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INCREASING D&O CRIMINAL EXPOSURES: INSURANCE AND INDEMNIFICATION ISSUES

In response to recent criticisms, federal law enforcement authorities are now investigating with greater frequency and vigor potential criminal charges against directors and officers in a variety of contexts. Most notably, on September 9, 2015, deputy attorney general Sally Quillian Yates issued a memorandum to all Assistant U.S. Attorneys and other key agencies which sets forth the federal government's focus on individual criminal accountability for corporate wrongdoing. In the so-called Yates Memorandum, the Department of Justice recognized that "[o]ne of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing" and that it is "important that the Department fully leverage its resources to identify culpable individuals at all levels in corporate cases."

The cornerstone of the policies and procedures set forth in the Yates Memorandum (which have now been incorporated into the U.S. Attorneys' Manual) is that in order for a company which is targeted in a federal investigation to gain any credit for cooperation with the government, the company must provide to the DOJ "all relevant facts relating to the individuals responsible for the misconduct." In other words, a company is now highly motivated to disclose to federal investigators the identify and "all relevant facts" relating to directors, officers and other individuals arguably responsible for the company's alleged wrongdoing, thereby creating a huge conflict between the company and those potentially responsible individuals.

The practical impact of this new and aggressive DOJ initiative is still largely unknown. However, when combined with several highly publicized recent D&O criminal trials (including trials against the CEO of Massey Energy arising out of a deadly mining incident and against senior officers of the Dewey LeBoeuf law firm arising out of that firm's financial collapse), it is clear that directors and officers—and their advisors—should reconsider the adequacy of the insurance and indemnification protection for the directors and officers. This article summarizes many of the more important features of a D&O insurance policy and corporate indemnification provisions which should be examined when evaluating the quality of financial protection for a criminal investigation of or charges against directors and officers.

A. INSURANCE ISSUES

Coverage under a D&O policy for criminal proceedings is subject to many of the same provisions which are equally applicable to coverage for civil proceedings. However, there are several unique considerations which apply to criminal investigations and proceedings against Insured Persons, many of which are summarized below.

1. Definition of Claim

Under most D&O policies today, coverage is likely triggered for an Insured Person who is involved in any stage of a criminal investigation or proceeding, although different provisions within the policy's definition of "Claim" will apply to different stages of that criminal matter. Virtually all Side A policies and most ABC D&O policies today include coverage for the costs incurred by an Insured Person in responding to a request from an enforcement authority to provide testimony or produce documents in connection with a criminal or civil investigation by the enforcement authority, whether or not the Insured Person is a target of the investigation or is alleged to have committed any wrongdoing. This so-called Pre-Claim Inquiry coverage applies, though, only if the Insureds elect to provide notice of the inquiry to the insurer.

If that inquiry progresses to a formal investigation of the Insured Person, pursuant to which the Insured Person receives a target letter or similar communication from the enforcement authority identifying the Insured Person as someone against whom a criminal proceeding may be commenced, another provision within the definition of "Claim" is triggered and the Insureds are then obligated to give notice of that investigation to the insurer as soon as practicable.

Finally, if the investigation culminates in the indictment of the Insured Person, yet another provision within the definition of "Claim" is triggered, and the Insureds should give notice of that indictment to the insurer as soon as practicable.

The net effect of these various provisions within the definition of "Claim" in the D&O policy is that Insured Persons likely have "cradle to grave" coverage for defense costs incurred in connection with criminal investigations and proceedings involving the Insured Person (subject to the other terms, conditions and coverage limitations in the policy), whether or not the company indemnifies the Insured Person for those defense costs.

2. Definition of Loss

Historically, D&O policies routinely excluded from the definition of "Loss" any fines or penalties. Because this exclusion is in the definition of "Loss" rather than in the Exclusions section of the policy, this exclusion eliminates coverage only for the fine or penalty itself, and does not apply to defense costs incurred in connection with a criminal proceeding which seeks to impose the fine or penalty.

In recent years, this fine/penalty exclusion has been narrowed in many D&O policies. Initially, a carve-out to the exclusion was added for certain fines and penalties imposed under the Foreign Corrupt Practices Act for unintentional violations of that Act. More recently, some D&O policies include a carve-out for fines or penalties assessed for any unintentional or non-willful violation of law. A few Side A policies now delete the fine/penalty exclusion in its entirety. Another important variable among policies with respect to this exclusion relates to whether the exclusion, or the carve-outs to the exclusion, apply to both civil and criminal fines/penalties or apply only to civil or only to criminal fines/penalties.

In addition to the express terms of the fine/penalty exclusion, it is also important to consider whether any fine or penalty is insurable under applicable law even if coverage is otherwise afforded for the fine or penalty. To maximize the likelihood that an otherwise covered fine or penalty is insurable, the policy could extend the "most favorable jurisdiction" provision which typically applies to the insurability of punitive damages, to also apply to the insurability of fines or penalties.

