Act via the private right of action authorized pursuant to sections 10(b) and 20(a) of the Exchange Act. The claims brought under the Exchange Act arising from how a corporation has addressed complaints of sexual harassment generally have centered on a company’s duty to disclose and report the claims and risks presented thereby in its public filings made to the Securities and Exchange Commission (SEC), such as the annual 10-K and quarterly 10-Q filings.

Under Rule 10b-5, it is unlawful for a public corporation to make any untrue statements or omissions of a “material fact” that would render any statement made to the SEC “misleading.”9 Under Item 103 of Regulation S-K of the Securities Act of 1933, a public corporation also has an affirmative duty to disclose “any material legal proceedings” that are pending against it before a court or agency, as well as “any proceedings known to be contemplated by governmental authorities.”10 Additionally, under Item 303 of Regulation S-K, a company must disclose any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.11

The U.S. Court of Appeals for the Second Circuit has held that a company is required to disclose statements from Item 303 pursuant to section 10(b) filings.12

**The Fiduciary Duty Owed to Shareholders by Officers and Directors**

Every officer and director of a company owes its company and shareholders fiduciary duties of care and loyalty, which, if violated, can subject them to a derivative action.13 A shareholder who brings a derivative action must either make a demand on the directors to bring a litigation or set forth particularized factual allegations in a complaint that such demand on the board would be futile by raising a reasonable doubt that either (1) the directors are disinterested and independent or (2) the board’s decision was not a valid exercise of business judgment.14

In the context of sexual harassment, officers and directors can breach their duties by sexually harassing employees (and, in so doing, intentionally act with a purpose other than that of advancing the best interests of the corporation) or failing to monitor or investigate known sexual harassment claims.15

**Sexual Harassment and the Risks Presented**
The Equal Employment Opportunity Commission defines sexual harassment as “unwelcome sexual advances, requests for sexual favors, and other verbal or physical harassment of a sexual nature.”16 It is defined similarly in many state and city statutes.17 Sexual harassment does not have to be of a sexual nature for it to be unlawful;
sexual harassment also extends to offensive comments about a person’s gender.\textsuperscript{18}

Until recently, sexual harassment claims were largely risk specific to the claimant, manageable through employment practices liability insurance (EPLI) coverage, and not likely to present a potential for risk in the form of securities fraud and/or shareholder derivative litigation. However, there have been a number of claims of recent vintage that should put every corporate leader on notice that these types of claims, and how they are handled, can pose such risks today—and in a very substantial way. These claims have been largely premised on two theories of liability: (1) violations of the Exchange Act and (2) breach of fiduciary duty claims.

\textbf{#MeToo: Securities Fraud and Shareholder Derivative Suits}

The private right of action under section 10(b) can be implicated in the sexual harassment context when a company makes statements to the SEC concerning its board’s integrity; success; or any ongoing investigations, which is the basis for one of the current suits against Steve Wynn, Wynn Resorts, and its various officers.\textsuperscript{19} In the class action that was brought in that matter, investors alleged violations of sections 10(b) and 20(a) based on the board’s alleged failure to disclose the CEO’s “pattern of sexual misconduct” in light of the alleged false statements that it previously made to the SEC that any reported violations of the company’s “code of business conduct” would be “taken seriously and promptly investigated.”\textsuperscript{20} The plaintiffs alleged that the company was under a duty to disclose the alleged “decades-long pattern of sexual misconduct” by Wynn, which has since been made public, and the ensuing arbitration against the company and its CEO.\textsuperscript{21}

In the context of sexual harassment, officers and directors can breach their duties by sexually harassing employees or failing to monitor or investigate known sexual harassment claims.

Similarly, last year, shareholders sued Signet Jewelers, which sells jewelry through Kay Jewelers and Zales, and its CEO, Mark Light, for violations of the anti-fraud provisions of sections 10(b) and 20(a) of the Exchange Act.\textsuperscript{22} The lawsuit in that case alleged that the company failed to disclose a nearly decade-old arbitration involving claims by approximately 69,000 female employees who had alleged a corporate culture of sexual harassment and discrimination that included a number of executives, including Light.\textsuperscript{23} The plaintiffs alleged violations of section 10(b) and Rule 10b-5 as a result of, among other things, the board’s failure to properly disclose the harassment and the board’s misleading statements and omissions “that caused the price of Signet common stock to be artificially inflated during the Class Period.”\textsuperscript{24} A month before the plaintiffs filed their complaint, the Washington Post published an article detailing the sexual harassment claims.\textsuperscript{25} While Light is not nearly as synonymous with the Signet brand as Harvey Weinstein is with the Weinstein Company or Steve Wynn is with Wynn Resorts, the Signet brand name was damaged by the news of the sexual harassment claims and Light’s alleged participation in activity by “top male managers,” including dispatching scouting parties to stores to find female employees they wanted to sleep with, laughing about women’s bodies in the workplace, and pushing female subordinates into sex by pleading better jobs, higher pay or protection from punishment.\textsuperscript{26}

 Plaintiffs alleged that these actions caused the company’s stock to fall nearly 13 percent and its common stock price to fall 58 percent from its class period high.\textsuperscript{27}

An example of an application of a derivative action arising from sexual harassment claims can also be found in the suit filed by the shareholders of Wynn Resorts, which alleged that the board and its CEO breached their fiduciary duties by failing to effectively exercise oversight over Wynn Resorts and its CEO by “failing to police, investigate and act . . . to address the known credible allegations of intentional egregious misconduct and violations of law by Steve Wynn involving Wynn Resorts.”\textsuperscript{28} The derivative complaint details the board’s alleged knowledge of decades-long sexual harassment by Wynn (which allegedly included, on numerous occasions, instructing a massage therapist employed at Wynn’s Las Vegas spa to touch his genitals), including the board’s specific knowledge of an alleged rape by
To allege a breach under Caremark, a plaintiff must show 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.”

(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, [they] consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

Directors may be liable under a Caremark theory where “red flags” are “waived in one’s face or displayed so that they are visible to the careful observer.” Because sexual harassment often involves surreptitious conduct, this can make a breach of fiduciary duty claim for failure to monitor and exercise oversight challenging. Nonetheless, where evidence of a systemic failure by the board to address a pattern of sexual harassment involving various red flags of misconduct that the board fails to address can be shown, such a claim may have legs.

In the past, plaintiffs were unsuccessful in efforts to pursue shareholder derivative suits arising out of alleged sexual harassment based on a Caremark theory of liability. As a relatively recent example, shareholders of American Apparel brought suit against the company, several directors, and the CEO in 2010 and then again in 2014, alleging that the board breached its fiduciary duties with regard to the CEO’s sexual harassment. A California district court dismissed the 2010 complaint, holding that bare allegations of the CEO’s sexual tendencies could not meet the high threshold imposed by Caremark. As more sexual harassment allegations arose, shareholders of American Apparel brought suit again in 2014. Yet again, however, the court concluded that plaintiffs had failed to show that the American Apparel board demonstrated a conscious disregard for its responsibilities when it “eventually did investigate, then suspended, and ultimately terminated [the CEO].”

The changing landscape. This challenging past history notwithstanding, it appears that the tide may be about to turn. Allegations involving a lengthy history of sexual harassment over many years, knowledge by the corporate boards of directors of their companies of this conduct, and conduct arguably designed as much to conceal and enable the harassing behavior as to provide recompense to the victims and avoid negative publicity could prove to be sufficient to meet this standard.

For instance, in DiNapoli v. Wynn, the New York State comptroller’s office and several pension funds filed a derivative suit against Steve Wynn and Wynn Resorts’
board of directors and officers, alleging that the board breached its fiduciary duties

... based on a decades-long pattern of sexual abuse and harassment by Steve Wynn that remained unchecked, tacitly permitted, and eventually covered up by Defendants, resulting in a breach of their duty of loyalty and other fiduciary duties to stockholders.42

The plaintiffs in this case tracked the language of a Caremark theory in their amended complaint, filed on March 23, 2018, alleging that the board failed to act “in the face of known and credible allegations.”43 In addition, the board members

... intentionally and knowingly breached their fiduciary duties by failing to implement internal controls that would alert them to the hostile work environment created by Steve Wynn’s widespread sexual harassment and abuse, which was repeatedly reported to senior Company Officials

... since at least 2005, and concealed his sexual misconduct from the stockholders by repeatedly misrepresenting the company’s corporate governance framework.44 Based on these allegations, it appears that the plaintiffs may have enough to meet the Caremark standard.45

Similarly, in Asbestos Workers’ Philadelphia Pension Fund v. Hewitt, a pension fund filed a derivative class action against several directors and officers of Liberty Tax and its CEO, John Hewitt, stemming from Hewitt’s alleged widespread sexual harassment that was claimed to have irreparably damaged the company and caused it to pay out settlements and enter into unfair transactions.46 In the complaint, plaintiffs allege that Hewitt breached his fiduciary duty by not only engaging in inappropriate sexual activity in the workplace and using company resources for his own “sexual gain” but also, after being fired for such conduct in September 2017,

... disloyally wielding corporate governance powers as Liberty’s controlling stockholder and Chairman of the Board to, in effect, vacate the Board’s decision, reestablish himself as the de facto sole power at the Company and make it intolerable for anyone but the most loyal to serve on the Board or in senior management.47

While the complaint against Liberty Tax did not track the language of a Caremark claim or explicitly allege a failure to monitor or oversee claim against the board of directors (most likely because the board fired Hewitt after an independent investigation two months prior), the plaintiffs did allege that several of the Hewitt-loyal individual directors breached their fiduciary duties (1) by rendering the corporate governance of the company “so dysfunctional that independent directors were unable to exercise their own respective fiduciary duties, causing them to resign,” and (2) by terminating the independent director recruitment process.48

Recent/Upcoming Legislation

In reaction to the spate of revelations of sexual harassment by senior corporate officers and directors over many years, a variety of legislation has been proposed or passed with the objective of making it more difficult to conceal such conduct. This has taken place on both the state and federal levels.

For example, on December 22, 2017, Congress passed the Tax Cuts and Jobs Act, which includes an amendment that focuses exclusively on a company’s sexual harassment claims. The amendment, entitled “Payments related to sexual harassment and sexual abuse,” provides thus:

No deduction shall be allowed under this chapter for—

(1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or

(2) attorney’s fees related to such a settlement or payment.49

This amendment theoretically could have far-reaching financial implications for companies going forward because most settlements for sexual harassment claims are accompanied by a nondisclosure agreement.

However, recent state legislation on the use of nondisclosure agreements actually may curb the impact of this amendment on a company. As of April 5, 2018, the New York legislature passed a bill that prohibits employers from including a nondisclosure agreement in any settlement of a sexual harassment claim unless the complainant is the party to request it.50 In addition, this legislation will prohibit employers from requiring employees to contractually agree to arbitrate sexual harassment claims.51 New York Governor Andrew Cuomo signed the legislation into law on April 12, 2018.52 New Jersey and California also are contemplating similar legislation regarding nondisclosure agreements.53

Moreover, California lawmakers have proposed legislation to extend the statute of limitations for employment-related sexual harassment claims under California’s Fair Employment and Housing Act from one year from the date upon which the unlawful
practice occurred to three years.\textsuperscript{54} Several other states are considering similar legislation to extend the statute of limitations for plaintiffs to file a civil suit or for district attorneys to prosecute related cases, including Massachusetts, Michigan, Missouri, New York, Vermont, Washington, and Wisconsin.\textsuperscript{55}

While we have yet to see what financial impact any of this legislation will have on companies, it is sure to put a company more at risk and change the way that it addresses allegations because negotiated resolution of sexual harassment claims will be more and more difficult going forward to keep secret, and the time frame within which such claims can be brought is likely to be broadly expanded.

Managing/Mitigating the Risk
D&O, EPLI, and related coverage. Traditionally, companies have sought to manage the risks presented by the potential for sexual harassment by officers and directors principally through the purchase of EPLI and directors and officers (D&O) policies, which include EPL coverage. These policies, however, have limits to their coverage.

As EPLI coverage is intended to cover claims brought by employees, standard EPLI policies may not extend to claims brought by third parties.\textsuperscript{56} Most D&O and EPLI policies also exclude coverage for claims of bodily injury, which means that an insurer will not cover claims for any type of touching, rape, assault, or battery. Additionally, both EPLI and D&O policies may have various other exclusions, including an exclusion for criminal acts, fraud, and dishonesty. On the other hand, emotional distress and anguish associated with any bodily injury may be covered under an EPLI policy, and stand-alone policies such as sexual abuse and molestation policies are available to protect management, employees, and the entity against allegations of abuse, molestation, or mistreatment of a sexual nature. Further, the exclusion for fraud and dishonesty typically requires final adjudication to apply.

It also should be noted that D&O insurance is intended to cover claims for the “wrongful acts” of a company’s directors and officers, but only if the director or officer was acting within the course and scope of his/her employment when committing the act. Accordingly, a gap in coverage may occur if the director or officer committed the wrongful act outside the scope of employment.

A gap in coverage may occur if the director or officer committed the wrongful act outside the scope of employment.\textsuperscript{57} D&O policies also typically contain an “insured versus insured” exclusion, which may operate to preclude coverage for claims made by an employee deemed an insured person under the policy terms against an executive and/or the company insured under the policy. And while damage to the company’s reputation from the disclosure of either claims of sexual harassment by senior corporate management or a culture that encourages or ignores rampant sexually harassing behavior may pose perhaps the biggest financial risk to the company, D&O policies may not afford coverage for the cost of retaining a public relations firm to respond to the situation.\textsuperscript{58}

Another issue to be aware of is that D&O and EPLI policies provide claims-made coverage and thus provide coverage for claims made against a policyholder only during a specified period. Claims-made policies generally require that a policyholder timely report any claim made against it to the insurer, which may be a period of thirty days. Accordingly, gaps in coverage may arise when a company fails to report promptly a sexual harassment claim to an insurer or assumes that a previous or future claim is covered by its policy.

Gaps in coverage can also arise through a prior acts or prior litigation exclusion, which excludes coverage for claims involving facts or occurrences that either were the subject of prior litigation or commenced before the start of coverage.\textsuperscript{59} Under this exclusion, an insurer can deny coverage where there are common facts between the prior claim and the current claim. If, for example, a company receives a books and records demand that includes certain allegations of potential wrongdoing, an insurer could potentially deem that demand a prior or pending litigation for purposes of the exclusion.

Moreover, companies should be aware of the aggregate limit of liability and per-claim deductibles in their policies’ terms. Specifically, claims that arise out of the same or related events are treated as a single claim starting from the earliest date that the claim is reported.\textsuperscript{60} As such, separate lawsuits, related class action complaints, and suits filed by multiple plaintiffs may be deemed to create a single claim subject to a single maximum limit of liability.
and only one claims-made policy.63 This will have an impact in the sexual harassment context when plaintiffs file various complaints stemming from the same wrongs, the same pattern of sexual harassment, and the same breaches of fiduciary duty—as evidenced by the various suits filed against Wynn and the directors and officers of Wynn Resorts.

Insurers can also refuse coverage when a policyholder previously made misrepresentations on its policy application. For instance, in *Zion Christian Church v. Brotherhood Mutual Insurance Co.*, the U.S. Court of Appeals for the Sixth Circuit found that an insurer could reject coverage where the insured made several misrepresentations on its application by concealing past sexual conduct.64 Similarly, a federal judge rescinded two D&O policies because the company failed to disclose past sexual harassment claims against its CEO on its policy applications.65 When filing applications, companies must confirm the accuracy of all statements made in applications or risk a lapse in coverage.

**SEC reporting duties.** As the Weinstein and Wynn cases evidence, an important part of risk management is being conscious of a possible need to report sexual harassment claims on the company’s public filings. It is abundantly clear that such claims can have a material impact on the firm’s business and stock price, so it no longer will be valid to assume that settlements of such claims have fully addressed the pertinent issues.

**Employment policies and sexual harassment claims.** Lastly, there needs to be a renewed focus on monitoring and enforcing the company’s sexual harassment policies. While insurance may cover the financial costs of a suit and any resulting settlement, the revelations emerging as a result of the #MeToo movement should cause boards to be warier of what might be lurking quietly beneath the surface. There is naturally a presumption that the individuals you entrust with the management and operations of your business are going to comport themselves appropriately, but “assuming the best” is not a viable risk-management policy—certainly not in the times that we now live in. Furthermore, it is dangerous to assume that just because the company has written policies in place, employees are fully aware of their rights and feel safe and comfortable reporting sexual harassment.

