The Role of Outside Counsel in Corporate Investigations

By Patrick S. Bryant

Allegations of corporate wrongdoing and the flurry of ensuing activity can be among the most stressful times in the life of a company. The prospect of such charges comes from a growing and often incentivized set of constituents, including employees and potentially compensated whistleblowers, social and other media sources, financial markets, regulators, and law enforcement. How the company responds to these allegations is often critical to its ability to weather the storm and mitigate its effects. Outside counsel can be an invaluable resource to the company in its efforts to execute a time-pressured exercise to gather and assess the facts, consider and implement any necessary remedial actions and possibly publicize the results of a process that is invariably subject to second-guessing with the benefit of hindsight. This article explores the role of outside counsel and related practical considerations in assisting clients with internal investigations.

I. When to Investigate?

Whether to commence an internal investigation, though an obvious threshold question, is often overlooked in discussions of this topic. Perhaps that is because, as with many questions in this area, the answer requires discretion and judgment and does not lend itself to simple bright-line answers. However, a few observations may be helpful. In general, "investigations" are more accurately viewed as a spectrum of activities—from recurring inquiries conducted by in-house counsel, compliance, or human resources staff into a variety of routine employment, compliance, disciplinary, and similar matters—to full-blown investigations led by separate independent counsel into evidence of serious misconduct or violations of law by the company or high ranking officials, the initiation of a government inquiry, or knowledge of other matters that could expose the company to significant civil or criminal liability, regulatory sanctions or private litigation. Although matters in the latter category are generally regarded as warranting a formal "internal investigation," there are numerous instances that fall short of this extreme. There also may be situations where triage and preliminary due diligence on vague or seemingly uncreditable allegations, particularly anonymous complaints, are appropriately conducted by in-house counsel as an initial step in reporting to and informing a decision by a disinterested corporate authority, such as the board or an independent board committee, whether to pursue the matter further. Regardless of any doubts held by company personnel about the validity of a particular complaint or allegation, it is important that such personnel follow established procedures for reporting and escalating such complaints to the appropriate corporate overseers with sufficient authority and credibility to determine how to respond.[1] If a decision is made not to investigate, the company's process for reaching that determination should best position it to counter a claim that the decision was made or influenced by management or others potentially implicated by the allegations.

II. Who Must Be Satisfied?

Let's assume for purposes of discussion that the company has received information of sufficient import to warrant a full-blown internal investigation. Before the whirlwind of investigative activity begins, a thoughtful front-end assessment of the situation, shaped by a preliminary sense of the potential outcomes and consequences is extremely important in assisting the client in structuring a process that will best serve its interests. A threshold question that informs numerous decisions throughout the process is determining who are the external authorities or constituents that must likely be satisfied with the process, results, and credibility of the inquiry.[2] For example, if the company is publicly traded and the allegations involve financial improprieties, at a minimum the company's outside auditors must ultimately be satisfied that the review was sufficient to enable the auditor to conclude that it has both discharged its obligations under Section 10A of the Securities Exchange Act of 1934 (the "Exchange Act") (regarding procedures when an auditor learns that an illegal act may have occurred) and determined whether or not previously issued and pending annual or interim financial statements subject to review or audit by the auditor are materially misstated.[3] Similarly, when an inquiry has been initiated or prompted by a regulator or the subject matter of the inquiry is under that regulator's jurisdiction, the company must consider what sort of investigation will be sufficient to satisfy that particular regulator's concerns. Not surprisingly, these considerations are often at odds with, and can outweigh, numerous investigative ideals such as confidentiality and protecting investigation materials to the maximum extent from discovery by potential adversaries.

III. Who at the Company Should Oversee the Investigation?

This question is largely a function of the nature of the allegations, the parties potentially implicated, and who must be satisfied with the investigation. In some cases, it may be appropriate for senior management or the entire board to oversee the investigation.

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However, in situations where high-level executives or directors are potentially implicated or when an investigation is likely to involve interaction with a key regulator or the company's auditors, the perceived independence and credibility of the investigation are of such importance that it is customary to form a special board committee or designate an existing committee of independent directors not potentially implicated in the alleged wrongdoing (e.g., the audit committee or a risk or compliance committee if the company has one) to direct and oversee the investigation. The roles, responsibilities, and authority of the board and any special committee overseeing the investigation should be clearly documented in resolutions of the board and, if applicable, the committee.

IV. Who Should Conduct the Investigation?

This question is similar to the one above about corporate oversight of the investigation—the nature and seriousness of the matter will inform the proper choice. Generally, the three options available to the company are (1) its own in-house counsel, compliance or other personnel; (2) its regular outside counsel; or (3) separate independent counsel. Because the three options rank in increasing order of cost, it is understandable that this would be the company's preferred order if cost were the only, or primary, consideration. However, these three options generally rank in reverse order of perceived credibility with outsiders. Thus, for the most serious matters, separate independent counsel with little or no previous connection to the company is the preferred choice because of this credibility factor and the signal it sends to regulators, auditors or other key constituents that the company is completely committed to objectively determining the facts and addressing the matter.[4] The expertise of separate outside counsel versed in dealing with a particular regulator can also be very helpful. Often, this experience and rapport with a regulator can go a long way toward shaping the regulator's initial view of the matter and appetite for permitting the company to conduct its own investigation and report back versus initiating or escalating the regulator's own investigation.

This is not to say that all investigations necessarily need to be conducted by separate independent counsel. If the allegations involve lower-level personnel within the company, are relatively confined, do not threaten significant civil or criminal liability to the company and do not relate to matters that would implicate advice or work previously done or given by in-house or outside regular counsel, such matters may be appropriately investigated by one or both counsel, assuming they have the requisite expertise to do so. The guiding questions in such a decision should continue to be who must likely be satisfied with the investigation and whether the nature and stakes of the matter expose the investigation to an unacceptable risk of skepticism.

V. Defining the Scope of Investigation and Initial Steps

Scoping the investigation is an important organizational step in conducting a credible, yet relatively cost-effective,[5] inquiry into the matter in question. In today's world where emails, documents and records number in the millions even for a small organization, one of the toughest challenges in scoping an investigation is collecting and reviewing a sufficient, but not excessive, amount of data to confirm that the company has conducted a thorough and credible inquiry (keeping in mind both notions of common sense and the expectations of those who must be satisfied). Although, as discussed below, document hold and preservation measures at the start of an investigation may cover a broad spectrum of data within the organization, the information collected for review as part of the investigation will typically be a significantly smaller subset. The preservation measures leave open the ability to expand the inquiry as needed if additional discoveries lead investigators down other paths, and the scope of the investigation must be periodically revisited and revised accordingly as newly discovered facts warrant. The initial universe of documents and records selected for review, however, will largely be framed by an assessment of the allegations and the sources of information that are likely to be responsive to the allegations. Although some aspects of scope are common sense, such as the need to review documents and communications involving potentially implicated persons—other aspects, such as how far back in time to go with the document review or which ancillary persons' documents also warrant review—require more judgment. These judgments are also informed by the guiding principles of what is reasonable and who must be satisfied.

VI. Document holds and other preservation measures

Document holds and other preservation measures are extremely important actions to be taken at the outset of any investigation. Failure to implement these measures in a thorough and timely manner, even if not actually prejudicial to the investigation, can be extremely damaging to the perceived credibility or integrity of the investigation, much in the same way that hints or allegations of destruction of evidence can be damaging in a trial. Such failures may also form the basis for obstruction of justice charges in the event the matter becomes the subject of a regulatory investigation.[6]

Keys to effective preservation are an accurate understanding of the multiple sources of potentially relevant data and implementation of reasonable measures to preserve all such sources. This starts with communication of a written litigation hold to an appropriate group of people within the company who may have relevant information, instructing them to preserve all specified categories of information relating to the relevant time period, in whatever form. Communication with the company's IT personnel is necessary to understand the landscape of available and relevant data and the steps necessary to preserve it. In most companies, some data is more at risk for scheduled or intentional destruction than other types of data, and the preservation measures can be tailored accordingly. Additional measures that should be considered, and to the extent necessary, implemented on the IT side include the stoppage of any auto delete or overwrite functions on company servers and back-up systems that store electronic information, coordination with any third-party storage providers, and as necessary, the impoundment or copying of information stored on portable devices, such as hard drives and flash drives, laptops, or other mobile devices. The assistance of an outside electronic discovery or forensic IT specialist[7]

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can be very useful in assisting with preservation, particularly if counsel or the company's internal IT staff is not well versed in such matters (including appropriate chain-of-custody procedures and preservation of metadata) or if the internal staff is potentially implicated or arguably biased through loyalty to management who may be the subject of the inquiry.

VII. Witness Interviews

Witness interviews should be coordinated with document review and other aspects of the investigation to maximize the potential knowledge of the interviewer and inform the line of questioning, much in the way that discovery is conducted in advance of depositions or trial testimony. Careful thought should also be given to the sequencing of interviews. Typical interviewees include company employees who might otherwise assume, or later assert, that investigating counsel was also serving as counsel for the interviewee. It is important to clarify the scope of counsel's representation and to whom any attorney-client privilege belongs. To address these issues, prior to commencing the interview counsel should give a so-called "*Upjohn* warning" or "corporate *Miranda* warning" to the witness to convey the following information: (1) counsel represents the company and not the witness; (2) counsel's purpose is to investigate certain matters on behalf of, and provide legal advice to, the company; (3) the attorney-client privilege over the interview belongs to the company, which may decide at any time and its sole discretion to waive the privilege and disclose the contents of the interview to third parties, including enforcement authorities; and (4) the interview should be kept confidential by the witness to assist in protecting the company's privilege.[8] If the company is already cooperating or has made the decision to share information regarding the interview with auditors or regulators, it is prudent to inform the witness of this fact.[9] As disputes and practices have evolved in this area, it has become more common for counsel to obtain some form of written acknowledgement from the witness of the receipt of the *Upjohn* warning and its contents.

Witness interviews in internal investigations can present a number of additional strategic and legal challenges. Unlike a court proceeding, the company's leverage over an employee to cooperate with a requested interview is typically limited by the bounds of the employment relationship and the prospect of disciplinary action or termination for failure to cooperate. The employment relationship generally includes an express or implied duty to comply with the employer's lawful directives,[10] and many companies' employee handbooks, codes of conduct, and executive employment agreements expressly address an employee's obligation to cooperate with an investigation. When an investigation spans a lengthy period of time or key witnesses plan to leave the company during the course of an investigation, consideration should be given to accelerating interview schedules to take advantage of this period when a company's chances of securing cooperation are greatest.

Employee whistleblowers raise a host of additional issues, including attention to laws and regulations that protect them from employment retaliation[11] and in some cases provide mandatory bounties.[12] For these and other reasons, whistleblower claims must be handled with particular care.[13] Though whistleblowers are often disgruntled employees or have other baggage that might otherwise lead an employer to discount their allegations, that does not necessarily mean that their claims are unfounded. A company should think carefully about how it responds to whistleblower claims and its rapport with the whistleblower during the process, particularly in light of the risk that a whistleblower who believes his concerns are being ignored or minimized may decide to go directly to the authorities.

Who should attend the interview is an additional strategic consideration. At least two members of the investigative team should be present to enable one to serve as principal note taker and a potential corroborating witness if the interview is later called into question. Beyond that, whether to permit the attendance of any additional persons, such as a disinterested in-house attorney who knows the employee, should be dictated by whether such person's presence would be viewed as reasonably promoting a legitimate objective of the investigation, such as increasing the likelihood that a nervous witness will be more comfortable and forthcoming in the interview. These considerations must be weighed against any potentially negative perception regulators or other important constituents may attach to the presence of any such company representative in the interview.

Under some circumstances, it may be appropriate for the company to hire separate counsel for employees being interviewed, or suggest that the employee consider hiring separate counsel, especially if it is likely that the employee may have interests divergent from the company's or may become the target of a government investigation or prosecution.[14] Whether an employee in this circumstance is entitled to representation at the company's expense is generally a function of the company's charter documents, any indemnification agreements, directors and officers' liability insurance, and state law. In certain cases, a company may voluntarily agree to provide counsel for employees at its expense in the interest of furthering the objectives of the investigation. Counsel should understand and be prepared to address these issues with witnesses before beginning the interview process.[15] In addition, some witnesses, even those without apparent involvement in the alleged misconduct or adverse interests to the company, may specifically ask if they need counsel prior to commencing an interview. Investigating counsel should be prepared for such questions and carefully caveat any response with a reminder that he or she is not counsel to the witness and therefore cannot provide legal advice to the witness. Depending on the perceived adversity of the witness and any instructions from the company regarding the issue, the typical response would range from an artful disclaimer to answer on grounds that the lawyer is not counsel to the witness to a statement that the witness may have a conflicting interest with the company and may wish to consider obtaining separate counsel.[16]

VIII. Privilege and other attorney-client issues

Preserving the attorney-client privilege in the context of an investigation is challenging for a number of reasons. First, even if all

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appropriate steps are taken to preserve any privilege or attorney work product protections that might otherwise be afforded materials generated in the investigation, practical considerations driven by the "who must be satisfied?" analysis often lead to voluntary disclosures to regulators, auditors, or other third parties that effectively waive these protections. A prudent planning guideline is to assume that the communications, findings, and other materials generated by an investigation will not ultimately be shielded by attorney-client privilege or work product doctrine, but to plan and execute the investigation in a manner that provides the best chance that as much of the investigation materials as possible will qualify for protection under one or both of these doctrines.

A seemingly simple question that can be complex in internal investigations is determining the identity of the client. The initial inclination is to say "the company," but when the interests of the company and those authorized to act on its behalf potentially diverge, the assessment is more complicated. As noted above in the discussion of witness interviews, it is important to clarify potential misunderstandings by clearly delineating who is and is not counsel's client. Moreover, although the board of directors and its committees are typically considered part of the corporation and would ordinarily share the privilege under the "common interest" doctrine, some courts have found that when an independent committee of the board itself retains outside counsel, the committee, rather than the full board (or the company) holds the privilege and can waive it by disclosure to the full board.[17] A common theme in these cases finding waiver is the presence of potentially adverse parties among the board members with whom the information is shared. Counsel representing a special board committee or the full board in conducting an investigation should keep this issue in mind when reporting investigation matters and take appropriate measures, including reporting in executive sessions to exclude potentially adverse parties who serve on the board.

