BUSINESS LAW TODAY

September 2013

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Inside Business Law
Committees form the core of the Business Law Section, but they can also be a means for members of the Section to collaborate with members of other sections whose work is relevant to core business law. This month's Inside Business Law describes three sections bridging the boundaries between the Business Law Section and other sections of the ABA or other business professionals.

BUSINESS LAW TODAY

Risky Business: "Bring-Your-Own-Device" and Your Company

By Pedro Pavón

Smartphones and tablets are everywhere. Largely prompted by Apple, Samsung, and Google's consumer-centric marketing strategies, people are spending more and more money on the latest and fastest mobile devices, upgrading them almost constantly, and integrating them into every part of their lives. A large part of that integration is work-related. Employees use their own devices to manage work calendars, view and respond to e-mail, take notes at meetings, and almost anything else they would ordinarily do at their in-office workstation. Allowing employees to bring their own devices to work is no longer a trend; it has become a business necessity. As a result, an increased number of personally owned devices are making their way onto company networks, and it is undeniable that the bring-your-own-device (BYOD) phenomenon is here to stay.

BYOD presents companies with a myriad of new risks and challenges and lawyers need to understand the issues involved in order to provide quality advice to clients as it relates to information management. The most important thing every corporate attorney and outside counsel advising clients on information governance and BYOD needs to understand is this: the biggest risk with BYOD is data loss. An effective BYOD program and policy should emphasize security and contain clear instructions on what behaviors and activities are permitted on personally owned devices that have access to corporate information systems. However, most companies do not have the information architecture, hardware infrastructure, or resources to protect and secure all the data flowing through networks filled with different operating systems, applications, and devices—many of which, by the way, are widely dispersed and access internal corporate data via unsecure Internet connections. In order to fill this gap, companies are turning to Mobile Device Management (MDM) service providers to equip themselves with software tools and security solutions to protect the devices and data on their networks. Installing MDM software can help mitigate a lot of the technical risk associated with allowing employees to access company data on their own devices. For example, it is common for MDM solutions to allow a company to encrypt data on mobile devices, remotely lock and wipe devices, know the location of the device in real time, enforce a PIN policy, access personal data and contacts, and track user activity. While these capabilities address many of the security risks associated with BYOD, they also create problems related to employee rights and privacy.

Monitoring privately-owned devices creates a significant policy dilemma for companies and it raises a lot of legal questions for attorneys. If your client monitors too much, it can be seen as invading employee privacy, and in some parts of the world, may even be breaking the law. If it does not monitor and control enough, it places the company's data at a huge risk. Balancing these two seemingly opposing interests is the single greatest challenge to successfully implementing a BYOD program, and it is the role of legal counsel and in-house lawyers to make sure this implementation is done within the law, transparently, and without exposing the company to unnecessary legal risk. So, as an attorney, when a company you represent or work for informs you that it is interested in investing in technical solutions such as MDM to address security risk factors associated with BYOD, you should be prepared to respond that along with a technical solution, and in fact, ahead of it, it will be necessary to create a comprehensive BYOD policy that is transparent, easy to understand, and sufficiently detailed to help protect the company from unwanted regulatory scrutiny and litigation and to avoid the privacy pitfalls that can arise with the rollout of a BYOD program.

As briefly described above, MDM software gives companies a lot of power to control and manipulate the devices their employees use to access corporate data. Before they deploy any type of MDM, counsel should advise their clients to create a training program to educate employees about the scope and capabilities of the software. Every single person employed by your client should consent to MDM software installation before installation and should understand exactly what information is collected, how the MDM software is used, which capabilities are enabled, what happens during an incident, and what the employees' expectations are upon termination of employment. Security incident procedures must also be spelled out in your client's BYOD policy. For example, the BYOD policy must clearly explain what will happen if an employee reports a missing smartphone. Will the device be auto-locked? Will the company attempt to locate it using geo-location? Will the device be wiped completely? Will the employee's access rights be restricted? To avoid confusion and provide a framework for incident response, all these procedures should be spelled out in writing in the BYOD policy and provided ahead of time so employees do not encounter any unexpected results or surprises. Lawyers will have to work hand-in-hand with the CIO and the IT department to ensure that the BYOD policy accurately reflects and considers all of the capabilities of the MDM solution being deployed.

There are also several notices that must be incorporated into an effective BYOD policy. For example, employees must be made aware of all "passive" or "background" security measures in effect on their devices. If your client is going to track user activity on its employees' devices, they must be told exactly what is being tracked and how that information is being used and stored by your client. If the client is tracking the location of the device via MDM software or other means, the BYOD policy must also describe how location data is used and who has access to it and why. The best and most transparent way to increase monitoring of activity on privately-owned devices is to provide notice and ask for permission. When drafting a BYOD policy, it is "smart lawyering" to explain each process in detail and ask for specific consent.

Consent is a key component to any successful BYOD policy and BYOD program because it empowers your client to govern and monitor the activity of its employees' privately-owned devices without appearing to be secretive or deceptive. Here is a good rule of thumb: advise your clients never to install anything on any employee's personally-owned device without obtaining consent first. If a new feature is added that changes the way monitoring occurs, revise the BYOD policy and have employees acknowledge that they understand the changes. If (not really if, but when) it is discovered that your client has been engaged in any clandestine activity or secret monitoring of an employee's privately-owned device, it will almost certainly lead to conflict, disapproval, and possibly litigation. For example, in a case that went all the way to the U.S. Supreme Court, a California police officer sued his police department after he discovered that they had collected and reviewed personal text messages he sent from an employer-issued device. The Court, in *City of Ontario, California v. Quon*, ruled that the Fourth Amendment rights of a government employee had not been violated when the contents of his personal text messages—which were sent from a government-issued device—were reviewed in the course of an investigation. However, the Court expressed restraint in saying that its decision was deliberately narrow because "a broad holding concerning employees' privacy expectations vis-à-vis employer-provided technological equipment might have implications for future cases that cannot be predicted." Further, the Court stipulated for purposes of its discussion that Quon had a reasonable expectation of privacy in the text messages sent on the government-issued device. The implications of this reasoning for purposes of BYOD are significant because it is fair to assume that if a reasonable expectation of privacy exists on a government-issued device, then at least the same or an increased expectation of privacy will exist for a device the employee personally owns. In addition to the Supreme Court chiming in on digital privacy in the workplace, several state legislatures have passed laws requiring employers to notify employees when monitoring their electronic communications. *See* Del.Code Ann., Tit. 19, § 705 (2005); Conn. Gen.Stat. Ann. § 31-48d.

The threat of "spillage" or information leaking out of the confines of the company's protected network is another significant challenge with BYOD. In order to prevent spillage, IT departments want to have the option and capability to wipe devices or destroy data at any time. Lawyers must caution clients against such broad control of and access to personally-owned devices because wiping or destroying data on any device with or without the consent of the owner is a very risky proposition. For example, if wiping a device deletes the owner's media library containing thousands of dollars worth of movies and music, is your client then responsible for the loss of property? What if a device is reported lost, gets wiped, and then is found the next day in a safe location? Is your client responsible for helping recover all of the wiped personal information? As employees become more aware of their own risks associated with BYOD, it will become more difficult for companies to implement security solutions that grant them widespread control over their devices. Companies will be forced to make uncomfortable compromises and lawyers will have to play a lead role in helping them decide what their risk tolerance is for both the loss of corporate data and the possibility of violating their employees' privacy.

One countermeasure that can be employed to reduce the risks associated with device control and device-wide wipes is "sandboxing." Sandboxing is a form of software virtualization (via MDM software) that allows programs to run in an isolated virtual environment on a device. MDM software can then manage the sandboxed portion of the device only and encrypt and wipe data inside the sandbox as necessary. For sandboxing to be effective, the data in the sandbox must stay in the sandbox, but unfortunately, that is not always the case. Two close cousins of BYOD—BYOA (bring your own app) and BYOC (bring your own cloud)—are making it increasingly difficult for companies to employ sandboxing methods to safeguard data. BYOA includes all of the "wild" apps on your client's employees' devices. These apps are impossible to control and it would be extremely difficult—both legally and logistically—to know, let alone regulate, what apps employees should and should not install on their devices. BYOC presents an even more complex problem. In many instances, people use cloud services on mobile devices without even knowing it. For example, many smartphones back up data to the cloud automatically and tons of apps operate in their own proprietary clouds or interface with multiple clouds at once. With this level of cross-pollination taking place, it is impossible to prevent at least some data from leaking onto a third-party cloud. And when your client's corporate data is stored on or travels through a third-party cloud, you must consider it compromised.

An often-overlooked challenge with BYOD is legal discovery. If your client is engaged in litigation or involved in some other type of legal proceeding, an employee's device may become discoverable. This presents significant legal problems. People store all sorts of private information on their mobile devices, ranging from healthcare information, financial data, search results, and contact lists to family photos, social media profiles, and personal passwords. Some of this information, such as healthcare information, is legally protected, but may nonetheless be made public during the discovery process. Something as seemingly innocuous as a missed call may reveal private information if it is discovered that the call came, for example, from a psychiatrist's office. As you can see, the privacy concerns surrounding incidental or nonrelevant disclosures as a result of discovery that involves BYOD are considerable. On the other hand, if it is the employee who is in litigation and he or she turns over a device for discovery, sensitive company information may be compromised in the process. Worse yet, if your client were to attempt to wipe a device subject to discovery, the punitive legal consequences may be significant. It is important for counsel to emphasize the dangers of BYOD in the discovery process to clients because it is very likely to be overlooked if not considered at the outset.

BYOD presents some surprising but inevitable challenges as well. For instance, no matter how hard they try, companies will never be able to ensure that only pre-approved and authorized persons have access to their employees' devices. For example, if an employee takes his or her iPhone into an Apple store for repair, he or she has to give the device password to the technician, and in many cases has to leave the phone in the store overnight or ship it to a remote location. If your client handles financial data or healthcare data as part of its business, just leaving an iPhone at the Apple store may be considered a data breach and trigger reporting requirements. As explained above, the use of third-party apps is also problematic. For instance, many people use tools such as Siri or other personal assistant apps to send e-mails, make calendar appointments, etc. Apple stores (in the cloud) everything you tell Siri for two years. Therefore, without intending to, employees may be sharing sensitive information with unauthorized parties simply by using the common features on their phone or tablet.