**Conclusion**

Even in the current climate, it is still unlikely that there will be successful securities fraud actions based on alleged misrepresentations stemming from a corporation’s aspirational statements regarding (1) a refusal as a matter of policy to tolerate harassment or (2) a practice of consistently promoting a culture committed to honest and ethical conduct. But if a complaint sets forth specific allegations of abhorrent ongoing conduct by senior management and/or a widespread toxic culture, there is a much greater likelihood that the complaint will survive a motion to dismiss. Indeed, the most likely basis for a successful securities fraud or shareholder derivative action is allegations of knowledge of ongoing and continuing sexual harassment and other sexual misconduct—which potentially expose the corporation to significant liability and have the capacity to do substantial damage to the corporate brand—coupled with efforts to insulate particular officers and directors from the consequences of such conduct and conceal such conduct via confidential settlements.

While one might think that these types of circumstances are rare, the fact of the matter is that the #MeToo movement has lifted what was previously a very large and protective boulder and, in the process, has given the world a peek at some very ugly things crawling around underneath. As such, it can be reasonably anticipated that claims of this sort are more likely to grow in the short term, particularly in the realm of the shareholder derivative suit against the small to midsize privately held corporation dominated by an individual around whose entrepreneurial aptitude the company has been built.

Corporate awareness of the risk presented by this behavior and the implementation of systemic processes to meet the risk are critical so that the lessons currently being taught by the #MeToo movement quickly become lessons learned. In order to address this developing risk, professors Daniel Hemel and Dorothy Lund offer a useful list of suggestions for boards to consider going forward in an effort to both avoid the risk altogether and attempt to manage it as claims may arise:

- Take stock of their companies’ past responses to sexual harassment claims and, in so doing, identify repeat offenders so that they can be weeded out.66
- Review their companies’ procedures for handling complaints, and take steps to ensure that employees are fully aware of and feel comfortable reporting misconduct.66
- Ensure that policies providing for “meaningful consequences” for harassers are in place (including empowering managers to impose sanctions ranging from reprimands to bonus reductions to termination for...
repeat offenders).67
• When confronted with allegations of sexual harassment by corporate officers or widespread harassment throughout the company, hire outside counsel to conduct a thorough investigation of the claims.58
• Approve the use of corporate funds to pay liability- and litigation-related expenses only in those instances where an internal investigation has been undertaken and it has been concluded that those claims are unfounded.69
• Accept that even in cases where the target of the allegations is a CEO who is associated with the company’s brand, there is misconduct that rises to the level of a fireable offense, and that “[t]he damage to a firm’s value from losing an iconic CEO may be far less than the reputational consequences of a high-profile sexual harassment scandal.”70
• Consider whether statements in their SEC filings might be misleading if sexual misconduct claims emerge.71

Additionally, boards need to consider carefully the insurance coverages in place, what is and is not likely to be covered, and the issues that potentially may arise in regard to insurance claims:
• Analyze the company’s D&O and EPLI policies to make sure that they provide the levels of coverage necessary to meet the risks presented. This includes careful consideration of per-claim deductibles and aggregate limits.
• Take stock of the complaints that have been resolved via settlement and whether the continued employment of particular repeat-offender directors and officers, because of the new dynamic, may present much greater exposure to financial risk than previously anticipated.
• Make sure that knowledge and awareness of claims have been fully vetted at the time of the policy application.
• Consider the purchase of coverage for retention of a public relations firm to handle crisis management.

As Ben Franklin famously stated, “By failing to prepare, you are preparing to fail.” For corporate boards, the #MeToo movement is a call to action—and none too soon.

Corporate awareness of the risk presented by this behavior and the implementation of systemic processes to meet the risk are critical so that lessons taught by the #MeToo movement quickly become lessons learned.

Notes
1. An excellent discussion of some of these cases can be found in Daniel Hemel & Dorothy S. Lund, Sexual Harassment and Corporate Law, Colum. L. Rev. (forthcoming 2018).
7. Recent developments indicate that the trend evidenced by these cases is just getting started and that a number of similar claims will be brought going forward. For example, as this article was being readied for print, a federal securities class action complaint, Danker v. Papa John’s International, Inc., was filed in the U.S. District Court for the Southern District of New York. No. 1:18-cv-07927 (S.D.N.Y. Aug. 30, 2018). The suit alleges that throughout the class period (alleged to run from February 25, 2014, through July 19, 2018, when an article was published in Forbes magazine entitled “The Inside Story of Papa John’s Toxic Culture” and Papa John’s stock price fell $2.60 per share),
defendants (including Papa John's International, Inc. (Papa John's) and John H. Schnatter (Schnatter), the company's founder) made materially false and misleading statements regarding Papa John's business, operational, and compliance policies:

Papa John's executives, including Defendant Schnatter, (i) had engaged in a pattern of sexual harassment and other inappropriate workplace conduct at the Company; (ii) Papa John's Code of Ethics and Business Conduct was inadequate to prevent the foregoing misconduct; (iii) the foregoing conduct would foreseeably have a negative impact on Papa John's business and operations, and expose Papa John's to reputational harm, heightened regulatory scrutiny, and legal liability; and (iv) as a result, Papa John's public statements were materially false and misleading at all relevant times.

Id. ¶ 4. Asserting claims for violation of sections 10(b) and 20(a) of the Exchange Act, plaintiffs allege that Papa John's filed 10-Ks each year during the class period that failed to disclose that Schnatter had spied on workers and engaged in sexually inappropriate conduct, which resulted in at least two confidential settlements. Id. ¶ 47. Another recent suit is Luctak v. National Beverage Corp., pending in the U.S. District Court for the Southern District of Florida, No. 0:18-cv-61631-KMM (S.D. Fla. July 17, 2018). The suit involves claims brought under the Exchange Act based on violations of sections 10(b) and 20(a) against the company that owns La Croix, National Beverage Corp., and its chief executive officer and executive vice president. The complaint alleges that the defendants failed to disclose that its CEO engaged in a pattern of sexual misconduct between 2014 and 2016 despite stating that it "absolutely prohibited" sexual harassment and actively enforced its anti-harassment policy. Id. The complaint goes on to allege that, in July 2018, the Wall Street Journal reported the CEO's sexual misconduct in an article that detailed that two pilots had previously filed lawsuits alleging that National Beverage's CEO "engaged in repeated unjustified, unwanted and uninvited grabbing, rubbing and groping of [plaintiff's] leg in a sexual manner, reaching up towards [plaintiff's] sexual organs." Id. With regard to the recent allegations of sexual harassment by Les Moonves, no suits had been filed at the time this article went to print, but it is anticipated that litigation in the form of securities fraud and/or a shareholder derivative suit likely will be in the offing. These allegations are detailed in an August 2018 New Yorker article by Ronan Farrow, Les Moonves and CBS Face Allegations of Sexual Misconduct, New Yorker, Aug. 8, 2018.

17. See, e.g., Fair Employment and Housing Act, Cal. Gov't Code § 12940(C) (West 2018):

For purposes of this subdivision, “harassment” because of sex includes sexual harassment, gender harassment, and harassment based on pregnancy, childbirth, or related medical conditions. Sexually harassing conduct need not be motivated by sexual desire.


The State and City Human Rights Laws apply the same Federal standards for determining quid pro quo and hostile environment sexual harassment claims, and differ only in that the City law allows for the recovery of punitive damages.

20. Id. ¶¶ 4–5, 25–27, 45.
21. Id. ¶¶ 4–5, 49–50.
22. See Complaint, Irving Firemen’s Relief & Ret. Fund v. Signet Jewelers,
27. See id.; see also Harwell, supra note 25.
29. Id.

[T]o establish oversight liability a plaintiff must show that the directors knew they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities such as by failing to act in the face of a known duty to act.

41. Id.
43. Id. ¶ 131.
44. Id. (emphasis added).
45. For a more in-depth analysis of the various claims that a plaintiff may bring against a company and the implications of sexual harassment on corporate law, see the recent and insightful article by Daniel Hemel and Dorothy S. Lund in the Columbia Law Review. See supra note 1.
48. Id.
50. S. 7507C, 2017–2018 Leg. Sess., subpt. D (N.Y. 2018), www.nysenate.gov/law/citation/bills/2017/7507 (last visited May 24, 2018): Non-disclosure agreements. Notwithstanding any other law to the contrary, no employer, its officers or employees shall have the authority to include or agree to include in any settlement, agreement or other resolution of any claim, the factual foundation for which involves sexual harassment, any term or condition that would prevent the disclosure of the underlying facts and circumstances to the claim or action unless the condition of confidentiality is the complainant’s preference.

(amending general obligations law with new § 5-336).
lawyers-rethink-confidentiality-idUSKB161ED1DM.


55. Rebecca Beitsch, #MeToo Movement Has Lawmakers Talking About Consent, HUFFINGTON POST (Jan. 24, 2018), www.huffingtonpost.com/entry/metoo-movement-has-lawmakers-talking-about-consent_us_5a6758de4b06bd14be5067f.

56. That said, many modern forms have incorporated insuring agreements or optional coverage for discrimination and harassment claims brought by third parties such as customers, clients, and vendors.


58. Some D&O policies offer crisis fund-type coverage; however, whether such coverage may apply in any given situation will depend on the applicable facts and the policy’s wording.


60. See id. §§ 47:13, 74:26.

61. Id.

62. See 126 F. App’x 235 (6th Cir. 2005).


64. A useful article summarizing some of the issues to consider with regard to D&O insurance for sexual misconduct can be found at LaCroix, supra note 57.

65. See Hemel & Lund, supra note 1, at 57.

66. Id. at 58.

67. Id.

68. Id. at 59.

69. Id.

70. Id. at 60.

71. Id.
Preventing Liability for Sexual Harassment by Creating a Culture of Civility
By Joan M. Gilbride

Given the close quarters, intense pressures and at times informality of communication surrounding the provision of medical care, it is no wonder that healthcare facilities can be breeding grounds for harassment and sexual misconduct allegations and claims. Unlike an office setting, a hospital environment exposes patients and coworkers as potential victims of harassment, which not only often leads to lawsuits, but also negative publicity, legal fees and all types of complications and complexities. To avoid this quagmire, it is important that risk managers are aware of potential liability and ways to foster a safe working environment at a healthcare facility.

The seriousness of preventing sexual harassment and sexual misconduct grabbed the public’s attention when earlier this year, a shocking news story reported a Mt. Sinai emergency room doctor was indicted for sexual assault of a patient. In graphic detail, the reporter described the sexual assault alleged by a patient who was sedated, but aware that she was being violated by a physician, and incapable of reacting. The type of sexual misconduct described by this patient is a nightmare for the patient and the hospital and, thankfully, happens rarely. To prevent this type of conduct and less egregious variations, it is crucial that employers implement training programs to promote an environment that encourages civility, peer reporting and clear avenues for complaining of sexual harassment and sexual misconduct in the healthcare profession.

As a first step, the employer must be aware of the risks before deciding which tactics would be most effective in preventing liability and determine whether its workplace culture needs to be transformed.

Risk Factors for Sexual Harassment and Sexual Misconduct

In June 2016, the United States Equal Employment Opportunity Commission (EEOC) Select Task Force on the Study of Harassment in the Workplace (the “Task Force”) released a report. In its report, the Task Force identified factors that increase the likelihood of harassment in a workplace, which include characteristics typical of healthcare environments, such as: “high value” employees, significant power disparities, and decentralized workplaces. Based on these factors, hospitals and healthcare facilities are extremely susceptible to allegations of a hostile work environment based upon harassment and indeed, to unknowingly allowing such circumstances to develop. The Task Force also noted that in addition to the expected legal and financial implications of sexual harassment, harassed employees were found to be less productive, and employers often suffered reputational damage and risked losing patients.

Understanding Potential Liability for Healthcare Facilities

In egregious events of sexual misconduct (like the case of the emergency room doctor at Mt. Sinai), under New York law, healthcare facilities face risks to the extent that the conduct was foreseeable. A hospital may be able to defend successfully against liability for a doctor’s outrageous or near criminal behavior, but not against a hostile work environment that breeds such behavior. It is essential that healthcare facilities implement procedures to prevent harassment and successfully defend against allegations of harassment regardless of the legal risks.

A hospital’s duty to protect patients and visitors as a caretaker is governed by a standard of foreseeability. New York courts have limited the duty to protect persons lawfully present on a hospital’s premises from the reasonably foreseeable criminal or tortious acts of third persons. For example, a New York hospital faced potential liability when a male nurse assistant allegedly sexually assaulted a female patient while preparing her for a surgical procedure. The court found in favor of the hospital and held that plaintiffs failed to show the hospital knew or should have known of the assailant’s propensity for the conduct that caused plaintiff’s injury. In a decision rendered by the Appellate Division, First Department, the court found that it was not reasonably foreseeable that a hospital’s independent contractor would sexually assault a patient while conducting her vaginal sonogram, and the patient therefore was not entitled to recover on her negligent supervision claim against the hospital. In that case, the court considered the sufficiency of the independent contractor’s background check on its employee and examined whether the hospital was on notice of the independent contractor’s employee’s potential for violence or sexual abuse. The hospital was lucky that its independent contractor thoroughly vetted its employee and plaintiff failed to rebut the lack of reasonable foreseeability based on the background check. Although the court found in favor of the healthcare facility in these cases where patients sued, when a hospital is sued as an employer by its own employee, it is less likely to avoid liability.

In Salamon v. Our Lady of Victory Hosp., a former employee attempted to hold the hospital liable for conduct of a doctor on staff. The hospital argued it was not liable as a matter of law for the harassing conduct of a doctor who was not an employee, but an independent contractor. The federal district court in Salamon denied the hospital’s motion for summary judgment, finding the Second Circuit had not definitively ruled on the question of whether an employer can be liable for a non-employee’s harassing conduct. The court recognized, however, that the Second Circuit limited any potential liability for non-employees to “instances in which the employer provided no reasonable avenue of complaint or knew of the harassment but did nothing about it.” Thus, an employer could be exposed to liability for even a non-employee’s conduct if the employer does not have a complaint procedure in
place. As such, not implementing a complaint procedure or failing to educate your employees about an existing procedure can exponentially increase risk.

Harassment often involves multiple missteps by more than one employee. A recent case involved allegations of harassment against a nurse’s colleague where one long term pediatric nurse alleged she was harassed by another long term nursing employee; the harassment included late night phone calls, adjusting the plaintiff’s label on her underwear and discussing plaintiff’s medical history with other employees. In addition, plaintiff claimed that she suffered harassment from her treating physician, a surgeon who worked at the same facility and made comments to her while at work that she perceived as references to her personal medical history. For instance, her physician referenced the movie 40 Year Old Virgin, teased plaintiff about getting pregnant when she mentioned taking vacation to visit a male friend, and made comments about her not having children. Plaintiff also alleged that she complained to human resources about the harassment, but nothing was done. In the Complaint, plaintiff implicates several actors who allegedly contributed to her damages: a fellow nurse, a doctor, and human resources staff. The court denied the hospital’s motion to dismiss as to negligent retention and supervision, hostile work environment, sexual harassment, and disability discrimination.

Another scenario which has potential for posing great risk to healthcare facilities is relationships that might occur between interns and residents in medical teaching facilities. If the facility allows or empowers a resident in his or her second year of postgraduate residency (PGY2) to supervise and direct a first year postgraduate student (PGY1), the facility may be liable for sexual harassment based on PGY2’s behavior. It is not hard to imagine two postgraduate students dating, but if a PGY2 uses his or her supervisory position to persuade the PGY1 to go on a date, this can pose serious risk for the hospital. Environments where supervisors do not constantly observe their subordinates, and are not trained to spot troubling inappropriate behavior, are more likely to breed a culture of acquiescence rather than a culture of civility. Managers and supervisors are the heart of an employer’s prevention system.

**Implementing Solutions**

Regardless of the legal outcome, the defendants will be forced to pay substantial legal fees and the incident can have lasting effects on the hospital’s reputation. Accordingly, preventative measures are in everyone’s best interest. As noted previously, to create a culture in which employees believe that the organization will not tolerate harassment, managers and supervisors must receive clear messages of accountability. Compliance training translates those expectations into concrete actions that managers and supervisors are expected to take – either to prevent harassment or to stop and remedy harassment once it occurs. Employers should begin by taking complaints of sexual harassment and misconduct made against their current employees very seriously and evaluating current employees to ensure employees who demonstrate a propensity toward such misconduct are not retained.

