

# Risky Business: Protecting the Personal Assets of Ds&Os

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Thursday, January 28, 2016



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# Topics

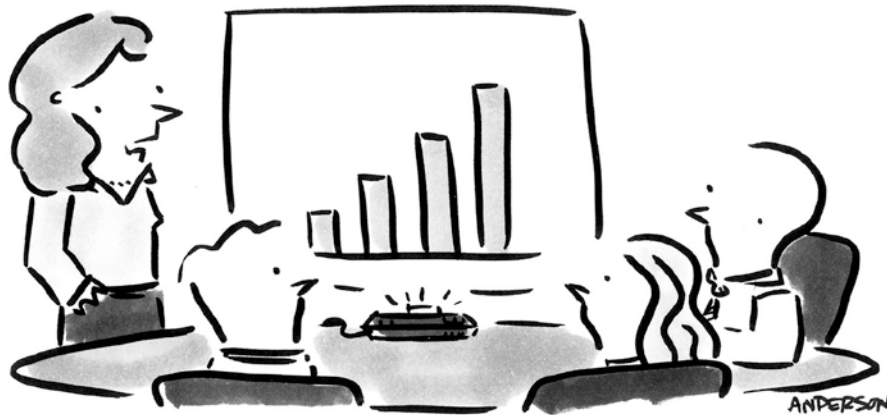
- ▶ Nuts and Bolts - D&O Liability, Indemnity, Advancement
- ▶ Structure of D&O Insurance Policies
- ▶ Executive Compensation Claw Back
- ▶ Government Enforcement Targeting Individuals
- ▶ D&O Exposure for Cybersecurity Breach
- ▶ Trends in Derivative Suits and M&A Class Actions
- ▶ Covering Ds&Os Overseas

# Nuts and Bolts of D&O Liability

Oh... Oh...

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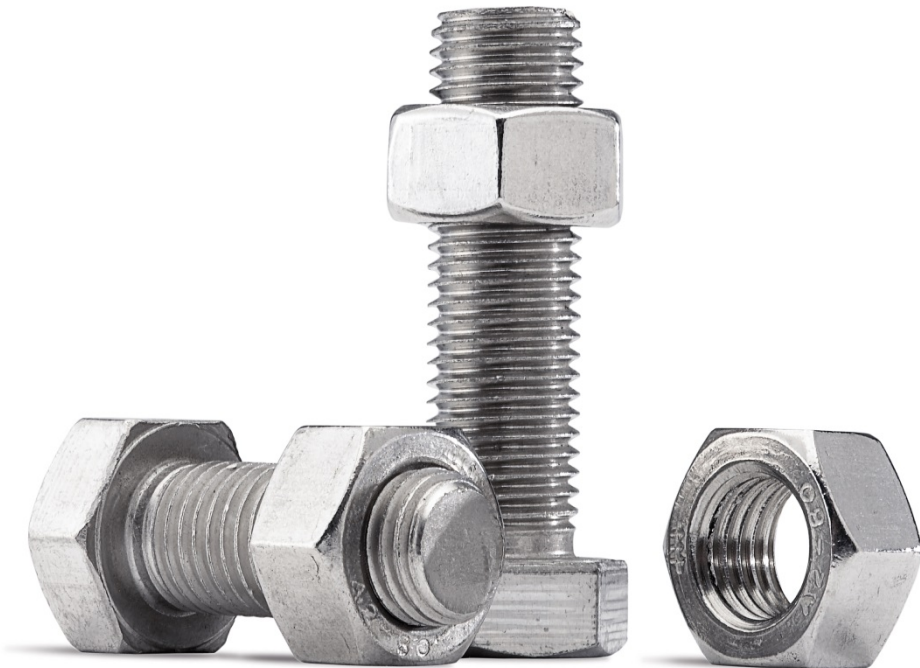
"I'm sorry, that's my cell reception. Our sales are actually quite bleak."



"So, to sum up, not only are sales dropping, but apparently moving back in time."