Implementing a BYOD program is a choice, but failing to do so may result in decreased employee satisfaction, lower performance, increased costs, and loss of competitiveness. Many of the risks associated with BYOD can be mitigated or avoided by implementing MDM solutions and encryption solutions. But as you have just read, these solutions themselves create a series of new challenges. It is up to counsel to help their clients navigate the legal hurdles involved in implementing a BYOD program and to help them develop a BYOD policy and BYOD program that combines technology solutions with clear and comprehensive policies and procedures to help safeguard sensitive data, remain respectful of employee rights and privacy, and defend against litigation. Because the rules of the game are not clear, and because technology continues to evolve at breakneck speed, litigation is inevitable in this field and BYOD will be at the forefront of the controversy. By investing in new technology and implementing comprehensive and commonsense policies that are understandable and transparent, you can help your clients mitigate some of the exposure that has become necessary to remain competitive in the marketplace.

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Side-Stepping Fiduciary Issues in Negotiating Exit Strategies for Preferred Stock Investments after *Trados*

By Lisa R. Stark

In *In re Trados Inc. Shareholders Litig.*, C.A. No. 1512-VCL (Del. Ch. Aug. 16, 2013), the Delaware Court of Chancery held that a venture-backed board's approval of a merger in which the company's common stockholders received nothing was entirely fair despite the merger having been approved as part of an unfair process in which the interests of the company's preferred stockholders were favored over the interests of the common stockholders. The court reluctantly reached the conclusion that the board's actions survived scrutiny under the exacting entire fairness standard of review after finding that: (1) the value of the common stock was nothing at the time of the merger, and (2) the entire fairness standard is not a bifurcated test as between fair price and fair process, the two components of an entire fairness analysis. Thus, in the court's view, it could find that the board's approval of the merger was entirely fair even if the VC-backed board's process was unfair. In principle, the Delaware courts have consistently held that the entire fairness test is not a bifurcated analysis. However, in practice, the Delaware courts have consistently found against defendants in cases reviewed under the entire fairness standard where there has been unfair dealing because an unfair process usually results in an unfair price. Although the court found the directors committed no breach of fiduciary duty under the entire fairness standard, the court noted, in dicta, that the company's venture capital investors could have averted or mitigated fiduciary issues in connection with a merger in which the interests of the common and preferred were not aligned.

Background

This action arose from the July 2005 acquisition of TRADOS Inc. (Trados) by SDL plc (SDL) for $60 million in cash and stock. The preferred stockholders received $52.2 million as partial payment of their liquidation preference, which was triggered by the merger, and management received $7.8 million as part of a management incentive plan (the MIP). The common stockholders did not receive any merger consideration. Without the MIP, the common stockholders would have received $2.1 million in the merger. The merger constituted the culmination of a process initiated in 2004 by four venture capital firms, which held Trados preferred stock and designated five of seven members of the Trados board. Trados had initially obtained venture capital funding in 2000, from Wachovia Capital Partners (Wachovia) and Hg Capital LLP (Hg), and Wachovia and Hg each obtained the right to designate a director. Subsequent preferred stock investors included Sequoia Capital (Sequoia), which designated two directors, and Invision AG ("Invision" and, collectively, with Wachovia, Sequoia and HG, the "VC Investors"), which also designated a director.

Although Trados increased revenue year-over-year, the company struggled financially. By 2004, the VC Investors were no longer willing to fund Trados and began to demand an exit strategy. To this end, the Trados board approved the MIP, which compensated management for achieving a sale even if the transaction yielded nothing for the common stock. As the company's financial picture improved, Trados management actively solicited offers for the company. SDL emerged from the sales process as the only merger partner offering the possibility of a near-term exit for the VC Investors. On June 15, 2006, the Trados board approved a merger with SDL which triggered the preferred stockholders' contractual liquidation preference and provided no value to the holders of Trados common stock. At the time of the board's approval of the merger, five of seven Trados directors were designees of VC Investors and the remaining two directors were members of Trados management who reaped the benefits of the MIP and post-closing employment agreements with SDL.

Analysis

Plaintiff, a common stockholder, subsequently brought this action for breach of fiduciary duty and for an appraisal of his common stock. The plaintiff contended that the Trados board should not have approved a merger because it had a fiduciary obligation to continue operating Trados on a stand-alone basis to maximize the value of the corporation for the ultimate benefit of the common stock. Plaintiff's fiduciary claims survived a motion to dismiss, and this decision followed a five-day trial in which defendants bore the burden of proving that their actions were entirely fair because the court found that six of the seven Trados directors were not disinterested and independent.

In reviewing the plaintiff's fiduciary claims, the court focused on the two elements of an entire fairness analysis: fair dealing and fair price. As to fair dealing, the court found that the Trados board dealt unfairly with the holders of common stock when negotiating and structuring the merger. Indeed, the court found that there was "no contemporaneous evidence suggesting that the directors set out to deal with the common stockholders in a procedurally fair manner." According to the court, the MIP skewed the negotiation and structure of the merger in a manner adverse to the common stockholders. But for the MIP, the personal financial interests of the two management directors would have been aligned with the interests of the other common stockholders because the directors owned common stock, an incentive to evaluate critically the merger. The court also found that the board's failure to obtain a fairness opinion or to seek the advice of an investment banker to present the alternatives available to Trados constituted strong evidence of unfair dealing.

However, in contrast to the evidence on fair dealing, which decidedly favored the plaintiff, the court found that the evidence on fair price supported defendants. Specifically, the court determined that, at the time the Trados board approved the merger, Trados common stock had no economic value, and Trados did not have a realistic chance of generating a return for the holders of its common stock. Thus, the court found that the Trados directors had no duty to continue to operate the fledgling company independently to generate value for the common stock. Because the test for entire fairness is not a bifurcated one as between fair dealing and price, the defendants' evidence on price fairness was ultimately persuasive to the court's unitary fairness determination. Thus, the approval of a merger in which the holders of common stock received no consideration did not constitute a breach of fiduciary duty under the specific facts of this case. The court also found that the appraised value of the common stock for purposes of the appraisal proceeding was likewise zero.

Lessons from *Trados*: Draft a Better Exit Strategy

Use a Drag-Along Right or Forced-Sale Provision

In *Trados*, the court noted that the VC Investors did not "attempt to incorporate any mechanism for side-stepping fiduciary duties (such as a drag-along right if the VC funds sold their shares). . . ." Drag-along rights are frequently found in voting or stockholders' agreements for venture-backed companies and typically grant a specified percentage of the company's voting power, the right to force the company's remaining stockholders (who have previously consented to the drag-along provision) to participate in the sale of the company. The drag-along right typically would require the drag-along stockholders to vote in favor of a transaction that requires stockholder approval or sell their shares in a stock sale. If the trigger for the drag-along right is based solely on a vote of a specified percentage of the corporation's voting power, as opposed to being predicated on both board and stockholder approval, and the board takes no action in connection with the subsequent forced-sale, then the board should not be exposed to liability for breach of fiduciary duty.

However, even if the drag-along provision requires board action to trigger forced participation in the sale of the company, the existence of a drag-along right should still mitigate (or even completely end-run) subsequent fiduciary duty issues at the board level. In *Trados*, the court held that a board does not owe fiduciary duties to preferred stockholders with respect to the exercise of rights which are specifically addressed by contract. Rather, the board only owes holders of preferred stock fiduciary duties when it takes action on matters where the rights of the common and preferred stock exist on equal footing because the preferred failed to negotiate for preferred or special rights. Thus, for example, in a case where the board must allocate merger consideration between the holders of common stock and preferred stock and the rights of the preferred are not addressed by contract, a preferred stockholder may maintain a breach of fiduciary duty action.

Using a Contract to Render Fiduciary Claims Superfluous

By contrast, if the preferred stock designation provides some discretion for the board in allocating merger consideration, but clarifies that the discretion is to be exercised in good faith, the rights of the preferred may be limited to challenging bad faith actions of the board. This principle is not unique to preferred stock; it applies to other holders of contract rights against the corporation, including holders of common stock to whom the board owes fiduciary duties. Thus, disputes relating to the exercise of a contractual right by common stockholders should be treated as a breach of contract claim, not a fiduciary claim, if the rights and obligations at issue are expressly addressed by contract. In this specific context, any fiduciary duty claims arising out of the same facts that underlie the contract obligations generally should be foreclosed as superfluous.

For example, in the recent 2013 decision in *Blaustein v. Lord Baltimore Capital Corp.*, the Delaware Court of Chancery held that plaintiff, a stockholder of Lord Baltimore Capital Corp. (Lord Baltimore), could not bring a fiduciary claim against the directors of Lord Baltimore for breach of fiduciary duty arising from the board's decision to forego the repurchase of her shares of common stock pursuant to an optional repurchase provision in a stockholders' agreement. *Blaustein v. Lord Baltimore Capital Corp.*, C.A. No. 6685-VCN (Del. Ch. Apr. 30, 2013). Section 7(d) of the stockholders' agreement at issue provided that: "the Company *may* repurchase Shares *upon terms and conditions agreeable to the Company* and the Shareholder [.]" (emphasis added). Plaintiff alleged that the Lord Baltimore board breached its fiduciary duties by voting to reject a repurchase proposal she submitted for the company's consideration. The court disagreed and held that the board' decision whether to repurchase plaintiff's shares was *not* limited by fiduciary duties absent gross abuse of discretion or inequitable conduct because the stockholders' agreement addressed the matter at issue. In other words, the Lord Baltimore board could just say no to plaintiff's repurchase proposal irrespective of its reasons because the stockholders' agreement did not provide plaintiff with a right to compel the company to repurchase her shares and required the terms of any repurchase to be agreeable to the company. According to the court, any fiduciary duty claims arising out of the same facts that underlie contract obligations are generally foreclosed as superfluous. Indeed, the Court of Chancery held that Lord Baltimore did not even have an obligation to accept a "reasonable" repurchase proposal from plaintiff under the implied covenant of good faith and fair dealing. However, the court did note that the specification of a redemption price in the stockholders' agreement or the elimination of all board discretion on the matter would have facilitated its conclusion to dispense with plaintiff's fiduciary claims.

* * *

Directors of Delaware corporations owe fiduciary duties to the corporation's equity holders. Unlike the fiduciary duties of managers of an alternative investment vehicle, such as a Delaware limited liability company, the fiduciary duties of directors of Delaware corporations cannot be eliminated or modified by contract. However, VC and other investors in privately held corporations may use contractual provisions to side-step the fiduciary duty issues that typically arise when exiting the investment becomes imperative.