The touchstone of the attorney-client privilege is a confidential communication between an attorney and a client for the primary purpose of providing legal advice. Accordingly, the documentation relating to the investigation, beginning with the authorizing board and, if applicable, committee resolutions and the engagement letter with counsel conducting the investigation, should appropriately describe the subject matter and purpose of the investigation, including the purpose of obtaining legal advice. Often, additional outside experts, such as forensic IT and accounting personnel, are engaged to work on the investigation. Because no independent privilege exists for communications outside the attorney-client relationship or communications regarding the provision of business, as opposed to legal, advice,[18] it is preferable to have these outside experts retained and directed by counsel through an engagement letter that similarly details the nature of the engagement and explains that the expert's role is to assist counsel in providing legal advice to the client.[19]

The work product doctrine generally protects a lawyer's mental impressions, conclusions, theories or opinions in materials prepared in anticipation of litigation.[20] It is also broader and more difficult to waive than the attorney-client privilege. Accordingly, similar attention to documenting any prospect of litigation in the context of investigations and labeling documents accordingly may assist the company in asserting work product protection for investigation materials in addition to, or separate from, the attorney-client privilege.

The difficulty in preserving these protections is often driven by the endgame objectives of the investigation, which frequently include sharing of information with regulators, auditors, or other key constituents in order to obtain cooperation credit or other benefits the company desires in order to minimize the impact of the conduct investigated. Numerous regulators, in overt or subtle ways, push companies to waive these protections. In particular, the historical enforcement practices and guidelines of the Department of Justice[21] and SEC[22] that instructed agency attorneys to specifically consider whether a company had waived privilege as a measure of the company's cooperation led to growing criticism of a regulatory "culture of waiver, " as well as legislative efforts[23] to roll back the trend. In response, the Department of Justice and SEC have revised their enforcement guidelines in recent years to instruct their personnel generally not to request an explicit waiver of these protections and to base cooperation on full disclosure of all relevant facts regarding the alleged conduct (whether or not such disclosure includes waiver of privilege).[24] Despite this seemingly more company-favorable approach, it often remains a tenuous challenge to separate the key facts in an investigation from otherwise privileged or work product materials that uncovered those facts. In addition, not all government regulators have adopted these guidelines, so the company may be faced with differing sets of expectations if dealing with multiple regulators. These dynamics continue to present companies and their counsel with difficult choices in balancing the desire to protect investigative findings and materials against discovery by civil litigants or other future adversaries with the desire to obtain the most favorable treatment and result in any current or imminent regulatory proceedings.

IX. Reporting and memorializing findings, recommendations, and remedial actions

Whether to memorialize the findings of an investigation in a written report is an often debated issue to which there is no uniform answer. The obvious concern with a written report is the likely prospect that the report will lose privilege protections through inadvertent disclosure or voluntary disclosure to a regulator or other third party and thus provide a road map to a potential adversary. In many cases, however, this concern is outweighed by the "who must be satisfied" calculus that a regulator, auditor, law enforcement, board of directors, or other constituent will expect a written report. A positive aspect of producing some type of formal investigation report is that counsel can carefully think through and craft the formal narrative with a view toward all the potential hindsight considerations. A written report also serves as a contemporaneous and comprehensive record that minimizes the risk of inconsistent recollections if investigation participants or overseers are later called upon to recount the details of the investigation. A negative is the potential that a written report prepared at a premature stage can be undermined (along with the credibility of the investigation that produced it) by the discovery of subsequent events that render the report inaccurate. Hybrid approaches include an internally prepared summary of the investigation by counsel that documents the scope, process, findings, and recommendations of

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the investigation, followed with oral reporting on the investigation to the board or committee overseeing the investigations and, if agreeable, to any regulator with whom the company is cooperating pursuant to a confidentiality agreement. Although confidentiality agreements with regulators are a prudent measure, courts are split on the concept of "selective waiver," and many have held that disclosure of privileged information to a regulator, even if pursuant to a confidentiality agreement, constitutes a waiver of privilege with respect to the disclosed information.[25]

Unless an investigation turns up no indication of wrongdoing, it will likely produce some recommended remedial actions. Remedial actions are typically devised in conjunction with counsel, who is often best positioned to recommend actions that can or should be taken to address any violations of law and help the company minimize any potential regulatory actions or sanctions. It is ultimately the decision of the corporate authority overseeing the investigation or, depending on the terms of its mandate, the board of directors, to determine what, if any, remedial actions to take. The authority making this decision should be mindful, however, that a scenario even more potentially damaging than an opponent's discovery of an investigation report would be its discovery of a report containing reasonable remedial recommendations that the company has failed to implement. Good communication between counsel and the overseeing authority and follow-through on the part of the company should largely eliminate this risk; but in the event the company elects not to implement a recommended remedial action, its basis for doing so should be well reasoned and documented.

X. Dealing with Regulators and Auditors

If an internal investigation confirms allegations of illegal conduct, the company will be faced with the question of whether to "self-report" to one or more regulators. The answer to this question is fact-intensive and involves numerous considerations. In certain highly regulated industries or matters involving publicly traded companies, there may be direct or indirect disclosure obligations or practical pressures that make self-disclosure the only viable choice.[26] Apart from those situations, self-reporting may still be the appropriate course of action depending on the facts and circumstances. Some factors to consider are (1) the potential exposure to the company (e.g., nature and extent of potential civil or criminal liability) as a result of the misconduct; (2) the relative certainty of the facts that would support any charges; (3) the extent to which self-disclosure is likely to mitigate these exposures; and (4) the likelihood that the information will come to the attention of regulators in any event. Although self-reporting implicates many of the tensions previously discussed, numerous examples attest to the success of companies in significantly mitigating regulatory consequences, despite egregious conduct, by self-reporting and cooperating with regulators.[27]

Dealing with the company's auditors presents a unique set of challenges. As alluded to above, auditors of reporting companies have statutory obligations under Section 10A of the Exchange Act when they become aware of a possible illegal act. [28] Other Exchange Act rules adopted pursuant to the Sarbanes-Oxley Act impose obligations of candor on management with respect to auditors.[29] In addition, management is typically required to sign representation letters to its auditors as a condition to the auditors' release of audited or reviewed financial statements; these letters contain representations that would be breached if such officers did not disclose the existence of information giving rise to an investigation. Beyond any statutory obligations, the company's auditors have an important stake in understanding any matters that may affect the integrity of the company's financial statements, as they sign audit reports on the company's financials that can expose the firm to substantial liability and regulatory sanctions. As a practical matter, the auditors hold significant leverage over the company in these situations because they alone determine if and when they are satisfied to sign off and release their audit report. Thus, resolving these matters to the satisfaction of the auditors is critical to a public company's ability to comply with its periodic reporting obligations. Even for private companies, the failure to produce timely audited or reviewed financial statements may create problems such as defaults under loan covenants. For all these reasons, careful planning and coordination of any investigation and related reporting with the company's outside auditors is imperative. In many instances, certain terms of the investigation and protocols regarding reporting and other matters will be agreed in advance with the auditors. While these negotiations and their ultimate resolution may in some cases compromise investigative ideals such as maximum privilege retention, it is far better to hash out the auditors' expectations in advance than after undertaking an investigation that the auditors deem unsatisfactory.

XI. Whether to publicize the initiation or results of an investigation?

This question arises mainly when the investigation involves a company with publicly traded securities, though it can come up for other companies, particularly if the conduct in question involves significant reputational risk to the company and is already public or the subject of public rumors. In the latter case, an announcement may be deemed necessary to protect brand or reputational risk and restore the confidence of customers, suppliers, or other important constituents.

In general, there is no express legal duty to publicly disclose the existence of an investigation. Publicly traded companies, however, must continually evaluate the question of disclosure in the context of complying with securities regulations. These include the prohibition on trading while in possession of material nonpublic information and the company's periodic reporting requirements, which may indirectly require disclosures regarding the matter if the investigation will prevent the company from timely filing its periodic reports[30] or render misleading any other statement the company has made or will be required to make in a periodic report.

The obvious challenge in making a disclosure at the inception of an investigation is determining what can accurately be said—usually not very much until the investigation has made significant progress—to financial markets or other key constituents who tend to fear uncertainty. If a front-end disclosure is made, the inherent risk of making a misleading disclosure typically results in relatively terse factual statements about the existence of the investigation and subject matter being investigated. Any decision to disclose must be carefully coordinated with the company's investor relations officers or other spokespersons, as well as any regulators unaware of the investigation whose interest will likely be piqued by such a disclosure. In such cases, it is far better for counsel to contact the regulator to provide a "heads up" about the matter and the pending public disclosure. Not only does such a disclosure preserve the potential for the company to receive credit for self-reporting, but may favorably affect the regulator's view of the company and situation versus the alternative scenario of discovering it through press reports or other third-party sources.

Whether to disclose the results of an investigation also will depend on numerous factors, perhaps most importantly the extent to which information regarding the investigation has already been made publicly available and privileges over such information have already been waived. As a practical matter, a company that makes an initial disclosure about an investigation will be hard-pressed not to provide an update or summary of its outcome. In the case of protracted investigations, the company will likely face pressure to provide interim updates, which can be particularly challenging at a time when the company may be aware of actual or probable material information gleaned from the investigation but less than full knowledge of how the information will ultimately affect the company. Public companies must also continue to consider the impact of applicable securities laws, including a potential duty to update and any requirement to disclose certain material events under SEC reporting rules, such as material legal proceedings or any conclusion that previous financial statements should no longer be relied on. Absent these prescribed disclosure obligations, a company that decides to disclose the results of an investigation may best position itself to argue for protection over any remaining attorney-client communications and work product by limiting its disclosures to factual information, but should be under no illusion that such arguments will ultimately prevail.[31] Because a typical objective of any post-investigation communication is to restore confidence in the company's customers, suppliers, investors, or other key constituents, most such disclosures provide some information about remedial actions that have been or are being taken by the company in response to its findings. Companies making public disclosures about investigations and remedial actions must also take care in their characterization of any wrongdoing by employees to guard against claims of defamation, libel, or slander.[32]

XII. Takeaways

For better or worse, internal investigations are an increasingly necessary task that companies must be prepared to undertake. A well-organized and executed internal investigation can assist the company in minimizing the collateral damage from wrongdoing within the organization and often enhance the company's chances of shaping the outcome of a matter by gathering the facts and informing strategic decisions before these exercises are required by outside forces, such as regulators or litigants. A good internal investigation must anticipate and understand the likely endgame consequences to be of most benefit. In light of the numerous decision points, judgment calls, and pitfalls that line the pathway of internal investigations, the early and active involvement of good counsel is critical to conducting a successful and efficient investigation, preserving its integrity and credibility, and managing post-investigation risks.

Bryant practices with Robinson, Bradshaw & Hinson, P.A. in Charlotte.

(Endnotes)

1 For example, Rule 10A-3(b)(3) under the Securities Exchange Act of 1934 and related stock exchange listing rules require public company audit committees to establish procedures for the receipt and treatment of complaints about accounting, internal accounting controls and auditing matters, including the ability of employees to submit anonymous complaints about questionable accounting or auditing matters.

2 The focus on satisfaction of external authorities is not intended to minimize the interest of a company's directors in confirming that an investigation is adequate and consistent with a board's generally recognized *Caremark* duties to monitor and confirm that the company has systems in place that are reasonably designed to ensure compliance with laws and regulations. See Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996); see also Stone v. Ritter, 911 A.2d 362 (Del. 2006).

3 See "Dealing with Regulators and Auditors" below for further discussion of auditors in the context of internal investigations.

4 Separate counsel should be engaged pursuant to an engagement letter that specifies who has engaged the counsel and to whom counsel reports (e.g., the board or committee overseeing the investigation), the nature of the matter for which counsel has been retained and the purpose of providing legal advice in connection with that matter. See "Privilege and other attorney-client issues" below for further discussion of the engagement.

5 No company should be under the illusion that internal investigations are inexpensive. For complex multinational organizations, investigation costs can run into the hundreds of millions or even billions of dollars. For example, Siemens spent $1 billion on its internal investigation into violations of the Foreign Corrupt Practices Act ("FCPA"), in addition to the $1.6 billion it paid in regulatory fines. See ***http://www.nytimes.com/2008/12/16/business/worldbusiness/16siemens.html?_r=0***. Attempting to do an investigation on the cheap, however, can backfire and ultimately cost the company substantially more to remediate. A recent example was an internal probe conducted by a U.S. subsidiary of Australian company Redflex Holdings Ltd. in response to a whistleblower claim that senior management was bribing Chicago city officials in connection with its contracting to provide the city traffic camera services. After a three-week, $100,000 investigation that cleared the charges, subsequent media and government scrutiny led the company to engage a second firm to undertake a new investigation, at a cost of $2.5 million, which largely substantiated the allegations and found evidence of a $2 million dollar bribery scheme, as well as significant deficiencies in the initial investigation. See ***http://articles.chicagotribune.com/2013-03-15/news/ct-met-redflex-internal-investigations-20130315_1_law-firm-redflex-holdings-ltd-company***.

6 See, e.g., **Arthur Andersen LLP vs. United States**, 544 U.S. 696 (2005); **United States v. Quattrone**, 441 F.3d 153 (2d Cir. 2006).

7 See "Privilege and other attorney-client issues" below for a discussion of best practices in retaining such outside experts.

8 See **Upjohn v. United States**, 449 U.S. 383 (1981), the seminal case on the application of attorney-client privilege to communications between a company's employees and company counsel in the context of an internal investigation. Rule 1.13 of the North Carolina Professional Rule of Conduct and related commentary are also instructive on the topic of dealing with corporate employees in the context of an investigation. Rule 1.13(f) provides that "[i]n dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain

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the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing." In addition, Comment 2 to Rule 1.13 of the North Carolina Rules of Professional Conduct states that "[w]hen one of the constituents of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is protected by Rule 1.6 [rule regarding a lawyer's obligation to keep client information confidential unless the client gives informed consent or the disclosure is impliedly authorized in order to carry out the representation]. Thus, by way of example, if an organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client's employees or other constituents are covered by Rule 1.6. This does not mean, however, that constituents of an organizational client are the clients of the lawyer. The lawyer may not disclose to such constituents information relating to the representation except for disclosures explicitly or impliedly authorized by the organizational client in order to carry out the representation or as otherwise permitted by Rule 1.6." See also *infra* note 16.