3. Conduct Exclusion

All D&O policies have some type of conduct exclusion, which eliminates coverage for certain types of egregious wrongdoing by an Insured Person. However, this exclusion varies significantly among policies in several respects, as summarized below.

First, the conduct falling within the exclusion varies among policies. Historically, the exclusion typically applied only to "dishonest" or "fraudulent" conduct, which would likely not apply to many criminal claims. Subsequently, additional types of egregious conduct were added to the exclusion in many policies. Today, the exclusion frequently applies not only to deliberately fraudulent or dishonest conduct, but also to "intentional violations of law" and, under many policies, "criminal" conduct.

Second, different policies apply different triggers to the applicability of this exclusion. Some policies require a "judgment or other final adjudication" which establishes that the referenced conduct actually occurred. More recent policies frequently require a "final and non-appealable adjudication in the underlying proceeding." Under this very narrow trigger, the exclusion does not apply unless and until the underlying proceeding is completely resolved (including all appeals) and the requisite adjudication exists in the underlying proceeding (not in a related coverage proceeding). Whether this type of exclusion trigger would apply the exclusion to a related civil claim if the adjudication occurs in a criminal proceeding has been debated by insurers and insureds, but there is little authority addressing that question.

Third, the exclusion typically applies only to the Insured Persons who committed the egregious conduct and does not apply to other Insured Persons (i.e., the exclusion states that the conduct of one Insured Person is not imputed to another Insured Person).

Fourth, many versions of the exclusion contain exceptions or carve-outs to which the exclusion does not apply. For example, the exclusion as contained in many Side A policies (and some ABC policies) expressly does not apply to outside directors and/or defense costs.

Importantly, prior to the exclusion being triggered, D&O policies typically require the insurer to advance defense costs in a claim which alleges conduct described in the exclusion (including criminal conduct), subject to the Insureds being required to repay the advanced defense costs to the insurer if and when the exclusion is ultimately triggered.

4. Fifth Amendment Privilege Impacting Coverage

Several courts have held that an insured breaches his duty to cooperate with the insurer under an insurance policy when the insured asserts the Fifth Amendment privilege against self-incrimination in response to questions by an insurer in connection with a claim for coverage under the policy. See, *U.S. Specialty Ins. Co. v. Skymaster of Va., Inc.*, 2001 U.S. App. LEXIS 26786, * 8 (4th Cir. 2001) ("Any argument of the insured that giving the [examination under oath] provision such a broad scope would effectively abrogate their right against self-incrimination is unavailing; they may avoid incriminating themselves by refusing to submit to relevant requests made by the insurer under the policy provision, although to do so may ultimately cost the insurance coverage under the terms of the contract for which they and the insurer bargained."); *Miller v. Augusta Mut. Ins. Co.*, 335 F. Supp. 2d 727, 731 (W.D. Va. 2004), *aff'd*, 2005 U.S. App. LEXIS 26862 (4th Cir. Dec. 8, 2005) ("[The insured's] assertion of the Fifth Amendment in response to [the insurer's] questioning therefore constituted a failure to cooperate as a matter of law."); *U.S. Fidelity & Guaranty Co. v. Wigginton*, 964 F.2d 487, 491 (5th Cir. 1992) ("[The insured] cannot, however, rely upon his Fifth Amendment right against self-incrimination as a valid excuse to avoid examination in this civil case."); *State Farm Fire & Cas. Co. v. Richardson*, 2008 U.S. Dist. LEXIS 80150, *29 (S.D. Ala. Oct. 9, 2008) ("[W]hen an insured seeks to recover proceeds from an insurance contract to which he is a party, he must be held to the express terms of the agreement. He is not compelled to incriminate himself. He is, however, bound by the provisions to which he stipulated when he signed the insurance agreement and cannot expect [the insurer] to perform its obligations under the contract, by being subject to suit for payment of proceeds, without compliance on his part."); *Aetna Cas. & Surety Co. v. State Farm Mut. Auto. Ins. Co.*, 771 F. Supp. 704, 707 (W.D. Pa. 1991) (rejecting an argument that "the Fifth Amendment privilege trumps the insurance policy's duty to cooperate requirement"); *FT Mortgage Co. v. Williams*, 2001 Ohio App. LEXIS 4728 (12th Dist. Oct. 22, 2001) (insured breached the cooperation clause in the insurance policy by invoking her Fifth Amendment right and therefore lost coverage under the insurance policy); *Ohio Bar Liability Ins. Co. v. Silverman*, 2006 Ohio App. LEXIS 2881 (10th Dist. June 15, 2006) (an insured "cannot wield [his] Fifth Amendment privilege as a shield and a sword by demanding coverage and a defense under the insurance contract, while at the same time refusing to answer questions material to determining [the insurer's] duties under the contract.").