Compliance training provides managers and supervisors with easy-to-understand and realistic methods for dealing with harassment that they observe, that is reported to them, or of which they have knowledge or information. This includes practical suggestions on how to respond to different levels and types of offensive behavior, and clear instructions on how to report harassing behavior up the chain of command. Training should also stress the affirmative duties of supervisors to respond to harassing behavior, even in the absence of a complaint. This training should be tailored to the specific worksite, organization, and/or industry, so that the examples used are helpful to managers and supervisors.

The EEOC encourages strong anti-harassment policies that provide a clear explanation of prohibited conduct and assurance of protection from retaliation. Compliance training is essential, but focusing on steps to avoid legal liability may fall short of preventing a hostile work environment and a culture of harassment. The EEOC recommends creating a culture of civility by training with specific goals in mind as a “holistic effort” to prevent harassment, which should also include accountability and leading by example.

The goals of training should be to educate employees and supervisors, to ensure that employees understand what is considered harassment in the workplace and empower supervisors by creating procedures for complaint follow-up. Understanding what is not appropriate is the first step towards preventing a volatile work environment or changing an already toxic one. The EEOC also suggests that trainings educate employees about the external consequences (including reputational harm) of conduct that rises to the level of illegal harassment. A senior leader’s attendance at the training is the strongest expression of support. As an alternative, a video of a senior leader introducing the training could be shown, or a memo from leadership sent prior to the training. Trainings should be interactive and take place at least every other year to demonstrate the employer’s commitment to preventing harassment. Also, the trainings should evolve to ensure they are relevant and grab employees’ attention with new content.

The EEOC Task force recommends “bystander intervention training” and “civility training” given that incivility is a harbinger of a hostile work environment. This type of training focuses on what employees and
supervisors should do, rather than what they should not do. The training alone, however, is not enough. The employers who are most successful in preventing harassment have taken other steps to convince employees that they will not be tolerant of sexual harassment. The EEOC suggests that prior to training, employers should provide their employees with avenues for complaints (such as a hotline).

A proactive employer that is focused on creating an environment of civility through adequate training and leadership will reduce the likelihood of sexual harassment and sexual misconduct in the workplace. These strategies not only make the workplace safer, but lower the possibility of flagrant sexual misconduct as well as liability and the economic and intangible impact on an employer’s business.

REFERENCES ON PAGE 32

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Oceanus RRG was put into liquidation, what should we learn from this?

By Phalanx Healthcare Solutions

South Carolina Department of Insurance has formally executed the liquidation order effective September 21, 2017 after adverse development in the malpractice insurer’s claims reserves. Simply put, Oceanus no longer has the assets to meet their claim obligations.

Oceanus, as recently as 2013, was the sixth largest writer of physician malpractice liability in New York but in 2016 their premium volume decreased by over 40%. This decrease coupled with an increase in claim reserves due to adverse loss development reduced their policyholders’ surplus (net assets) to negative $6M and placed the company in extreme financial distress (per the Oceanus June 30, 2017 statutory statement).

What is most unsettling about this is that providers who are currently insured with, or that have purchased “tail” coverage with Oceanus, may be personally responsible for existing or future claims made against them. Providers paid hard earned dollars to a company that may be unable to uphold their responsibility to their insureds.

Frequently Asked Questions about the Oceanus Insurance RRG Liquidation (source: oceanusinsurance.com):

1. What is a liquidation proceeding?

Liquidation is a type of receivership and is similar to bankruptcy. The South Carolina Insurance Code authorizes the Director of the South Carolina Department of Insurance, in his or her capacity as Liquidator, to liquidate the insurance company. The Liquidation Order directs the Liquidator, to (i) take possession of and safeguard the property of the insurer, (ii) conduct the insurer’s business, and (iii) take such steps needed to liquidate (wind-up the affairs of) the business of the insurer under the supervision of the Court and as the Court may direct.

2. What happens to my coverage under my Oceanus policy?

All policies in effect at the time of the issuance of the Liquidation Order continue only for the lesser of: 1) 30 days from the date of entry of the Liquidation Order (10/21/17 at 11:59 p.m. EDT) 2) the expiration of the policy coverage 3) the date the coverage has been replaced with equivalent insurance with another insurer or otherwise terminated the policy or 4) the Liquidator has effected a transfer of the policy obligation pursuant to Item (8) of subsection (a) of Section 38-27-400.
ARTICLE REFERENCES

Sexual Liability ……………………………………… from page 17

3. Id. at Section D.
8. Id.
9. Id. see also Heskin v. Insite Advertising, Inc., No. 03-cv-2598, 2005 WL 407646, at *20–21 (S.D.N.Y. Feb. 22, 2005) (holding that an employer can be held liable for the harassing acts of non-employees if a plaintiff’s “[a]dd[ed] evidence tending to show that [the employer] either failed to provide a reasonable complaint procedure or that it knew of [the] harassment by [a non-employee] and failed to take any action”).
11. This particular allegation involved plaintiff’s medical records being improperly accessed by another NYU employee raises HIPAA violations that are beyond the scope of this article, but are very important issues to address given the advent of electronic medical records.
12. Because it is common for healthcare professionals to receive treatment where they work, employers in this setting must impose a higher than normal standard of respect between employees.

EHR In Malpractice Litigation …………………………… from page 22

10. EHRs have existed for some time, but their prevalence increased after the passage of the Health Information Technology for Economic and Clinical Health (HITECH) Act of 2009, which promotes the adoption and meaningful use of health information technology i.e. the EHR. Mangalmurti, supra.
13. Id.
16. Levinson, supra.
20. Id.
21. Id.
24. Id.
27. Id.
28. Id. see generally, Mullins v. Edens, 493 F.3d 836 (D.C. Cir. 2007).
29. Id.
30. Id.
31. Id.
33. Id.
34. Id.
37. Id.
Managing EPL and Management Liability Risks in the Wake of the #MeToo and #Times Up Movements

I. Overview of EPL Litigation in Wake of MeToo and Times Up Movement (30 minutes)
   a. Analysis of Claim Trends by type, frequency and industry
   b. Discussion of How Movement has Impacted Settlement and Jury Perceptions
   c. New Legislation and Expected Impact
   d. What’s on the Horizon

II. Corporate Directors’ and Officers’ Liability stemming from Sexual Harassment Claims (30 minutes)
    a. Fiduciary Duties of Directors and Officers
    b. 10b-5 Securities Fraud Claims under the Securities Exchange Act
    c. Lessons Learned from High Profile Shareholder Litigation Resulting from EPL Claims

III. From the Trenches: Managing and Mitigating Risks (20 minutes)
    A. How to Minimize Risk if a Claim has Been Made Against You
       1) Initial Response and Investigation Process
       2) Coordinating Defense with Insurance Carrier
       3) Settlement Considerations
       4) Coverage Issues Presented in Claim Resolution
          a. Capacity Issues
          b. Other Insurance
          c. Uninsurable Exposure and Allocation

IV. Questions -10 minutes
Corporate D&O Liability and Sexual Harassment in the Workplace

By Peter J. Biging and Heather M. Zimmer

The #MeToo movement has spawned a new era for corporate America with regard to how we look at and what we do in response to allegations of sexual harassment. It has forced corporate America to give serious consideration to the manner in which to consider and manage the risks stemming from sexual harassment by corporate officers and directors.

While complaints of sexual harassment at work are not new, the revelation that the head of a film studio not only was permitted to pursue a decades-long career as a sexual predator but also, in fact, was enabled by corporate leadership to engage in such behavior has been met with a collective sense of horror. The practice of journalistic "catch and kill" to bury claims of sexual misconduct and grossly inappropriate behavior has drawn scrutiny, as well. And the spotlight is shining starkly on the manner in which corporations have placed a premium on "managing" the immediate financial risk presented by the claims and fallout from the allegations, and insulating individuals perceived to be key performers, rather than placing the focus on refusing to tolerate and taking aggressive action toward eradicating such behavior. All of this has revealed a corrosive culture that society at large now seems unwilling to tolerate.

Previously, ugly allegations might have been addressed quietly, settlement agreements might have been drawn up, and the individuals accused of such conduct might have been permitted to proceed in their leadership positions as if nothing had happened—with the excuse being that the individual's value to the company justified dealing with the allegations in this manner. Times have changed. While a company's stock price may not be impacted when allegations of sexual harassment first surface, a company has to consider the possibility that a serious financial risk can occur when a company does not deal with claims promptly, directly, and in a manner that evidences a corporate culture intolerant of such behavior.

An illustrative example can be seen in what happened when model Kate Upton accused the Guess cofounder of sexual harassment: shortly thereafter, the company's shares dropped nearly 18 percent, shedding roughly $250 million in value. As another example, Twenty-First Century Fox paid out an eight-digit settlement in 2016 for its mishandling of sexual harassment claims against Roger Ailes and Bill O'Reilly. Still another cautionary tale is told in how the market reacted to the lawsuits against Steve Wynn, Wynn Resorts, and his board of directors.
nondisclosure agreements presents a new risk.

The Securities Exchange Act of 1934
The Securities Exchange Act of 1934 (Exchange Act) regulates the secondary trading of securities and, under its antifraud provisions, makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange[,] . . . [t]o use or employ . . . any manipulative or deceptive device or contrivance [in selling securities].

The purpose of the Act is to create a mandatory disclosure process designed to force companies to make public information that investors would find pertinent in making investment decisions, and to provide a means of punishing individuals and companies that either make false or misleading statements about the company or make use of information not available to the public to enrich themselves at the expense of other investors.

A plaintiff may bring an action against a public company for violations of the antifraud provisions of the Exchange Act via the private right of action authorized pursuant to sections 10(b) and 20(a) of the Exchange Act. The claims brought under the Exchange Act arising from how a corporation has addressed complaints of sexual harassment generally have centered on a company’s duty to disclose and report the claims and risks presented thereby in its public filings made to the Securities and Exchange Commission (SEC), such as the annual 10-K and quarterly 10-Q filings.

Under Rule 10b-5, it is unlawful for a public corporation to make any untrue statements or omissions of a “material fact” that would render any statement made to the SEC “misleading.” Under Item 103 of Regulation S-K of the Securities Act of 1933, a public corporation also has an affirmative duty to disclose “any material legal proceedings” that are pending against it before a court or agency, as well as “any proceedings known to be contemplated by governmental authorities.” Additionally, under Item 303 of Regulation S-K, a company must disclose any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

The U.S. Court of Appeals for the Second Circuit has held that a company is required to disclose statements from Item 303 pursuant to section 10(b) filings.

The Fiduciary Duty Owed to Shareholders by Officers and Directors
Every officer and director of a company owes its company and shareholders fiduciary duties of care and loyalty, which, if violated, can subject them to a derivative action. A shareholder who brings a derivative action must either make a demand on the directors to bring a litigation or set forth particularized factual allegations in a complaint that such demand on the board would be futile by raising a reasonable doubt that either (1) the directors are disinterested and independent or (2) the board’s action was not a valid exercise of business judgment.

In the context of sexual harassment, officers and directors can breach their duties by sexually harassing employees (and, in so doing, intentionally act with a purpose other than that of advancing the best interests of the corporation) or failing to monitor or investigate known sexual harassment claims.

Sexual Harassment and the Risks Presented
The Equal Employment Opportunity Commission defines sexual harassment as “unwelcome sexual advances, requests for sexual favors, and other verbal or physical harassment of a sexual nature.” It is defined similarly in many state and city statutes. Sexual harassment does not have to be of a sexual nature for it to be unlawful;
sexual harassment also extends to offensive comments about a person’s gender.18

Until recently, sexual harassment claims were largely risk specific to the claimant, manageable through employment practices liability insurance (EPLI) coverage, and not likely to present a potential for risk in the form of securities fraud and/or shareholder derivative litigation. However, there have been a number of claims of recent vintage that should put every corporate leader on notice that these types of claims, and how they are handled, can pose such risks today—and in a very substantial way. These claims have been largely premised on two theories of liability: (1) violations of the Exchange Act and (2) breach of fiduciary duty claims.

#MeToo: Securities Fraud and Shareholder Derivative Suits

The private right of action under section 10(b) can be implicated in the sexual harassment context when a company makes statements to the SEC concerning its board’s integrity; success; or any ongoing investigations, which is the basis for one of the current suits against Steve Wynn, Wynn Resorts, and its various officers.19 In the class action that was brought in that matter, investors alleged violations of sections 10(b) and 20(a) based on the board’s alleged failure to disclose the CEO’s “pattern of sexual misconduct” in light of the alleged false statements that it previously made to the SEC that any reported violations of the company’s “code of business conduct” would be “taken seriously and promptly investigated.”20 The plaintiffs alleged that the company was under a duty to disclose the alleged “decades-long pattern of sexual misconduct” by Wynn, which has since been made public, and the ensuing arbitration against the company and its CEO.21

In the context of sexual harassment, officers and directors can breach their duties by sexually harassing employees or failing to monitor or investigate known sexual harassment claims.

Similarly, last year, shareholders sued Signet Jewelers, which sells jewelry through Kay Jewelers and Zales, and its CEO, Mark Light, for violations of the antifraud provisions of sections 10(b) and 20(a) of the Exchange Act.22 The lawsuit in that case alleged that the company failed to disclose a nearly decade-old arbitration involving claims by approximately 69,000 female employees who had alleged a corporate culture of sexual harassment and discrimination that included a number of executives, including Light.23 The plaintiffs alleged violations of section 10(b) and Rule 10b-5 as a result of, among other things, the board’s failure to properly disclose the harassment and the board’s misleading statements and omissions “that caused the price of Signet common stock to be artificially inflated during the Class Period.”24 A month before the plaintiffs filed their complaint, the Washington Post published an article detailing the sexual harassment claims.25 While Light is not nearly as synonymous with the Signet brand as Harvey Weinstein is with the Weinstein Company or Steve Wynn is with Wynn Resorts, the Signet brand name was damaged by the news of the sexual harassment claims and Light’s alleged participation in activity by “top male managers,” including dispatching scouting parties to stores to find female employees they wanted to sleep with, laughing about women’s bodies in the workplace, and pushing female subordinates into sex by pledges better jobs, higher pay or protection from punishment.26

Plaintiffs alleged that these actions caused the company’s stock to fall nearly 13 percent and its common stock price to fall 58 percent from its class period high.27

An example of an application of a derivative action arising from sexual harassment claims can also be found in the suit filed by the shareholders of Wynn Resorts, which alleged that the board and its CEO breached their fiduciary duties by failing to effectively exercise oversight over Wynn Resorts and its CEO by “failing to police, investigate and act . . . to address the known credible allegations of intentional egregious misconduct and violations of law by Steve Wynn involving Wynn Resorts.”28 The derivative complaint details the board’s alleged knowledge of decades-long sexual harassment by Wynn (which allegedly included, on numerous occasions, instructing a massage therapist employed at Wynn’s Las Vegas spa to touch his genitals), including the board’s specific knowledge of an alleged rape by
To allege a breach under *Caremark*, a plaintiff must show 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.”

(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, they consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

Directors may be liable under a *Caremark* theory where “red flags” are “waived in one’s face or displayed so that they are visible to the careful observer.” Because sexual harassment often involves surreptitious conduct, this can make a breach of fiduciary duty claim for failure to monitor and exercise oversight challenging. Nonetheless, where evidence of a systemic failure by the board to address a pattern of sexual harassment involving various red flags of misconduct that the board fails to address can be shown, such a claim may have legs.

In the past, plaintiffs were unsuccessful in efforts to pursue shareholder derivative suits arising out of alleged sexual harassment based on a *Caremark* theory of liability. As a relatively recent example, shareholders of American Apparel brought suit against the company, several directors, and the CEO in 2010 and then again in 2014, alleging that the board breached its fiduciary duties with regard to the CEO’s sexual harassment. A California district court dismissed the 2010 complaint, holding that bare allegations of the CEO’s sexual tendencies could not meet the high threshold imposed by *Caremark*. As more sexual harassment allegations arose, shareholders of American Apparel brought suit again in 2014. Yet again, however, the court concluded that plaintiffs had failed to show that the American Apparel board demonstrated a conscious disregard for its responsibilities when it “eventually did investigate, then suspended, and ultimately terminated [the CEO].”