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SEC Lifts Ban on General Solicitation in Private Placements to Accredited Investors

By Daniel H. Aronson

On July 10, 2013, the U.S. Securities and Exchange Commission (SEC) adopted rule changes eliminating the prohibition against general solicitation and advertising in private securities offerings conducted under Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 (Securities Act). The Rule 506 private placement safe harbor is the most widely used exemption from Securities Act registration and is relied upon by many private issuers (i.e., companies that issue and sell their securities, including start-up and emerging companies, EB-5 programs, private equity funds, venture capital funds, and hedge funds) in connection with their capital raising activities. The new rules, which mark a radical departure from long-standing law governing private placements and which are aimed at providing greater and more efficient access to capital markets, implement a congressional mandate under Section 201(a) of The Jumpstart Our Business Startups Act, the so-called JOBS Act.

The amendments approved by the SEC create new Rule 506(c), which provides an additional "safe harbor" exemption from registration for securities offerings marketed using general solicitation and general advertising (together, referred to as "general solicitation"), provided that:

- all of the ultimate purchasers of securities are, or are reasonably believed by the issuer to be, "accredited investors" (as defined under applicable SEC rules) at the time of sale, and
- the issuer takes reasonable steps to verify that each purchaser is an accredited investor.

Alternatively, private issuers may choose to forgo marketing to the general public and continue to rely on Rule 506's existing regulatory framework.

In a companion release also issued on July 10th, the SEC adopted amendments to Rule 506 that disqualify issuers from relying on Rule 506 if certain "felons and other bad actors" participate in the Rule 506 offering, as mandated by the Dodd-Frank Act of 2010.

Market participants and consumer advocates have voiced concerns that lifting the ban on general solicitation in private offerings could adversely affect the investing public and could lead to an increase in fraudulent activity aimed at unqualified investors. In response to these concerns, and in order to enhance the SEC's ability to monitor and evaluate changes in the private offering market and developing practices in Rule 506 offerings, the SEC also proposed a series of amendments to Rule 506 and Form D (i.e., the form filed with the SEC for claiming a registration exemption). If adopted, these amendments would impose significant new filing and disclosure requirements on Rule 506 private offerings, particularly those conducted with general solicitation. The proposed rule changes are expected to draw significant comments, including concerns about costs versus benefits, the potential chilling effect on the use of general solicitation in private offerings and the resulting frustration of the JOBS Act's central purpose of facilitating capital formation.

The final rules and related amendments approved by the SEC will become effective on September 23, 2013 (60 days after publication in the Federal Register). The SEC has yet to issue proposed rules permitting so-called "crowd funding" offerings and transactions as mandated under the JOBS Act.

A summary of the new rules, as well as observations regarding practical implications for issuers and market participants regarding these rules, follows.

Rule Changes Permitting General Solicitation in Private Offerings

Summary of New Rule 506(c)

Rule 506 of Regulation D is a non-exclusive safe harbor rule adopted in 1982 under Section 4(a)(2) of the Securities Act, which exempts offers and sales of securities by an issuer "not involving any public offering" from the registration requirements of

Section 5 of the Securities Act. Under current law, it is a requirement of most private placement exemptions from the registration requirements of the Securities Act, including Rule 506 and (in the view of the SEC's staff) Rule 144A, that issuers are prohibited from using any form of general solicitation when conducting an unregistered offering of their securities. This restriction has been interpreted broadly to prohibit all public marketing efforts and outlets in an issuer's capital raising activities, including, among others, publicly accessible websites and social media, media broadcasts (such as radio and television advertisements), newspaper advertisements, mass e-mail campaigns, and public seminars and meetings.

Under new Rule 506(c), issuers will be permitted to use general solicitation in private securities offerings made under Rule 506, provided that the following conditions are met:

- all purchasers of securities in the offering must be "accredited investors," either because they fall within one of the enumerated categories of accredited investors under applicable SEC rules or because the issuer reasonably believes that they do, at the time of the sale of securities, and
- the issuer must take "reasonable steps to verify" that each purchaser of its securities is an accredited investor.

The SEC stated in its adopting release that whether the steps taken by an issuer to verify the accredited investor status of a purchaser are "reasonable" requires a principles-based, objective determination in the context of the particular facts and circumstances of each purchaser and transaction. This is an independent procedural requirement which must be satisfied even if all purchasers are in fact accredited investors. Factors that issuers should consider in making this determination include (1) the nature of the purchaser and the type of accredited investor that it claims to be, (2) the amount and type of information that the issuer has about the purchaser, and (3) the nature of the offering (such as the manner in which the purchaser was solicited to participate in the offering and the terms of the offering, including the minimum investment amount).

These factors are interconnected, and may require more, or less, consideration depending upon the specific facts and context. For example, an issuer that solicits new investors through a website accessible to the public or through a widely disseminated e-mail or social media solicitation would likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party, such as a federally registered broker-dealer or investment adviser. Furthermore, if the minimum investment amount in the offering is sufficiently high such that only accredited investors could reasonably be expected to meet it, and the investment is made with a direct cash investment that is not financed by the issuer or any other third party, these factors would be relevant in determining what additional steps should reasonably be taken to verify a purchaser's accredited investor status.

Regardless of the particular steps taken, given that the issuer bears the burden of proving that the exemption from registration is available, the SEC cautioned in its adopting release that issuers should retain adequate records documenting the steps taken to verify that a purchaser is an accredited investor. In addition, the SEC stated that:

> [we do] not believe that an issuer will have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.

Thus, the relatively common practice in which prospective investors complete a suitability questionnaire, or sign a form or agreement, self-certifying as to accredited investor status, will not by itself satisfy the "reasonable steps to verify" standard, at least not for natural person investors.

"Reasonable Steps to Verify" Accredited Investor Status

In response to comments seeking specific guidance on how an issuer can reliably verify accredited investor status, the SEC included in the Rule 506 amendments a non-exclusive list of four verification methods deemed to satisfy the required "reasonable steps" standard as applicable to natural person purchasers (as long as the issuer or person acting on its behalf does not have knowledge that a potential investor is not an accredited investor):

Income Test. If the potential purchaser's accredited investor status is premised on meeting the (accredited investor) income test—i.e., for a natural person, income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year—reasonable verification can be established by reviewing copies of any IRS form that reports the person's income (e.g., a Form W-2, Form 1099, Schedule K-1 or a copy of a filed Form 1040) for the two most recent years, and by obtaining a written representation from the person that he or she reasonably expects to meet the required income level during the current year.

Net Worth Test. If the potential purchaser's accredited investor status is premised on meeting the (accredited investor) net worth test—i.e., for a natural person, individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of such person's primary residence—reasonable verification can be established by reviewing certain specific documents, dated within the prior three months, and by obtaining a written representation from the person that all liabilities necessary to make a determination of net worth have been disclosed. For assets, the issuer may rely on bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and for liabilities, a credit report from at least one of the nationwide consumer reporting agencies is required.

Third Party Confirmation. An issuer is also deemed to satisfy the verification requirement by obtaining written confirmation from one of the following persons that it has taken reasonable steps within the prior three months to verify the accredited status of the purchaser (and has determined that the purchaser is accredited): an SEC-registered broker-dealer or investment adviser, a licensed attorney, or a certified public accountant. An issuer may be entitled to rely on accredited investor verification by other persons—if the third party takes reasonable steps to verify that potential purchasers are accredited and has determined that they are accredited—so long as the issuer has a reasonable basis to rely on the verification.

Prior/Existing Investor Confirmation. For any person who purchased securities in an issuer's Rule 506 offering as an accredited investor before the effective date of Rule 506(c) and who continues to own such securities, the issuer is deemed to satisfy the verification requirement by simply obtaining a bring-down certification from such person at the time of sale that he or she still qualifies as an accredited investor.

Private Offering Safe Harbor and "Reasonable Belief" Standard Continue

New Rule 506(c) leaves the traditional, existing safe harbor under Rule 506 unchanged, and redesignates it as Rule 506(b). Thus, issuers that do not wish to avail themselves of the opportunity to conduct their securities offerings using general solicitation may continue to offer their securities in reliance on the traditional safe harbor under Rule 506(b). Rule 506(b) permits sales of securities (with no limit as to dollar amount), without registration, to an unlimited number of accredited investors and up to 35 non-accredited investors who satisfy certain "sophistication" requirements (i.e., knowledge and experience in financial and business matters so as to be capable of evaluating the merits and risks of the prospective investment), if the required resale limitations are imposed, any applicable information requirements are satisfied and other conditions of the rule are met. If an issuer does not engage in any general solicitation, it will not be required to take reasonable steps to verify (under the new standards) the accredited investor status of its purchasers. However, as discussed further below, once a general solicitation has been made to potential investors in an offering, the issuer is precluded from relying on the Rule 506(b) safe harbor in that offering.

In addition, in its adopting release, the SEC reiterated its position that the "reasonable belief" standard in the definition of accredited investor in Rule 501 of Regulation D is unchanged by the new amendments to Rule 506. In this regard, as long as an issuer takes reasonable steps to verify that a purchaser is accredited and has (and those acting on its behalf have) a reasonable belief that the purchaser is accredited, the issuer would not lose its ability to rely on Rule 506(c) if it is later discovered that the purchaser was not in fact an accredited investor.

Changes to Form D

Issuers relying on Regulation D's safe harbor exemptions are required to file a Form D with the SEC no later than 15 calendar days after the first sale of securities in the offering. In connection with the rule changes, Form D is being amended by adding a new check box for issuers to indicate whether they are using general solicitation under the Rule 506(c) safe harbor (or instead are relying on Rule 506(b)). Issuers may not check both boxes. In addition, Form D will be amended to require issuers claiming a Rule 506 exemption to confirm that the offering is not disqualified from reliance on the Rule 506 exemption (see the discussion below regarding the new felon and "bad actor" disqualification rules). It should be noted that the SEC, on the same day it issued its final rules, issued certain proposed amendments to Form D that would condition prospective reliance on Rule 506(c) on complying with expanded Form D filing requirements.