At least one court applied this same reasoning to preclude coverage where the insured invoked the Fifth Amendment privilege in the underlying proceeding. The 8th Circuit reconciled the cooperation duty of an Insured Person under an insurance policy with the Insured Person's Fifth Amendment rights as follows:

> "[T]he insurance policy did not require an actual waiver of [the insured's] constitutional rights. He retained the choice whether to invoke his Fifth Amendment rights at the price of losing his insurance coverage or to cooperate with the defense attorneys provided him and retain his coverage. Both options remained available to him throughout the pendency of the [underlying] case. We conclude that the district court did not err in concluding

> that [the insured] materially breached the cooperation clause in his insurance policy.

Medical Protective Co. v. Bubenik, 594 F.3d 1047, 1052 (8th Cir. 2010).

To address this potential coverage limitation, the D&O policy could include a provision which prohibits the insurer from raising a lack of cooperation coverage defense based on an insured's assertion of the Fifth Amendment privilege. Because D&O policy forms do not typically contain this provision, the insureds and their broker will need to specifically request such a provision.

5. Insurance Claims Handling

Criminal investigations and proceedings raise unique issues regarding communications between the insured and the D&O insurer. Like any other type of claim submitted for coverage, insurers expect to receive from the insured full information regarding any criminal investigation or proceeding, including frank discussions concerning defense strategies and exposures. However, unlike civil claims, various statutes and rules applicable to criminal investigations and proceedings potentially limit the extent to which the insured can fully comply with the insurers' requests.

For example, Rule 6(e) of the Federal Rules of Criminal Procedure impose upon certain participants in the grand jury process a strict duty to keep any "matter occurring before the grand jury" a secret. Although that secrecy obligation does not apply to grand jury witnesses, prosecutors frequently request witnesses (including the target defendant) to maintain the confidentiality of the grand jury proceeding.

In addition, defense counsel and D&O insurers should avoid creating the appearance of influencing witness testimony or otherwise obstructing the criminal justice process by exchanging information or ideas about defense strategies. Federal statutes prohibit witness tampering (18 U.S.C. §1512(b)) and any attempt to "influence, obstruct or impede the due administration of justice" (18 U.S.C. §1503(a)).

Both defense counsel and D&O insurers should be sensitive to but not over react to these potential impediments to the insurer's involvement in the criminal defense process. Typical insurer involvement in a claim should not technically violate any of these statutes or rules. The potential concern relates to creating the appearance of impropriety rather than actual illegal behavior.

B. INDEMNIFICATION ISSUES

A criminal investigation or proceeding against directors and officers also raises several important issues with respect to the company's legal ability and obligation to indemnify the director or officer for defense costs, fines, penalties or other loss incurred as a result of the criminal investigation or proceeding. The following summarizes many of those issues. The indemnification law of the state in which the company is incorporated typically applies.

Although generally consistent, those state indemnification laws vary in several important respects. Therefore, the applicable state law should be reviewed when evaluating indemnification protection by a particular company. The discussion below is generally based upon Section 145 of the Delaware General Corporation Law, which describes indemnification of directors and officers for a company incorporate in Delaware.

1. Permissive/Mandatory

State indemnification statutes generally permit but do not require a company to indemnify its directors and officers. The one exception is where the defendant director and officer is successful in defending the claim, in which case indemnification statutes usually require the company to indemnify the person's costs incurred in that successful defense.

A company can, and almost always does, create an obligation to indemnify its directors and officers by adopting an indemnification provision in the company's bylaws or certificate of incorporation. Therefore, to evaluate a company's right and obligation to indemnify its directors and officers in connection with criminal matters, one should examine both the company's internal indemnification provision as well as the applicable state indemnification statute. In addition, some companies enter into formal indemnification agreements with certain key officers and directors in order to create extraordinary indemnification protection, although virtually all of the benefits of an indemnification agreement can be created through a broadly drafted bylaw indemnification provision if a company wants to afford those extraordinary protections to all directors and officers rather than a few select directors and officers.

2. Standard of Conduct

Indemnification statutes generally apply to both civil and criminal proceedings which are commenced or threatened against current or former directors and officers (as well as employees and agents, although a company's bylaw indemnification provision frequently does not mandate indemnification for employees or agents). This indemnification is subject to the person satisfying a standard of conduct set forth in the statute. For example, to qualify for indemnification under the Delaware statute, a director or officer must have acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the company. With respect to any criminal proceeding, the person must also have had no reasonable cause to believe his conduct was unlawful. The Delaware statute further states that the termination of any civil or criminal proceeding by judgment, order, settlement, conviction or upon a plea of *nolo contendere* does not alone create a presumption that the person's conduct failed to satisfy the statutory standard of conduct.