**The changing landscape.** This challenging past history notwithstanding, it appears that the tide may be about to turn. Allegations involving a lengthy history of sexual harassment over many years, knowledge by the corporate boards of directors of their companies of this conduct, and conduct arguably designed as much to conceal and enable the harassing behavior as to provide recompense to the victims and avoid negative publicity could prove to be sufficient to meet this standard.

For instance, in *DiNapoli v. Wynn*, the New York State comptroller’s office and several pension funds filed a derivative suit against Steve Wynn and Wynn Resorts’
board of directors and officers, alleging that the board breached its fiduciary duties

based on a decades-long pattern of sexual abuse and harassment by Steve Wynn that remained unchecked, tacitly permitted, and eventually covered up by Defendants, resulting in a breach of their duty of loyalty and other fiduciary duties to stockholders.42

The plaintiffs in this case tracked the language of a Caremark theory in their amended complaint, filed on March 23, 2018, alleging that the board failed to act “in the face of known and credible allegations.”43 In addition, the board members

intentionally and knowingly breached their fiduciary duties by failing to implement internal controls that would alert them to the hostile work environment created by Steve Wynn’s widespread sexual harassment and abuse, which was repeatedly reported to senior Company Officials since at least 2005, and concealed his sexual misconduct from the stockholders by repeatedly misrepresenting the company’s corporate governance framework.44 Based on these allegations, it appears that the plaintiffs may have enough to meet the Caremark standard.45

Similarly, in Asbestos Workers’ Philadelphia Pension Fund v. Hewitt, a pension fund filed a derivative class action against several directors and officers of Liberty Tax and its CEO, John Hewitt, stemming from Hewitt’s alleged widespread sexual harassment that was claimed to have irreparably damaged the company and caused it to pay out settlements and enter into unfair transactions.46 In the complaint, plaintiffs allege that Hewitt breached his fiduciary duty by not only engaging in inappropriate sexual activity in the workplace and using company resources for his own “sexual gain” but also, after being fired for such conduct in September 2017, disloyally wielding corporate governance powers as Liberty’s controlling stockholder and Chairman of the Board to, in effect, vacate the Board’s decision, reestablish himself as the de facto sole power at the Company and make it intolerable for anyone but the most loyal to serve on the Board or in senior management.47

While the complaint against Liberty Tax did not track the language of a Caremark claim or explicitly allege a failure to monitor or oversee claim against the board of directors (most likely because the board fired Hewitt after an independent investigation two months prior), the plaintiffs did allege that several of the Hewitt-loyal individual directors breached their fiduciary duties (1) by rendering the corporate governance of the company “so dysfunctional that independent directors were unable to exercise their own respective fiduciary duties, causing them to resign,” and (2) by terminating the independent director recruitment process.48

Recent/Upcoming Legislation

In reaction to the spate of revelations of sexual harassment by senior corporate officers and directors over many years, a variety of legislation has been proposed or passed with the objective of making it more difficult to conceal such conduct. This has taken place on both the state and federal levels. For example, on December 22, 2017, Congress passed the Tax Cuts and Jobs Act, which includes an amendment that focuses exclusively on a company’s sexual harassment claims. The amendment, entitled “Payments related to sexual harassment and sexual abuse,” provides thus:

No deduction shall be allowed under this chapter for—

(1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or

(2) attorney’s fees related to such a settlement or payment.49

This amendment theoretically could have far-reaching financial implications for companies going forward because most settlements for sexual harassment claims are accompanied by a nondisclosure agreement.

However, recent state legislation on the use of nondisclosure agreements actually may curb the impact of this amendment on a company. As of April 5, 2018, the New York legislature passed a bill that prohibits employers from including a nondisclosure agreement in any settlement of a sexual harassment claim unless the complainant is the party to request it.50 In addition, this legislation will prohibit employers from requiring employees to contractually agree to arbitrate sexual harassment claims.51 New York Governor Andrew Cuomo signed the legislation into law on April 12, 2018.52 New Jersey and California also are contemplating similar legislation regarding nondisclosure agreements.53

Moreover, California lawmakers have proposed legislation to extend the statute of limitations for employment-related sexual harassment claims under California’s Fair Employment and Housing Act from one year from the date upon which the unlawful
practice occurred to three years. \(^{54}\) Several other states are considering similar legislation to extend the statute of limitations for plaintiffs to file a civil suit or for district attorneys to prosecute related cases, including Massachusetts, Michigan, Missouri, New York, Vermont, Washington, and Wisconsin. \(^{55}\)

While we have yet to see what financial impact any of this legislation will have on companies, it is sure to put a company more at risk and change the way that it addresses allegations because negotiated resolution of sexual harassment claims will be more and more difficult going forward to keep secret, and the time frame within which such claims can be brought is likely to be broadly expanded.

### Managing/Mitigating the Risk

**D&O, EPLI, and related coverage.** Traditionally, companies have sought to manage the risks presented by the potential for sexual harassment by officers and directors principally through the purchase of EPLI and directors and officers (D&O) policies, which include EPLI coverage. These policies, however, have limits to their coverage.

As EPLI coverage is intended to cover claims brought by employees, standard EPLI policies may not extend to claims brought by third parties. \(^ {56}\) Most D&O and EPLI policies also exclude coverage for claims of bodily injury, which means that an insurer will not cover claims for any type of touching, rape, assault, or battery. Additionally, both EPLI and D&O policies may have various other exclusions, including an exclusion for criminal acts, fraud, and dishonesty. On the other hand, emotional distress and anguish associated with any bodily injury may be covered under an EPLI policy, and stand-alone policies such as sexual abuse and molestation policies are available to protect management, employees, and the entity against allegations of abuse, molestation, or mistreatment of a sexual nature. Further, the exclusion for fraud and dishonesty typically requires final adjudication to apply.

It also should be noted that D&O insurance is intended to cover claims for the “wrongful acts” of a company’s directors and officers, but only if the director or officer was acting within the course and scope of his/her employment when committing the act. Accordingly, a gap in coverage may occur if the director or officer committed the wrongful act outside the scope of employment.

A gap in coverage may occur if the director or officer committed the wrongful act outside the scope of employment. \(^ {57}\) D&O policies also typically contain an “insured versus insured” exclusion, which may operate to preclude coverage for claims made by an employee deemed an insured person under the policy terms against an executive and/or the company insured under the policy. And while damage to the company’s reputation from the disclosure of either claims of sexual harassment by senior corporate management or a culture that encourages or ignores rampant sexually harassing behavior may pose perhaps the biggest financial risk to the company, D&O policies may not afford coverage for the cost of retaining a public relations firm to respond to the situation. \(^ {58}\)

Another issue to be aware of is that D&O and EPLI policies provide claims-made coverage and thus provide coverage for claims made against a policyholder only during a specified period. Claims-made policies generally require that a policyholder timely report any claim made against it to the insurer, which may be a period of thirty days. Accordingly, gaps in coverage may arise when a company fails to report promptly a sexual harassment claim to an insurer or assumes that a previous or future claim is covered by its policy.

Gaps in coverage can also arise through a prior acts or prior litigation exclusion, which excludes coverage for claims involving facts or occurrences that either were the subject of prior litigation or commenced before the start of coverage. \(^ {59}\) Under this exclusion, an insurer can deny coverage where there are common facts between the prior claim and the current claim. If, for example, a company receives a book and records demand that includes certain allegations of potential wrongdoing, an insurer could potentially deem that demand a prior or pending litigation for purposes of the exclusion.

Moreover, companies should be aware of the aggregate limit of liability and per-claim deductibles in their policies’ terms. Specifically, claims that arise out of the same or related events are treated as a single claim starting from the earliest date that the claim is reported. \(^ {60}\) As such, separate lawsuits, related class action complaints, and suits filed by multiple plaintiffs may be deemed to create a single claim subject to a single maximum limit of liability.
and only one claims-made policy.\textsuperscript{61} This will have an impact in the sexual harassment context when plaintiffs file various complaints stemming from the same wrongs, the same pattern of sexual harassment, and the same breaches of fiduciary duty—as evidenced by the various suits filed against Wynn and the directors and officers of Wynn Resorts.

Insurers can also refuse coverage when a policyholder previously made misrepresentations on its policy application. For instance, in Zion Christian Church v. Brotherhood Mutual Insurance Co., the U.S. Court of Appeals for the Sixth Circuit found that an insurer could reject coverage where the insured made several misrepresentations on its application by concealing past sexual conduct.\textsuperscript{62} Similarly, a federal judge rescinded two D&O policies because the company failed to disclose past sexual harassment claims against its CEO on its policy applications.\textsuperscript{63} When filing applications, companies must confirm the accuracy of all statements made in applications or risk a lapse in coverage.

**SEC reporting duties.** As the Weinstein and Wynn cases evidence, an important part of risk management is being conscious of a possible need to report sexual harassment claims on the company’s public filings. It is abundantly clear that such claims can have a material impact on the firm’s business and stock price, so it no longer will be valid to assume that settlements of such claims have fully addressed the pertinent issues.

**Employment policies and sexual harassment claims.** Lastly, there needs to be a renewed focus on monitoring and enforcing the company’s sexual harassment policies. While insurance may cover the financial costs of a suit and any resulting settlement, the revelations emerging as a result of the #MeToo movement should cause boards to be warier of what might be lurking quietly beneath the surface. There is naturally a presumption that the individuals you entrust with the management and operations of your business are going to comport themselves appropriately, but “assuming the best” is not a viable risk-management policy—certainly not in the times that we now live in. Furthermore, it is dangerous to assume that just because the company has written policies in place, employees are fully aware of their rights and feel safe and comfortable reporting sexual harassment.

**Conclusion**

Even in the current climate, it is still unlikely that there will be successful securities fraud actions based on alleged misrepresentations stemming from a corporation’s aspirational statements regarding (1) a refusal as a matter of policy to tolerate harassment or (2) a practice of consistently promoting a culture committed to honest and ethical conduct. But if a complaint sets forth specific allegations of abhorrent ongoing conduct by senior management and/or a widespread toxic culture, there is a much greater likelihood that the complaint will survive a motion to dismiss. Indeed, the most likely basis for a successful securities fraud or shareholder derivative action is allegations of knowledge of ongoing and continuing sexual harassment and other sexual misconduct—which potentially expose the corporation to significant liability and have the capacity to do substantial damage to the corporate brand—coupled with efforts to insulate particular officers and directors from the consequences of such conduct and conceal such conduct via confidential settlements.

While one might think that these types of circumstances are rare, the fact of the matter is that the #MeToo movement has lifted what was previously a very large and protective boulder and, in the process, has given the world a peek at some very ugly things crawling around underneath. As such, it can be reasonably anticipated that claims of this sort are more likely to grow in the short term, particularly in the realm of the shareholder derivative suit against the small to midsize privately held corporation dominated by an individual around whose entrepreneurial aptitude the company has been built.

Corporate awareness of the risk presented by this behavior and the implementation of systemic processes to meet the risk are critical so that the lessons currently being taught by the #MeToo movement quickly become lessons learned. In order to address this developing risk, professors Daniel Hemel and Dorothy Lund offer a useful list of suggestions for boards to consider going forward in an effort to both avoid the risk altogether and attempt to manage it as claims may arise:

- Take stock of their companies’ past responses to sexual harassment claims and, in so doing, identify repeat offenders so that they can be weeded out.\textsuperscript{64}
- Review their companies’ procedures for handling complaints, and take steps to ensure that employees are fully aware of and feel comfortable reporting misconduct.\textsuperscript{65}
- Ensure that policies providing for “meaningful consequences” for harassers are in place (including empowering managers to impose sanctions ranging from reprimands to bonus reductions to termination for
repeat offenders).  
- When confronted with allegations of sexual harassment by corporate officers or widespread harassment throughout the company, hire outside counsel to conduct a thorough investigation of the claims.  
- Approve the use of corporate funds to pay liability- and litigation-related expenses only in those instances where an internal investigation has been undertaken and it has been concluded that those claims are unfounded.  
- Accept that even in cases where the target of the allegations is a CEO who is associated with the company’s brand, there is misconduct that rises to the level of a fireable offense, and that “[t]he damage to a firm’s value from losing an iconic CEO may be far less than the reputational consequences of a high-profile sexual harassment scandal.”  
- Consider whether statements in their SEC filings might be misleading if sexual misconduct claims emerge.  

Additionally, boards need to consider carefully the insurance coverages in place, what is and is not likely to be covered, and the issues that potentially may arise in regard to insurance claims:  
- Analyze the company’s D&O and EPLI policies to make sure that they provide the levels of coverage necessary to meet the risks presented. This includes careful consideration of per-claim deductibles and aggregate limits.  
- Take stock of the complaints that have been resolved via settlement and whether the continued employment of particular repeat-offender directors and officers, because of the new dynamic, may present much greater exposure to financial risk than previously anticipated.  
- Make sure that knowledge and awareness of claims have been fully vetted at the time of the policy application.  
- Consider the purchase of coverage for retention of a public relations firm to handle crisis management.

As Ben Franklin famously stated, “By failing to prepare, you are preparing to fail.” For corporate boards, the #MeToo movement is a call to action—and none too soon.  

Notes

1. An excellent discussion of some of these cases can be found in Daniel Hemel & Dorothy S. Lund, Sexual Harassment and Corporate Law, Colum. L. Rev. (forthcoming 2018).  
7. Recent developments indicate that the trend evidenced by these cases is just getting started and that a number of similar claims will be brought going forward. For example, as this article was being readied for print, a federal securities class action complaint, Danker v. Papa John’s International, Inc., was filed in the U.S. District Court for the Southern District of New York. No. 1:18-cv-07927 (S.D.N.Y. Aug. 30, 2018). The suit alleges that throughout the class period (alleged to run from February 25, 2014, through July 19, 2018, when an article was published in Forbes magazine entitled “The Inside Story of Papa John’s Toxic Culture” and Papa John’s stock price fell $2.60 per share).
defendants (including Papa John’s International, Inc. (Papa John’s) and John H. Schnatter (Schnatter), the company’s founder) made materially false and misleading statements regarding Papa John’s business, operational, and compliance policies:

Papa John’s executives, including Defendant Schnatter, (i) had engaged in a pattern of sexual harassment and other inappropriate workplace conduct at the Company; (ii) Papa John’s Code of Ethics and Business Conduct was inadequate to prevent the foregoing misconduct; (iii) the foregoing conduct would foreseeably have a negative impact on Papa John’s business and operations, and expose Papa John’s to reputational harm, heightened regulatory scrutiny, and legal liability; and (iv) as a result, Papa John’s public statements were materially false and misleading at all relevant times.

Id. ¶ 4. Asserting claims for violation of sections 10(b) and 20(a) of the Exchange Act, plaintiffs allege that Papa John’s filed 10-Ks each year during the class period that failed to disclose that Schnatter had spied on workers and engaged in sexually inappropriate conduct, which resulted in at least two confidential settlements. Id. ¶ 47. Another recent suit is Luczak v. National Beverage Corp., pending in the U.S. District Court for the Southern District of Florida, No. 0:18-cv-61631-KMM (S.D. Fla. July 17, 2018). The suit involves claims brought under the Exchange Act based on violations of sections 10(b) and 20(a) against the company that owns La Croix, National Beverage Corp., and its chief executive officer and executive vice president. The complaint alleges that the defendants failed to disclose that its CEO engaged in a pattern of sexual misconduct between 2014 and 2016 despite stating that it “absolutely prohibited” sexual harassment and actively enforced its anti-harassment policy. Id. The complaint goes on to allege that, in July 2018, the Wall Street Journal reported the CEO’s sexual misconduct in an article that detailed that two pilots had previously filed lawsuits alleging that National Beverage’s CEO “engaged in repeated unjustified, unwanted and uninvited grabbing, rubbing and groping of [plaintiff’s] leg in a sexual manner, reaching up towards [plaintiff’s] sexual organs.” Id. With regard to the recent allegations of sexual harassment by Les Moonves, no suits had been filed at the time this article went to print, but it is anticipated that litigation in the form of securities fraud and/or a shareholder derivative suit likely will be in the offing. These allegations are detailed in an August 2018 New Yorker article by Roman Farlow, Les Moonves and CBS Face Allegations of Sexual Misconduct, New Yorker, Aug. 8, 2018.

3. Id. ¶ 229.103.
4. Id. ¶ 229.303.
6. 18 AM. JUR. 2D CORPORATIONS § 1441 (2018).
10. 17 C.F.R. § 229.103.

   The State and City Human Rights Laws apply the same Federal standards for determining quid pro quo and hostile environment sexual harassment claims, and differ only in that the City law allows for the recovery of punitive damages.

