Panel Presentation on April 12, 2014 in Los Angeles at
ABA Business Section Spring Meeting:
"Directors, Officers, and In-House Counsel: You Think You're Covered,
But You're Probably Not (And What To Do About It)"

No one these days doubts that businesses of all kinds face increasing risk of having their actions questioned by regulators and other law enforcement authorities. Less well known to the executives of these businesses (despite wide publication) is the concept of the "corporate internal investigation." To escape or mitigate legal responsibility for actions of its employees or executives, the company hires outside counsel to conduct an internal investigation. This is today the preferred means of investigating behavior that may be legally troubling for the involved company.

The facts and allegations that give rise to an internal investigation can reach the attention of the company's chief legal officer, senior management, or board in any number of ways. They may be communicated from a wide variety of sources, some of them informal. These investigations, by their very nature, commence without there being a specific charge of misconduct against any specific individual and even without there having been first identified a discrete alleged wrongful act. Almost invariably, however, the investigation involves potential violations of criminal law. Raising the stakes is today's public clamor for corporate agents to be brought to justice for criminal misconduct and the general recognition that innocent shareholders should not pay for the defense costs, much less the penalties, that are incurred by corporate agents who are viewed in hindsight as having implicated the company in violations of criminal law.

For over two years, the Director & Officer Liability Committee has focused on whether the existing framework of statutory law, case law, insurance coverage, and court practices and attitudes are dealing effectively with the corporate internal investigation and the attendant criminalization of executive conduct. This year, the Director & Officer Liability Committee combined forces with three other Committees of the Business Law Section of the ABA -- Corporate Governance, Private Equity and Venture Capital, and Corporate and Business Litigation -- to sponsor a two-hour session to bring the profession up to date on these efforts. Five panelists with diverse perspectives shared observations, personal experience, and expertise before, during, and after the program.[1] This was truly a knowledgeable and experienced group.

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[1] The panel was moderated by James Wing of Holland & Knight Miami and Chicago. Jim is a frequent speaker and author on this subject in specialty insurance publications and has actively litigated advancement rights for executives under criminal law scrutiny. He is currently the chairman of the D&O Insurance Subcommittee of the Director & Officer Liability Committee.

Francis Pileggi of Eckert Seamans Wilmington and Nancy Adams of Mintz Levin Boston are co-chairs of the Indemnification and D&O Insurance Subcommittee of the Corporate and Business Litigation Committee. Nancy regularly advises primary and excess insurance carriers in a variety of contexts and has extensive experience in D&O risk management, advancement and indemnity by-law drafting, and auditing executive protection programs. Francis is the noted creator of the respected Delaware Corporate and Commercial Litigation Law Blog (www.delawarelitigation.com) who regularly updates the profession on developments in this area. Francis also litigates cases involving advancement and indemnity.

Leslie Kurshan is a member of the California bar and a solicitor of England and Wales. Based in London, she is head of product development for the UK financial and professional lines practice of Marsh (the world's largest insurance broker). Leslie is a former insurance coverage litigator, experienced at negotiating and drafting D&O policies for companies in the U.S. and Europe.

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In preparation, the panel assessed all recent ABA publications on point, including the 2012 and 2013 Checklists for Corporate Counsel Supervising the Creation or Renewal of an Executive Protection Program, the 2013 Annotated Model Indemnification Agreement, and the chapter on indemnification and advancement contained in the ABA's "2014 Edition of Recent Developments in Business and Corporate Litigation." The panel also reviewed an in-depth discussion of the Fifth Amendment to the U.S. Constitution as it applies to executives involved in corporate internal investigations and a 52-jurisdiction survey of the law relating to corporate advancement of litigation expenses (both distributed in the program materials), as well as other relevant materials, including the publications set out in the panelists' resumes and cited in them.