# Nuts & Bolts: Liability and Protection

- ▶ Liability Standards
- ▶ Indemnification
- ▶ Advancement
- ▶ Exculpation
- ▶ D&O Insurance



# Liability Standards

- ▶ Standards of Liability
  - **Directors:** gross negligence (Delaware & California)
  - **Officers:** ordinary negligence (California)
- ▶ Standard of conduct permitting corporate indemnification
- ▶ decisions and actions made “in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation”
- ▶ Rebuttable Presumption of Valid Business Judgment
  - Protects directors in Delaware and California
  - Protects officers in Delaware, not California

# Advancement

- ▶ Corporations may advance D&O litigation defense costs before final adjudication
- ▶ Indemnified person must execute an “undertaking” to repay if ultimately found not to be entitled to indemnification.
- ▶ Companies may commit **contractually** or in corporate **bylaws** to advance and indemnify even in litigation by or on behalf of the company against the indemnified person

# Exculpation

- ▶ Most articles of incorporation exculpate directors from monetary liability to the company and stockholders to the greatest extent allowed by law
  - No monetary liability for gross negligence
  - Only protects directors, not officers (Delaware & California)
- ▶ Companies cannot exculpate directors for:
  - breach of the duty of loyalty
  - “bad faith”
  - intentional misconduct
  - knowing violation of law
  - transactions “from which the director derived an improper personal benefit”

# Corporate Indemnity Fails When.....

- ▶ Corporation becomes insolvent
- ▶ Ds&Os engage in non-indemnifiable, non-exculpable conduct
  - Violation of the duty of loyalty
  - Self-dealing, bad faith, intentional or knowing wrongdoing
  - Failure of board oversight under *Caremark* (1996 Delaware)
    - utter failure to assure reasonable information and reporting systems in place
    - conscious disregard of a known duty to act
    - directors knew or should have known that violations of law were occurring and failed to take steps to prevent or remedy