9 Not only may such a disclosure be fundamentally fair to the witness, but it may also protect the company against later disputes regarding the adequacy of any **Upjohn** warning or the reasonableness of witness expectations. See **United States v. Ruehle**, 583 F.3d 600, 609-12 (9th Cir. Sept. 30, 2009) (despite district court's finding that CFO's statements in internal investigation could be suppressed in attempt to prosecute him because of his reasonable belief that company counsel also represented him, in part because of a faulty **Upjohn** warning, the Ninth Circuit reversed on grounds that CFO's statements were not made in confidence because CFO was fully aware that his statements were going to be shared with the company's outside auditors to convince them of the adequacy of the company's financials or to take appropriate remedial measures).

10 See, e.g., In re: Grand Jury Subpoena 274 F.3d 563, 571 (1st Cir. 2001); **Tremlett v. Bassett Mirror Co.,** 956 F.2d 1163 (4th Cir. 1992); **United States v. Sawyer**, 878 F. Supp. 295 (D. Mass 1995).

11 Innumerable statutes provide whistleblowers with some form of protection against employment retaliation. See, e.g., 29 U.S.C. §660(c) (Occupational Safety and Health Act); 15 U.S.C. §2087 (Consumer Product Safety Improvement Act); 18 U.S.C. § 1514A (Sarbanes-Oxley Act); N.C.G.S. 95-241 (North Carolina Retaliatory Employment Discrimination Act).

12 See, e.g., 31 U.S.C. §3730(d) (providing for potential awards of between 15-25% of the proceeds of an action or settlement under the False Claims Act); Section 21F(b) of the Exchange Act (providing for awards of between 10-30% of any monetary sanctions collected in excess of $1,000,000 under SEC's whistleblower bounty program mandated by the Dodd-Frank Act).

13 Dealing with whistleblowers can also be complicated in certain cases by statutes, such as those referenced in note 12 above, or corporate policies that enable a whistleblower to remain anonymous.

14 See *infra* note 16.

15 Although former guidelines in the DOJ's former Thomson Memorandum required prosecutors in making charging decisions against a company to consider whether it was supporting "culpable employees and agents . . . through the advancing of attorney's fees," this provision was held unconstitutional in **U.S. v. Stein**, 541 F.3d 130 (2d Cir. 2008) (affirming dismissal of indictment of 13 individual defendants in the KPMG tax shelter cases based on KPMG's unwillingness to continue advancing legal expenses to these defendants as the result of pressure from government prosecutors).

16 See s*upra* note 8. Comments 10 and 11 Rule 1.13 of the North Carolina Rules of Professional Conduct provide that "[t]here are times when the organization's interest may be or become adverse to those of one or more of its constituents. In such circumstances the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussions between the lawyer for the organization and the individual may not be privileged. Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case."

17 See, e.g. **DeFrees v. Kirkland**, CV 11-4272 GAF (SPx),CV 11-4574 GAF (SPx), 2012 U.S. Dist. WL 1346495, *9-12 (C.D. Cal. Apr. 11, 2012) (CEO's disclosure to board of outside law firm's investigation report waived privilege as to report because report's findings of board wrongdoing ensured that board was likely to be an adverse party to CEO and company); In re OM Group Sec. Litig., 226 F.R.D. 579, 590-94 (N.D. Ohio 2005) (audit committee waived attorney-client privilege as to documents underlying detailed presentation to board of directors concerning its investigation); **Ryan v. Gifford** 2007 WL 4259557, at *3 (Del. Ch. Nov. 30, 2007) (special committee's presentation of its findings to the corporation's board of directors, including directors suspected of wrongdoing, constituted subject matter waiver of attorney-client privilege as to communications between the committee and the committee's counsel); but see **Jones v. Nat'l Council of YMCAs of the United States**, No. 09 C 6437, 2011 U.S. Dist. WL 1740122, *1-4 (N.D. Ill. May 3, 2011) (investigation by outside consulting firm, undertaken at request of general counsel, remained privileged after disclosure to board of directors).

18 The requirement that the communication pertain to primarily to legal advice can create difficulties in claiming privilege over "routine" investigations conducted as part of a company's compliance program and pursuant to applicable regulatory requirements. See **United States ex rel. Barko v. Haliburton Co**., No. 1:05-CV-1276, 2014 U.S. Dist. WL 1016784 (D.C. Dist. March 6, 2014) (holding no privilege or work product protection over investigation into potential Code of Business Conduct violations conducted by non-lawyers and pursuant to company policy and obligations under Department of Defense contracting regulations). Similar difficulties can arise over communications with in-house counsel when the communications are deemed primarily business advice rather than legal advice. *See, e.g.*, **In re Chase Bank USA**, N.A. "Check Loan" Contract Litigation., No. 3:09-md-2032 MMC (JSC), 2011 U.S. Dist. WL 3268091 (N.D. Cal. July 28, 2011); Lyondell-Citgo Ref., **LP v. Petroleos de Venez**., S.A., 2004 U.S. Dist. LEXIS 26076 (S.D.N.Y. Dec. 24, 2004).

19 See **United States v. Kovel**, 296 F.2d 918, 921 (2d. Cir. 1961).

20 See, e.g., **Hickman v. Taylor**, 329 U.S. 495 (1947); see also Federal Rule of Civil Procedure 26(b)(3).

21 At the Department of Justice, these guidelines were embodied in a series of memoranda from Deputy Attorneys General starting with the "Holder Memorandum" in 1999 and "Thompson Memorandum" in 2003. See Memorandum from Eric Holder Jr., Deputy Attorney General, to Heads of Department Components and United States Attorneys on Bringing Criminal Charges Against Corporations (June 16, 1999); Memorandum from Deputy Attorney General Larry D. Thompson to Heads of Department Components and United States Attorneys, on Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003). In response to growing criticism and introduction of a congressional bill designed to override the Thompson Memorandum, the "McNulty Memorandum" was issued in late 2006. See U.S. Department of Justice, Office of the Deputy Attorney General, Principles of Federal Prosecution of Business Organizations (December 12, 2006).

22 The SEC's position on this matter was initially embodied in the "Seaboard Report." See Report of Investigation Pursuant to Section 21(a) of the Exchange Act and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 (Oct. 23, 2001), available at ***http://www.sec.gov/litigation/investreport/34-44969.htm***.

23 See, e.g., Attorney-Client Privilege Protection Act of 2006, S. 30, 109th Cong. (2006).

24 See U.S. Department of Justice, Office of the Deputy Attorney General, Principles of Federal Prosecution of Business Organizations (August 28, 2008) (the "Filip Memorandum"), available at ***http://federalevidence.com/pdf/Corp_Prosec/Filip.Memorandum.2008.pdf***; Enforcement Manual of Securities and Exchange Commission Division of Enforcement (Office of Chief Counsel, October 6, 2008, as revised effective October 9, 2013) (see Section 4.3, "Waiver of Privilege,") available at ***http://www.sec.gov/divisions/enforce/enforcementmanual.pdf***.

25 See, e.g., **Gruss v. Zwirn** 296 F.R.D. 224 (S.D.N.Y., Nov. 20, 2013) (finding subject matter waiver with respect to witness interview notes when summary of

interviews were disclosed in PowerPoint presentations to SEC pursuant to a confidentiality agreement); **In re Pacific Pictures Corp.**, 679 F.3d 1121, 1126-29 (9th Cir. Apr. 17, 2012, amended May 10, 2012) (holding disclosure of privileged materials to government waives privilege notwithstanding confidentiality agreement); **In re Qwest Communications Int'l, Inc.**, 450 F.3d 1179 (10th Cir. 2006) (rejecting broad "government investigations" privilege and holding confidentiality agreement insufficient to preserve privilege); but see, e.g., **Saito v. McKesson HBOC, Inc**., Civ. A. No. 18553, 2002 WL 31657622 (Del. Ch. Oct. 25, 2002), at *11 (adopting selective waiver rule that confidential disclosure of work product to law enforcement agency in agency investigation waives the work product privilege only as to that agency, but not as to client's other adversaries). Federal Rule of Evidence 502, adopted in 2008, addresses some aspects of intentional and inadvertent privilege waivers in federal and state proceedings and attempted to provide more uniform standards regarding waivers. However, the final rule omitted draft language that would have specifically addressed the issue of selective waiver in the context of governmental investigations. See Letter of Lee H. Rosenthal, Chair, U.S. Judicial Conference Committee on Rules of Practice and Procedure, to Senate Jucidiary Committee (Sept. 27, 2007) p. 6, available at ***http://federalevidence.com/pdf/2008/06-June/Hill_Letter_EV_502on9-26-07.pdf*** (noting consideration of "selective waiver" provision but indicating that Conference Committee was not proposing adoption of the language prepared on this topic because the provision "proved to be very controversial"); see Carol Basri and Irving Kagan, Corporate Legal Departments: Practicing Law in a Corporation, § 9.6, note 126 and related text (Practicing Law Institute 4th Ed. 2013) (including text of proposed Rule 502 selective waiver provision)..

26 For example, the Bank Secrecy Act and related Treasury Department regulations require all financial institutions to file suspicious activities reports with the Financial Crimes Enforcement Network when they become aware of certain potentially illegal activity. See 31 U.S.C. § 5318; 31 C.F.R. Part 103. For public companies, periodic reporting requirements under the Exchange Act and the required CEO and CFO certifications that accompany those reports may make it impossible to accurately file these reports and certifications without disclosing findings of illegal conduct. For companies that contract with the government, federal regulations providing for debarment or suspension for, among other things, a knowing failure to disclose "credible evidence" of certain violations of law in connection with such contracting may pose an unacceptably high risk of not reporting such evidence. See 48-C.F.R. §3.1003(a)(2); see also 21 C.F.R. 1404.800. For healthcare providers, the Fraud Enforcement and Recovery Act of 2009 (see 31 U.S.C. Sec. 3729(a)(1)(G)) and the Patient Protection and Affordable Care Act (see 42 U.S.C. Sec 1320a-7k(d)) impose affirmative duties to report and return overpayments under Medicare and Medicaid. Depending on the nature of the overpayment, options for reporting and return range from simply sending the funds to the fiscal intermediary, self-reporting under the anti-kickback statute through the Department of Health & Human Services Office of the General Counsel's Self-Disclosure Protocol and self-disclosing potential overpayments resulting from Stark law violations to the Centers for Medicare and Medicaid Services under its Self-Referral Disclosure Protocol. Some states also have separate mechanisms for reporting Medicaid overpayments

27 A high profile example is the Siemens FCPA prosecution. Though Siemens paid a record $1.6 billion in fines to resolve the matter, it was not charged with violating the FCPA's anti-bribery provisions, but instead, pled to the much lesser charges of maintaining inadequate internal controls and books and records, thus avoiding likely debarment from government contracting under various U.S. and foreign regulatory regimes despite evidence of a "pattern of bribery" "unprecedented in scale and geographic reach." See Transcript of Department of Justice Press Conference Announcing Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations (December 15, 2008), available at ***http://www.justice.gov/opa/pr/2008/December/08-opa-1112.html***. In a similar result from the healthcare industry, GlaxoSmith-Kline LLC was permitted to plead guilty to criminal misdemeanor charges of violating the Food, Drug, and Cosmetic Act in connection with improper marketing of the drugs Paxil and Wellbutrin and failing to report safety information about Avandia. Though resulting in $3 billion in penalties, the company's conduct more likely constituted felony offenses that would have led to exclusion from participation in Medicare and Medicaid, effectively a "death sentence" for a healthcare industry participant.

28 See Section 10A(a) of the Exchange Act. Under these obligations, if an auditor in the course of an audit becomes aware of information indicating that an illegal act may have occurred (whether or not that act is perceived to have a material effect on the issuer's financials), the auditor must take steps to determine whether it is likely that the illegal act occurred, and if so, determine the possible effect on the issuer's financial statements, inform an appropriate level of management and the audit committee of the issuer of the illegal act (unless it is clearly inconsequential), confirm that timely and appropriate remedial action has been taken in response to an illegal act that would have a material effect on the issuer's financial statements, and if remedial action has not been taken, report its conclusion to the company's board of directors, which must in turn disclose receipt of such report to the SEC.

29 Exchange Act Rule 13b2-2. These provisions make it unlawful for any director or officer of an issuer to make a materially false or misleading statement to an auditor (including through omissions) in connection with an audit or review of financials or preparation of an SEC report, or for any director, officer, or anyone acting under their direction to directly or indirectly mislead an auditor in connection with an audit or review of financials if such person knew or should have known that such action, if successful, could result in rendering the financials materially misleading.

30 Rule 12b-25 under the Exchange Act requires a registrant who is unable to file all or part of an annual report on Form 10-K or quarterly report on Form 10-Q to file a Form 12b-25 with the SEC that sets forth "in reasonable detail" the reasons for its inability to file the required report.

31 See *supra* note 25 and related text.

32 See, e.g., Complaint, **Roberts v. McAfee, Inc**., No. C 09-4303 2009 WL 2135430 (N.D. Cal. filed Sept. 16, 2009) (dismissed as time-barred); **Roberts v. McAfee**, 660 F. 3d 1156 (9th Cir. 2011); see also **Hawran v. Hixson**, 209 Cal. App. 4th 256 (Sept. 13, 2012) (upholding complaint for defamation by former CFO based on statements made in company press release announcing completion of internal investigation and disclosure in Form 8-K).

Key Issues in Evaluating and Negotiating D&O Insurance Coverage

By Stephen D. Allred

I. Introduction

Over the last decade directors and officers of public and private companies have increasingly become targets in civil litigation, government investigations, and enforcement actions. In today's claims and regulatory environment—with civil actions of many stripes often naming individual directors and officers as defendants and stepped up enforcement activity by the SEC and Department of Justice—directors and officers are sharply aware that their personal assets may be at risk whenever events occur in the life of their company that could make shareholders, customers, employees, or regulators unhappy, or could otherwise fetch the attention of plaintiffs' lawyers.