The panel's conclusions were neither pretty nor comforting to hear. The panel broke down its presentation by addressing separately each of the three elements of an acceptable executive protection program -- underlining that each of the three elements must be separately considered and then coordinated with the other elements: exculpation statutes, advancement and indemnification provisions of articles of incorporation, by-laws, or agreements, and D&O insurance. The conclusions of their coordinated presentations were as follows:

1. Exculpation. Almost all state statutes have a provision authorizing corporations formed under them to include a provision in their articles/certificate of incorporation insulating their directors (rarely do the statutes include officers) from liability for damages based on the breach of the fiduciary duty of due care (as opposed to the duty of loyalty). The charters of many (usually non-public) corporations lack such a provision, and under present political circumstances, it is frequently difficult to get one inserted into an existing charter.[2] Court decisions vary as to whether a defense based on such a statute can be raised in litigation by a motion to dismiss or only as an affirmative defense, with the states adopting the latter view significantly reducing the utility of such protection because in those jurisdictions the provision may not be sufficient to avoid expensive discovery.

Bottom Line: A lawyer creating or renewing an executive protection program should determine whether the corporation's charter has such a clause and, if not, advise the client appropriately.

2. Advancement of Defense Costs -- Does the Executive Have an Enforceable Right to Advancement At All? The "corporate internal investigation" has become the criminal law's instrument of choice that can place interviewed executives in a legal quagmire fraught with risk. An interviewed executive without funding to secure immediate access to experienced counsel faces potentially catastrophic familial, personal, career, and financial loss. The panel emphasized the absolute need for executives to have secured in advance of the investigation a mandatory right to advancement from the company of his/her defense costs, repayment of which can be compelled by the company only if the executive is found to have acted in bad faith or to have acted contrary to the company's interests in respect of the underlying matter without a reasonable belief that s/he

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[2] In Delaware, however, exculpatory provisions are customary and appear in the certificate of incorporation of most corporations, whether public or non-public.

was acting appropriately. It is the job of drafting counsel to deliver that protection, assuming that the company's board has decided to grant it. (Corporate boards, once advised of the law, rarely decline to provide advancement rights to directors and officers.)

It was emphasized that Delaware law (and presumably that of the twelve other U.S. jurisdictions that are considered to follow Delaware in this area) does not mandate advancement unless the right is specifically granted in the company's by-laws, certificate of incorporation, or a separate agreement. Granting executives mandatory "indemnity to the fullest extent permitted by law" or other such general language is not sufficient to assure advancement in Delaware-pattern jurisdictions. In stark contrast, fourteen jurisdictions follow the current Model Business Corporation Act and reject the Delaware rule. Those jurisdictions' statutes specifically provide that a grant of mandatory indemnity rights alone includes a right to mandatory advancement without further specificity. This means that in the remaining twenty Model Act-based states that omit the language explicitly rejecting the Delaware rule, it can be argued that the omission of the rejection implies that the Delaware rule has been adopted so that executives who are merely "indemnified" have no right to mandatory advancement.

The 52-jurisdiction summary appended to the program materials catalogs these and other potential statutory impediments to advancement in the various jurisdictions. Delay in advancement resulting from having to litigate these questions alone can seriously harm an executive who needs immediate assistance.

Bottom Line: Practitioners need to draft advancement and indemnification provisions of charters and by-laws or agreements with sensitivity to these issues and may consider lobbying their Bar representatives to the state legislatures to keep up to date through potential amendments to their state's corporate law statutes.

3. Advancement of Defense Costs – "Final Adjudication." Equally striking are the differences among the states on the critical issue of what is known as "final adjudication." Delaware lawyers report that in practice, a company that wishes to oppose a qualified, entitled executive's demand for advancement may not file affirmative defenses, counterclaims, or even independent suits that force the executive to litigate facts relevant to an alleged breach of fiduciary duty that might ultimately disentitle him to indemnity until and unless there is a "final adjudication" in the underlying case or (perhaps) a final judicial finding in another case or sworn admission of facts that constitute disabling misconduct. While this means, in common law parlance, that the duty to advance defense costs remains no broader than the duty to indemnify, breach of the latter duty may not be determined before there is a ruling in the underlying (civil or criminal) case.

Query whether the same rule will necessarily be followed by courts in other Delaware-pattern states or, for that matter, non-Delaware courts asked to apply Delaware law? For sure it will likely not be followed in the three Delaware-pattern states that, consistent with the current Model Act, require the executive to provide a written profession of innocence of breach of fiduciary duty. Only a few states have even considered this issue, much less decided it.