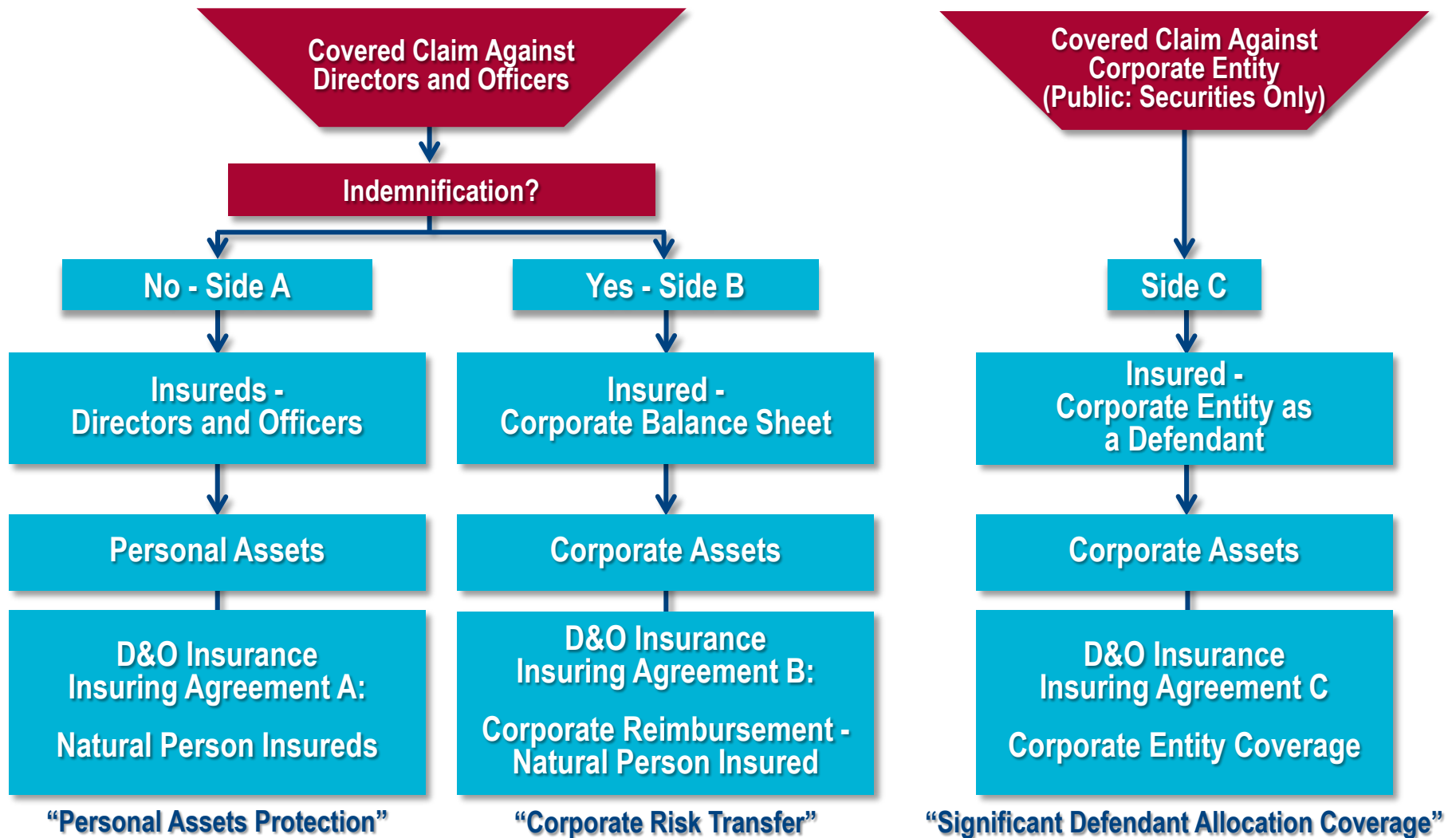
# D&O Insurance

- ▶ Corporations have the “power to purchase and maintain insurance” on behalf of current and former officers and directors “against any liability”

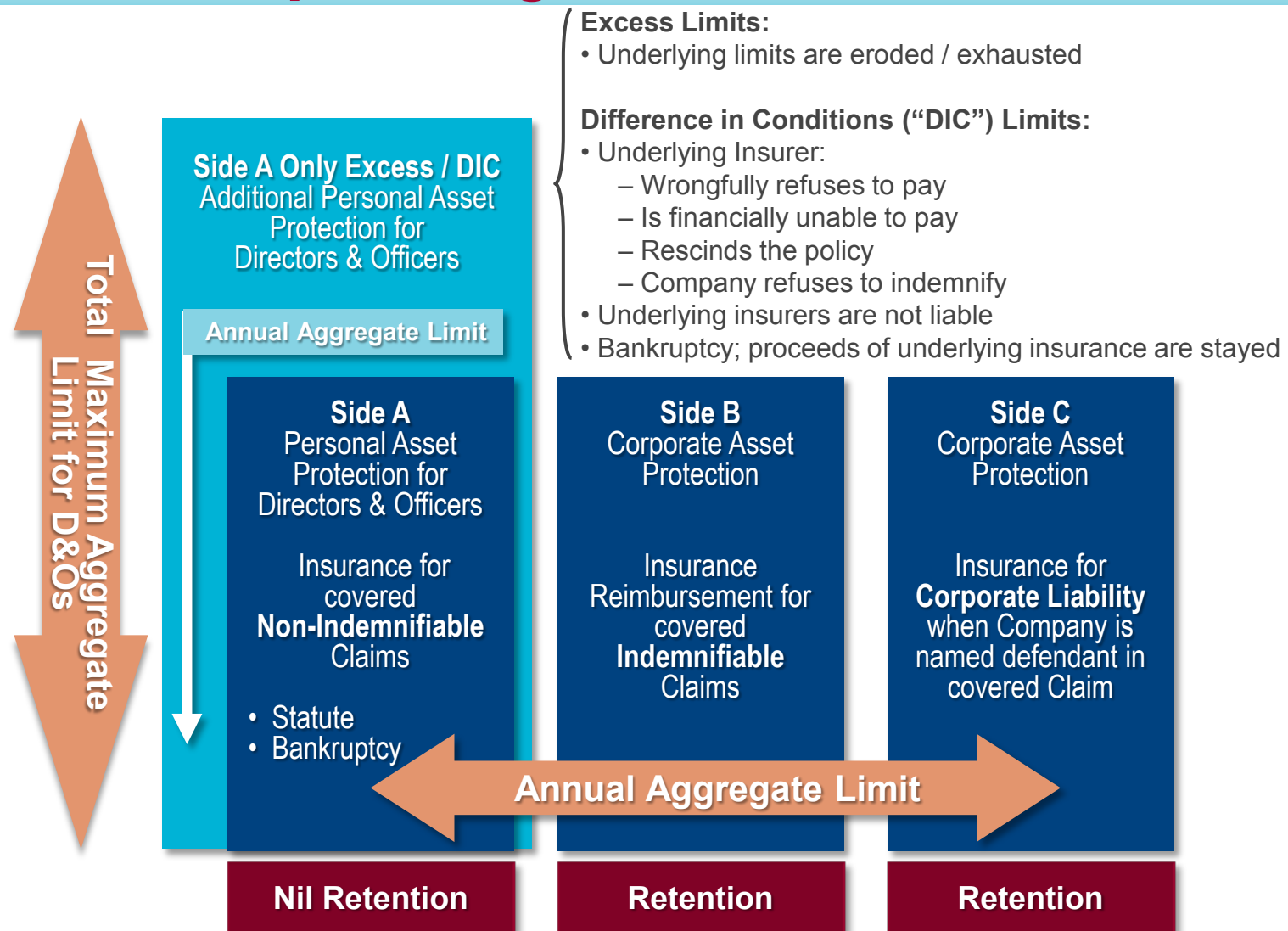
**“whether or not the corporation would have the power to indemnify such person against such liability”**