Rule 144A Clarification

A Rule 144A offering involves a primary offering of securities by an issuer to one or more financial intermediaries in a transaction exempt from registration under Section 4(a)(2) or Regulation S under the Securities Act, followed by the resale of those securities to qualified institutional buyers (QIBs) in reliance on Rule 144A. QIBS, in general terms, are entities, owned entirely by accredited investors, which own and invest, on a discretionary basis, at least $100 million in securities; for a registered broker-dealer, the threshold is $10 million. In order to qualify for the exemption in existing Rule 144A, offers as well as sales must be made to QIBs. Thus, under current law, it's not clear whether issuers and sellers may permissibly offer securities under Rule 144A to investors which are not QIBs, which effectively prohibits the use of general solicitation in such offerings. An amendment to Rule 144A under the new rules confirms that securities may be offered to persons other than QIBs (i.e., they may be offered via general solicitation), as long as the securities are sold only to persons that the seller reasonably believes are QIBs.

Disqualification of Offerings Involving Felons and Bad Actors

Separately, in a companion release also issued on July 10 and as mandated under Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC also adopted rule changes adding a felon and "bad actor" disqualification provision applicable to offerings conducted under Rule 506 of the Securities Act. Under this amendment, the Rule 506 registration exemption will not be available for any securities offering, regardless of whether the offering is made using general solicitation under Rule 506(c), if the issuer or any other "covered person" (including directors, executive officers, other officers involved in the offering, general partners and managing members, 20 percent beneficial owners, promoters, placement agents, and persons compensated for soliciting investors) had a "disqualifying event" during a specified time period. The list of disqualifying events is broad, and includes certain securities-related felonies and misdemeanors, SEC cease-and-desist orders barring future violations of specified securities laws, suspensions from registration with national securities exchanges or national securities associations such as FINRA and other regulatory disciplinary actions. The rule does not apply if the issuer can show that it did not know, and in the exercise of reasonable care could not have known, that a covered person with a disqualifying event participated in the offering. In its adopting release, the SEC noted that the steps an issuer should take to satisfy the reasonable care standard—including reasonable factual inquiry into whether any disqualifications exist—will vary according to the particular facts and circumstances of the "bad actor" and the offering. Additionally, the SEC may grant waivers from disqualification under certain circumstances, including a change of control and absence of notice and opportunity for hearing. The rule applies only to disqualifying events that occur after its effective date, but disqualifying events that occurred prior to the effective date must be disclosed to investors at a reasonable time prior to the securities sale date.

Regulation S Offshore (and Concurrent) Offerings

Many private securities offerings are made concurrently (side-by-side) to the U.S. domestic market under Rule 506 or Rule 144A and to non-U.S. investors in reliance on Regulation S, a safe harbor for offers and sales of securities made outside the United States. These safe harbors are important when U.S. and non-U.S. companies, including EB-5 programs, engage in multi-country securities offerings in which the U.S. portion of the offering is conducted in accordance with Rule 506 or Rule 144A and the non-U.S. (offshore) portion is conducted in reliance on Regulation S. One requirement of a Regulation S offering is that there be no "directed selling efforts" in the United States, a concept similar in some respects to general solicitation (or "conditioning of the market" where the securities will be sold). In its adopting release, the SEC confirmed that concurrent (offshore) non-U.S. offerings that are conducted in compliance with Regulation S will not be integrated with domestic U.S. offerings that use general solicitation and are otherwise conducted in compliance with Rule 506 or Rule 144A, as amended.

Proposed Rules Regarding Form D and Exempt Offering Filing and Disclosure Requirements

In view of lifting the ban on general solicitation, the SEC, in proposed rules published for public comment on July 10, proposed a number of investor protection requirements applicable to Rule 506 private offerings, particularly those conducted with general solicitation. These provisions, in the words of the SEC, are intended to enhance the SEC's ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise given that issuers are permitted to engage in general solicitation under the new rules. The proposed rule changes cover a variety of significant topics and proposed new requirements, including an expansion of the information required to be included in Form D, new "advance" and "closing" Form D filing requirements, mandated legends and disclosure requirements (particularly regarding offerings using general solicitation), disqualification from the ability to rely on Rule 506 for a failure to make compliant Form D filings and a temporary rule requiring submission of written solicitation materials (where general solicitation is used) to the SEC on a non-public basis. The SEC's proposing release also includes a request for public comment on the "accredited investor" definition and thresholds. As noted above, the proposed rules (extensive discussion of which is beyond the scope of this article) are expected to draw significant comments, including concerns about costs versus benefits, the potential chilling effect on the use of general solicitation in private offerings and the resulting frustration of the JOBS Act's central purpose of facilitating capital formation.

Effective Date; Limitations; No Fallback Exemption

The final rules and related amendments described above are effective on September 23, 2013 (60 days following publication in the Federal Register), and the proposed rules provide for a 60-day public comment period (which ends on September 23, 2013). Accordingly, Rule 506 and Rule 144A remain unchanged at present (until September 23), and issuers should continue to comply with the existing requirements of such rules (including Rule 506's prohibition on general solicitation).

Importantly, the elimination of the prohibition on general solicitation under the new rules applies only to private offerings meeting the requirements of Rule 506(c), and not to other private offerings made under Section 4(a)(2) generally, under the so-called "private resale" exemption or under any other registration exemption other than Rule 144A. In this regard, issuers unable to rely upon the Rule 506 safe harbor that seek instead to qualify under the Section 4(a)(2) statutory exemption for private offerings should tread very carefully (with the advice of securities counsel), since the scope of that exemption as interpreted by the SEC and the courts is substantially more limited and less clearly defined than under Rule 506, and a failure to qualify could lead to possible SEC enforcement action and would possibly trigger rescission rights in favor of investors. As the SEC made clear in its final rules adopting release, issuers engaging in general solicitation in a securities offering in the U.S. face significant consequences if they rely on the new Rule 506(c) exemption but fail to meet the "reasonable steps to verify" accredited investor status standard; in such a case, they will not be able to rely on the statutory exemption provided by Section 4(a)(2) of the Securities Act and thus likely would be left without any exemption from—and would consequently be in violation of—the Securities Act's registration requirements.

Practical Implications for Issuers and Market Participants

The introduction, for the first time, of the ability to engage in general solicitation in Rule 506 and Rule 144A offerings is expected to have a significant impact on the way that certain issuers approach and market their private placements. The new rules present the opportunity for issuers (including start-up and emerging companies, EB-5 programs, and private investment funds) and their advisors to reach potential investors beyond their traditional relationships and networks, and to take advantage of a wide variety of state-of-the-art, broadly-inclusive and instantaneous communication and marketing tools and platforms, including through newspaper, television and radio advertisements, and via relatively inexpensive Internet-based media. Electing to go the general solicitation route, however, will come at a price. Issuers and their advisers (and, in the case of private investment funds, their sponsors) should bear in mind the increased responsibilities for due diligence with respect to verifying accredited investor status of potential investors and assuring that offering participants and other covered persons are not felons or bad actors subject to a disqualifying event, and should keep a watchful eye on the currently proposed rules and other rulemaking initiatives as these markets and offering practices, as well as SEC enforcement priorities and actions, develop and evolve. Some practical implications for issuers and market participants to consider include:

Many issuers will likely stick with the known, existing regulatory regime (and no general solicitation) for now. Current private offering practices, designed to prevent any form of general solicitation, are well understood and practiced by sophisticated issuers, their owners, advisors (including private placement agents registered as broker-dealers), and other market participants. The SEC has made clear that issuers may continue to rely on the existing regulatory framework (redesignated as Rule 506(b)) and conduct private offerings precisely the way they are being conducted today, provided that no general solicitation is used. Complying with the final and proposed rules (and other possible rulemaking) will significantly increase regulatory burdens and costs associated with compliance—including increased due diligence, verification of accredited investor status and more robust Form D disclosure requirements. Accordingly, initially (and until the regulatory "dust" settles), it is likely that many issuers—and particularly private investment fund issuers—and their advisors will forego general solicitation flexibility in favor of conducting their offerings under the current regulatory regime (i.e., the existing safe harbor exemption under Rule 506(b)).

Taking reasonable steps to verify accredited investor status; due diligence and record keeping; third party verification services. Issuers choosing to engage in general solicitation will be required to take "reasonable steps to verify" that each purchaser of securities in a Rule 506(c) offering is an accredited investor. Having a person check a box on a questionnaire or sign a form or agreement is not sufficient to verify accredited investor status, absent other information about the purchaser. The issuer has the burden of demonstrating that its offering is entitled to an exemption from registration, and thus should retain all records evidencing its "reasonable steps to verify." As a best practice, issuers should review with counsel their offering and subscription documents and practices, and fund sponsors and placement agents should also review their due diligence investigation protocols and private offering and other policies and procedures, including how best to document and verify that each purchaser qualifies in view of the factors discussed above. Among other things, consideration should be given to maintaining a detailed list of the steps taken and materials reviewed for each prospective purchaser. In addition, it is anticipated that a robust and dynamic "industry" of third-party verification service providers (regarding accredited investor status) may develop, and compete, to participate in and facilitate this process. Verification services will likely be offered by (among others) affiliates of placement agents, investment advisers, and other investment "matchmakers" who also compete for investment offering deal flow. Providing reliable verification regarding potential investors' accredited investor status, via a safe, trusted, and user-friendly access point to personal and financial information, will be important, both from a compliance and marketing point of view.

Addressing investor privacy concerns. Issuers who choose to take advantage of the new general solicitation rules must request personal and private financial information from potential investors, or must find some other acceptable way to demonstrate and document that each purchaser qualifies as an accredited investor (see discussion above regarding third-party verification service providers). Requesting such information, or obtaining other verifications concerning personal financial (including income and net worth) data, will raise privacy and data security concerns and may deter potential investors from participating in Rule 506(c) private offerings.

Offerings involving felons and bad actors disqualified from using Rule 506; due diligence on covered persons and disqualifying events. In view of the new felon and "bad actor" disqualification rules, and the reasonable care exception to the rule, issuers and placement agents will need to adopt and implement due diligence and verification procedures and practices to ferret out whether the issuer, any placement agent or any other covered person is, or during the applicable look-back period was, subject to a "disqualifying event." Registered broker-dealer firms and their employees are often subject to certain disqualifying events and thus will not be able to promote or assist with Rule 506 offerings without an SEC waiver. Issuers should consider adding appropriate additional questions to D&O questionnaires, requiring 20 percent or greater owners to complete questionnaires, and requiring placements agents, compensated finders, their personnel, and other covered persons to provide appropriate contractual representations. Judgment searches and review of broker-dealer compliance and other public records should also be conducted. Placement agents, broker-dealers and private fund advisors should adopt and implement new and more robust protocols and procedures in light of the rule changes, including (1) making sure their "houses are in order" (and that they, their affiliates and personnel are not subject to a "disqualifying event"), and (2) reviewing and revising, with their counsel, their due diligence requests and activities, disqualification protocols, form of placement agent agreement and other documents to address and conform to the requirements of the new rules.