15. Id. ¶¶ 4–5, 25–27, 45.
17. See Complaint, Irving Firemen’s Relief & Ret. Fund v. Signet Jewelers,
23. Id.
24. Id. ¶ 16.
27. See id.; see also Harwell, supra note 25.
29. Id.
[T]o establish oversight liability a plaintiff must show that the directors knew they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities such as by failing to act in the face of a known duty to act.
41. Id.
43. Id. ¶ 131.
44. Id. (emphasis added).
45. For a more in-depth analysis of the various claims that a plaintiff may bring against a company and the implications of sexual harassment on corporate law, see the recent and insightful article by Daniel Hemel and Dorothy S. Lund in the Columbia Law Review. See supra note 1.
48. Id.
Nondisclosure Agreements. Notwithstanding any other law to the contrary, no employer, its officers or employees shall have the authority to include or agree to include in any settlement, agreement or other resolution of any claim, the factual foundation for which involves sexual harassment, any term or condition that would prevent the disclosure of the underlying facts and circumstances to the claim or action unless the condition of confidentiality is the complainant’s preference.

( amending general obligations law with new § 5-336).
lawyers-rethink-confidentiality-idUSKBN1ED1DM.
55. Rebecca Beitsch, #MeToo Movement Has Lawmakers Talking About Consent, HUFFINGTON POST (Jan. 24, 2018), www.huffingtonpost.com/entry/metoo-movement-has-lawmakers-talking-about-consent_us_5a6758de7e34b6e4bdc5067f.
56. That said, many modern forms have incorporated insuring agreements or optional coverage for discrimination and harassment claims brought by third parties such as customers, clients, and vendors.
58. Some D&O policies offer crisis fund-type coverage; however, whether such coverage may apply in any given situation will depend on the applicable facts and the policy’s wording.
60. See id. §§ 47:13, 74:26.
61. Id.
62. See 126 F. App’x 235 (6th Cir. 2005).
64. A useful article summarizing some of the issues to consider with regard to D&O insurance for sexual misconduct can be found at LaCroix, supra note 57.
65. See Hemel & Lund, supra note 1, at 57.
66. Id. at 58.
67. Id.
68. Id. at 59.
69. Id.
70. Id. at 60.
71. Id.
Given the close quarters, intense pressures and at times informality of communication surrounding the provision of medical care, it is no wonder that healthcare facilities can be breeding grounds for harassment and sexual misconduct allegations and claims. Unlike an office setting, a hospital environment exposes patients and co-workers as potential victims of harassment, which not only often leads to lawsuits, but also negative publicity, legal fees and all types of complications and complexities. To avoid this quagmire, it is important that risk managers are aware of potential liability and ways to foster a safe working environment at a healthcare facility.

The seriousness of preventing sexual harassment and sexual misconduct grabbed the public’s attention when earlier this year, a shocking news story reported a Mt. Sinai emergency room doctor was indicted for sexual assault of a patient. In graphic detail, the reporter described the sexual assault alleged by a patient who was sedated, but aware that she was being violated by a physician, and incapable of reacting. The type of sexual misconduct described by this patient is a nightmare for the patient and the hospital and, thankfully, happens rarely. To prevent this type of conduct and less egregious variations, it is crucial that employers implement training programs to promote an environment that encourages civility, peer reporting and clear avenues for complaining of sexual harassment and sexual misconduct in the healthcare profession.

As a first step, the employer must be aware of the risks before deciding which tactics would be most effective in preventing liability and determine whether its workplace culture needs to be transformed.

**Risk Factors for Sexual Harassment and Sexual Misconduct**

In June 2016, the United States Equal Employment Opportunity Commission (EEOC) Select Task Force on the Study of Harassment in the Workplace (the “Task Force”) released a report. In its report, the Task Force identified factors that increase the likelihood of harassment in a workplace, which include characteristics typical of healthcare environments, such as “high value” employees, significant power disparities, and decentralized workplaces. Based on these factors, hospitals and healthcare facilities are extremely susceptible to allegations of a hostile work environment based upon harassment and indeed, to unknowingly allowing such circumstances to develop. The Task Force also noted that in addition to the expected legal and financial implications of sexual harassment, harassed employees were found to be less productive, and employers often suffered reputational damage and risked losing patients.

**Understanding Potential Liability for Healthcare Facilities**

In egregious events of sexual misconduct (like the case of the emergency room doctor at Mt. Sinai), under New York law, healthcare facilities face risks to the extent that the conduct was foreseeable. A hospital may be able to defend successfully against liability for a doctor’s outrageous or near criminal behavior, but not against a hostile work environment that breeds such behavior. It is essential that healthcare facilities implement procedures to prevent harassment and successfully defend against allegations of harassment regardless of the legal risks.

A hospital’s duty to protect patients and visitors as a caretaker is governed by a standard of foreseeability. New York courts have limited the duty to protect persons lawfully present on a hospital’s premises from the reasonably foreseeable criminal or tortious acts of third persons. For example, a New York hospital faced potential liability when a male nursing assistant allegedly sexually assaulted a female patient while preparing her for a surgical procedure. The court found in favor of the hospital and held that plaintiffs failed to show the hospital knew or should have known of the assailant’s propensity for the conduct that caused plaintiff’s injury.

In a decision rendered by the Appellate Division, First Department, the court found that it was not reasonably foreseeable that a hospital’s independent contractor would sexually assault a patient while conducting her vaginal sonogram, and the patient therefore was not entitled to recover on her negligent supervision claim against the hospital. In that case, the court considered the sufficiency of the independent contractor’s background check on its employee and examined whether the hospital was on notice of the independent contractor’s employee’s potential for violence or sexual abuse. The hospital was lucky that its independent contractor thoroughly vetted its employee and plaintiff failed to rebut the lack of reasonable foreseeability based on the background check. Although the court found in favor of the healthcare facility in these cases where patients sued, when a hospital is sued as an employer by its own employee, it is less likely to avoid liability.

In Salamon v. Our Lady of Victory Hosp., a former employee attempted to hold the hospital liable for conduct of a doctor on staff. The hospital argued it was not liable as a matter of law for the harassing conduct of a doctor who was not an employee, but an independent contractor. The federal district court in Salamon denied the hospital’s motion for summary judgment, finding the Second Circuit had not definitively ruled on the question of whether an employer can be liable for a non-employee’s harassing conduct. The court recognized, however, that the Second Circuit limited any potential liability for non-employees to “instances in which the employer provided no reasonable avenue of complaint or knew of the harassment but did nothing about it.” Thus, an employer could be exposed to liability for even a non-employee’s conduct if the employer does not have a complaint procedure in
place. As such, not implementing a complaint procedure or failing to educate your employees about an existing procedure can exponentially increase risk.

Harassment often involves multiple missteps by more than one employee. A recent case involved allegations of harassment against a nurse’s colleague where one long term pediatric nurse alleged she was harassed by another long term nursing employee; the harassment included late night phone calls, adjusting the plaintiff’s label on her underwear and discussing plaintiff’s medical history with other employees. In addition, plaintiff claimed that she suffered harassment from her treating physician, a surgeon who worked at the same facility and made comments to her while at work that she perceived as references to her personal medical history. For instance, her physician referenced the movie 40 Year Old Virgin, teased plaintiff about her medical history with other employees. 11 In the Complaint, plaintiff complained to human resources about the harassment, but nothing was done. In the Complaint, plaintiff implicated several actors who allegedly contributed to her damages: a fellow nurse, a doctor, and human resources staff. The court denied the hospital’s motion to dismiss as to negligent retention and supervision, hostile work environment, sexual harassment, and disability discrimination.

Another scenario which has potential for posing great risk to healthcare facilities is relationships that might occur between interns and residents in medical teaching facilities. If the facility allows or empowers a resident in his or her second year of postgraduate residency (PGY2) to supervise and direct a first year postgraduate student (PGY1), the facility may be liable for sexual harassment based on PGY2’s behavior. It is not hard to imagine two postgraduate students dating, but if a PGY2 uses his or her supervisory position to persuade the PGY1 to go on a date, this can pose serious risk for the hospital. Environments where supervisors do not constantly observe their subordinates, and are not trained to spot troubling inappropriate behavior, are more likely to breed a culture of acquiescence rather than a culture of civility. Managers and supervisors are the heart of an employer’s prevention system.

Implementing Solutions

Regardless of the legal outcome, the defendants will be forced to pay substantial legal fees and the incident can have lasting effects on the hospital’s reputation. Accordingly, preventative measures are in everyone’s best interest. As noted previously, to create a culture in which employees believe that the organization will not tolerate harassment, managers and supervisors must receive clear messages of accountability. Compliance training translates those expectations into concrete actions that managers and supervisors are expected to take – either to prevent harassment or to stop and remedy harassment once it occurs. Employers should begin by taking complaints of sexual harassment and misconduct made against their current employees very seriously and evaluating current employees to ensure employees who demonstrate a propensity toward such misconduct are not retained.

Compliance training provides managers and supervisors with easy-to-understand and realistic methods for dealing with harassment that they observe, that is reported to them, or of which they have knowledge or information. This includes practical suggestions on how to respond to different levels and types of offensive behavior, and clear instructions on how to report harassing behavior up the chain of command. Training should also stress the affirmative duties of supervisors to respond to harassing behavior, even in the absence of a complaint. This training should be tailored to the specific worksite, organization, and/or industry, so that the examples used are helpful to managers and supervisors.

The EEOC encourages strong anti-harassment policies that provide a clear explanation of prohibited conduct and assurance of protection from retaliation. Compliance training is essential, but focusing on steps to avoid legal liability may fall short of preventing a hostile work environment and a culture of harassment. The EEOC recommends creating a culture of civility by training with specific goals in mind as a “holistic effort” to prevent harassment, which should also include accountability and leading by example.

The goals of training should be to educate employees and supervisors, to ensure that employees understand what is considered harassment in the workplace and empower supervisors by creating procedures for complaint follow-up. Understanding what is not appropriate is the first step towards preventing a volatile work environment or changing an already toxic one. The EEOC also suggests that trainings educate employees about the external consequences (including reputational harm) of conduct that rises to the level of illegal harassment. A senior leader’s attendance at the training is the strongest expression of support. As an alternative, a video of a senior leader introducing the training could be shown, or a memo from leadership sent prior to the training. Trainings should be interactive and take place at least every other year to demonstrate the employer’s commitment to preventing harassment. Also, the trainings should evolve to ensure they are relevant and grab employees’ attention with new content.

The EEOC Task force recommends “bystander intervention training” and “civility training” given that incivility is a harbinger of a hostile work environment. This type of training focuses on what employees and
supervisors should do, rather than what they should not do. The training alone, however, is not enough. The employers who are most successful in preventing harassment have taken other steps to convince employees that they will not be tolerant of sexual harassment. The EEOC suggests that prior to training, employers should provide their employees with avenues for complaints (such as a hotline).

A proactive employer that is focused on creating an environment of civility through adequate training and leadership will reduce the likelihood of sexual harassment and sexual misconduct in the workplace. These strategies not only make the workplace safer, but lower the possibility of flagrant sexual misconduct as well as liability and the economic and intangible impact on an employer’s business.

ABOUT THE AUTHOR
Joan is the managing partner of KBR’s national Employment Law Practices Team. Her practice focuses on the representation of management in employment litigation and complex commercial litigation which includes insurance coverage litigation and professional liability defense. Practicing law since 1987, Joan has obtained extensive pre-trial, trial, and appellate experience in both individual and class actions in federal and state courts throughout the country. She has been admitted to practice on a pro hac vice basis in numerous states and often manages complex litigation on a national basis. Joan has tried many cases to verdict over the past 26 years and has been involved in media-intensive class action litigation. She litigates and arbitrates before administrative agencies as well and is well-versed in ADR proceedings.

REFERENCES ON PAGE 32

Oceanus RRG was put into liquidation, what should we learn from this?

By Phalanx Healthcare Solutions

South Carolina Department of Insurance has formally executed the liquidation order effective September 21, 2017 after adverse development in the malpractice insurer’s claims reserves. Simply put, Oceanus no longer has the assets to meet their claim obligations.

Oceanus, as recently as 2013, was the sixth largest writer of physician malpractice liability in New York but in 2016 their premium volume decreased by over 40%. This decrease coupled with an increase in claim reserves due to adverse loss development reduced their policyholders’ surplus (net assets) to negative $6M and placed the company in extreme financial distress (per the Oceanus June 30, 2017 statutory statement).

What is most unsettling about this is that providers who are currently insured with, or that have purchased “tail” coverage with Oceanus, may be personally responsible for existing or future claims made against them. Providers paid hard earned dollars to a company that may be unable to uphold their responsibility to their insureds.

Frequently Asked Questions about the Oceanus Insurance RRG Liquidation (source: oceanusinsurance.com):

1. What is a liquidation proceeding?

Liquidation is a type of receivership and is similar to bankruptcy. The South Carolina Insurance Code authorizes the Director of the South Carolina Department of Insurance, in his or her capacity as Liquidator, to liquidate the insurance company. The Liquidation Order directs the Liquidator, to (i) take possession of and safeguard the property of the insurer, (ii) conduct the insurer's business, and (iii) take such steps needed to liquidate (wind-up the affairs of) the business of the insurer under the supervision of the Court and as the Court may direct.

2. What happens to my coverage under my Oceanus policy?

All policies in effect at the time of the issuance of the Liquidation Order continue only for the lesser of: 1) 30 days from the date of entry of the Liquidation Order (10/21/17 at 11:59 p.m. EDT) 2) the expiration of the policy coverage 3) the date the coverage has been replaced with equivalent insurance with another insurer or otherwise terminated the policy or 4) the Liquidator has effected a transfer of the policy obligation pursuant to Item (8) of subsection (a) of Section 38-27-400.
ARTICLE REFERENCES

Sexual Liability ……………………………………………………… from page 17

3. Id. at Section D.
8. Id.
9. Id. see also Heskin v. Insite Advertising, Inc., No. 03-cv-2598, 2005 WL 407646, at *20–21 (S.D.N.Y. Feb. 22, 2005) (holding that an employer can be held liable for the harassing acts of non-employees if a plaintiff “adduces[e] evidence tending to show that [the employer] either failed to provide a reasonable complaint procedure or that it knew of [the] harassment by a non-employee and failed to take any action”).
11. This particular allegation involved plaintiff’s medical records being improperly accessed by another NYU employee raises HIPAA violations that are beyond the scope of this article, but are very important issues to address given the advent of electronic medical records.
12. Because it is common for healthcare professionals to receive treatment where they work, employers in this setting must impose a higher than normal standard of respect between employees.

EHR In Malpractice Litigation………………………………… from page 22

10. EHRs have existed for some time, but their prevalence increased after the passage of the Health Information Technology for Economic and Clinical Health (HITECH) Act of 2009, which promotes the adoption and meaningful use of health information technology i.e. the EHR. Mangalmurti, supra.
13. Id.
16. Levinson, supra.
20. Id.
21. Id.
24. Id.
26. Id.
30. AHC Media, supra.
Managing EPL and Management Liability Risks in the Wake of the #MeToo and #Times Up Movements

I. Overview of EPL Litigation in Wake of MeToo and Times Up Movement (30 minutes)

   a. Analysis of Claim Trends by type, frequency and industry
   b. Discussion of How Movement has Impacted Settlement and Jury Perceptions
   c. New Legislation and Expected Impact;
   d. What's on the Horizon.

II. Corporate Directors’ and Officers’ Liability stemming from Sexual Harassment Claims (30 minutes)

   a. Fiduciary Duties of Directors and Officers
   b. 10b-5 Securities Fraud Claims under the Securities Exchange Act
   c. Lessons Learned from High Profile Shareholder Litigation Resulting from EPL Claims.