# Overview of a D&O Policy



# D&O: Example Program Structure



# D&O Liability in Corporate Crisis



# D&O Liability in Corporate Crisis

- ▶ A General Counsel's perspective
- ▶ What happens when things go REALLY bad?
  - government enforcement is at the door
  - stockholders make demands on the board
  - investors file securities fraud class actions suits
  - the Ds&Os all want separate legal counsel
  - Congress wants to hear about it
  - the company is running out of money...

# Executive Compensation Claw Back

## The New York Times

### S.E.C. Claws Back \$2.8 Million From CSK Executive

By BEN PROTESS NOVEMBER 15, 2011 6:58 PM [Comment](#)

The [Securities and Exchange Commission](#) announced on Tuesday that it had reached a deal to claw back \$2.8 million in compensation from CSK Auto Corporation's former chief executive and chairman, who ran the company during an accounting fraud scandal.

The S.E.C. never accused the executive, Maynard L. Jenkins, of any wrongdoing. But in 2009, the S.E.C. moved to recoup the \$2.8 million in bonus and stock profits on behalf of CSK, citing the accounting compliance law known as the Sarbanes-Oxley Act

# Executive Compensation Claw Back

## Got a restatement?

- ▶ **Current Rule – Sarbanes-Oxley Section 304:** CEO and CFO must return incentive-based compensation paid within one year prior to restatement due to someone's misconduct
  - Poster CEO Maynard Jenkins, CSK Auto, \$2.7 million
- ▶ **New Rule – Dodd-Frank Section 954:** All executives must return incentive-based compensation paid within three years prior to restatement regardless of any misconduct

# Executive Compensation Claw Back

## SEC Dodd-Frank Rules

- ▶ Claw back mandatory (unless expense exceeds stake)
- ▶ Claw back reaches back three years before restatement
- ▶ Claw back is for delta between amount paid and earned
- ▶ Companies must self-enforce
- ▶ Companies cannot indemnify or buy insurance for executives





# DOJ Targeting Individuals

## Major Developments

- ▶ DOJ: Targeting individuals in Yates Memo, FCPA cases
- ▶ SEC: Targeting individuals in cooperation policy, whistleblower policy, settlement admissions policy



# DOJ Targeting Individuals

## DOJ Yates Memo

### ► Six Factors:

- No corporate cooperation credit unless individuals are identified
- Staff should target individuals from the outset
- Civil and criminal staff should share information
- No trade off s of larger corporate fine for release of individuals
- No corporate settlements without “clear plan” for individuals
- Civil staff should pursue individuals regardless of ability to pay

# DOJ Targeting Individuals

## Yates Memo - Insurance Coverage Implications

- ▶ From the individual's perspective...
  - Secure separate counsel
  - Secure advancement and indemnification
  - Maximize Side A coverage
- ▶ From the company's perspective...
  - Expect more requests for separate counsel
  - Expect more protracted government investigation
  - Secure flexibility to refuse advancement
  - Relevance of Side A coverage?