Because of the increasing risk to their personal assets, directors and officers are more frequently calling on outside and in-house counsel to evaluate the adequacy of their company's D&O insurance, looking for assurances that their coverage is as broad as possible with limits sufficient to protect them. This is a challenging task for an attorney because D&O policies are densely written and complex, filled with turgid terms, exclusions, and conditions that must be weighed to evaluate possible shortfalls in coverage. In addition, a client's D&O insurance program will often consist of a primary policy and multiple excess policies (including different types of excess policies) which are frequently issued by many different insurers, often resulting in a crazy quilt of different contract forms. Also, D&O policies are intended to (or at least should) mesh with both the company's indemnification obligations to its officers and directors and the company's other liability insurance policies—further complicating efforts to take comprehensive stock of the client's coverage.

In approaching the task of assessing D&O coverage, it is important to recognize that D&O policies are not issued on standard forms and the coverage extended under D&O policies can differ in many game-changing ways. While most D&O policies follow the same basic structure and have common traits, insurance companies typically develop and use their own policy forms; there are many differences in the specific terms offered by primary and excess insurers in the market. Seemingly minor differences in policy language can make a big difference in whether directors and officers have the coverage they expect when a claim arrives.

Additionally, there is a range of difference in the willingness of insurers to negotiate policy terms. Depending on the insurer, the nature of the client's business, the risk tolerance and premium tolerance of the client—among other factors—many D&O policy terms are subject to negotiation. In any event, you don't know whether a term is negotiable until you ask, and it is difficult to ask until you know what to ask for.

The purpose of this article is to identify and discuss some of the key policy terms to review and other issues to assess in evaluating a company's D&O coverage and in negotiating D&O policies.

II. Threshold Practical Considerations for D&O Policy Negotiations

Before discussing the details of D&O policies and key terms to evaluate in policy negotiations, there are a few front-end tips to consider in approaching the task.

The broker's role. The services of an experienced and well informed insurance broker are absolutely vital in negotiating and procuring D&O coverage. Brokers who have experience placing D&O policies should know what insurers are willing to offer and at what price, and how far one might be able to push insurers in negotiations over terms and price in light of the dynamics of the current D&O market. The lawyer's job in evaluating and assisting in the negotiation of D&O policy terms differs substantially from the broker's job. The broker typically interfaces directly with the insurers to obtain policy proposals and, if she is doing her job, proactively pushing for coverage enhancements. A lawyer should not try to take on the broker's job because it would be hazardous to the client and the lawyer.

It is best if counsel works with broker and client together to identify the client's goals and needs in obtaining D&O coverage and assess the current policy terms and the terms that can be negotiated at renewal, comparing different proposal by different insurers. A good broker will have a better understanding of the terms that are available in the market and the intent behind those terms. Counsel is usually in a better position to evaluate how policy terms have been, or will be, applied and interpreted by the courts, and where there are gaps between expectations regarding coverage and how the policy terms will actually play out when coverage disputes arise.

The timing of policy negotiations and the parties involved in the process. For policy and renewal negotiations to be successful, counsel should encourage clients to start the process early to provide plenty of time to evaluate current coverage, identify gaps or concerns in coverage, assess the client's current liability exposures (taking into account any business plans that might impact liability risks), and then give the broker enough time to negotiate with several insurers to obtain the most favorable prices, terms, and coverage enhancements available. This process can take months, not weeks or days. An insurer who knows that the expiration date on the client's current D&O policy is imminent will be much less motivated to engage in negotiations over coverage enhancements.

Counsel should also identify the executives and divisions of the company that should play a role in assessing risk exposures and identifying D&O coverage needs and goals. The risk management department frequently has primary responsibility for D&O policy negotiations and procurement, but many other officers and executives have responsibilities related to the D&O coverage and are constituents of the D&O policy. For example, the general counsel or the company's in-house legal department may need to be involved in addition to other executives who have to report to the board regarding the company's coverage. This is another reason to stress that ample time should be allocated for the D&O negotiation and placement process, so that all of the key players are provided more than a last minute opportunity to ask questions and raise concerns about the D&O coverage and the risks of liability that are of greatest concern for the company and its officers and directors.

III. Common Features of D&O Coverage

A. The Kinship between D&O Insurance and Corporate Indemnification of the Directors and Officers

D&O insurance is chiefly intended to protect directors and officers from personal liability arising from their work for the companies they serve by providing them with coverage for defense costs, settlements, and judgments for claims asserted against them. Even when a corporation broadly agrees to indemnify its officers and directors, there will be times when the company is not financially able or legally permitted to advance defense costs or fund indemnification. For example, under many states' laws, corporations are not permitted to indemnify executives for shareholder derivative actions or for liability due to the individual's breach of the duty of good faith. As another example, the SEC has long taken the position that it is against public policy for a corporation to indemnify directors and officers for violating the registration and anti-fraud provisions under the Securities Act of 1933.

D&O insurance is often viewed as filling in the gaps where advancement of defense costs or indemnification by the company is unavailable. Accordingly, D&O insurance should be structured to insure individual directors and officers when the company cannot or will not indemnify them due to insolvency, legal restrictions, or for other reasons. To achieve this and to guard against gaps occurring in the D&O coverage, the D&O policy should be evaluated in connection with the mandatory and permissive rights of advancement of defense expenses and indemnification that the company extends to company executives through its charter and other governing documents or indemnity agreements.

Be aware of "presumptive indemnification" provisions. There are a number of places in a D&O policy where a company's indemnity obligations to its officers and directors intersect with the policy terms. For example, many D&O policies include a "presumptive indemnification" clause that could determine whether an individual director or officer must personally pay the self-insured retention before she can access coverage under the policy.

Most companies buy D&O policies with a large self-insured retention, ranging from thousands to millions of dollars depending on the size of the company and other factors. The retention must be paid by the company before the policy will indemnify the company for losses, but the retention typically does not apply to coverage extended directly to individual directors and officers for losses that are not indemnified by the company—such that the insured individual is not required to pay the retention as a condition of obtaining coverage for losses the company does not indemnify.

However, if the policy contains a "presumptive indemnification" clause, the policy will generally provide that if the insured company is *legally permitted* to indemnify a director or officer but fails to do so for reasons other than insolvency, then the individual insured will have to pay the full retention from her own pocket before the insurer is obligated to step in and provide coverage. This term builds a presumption into the policy that the company will indemnify its officers and directors to the fullest extent permitted under governing law. This term is designed to guard against the risk to the insurer that the insured company will elect not to indemnify officers and directors to force the insurer to indemnify them. Unless the individual insured has the financial resources to pay the large retention, a presumptive indemnification term could effectively bar an individual insured from gaining access to D&O insurance.

Even if an insurer refuses to remove a presumptive indemnification provision from the policy, there are ways to eliminate the risk that an individual executive will have to personally pay a huge retention. (See the discussion below regarding the "drop down" coverage provided by "Side A-only excess DIC policies.") But one way to address this risk is to try to ensure that the terms of the company's D&O policies align with the indemnification provisions in the company's charter documents and indemnity contracts.

B. The Many Sides of D&O Coverage.

Almost every D&O policy provides liability coverage to individual officers and directors for losses resulting from claims made against them arising from wrongful acts in

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connection with their role and responsibilities as executives for the company. D&O policies also usually provide coverage to the insured company for certain types of losses and claims, although the extent and nature of the insured entity's coverage can vary substantially.

The ABC's of Coverage. D&O policies typically include several different insuring agreements, often referred to as Side-A, Side-B, and Side-C coverage. While this naming convention is a bit obtuse, it is useful to understand the ABC's of D&O coverage grants because these terms are routinely used in D&O policies and by brokers discussing the core terms of coverage.

Side-A coverage (or Insuring Clause 1) – The Side A coverage grant insures individual directors and officers against losses that the company is not legally or financially able to indemnify, often referred to as insurance for directors' and officers' "non-indemnifiable losses." This coverage protects the personal assets of directors and officers in the event the company does not pay defense costs or fund indemnification.

Side-B coverage (or Insuring Clause 2) – This coverage provides the company with balance sheet protection by agreeing to reimburse the company if it advances legal fees to officers or directors or indemnifies them against losses.

Side C coverage or "entity coverage" (Insuring Clause 3) – This coverage provides insurance directly to the insured company for certain types of claims. In policies issued to public companies, Coverage C is almost always limited insurance for "Securities Claims" — claims based on state or federal securities laws. In D&O policies issued to private companies, the entity coverage (sometimes referred to as "management liability coverage") often applies broadly to a wide range of claims against the company arising from wrongful acts by the insured company or its officers or directors.

Other Insuring Agreements – Many D&O policies extend other types of entity coverage to the company. For instance, it is fairly common to see policies include an insuring agreement (Side D) that provides a company with separate coverage for costs incurred in connection with internal investigations incurred in response to a shareholder derivative claim. Such coverage is typically subject to a "sub-limit" that is often insufficient to cover the likely costs of such investigations. Thus, a company with a D&O policy that carries a $10 million limit of liability may provide a sub-limit of $250,000 for corporate investigations in response to a demand from an unhappy shareholder.

When a policy contains an insuring agreement that is subject to a reduced sub-limit of insurance for entity coverage extended to the insured company, counsel should evaluate whether the additional insuring agreement is a backhanded effort to impose a lower limit of liability on certain types of claims, expenses, or losses that might otherwise be covered under the policy without being subject to a reduced limit of liability. Additionally, counsel should keep in mind that any additional coverage extended to the insured company can exhaust the limits that would otherwise be available for directors and officers. Also note that an insuring agreement subject to a sub-limit typically does not increase the total limits of liability under the policy, meaning that (using the example discussed above regarding the derivative claim) if $250,000 is incurred for an internal investigation, the $10 million in limits will be eroded by those covered expenses.

IV. Key Policy Terms, Exclusions and Conditions to Review and Assess

A. Limits of Liability and Self-Insured Retention

A threshold issue in any review of D&O coverage is determining the appropriate limits of liability that the client should have. A companion issue is determining the size of the self-insured retention, i.e. the amount the insured must pay out of pocket before the D&O coverage is triggered.

Determining Limits – How Much is Enough. There is no science or formula for forecasting the amount of D&O insurance a company will need for the upcoming policy period. Like most insurance, determining the amount of insurance to obtain is a matter of weighing tomorrow's unknown future liability scenarios against today's premium dollars. At bottom, D&O insurance limits need to be sufficient to pay for a vigorous defense of claims for all of the directors and officers and perhaps for the company itself, with enough remaining to settle claims and satisfy judgments so that plaintiffs are not motivated to pursue individuals director's and officer's personal assets.

Brokers have sophisticated, data-driven methods that they use for recommending D&O insurance limits by identifying and comparing the amount of limits that other similar companies obtain and, in some cases, using formulas for forecasting likely defense costs and settlement value ranges for certain types of liability risks, such as class action securities suits. This sort of benchmarking serves a good purpose but it is only part of the picture.

Counsel can assist in this endeavor by evaluating key liability risk exposures for directors and officers and potential litigation expenses associated with those risks, taking into account claims that can be reasonably anticipated with particular attention paid to those that could be enterprise threatening. This requires a thorough understanding of the client's liability risk exposures and the client's business plans during the upcoming policy period. A company that is actively pursuing mergers and acquisitions, preparing for an initial public offering, or that has other strategic plans that could increase the risk of claims should take these plans into account when evaluating the adequacy of D&O limits.

All of the Insureds Draw from the Same Well. Keep in mind that the same bucket of limits is being used to defend and protect all of the insured directors and officers (and other employees who qualify as individual insureds) in addition to the company. And the same limits of insurance will be depleted to pay defense costs for all of the directors and officers who are targeted in claims – some of whom may have radically conflicting interests based on the claims asserted against them.

Some directors and officers may be more culpable than others for the potential liability arising from a claim—e.g., some officers may be alleged to have knowingly participated in fraudulent acts, while others are alleged simply to have breached their duty of care. Nevertheless, the so-called innocent (or "white hat") directors and officers—such as outside directors who are named as defendants in a lawsuit—are sharing defense costs with the directors and officers implicated in the alleged wrongful acts that led to the claims, the so-called "black hat" D's and O's).

Consequently, directors and officers may rightfully object to being represented by the same counsel, and in some cases multiple lawyers will end up representing different directors, officers and the company—all of whom will want to draw from the same trough of insurance limits to pay their fees.

Defense Costs Erode Limits. Also bear in mind that in most D&O policies, defense costs reduce the limits of liability. Unlike commercial general liability insurance, which pays defense costs outside the limits of liability, D&O policies are "wasting policies" where legal fees and other defense costs erode the limits.

Self-Insured Retention. As noted above in connection with "presumptive indemnification" clauses, counsel should work to ensure that the self-insured retention does not apply to coverage for claims against directors and officers that the company does not indemnify (Side A coverage). Counsel should discuss with the broker options for either avoiding or navigating around a scenario in which an insured executive will be required to pay a retention if the insurance company takes the position that the insured company has "wrongfully refused" to indemnify its officers or directors by failing to indemnify them to the full extent permitted under law.

B. Definition of an Insured "Claim"

The definition of "Claim" in the policy is a key term because it determines the events that trigger coverage under the policy—ranging from a lawsuit or criminal indictment to a regulatory investigation or subpoena. Equally important, the meaning of "claim" in the policy also determines the events that trigger an insured's obligation to timely report a claim to the insurer to ensure coverage is not jeopardized by violating the notice requirements under the policy. The definition of Claim routinely includes (and should include):

- Written demands for monetary damages. The definition also frequently includes written demands for non-monetary or injunctive relief. Under this definition a mere letter to the insured demanding damages or arbitration or mediation would qualify as a "claim" under this prong of the definition.

- Civil, criminal, regulatory, or administrative proceedings commenced by service of a complaint, criminal indictment or similar document.

- "Securities Claims," typically defined broadly in the policy to include any claims involving the violation of any state of federal securities laws. In recent years insurers have been willing to expand the definition of Claim. Thus, counsel should look to see if the meaning of "claim" includes the following events, and if it does not, consider requesting that the definition be expanded to include them:

- A request to the insured to toll the statute of limitations period with respect to a potential claim.