III. From the Trenches: Managing and Mitigating Risks (20 minutes)

   A. How to Minimize Risk if a Claim has Been Made Against You
      1) Initial Response and Investigation Process
      2) Coordinating Defense with Insurance Carrier
      3) Settlement Considerations
      4) Coverage Issues Presented in Claim Resolution
         a. Capacity Issues
         b. Other Insurance
         c. uninsurable Exposure and Allocation

IV. Questions -10 minutes
I. Overview of Cyber Threats Facing Law Firms and Other Businesses (20-30 minutes)

A. Types of Cyber Threats
   a. Email Compromise Scams and Common Targets
      i. Real Estate
      ii. Law Firms
      iii. Bank to Bank Transactions
      iv. Database and W-2 Theft
   b. Spear-Phishing and Phishing
   c. Malware
      i. Ransomware
      ii. Denialware
      iii. Distributed Denial-of-Service

B. Motivation of Cyber Criminals
   a. Money
   b. Disruption
   c. Fame and Accord
   d. Hacktivism

C. Means of Perpetrating Cyber Crime
   a. Human Beings
   b. Naiveté
   c. Technical Vulnerabilities

II. Prevention (10 minutes)

A. Software
   a. Intrusion Detection
   b. Encryption

B. Training and Protocols
   a. Employee Education
   b. Multi-Factor Verification
   c. Separation of Duties
   d. Separation of Work Stations

C. Law Enforcement

III. Most Common Loss Facing Law Firms – Email Scams (10-15 minutes)

A. Common Fact Patterns – Loss of Money
a. Email Purporting to be from a Partner or Employee
b. Email Purporting to be from a Vendor
c. Email Purporting to be from a Client or Potential Client
d. Computer System Infiltrated and Unauthorized Transaction Effectuated
e. The Payroll Processor

B. Unusual or Creative Fact Patterns Experienced by Panelists

C. Loss of Data or Information

D. Loss of Client’s or Employee’s Data or Information

IV. Insurance Products Available (30 minutes)

A. Cyber Forms
   a. Ransomware or Cyber Extortion Costs
   b. Data Restoration
   c. Credit Monitoring
   d. Data Breach Response and Notification
   e. Legal Expenses

B. Commercial Crime Policies and Financial Institution Bonds
   a. Brief History and Overview

C. Computer Fraud Coverage
   a. Generally Provides Coverage for Unauthorized Transfer Without Insured’s Knowledge or Consent
   b. Use of a Computer to Fraudulently Cause a Transfer
      i. Courts’ Distinction of “Fraudulently Cause a Transfer” and “Cause a Fraudulent Transfer”
   c. Often, but not Always, Involves a Breach or Infiltration of the Insured’s System and Access to Confidential Information
   d. Discussion of Representative Case(s) and Coverage Issues

D. Fraudulently Induced Transfer Fraud / Funds Transfer Fraud
   a. An Instruction, Purportedly from the Insured, to a Financial Institution Directing the Financial Institution to Transfer the Insured’s Funds
   b. An Instruction, Purportedly from an Insured’s Employee, Directing the Insured to Transfer Funds
   c. May not Involve a Breach of Infiltration of the Insured’s System
   d. Discussion of Representative Case(s) and Coverage Issues

E. Social Engineering Fraud
   a. When an Insured is Tricked into Transferring Funds via Means Not Covered Above
i. Often an Email or Other Communications Purporting to be from a Client, Customer, or Vendor

ii. Client, Customer, and Vendor – Defined Terms and Pre-Existing Relationship

b. Discussion of Representative Case(s) and Coverage Issues

V. Conclusion and Questions (5-10 minutes)
The Next Cyber Loss Could be Yours: 
The Fidelity/Crime Insurance Your Law Firm Needs to Carry

2019 ABA TIPS Section Conference
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Technological advances have revolutionized the manner in which business is now conducted. Today’s business environment is driven by information assets and network connectivity. While these advances have added a great deal of value to all participants in the global marketplace, they have also created additional risks for which businesses must be aware. As reliance on technology has increased, so too have the risks associated with information security and computing, referred to here as “cyber” risks. Businesses must accept that cyber risks are now a routine part of doing business in today’s technologically-driven age.¹

However, keeping pace with appropriate security measures is both challenging and costly. The types of cyber threats are constantly changing, targeting new users and new platforms at a rapid pace.² Add to that the fact that business leaders may lack a clear understanding of the nature and magnitude of today’s cyber threats, it should not be surprising that defensive strategies aimed to thwart internal and external cyber attacks commonly fall short of the intended objectives.

Because cyber risks cannot be eliminated completely, it is common for organizations to implement security measures only to the extent feasible, and to seek to shift any remaining risks to a willing third party (commonly, an insurer).³ In the case of cyber risk, however, traditional forms of insurance coverage were not necessarily drafted with potential cyber liability or loss in mind. In turn, these policies often provide little if any coverage for cyber losses. Given the lack of coverage for information security, computing, and other forms of cyber risk, insurers sought to fill an unmet demand by insureds seeking to mitigate exposure from cyber attacks. From this, the market for cyber insurance was born.

Cyber insurance is still a relatively new phenomenon, commonly offered as a standalone policy or an endorsement to existing coverage. Given its infancy, it should come as no surprise that the scope of cyber insurance coverage varies significantly from policy to policy. There is also relatively little case law interpreting the scope of cyber coverages. What follows is a discussion of case addressing three (3) types of electronic coverages – the Computer Fraud coverage, the Electronic Funds Transfer Fraud coverage, and non-standard electronic coverages. Insureds often pursue computer crime claims under the Computer Fraud or the Electronic Funds Transfer Fraud provisions. Although each insuring agreement imposes different elements of coverage, both are intended to limit coverage to instances in which a fraudster, without the insured’s knowledge, accesses the insured’s computer system and steals property (either via directly transferring funds

or causing the insured’s bank to transfer funds) without any intervening action by the insured. The case law regarding computer crime is still evolving and courts have not always reached consistent results.

**Computer Fraud Insuring Agreement**

We will pay for your direct loss of, or your direct loss from damage to, Money, Securities and Other Property directly caused by Computer Fraud.

“Computer Fraud” is defined as:

The use of any computer to fraudulently cause a transfer of Money, Securities or Other Property from inside the Premises or Banking Premises:

1. to a person (other than a Messenger) outside the Premises or Banking Premises; or
2. to a place outside the Premises or Banking Premises.

**Funds Transfer Fraud Insuring Agreement**

We will pay you for your direct loss of Money and Securities contained in your Transfer Account on deposit at a Financial Institution directly caused by Funds Transfer Fraud.

“Funds Transfer Fraud” is defined as:

1. an electronic, telegraphic, cable, teletype or telephone instruction fraudulently transmitted to a Financial Institution directing such institution to debit your Transfer Account and to transfer, pay or deliver Money or Securities from your Transfer Account which instruction purports to have been transmitted by you, but was in fact fraudulently transmitted by someone other than you without your knowledge or consent;

2. a fraudulent written instruction, other than one covered under Insuring Agreement B., issued to a Financial Institution directing such Financial Institution to debit a Transfer Account and to transfer, pay or deliver Money or Securities from such Transfer Account by use of an electronic funds transfer system at specified intervals or under specified conditions which written instruction purports to have been issued by you but was in fact fraudulently issued, Forged or altered by someone other than you without your knowledge or consent; or
3. an electronic, telegraphic, cable, teletype, telefacsimile, telephone or written instruction initially received by you which purports to have been transmitted by an Employee, but which was in fact fraudulently transmitted by someone else without your or the Employee’s consent.

Annotations – Computer Fraud

C.D. Cal. 2015. Taylor and Lieberman, the insured accounting firm (the “Firm”), had power of attorney to make transfers from a client’s account. In response to fraudulent emails purportedly sent by the Firm’s client, the Firm’s employee made two wire transfers to bank accounts in Asia. When the client disavowed the emails, the Firm was able to recover some of the transferred funds and reimbursed the client for the remainder. The insured asserted a claim under the Forgery, Computer Fraud, and Funds Transfer Fraud coverages of the subject policy. Each of these coverages required a direct loss sustained by an insured, and the court found that the loss from reimbursing the client was not a direct loss. The original transfers were of the client’s funds from the client’s account. The Firm sustained a loss only when it later reimbursed the client. The court held that this was not a direct loss and granted summary judgment to Federal Insurance Company. Taylor and Lieberman v. Federal Insurance Co., 2015 WL 3824130 (C.D. Cal. June 18, 2015).

C.D. Cal. 2014. Travelers was awarded summary judgment under its Computer Fraud insuring agreement. The insured, Pestmaster Services, Inc. (“Pestmaster”), retained Priority 1 Resource Group (“Priority 1”) to handle preparation of Pestmaster’s payroll, payment of payroll taxes, and delivery of payroll checks. In order to allow Priority 1 to perform the agreed upon payroll and payroll tax services, Pestmaster executed an ACH authorization which authorized Priority 1 to obtain payment of Priority 1’s approved invoices by initiating ACH transfers of funds from Pestmaster’s bank account to Priority 1’s bank account. For each payroll period, Priority 1 would prepare and deliver invoices to Pestmaster reflecting amounts owed for employee salaries and payroll taxes. Once Pestmaster approved payment of the invoices, Priority 1 would initiate an ACH transfer and move sufficient funds from Pestmaster’s bank account to Priority 1’s account in order to pay the amounts approved by Pestmaster. Although Priority 1 would typically complete Pestmaster’s payroll on a Friday, it was not required to pay payroll taxes until the following Wednesday. Thus, the funds transferred to Priority 1’s account would remain in Priority 1’s account for several days until Priority 1 was required to pay the payroll taxes.

Pestmaster discovered that Priority 1 had failed to remit payroll taxes to the IRS from 2010-2011 in the amount of $373,136.00, and it sought coverage under the policy. The court held that the Computer Fraud provision was not implicated. The court stated that this insuring agreement is potentially implicated “when someone ‘hacks’ or obtains unauthorized access or entry to a computer in order to make an unauthorized transfer or otherwise uses a computer to fraudulently cause a transfer of funds.” Priority 1 did not hack or obtain unauthorized access to Pestmaster’s computer, and the court distinguished between “fraudulently causing a transfer” (which may implicate coverage) and “causing a fraudulent transfer.” Because Priority 1 had access to Pestmaster’s account, its conduct equated to “causing a fraudulent transfer,” and not “fraudulent causing a transfer.” Finally, the court held that Priority 1’s use of a computer was merely incidental.
to the scheme, and that the claimed loss did not result directly from the use of a computer. *Pestmaster Services, Inc. v. Travelers Casualty and Surety Co. of America*, 2014 WL 3844627 (C.D. Cal. July 17, 2014).

**E.D. La. 2011.** The insured, Methodist Health System Foundation, Inc. (“Methodist”), suffered a loss involving the infamous Bernie Madoff ponzi scheme. Specifically, Methodist invested in Meridian Diversified Fund, which invested a portion of its holdings in Tremont Hedge Fund, which invested a portion of its holdings in Bernard L. Madoff Investment Securities, Inc. When the ponzi scheme collapsed, Methodist sought coverage under a commercial crime provision substantially similar to the Computer Fraud insuring agreement. Methodist argued that coverage was implicated because Madoff used computers to create false documents that misled investors and gave the appearance of a legitimate investment operation. The court disagreed, and awarded summary judgment to Hartford Fire Insurance Company. The court held that the use of computers was not the direct cause of loss. *Methodist Health System Foundation, Inc. v. Hartford Fire Ins. Co.*, 2011 WL 2607107 (E.D. La. July 1, 2011).

**N.D. Tex. 2008.** Great American Insurance Company (“Great American”) filed a declaratory judgment action seeking a declaration that crime insurance policies issued to AFS/IBEX Financial Services, Inc. (“AFS”) did not provide coverage for a loss involving checks issued by AFS and payable to Charles McMahon Insurance Agency. AFS provided premium financing in the insurance industry. AFS entered into an agreement with Charles Owen McMahon, Sr. (“McMahon Sr.”), the owner of the Charlie McMahon Insurance Agency. This agreement contemplated that McMahon Sr. would create and sign premium finance applications on behalf of insureds. AFS would then send a check to the insurance company for the purchase price of the insurance, and the insureds would send regular payments to AFS. McMahon Sr.’s son, Charles Owen McMahon, Jr. (“McMahon Jr.”), was an insurance agent and owner of McMahon Insurance Services. McMahon Jr. worked in an office adjoining the offices of McMahon Sr.’s agency. McMahon Jr. was also the office manager at McMahon Sr.’s agency, and had responsibility for submitting applications for premium financing to Defendant under his father’s contract with Defendant. McMahon Jr. exploited this business relationship by submitting approximately 122 false applications to dupe AFS into issuing checks for the premium financing made payable to “Charles McMahon Insurance Agency.” McMahon Jr. endorsed these checks “Charles McMahon Insurance Agency” and deposited the funds into his own personal bank account. McMahon Sr. was unaware of the fraudulent applications submitted to AFS.

AFS sought coverage under a Forgery insuring agreement, as well as a Computer Fraud insuring agreement and a Funds Transfer Fraud insuring agreement. Great American was awarded summary judgment under the Computer Fraud provision, successfully arguing that no computer actually caused the transfer of any funds from AFS’ account. The court noted that “the language of these provisions indicate that they are designed to cover losses directly stemming from fraud perpetrated by use of a computer.” *Great American Ins. Co. v. AFS/IBEX Financial Services, Inc.*, 2008 WL 2795205 (N.D. Tex. July 21, 2008).

**Conn. Super. Ct. 2010.** The court held that using an email to initiate a fraudulent scheme implicated the Computer Fraud insuring agreement. The insured, a law firm called *Owens, Schine & Nicola, P.C.* (the “Law Firm”), was contacted via an email message from an individual claiming to be a North Carolina attorney. The email message stated that the North Carolina attorney was seeking the Law Firm’s assistance collecting a debt for one of the attorney’s China-based clients.
Shortly thereafter, the Law Firm received an email purporting to be from the director of the Chinese client. The following week, the purported client notified the Law Firm that the debtor had agreed to pay its debt and the Law Firm should expect a check in the mail. The next day, the Law Firm received what appeared to be an “Official Check” drawn on Wachovia Bank and made payable to the Law Firm in the amount of $198,610.00. The purported client sent the Law Firm instructions via email to wire the funds from the Law Firm’s trust account at Chase Bank to a South Korea account, after deducting $1,500 in fees for the Law Firm’s assistance regarding the collection. After the funds were wired, it was determined that the “Official Check” was fraudulent and had not been honored by Wachovia.

The Law Firm submitted a claim to Travelers and litigation ensued. Travelers argued that the Computer Fraud provision required that a loss result from a third-party hacking into the Law Firm’s computer system, such as using a computer to manipulate numbers or events. The court disagreed and determined that seventeen (17) emails exchanges between the Law Firm and purported client constituted “computer fraud.” According to the court, “the policy [was] ambiguous as to the amount of computer usage necessary to constitute computer fraud. This ambiguity is resolved in favor of the [insured].” A “computer hacking” incident was not required. The court also equated direct cause with proximate cause and held that the emails sent from the imposter directly caused the loss because the emails “set the chain of events in motion that led to the entire loss.” 


**N.Y. Super. Ct. 2010.** The insured, Cumberland Packing Corp. (“Cumberland”) suffered a loss involving the Bernie Madoff ponzi scheme. Cumberland began investing with Madoff in 2002 on behalf of its employees through the Cumberland Employee’s Pension Plan and Trust. Cumberland also made separate investments with Madoff beginning in 2005. When the Ponzi scheme collapsed, Cumberland submitted a claim of approximately $11 million under a variety of insuring clauses. Chubb paid $3.5 million but denied the balance of the claim under, inter alia, the Computer Fraud and the Funds Transfer Fraud insuring clauses. The court held that coverage was precluded by a number of exclusions, including (1) loss caused by an Employee (as Madoff qualified as an Employee as a fiduciary of the pension plan), and (2) loss caused by a fraudulent, dishonest, or criminal act of an “authorized representative.” Cumberland Packing Corp. v. Chubb Ins. Corp., 958 N.Y.S. 2d 306 (N.Y. Sup. Ct. Ct. 2010).