Potential unintended consequences of general solicitation offerings. For issuers choosing to take advantage of the new general solicitation rules, careful consideration should be given to what information should be included in the marketing effort and what impact, positive or negative, the general solicitation may have on the image or credibility of their company and management team, or on the company's customers, vendors, or employees, or its ability to attract accredited investors. Information accessible on an issuer's website in advance of and during a private offering is deemed to be part of the general solicitation. Once marketing information is "out there," despite confidentiality notices and precautions, the publicity (and related communications) may take on a life of its own, whether or not the subject offering is ultimately successful.

Antifraud rules continue to apply. The new rules do not incorporate any exemption from traditional anti-fraud rules under the securities laws, including under Section 10(b) of and Rule 10b-5 under the Securities Exchange Act of 1934 (and related sanctions for making false or misleading statements in connection with securities offerings). Issuers and their agents should carefully review and consider the form, content, and distribution of all marketing, advertising, and solicitation information and materials, however communicated or accessible (including via website and social media outlets). Issuers should expect the SEC to be vigilant in surveying the market for examples of improper conduct to target for enforcement action.

Having a high degree of confidence in the success of an offering sold solely to accredited investors before any general solicitation. Once an issuer commences any general solicitation activities, if it is later unable to meet the requirements of Rule 506(c) (including the "reasonable steps to verify" accredited investor status standards and assuring that all purchasers are accredited investors), it may be left without any exemption from the Securities Act's registration requirements, and thus be unable to pursue or close any private offering of securities for some time. In addition, start-up, early stage, and other issuers that may need frequent access to private investment capital will need to be careful to avoid possible "integration" of offerings conducted within a six-month period—for example, when an offering to friends, family and known persons (including non-accredited investors and without general solicitation, under the traditional Rule 506(b)) is planned to be conducted concurrently with or following one or more offerings to other investors (using general solicitation, under new Rule 506(c)).

Regulatory "Soup"—watch for additional related, perhaps significant, private offering reforms. In embarking upon this new era of securities offering reform, the SEC will monitor closely the impact of its rule changes, and developing market practices, in the private, exempt offering arena. The proposed rules discussed above signal the SEC's desire, while implementing congressional mandates, to craft "speed bumps" and safeguards for the protection of investors (including by requiring new, rather extensive filing and disclosure requirements in offerings sold entirely to accredited investors). In addition, for startup and early stage companies seeking to raise capital in relatively small amounts from a wide audience, the SEC has yet to issue proposed rules to permit "crowd funding" offerings and transactions (as mandated under the JOBS Act). Issuers and their advisors will need to assess carefully the new rules, proposed rules, and future rulemaking efforts—and the associated costs, burdens, potential liabilities, and other consequences—as they consider and plan for their capital raises and related offering alternatives.

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RESOURCES

Links to Final and Proposed SEC Rules

The final rules permitting general solicitation in certain private securities offerings can be found at https://www.federalregister.gov/articles/2013/07/24/2013-16883/eliminating-the-prohibition-against-general-solicitation-and-general-advertising-in-rule-506-and; the final rules disqualifying private securities offerings involving certain felons and "bad actors" with "disqualifying events" can be found at https://federalregister.gov/a/2013-16983; and the proposed rules relating to Form D, Regulation D and certain offering filing and disclosure requirements can be found at https://federalregister.gov/a/2013-16884. These are the final and proposed rules as published in the Federal Register.

BUSINESS LAW TODAY

Keeping Current

Nassar and Vance: Supreme Court Limits Scope of Title VII of the 1964 Civil Rights Act

By Jon D. Bible

In June, the U. S. Supreme Court handed down two important decisions involving Title VII of the 1964 Civil Rights Act, which prohibits employers with at least 15 employees from discriminating against their employees because of their race, color, religion, national origin, or sex. In *University of Texas Southwestern Medical Center v. Nassar,* the Court held 5–4 (Roberts, Scalia, Kennedy, Thomas, and Alito) that a plaintiff in a retaliation case must prove that a retaliatory motive was the but-for cause of, not just a motivating factor in, an adverse employment action taken against him or her. This means that the action would not have occurred absent (but for) the retaliatory motive. In *Vance v. Ball State University,* the same majority adopted a narrow definition of "supervisor" for Title VII purposes. If an employer's agent who sexually harasses an employee was the latter's supervisor, the employer may be strictly liable for the harassment, whereas a negligence standard is applied if the agent is the employee's co-worker.

Predictably, the majority and the dissenters were poles apart in terms of what the Court actually did in these two cases. According to the majority, it was merely being faithful to the text of Title VII as amended by the 1991 Civil Rights Act. In the dissenters' eyes, by contrast, the rulings are the latest in a series of decisions that have gutted federal discrimination laws and thereby thwarted the will of Congress. In 2007, for example, the same majority held in *Ledbetter v. Goodyear Tire & Rubber Co.* that a suit by an employee alleging that she was underpaid for 19 years because of her sex was time-barred because she did not complain to the Equal Employment Opportunity Commission (EEOC) within 300 days of receiving her first allegedly discriminatory paycheck. Congress overturned that decision in 2008 in the Lilly Ledbetter Fair Pay Act; now, the 300-day clock is reset on the employee's receipt of each such paycheck. In 2009, that majority held in *Gross v. FBL Financial Services, Inc.* that the but-for standard applies in cases arising under the Age Discrimination in Employment Act of 1967.

Turning first to *Vance*, the Court held in *Burlington Industries v. Ellerth* and *Faragher v. City of Boca Raton* (1998) that if the sexual harassment of an employee by a supervisor culminates in a tangible employment action, e.g., dismissal, failure to promote, or a pay decrease, the employer is strictly liable for the harassment. In a hostile environment case, by contrast, the employer has a two-part defense: (1) it acted promptly to prevent or correct the harassing behavior, and (2) the employee unreasonably failed to invoke any available complaint mechanism. In a case involving harassment by the plaintiff's co-worker, the employer is liable only if it was negligent, that is, it knew or should have known of the harassment and failed to stop it.

The issue in *Vance* was how to define "supervisor." Vance, an African-American woman, worked for several years in Dining Services at Ball State University (BSU). During her employment she lodged numerous complaints of racial discrimination and retaliation against Davis, a white woman also employed in dining services. Although at trial the parties disputed the precise nature of Davis's duties, they agreed that she could not hire, fire, demote, promote, transfer, or discipline Vance. Despite BSU's attempts to resolve the problem, the workplace strife persisted and Vance eventually sued, claiming that she had been subjected to a racially hostile work environment in violation of Title VII.

The lower court held that BSU could not be held vicariously liable for Davis's alleged harassment because she lacked the authority to take any tangible employment action against Vance and, therefore, was not Vance's supervisor. As well, BSU could not be liable in negligence because it had reasonably responded to the incidents of which it was aware. The Seventh Circuit Court of Appeals affirmed.

The Supreme Court, speaking through Justice Alito, noted that while some federal circuits agreed with the Seventh Circuit, others followed the more open-ended approach advocated by the EEOC's Enforcement Guidance and adopted by many state and lower federal courts, which tied supervisor status to the ability to exercise significant direction over another's daily work. The Court, however, rejected the latter approach. While it conceded that its research showed that the term "supervisor" has varying meanings colloquially and in the law, it concluded that the law most often contemplates that the ability to supervise includes the power to take tangible employment actions. Along this line, the Court observed that Title VII does not refer to supervisors; instead, that term was adopted in *Ellerth* and *Faragher* to signify the class of agents whose misconduct may give rise to vicarious employer liability. This meant that the Court should now choose the interpretation that best fits, and because the employer's agents who committed sexual harassment in those cases had the ability to take tangible employment actions against the employees whom they oversaw, the Seventh Circuit's interpretation of the term made the most sense.

Alito also said that while *Ellerth* and *Faragher* presuppose a clear distinction between co-workers and supervisors, there is nothing to indicate that the Court had in mind two categories of supervisors: those with the power to take a tangible employment action, and those who merely have the ability to direct a co-worker's labor to some ill-defined degree. Finally, Alito observed that the EEOC approach would make the determination of supervisor status dependent on a case-specific, fact-intensive evaluation of numerous factors, which would likely frustrate judges and confound jurors.

The dissent, by Justice Ginsburg, argued that the majority ignored the reality that, even if they cannot take tangible employment actions, employees with the power to control their subordinates' work are aided by that authority in perpetuating a discriminatory work environment. Additionally, agents empowered to assign daily tasks performed by employees whom they oversee are often regarded as supervisors by other employees. She concluded by imploring Congress to overturn this decision, as it did the *Ledbetter* ruling, because it "disserves the objectives of Title VII to prevent discrimination from infecting the Nation's workplaces."

The majority's approach has the benefit of clarity. Courts that held that strict liability applies if the harasser merely directs the victim's daily work had to decide how much and what kind of control was needed to trigger this standard; arguably, simply asking a subordinate to run an errand would be enough to do so. This task was exacerbated by the changing nature of organizational hierarchies, in which it can be increasingly difficult to tell who supervises whom. For their part, employers faced substantial challenges as they sought to identify the proper scope of managerial authority and anticipate which employees would be deemed supervisors in a dynamic labor force under an imprecise standard. Now, the relevant issue is the black-and-white one of whether the harasser can hire, fire, demote, reassign, alter pay and benefits, etc.

That said, Justice Ginsburg is correct in arguing that people who merely have the authority to control their subordinates' daily work can, and often do, use it to perpetuate a discriminatory work environment. Now, with these individuals in the co-worker category, their behavior will go unpunished unless the employer is found to be negligent. It is also reasonable to expect that fewer cases will be brought in the future for harassment victims, who often find it tough enough to proceed under the best of circumstances, may decide it is simply not worth the effort to do so. While one can never be certain, this may well have factored into the majority's thinking.

Nassar involved a medical center that was part of the University of Texas system. The center had an affiliation agreement with a hospital that required the hospital to offer vacant staff position posts to university faculty members. Nassar, a man of Middle Eastern descent who was both a university faculty member and a hospital staff physician, claimed that Levine, one of his supervisors at the university, was biased against him because of his religion and ethnicity. He complained to Fitz, Levine's supervisor, but after the hospital agreed to let Nassar keep working there without also being on the university's faculty, he resigned his teaching post and sent a letter to Fitz and others, stating that he was leaving because of Levine's harassment. Fitz, upset at Levine's public humiliation and wanting public exoneration for her, objected to the hospital's job offer, which was then withdrawn.