- A shareholder derivative demand or claim for breach of fiduciary duties by an officer or director.

- The commencement of government or regulatory investigations of the insured company or of officers or directors of the insured company.

- The issuance of subpoena to the insured company or its officers or directors by a governmental agency or regulatory body.

Insures are typically willing to include governmental or regulatory proceedings and formal investigations within the meaning of a "claim," but policy terms differ substantially on what actions the enforcement authority must take before a covered "claim" commences. Some policies define a claim to include "civil, administrative or regulatory investigations"

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against an insured so long as it is commenced by the filing of a notice of charges, investigative order, or similar document. Some policies state that an investigation that qualifies as a "claim" commences when the insured person receives a target letter or SEC Wells notice. However, requiring a formal charge or order to be issued before a claim commences under the policy may leave some serious and costly governmental investigations uncovered if no formal charge or order is obtained.

One coverage dispute that has been litigated several times between D&O insurers and their insureds involves the issue of whether D&O insurance covers the costs a company incurs responding to an "informal" investigation by a regulatory agency such as the SEC or the Department of Justice before any formal order of investigation is issued, or the costs incurred for a follow-on internal investigation by a special litigation or audit committee often triggered by a government agency's investigation. Policies that do not insure informal investigations could leave a big hole in coverage because such investigations, which typically require the company's full cooperation, often means hiring outside counsel and accounting firms, resulting in substantial legal fees. A coverage dispute about whether such fees are insured could be avoided by negotiating with the insurer to expand the definition of "claim" in the policy to include informal regulatory and administrative investigations of any insured for a "wrongful act" covered by the policy.

Finally, counsel should emphasize to the client that there are backhanded hazards to expanding the definition of claim to broadly include all administrative or regulatory proceedings, investigations, subpoenas, and written demands requesting monetary, nonmonetary, and injunctive relief. Most notice terms in D&O policies require insureds to report claims to the insurer as soon as practicable or words to that effect. If the insured fails to report a regulatory investigation or even a simple letter demanding damages, and then a related formal civil, administrative or criminal action subsequently arises, the insurer may take the position that there is no coverage for the action because the insured violated the requirements in the policy to report a "claim" as soon as practicable.

C. The Conduct Exclusions Barring Coverage for Fraud, Intentional Violations of Law, and Illegal Personal Profit

All standard D&O policies exclude coverage for certain bad acts by the insureds, such as fraud, dishonesty, violations of law, and unlawful personal profit or remuneration. The wording of such exclusions must be examined with care because these exclusions are implicated in most claims against directors and officers. It is standard fare, for instance, to see securities or other claims alleging that an executive knew or should have known that the information provided to investors was false or fraudulent.

There are three aspects of the conduct exclusions that should be examined for the purpose of trying to narrow their scope and application.

Conduct Exclusion Issue 1 – What event triggers the exclusion? In almost every D&O policy, there must be some finding or ruling that the insured actually engaged in the prohibited conduct before the exclusion will apply; an allegation that the director or officer engaged in the bad acts listed in the exclusion (e.g. fraud or illegal personal profit) is not enough for the exclusion to bar coverage.

Many policies on the market today provide that the exclusion applies only if there is a judgment or "final adjudication" adverse to the insured that establishes that the bad acts referenced in the exclusion occurred. The final adjudication trigger in a conduct exclusion can substantially reduce the risk that an insurer will be able rely on the exclusion to bar coverage because most matters are settled before there is a final adjudication.

However, counsel must try to ensure that the policy terms make clear that the exclusion applies only if the referenced bad acts (e.g. fraud or illegal personal profit) are established by a final, non-appealable adjudication in the underlying action or underlying judicial proceeding. Restricting the final adjudication to the underlying action means that the exclusion will not be triggered if the insurer files a coverage action in an effort to establish that the insured engaged in the bad acts referenced in the exclusion.

Also, note that if the exclusion states that there must be a final adjudication in an "underlying proceeding," it would be best to refer to it as an "underlying judicial proceeding," to try to eliminate triggering the exclusion based on an administrative proceedings. It has become more important of late to distinguish judicial proceedings from administrative proceedings, in part, because of the SEC's recently announced policy that it will require enforcement action defendants in "egregious" cases to admit wrongdoing as a condition of settlement. This requirement could impact D&O coverage for directors and officers who make such admissions in order to settle the SEC's action, because the insurer may take the position that such an admission constitutes a final adjudication in an underlying proceeding.

Instead of a final adjudication trigger in the conduct exclusion, some policies merely provide that the conduct exclusion applies if the referenced bad acts occurred "in fact." For instance, the exclusion might state that the insurer will not pay losses for claims made against the insured arising out of or based upon "the committing in fact" of any deliberate criminal or deliberate fraudulent act by the insured, or the "gaining in fact" of any profit, remuneration or financial advantage to which the insured was not legally entitled.

This "in fact" trigger is regarded as much less favorable for insureds because it is unclear who gets to determine whether the bad acts referenced in the exclusion "in fact" occurred. Insurers may take the position that they can make the determination and unilaterally deny coverage, or they can file a coverage action to have a court make the determination for purposes of denying coverage. Some courts have held that this "in fact" trigger is not satisfied unless there is an adjudication in the underlying action, but other courts have not imposed this interpretation on the "in fact" trigger in conduct exclusions. Counsel should steer clear of an "in fact" trigger in conduct exclusions if possible.

Conduct Exclusion Issue 2 – Limiting the bad acts that trigger the exclusion. Work to make sure that the appropriate modifiers are used to describe the bad acts that are listed in the exclusion. If it just says "fraud," change it to "deliberate fraud." If the exclusion just says "willful violation of law," see if the insurer will accept "willful and knowing violation of law." Where policies refer to excluding claims arising from "profit or advantage" to which the insured is not legally entitled, change it to "financial advantage," to limit the exclusion to illegal monetary benefits received by the director or officer rather than non-monetary advantages. Generally speaking, whatever words the insurer uses to describe the bad acts, look for ways to add modifiers or other terms to describe the nature of the bad deeds to limit the potential breadth of the exclusion.

Conduct Exclusion Issue 3 – Severability clauses. Finally, the policy should include a term stating that for purposes of applying the exclusions, the facts pertaining to and knowledge possessed by one insured director or officer will not be imputed to, or attributable to, any other insured individual, such that the bad acts of one officer does not impair the coverage for the rest of the directors and officers insured under the policy.

Many standard D&O policies include such terms – sometimes referred as non-imputation or severability of exclusion clauses. However, many policies will provide that the bad acts of certain corporate executives may be imputed to the company to determine whether the coverage extended to the corporation under Side B (reimbursement for indemnification of directors and officers) or Side C coverage (entity coverage) is barred based on the conduct exclusions. Insurers almost always insist that the knowledge of the Chief Executive Officer and Chief Financial Officer can be imputed to the company, but frequently insurers want the general counsel and other officers on the list as well. Obviously, it is more advantageous for the insured to limit the corporate executives whose knowledge can be imputed to the corporation. And it is best to make it clear that only the *actual* knowledge possessed by the chief executive officer or financial officer of the *"named insured"* under the policy – as distinguished from every subsidiary or affiliated company that might also be insured under the policy – will be imputed to the insured company for purposes of applying the conduct exclusion.

D. Application Severability and Rescission

One of the frequently litigated D&O coverage issues is whether the insurer may rescind a policy, or deny coverage for a claim, based on fraudulent or deceptive information contained in the policy application or materials that were incorporated by reference in the application as documents on which the insurer relied in issuing the policy. Most D&O policy applications provide that the application materials on which the insurer has relied in underwriting and issuing the policy include not only the information provided in the application but also include (and incorporates by reference) the company's financial statements, including public filings such as annual and quarterly statements filed with the SEC.

Thus, when securities claims or other claims are made against the company and its directors and officers based on misrepresentations or fraud in the company's financial statements, insurers may seek to rescind the D&O policy, or deny coverage for a claim, arguing that the policy is void or that there is no coverage for the claim, because of material misrepresentations in the information that the insurer relied upon in agreeing to issue the insurance.

There are several terms that counsel should evaluate to limit or prevent an insurer from rescinding the policy or denying coverage based on alleged misrepresentations in the application materials.

Full severability clauses. Currently, most D&O insurers will include a severability term (sometimes called a "non-imputation" clause) which provides that the knowledge of one insured individual cannot be imputed to any other insured individual for purposes of denying or rescinding coverage based on misrepresentations in policy application materials. (This application severability clause is similar to the severability provision discussed above with respect to the conduct exclusions.) The policy usually affirmatively states that the insurer is permitted to rescind or deny coverage based on misrepresentations or failures to disclose material information in the application materials. However, to protect coverage for directors and officers who were unaware of the misrepresentations, such a term should be subject to a full severability clause making it clear that the insurer cannot rescind or deny coverage for <u>any</u> individuals who had no knowledge of the misrepresentations.

Some insurers may still seek to include partial (rather

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than full) severability clauses, which state with respect to the application materials that the knowledge of individual insureds cannot be imputed to other insureds, except that the policy can be rescinded and coverage voided as to all insureds if the individual officers who signed the application had knowledge of the misrepresentations. Such a term should be vigorously resisted in today's market, where full severability clauses are widely available.

Similar to the severability provision regarding conduct exclusions, the policies will typically provide that the knowledge of certain senior executives can be imputed to the company for determining whether the insurer can deny or rescind coverage for the company under Side B or Side C entity coverage. Counsel's goal here is twofold: (1) try to reduce the list of key executives whose knowledge of misrepresentations in the application materials can be imputed to the company; and (2) make it clear that only the designated officers of the <u>named insured</u> company can be imputed to that company for purposes of voiding coverage, and that this will not impact the coverage for subsidiaries and other insured companies under the policy. With respect to Side B coverage, counsel should also strive to apply a <u>full</u> severability clause to the insurer's obligation to reimburse the company for its indemnity obligation to directors and officers who had no knowledge of misrepresentations in the application. Thus, even if the insurer voids coverage as to certain directors and officers because they had knowledge of the misrepresentations, the insurer remains obligated to provide Side B coverage to the company with respect to other officers and directors.

Non-rescindable policy terms. It is fairly common in today's market for D&O insurers to include (or they will agree to include if asked) terms providing that the insurer cannot rescind coverage for individual directors and officers under Side A of the policy. These D&O policies affirmatively provide that the directors' and officers' coverage extended for non-indemnifiable losses is "non-rescindable." That means even in cases where certain officers made intentional misrepresentations in the policy application or falsified financial statements that are included within the meaning of application materials—which will may result in those officers having no D&O coverage—the Side A coverage for the other individual insureds cannot be rescinded. At the very least, the insured should insist on non-rescindable coverage for claims against directors and officers that the company is financially unable to indemnify or legally prohibited from indemnifying.

However, counsel should pay close attention to policy terms that purport to make the coverage broadly "non-rescindable." For example, some insurers are issuing policies that are fully non-rescindable under Side A, B and C coverage. However, these policies will usually also contain terms that permit the insurer to deny coverage for a claim—as distinguished from voiding coverage through rescission—based on misrepresentations in application materials. A broad non-rescindable policy term is usually counterbalanced by another term that allows an insurer to deny coverage for a claim based on misrepresentations in application materials. Just as there is a legal distinction between rescinding coverage under a policy and denying coverage for a specific claim, there is often a policy distinction between the insurer's right to void coverage through rescission (which the insurer may agree to waive) versus the insurer's right to deny coverage for a claim to insureds who had knowledge of misrepresentations in application materials (which insurer will not typically waive). Thus, even in policies that purport to be non-rescindable, ensure that the severability clauses in the policy expressly protect coverage with respect to "innocent" individual directors and officers who were unaware of any misrepresentations in the application materials.

Definition of Application. Finally, counsel should review the definition of "application" in the policy to identify what documents and information fall within the definition, including the materials and information that are incorporated by reference within the definition, irrespective of whether the insurer actually examines or obtains a copy of the documents referenced in the definition. If possible, try to narrow the scope of the definition of application and the information submitted to the insurer with the application. For example, with respect to financial statements incorporated by reference as application materials, seek to limit them only to financial statements filed within the past year.

Definition of an Insured "Loss"

The definition of "loss" in a D&O policy should be examined to determine whether it includes, to the maximum extent permissible under law, coverage for punitive, exemplary, and multiplied damages, and to evaluate the types of things that are carved out of the meaning of a covered loss.

Insuring agreements in D&O policies typically provide that the insurer will indemnify the insureds for "loss" they are legally obligated to pay arising from covered claims. Thus, the term loss identifies the things for which the policy will pay. Loss is typically broadly defined to include damages, settlements, judgments, awards, legal fees and other defense costs. But the definition also includes an exception clause that carves out certain kinds of fines, penalties, and damages. Under this exception clause, loss does not normally include fines or penalties imposed by law or matters that are uninsurable as a matter of law. Policies will also usually list several other exceptions to the definition.

Any exception to what constitutes a loss effectively acts an exclusion under the policy that can have a significant impact on coverage. Counsel should thus seek to limit the list of exceptions in the definition. For example, if "restitution" or "disgorgement" are included in the list of exceptions, counsel should seek to remove them. Including restitution and disgorgement in the list of exceptions to the meaning of a loss may result in a significant reduction of coverage because these are concepts that can apply to damages recoverable under many different types of claims. Counsel can argue that there is no need to carve out restitution or disgorgement from the definition of loss because the policy already excludes illegal personal profit and remuneration in the conduct exclusion.

However, even if restitution and disgorgement are not included in the list of exceptions to the meaning of loss, an insured may have no coverage for such damages because a number of courts have ruled that disgorgement of ill-gotten gains or restitutionary damages are uninsurable as a matter of law. For example, some courts have ruled that losses for violations of Sections 11 and 12 of the Securities Act of 1933 are uninsurable because they amount to the return of ill-gotten gains earned by the insured as a result of selling the company stock at an artificially inflated price due to misrepresentations that violate the securities laws. Most D&O insurers will state (or agree to state if asked) in the definition of loss that losses for violations of Sections 11, 12 and 15 of the Securities Act of 1933 are not considered uninsurable.