# SEC Targeting Individuals

- ▶ The Cooperation Program
  - Individuals “cooperate” in exchange for avoiding DOJ referral, and/or paying lower fines and/or suffering industry bar
  - Per WSJ, used in 92 cases so far
- ▶ The Whistleblower Program
  - Cash rewards for individuals who “voluntarily” give the SEC “original information”
- ▶ May 13, 2015 – Enforcement Director Ceresney speech
  - More “reverse proffers” to get individuals to “cooperate”

# SEC Targeting Individuals

- ▶ June 2013, SEC Chairman Mary Jo White announced new policy: in “egregious” cases, the SEC will demand an admission as a condition of settlement
- ▶ Criteria include:
  - Number of harmed investors
  - Deterrence
  - Wilfulness
  - Obstruction of SEC investigation
- ▶ As of March 14, 2015, SEC obtained admissions in 18 cases involving 19 companies and 10 individuals.

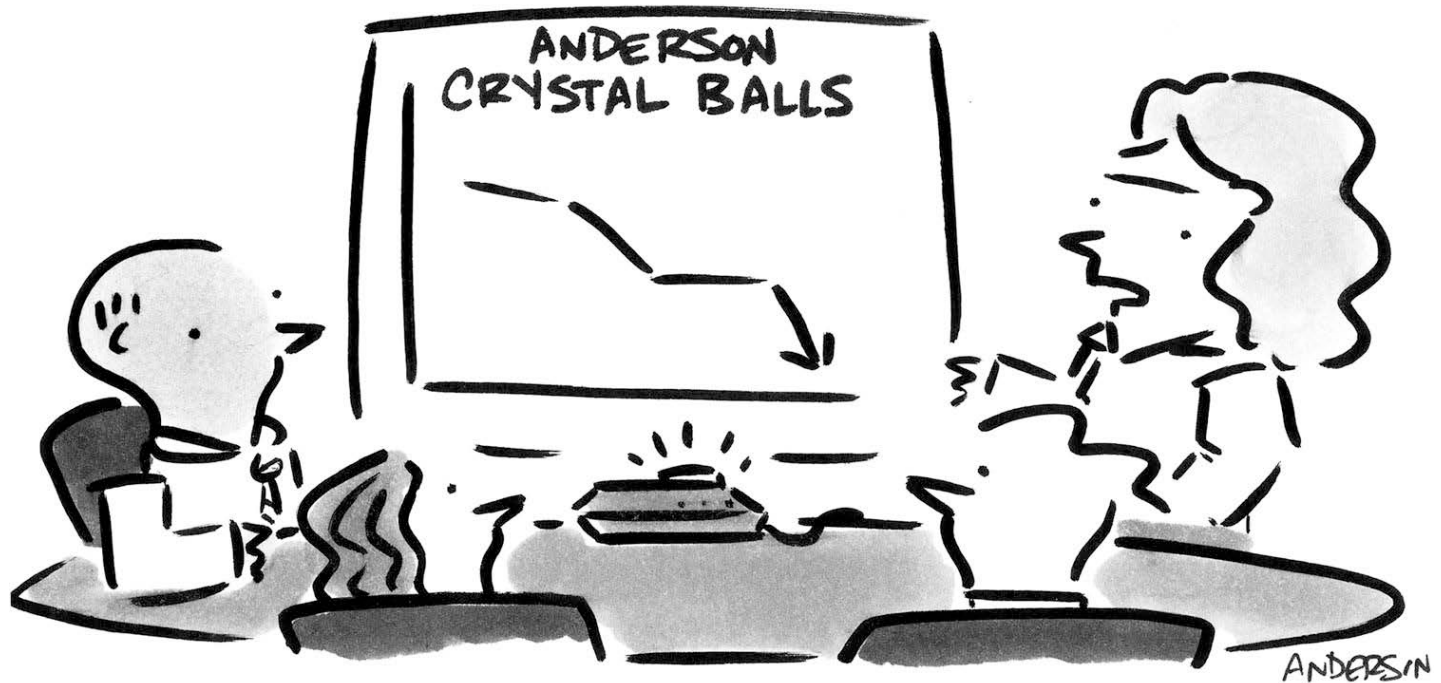
# Coverage Considerations

- ▶ Increased pursuit of individuals
  - More requests for separate counsel
- ▶ SEC's Policy of Wrongful Admissions
  - Impairs D&O corporate indemnity
  - Impairs insurance coverage

# Cyber Breach

## And D&O Exposure

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"Seriously?! No one saw this coming?!"