**Wis. Ct. App. 2008.** This case involves theft from the insured Milwaukee Area Technical College (the “College”) by Frontier Adjusters of Milwaukee and its former owner, Michael D. McNichols. The College hired McNichols and Frontier Adjusters of Milwaukee to process the College’s workers’ compensation claims. Under the agreements, Frontier Adjusters of Milwaukee evaluated the College’s workers’ compensation claims, and was supposed to pay those that had been approved. The payments were to be made from a Frontier Adjusters of Milwaukee bank account controlled by McNichols. The College replenished the money in that account by periodically sending checks to McNichols. The College also paid to Frontier Adjusters of Milwaukee an administrative fee. McNichols used his arrangement with the College to steal money that the College gave him to pay the workers' compensation claims. McNichols informed the College that he had sent checks to healthcare providers when, in reality, he had not done so. Instead, he kept the checks made payable to the healthcare providers in a box, unsent. McNichols would also send
dummy check ledgers to the College that represented that he had paid the healthcare providers. The College sent the replenishment checks to McNichols based on the dummy check ledgers. McNichols put the replenishment money in the Frontier Adjusters of Milwaukee bank account and then stole that money by issuing checks from that account. The College sought coverage from St. Paul Travelers under, *inter alia*, the Computer Fraud insuring agreement. According to the College, coverage was implicated because McNichols used a computer to print the fraudulent ledgers and to manage the Frontier Adjusters of Milwaukee bank account into which he put the College’s replenishment funds. The court held that it need not determine whether the Computer Fraud provision was implicated because the claim was precluded by the “authorized representative” exclusion. The policy excluded coverage for “any dishonest or criminal acts committed by any of your ... authorized representatives whether acting alone or in collusion with other persons or while performing services for you or otherwise.” The College asserted that it never “authorized” McNichols to steal from it, but that was insufficient to prevent the exclusion from applying. The trial court’s award of summary judgment to St. Paul Travelers was affirmed. *Milwaukee Area Technical College v. Frontier Adjusters of Milwaukee*, 2008 WL 1787682 (Wis. Ct. App. Apr. 22, 2008).

**Annotations – Funds Transfer Fraud**

**C.D. Cal. 2015.** Taylor and Lieberman, the insured accounting firm (the “Firm”), had power of attorney to make transfers from a client’s account. In response to fraudulent emails purportedly sent by the Firm’s client, the Firm’s employee made two wire transfers to bank accounts in Asia. When the client disavowed the emails, the Firm was able to recover some of the transferred funds and reimbursed the client for the remainder. The insured asserted a claim under the Forgery, Computer Fraud, and Funds Transfer Fraud coverages of the subject policy. Each of these coverages required a direct loss sustained by an insured, and the court found that the loss from reimbursing the client was not a direct loss. The original transfers were of the client’s funds from the client’s account. The Firm sustained a loss only when it later reimbursed the client. The court held that this was not a direct loss and granted summary judgment to Federal. *Taylor and Lieberman v. Federal Insurance Co.*, 2015 WL 3824130 (C.D. Cal. June 18, 2015).

**C.D. Cal. 2014.** Travelers was awarded summary judgment under its Computer Fraud insuring agreement. The insured, Pestmaster Services, Inc. (“Pestmaster”), retained Priority 1 Resource Group (“Priority 1”) to handle preparation of Pestmaster’s payroll, payment of payroll taxes, and delivery of payroll checks. In order to allow Priority 1 to perform the agreed upon payroll and payroll tax services, Pestmaster executed an ACH authorization which authorized Priority 1 to obtain payment of Priority 1’s approved invoices by initiating ACH transfers of funds from Pestmaster’s bank account to Priority 1’s bank account. For each payroll period, Priority 1 would prepare and deliver invoices to Pestmaster reflecting amounts owed for employee salaries and payroll taxes. Once Pestmaster approved payment of the invoices, Priority 1 would initiate an ACH transfer and move sufficient funds from Pestmaster’s bank account to Priority 1’s account in order to pay the amounts approved by Pestmaster. Although Priority 1 would typically complete Pestmaster’s payroll on a Friday, it was not required to pay payroll taxes until the following Wednesday. Thus, the funds transferred to Priority 1’s account would remain in Priority 1’s account for several days until Priority 1 was required to pay the payroll taxes.
Pestmaster discovered that Priority 1 had failed to remit payroll taxes to the IRS from 2010-2011 in the amount of $373,136.00, and it sought coverage under the policy. The court held that the Funds Transfer Fraud provision was not implicated. According to the court, the Funds Transfer Fraud insuring agreement generally provided coverage for loss involving a fraudulent instruction to Pestmaster’s bank instructing a transfer of funds when, in reality, Pestmaster was unaware of the instruction, the instruction was forged or altered, etc. The court held that coverage was not implicated under this provision because it “does not cover authorized or valid electronic transactions, such as the authorized ACH transfers in this case, even though they are, or may be, associated with a fraudulent scheme.” All of the instructions from Priority 1 to Pestmaster’s bank, while in the furtherance of a fraudulent scheme, were authorized and proper. The fact that Priority 1 simply stole the funds once they were properly transmitted did not trigger coverage. Pestmaster Services, Inc. v. Travelers Casualty and Surety Co. of America, 2014 WL 3844627 (C.D. Cal. July 17, 2014).

C.D. Cal. 2014. A payroll processor defrauded the insured, Southern California Counseling Center (“SCCC”). SCCC authorized the processor to debit SCCC’s bank account for funds which were supposed to be used to pay SCCC’s payroll tax obligations. Instead, the funds were diverted to the use of the president of the processor. SCCC submitted a claim to Great American Insurance Company (“Great American”). The insuring clause at issue was subject to an exclusion for acts of SCCC’s authorized representatives. The district court followed Ninth Circuit precedent and found that an authorized representative was someone authorized by SCCC to have access to the stolen funds; that is, someone whom SCCC empowered to act on its behalf. Applying this meaning, the payroll processor was an authorized representative, and the loss was not covered. The court rejected SCCC’s argument that the processor never intended to apply the funds properly and so the agreement authorizing the processor to act on SCCC’s behalf was void ab initio and the processor was not an authorized representative. The court found that there was fraud in the inducement to the agreement and it was voidable, as opposed to void ab initio. SCCC knew what it was signing and intended to authorize the processor to act on its behalf. The court also noted that SCCC’s argument “would render the authorized representative exclusion a nullity.” The court granted summary judgment to Great American and denied SCCC’s cross-motion for summary judgment. Southern California Counseling Center v. Great American Insurance Co., Case No. 2:13-cv-5468 (C.D. Cal. June 17, 2014).

S.D. Ind. 2006. The insured, Brightpoint, Inc. (“Brightpoint”) submitted a claim to Zurich American Insurance Company (“Zurich”) for loss involving the theft of pre-paid phone cards. The fraudsters utilized fraudulent purchase orders, post-dated checks, and purported bank guaranty of checks to be transmitted via facsimile to Brightpoint. On the day of the alleged theft, Brightpoint received the usual documents by facsimile and Brightpoint’s representative met with the fraudster near Brightpoint’s office and exchanged the cards for the original documents. Zurich was granted summary judgment because the allegedly fraudulent facsimiles (facsimiles came within the subject coverage) did not directly cause the surrender of the money. The court stated, “Only after Brightpoint received the physical documents would it release the phone cards and, based on established practices of Brightpoint, the cards would not have been turned over simply on the basis of a facsimile. The fraud in this instance occurred through the use of the unauthorized checks and guaranties, not the manipulation of numbers or events through the use of a computer, facsimile machine or other similar device.” The court expressly rejected Brightpoint’s argument that coverage was implicated if a computer was used and a loss subsequently followed. According to

N.D. Tex. 2008. Great American Insurance Company (“Great American”) filed a declaratory judgment action seeking a declaration that crime insurance policies issued to AFS/IBEX Financial Services, Inc. (“AFS”) did not provide coverage for a loss involving checks issued by AFS and payable to Charles McMahon Insurance Agency. AFS provided premium financing in the insurance industry. AFS entered into an agreement with Charles Owen McMahon, Sr. (“McMahon Sr.”), the owner of the Charlie McMahon Insurance Agency. This agreement contemplated that McMahon Sr. would create and sign premium finance applications on behalf of insureds. AFS would then send a check to the insurance company for the purchase price of the insurance, and the insureds would send regular payments to AFS. McMahon Sr.’s son, Charles Owen McMahon, Jr. (“McMahon Jr.”), was an insurance agent and owner of McMahon Insurance Services. McMahon Jr. worked in an office adjoining the offices of McMahon Sr.’s agency. McMahon Jr. was also the office manager at McMahon Sr.’s agency, and had responsibility for submitting applications for premium financing to Defendant under his father’s contract with Defendant. McMahon Jr. exploited this business relationship by submitting approximately 122 false applications to dupe AFS into issuing checks for the premium financing made payable to “Charles McMahon Insurance Agency.” McMahon Jr. endorsed these checks “Charles McMahon Insurance Agency” and deposited the funds into his own personal bank account. McMahon Sr. was unaware of the fraudulent applications submitted to AFS.

AFS sought coverage under a Forgery insuring agreement, as well as a Computer Fraud insuring agreement and a Funds Transfer Fraud insuring agreement. Great American was awarded summary judgment under the Computer Fraud provision, successfully arguing that no computer actually caused the transfer of any funds from AFS’ account. The court noted that “the language of these provisions indicate that they are designed to cover losses directly stemming from fraud perpetrated by use of a computer.” Great American Ins. Co. v. AFS/IBEX Financial Services, Inc., 2008 WL 2795205 (N.D. Tex. July 21, 2008).

N.Y. Super. Ct. 2010. The insured, Cumberland Packing Corp. (“Cumberland”) suffered a loss involving the Bernie Madoff ponzi scheme. Cumberland began investing with Madoff in 2002 on behalf of its employees through the Cumberland Employee’s Pension Plan and Trust. Cumberland also made separate investments with Madoff beginning in 2005. When the Ponzi scheme collapsed, Cumberland submitted a claim of approximately $11 million under a variety of insuring clauses. Chubb paid $3.5 million but denied the balance of the claim under, inter alia, the Computer Fraud and the Funds Transfer Fraud insuring clauses. The court held that coverage was precluded by a number of exclusions, including (1) loss caused by an Employee (as Madoff qualified as an Employee as a fiduciary of the pension plan), and (2) loss caused by a fraudulent, dishonest, or criminal act of an “authorized representative.” Cumberland Packing Corp. v. Chubb Ins. Corp., 958 N.Y.S. 2d 306 (N.Y. Sup. Ct. 2010).

Annotations – Non-Standard Electronic Coverages
1st Cir. 1999. Stop & Shop Companies, Inc. (“Stop & Shop”) sought coverage when an entity retained by Stop & Shop to process and pay taxes stole Stop & Shop’s funds. Stop & Shop’s On Premises coverage included the “Computer Theft of Money and Securities within or from the Premises.” Meanwhile, the subject policy excluded coverage for loss due to the “[t]heft or any other fraudulent, dishonest or criminal act ... by any [e]mployee, director, trustee or authorized representative of the Insured whether acting alone or in collusion with others.” The court held that coverage was excluded pursuant to the “authorized representative” exclusion. The court held that an “authorized representative” encompassed “either a person or company empowered to act on an entity’s behalf.” Stop & Shop Companies, Inc. v. Federal Ins. Co., 136 F.3d 71 (1st Cir. 1999).

6th Cir. 2014. The insured, Bank of Ann Arbor (the “Bank”), received a fax purporting to be from a customer requesting that $196,000 from the customer’s home equity line of credit (HELOC) be wired to a bank in South Korea. The Bank verified the instruction by (1) comparing the signature on the fax with the signature on file for the customer and (2) calling the customer. The call confirmed the instruction. The Bank was unaware that the telephone number for the customer in its records had been changed a few days earlier via a fax purportedly from the customer. The Bank wired the funds. When the imposter attempted to repeat the fraud a few days later, another employee of the Bank looked up the prior number and called the true customer who denied making the transfer. Everest National Insurance Company (“Everest”) had issued a financial institution bond (“FIB”) to the Bank, and the Bank sought coverage under Insuring Agreement (D). Everest denied the claim based on the FIB’s loan loss exclusion and a rider entitled Electronic/Computer Systems Rider. The Bank sued, was awarded summary judgment, and the Sixth Circuit affirmed. The reported decisions did not address the Electronic/Computer Systems Rider.

With regard to the FIB’s loan loss exclusion, the court considered the purpose of the provision and concluded, “Plaintiff did not lose $196,000 as a result of giving out a loan or extension of credit. Plaintiff lost $196,000 because an individual forged the signature of its true customer and thereby managed to get $196,000 transferred from the true customer’s HELOC to an account in South Korea which resulted in the money being stolen. The plain language of the Bond covers this type of loss and the exclusion in section 2(e) clearly does not apply.”

Finally, after summary judgment was granted by the district court, Everest filed a motion for reconsideration and argued, for the first time, that the faxed transfer instruction was not an “original” document as required by Insuring Agreement (D). The motion for reconsideration was denied, and on appeal the Sixth Circuit held that Everest had waived this potential defense by not citing it as a basis for denial of coverage. The Sixth Circuit also held that the district court did not abuse its discretion in refusing to grant reconsideration since the argument that the fax was not an “original” could have been made in opposition to the Bank’s summary judgment motion. 2013 WL 665067 (E.D. Mich. Feb. 25, 2013), aff’d 563 F. App’x 473 (6th Cir. 2014). Denial of Everest’s motion for reconsideration reported at 2013 WL 1914232 (E.D. Mich. May 8, 2013).

6th Cir. 2012. Computer hackers utilized the local wireless network at a DSW shoe store to access the main computer system or the insured, Retail Ventures, Inc. (“Retail Ventures”). Once in the main computer system, the hackers downloaded credit card and checking account information for more than 1.4 million customers of 108 DSW stores. The hackers then used the stolen customer credit card and checking account information to initiate unauthorized transactions on the customers’ accounts. Retail Ventures made a claim under the Computer and Funds Transfer Fraud
Endorsement of their Blanket Crime Policy to recover “expenses for customer communications, public relations, customer claims and lawsuits, and attorney fees in connection with investigations by seven state Attorney Generals and the Federal Trade Commission (FTC).” The largest portion of Retail Ventures’ alleged loss stemmed from credit card charge backs, credit card reissuance, account monitoring, and fines by VISA/MasterCard.

The Computer and Funds Transfer Fraud Endorsement covered “Loss which the Insured shall sustain resulting directly from . . . [t]he theft of any Insured property by Computer Fraud.” National Union Fire Insurance Company of Pittsburgh, Pa. (“National Union”), denied the claim, in part, on the grounds that Retail Ventures did not suffer a loss “resulting directly from” the theft of customer credit card and checking account information. National Union argued that the “‘resulting directly from’ language unambiguously required that the theft of property by computer fraud be the “sole” and “immediate” cause of the insured’s loss.” The theft of customer information, standing alone, appeared to have caused no loss to Retail Ventures; it was the subsequent use of the information that resulted in an eventual loss to Retail Ventures.

The district court disagreed and the Sixth Circuit affirmed an award of summary judgment in favor of Retail Ventures. The Sixth Circuit equated direct cause with proximate cause and held that Retail Ventures’ loss from customer credit card charge backs, card reissuance, account monitoring, and fines were losses “resulting directly from” Computer Fraud. Retail Ventures, Inc. v. National Union Fire Insurance Co. of Pittsburg, Pa., 691 F.3d 821 (6th Cir. 2012).

9th Cir. 2015. The insured, First National Bank of Northern California (the “Bank”) sought coverage regarding wire transfers from its customer’s account based on what turned out to be fraudulent instructions. After reimbursing the customer, the Bank sought to recover on its financial institution bond (the “FIB”). The FIB included a Fraudulent Instructions Insuring Clause that provided coverage if the Bank “suffers a loss directly from ... having in good faith ... transferred funds on deposit in a Customer’s account in reliance upon a fraudulent telephonic voice instruction” transmitted to the Bank “which purports to be from ... [among others] an individual person who is a Customer of” the Bank. For purposes of the Fraudulent Instructions Insuring Clause, a Customer is defined as “an entity or natural person” that

(i) has a Written agreement with the Insured authorizing the Insured to rely on telephonic voice or Telefacsimile Device instructions to make transfers;
(ii) has provided the Insured with the names of persons authorized to initiate such transfers; and
(iii) with whom the Insured has established an instruction verification procedure other than voice recognition.

The Bank had a standard form agreement authorizing wire transfers based on telephone or facsimile instructions, but had not secured the customer’s signature or ascent to it. Travelers was therefore awarded summary judgment, and the Ninth Circuit affirmed. The court rejected the Bank’s argument that the signed signature card regarding the account somehow incorporated by reference the non-signed, standard form agreement authorizing wire transfers based on telephone or facsimile instructions. The requisites for incorporation by reference under California law were not met, and the district court properly found that the signature card and other documents did not qualify as a written agreement under the bond. First National Bank of Northern California v. St.
9th Cir. 1999. The insured, Stanford University Hospital (the “Hospital”), sought coverage when a payroll processor stole the Hospital’s funds. The Hospital’s On Premises coverage included the “Computer Theft of Money and Securities within or from the Premises.” The Ninth Circuit held that coverage was excluded pursuant to the “authorized representative” exclusion. The court commented that “the plain meaning of the ‘authorized representative’ language in the crime insurance policies is not ambiguous and covers those who by authorization of the insured are given access to and permitted to handle the insured's funds. No other interpretation would make sense in terms of the crime insurance policy. The ‘authorized representative’ provision excludes coverage for misappropriation of funds by those individual or entities authorized by the insured to have access to the funds-in essence, those whom the insured empowers to act on its behalf.” *Stanford Univ. Hospital v. Federal Ins. Co.*, 174 F.3d 1077 (9th Cir. 1999).