State indemnification statutes require a majority of disinterested directors or independent legal counsel to make a determination, based upon the facts of each claim, whether the conduct of the director or officer satisfies this statutory standard of conduct and thus whether indemnification for the director or officer is authorized. Like D&O policies, indemnification statutes permit, and bylaw indemnification provisions should require, the

company to advance defense costs throughout the pendency of a claim until such a determination can be made at the end of the claim. However, if it is ultimately determined that indemnification is not permitted, then the director and officer must repay to the company the amount of defense costs advanced by the company.

3. Fine/Penalty Indemnification

State indemnification statutes describe the type of loss incurred by a director and officer which may be indemnified by the company. The Delaware statute, like most state indemnification statutes, expressly authorizes indemnification of a wide variety of losses, including among other things, not only defense costs in a criminal proceeding but also fines incurred by the director or officer, provided the fine is assessed with respect to conduct which is indemnifiable.

4. Conflict with the Company

Based on the foregoing, directors and officers who are targets of or defendants in a criminal proceeding will in most instances be entitled to advancement of defense costs and potentially to indemnification if the conduct giving rise to the criminal investigation or proceeding is found to satisfy the statutory standard of conduct. However, that standard of conduct will likely be difficult to satisfy in many criminal matters where the director or officer is convicted or pleads guilty. Therefore, indemnification is far from certain in this context. In addition, the new strategy by the DOJ, as evidenced in the Yates Memorandum, to require companies to disclose to the DOJ full details of potential director and officer criminal wrongdoing as part of the company's cooperation with the DOJ could further reduce the likelihood of indemnification in criminal matters. Companies may now be reluctant to grant indemnification for targeted directors and officers out of concern that the DOJ may view that indemnification as evidence of both the company's lack of cooperation and the company's failure to support the DOJ's efforts to deter future illegal activity.

5. Indemnification Planning

Because mandatory indemnification of directors and officers generally exists only pursuant to a bylaw indemnification provision, it is important that the bylaw provision affords the broadest indemnification protection for directors and officers which is desired by the company. Most such provisions mandate indemnification and defense costs advancement "to the fullest extent permitted by law." A number of other protective provisions could be (but frequently are not) included in order to maximize the protections afforded to directors and officers. Some of those additional provisions are summarized below.

Discourage Wrongful Refusal. Even under a mandatory indemnification provision, there is some subjectivity to the indemnification process since the incumbent board of directors must determine that the defendant director or officer qualifies for indemnification. If the defendant and the incumbent directors are antagonistic, the indemnification protection may be wrongly withheld. The bylaw indemnification provision can contain several features which

disincentivize the company from wrongfully refusing to indemnify a director or officer. For example, the provision can state that a director or officer who is denied indemnification and who is successful in whole or in part in a lawsuit against the company to enforce his or her indemnification rights, is entitled to reimbursement from the company of costs incurred in enforcing his or her indemnification rights. In addition, the provision can state that in any such suit to enforce one's indemnification rights, the company bears the burden of proof to establish that the claimant is not entitled to indemnification. Also, the provision can state that any determination by the board of directors with respect to the claimant's right to indemnification is not a defense for the company in such a suit, and does not create a presumption against the claimant. All of these provisions minimize the chance the company will wrongly withhold indemnification, and maximize the chance the director or officer will prevail in any suit to enforce his or her indemnification rights.

Contractual Rights. The provision can expressly create a contractual right in favor of the directors and officers to the broad indemnification protection described in the provision. Because of such a provision, the company should not be permitted to unilaterally and retroactively amend or eliminate those indemnification rights. This provision affords protection equivalent to that available under a separate indemnification contract between the company and its directors and officers.

Subsidiaries. By statute, a company is authorized to indemnify its directors, officers, employees and agents, as well as any person serving at the request of the company as a director or officer of another organization. As a result, a parent company is probably not permitted or required to indemnify the directors and officers of its direct and indirect subsidiaries unless those subsidiary directors and officers are serving in that capacity at the request of the parent company. The parent company's bylaw indemnification provision can state that a director or officer of a direct or indirect subsidiary of the company or any employee benefit plan of the company or such subsidiary, is deemed to be serving in that capacity at the request of the company. This provision requires a parent company to indemnify all of the directors and officers of all of its subsidiaries as well as fiduciaries of their employee benefit plans. Although ultra-protective for the directors and officers of the subsidiaries, this provision obviously creates new liability exposures for the parent company that should be considered before adopting such a provision. An alternative approach would be to afford this indemnification protection only to directors and officers of the parent company who serve a subsidiary in any capacity.

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