Bailey Cavalieri LLC
ATTORNEYS AT LAW

CLIENT ALERT

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About the Authors:

Dan Bailey is a nationally recognized expert regarding directors' and officers' responsibilities, liabilities, indemnification, insurance and loss prevention. As Chairman of Bailey Cavalieri LLC's "D&O" practice group, he represents or consults with directors and officers, corporations, insurance companies and law firms across the country.

Tom Geyer is an attorney with Bailey Cavalieri LLC, where he practices in the areas of Directors and Officers Liability and Insurance, and Corporate and Securities Law.

Bailey Cavalieri LLC
One Columbus
10 W. Broad St., Suite 2100
Columbus, Ohio 43215-3422
phone - 614/221-3155
facsimile - 614/221-0479

Kettering Tower
40 N. Main St., Suite 2310
Dayton, Ohio 45423-0001
phone - 937/223-4701
facsimile - 937/223-0170

www.baileycavalieri.com

SEC's Dim View of Indemnification Darkens

The Securities and Exchange Commission ("SEC") has long taken the position that indemnification for violation of the federal securities laws is against public policy and unenforceable. Historically, the SEC has enforced this position by requiring that registrants seeking accelerated effectiveness of securities registration statements disclose indemnification arrangements and, if such indemnification is not waived, include a statement acknowledging the SEC's position. However, under the tenure of current Chairman William H. Donaldson, the SEC has begun to apply this dim view in the enforcement context, specifically by including prohibitions on indemnification and reimbursement in agreements to settle civil enforcement actions. This development sends yet another[1] sobering message to directors and officers that their personal assets are very much at risk by reason of their corporate service. This article discusses the past, present and future of the SEC's views on indemnification, and suggests that those who are interested in D&O coverage—corporations, D&O insurers, and directors and officers themselves—should carefully monitor the emerging trend of the SEC's inclusion of indemnification and reimbursement prohibitions in settlement agreements.

The Past – The "Johnson & Johnson Doctrine"

In enacting Sections 11 and 12 of the Securities Act of 1933, the Congressional intent was "to impose a duty of competence as well as innocence and to promote careful adherence to the statutory requirements, which may be thwarted by allowing indemnification."[2] As a result, the SEC has taken the position for several decades that a company's indemnification of its directors, officers or others for violation of the federal securities laws would defeat the deterrent effect of the laws and therefore is prohibited by public policy. Under the so-called "Johnson & Johnson Doctrine," the SEC has required that in order to qualify for acceleration of the effective date of a securities registration statement, unless rights of indemnification arising out of the offering are waived, the registrant must acknowledge in the registration statement the SEC's position that indemnification for violation of the Securities Act is against public policy and is unenforceable. Further, in order to qualify for acceleration, the registrant must undertake that unless the issue is settled by controlling precedent, claims for indemnification for violation of the Securities Act will be submitted to a court for approval.[3]

Similarly, the federal courts have not permitted indemnification for violation of the federal securities laws. The leading case on this point is *Globus v. Law Research Service, Inc.*,[4] in which the U.S. Court of Appeals for the Second Circuit relied on the SEC's position against indemnification and upheld the district court's refusal to permit indemnification for claims under section 17(a) of the Securities Act and section 10(b) of the Securities Exchange Act of 1934.

As the *Globus* decision demonstrates, the judicial prohibition on indemnification is equally applicable to both the Securities Act and the Exchange Act. Decisions subsequent to *Globus* have invalidated contractual provisions that purported to provide indemnification for violation of the federal securities laws.[5] In addition, some courts have prohibited indemnification for defense costs incurred in actions for violation of the federal securities laws.[6]

However, the SEC does not regard a company's purchase of insurance which covers violations of the securities laws as violating public policy,[7] and judicial decisions have agreed.[8] Thus, financial protection against violations of the securities laws is one of the primary reasons why D&O insurance is critically important to directors and officers.

The Present – The "Donaldson Doctrine"

This public policy prohibition against indemnification for securities law violations historically has not been a meaningful impediment to protecting directors and officers since the prohibition generally applies only if there is an actual violation of the securities laws.[9] Since claims for securities law violations invariably settle without a finding of an actual violation, this indemnification prohibition has rarely applied in the past. In any event, D&O insurance would usually cover the loss even if not indemnifiable, so this indemnification prohibition has been largely ignored.

Despite the fact that D&O insurance policies typically cover violations of securities laws (subject to exclusions for fines and penalties or for egregious wrongdoing), the SEC and some state regulators have recently begun an alarming trend of requiring, as a condition to settling claims against directors, officers and others, that the settling party agree not to seek or accept indemnification or reimbursement from any source (including the D&O insurance policy) for any amount paid in settlement of the enforcement action. In other words, the defendant director or officer is required to give up any rights to coverage for the settlement amount and is required to personally pay the settlement amount without any indemnification or insurance protection.