Bottom Line: Practitioners should write a "final adjudication" provision into any advancement or indemnification charter or by-law provision or agreement intended to confer mandatory advancement. This is true even for Delaware practitioners whose advancees may need to seek court relief under Delaware law in jurisdictions outside of Delaware.

4. Advancement of Defense Costs-- Fifth Amendment Complications. As noted above, the principal goal of the program was to explore the interaction between the criminal law as applied in corporate internal investigations and the advancement rights of indemnified executives. Even a completely innocent executive, when interviewed in an internal investigation, takes significant legal risks of which he is not generally aware. The panel demonstrated that he is given an "Upjohn Warning" (not a Miranda Warning), not to advise him of his rights, but to guarantee that what he says may be disclosed by the company's private counsel to governmental authorities or prosecutors. The panel graphically posited a hypothetical where an innocent executive is first notified in the investigation that he has been (falsely) accused of criminal wrongdoing by a subordinate employee. The panel explained how both his verbal and nonverbal reactions to the accusation can be used against him later in court. The panel demonstrated the quandary in which he is placed and that even a decision to invoke Fifth Amendment rights in that context must be express or is waived under a recent 5-4 decision of the U.S. Supreme Court. *Salinas v. Texas,* -- U.S. --, 133 S.Ct. 2174 (2013).

The panel further pointed out that merely denying the (false) allegation would constitute a Fifth Amendment waiver and is thus anathema to experienced white collar defense counsel. This is because a premature denial of liability can be highly disadvantageous to the innocent indemnified executive's legal interests. If he fails to respond at all or if he asserts Fifth Amendment rights, the panel explained that he can be, and probably will be, fired with all the personal, career, and financial damage that a termination entails. If he were a government employee, he could not be terminated unless he were first granted immunity and still refused to talk. As an employee of a private company, he has no such Constitutional protection. All these issues are explored in more detail in the Fifth Amendment memo contained in the program materials.

But all the news is not bad. The statutes of Delaware-pattern jurisdictions (except for the three that require the putative advancee to testify as to his innocence of breach of fiduciary duty) do not expressly condition advancement on the executive's assertion of innocence. Thirty-one Model Act jurisdictions, however, impose the assertion of innocence requirement by statute, as does New York and New Jersey by implication. However, the panel was pleased to announce that an amendment to the Model Act has been approved on second reading by the Corporate Laws Committee to delete the requirement from the Model Act; the proposed deletion will be submitted to the ABA membership for comment in the May edition of *The Business Lawyer*. Of course, even if approved by the ABA, it may be years before the change is adopted by many states that follow the Model Act.

Bottom Line: Support for the Model Act amendment is crucial for those who wish to see greater clarity of executives' advancement rights. In the meantime, practitioners should draft charter and/or by-laws or agreements that provide rights to advancement in a way that will not impair the advancee's Fifth Amendment rights. Even if the state of incorporation omits the requirement, you rarely have control over which state's courts will be called upon to decide the issue.

5. Can D&O Insurance Cure Certain Uncertainty With Respect To Advancement Reflected in the Common Law of Advancement? As detailed above, the common law of advancement does not have a uniform approach across jurisdictions. One would think that D&O insurance would spring to the rescue and write cover to insure executives against these deficiencies and complications. The panel's conclusion was that it does not, at least completely, but that relief is on the way.

The panel explained the topsy-turvy growth and proliferation of covers in this area and furnished a chart demonstrating the current interaction of covers known as A-Side, B-Side, C-Side (when combined, ABC), towers of "follow-form" and sometimes non-follow-form excess cover, and specialty covers called "Side-A only difference-in-conditions" (DIC) cover. It was explained how the definition of "Claim" in most current policies requires, typically, a written complaint, criminal charge, maybe a Wells Notice, maybe a request for a statute of limitations tolling agreement, maybe a subpoena, and maybe a request for an interview by a recognized "enforcement authority" or one incident to a corporate derivative demand. But almost never does a policy define a "Claim" to include a "pure" corporate internal investigation initiated before any claim is made against anyone. The panel explained how the definition of "Claim" also invariably includes the allegation of a discrete "wrongful act" by the insured executive, also something by definition not involved in a corporate internal investigation. Thus, most of today's policies fail to cover the principal catastrophic risk that today's executives most commonly face.