E. Who is an Insured and Whether to Obtain Entity Coverage?

Counsel should evaluate how the policy defines an "insured individual" or "insured person," i.e. who will qualify as an insured director or officer under the policy. Despite the D&O name of the policy, the policy can insure individuals who are not directors or officers of the company. For example, the definition of an insured person might include any employee so long as a director or officer is named as a defendant or targeted party in the claim.

If the definition of insured individual is limited to duly elected and appointed officers and director, evaluate whether the coverage extends to all of the executives that the company wishes to include within it D&O coverage. Some key management team members might not qualify as "officers" of the company and thus they will not be eligible for insurance under the policy. In particular consider whether the general counsel qualifies as an insured individual under the policy.

Counsel should also discuss with the client whether to limit the D&O coverage solely to directors and officers, and forego any entity coverage for the company in the policy. By eliminating coverage for the company—an option that some companies have elected to take—the policy limits are available exclusively for the benefit of the insured officers and directors. Entity coverage not only threatens to deplete policy limits that would otherwise be available to the individual directors and officers, it can also create coverage issues for the insured individuals if the insured company files bankruptcy. If the company has entity coverage under the D&O policy, the policy is usually deemed to be an asset of the bankruptcy estate, which can substantially interfere with the individual insureds' ability to access the policy.

If entity coverage is eliminated from the policy, allocation disputes can arise between the insurer and insureds when claims are made against both the company and individual insureds. If the company has no entity coverage under the D&O policy and claims are asserted against the company and its directors and officers, the insurance company will usually take the position that it is not obligated to pay 100% of defense costs or judgment or settlement payments because some percentage of such payments must be allocated to the claims against the entity, which is not insured under the policy. In fact, entity coverage was originally added to D&O policies because of the allocation disputes that arose when a securities claim was made against both the company and insured officers and directors.

Thus, if entity coverage is eliminated from the policy, a predetermined allocation term should be added which sets forth the portion of jointly incurred defense costs and settlement payments that will be paid under the policy. If the predetermined allocation is set at less than 100%—some insurers have agreed to pre-set allocation of 100%—the clause should make clear that the allocation does not apply to coverage under Side A to ensure that insured executives are not personally liable for losses that are not indemnified by the company.

F. Advancement of Defense Costs and Priority of Payments

Under D&O policies, the insurer usually does not have a "duty to defend" the insured against a claim. Rather, the insurer has a duty to indemnify the insured for covered losses, which includes paying defense costs incurred to defend a claim. Even if the insurer does not have a contractual duty to defend, the policy terms provide that the insurer is still involved in the defense of the claim because the insured is obligated to cooperate with insurer with respect to the defense and cannot make any decisions to settle the claim without the insurer's knowledge and consent. But usually, the insured under a D&O policy hires counsel and controls the defense, although there are often various restrictions in policies regarding selection of defense counsel and the insurer's right to participate in the defense of a case.

Ensure defense cost advancement obligation is

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spelled out. Counsel should ensure that the D&O policies contain express provisions requiring the insurer to advance defense costs as they are incurred, rather than permitting the insurer to wait and reimburse the insured for defense costs at the end of the case or at the insurer's discretion. Generally, a corporation is obligated to advance defense costs to officers and directors on a current basis as a matter of law, corporate bylaws, or contractual indemnification agreements. D&O policies should contain terms that likewise impose an obligation on the insurer to advance defense costs on a current basis.

Priority of payments clause. Additionally, counsel should ensure that the policy contains a "priority of payments" or "order of payments" clause. This clause specifies how an insurer is required to make defense and indemnity payments if there are competing claims on the policy's proceeds and the aggregate liability that may be covered by the policy exceeds the total limits of liability under the policy. For example, if there are covered claims made against the company and covered claims made against insured directors and officers, most priority payments clauses dictate that the insurer must pay Side A claims first. Indeed, the priority of payments term should make it clear that the insurer is contractually bound to give the directors and officers first priority for any claims that the company is unable or unwilling to indemnify. After the Side A coverage proceeds are paid out, then the insurer can pay Side B coverage proceeds to the insured company and Side C entity coverage proceeds.

These priority payment terms are extremely valuable to directors or officers who are defending themselves, particularly if the insured company is unable to indemnify them because it is in bankruptcy. As noted above, if the insured company is in bankruptcy, the D&O policy is typically viewed as property of the bankruptcy estate, and is thus subject to the automatic stay imposed by the U.S. Bankruptcy Code, unless and until a bankruptcy judge lifts the stay as to the D&O policy proceeds. Tying up the D&O policy in a bankruptcy proceeding can leave individual directors and officers without access to the policy proceeds that they need to defend themselves and settle claims filed against them. With a priority payment clause that makes it clear that the directors and officers are contractually entitled to first dibs on the D&O limits, bankruptcy courts are usually willing to permit the D&O insurer to continue paying defense and indemnity payments to directors and officers who are entitled to coverage under the policy.

G. The Insured Versus Insured Exclusion and the Carve-Outs to the Exclusion

All D&O policies contain some kind of "insured versus insured" exclusion, which generally bars coverage for claims made by or on behalf of the company or made by any individual director or officer under the policy. The I v. I exclusion was designed to guard against collusive or friendly lawsuits brought by one insured against another insured for the purpose of tapping the company's D&O policy – e.g., the company sues directors or officers alleging mismanagement or waste solely to get at the D&O policy proceeds to recover for business losses.

The insurer's concerns about barring coverage for such lawsuits may be valid, but there are plenty of non-collusive claims that can be asserted by or on behalf of insureds that should be covered by the policy. Consequently, insured versus insured exclusions will have a list of carve-outs or exceptions, which provide that the exclusion does not apply to certain species of claim. As discussed below, the list of carve-out claims is critically important because the claims on the list are explicitly covered by the policy. As an initial matter, counsel should try to limit the insured exclusion to claims brought directly by the company. Some insurers have agreed to replace I v. I exclusions with E v. I (entity versus insured) exclusions.

If the insurer will not agree to an E v. I exclusion, counsel should look to see if the version of the I v. I exclusion in the policy bars coverage for claims brought by *any shareholder* of the company, rather than claims brought by insured directors and officers. Counsel should seek to remove the "any shareholder term" from the I v. I exclusion because it is potentially over broad in barring coverage for legitimate derivative actions and whistleblower actions that should be covered under the policy.

With respect to the list of exceptions to the I v. I exclusion, counsel should try to make sure that the list carves back coverage for the following claims – all of which are exceptions to the I v. I exclusion that currently available in the market and should thus be available in policy negotiations with the D&O carrier:

- Shareholder derivative actions;
- Corporate whistle blower claims brought under state or federal whistleblower laws;
- Claims brought by or on behalf of the company when it is in bankruptcy, including claims against directors and officers brought by trustees, liquidators, debtors-in-possession, or even creditors' or bondholders' committees;
- Claims brought entirely outside the United States;

- Employment-practices claims against officers or directors; and

- Claims brought by officers and directors who have not served in that capacity for the last four years (or a shorter time period, if possible).

H. The Notice of Claim Requirements (and the Life or Death Importance of Providing Timely Notice of a Claim)

As noted above, D&O policies usually require insureds to give notice of a claim as soon as practicable or words to that effect; and frequently the notice clause also sets a hard "no later than" deadline after the policy expires. For instance, policies will state that the insured must provide notice of a claim as soon as practicable after the insured becomes aware of it but no later than 60 days after the policy expires, unless the insured purchases the extended reporting period coverage under which the post-expiration notice period is extended. It warrants emphasizing again here that late notice can kill coverage under a D&O policy. Counsel should stress to clients that one of the first critical issues to figure out when a claim or potential claim arises is which insurers must be notified.

To mitigate the risk that an inadvertent delay in reporting a claim will impair coverage, the notice clause in the policy should require notice to the insurer only after certain executives first learn of a claim, such as the general counsel or risk manager of the *named insured* on the policy.

I. The Professional Services Exclusion

Most D&O policies include a professional services exclusion. There is wide range of wording used for such exclusions, but a typical one might provide that the policy does not insure claims alleging, arising out of, based upon or attributable to the insured's performance, rendering or failing to render professional services. These exclusions have created vexing problems for D&O insureds and have been responsible for unintended gaps in coverage.

The D&O insurers' rationale for including such exclusions is that any liability for the insured's professional services should be covered by a professional services errors and omissions policy, rather than the D&O policy. However, even if a company has professional services E&O coverage, the professional services liability insured by the E&O policy might not insure liability that should be covered by the D&O policy. Perhaps the claims against the insured do not fall within professional services identified in the E&O policy, or the insured's alleged wrongful acts giving rise to the claim are only obliquely related to any professional services provided by the insured. E&O policies usually define the specific professional services that are insured under the policy; while D&O policies often do not define the term professional services in the professional services exclusion. As a result, the E&O and D&O policies may not fit together, leaving a coverage hole for claims to fall through.

D&O insurers will rarely agree to eliminate the professional services exclusion, so counsel's goal will be to seek revisions that make it as narrow as possible and reduce the risk of gaps between the client's D&O and E&O policies. To address these issues, counsel can take the following steps:

- Review the wording of the D&O and E&O policy together with the goal of trying to obtain in the E&O policy a definition of professional services as broad as possible (that addresses all of the services the company provides); and the concurrent goal of trying to obtain terms in the professional services exclusion in the D&O policy that precludes coverage only for the services that are insured under the E&O policy.

- Limit the terms of the professional services exclusion in the D&O policy by adding terms making it clear that it applies only to services provided directly to customers or others for a fee and that it does not apply to supervising or failure to supervise professional services or professionals.

- If the professional services exclusion has broad language like "arising out of, based upon, relating to, or attributable to" the rendering of professional services, seek to dial back such terms with something direct and simple, such as "caused solely by," or "due exclusively to."

V. Excess Insurance Issues

A. Follow Form Excess Policies and Exhaustion of Underlying Limits

For many companies, their primary D&O policy is the base of a tower of D&O coverage made up of various excess policies that each provide an additional layer of D&O coverage. A company might have $100 million in coverage made up of a primary policy that provides $10 million in limits and then nine excess policies issued by multiple insurers that combine together to provide the $100 million aggregate protection.

Some "follow form" excess policies don't really follow form. The terms of the primary policy are obviously keenly important because in most cases the excess policies are "fol-

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low form" policies that generally provide coverage in accordance with the same terms and conditions as the primary policy. However, so called follow form excess policies will usually provide that they follow the terms and conditions of the primary except as otherwise provided in the excess policy. In fact, it is relatively uncommon to see pure follow form excess policies. And in many cases the excess policies will contain terms that differ substantially from the primary policy. For example, such conditional follow form excess policies may contain choice of law provisions, mandatory arbitration clauses, different notice requirements, and other policy terms that stray substantially from the primary policy's exclusions, rescission restrictions, application definition, or severability clauses.

Too often in policy negotiations, the terms of the follow form excess policies are given scant attention while the focus is consumed by the terms of the primary policy. It is a tedious chore to review multiple excess policy forms that appear on their face to be mostly follow form policies, but the tedium can pay off if a catastrophic claim comes that will tap the client's excess D&O tower.

Ensuring that the attachment point for the excess coverage actually attaches. One of the excess policy terms that should be consistent from one excess layer to the next is the term that defines when the excess coverage under the policy will be triggered by the exhaustion of the underlying limits of insurance, often called the attachment point.

Some policies provide that the excess insurer's liability attaches only after each of the underlying insurers beneath the excess policy have exhausted their respective limits of liability by payment of losses under those policies. If an excess policy mandates that it attaches only if the underlying insurers pay the full amount of the underlying limits of liability, this can create a dire situation for the insureds if the underlying insurers refuse to pay their full limits due to coverage disputes, or if one of the underlying insurers becomes insolvent. In many cases where there are coverage disputes between insureds and insurers, the insureds may settle the coverage dispute by allowing an insurer to pay only part of its limits in exchange for a release under the policy. With attachment point language that triggers the excess policy only if the limits are paid by the underlying insurer, insureds that settle for less than full limits with their primary insurer might find their excess insurers denying all coverage on the grounds that the excess policies do not attach, even if the insureds make up the difference between the amount that the primary insurer paid and the limits of liability under the primary policy.

To avoid this, it is best to have attachment language in the excess policies that provides that excess insurer's liability attaches if the underlying limits are paid by any person or entity, or at the very least if the underlying insurer(s) or the insureds pay the amount of the underlying limits. This broader attachment language will allow insureds to settle coverage disputes with primary and/or excess insurers by accepting less than full limits payments from underlying insurers without jeopardizing coverage under upstream excess policies.

B. The Benefits of Side A Difference-in-Conditions (DIC) Excess Insurance

Many companies opt to purchase Side Aonly DIC excess insurance coverage in addition to the company's tower of traditional Side ABC D&O coverage. Side A-only DIC excess policies insure directors and officers for non-indemnified loss; the policies do not provide any Side B or Side C entity coverage, meaning that the limits are not eroded by any entity coverage. These policies substantially supplement coverage for directors and officers by affording excess insurance that is much broader than standard ABC D&O policies.

The terms of Side A-only excess policies currently circulating in the market vary substantially. Counsel will need to consult with the broker to identify the terms (and the insurers offering those terms) that are most advantageous for the client. In evaluating the terms of Side A-only excess policies, consider the following (non-exclusive) list of coverage enhancements that are seen in many of the policies in the market today:

- The DIC part of the name (difference-in-conditions) indicates that policy will drop down and fill in the gaps for non-indemnifiable claims that are not insured under the terms of the standard ABC coverage, or if one of the underlying insurers becomes insolvent. Thus, if one of the D&O insurers below the Side A-only excess policy denies coverage for a claim that would be covered under the broader terms of the Side A-only policy, the Side A-only policy with drop down terms should step in to provide coverage.

- No exclusion for pollution liability (pollution exclusions are standard in traditional D&O policies) and the policy does not exclude coverage for bodily injury or property damage claims that arise from pollution liability.

- No ERISA exclusion (also standard in traditional D&O policies).

- The insured versus insured and conduct exclusions are much more favorable to the insureds. For example, the conduct exclusion does not apply to defense costs.

- No "presumptive indemnification" provision; thus the policy will provide coverage to directors and officers even if the company wrongfully refuses to indemnify them against a claim.