S.D. Fla. 1997. The insured, Peoples Telephone Company (“Peoples”), sought coverage from Hartford under a crime policy for loss involving stolen information. Peoples provided cellular phones for rental car fleets. Lists containing combinations of electronic serial numbers and mobile telephone identification numbers (“ESN/MIN combinations”), which are necessary to activate and use cellular phones, was allegedly stolen by a Peoples employee. The employee allegedly sold the lists to third parties, who, in turn, used the number combinations to program (or “clone”) other cellular phones. As a result, Peoples claims to have incurred significant charges for unauthorized telephone usage. Peoples sought coverage for usage charges billed to Peoples by its cellular telephone providers, plus deactivation/reactivation charges incurred by Peoples to disconnect the stolen numbers and install new numbers on its cellular phone inventory. At issue was whether the stolen information constituted “property other than money and securities” under the subject policy, which was defined as “tangible property other than money and securities that has intrinsic value.” The court held that the stolen information was not tangible property, and Hartford Fire Insurance Company was awarded summary judgment. *Peoples Telephone Co. v. Hartford Fire Insurance Co.*, 36 F. Supp. 2d 1335 (S.D. Fla. 1997).

D. Minn. 2014. The State Bank of Bellingham (the “Bank”) suffered a loss of $485,000 when unknown criminals transferred that amount from an account at the Bank to an account at a bank in Poland. The transfer could not be reversed. The Bank used FedLine for wire transfers, and its security procedures included two separate users to authorize transfers, several passwords (including ones generated by tokens), and various firewalls and anti-virus services. The investigation of BancInsure, Inc. (“BancInsure”) showed that the Bank’s employees used the computer for such things as email and visits to Facebook, that the tokens for two users were left in the computer’s USB ports, and that one employee would commonly enter information for herself and the supposed second employee. By clicking on a link in an email, the Zeus virus was introduced into the computer, and for various reasons the anti-virus systems failed to prevent the virus from working. The result was that the criminals obtained the information needed to initiate the fraudulent wire transfer.

BancInsure did not dispute that the loss resulted from a fraudulent transfer within the Computer Systems Fraud insuring agreement, which provides coverage for:

Loss resulting directly from a fraudulent
(1) entry of Electronic Data or Computer Program into, or
(2) change of Electronic Data or Computer Program within
any Computer System operated by the Insured, whether owned or
leased, or any Computer System identified in the application for this
Bond, or a Computer System first used by the Insured during the
Bond Period, provided the entry or change causes

(1) property to be transferred, paid or delivered,
(2) an account of the Insured or of its customer to be added, deleted,
debited or credited, or
(3) an unauthorized account or a fictitious account to be debited or
credited.

In this Insuring Agreement (H), fraudulent entry or change shall
include such entry or change made by an employee of the Insured
acting in good faith

(1) on an instruction from a software contractor who has a written
agreement with the Insured to design, implement or service
programs for a Computer System covered by this Insuring
Agreement (H), or
(2) on an instruction transmitted by Tested telex or similar means of
Tested communication identified in the application for this Bond
purportedly sent by a customer, financial institution, or
automated clearing house.

BancInsure asserted that several exclusions and the Bank’s alleged lack of cooperation barred the
claim. The court held that none of the exclusions asserted by BancInsure – including loss caused
by an Employee and lost resulting directly or indirectly from the theft of confidential information
– rose to the level of an overriding cause of the loss. The acts of the insured’s employees, theft of
confidential information, and failure to keep the anti-virus protections up to date were not an
overriding cause of the loss as required by Minnesota law to defeat coverage. The court concluded,
“Thus, even if those circumstances ‘played an essential role’ in the loss, they were not
‘independent and efficient causes’ of the loss. In other words, without the fraudster’s actions, there
would have been no loss even if all of the other circumstances existed.” Finally, the court also
rejected BancInsure’s defense based on the Bank’s breach of the cooperation provision of the Bond
because the lack of cooperation had not prejudiced BancInsure.  State Bank of Bellingham v.

E.D. Pa. 2014. An employee of the insured, Sb1 Federal Credit Union (the “Credit Union”), made
several wire transfers to accounts in Thailand based on email requests and faxed transfer
instructions purportedly transmitted by an accountholder. The Credit Union sought coverage
under, inter alia, a Funds Transfer insuring agreement in the subject credit union bond. The Funds
Transfer insuring agreement provided coverage for:
Loss resulting directly from fraudulent instruction through E-mail, Telefacsimile or Telephonic means received by the Insured from a person who purports to be the Accountholder, the Accountholder’s authorized representative or an Employee but is not the Accountholder, provided:

(a) the Insured performed a Callback Verification with respect to such instruction, or
(b) the Insured followed a commercially reasonable security procedure set forth in a written funds transfer agreement, signed by the Accountholder or the Accountholder’s authorized representative, that governs the transaction and instruction.

The insurer, Berkley Regional Insurance Company ("Berkley"), filed a motion to dismiss, which was granted. The Credit Union’s employee did not follow the Credit Union’s own requirement for a telephone verification callback. The employee did request that the "accountholder" send a copy of his driver’s license or passport to verify his identity, but the imposter explained by email that he was traveling and could not make a copy.

The Credit Union argued that verification of the signature on the faxed transfer instruction was a “commercially reasonable security procedure” under the insuring agreement. The court did not reach the question of whether a signature comparison could be a security procedure, although it noted that the Pennsylvania UCC said it was not. The complaint failed as a matter of law because the accountholder had “membership and account agreements” with the Credit Union, but they were not written, signed by the accountholder, or authorized funds transfers as required by the Funds Transfer insuring agreement. *Sb1 Federal Credit Union v. FinSecure LLC*, 2014 WL 1395036 (E.D. Pa. Apr. 9, 2014).

W.D. Wash. 2011. The insured, Pinnacle Processing Group, Inc., ("Pinnacle"), was a company that processed credit card transactions for merchants. In short, merchants would contract with Pinnacle to lease a credit card terminal so the merchant’s customers could pay for goods and services with credit cards. At the end of each day, a third-party called Merrick Bank would deposit funds in the merchant’s account equal to the sum of all credit card transactions. Merrick Bank was reimbursed by the financial institutions that issued the credit card to the consumers (the “Issuing Banks”). In the event a credit card transaction had to be reversed or refunded (either through error, fraud, or a returned item), funds were returned to the Issuing Banks by Merrick Bank, and Merrick Bank was reimbursed by the merchant. If for some reason Merrick Bank could not be reimbursed (if, for example, the merchant is insolvent or has disappeared), Pinnacle was required to reimburse Merrick Bank. Pinnacle established a $250,000 reserve account that Merrick Bank could draw from to reimburse chargebacks that were not reimbursed by the merchant. When Merrick Bank withdrew from the reserve account, Pinnacle was required to replenish those funds within two (2) days.

From December 8, 2008 through December 17, 2008, Pinnacle processed $228,000 worth of credit card transactions from a jeweler. In January 2009, there were $228,044 of chargebacks that were not paid by the jeweler and therefore paid by Pinnacle. The “purchases” that resulted in the chargebacks were alleged to be fraudulent. Pinnacle sought coverage under an endorsement
that provided coverage for loss resulting directly from Computer Fraud. The endorsement defined Computer Fraud as:

[A]ny act of stealing property following and directly related to the use of any computer to fraudulently cause a transfer of that property from inside your premises or from a banking institution or similar safe depository, to a person (other than a “messenger”) outside those premises or to a place outside those premises.

Hartford Casualty Insurance Company argued that coverage was not implicated because there was no “direct loss,” and the court agreed. The court held that direct means “without any intervening agency or step: without any intruding or diverting factor.” In this matter, Pinnacle’s loss did not occur until (1) Merrick Bank was unable to recover the chargeback funds from the merchant banks; (2) Merrick Bank deducted funds from Pinnacle’s reserve account; and (3) Pinnacle fulfilled its contractual obligation to replace those deducted funds. The court held that finding coverage under these facts would render the word “directly” to be superfluous. *Pinnacle Processing Group, Inc. v. Hartford Cas. Ins. Co.*, 2011 WL 5299557 (W.D. Wash. Nov. 4, 2011).

**N.J. App. Div. 2005.** Morgan Stanley Dean Witter & Co. (“Morgan Stanley”) sued numerous insurance carriers seeking to recover over $21 million Morgan Stanley paid to defend and settle a lawsuit brought by First Tokyo Index Trust Limited (“First Tokyo”). The First Tokyo lawsuit involved fraudulent conduct by First Tokyo's investment advisor, London and Bishopsgate International (“London/Bishopsgate”), a company affiliated with a prominent English businessman named Robert Maxwell. The relationship between Morgan Stanley and London/Bishopsgate began when the companies executed a written custodial services agreement in which Morgan Stanley agreed to safeguard money and property that was owned and held by London/Bishopsgate. As custodian, Morgan Stanley was to be responsive to London/Bishopsgate's instructions, which could come from several persons specifically authorized to issue instructions on behalf of London/Bishopsgate. London/Bishopsgate also identified which of the authorized persons served as its authorized signatories. In order to facilitate receipt of any instructions, Morgan Stanley provided London/Bishopsgate with computer software allowing access to Morgan Stanley's computer programs.

After London/Bishopsgate and Morgan Stanley entered into the custodial services agreement, London/Bishopsgate entered into an investment management contract with First Tokyo. Under this contract, First Tokyo agreed to allow London/Bishopsgate to manage its investments. To effectuate this agreement, London/Bishopsgate opened an account with Morgan Stanley, where it also held accounts for eight other clients. The account opened by London/Bishopsgate to manage First Tokyo's investments was entitled “Client Account: 00040056 First Tokyo Index Trust.” Two years later, an entity called Headington Investments Limited (“Headington”), which owned 75% percent of London/Bishopsgate, announced that it was making a public offer to purchase First Tokyo. After the offer became unconditional, Headington requested that there be no change to First Tokyo's securities portfolio without Headington’s consent. Therefore, First Tokyo instructed London/Bishopsgate to cease trading on its behalf. No one informed Morgan Stanley that London/Bishopsgate no longer had authority to trade for First Tokyo. Despite revocation of London/Bishopsgate’s authority, London/Bishopsgate subsequently instructed Morgan Stanley to liquidate the bulk of First Tokyo's portfolio in five different transactions. Through each of these transactions, the sale proceeds were delivered to London/Bishopsgate-affiliated accounts. The transactions were accomplished through instructions
sent by computer, fax, and voice to Morgan Stanley by persons associated with and specifically authorized by London/Bishopsgate to do its business. After discovering the loss, First Tokyo sued Morgan Stanley.

In its complaint against the carriers, Morgan Stanley asserted coverage under three insuring agreements protecting Morgan Stanley against fraudulent instructions communicated by voice, fax, and computer. The carriers were awarded summary judgment by the trial court, but the appellate court reversed in part—affirming summary judgment with regard to the fax instructions and computer instructions insuring agreements, but reversing with regard to the voice instructions insuring agreement. The court described coverage with regard to fax instructions as “imposter coverage,” and the instructions received by Morgan Stanley were unquestionably not sent by an imposter. Coverage was also not implicated under the computer instructions insuring agreement, as an exclusion expressly precluded coverage for “loss by reason of the input of Electronic Data at an authorized electronic terminal ... or a Customer Communication System by a customer or other person who had authorized access to the customer's authentication mechanism.” Morgan Stanley Dean Witter & Co. v. Chubb, 2005 WL 3242234 (N.J. App. Div. Dec. 2, 2005).

N.Y. 2015. The insured, Universal American Corp. (“Universal”), suffered a loss when an authorized user of its computer system submitted medicare claims for services that were never rendered. Universal sought coverage under a Computer System Fraud rider to the subject policy. The rider provided coverage for:

Loss resulting directly from a fraudulent
(1) entry of Electronic Data or Computer Program into, or
(2) change of Electronic Data or Computer Program within the
   Insured's proprietary Computer System

... provided that the entry or change causes

(a) Property to be transferred, paid or delivered,
(b) an account of the insured, or of its customer, to be added,
    deleted, debited or credited, or
(c) an unauthorized account or a fictitious account to be debited or
    credited

National Union Fire Insurance Company of Pittsburgh, Pa. (“National Union”) prevailed at the trial court and appellate court levels, and National Union’s judgment was affirmed by Court of Appeals of New York (New York’s highest court). The court held that the rider applies to loss resulting directly from fraudulent access to the computer system, and not from loss resulting directly from the content submitted by authorized users. Thus, the court distinguished between fraudulent entry of data (which may be covered) and entry of fraudulent data (which is not covered). Universal American Corp. v. National Union Fire Insurance Company of Pittsburgh, Pa., 959 N.Y.S. 2d 849 (N.Y. Sup. Ct. 2013), aff’d 972 N.Y.S. 2d 241, aff’d 2015 WL 3885816 (N.Y. June 25, 2015).
Northside Bank (“the Bank”) sought coverage under an insurance policy issued by American Casualty Co. of Reading, Pa. (“American Casualty”) for a computer crime loss. The Bank opened an account incident to a merchant services agreement with a company known as Dakco PC Product Division Inc. (“Dakco”). Dakco then proceeded to accept orders for merchandise, and take payment by debit and credit cards. Dakco electronically transmitted the debit and credit card authorizations to the Bank, and upon receipt the Bank transferred money into Dakco’s account. Eventually, it was discovered that Dakco never delivered the purchased merchandise to its customers, and they exercised their rights under federal law to rescind their obligation to pay for the unshipped merchandise. When these customers refused to pay, their creditors, in turn, refused to pay, or charged back the amounts paid to the Bank. When the Bank went to charge back Dakco, it found Dakco’s accounts depleted. The Bank sustained a loss of about $300,000. The Bank sought coverage under a Computer Fraud insuring provision, which provided coverage for:

Loss resulting from the insured having in good faith and in the usual course of business transferred, paid or delivered any funds or property, established any credit, debited any account or given any value or assumed any liability as the direct result of any fraudulent electronic instruction or advice transmitted to or from the insured through

1. the insured’s computer system;
2. any shared network or facility for any automated teller machine or point-of-sale terminal in which the insured participates; or
3. a corporate customer cash management system.

The Bank also sought coverage under an Electronic Funds Transfer insuring provision, which provided coverage for:

Loss resulting directly from the insured having in good faith and in the usual course of business transferred, paid or delivered any funds or property, or established any credit or given any value on the faith of, or assumed any liability or otherwise acted upon, any fraudulent electronic instruction or advice transmitted to the insured through an electronic funds transfer system.

For both insuring provisions, the phrase “fraudulent electronic instruction or advice” was defined as:

(a) an electronic instruction or advice purporting to have been sent by another financial institution or automated clearing house or by a customer of the insured, and which instruction or advice is intended to deceive and is not in fact sent by said financial institution or automated clearing house or by said customer; or
(b) an electronic instruction or advice which is modified or altered with intent to deceive after being sent by another financial institution or automated clearing house or by a customer of the insured.
The Bank argued that the instructions it received were “modified or altered with intent to deceive” under subsection (b) of the definition of “fraudulent electronic instruction or advice.” The court disagreed and American Casualty was awarded summary judgment. The court opined that the terms “modified” and “altered” were unambiguous and that the Bank paid the electronic instructions it received in their unmodified and unaltered language. The court also commented “A review of the insurance policy in toto, and the electronic fund transfer and computer crimes coverage in particular, establishes that the purpose of the coverage was to protect the Bank from someone breaking into the electronic fund transfer system and pretending to be an authorized representative or altering the electronic instructions to divert monies from the rightful recipient. That is simply not what happened in this case.” Northside Bank v. American Cas. Co. of Reading, 2001 WL 34090139 (Pa. Commw. Pl. Jan. 10, 2001).

Selected Secondary Sources


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