But there was good news. The panel reported that two DIC policies currently on the market and a third to be soon announced have expanded the definition of "Claim" to include facts that form the basis of what is called a "notice of circumstance." The latter is a concept heretofore used in insurance policies only to cement cover under a particular policy year for matters that may not ripen into a defined "Claim" until a later year when the D&O coverage may be non-existent or reduced. The two (and soon three) DIC policies effectively attach coverage earlier than other policies on the market so as to cover "pure" internal investigations without subjecting the insured to the risk that his/her failure to notify the item to the carrier will give the carrier a late notice defense.

This is a major and positive development. Still to be resolved (although a resolution is hopefully in process) is a means to protect an insured executive from losing his/her cover for breach of the policy's cooperation clause if s/he or counsel is required to assert legal privileges against the insurance company for fear that communicated information can be subpoenaed by an adversary.

Bottom Line: Advise your boards of the coverage gaps in policies under their consideration, recommend DIC cover, and be sure the cover includes the "notice of circumstance = claim" feature described above. Remember, even if the form does not have the cover, it can be negotiated into the cover. The forms on the market are not exclusive representations of what can be achieved.

6. In-House Counsel Exposure. The panel was unable to give comfort to employed lawyers in terms of their ability to obtain advancement and indemnity from their own corporate clients under state Bar rules that prohibit lawyers from obtaining indemnity from clients for their own misconduct. It was further noted that most D&O policies that cover general counsel as a corporate officer exclude liability for professional services, thereby reducing D&O coverage for them and motivating them to obtain separate "employed counsel" coverage. Further uncertainty can arise in those cases (fortunately rare) where "employed counsel" are accused of conspiring with or aiding and abetting an allegedly miscreant corporate officer. In those cases, it is important that the employed lawyer's policy cover all actions taken in the process of rendering legal advice, and not be limited strictly to professional negligence.

Bottom Line: Give careful attention to the policy language to be sure that "all risk" coverage for employed lawyers is obtained to the maximum extent possible.

7. Implications for Legal Ethics. Included in the program materials was the D&O Liability Committee's "2013 Checklist for Corporate Counsel Managing the Creation or Renewal of an Executive Protection Program." The Checklist attempts to catalog all the issues of exculpation, advancement and indemnity, and D&O insurance known on the date of its publication. New issues have already arisen since then and will be included in next year's version. The current Checklist is intended to provide a "best practice" safe harbor. It also raises the question of counsel's potential conflict in advising simultaneously the company's board, members of which may be advancees/indemnitees, and in its capacity as counsel for the company itself. It resolves the conflict by acknowledging that one exists but pointing out that the conflict is that of the board itself, not that of counsel. This is because it is the statutes that put the board in the position of authorizing the company to grant mandatory advancement and indemnity so that the company may obtain and retain qualified personnel.

But as the advancement rights of executives are broadened and clarified through statutory and drafting improvements, is the answer so obvious? Can counsel managing or supervising the process remain completely objective when advising about advancement rights for executives who may be sued by the company itself for improper personal gain, or when advising on whether advancement rights should be limited, say, to a percentage of the insurance cover so as not to threaten the solvency of the company once insurance cover is exhausted? Should any one lawyer be compelled to advise a company on executive protection when one of its principal objectives is to decide how to handle the relationship between parties whose interests can become so starkly adverse? Can any lawyer be reasonably asked to put him - or herself in a position of being subject to later criticism that s/he led the overall board to a solution that to them seems so wrong in hindsight? Is this fair to the lawyer?

And how does any one counsel deal with the question of which executives should have separate cover to avoid their policy limits being exhausted by other accused (and no doubt disfavored and maligned) inside directors who become the targets of governmental prosecution, leaving the former exposed? Should the concept of "suitcase" cover be encouraged, whereby each director obtains separate cover for a single premium that covers his liability as a member of a board or of number of different boards, to which each company for which s/he is a director contributes?

To what extent is corporate counsel obliged to even raise these issues? And how does all of this affect the non-profit area whose boards are populated by wealthy individuals who are seriously exposed to claims but where the entity itself cannot be seen by charitable donors as using its assets to pay legal defense costs in derogation of its overall charitable mission?

Bottom Line: The panel leaves these issues of basic policy and legal/positional conflicts for future review.