The SEC's current philosophy regarding indemnification and reimbursement can be traced to Chairman Donaldson's remarks on June 5, 2003 before the New York Financial Writers Association. In discussing the SEC's enforcement actions and strategies, he stated:

> I'm concerned about companies that, under permissive state laws, indemnify their officers and directors against disgorgement and penalties ordered in law enforcement actions, including those brought by the Commission. In my mind, this just isn't good public policy. This is an area in which we may need to consider ways to bring about reform.[10]

The Chairman's statement appears to have been in response to Xerox Corporation's disclosure that it would indemnify six of its former officers for $19 million out of $22 million in fines, penalties and disgorgement assessed by the SEC in the settlement of an enforcement action.

A prohibition on indemnification or reimbursement in the enforcement context, referred to as the "Donaldson Doctrine," was a prominent part of the SEC's settlement of the research analyst conflict of interest cases in mid-2003. The settlement included payments into a Distribution Fund for the benefit of investors, and each of the consent agreements with the 10 settling broker-dealers included the following language:

> Defendant agrees that it shall not seek or accept, directly or indirectly, reimbursement or indemnification, including but not limited to payment made pursuant to any insurance policy, with regard to the penalty amounts that Defendants shall pay pursuant to Section II of the Final Judgment, regardless of whether such penalty amounts or any part thereof are added to the Distribution Fund Account or otherwise used for the benefit of investors.[11]

Significantly, the SEC also included this same language in settlements with the individual analyst defendants Henry Blodget[12] and Jack Grubman.[13] Assuming that indemnification or reimbursement were otherwise available to Blodget and Grubman, the prohibition on indemnification prevented their employers from indemnifying them, and the prohibition on insurance reimbursement prevented Blodget and Grubman from seeking coverage under their D&O policy.

The Donaldson Doctrine gained momentum in the May 2004 agreements to settle the SEC's civil enforcement action against Lucent Technologies, Inc. and certain former employees. Like in the settlements of the analyst conflict of interest cases, in settling the SEC charges Lucent and the three settling individual defendants agreed not to seek or accept, directly or indirectly, reimbursement or indemnification from any source, including but not limited to payment made pursuant to any insurance policy, with regard to any civil penalty amounts paid by such defendant.

Perhaps the most notable aspect of the Lucent settlement, however, was the SEC's criticism of Lucent's decision to expand the scope of employees eligible for indemnification in respect of the SEC enforcement action. In announcing the settlement, the SEC stated:

> After reaching an agreement with the staff to settle the case, and without being required to do so by state law or its corporate charter, Lucent expanded the scope of employees that could be indemnified against the consequences of this SEC enforcement action. Such conduct is contrary to the public interest.[14]

In particular, Lucent had decided to advance defense costs to employees who did not settle with the SEC, and who were not the subject of preexisting indemnification or advancement agreements. Reportedly, the SEC viewed this action as handing those employees "a blank check to litigate with [the SEC], with no consequences." The SEC considered this indemnification decision to be a failure to cooperate, and imposed a $25 million fine on Lucent for this decision, as well as several other instances of conduct, that the SEC deemed to be a "lack of cooperation." No fine had been contemplated under the initial agreement in principle to settle the case.

The Lucent settlement demonstrates that in addition to precluding indemnification and reimbursement as a term of settlement agreements, the Donaldson Doctrine may include the SEC reviewing indemnification practices, including advancement of defense costs, especially in the face of an SEC enforcement action.

This antagonism by regulators towards indemnification has emerged at the state level as well, where state authorities have been emboldened to seek to prohibit or limit indemnification and reimbursement in settling enforcement actions. For example, the Massachusetts Secretary of the Commonwealth and the New York Attorney General have prohibited or limited indemnification and reimbursement in settling investigations into alleged improprieties in the mutual fund industry.

Since fines and penalties are typically excluded from coverage under a D&O policy in any event, the regulator's prohibition against insurance reimbursement may appear to be merely a theoretical prohibition. However, two types of loss which usually are covered are subject to this prohibition. First, defense costs in connection with a claim seeking fines or penalties typically are covered, but may become subject to a regulator's reimbursement prohibition. Second, many settlements with regulators are structured not as a fine or penalty, but as payment of compensatory damages to a fund that is distributed to parties injured by the alleged wrongdoing. Such a compensatory damage settlement with a regulator typically would be covered, but may become subject to the regulator's reimbursement prohibition.

The Future...