Nassar sued, alleging that he had been subjected to racial and religious harassment that resulted in his constructive discharge from the university. He also claimed that Fitz's efforts to prevent the hospital from hiring him were in retaliation for complaining about Levine's harassment, in violation of the Title VII ban on employer retaliation because an employee has opposed an unlawful employment practice or made a Title VII charge. Fitz countered that the hospital's offer to employ Nassar without his being on the university faculty was at odds with the affiliation agreement's requirement that all staff physicians be members of that faculty. The jury found for Nassar on both claims. The Fifth Circuit Court of Appeals vacated the ruling on the discrimination claim for lack of evidence to support the constructive discharge allegation but upheld the retaliation claim on the basis that Title VII only requires a showing that retaliation was a motivating factor in an adverse employment action.

The Supreme Court spoke through Justice Kennedy. Observing that traditional tort law requires a plaintiff to prove that whatever harm he or she suffered would not have occurred but for the defendant's conduct, he concluded that this is the default rule that Congress presumably adopted in enacting Title VII, absent an indication to the contrary in the statute itself. He went on to note that Title VII prohibits employers from discriminating against their employees on any of seven criteria: five, which he termed status-based, are the personal characteristics of race, religion, sex, national origin, and color, while the two remaining categories involve an employee's opposition to employment discrimination and his or her submission of or support for a complaint that alleges such discrimination. Retaliation cases involve employees who have allegedly been punished for doing either of these two things.

In *Price Waterhouse v. Hopkins* (1989), Kennedy said, the Court ruled that if an employee could show that status-based discrimination was a motivating factor in an adverse employment action taken against him or her, the employer could escape liability only if it could prove that it would have taken the same action absent consideration of a protected trait. In 1991, Congress enacted the Civil Rights Act (CRA), one part of which partially overruled this aspect of *Price Waterhouse* by providing that the same-decision defense could not relieve an employer of liability, but instead would preclude the awarding of damages and leave a plaintiff with the remedies of injunctive or declarative relief. This CRA section explicitly left the motivating factor standard intact.

Kennedy then asserted that this section only applies to status-based discrimination, not retaliation, which is dealt with in a part of Title VII other than the one the CRA amended. This, in turn, led him to conclude that retaliation cases are governed by the default but-for standard. Kennedy bolstered his claim by referring to the *Gross* decision, where the Court used essentially the same textual argument to justify its conclusion that age discrimination cases are different from status-based Title VII discrimination cases, were not affected by the CRA, and must therefore be governed by the but-for standard.

The dissenters, again speaking through Justice Ginsburg, essentially made two arguments. First, they asserted that it is, at best, facetious to conclude that the 1991 Congress meant to split hairs in the manner asserted by the majority. On the contrary, Congress's intent was to overrule *Price Waterhouse* insofar as it held that the same-decision defense would relieve an employer of liability for discrimination, and there is no reason to conclude that it wanted cases involving discrimination other than the status-based variety to be governed by a stricter standard than "motivating factor." The dissent also argued that retaliation for complaining about discrimination is "tightly bonded" to the core prohibition of Title VII and cannot be disassociated from it, and that in subjecting retaliation claims to a different proof standard, the Court was undermining the intent of the 1964 and 1991 Congresses.

Ironically, Kennedy argued for the but-for causation standard in *Price Waterhouse,* but his approach garnered only two other votes. In *Nassar,* however, he attracted two more votes, and that was enough for his position to become law, at least insofar as non-status-based discrimination cases are concerned. It is submitted, however, that it is a stretch to argue that an act (i.e., CRA) designed to make that case *less* employer-friendly as regards status-based discrimination cases was somehow intended to adopt a *more* employer-friendly standard of causation in non-status-based cases.

Nasser puts another roadblock in front of Title VII plaintiffs, for proving that an action would not have occurred but for X is a far cry from proving that X was a motivating factor in the decision to take the action. Its likely effect will be that fewer retaliation cases are filed and that in those that are, summary judgment for the employer is more likely. Given that the EEOC and the courts have seen an upsurge in retaliation cases in recent years – retaliation complaints to the EEOC have doubled in the last decade and a half – it is easy to applaud the notion of cutting down on frivolous litigation. The difficulty, however, is that a fair number of meritorious claims will likely be the victim of the new causation standard as well, and it is hard to argue that this was the intent of the Congresses that enacted Title VII and the CRA.

These decisions clearly continue the pro-employer trend of the Roberts Court, although it remains to be seen whether they will have the draconian effect predicted by the dissenters. Two points must be stressed, however. First, while employees will have a tougher row to hoe in these kinds of Title VII cases, they can still prevail. Second, the law in a given state or city may be more employee-friendly. Employers should not, therefore, infer that, from a managerial perspective, they can afford to become more lax. On the contrary, it remains necessary to have well-thought-out, clear anti-discrimination policies, which deal specifically with retaliation; to properly train employees; to have clear and reasonable reporting procedures; to carefully and immediately investigate employee complaints; and to take appropriate corrective action when necessary.

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BUSINESS LAW TODAY

Delaware Insider:

Key Delaware Corporate and Commercial Decisions from First Half of 2013

By Kevin F. Brady and Francis G.X. Pileggi

During the first half of 2013, Delaware's Supreme Court and Court of Chancery issued a number of important decisions with far reaching implications. This is a short overview of several key decisions during that time period.

Starting with what one expert in Delaware corporate law described as one of the "best corporate opinions ever"! the Delaware Court of Chancery in *In Re MFW Shareholder Litigation,* C.A. No. 6566-CS (Del. Ch. May 29, 2013), addressed a "novel question of law" – what standard of review should apply to a going-private merger conditioned upfront by the controlling shareholder on approval by both a properly empowered independent committee and an informed, uncoerced majority-of-minority shareholder vote – business judgment rule or entire fairness test?

Surprisingly, the question of what standard of review should apply to this situation had never been put directly to either the Court of Chancery or the Delaware Supreme Court. In *Kahn v. Lynch,* the Delaware Supreme Court held that the approval by either a special committee or the majority of the non-controlling stockholders of a merger with a controlling stockholder would shift the burden of proof under the entire fairness standard from the defendant to the plaintiff.

The court in *MFW,* in concluding that the business judgment rule should apply, noted:

> This conclusion is consistent with the central tradition of Delaware law, which defers to the informed decisions of impartial directors, especially when those decisions have been approved by the disinterested stockholders on full information and without coercion. Not only that, the adoption of this rule will be of benefit to minority stockholders because it will provide a strong incentive for controlling stockholders to accord minority investors the transactional structure that respected scholars believe will provide them the best protection, a structure where stockholders get the benefits of independent, empowered negotiating agents to bargain for the best price and say no if the agents believe the deal is not advisable for any proper reason, plus the critical ability to determine for themselves whether to accept any deal that their negotiating agents recommend to them.

The court also recognized that the Delaware Supreme Court is the final arbiter of all Delaware corporate matters, so this decision leaves corporate lawyers and shareholder counsel with something to think about when advising or evaluating the process for going-private deals until the Delaware Supreme Court rules on the matter which is currently pending before it on appeal.

In *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* C.A. No. 7220-CS and *ICLUB Investment Partnership v. Fedex Corp*., C.A. No. 7238-CS (Del. Ch. June 25, 2013) the Delaware Court of Chancery addressed the enforceability of forum selection bylaws providing that litigation relating to the internal affairs of the corporation must be filed only in Delaware.

Plaintiffs charged that the bylaws were: (1) statutorily invalid because they were beyond the board's authority under Section 109 of the Delaware General Corporation Law (DGCL); and (2) contractually invalid because they were unilaterally adopted by those boards using their power to make bylaws.

The standard of review for this motion was also important in this case. The plaintiffs argued for the traditional test that the court may only grant judgment on the pleadings if there are no material facts in dispute. However, the defendants argued (and the court agreed) that because the motion concerned allegations that the bylaws were invalid in that they were beyond the authority granted in 8 Del. C. § 109(b), the motion was only concerned with the facial statutory and contractual validity of the bylaws and not how the bylaws might be applied in any future, real-world situation. Under Section 109(a) of the DGCL, while the power to adopt bylaws rests with the stockholders, a corporation may, in its certificate of incorporation, confer that power on directors. Under Section 109(b), the bylaws may contain any provision relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers, or employees.

Both Chevron's and FedEx's certificates of incorporation conferred on the boards the power to adopt bylaws under § 109(a). As a result, any investors who bought stock in those corporations were on notice that (1) the DGCL allows for bylaws to address the subjects identified in 8 Del. C. § 109(b), (2) the DGCL permits the certificate of incorporation to contain a provision allowing directors to adopt bylaws unilaterally, and (3) the certificates of incorporation of Chevron and FedEx contained a provision conferring this power on the boards. Acting in accordance with the power conferred to those boards by the certificates of incorporation, the boards amended the bylaws and adopted a forum selection bylaw to cover certain types of suits relating to internal corporate governance.

Because the certificate of incorporation conferred on the board the power to adopt bylaws, and the board had adopted a bylaw consistent with 8 Del. C. § 109(b), the court found that the stockholders had assented to that new bylaw being contractually binding. As a result, the court found that the bylaws were statutorily and contractually valid.

In *Gerber v. Enterprise Products Holdings, LLC,* Del. Supr., No. 46, 2012 (June 10, 2013), the Delaware Supreme Court addressed the increasingly important issue of whether a contract provision that presumes good faith can preclude a claim for a breach of the implied covenant of good faith and fair dealing in a limited partnership agreement. Delaware's high court answered that question in the negative. The court reasoned that the waiver in a limited partnership agreement of the fiduciary duty of good faith, and the substitution of a new contractual definition for good faith, cannot eliminate the implied duty of good faith and fair dealing which cannot be waived in Delaware.

Gerber is the first Delaware Supreme Court decision that directly addresses the issue of whether the presumption of good faith in a limited partnership agreement can, as a practical matter, prevent a claim for a breach of the implied covenant of good faith and fair dealing.

This Delaware Supreme Court decision needs to be distinguished from another recent decision by that court in *Brinckerhoff v. Endridge Energy Company, Inc*. The *Brinckerhoff* case also dealt with a presumption of good faith in a limited partnership agreement, but in that decision, the court did not address the effectiveness of that conclusive presumption because the ruling relied on a separate holding that the complaint failed to allege facts that suggested bad faith. The factual background involved an extensive network of multiple related entities involved in a number of labyrinthine transactions.