- The policies are fully non-rescindable.

Additionally, because the company is not an insured under the policy, Side Aonly excess policies would not be considered an asset of the estate in bankruptcy or subject to the bankruptcy automatic stay in the event the insured company files bankruptcy.

There are also outside director liability (ODL) excess policies available that provide the same sort of coverage provided under the Side A-only excess DIC policy but the coverage is extended solely to non-indemnified losses of outside directors, referring to directors who are not officers of the company or otherwise employed by the company. These policies are designed to provide additional protection for directors whose D&O policy limits might otherwise be eaten up by paying enormous criminal and civil defense costs and settlements incurred for senior executives of the company who were involved (or allegedly involved) in committing the acts that resulted in fraud claims against all of the directors and officers.

VI. Conclusion

This paper identifies only a handful of the issues that can come up in evaluating a client's D&O insurance coverage. To undertake the task properly, counsel will need to work with the broker and the client to review the language of each of the policies in the client's D&O program at every level—and then review proposals made by insurers during policy negotiations—to determine whether the client has the most advantageous terms that can be obtained and that the primary and excess policies fit together cohesively.

Allred practices with McGuire Woods LLP in Charlotte.

Compliance Plans: The Ounce of Prevention that Avoids the Pound of Cure

By Scott N. Schools and Neil T. Bloomfield

I. *Introduction*

Benjamin Franklin argued that "an ounce of prevention is worth a pound of cure" when advocating for the creation of a local firefighting organization.[1] Recent settlements between government entities and the subjects of their investigations prove the wisdom of Franklin's assertion in another context. One can safely assume, for example, that an effective compliance program would have cost JP Morgan Chase and Co. (JPMorgan) substantially less than the $13 billion it recently agreed to pay as part of its settlement with the Department of Justice (DOJ) and other entities to resolve allegations of malfeasance in connection with its sale of residential mortgage backed securities, or even the $1.7 billion it agreed to pay as part its deferred prosecution agreement related to the Madoff scheme.[2] If the JPMorgan settlements are a sign of the times—and there is substantial evidence that they are—the cost of an effective compliance program will continue to pale in comparison to the cost of non-compliance. And, of course, that would be the goal of law enforcement and regulators—to deter non-compliance by imposing meaningful monetary sanctions.

Nonetheless, money spent on a compliance plan is well-spent only if it achieves its intended result. While no compliance plan is fool-proof, an effective compliance plan will achieve at least two objectives. First, it will limit compliance failures. Second, it will help mitigate the damage from those failures that do occur. The mitigation can include lessening the harm that flows from non-compliance through early detection and remediation. It can also include credit from law enforcement agencies and regulators that will evaluate a corporation's compliance plan as part of their assessment of what action to take as a result of a compliance breach. At DOJ, for example, prosecutors follow policies set forth in the United States Attorneys' Manual (USAM), which includes the Principles of Federal Prosecution of Business Organizations Those principles list nine factors prosecutors should consider in deciding whether to prosecute a corporation, including "the existence and effectiveness of the corporation's pre-existing compliance program."[3]

At least two recent agreements explicitly noted DOJ's evaluation—one good and one bad—of the subject's pre-existing plan. The non-prosecution agreement between the United States Attorney's Office for the Eastern District of Washington and CH2M Hill Hanford Group Inc. (CHG) references in a somewhat ambiguous but seemingly positive way CHG's pre-existing compliance program as a basis for the non-prosecution agreement. On the other hand, the statement of facts made part of the HSBC deferred prosecution agreement contains a section entitled "HSBC Bank USA Failed to Provide Adequate Staffing and Other Resources To Maintain An Effective [Anti-Money Laundering] Program." In many other agreements, DOJ gave positive weight to the subject corporation's remedial measures that typically included compliance plan enhancements.

Although any compliance plan must be tailored to address specific activities of the implementing organization, one theme persists regardless of industry – the need for a culture of compliance. At a recent Anti-Money Laundering Conference, James Cole, Deputy Attorney General of the United States, succinctly summarized this theme:

> The last session in this conference is entitled "What to tell your CEO when you return to the bank: A 30-minute recap of the critical issues from the conference." With this in mind, here is my message to you: Businesses need to create a culture of compliance. To do this, compliance programs must be real, effective, and proactive.[4]

This concept of the "culture of compliance" is not unique within DOJ. The Department of Health and Human Services (HHS) Office of Inspector General (OIG) offers a series of compliance-related instructional videos on its website.[5] In the video entitled "Tips for Implementing an Effective Compliance Program," the first "tip" is to "foster a culture of compliance." Similarly, law enforcement agencies' and regulators' after-the-violation evaluation of any compliance program will start with examining the corporate culture. For example, the USAM not only directs prosecutors to evaluate compliance programs but provides guidance on how to do it. USAM § 9-28.800 provides:

> [T]he critical factors in evaluating any [corporate compliance] program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or *is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives.*[6]

There are specific components of effective compliance plans that will evidence a culture of compliance while also effectively avoiding compliance failures. However, the most artfully crafted plan will arguably do more harm than good if it serves only as a beard for reckless operations.

This article will explore the elements of an effective compliance plan based in part on available guidance from regulators, law enforcement, and the United States Sentencing Guidelines, will discuss the pros and cons of self-disclosure when violations do occur, and will close with some ideas about creating a culture of compliance.

II. Elements of an Effective Compliance Plan

DOJ and some regulators have issued guidance about the elements that should be present in an effective compliance plan. For example, in November 2012, DOJ and the Securities and Exchange Commission (SEC) jointly issued *FCPA: A Resource Guide to the U.S. Foreign Corrupt Practices Act (FCPA)*. Among other things, the agencies described what they believed to be the elements of an effective compliance plan for detecting and preventing corrupt practices.[7] Similarly, HHS has issued regulations setting forth elements of effective compliance plans for different types of providers including, for example, hospitals, pharmaceutical manufacturers, ambulance suppliers, hospices, and durable medical equipment suppliers.[8] The Commodity Futures Trading Commission (CFTC) has likewise issued guidance regarding an anti-money laundering program.[9] Similarly, the Financial Industry Regulatory Authority has issued guidance for its licensees.[10]

In addition to the guidance cited above, the United States Sentencing Guidelines (USSG) describes the elements of an effective compliance plan. That guidance is of particular importance since it will be relevant in determining whether a defendant corporation's pre-existing compliance plan was of sufficient quality to warrant a downward adjustment of the applicable sentencing options available post-conviction. This non-industry specific guidance provides that effective programs should have the following:

1. Compliance standards and procedures reasonably capable of reducing the prospect of criminal activity;
2. Oversight by high-level personnel;
3. Due care in delegating substantial discretionary authority;
4. Effective communication to all levels of employees;
5. Reasonable steps to achieve compliance, which include systems for monitoring, auditing, and reporting suspected wrongdoing without fear of reprisal;
6. Consistent enforcement of compliance standards including disciplinary mechanisms;
7. Reasonable steps to respond to the criminal conduct upon its detection, such as providing restitution to the victim, self-reporting, and cooperation with authorities;
8. Reasonable steps to prevent further similar offenses, such as use of an outside professional advisor to ensure adequate assessment and implementation of any modifications; and
9. The individual or individuals with operational responsibility for compliance and ethics programs have direct reporting obligations to the governing authority or an appropriate subgroup thereof (e.g., the audit committee for the board of directors).

Specifics of a compliance plan within that framework would necessarily be industry specific and/or specific to the nature of the potential areas of risk for regulatory or criminal non-compliance for a particular company. Thus, Step 1 in developing a compliance plan is to identify those statutes and regulations with which the company needs to comply based on its industry and the nature of its business. For example, health care practitioners must comply with regulations governing among other things their relationships with physicians, their possession and distribution of controlled substances, and their submission of claims to Medicare and Medicaid, and a compliance plan should seek to ensure compliance with the universe of applicable regulations, not just one or two. Similarly, entities that do business in foreign countries should evaluate the risk of their running afoul of the FCPA, and if necessary, have a plan for ensuring that employees do not bribe foreign officials to procure or retain business.

Having identified the universe of applicable regulations and statutes with which it must comply, the company should next develop a plan that generally covers the elements identified above. Fortunately, the USSG recognizes that the extent of a compliance plan will vary depending on the size and resources of the company.[11] The USSG elements can generally be grouped into six important factors in an effective compliance plan. Those factors are:

- Support of Management
- Policies and procedures
- Training
- Audit, detection and remediation
- Whistleblower outlets and protection
- Monitoring and Testing

A. Support of Management

In order for a compliance program to be successful, there must be management support. Members of the compliance team should participate in the groups responsible for directing the major decisions of the company. Management should support the independent operation of the compliance team and be covered by the compliance plan. As an example, the inclusion of a Chief Compliance Officer as part of senior management communicates to regulators and law enforcement that the company takes compliance seriously and also provides some comfort that high-level corporate decisions are overseen by a compliance professional. On the other hand, regulators will be skeptical of a compliance plan in which the Chief Compliance Officer does not have access to senior management and visibility into their activities.

B. Policies and procedures

A company's policies and procedures should consist of multiple tiers. Generally, every corporation should broadly require compliance with law, rule, and regulation. An effective compliance plan also should include more specific policies that reflect company specific risks. The policies and procedures should address:

1. *Known industry problems.* For example, when a regulatory agency or DOJ has focused on particular industry issues (e.g. off-label marketing of prescription drugs or foreign corrupt practices), compliance procedures should specifically address those issues. In addition, corporations should be alert to developments within the industry and

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proactively respond to emerging compliance risks.

2. *Previously identified internal problems.* If the company is aware of a prior problem within the company, compliance plans should be modified to try to prevent recurrence. Any law enforcement or regulatory agency would weigh recidivism strongly against a company in assessing the appropriate sanction.
3. *Higher risk compliance issues.* In evaluating the scope of a compliance plan in light of a particular company's resources, regulators will expect the plan to focus on the most likely and potentially most harmful risks, i.e. conduct that will cause significant harm to third parties and/or widespread harm, and violations that would result in significant regulatory or law enforcement sanction. In other words, the structure of the policies and the allocation of resources to ensuring compliance with them should reflect a determination of those areas of highest vulnerability.

C. **Training**

Of course, policies are of little moment unless employees are made aware of them. Therefore, any effective compliance plan would have a robust training component that might include among other things orientation for new employees, routine group training sessions, and computer-based training modules. Computerized training modules should include a testing component that confirms that the employee gained (or already had) some level of awareness of the policies that were the subject of the training. Compliance departments should maintain records of the content of the training and persons present. If law enforcement or government regulators are talking to company employees, they may ask the employees about the frequency and effectiveness of training and will also test their knowledge of applicable policies and procedures to evaluate the effectiveness of the training component of the compliance plan.

D. **Audit, review, and remediation**

The compliance plan must provide for monitoring of compliance through periodic formal audit by an internal audit team or by outside experts. It goes without saying that reviews required by the plan must actually be conducted, and violators must be disciplined. Failure to comply with the plan's audit standards will send a message to your employees and government officials that the company does not have a culture of compliance. The inescapable message of an un-followed plan is that the company knew it had compliance risk and failed to take the steps it knew it needed to take to avoid that risk.

Disciplinary procedures should be in place to address detected violators. Also, the plan should address the procedures for evaluating and then remediating the damage caused by non-compliance, whether financial (loss to victims or the government) or physical (environmental harm or structural damage). In evaluating an appropriate response to a compliance breach, government agencies will closely examine the company's response and will expect violators to have been disciplined. DOJ policy, for example, affirms:

> Although neither a corporation nor an individual target may avoid prosecution merely by paying a sum of money, a prosecutor may consider the corporation's willingness to make restitution and steps already taken to do so. A prosecutor may also consider other remedial actions, such as improving an existing compliance program or disciplining wrongdoers, in determining whether to charge the corporation and how to resolve corporate criminal cases.[12]

Disciplining wrongdoers can also have a significant deterrent effect. A recent study by The Sentencing Project regarding criminal sentences reported the traditional notion that "[r]esearch to date generally indicates that increases in the *certainty* of punishment, as opposed to the *severity* of punishment, are more likely to produce deterrent benefits."[13] (Emphasis in original). The severity of punishment is likely not a particularly effective deterrent to would-be criminals because they are (a) not rational thinkers, (b) unaware of the potential penalties for specific crimes, and/or (c) lulled by the perceived lack of certainty of punishment that makes the potential punishment less relevant. In the private sector, however, actors are typically more rational and informed. Therefore, a good compliance plan can combine certainty and appropriate severity of punishment along with training to achieve a significant deterrent effect. Of course, failure to impose discipline on violators sends the opposite message.

E. **Encouraging and detecting disclosures**

Regardless of the robustness of a company's compliance program, encouraging whistleblowers and protecting them once they have brought information to the surface can act as a force multiplier to significantly increase the likelihood of detecting wrongdoing. There are a number of different strategies to accomplish these two goals and establish an effective whistleblower program.

1. **Awareness**

A whistleblower program only works if employees know about it. There are a number of actions employers can take to make sure that happens. An important first step in this process is making a whistleblower policy widely available to all employees. One way to do this is to make it part of a code of ethics or other general policy that employees must review and acknowledge annually. As part of this policy, companies should consider implementing positive and prohibitive practices that encourage internal reporting, including: (i) internal communications conveying company commitment to internal reporting; (ii) developing meaningful rewards for whistleblowing; and (iii) establishing a policy that a failure to report wrongdoing is a violation of company policy and may result in disciplinary action. If the company is doing business internationally, the whistleblower hotline should be available in all local languages. The company must also be aware of local data protection laws.

2. **Creating Confidence in the Process**

Potential whistleblowers are unlikely to report potentially problematic conduct if they do not have confidence in the process, and often, the results of the investigation will not match the whistleblower expectations. As a result, instilling confidence should focus on the process.

One way to establish credibility is to assign responsibility for oversight of the whistleblower program to a senior executive. The company can also appoint an independent individual or group—typically within audit—to investigate all complaints. These investigations should be thorough, using the following work streams where possible: (i) reviewing documents; (ii) interviewing witnesses using an "outside in" approach by beginning interviews with peripheral witnesses and moving to the most central parties; and (iii) producing a final report with recommendations. The group performing the investigations should ensure consistency in recommendations through clear guidelines, collaboration with other team members and groups and the use of data analysis.