There is a tension between the state corporate laws that permit indemnification and the SEC's view that indemnification for violation of the federal securities laws is against public policy. Going forward, the Donaldson Doctrine has heightened this tension by expanding the SEC's dim view of indemnification into the enforcement context, and by criticizing the advancement of costs to defend against SEC enforcement actions. Notably, the SEC's concern about advancement of defense costs draws support from the Sarbanes-Oxley Act of 2002. Section 402 of Sarbanes-Oxley added to the Exchange Act section 13(k), which broadly prohibits the extension of credit to directors and executive officers. Although a number of commentators have taken the position that section 13(k) does not prohibit the advancement of defense costs,[15] this conclusion is by no means certain. In a recent decision, the Delaware Chancery Court sidestepped the question by holding that section 13(k) applied only with respect to *current* directors and officers, and therefore was not relevant to advancement to a *former* officer.[16] Query whether the SEC will seek to prohibit advancement upon the authority of section 13(k). And query further whether, in a situation where the corporation has declined to advance defense costs, the SEC may seek to prohibit advancement of defense costs under the D&O insurance policy.

Yogi Berra observed that "the future ain't what it used to be." Indeed, the Donaldson Doctrine signals the SEC's willingness to extend its negative view of indemnification from the securities registration context to the enforcement context. The SEC enforcement director was recently quoted as saying:

> There's nothing more important from our perspective in what we do than trying to hold accountable individuals. We think it's important to punish both individual and corporate wrongdoers. Effective deterrence requires personal accountability.[17]

All those who have a stake in D&O coverage—corporations and their shareholders, D&O insurers, and of course directors and officers themselves—should be aware that the SEC's darkening view of indemnification, insurance, reimbursement, and advancement creates additional personal liability exposure for directors and officers at a time when they are otherwise facing unprecedented financial and reputational risks. At some point, particularly outside directors will conclude these escalating risks far exceed the benefits of service and will simply quit. Corporations, and their shareholders, may discover there is a lack of qualified persons willing to undertake corporate service. In addition to impacting a person's willingness to serve as a corporate director or officer, the SEC's view impacts an insurer's payment obligation under a D&O policy. As a result, insurers should closely monitor settlement negotiations between an insured and the SEC (and state authorities) because the settlement may result in the prohibition or limitation on payments by the insurer under D&O policies.

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[1] Another vivid example of the enormous financial risks associated with director and officer service is the recent settlement of shareholder claims against the outside directors of WorldCom and Enron, pursuant to which the outside director defendants paid from their personal assets $18 million and $13 million respectively (in addition to recoveries from their D&O insurance policies). *See also* n. 17 and accompanying text.

[2] Knepper and Bailey, Liability of Corporate Officers and Directors §22.21 (7th Ed.) (internal quotation marks and citations omitted).

[3] 17 C.F.R. §§229.510 and 229.512(i). *See also* Hazen, The Law of Securities Regulation §7.14 (4th Ed.).

[4] 418 F.2d 1276 (2nd Cir. 1969).

[5] *See, e.g.,* Eichenholtz v. Brennan, 52 F.3d 478 (3rd Cir. 1995); Franklin v. Kaypro Corporation, 884 F.2d 1222 (9th Cir. 1989).

[6] *See, e.g.*, In re Wilshire Technologies Securities Litigation, 807 F. Supp. 236 (S.D. Cal. 1995).

[7] 17 C.F.R. §230.461(c).

[8] *See, e.g.,* PepsiCo, Inc. v. Continental Casualty Co., 640 F. Supp. 656 (S.D.N.Y. 1986).

[9] *See, e.g.,* Raychem Corp. v. Federal Insurance Co., 853 F. Supp. 1170 (N.D. Cal. 1994).

[10] Donaldson, Remarks Before the New York Financial Writers Association, available at http://www.sec.gov/news/speech/spch060503whd.htm.

[11] *See, e.g.,* Consent of Defendant Merrill Lynch, Pierce, Fenner & Smith Incorporated, available at http://www.sec.gov/litigation/litreleases/consentml.pdf.

[12] Consent of Defendant Henry McKelvey Blodget, Case No. 03-CV-2947 (S.D.N.Y.), available at http://www.sec.gov/litigation/litreleases/consentblodget.pdf.

[13] Consent of Defendant Jack Benjamin Grubman, Case No. 03-CV-2938 (S.D.N.Y.), available at http://www.sec.gov/litigation/litreleases/consent18111b.htm.

[14] SEC Release No. 2004-67, available at http://www.sec.gov/news/press/2004-67.htm.

[15] *See* "Sarbanes-Oxley Act Interpretative Issues under §402 – Prohibition of Certain Insider Loans," a "white paper" developed by 25 law firms, available at (among other places) http://www.lw.com/practice/corporategovernance/sarbanes.asp.

[16] Tafeen v. Homestore, Inc., 2004 Del. Ch. LEXIS 38 (March 22, 2004).

[17] "Your Fault: Directors' Payback Deal Shows Corporate Boards Aren't Safe," *Wall Street Journal*, Jan.7, 2005, p. C1.