The applicable agreements established a conclusive presumption when enumerated conditions were satisfied, which provided protection from any claims of conflict of interest. Those conditions included relying on the opinions of experts, and such reliance would be conclusively presumed to have been done in good faith. The court's reasoning was based on the distinction between the contractually defined duty of good faith, and the similar term that is a component of the implied covenant of good faith and fair dealing. Conflating those two concepts is an error. The court explained that the focus of any analysis under common law fiduciary duty is the action at the time that the wrong took place. By contrast, the focus of any analysis under the implied covenant is the intent of the parties at the time the contract was formed, which is often many years prior to the alleged wrong.

The Delaware Supreme Court emphasized that no contractual provision could eliminate the implied covenant, even on a de facto basis through a conclusive presumption. The high court provided several examples of why the implied covenant could not be "contracted away," and no provision in an agreement could bar a claim for arbitrary and unreasonable use of discretion that would be a breach of the implied covenant. The court concluded that an implied covenant claim can still be pursued even where, as in this case, the defendant allegedly attempted to satisfy his contractual obligations, within a conclusive presumption provision, by relying on a fairness opinion that did not value the consideration that was actually received by the LP Unitholders.

The court reasoned that it could "confidently conclude" that had the parties addressed the issue at the time of contracting, they would have agreed that any fairness opinion must address whether the consideration actually received was fair in order to satisfy the contractually defined duty, which was the good faith component of a contractually defined duty imposed under the agreement. The court held that a nonresponsive fairness opinion that was relied on is "the type of arbitrary, unreasonable conduct that the implied covenant prohibits." The court compared another of its recent opinions which did not involve claims that the fairness opinion did not state that the merger was fair. *See Norton v. K-Sea Transportation Partners L.P.*

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BUSINESS LAW TODAY

Training for Tomorrow

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

By [James D. Wing]

The corporation laws of every U.S. jurisdiction permit corporations to advance defense costs, indemnify, and insure innocent directors and officers against risks of liability that arise out of their good faith service to the corporation. They do so to encourage responsible and talented individuals to accept the weighty responsibilities these positions impose. Last year, Business Law Today published a checklist created by the Director and Officer Liability Committee to assist corporate counsel in supervising the creation or renewal of an executive protection program to implement that policy. Both before and after its first publication, the checklist was vetted through exposure to and comment by attendees at ABA live and webinar programs and at a webinar given to members of the Association of Corporate Counsel. The Committee promised that it would update the checklist each year to reflect changes in the law and insurance markets. This is that update.

The checklist was created by the Committee in response to requests by corporate counsel who had communicated their practical inability to master the nuances of this ethically dangerous, highly complex, and specialized area, much less keep up with new developments in the law and the insurance markets. They asked for a document that would assist them in managing the creation or renewal of an executive protection program to provide at least the maximum protections that the law and insurance markets allow. They asked for a compendium of issues that they could give their risk manager, insurance brokers, and outside counsel to use to vet the adequacy and breadth of the corporation's executive protection program. The checklist's objective is to assist professionals to meet the statutory goal of protecting innocent executives while not overly burdening shareholders with massive and unlimited defense cost obligations to perceived miscreants. The checklist highlights issues and suggests alternatives intended to meet the statutory objectives in a commonsense and balanced manner.

This year, the Committee has given particular attention to the increased frequency of cases where executives find that their behavior is the subject of potential criminal liability arising out of corporate internal investigations. The Committee has concluded that there are significant gaps in both advancement and insurance protection in this area, and is exploring ameliorative measures. As a result, it expects to further update the checklist next year to further address these issues in the context of developing law and changes in the insurance market. The Committee has also just published, through the ABA, an annotated

[Model Indemnification Agreement] based on Delaware law. The provisions of that agreement are consistent with the checklist.

* * *

The Checklist

A comprehensive director and officer's protection program has four elements, regardless of whether the corporation is for-profit or not-for-profit: (1) statutory immunity of directors of for-profit corporations from claims for damages by shareholders resulting from directors' failure to exercise "due care," and statutory protection against liability for (typically) volunteer executives of non-profits; (2) advancement to selected executives of defense costs and expenses until claims are resolved and then relief from any duty to repay the amounts advanced in a proper case; (3) indemnity from the corporation for any amount an executive may agree to pay in settlement of such a claim or that the executive may be compelled to pay by judgment in a proper case; and (4) a comprehensive program of D&O insurance that meshes with the corporation's advancement and indemnity by-laws to cover legitimate risks that state statutes leave uncovered. This checklist addresses these elements in turn.

I. Director Exculpation under Certificate/Articles of Incorporation; Statutory Protections for Volunteers of Non-Profits. Under most states' corporation laws, directors may be exculpated in advance from civil liability for damages for breach of the fiduciary duty of due care they owe to the corporation and its shareholders. This is a corporate articles/certificate of incorporation matter that requires no further checklist. Volunteers for not-for-profit corporations may additionally be entitled to exculpation or immunity from suit under federal and state laws. Taking the legal steps necessary to allow directors to avail themselves of exculpatory provisions permitted by governing law is an important component of any comprehensive director protection program. Guaranteeing this protection is a classic duty of in-house or regular corporate counsel.

II. Advancement and Indemnity. Executives may be given a right to advancement from the corporation of reasonable defense costs for all claims against them arising from their service, and a mandatory right to be relieved from repaying these advances. They may also be indemnified for any ultimate settlement or judgment against them under corporate by-laws or formal indemnification agreements. In all cases, however, these rights exist only if and to the extent that advancement and indemnity is permitted by governing law. No jurisdiction's statute expressly permits an executive to obtain advancement of defense costs if the executive asserts Fifth Amendment privileges in response to inquiries by a corporation including those made during a corporate internal investigation. No statute expressly permits an executive's counsel to assert work product privileges in respect of the attorney's billing entries when the reasonableness of the attorney's charges are at issue. These two privileges are generally critical to an innocent executive's defense, and to the extent they are compromised, the executive is at risk. These considerations give rise to the following issues:

A. Are the advancement and indemnity rights contractually mandatory, or are they only to be conferred by separate action of the board on a discretionary basis after a claim arises? If they are mandatory, do they cover the correct executives?

B. If mandatory rights are granted in by-laws, is the board prohibited from amending the by-laws to eliminate protection for circumstances that accrue during the executive's tenure but before a claim is made? (Some state statutes cover this question, but many do not.)

C. Does the right to advancement accrue at a sufficiently early stage to protect the executive without causing premature "lawyering up" that is detrimental to corporate collegiality and informal communication?

D. Does the right to advancement cover derivative and corporate internal investigations?

E. If the corporation has foreign subsidiaries on whose boards executives are expected to serve or if they are expected to otherwise supervise foreign operations, is the corporation obligated to post bonds or otherwise pay to secure the release of the executive's person from physical arrest and his personal assets from sequestration orders issued by a foreign court or governmental agency? May the corporation indemnify and advance defense costs, or even buy insurance for such executives, if the substantive law governing the subsidiary forbids advancement, indemnification, or insurance?

F. If the executive is in any way implicated in a matter that creates potential personal criminal exposure, does the executive:

   i. have access to (but not possession, custody or control over) all relevant corporate documents useful to his defense?

   ii. have the express contractual right to assert Fifth Amendment privileges (and his lawyer work product privileges) without jeopardizing his advancement and indemnity rights or limiting the amount of defense costs for which he is entitled to advancement? Does the by-law specify a mechanism for resolving privilege disputes?

   iii. have the right to receive advancement of defense costs until at least the first "final adjudication" (i.e., after appeal) of facts that forbid the corporation from indemnifying him under the relevant corporate law? Must these facts be found in the criminal or civil case for which advancement is sought or may they also be found in any U.S. case in which the executive has participated without the assertion of Fifth Amendment privileges by himself or a witness material to his defense? Is the corporation prohibited from instituting or continuing any civil case against the executive that requires him to waive his Fifth Amendment rights or the executive's counsel work product privileges before final adjudication of at least the first claim that gives rise to the need for advancement?

   iv. have the right to subrogate himself to the corporation's Side B coverage should the corporation refuse to advance him defense costs and the executive pay such a cost directly?

   v. have the right to judicially compel advancement at the corporation's expense using summary procedures, i.e., without having to make any assertions of fact, good faith, or innocence that can prompt an evidentiary hearing?

G. Assuming that the executive's advancement and indemnity rights cover claims that are broad in scope, does each director understand that a broad definition may include a duty to advance reasonable defense costs in an unlimited amount and in respect of claims for insider trading, embezzlement, diversion of corporate opportunities, or otherwise receiving improper personal benefits, leaving the corporation in a delicate public relations or financial position should uninsured defense costs rise to a substantial level? If the corporation elects not to assume a mandatory contractual duty to advance or indemnify for the latter claims, is that intention adequately expressed in the bylaws and is it consistent with similar exclusionary language contained in the corporation's D&O insurance policies?

H. Should the corporation leave its advancement and indemnity exposure unlimited in amount in respect of third-party claims in which the corporation and executive cooperate in the defense? In cases where the interests of the corporation and its executives are adverse so as to prohibit a joint defense on the merits of the claim, should the corporation limit its advancement and indemnity duty to the sum of insurance cover and the corporation's deductible?

I. Are executives permitted to be advanced and indemnified against all legal costs in any matter that includes non-indemnifiable claims or parties so long as the facts or issues relevant to the covered and uncovered claims overlap?

III. D&O Insurance. A corporation may obtain Side B insurance to cover its advancement and indemnity obligations to its executives and Side A cover to protect its executives directly from claims for matters in which the corporation and executives are joint defendants and are united in the defense. ABC policies may also cover claims where the interests of the executive and the corporation are in conflict. A corporation may purchase DIC insurance to cover defense costs arising from situations of adversity and also to cover claims for which the corporation may not legally indemnify, financially cannot indemnify, or for which the corporation refuses to indemnify.

Checklist issues are:

A. Are all individuals that the board wishes to insure in fact covered? Are those it does not wish to cover excluded from the policy definition of "Insured"?

B. Has the board made a reasoned and appropriate decision on policy limits, particularly given that under its Side B coverage, it seeks to cover its complete advancement and indemnity exposure to all covered executives beyond an agreed retention? Are all parties cognizant of the phenomenon of competition among insureds for access to policy limits and the accepted means for reducing such competition? Are litigation costs covered when they are incurred in board members' efforts to preserve policy limits for themselves?