# Cyber Breach

## D&O Suits

- ▶ MobileIron IPO Securities Class Action
  - MobileIron's IPO offering materials did not disclose a hack of a major customer. Stock price continues to suffer.
- ▶ Home Depot Derivative Action
  - 56 million customer credit card numbers compromised. Complaint alleges data breaches at other major retailers (Target, Neiman Marcus) should have been a wake-up call.
- ▶ Wyndham Derivative Action
  - Dismissed in October 2014 based on board's judgment to refuse a demand. Allegations of board failure of oversight would not have satisfied *Caremark* high showing anyway.



# Cyber Breach

## D&O Suits Ahead?

- ▶ Many consumer lawsuits against companies ... few stockholder / investor suits against Ds&Os
- ▶ Triggers for securities class actions
  - Stock price drop raising questions about prior positive disclosures about corporate cyber-security measures and risks
  - Stock price drop on publication of an SEC or FINRA investigation raising questions about prior disclosures
- ▶ Triggers for derivative suits
  - Consumer suits, government actions, and securities class actions that expose the company to loss raising questions of failure of board oversight

# Cyber Breach

## D&O Insurance

- ▶ Cyber policies cover different losses than D&O policies
- ▶ What are the differences?
- ▶ How is insurance underwriting for D&O policies responding to the onslaught of data breach occurrences and losses?



# Corporate Litigation

## M&A

- ▶ By the numbers - more than 90 percent of M&A transactions valued at \$100 million end up in litigation
- ▶ “Merger objection” lawsuits claim that directors and officers breached their fiduciary duties in negotiating mergers
- ▶ Trending Issues:
  - Judicial trend to reject pre-closing “disclosure” settlements for expansive releases and modest attorney fee awards
  - Plaintiffs bar trend toward post-closing money damages class actions for breach of fiduciary duties
  - Result exposes ex-directors to personal liability for non-exculpable breach of loyalty claims
  - Plaintiffs have low odds but high potential rewards

# Corporate Litigation

## Derivative Suits

- ▶ Historically, derivative suits settled for minor prophylactic governance measures and small attorneys' fee awards
- ▶ Recently, derivative suits have settled for big money:
  - \$275 million for *Activision Blizzard* (2014)
  - \$139 million for *News Corp.* (2013)
  - \$137.5 million for *Freeport-McMoRan* (2015)
  - \$62.5 million for *Bank of America Merrill Lynch* (2012)

Plaintiffs firms are noticing ...

# Corporate Litigation – Derivative Suits

## Demands

- ▶ Plaintiffs must make a demand on the board of directors to bring the desired action on behalf of the company or to plead that demand would be futile
- ▶ What is the status of D&O insurance coverage for board investigations in response to demands?
- ▶ Will insurers cover expenses of Ds&Os for separate counsel in the demand investigation?

# Corporate Litigation

## Books and Records

- ▶ Stockholders may take pre-suit discovery of “books and records” to investigate D&O wrongdoing
- ▶ Issues include
  - Delaware changing “race to the courthouse” dynamics
  - Delaware allowing more discovery of privileged information
  - Delaware allowing discovery in aid of pleading
  - Trends - *Walmart v. IBEW* (Del. 2014) allowed “books and records” discovery of internal FCPA investigation, including privileged information and back up tapes
  - Sharing of discovery among potential plaintiffs
- ▶ When does D&O insurance coverage kick in?
- ▶ When should Ds&Os get counsel?

# Protecting Ds&Os Overseas

## ▶ D&O Exposure

- Shareholder suits – once viewed as a U.S. phenomenon – Canada and the Netherlands now permit D&O lawsuits
- Regulatory investigations
- Foreign suits by employees, vendors, competitors and customers.
- Anti-bribery and corruption laws

## ▶ Gaps in Coverage

- Not all countries allow foreign insurers to pay claims
- Foreign insurance regulations may require “local” policies

# Be Careful Out There