C. Does the policy cover defense costs within overall limits or through sublimits for matters such as derivative investigations (both those that arise immediately after demand and those that arise after the creation of a special litigation committee) and corporate internal investigations?

D. Where advancement coverage incepts under C. above but before a defined "claim" arises, does the policy give each insured the separate option of not treating the event as a reportable claim or mandatorily-reportable circumstance? May individual insureds give notice of circumstance to cement cover under the policy in effect for that year over the objection of the corporation?

E. Does the policy cover employment practice claims, crisis management costs, searches and raids by enforcement authorities, and claims against employed lawyers? If the latter have separate professional liability cover, is it clear which cover is primary?

F. Is the policy definition of "wrongful act" sufficiently expansive so that "all risk" coverage is obtained, assuming such is the desire? Does the insurer agree that such cover includes claims by opposing parties for attorney's fees? Claims for personal injury and property damage arising from a wrongful act as defined? Section 11 and 12 securities law liability? All insurable fines and penalties and punitive, moral, and multiple damages to the extent permitted by law? Amounts paid to mitigate or reduce the likelihood of a claim? Personal liability for corporate taxes and statutory insurance contributions?

G. Does advancement coverage expressly continue until there has been a final adjudication of facts in the underlying proceeding for which advancement is given that permits the application of the "willful or intentional act" policy exception? Is the insurer prohibited from bringing any suit to accelerate that process? Are the "deliberate and intentional act" or "improper personal benefit" exclusions limited to cases where the act or gain was the result of deliberate misconduct?

H. Is the insurer prohibited from recovering its advances should the executive's conduct fall within the "willful or intentional act" exclusion?

I. Is the definition of "loss" sufficiently expansive? Does it exclude the types of claims for which the board may not wish to insure against such as insider trading, embezzlement, diversion of corporate opportunity, and other claims in which the executive is accused of receiving an improper personal gain or benefit?

J. Does the policy contain an exclusion for claims against executives that seek to recover amounts that the corporation should have paid in addition to amounts it did pay in a merger, share exchange, or sale transaction? If so, are executives entitled to advancement and indemnity if personally sued in such a case without being required to allocate their defense costs between other covered claims and the claims seeking an increase in consideration? Generally, are executives permitted to be advanced and indemnified against all legal costs in any matter that also includes uncovered claims or parties so long as the facts or issues relevant to the covered and uncovered claims overlap?

K. Are the exclusions for illegal conduct, "other insurance," and timing of claims (including the provisions relating to giving of notice of claim or circumstance), reasonable and readily understandable? Are the "notice of circumstance" provisions objective, subjective, or both; mandatory or permissive? Does the policy provide for an extended notice period should the corporation become insolvent?

L. Is there an "insured-versus-insured" exclusion and, if so, is it phrased narrowly to exclude only truly collusive claims?

M. Does the policy contain a clause that conditions or otherwise bases the executive's Side A cover on the corporation's fulfillment of an obligation to advance and indemnify "to the fullest extent permitted by law" or comparable language? Is this provision limited to prohibit the insurer from placing on the insured executive the duty to assume the corporation's Side B retention or deductible in a case where the corporation breaches its statutory or by-law advancement or indemnity obligations?

N. Does the insured corporation have in place reporting mechanisms to ensure that the risk manager is kept fully informed of any potential claim or circumstance requiring notice to the insurer? Does the insurer bear the burden of establishing prejudice from late notice and is its remedy for late notice limited to the actual damage it sustains as a result? Do the executives have the ability to notice claims or circumstances directly to the insurer under their Side A cover and are they entitled to receive notices of cancellation or changes in coverage?

O. Does the policy permit an executive subject to potential or actual criminal charges to assert against the insurer Fifth Amendment privileges, and the executive's counsel work product privileges, without violating the policy or limiting the executive's recovery of defense costs due to a claim by the insurer that the executive's counsel has provided insufficient billing detail? Is there an agreed mechanism for resolving privilege disputes by a court (not an arbitration) that requires advancement while any dispute is being resolved? Is there a severability clause that protects "cooperating" executives should "non-cooperating" executives be held to violate the policy's cooperation clause?

P. Is the policy's definition of "application" reasonably narrow and understandable? Are the covenants and representations made by the corporation and any insureds in either the application or the policy reasonable and understandable?

Q. Is there an application severability provision that insulates innocent executives from a claim of application fraud due to the guilty knowledge of less than all of their number?

R. Is there an incontestability or similar clause that limits the insurer's right to rescind a policy? Is the insurer's right to cancel the policy appropriately limited? Must it notify all affected insureds, or at least all current insureds?

S. Is there a settlement "hammer" clause and has it been appropriately drafted to avoid unfair and unintended results?

T. Does the policy sufficiently define the parameters of the consent-to-settlement clause and the clause permitting the insurer to associate counsel to eliminate micro-management of the defense? Do these clauses specifically exclude criminal matters and matters where the insurer pays defense costs while reserving its right to deny coverage?

U. Does the policy contain an "order of payments" provision sufficient to reasonably mitigate the effects of a corporate insolvency?

V. Are the claim reporting time limits reasonable? Does a broad definition of "claim" result in an undesirable expansion of the insureds' duties to give notice of claims or circumstance? Does the right to advancement of defense costs arise within a period of less than 60 days after demand is made on the underlying insurer or corporation?

W. Have the implications of "DIC" or "dedicated limits" coverage been explored to provide advancement and indemnity coverage (1) for risks that the corporation and the underlying ABC policy do not cover, (2) where the corporation refuses or is unable to advance defense costs and indemnify, (3) to mitigate the risk of program failure due to competition among competing insureds for policy limits, (4) to avoid loss of coverage in respect of criminal matters in which the executive or his counsel assert Fifth Amendment or work product privileges; (5) to cover cases where an underlying carrier may not a pay a claim arising in a foreign country due to its unlicensed status; and (6) to provide reinstated limits or separate limits for boards?

X. Does the policy insure executives for the costs of obtaining release from incarceration and release of sequestered personal assets if they act as directors or agents of a foreign subsidiary or for the parent corporation in a foreign country? Does the policy contain coverage for reputation restoration and cover crisis management public relations services?

Y. Does the policy contain appropriate cover for the costs of resisting Dodd-Frank/SOX claw-back claims?

Z. Does the carrier selected have a reasonable financial rating and a good reputation for claims handling and payment?

AA. Do the insureds have the right to recover their attorneys' fees under applicable law should they be required to litigate coverage with the insurer?

BB. If a DIC policy contains a choice of law clause, does it choose as the applicable law the law of the underlying ABC policy? What law is chosen in the ABC policy? If the policy contains an arbitration clause, is the legal seat of the arbitration (not just the hearing locale) a venue that understands American plea bargaining practices?

CC. Are there to be one or more excess policies above the negotiated first-tier policy that do not "follow the form" of the first-tier policy, and, if so, have questions B. through BB. above been asked in respect of each of the excess policies? Do these policies have appropriate provisions relating to when each layer of excess coverage attaches so as to avoid gaps in protection, including provisions requiring that upper tiers "drop down" should insureds reach a settlement with the lower tier carrier below its policy limits?

DD. Have the appropriate locally issued D&O policies been obtained in respect of foreign subsidiaries and operations and will all applicable foreign taxes be paid?

Conclusion

The time has long passed when executive protection programs could be evaluated by boards based simply on an inquiry into the limits of ABC insurance cover and the amount of the premium. The number and complexity of the issues listed above together with the potentially catastrophic results that can obtain when criminal charges are threatened against individual executives prove that this is no longer an issue that can safely be treated cavalierly. The amelioration of these risks can only be left to professionals. The Committee hopes that both corporate counsel and practitioners will find the Checklist a useful resource to guide their professional advice.

James D. Wing is co-chairman, D&O Insurance Subcommittee of the Director and Officer Liability Committee of the Business Law Section. Mr. Wing acknowledges the extensive contributions to the checklist of his partner, Thomas H. Bentz, Jr.

OTHER RESOURCES:

A suggested practical approach for boards attempting to implement the suggestions contained in this checklist is found in Wing, J.D., and Dixon, W., "Designing Liability Protection for Directors and Officers," *The John Liner Review* 25, no. 1, Spring, 2011, 27–42.

BUSINESS LAW TODAY

Inside Business Law

SEPTEMBER 2013

Effective practice of business law requires both an understanding of other areas of the law implicating one's specialty and collaboration with other business professionals to facilitate and guide a client's objectives. Several committees within the Business Law Section incorporate reaching across the boundaries of the ABA Section to collaborate with other sections or cooperation with an entirely separate profession into their mission.

The Taxation Committee:

The mission of the Taxation Committee is to help business lawyers gain a basic understanding of the important tax issues that inevitably arise in their practices. The Committee seeks to act as a bridge between tax law and business law, and to increase communication about tax issues among the various committees of the Business Law Section, and between the Business Law Section and the Tax Section.

The Taxation Committee is chaired by Michael J. Kliegman, who can be reached at michael.kliegman@us.pwc.com.

The Dispute Resolution Committee:

The mission of the Dispute Resolution Committee is to aid business lawyers in understanding and using alternative dispute resolution processes. The goals of the Committee are to focus on education for Section members, to encourage interaction between corporate legal departments and private law firms in the development of dispute resolution options relevant to the business needs of clients, and to foster continuing liaison and collaborative efforts with other sections and other committees within the Business Law Section.

To that end, the Committee works closely with ADR subcommittees within the Business Law Section, as well as the Dispute Resolution Section of the ABA, to ensure that business lawyers have the most current information on dispute resolution at their disposal. Among other resources, the Dispute Resolution Committee maintains a guide to drafting dispute resolution clauses within contracts.

F. Peter Phillips is the Chair of the Dispute Resolution Committee and can be reached at peter.phillips@businessconflictmanagement.com.

The Audit Responses Committee:

The mission of the Audit Responses Committee is to be a resource concerning lawyers' responses to auditor inquiries and related financial reporting and disclosure issues, focusing on implementation of the "treaty" reached with accountants in the ABA Statement of Policy regarding audit responses.

To that end, the Committee provides guidance in responses to auditor requests in light of the treaty and the importance of protecting privileged communications.

Thomas W. White is the chairman of the Audit Responses Committee. He can be reached at thomas.white@wilmerhale.com.

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