It is also important to ensure that there are appropriate reporting lines to allow for monitoring of these investigations. Keeping complainants apprised of the progress of the investigation and outcomes can convey to employees that the company takes the allegations seriously and is interested in a culture of compliance. The investigation team should also provide periodic reports to the audit committee of the board of directors. Companies should also considering implementing guidelines for escalating certain allegations or investigations to leadership immediately.

3. **Preventing retaliation and the fear of retaliation**

Whistleblowers need to have confidence that their reporting of potential misconduct in good faith will not result in retaliation. The first step in this process is implementing a detailed non-retaliation policy for whistleblowers who make reports in good faith. Again, the best place for this message is in an overall policy that is acknowledged on an annual basis so that employees are repeatedly reminded that they will not be retaliated against for attempting to root out problematic conduct.

Another useful tool is allowing whistleblowers to address complaints outside the direct chain of command. Ideally, this process includes a reporting mechanism that allows both confidential and non-confidential whistleblower complaints. Information for this reporting mechanism should be made widely available to employees. Confidential avenues for "whistleblowers" to report issues internally should ideally include multiple outlets such as a hotline and online reporting forms.

Access to investigation materials should be limited to a supervisor or group of supervisors and administrative personnel on a need-to-know basis.

Retaliation can take many forms and may not be readily apparent immediately following the whistleblower's complaint. As a result, designating a central function or person to monitor the career progression of whistleblowers and any proposed disciplinary action against whistleblowers for some period of time after they make whistleblower reports may be useful to ensure that no discrimination against whistleblowers is occurring after the investigation has been closed.

All employees should be subject to the same whistleblower hotline, although complaints related to high profile employees or matters may receive additional scrutiny.

The whistleblower program should not stop at the company walls. It should extend to cover the conduct of contractors, sub-contractors, and business partners to make sure vendors are held to the same standards and to limit reputation risks.

F. **Monitoring and testing effectiveness**

Once a program has been established, it is important to make sure that the program is achieving the desired results. This evaluation process can take many forms:

1. **Monitoring employee communications**

Monitoring employee communications is a good way to understand employee conduct, but the volume of these communications will overwhelm any compliance team. There are a number of ways to target this review, and the method used should be based on the employees being monitored. Reviewing communications based on search terms can be useful where specific terms or jargon are essential to the compliance concerns. However, this method is not without its problems. It is limited to written communications, and it relies on correct spelling or predictable misspellings. As a result, it is easy for employees to circumvent. For example, if you have an employee seeking to improperly influence records to increase a bonus, "bonus" would be a natural search term. However, employees knowing they are doing something improper may try to hide this conduct with alterations like "b0nus" or "bonu$".

Another option is to target specific times of the day or period of the year where you expect problematic conduct to be the most likely. This is particularly useful when year ends and quarter ends bring particular pressures, and daily activities are focused on particular points in the day. However, even these time limitations can produce an enormous amount of data that can dwarf the capabilities of the average compliance team.

2. **Analyze reporting trends**

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Investigating complaints raised by whistleblowers is only part of the process involved in establishing a whistleblower reporting system. The other, and perhaps more important step, is analyzing the complaints on a larger scale to determine trends. To do this, there needs to be a meaningful coding system to categorize complaints. Complaints can also be categorized by line of business, geography, employee level, or a number of other factors relevant to your organization.

Complaint categorization is important for two main reasons. It can allow you to spot trends that may not be observed by the individuals addressing specific complaints. This is particularly true where the complaints are addressed by a number of different individuals. In addition, when addressing these problematic trends, data analysis can help determine whether the proposed solution has had the desired effect and whether there have been any unintended consequences.

III. Self-Reporting

Often the most difficult decision where misconduct is found is deciding whether to self-report. In some instances, such as the Affordable Care Act Overpayment Requirement, self-reporting is mandatory, and the decision is easier.[14] In instances where it is not mandatory, self-reporting can have a tremendous upside. Recent press releases from the European Commission disclosed that Barclays and UBS avoided fines in excess of $4 billion for the reference rate investigations by self-reporting. "[T]here have been no FCPA declinations reported by the Department of Justice (DOJ) or the Securities and Exchange Commission (SEC) which did not result from self-reporting. It is difficult to imagine a scenario in which the government would award complete cooperation credit to a company whose FCPA issues came to light through the government's or others' independent efforts."[15]

For self-reporting to be meaningful, it must be truly voluntary and timely, but it should also be well informed. Timeliness is critical because generally the self-reporting must come before any outside investigation has begun or anyone has reported the potential wrongdoing. Incentives for whistleblowers under Dodd Frank make self-reporting more challenging because employees who once may have provided the company with information may now be going directly to the government. This is particularly true now that a former JP Morgan Chase employee received almost $64 million for disclosing information that led to a settlement with his former employer.[16] On the other hand, rushing to report a matter before it has been fully investigated may result in the disclosure of information that is not a violation of law, or worse, a violation of law that is much greater than originally anticipated.

Not all inquiries should be disclosed. There are a number of reasons a company may decide not to self-report. For example, evidence available to the company may not be clear or conclusive. Conduct that is perhaps unethical or against internal policies may not amount to a violation of law. Companies should also consider potential civil liability and action by other regulators. Ultimately, a company must weigh any benefit it might receive for self-reporting, such as leniency from the government, against potential costs, such as exposure to civil litigation, harm to investors, and the impact on the brand and other lines of business.

IV. More on the Culture of Compliance

The effectiveness of any compliance program will be directly related to the tone set by management. That tone cannot be a secret. In other words, a CEO with a pure heart who fails to communicate her commitment to compliance has failed to set a tone. Tone-setting must be affirmative and consistent. For example, a company might objectively set a tone by providing incentives and recognition to employees who show particular commitment to compliance or who disclose wrongdoing. Employees will also observe how senior management interacts with compliance personnel and whether that interaction suggests that the compliance team is an important part of the organization. The company can also establish a culture of compliance by responding to industry or internal developments as they occur. When an industry practice becomes notorious, management should address it before governmental action focuses on the company or firm. Finally, management can emphasize compliance even when it is not the focus of a meeting or session. Business planning meetings should include discussions of practices within compliance boundaries.

Perhaps most importantly, however, management must be consistent in demonstrating its respect for the compliance function. Reputations are built in a lifetime and lost in an instant. A communication that employees would see as a wink and a nod regarding compliance could undermine all efforts at creating a culture of compliance. Winks and nods do not happen when the commitment to compliance is real. Not only does the wink and nod increase the likelihood that employees may cut corners (or worse) in pursuit of corporate objectives, but if discovered by law enforcement or regulators post-breach, it can undermine the mitigating value of a well-crafted compliance program and lead to more severe sanctions.

V. Conclusion

Crafting and implementing an effective compliance plan is important both to prevent compliance breaches and to address them if they occur. Although effective compliance plans will consistently include certain elements, the best plans reflect a purposeful assessment of a company's compliance risks and implement polices to avoid those risks. However, the best compliance plan is only a stack of paper unless the plan is supported by a corporate culture that values compliance in a real and consistent way. An effective plan combined with a tone at the top that is consistent with the plan will not only result in fewer breaches but can also effectively mitigate company responsibility when breaches do occur. In short, the compliance plan ounce of prevention will be worth much more than the pound of cure.

Schools and Bloomfield practice with Moore and Van Allen, PLLC in Charleston and Charlotte respectively.

(Endnotes)

1 Kiel, Daniel, *An Ounce of Prevention is Worth a Pound Of Cure: Reframing the Debate About Law School Affirmative Action*, 88 Denver Univ. L. Rev. 791 (2011) (citing *Fire Department: The Electric Ben Franklin*, USHISTORY.ORG, ***http://www.ushistory.org/franklin/philadelphia/fire.htm*** (last visited May 18, 2011)).

2 Of further note, JP Morgan's settlement reflected only part of the cost of its alleged non-compliance. In October 2013, the bank disclosed "it had reserved $23 billion to cover litigation costs. Jenna Greene and Mike Scarcella, *JP Morgan's Legal Tab Ticks Up as Feds Bust Big Banks*, Nat'l Law Journal (December 30, 2013), ***http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202635017412&JPMorgans_Legal_Tab_Ticks_Up_as_Feds_Bust_Big_Banks#ixzz2oyrZK35t***

3 USAM § 9-28.300.

4 ***http://www.justice.gov/iso/opa/dag/speeches/2013/dag-speech-131118.html***.

5 ***https://oig.hhs.gov/newsroom/video/2011/heat_modules.asp*** (visited on 1/7/2014).

6 USAM § 28.800. (Emphasis added).

7 FCPA 56-65.

8 Regulations setting forth that guidance are collected on the HHS OIG's website at ***http://oig.hhs.gov/compliance/compliance-guidance/index.asp***.

9 *See* 31 U.S.C. 2318(h).

10 *See* FINRA Rule 3310.

11 USSG § 8B2.1, Application Note 2(c)(1).

12 USAM § 9-28.900.A.

13 Wright, Valerie, *Deterrence in Criminal Justice: Evaluating Certainty vs. Severity of Punishment*, November 2010, p. 1, available at ***http://www.sentencingproject.org/doc/deterrence%20briefing%20.pdf***.

14 PPACA § 6402(a).

15 *See* ***http://www.insidecounsel.com/2013/05/29/regulatory-deciding-whether-to-voluntarily-disclos*** (last visited Mar. 17, 2014).

16 (*See* ***http://www.reuters.com/article/2014/03/07/us-jpmorgan-whistleblower-idUSBREA261HM20140307*** (last visited Mar. 17, 2014).

Practice Tips: The Secretary of State as Service of Process Agent

Contributed by Ann Wall

In some limited circumstances you may use the Department of the Secretary of State to serve process on a business entity. For example: You unsuccessfully attempt to serve the registered agent of a corporation or limited liability company (LLC) authorized to do business in North Carolina at the address listed in the Department's database. You may then perfect service using the Service of Process (SOP) agent of the Department pursuant to G.S. § 55D-33(b) which says:

> When an entity required to maintain a registered office and registered agent under G.S. 55D-30 fails to appoint or maintain a registered agent in this State, or when its registered agent cannot with due diligence be found at the registered office, or when the Secretary of State revokes a certificate of authority or a statement of foreign registration of a foreign entity authorized to transact business or conduct affairs in this State, the Secretary of State becomes an agent of the entity upon whom any such process, notice or demand may be served. Service on the Secretary of State of any such process, notice or demand is made by delivering to and leaving with the Secretary of State or any clerk authorized by the Secretary of State to accept service of process, duplicate copies of the process, notice or demand and the applicable fee. In the event any such process, notice or demand is served on the Secretary of State in the manner provided by this subsection, the Secretary of State shall immediately mail one of the copies thereof, by registered or certified mail, return receipt requested, to the entity at its principal office or, if there is no mailing address for the principal office on file, to the entity at its registered office. Service on an entity under this subsection is effective for all purposes from and after the date of the service on the Secretary of State.

<u>**Practice Tips:**</u>

1. If you want the service using the SOP agent to be effective, you *must* include:
   A. The $10 fee. G.S. § 55-1-22(b).
   B. *Two* copies of the document to be served. G.S. § 55D-33(b).
2. You *should* also include:
   A. For multi-party cases, include either:
      1. A cover letter which states which entity it is that you want the SOS agent to serve, or
      2. An envelope addressed to: *Name of Entity c/o Secretary of State.*
   B. Your telephone number and an email address (in case of questions).
3. You may search SOS service of process by either the judicial Docket Number or the SOS File Number. Go to ***http://www.secretary.state.nc.us/sop/*** and click on: Search service of process.

<u>**Common service mistakes include:**</u>

1. Service on the Secretary of State using Rule 4 of the Rules of Civil Procedure is not effective to serve a business entity under G.S. § 55D-33 and will be rejected.

2. Serving the registered agent and the Department's SOP agent at the same time in an instance when service must be attempted on the registered agent *first*.

3. Using a third-party service agent without ensuring they know that they have to include the $10.00 fee and two copies when serving using the Department's SOP agent.

4. Trying to use the Department's SOP agent to serve an individual rather than a business entity.

5. Serving the Department with "information only" documents. The Department does not keep "information only" files.

A request from the Department: Regardless of the reason you have tried to send something to a business through its registered agent listed on the Department's website, *please* let us know if you find that a registered agent cannot be located or is not accepting service. You can let us know by sending an email to the Service of Process Agent with the subject line "Registered Agent Issue" to: ***sop@sosnc.com***.

Wall is General Counsel of the office of the North Carolina Secretary of State.

By the Numbers: Updates from the N.C. Department of the Secretary of State

By Cheri Myers & Ann Wall

Annual Reports At A Glance

In most cases the annual report is due to the N.C. Secretary of State's office on or before April 15 of each year. The report may be filed online 24/7 in real time or may be submitted in paper form as follows:

Type of entity	When report is due	Fee
Business Corporations Banks	If you file with us, you start with the day your fiscal year ends. Then add four months. Your report is due on the 15th day of the fourth month.	Online $20.00*
	If you file with the N.C. Department of Revenue, your annual report is due at the same time you file your taxes. If you get an extension for filing your taxes, your annual report due date is also extended.	Paper $25.00
Limited Liability Companies or L3Cs	Your report is due on April 15 of each year after the year of creation.	Online $202.00* Paper $200.00
Partnerships (LLPs and LLLPs)	Start with the day your fiscal year ends. Then add four months. Your report is due on the 15th day of the fourth month.	Online $202.00* Paper $200.00
N.C.G.S. Chapter 54, Article 16, Cooperative Associations (with common stock)	Before the first day of March of each year to the N.C. Secretary of State's office and copied to the Marketing Division at the Department of Agriculture.	Paper only $10.00 No form available at this time

* Fee stated includes a $2.00 electronic transaction fee. Additional information about Annual reports can be found in our FAQs on the Corporations Division website under "Ongoing Maintenance of Business Records."

Statistics | Number of Creation filings* in State Fiscal Year**
2010-2011 = 54,619
2011-2012 = 55,823
2012-2013 = 58,574
2013-2014 = 39,291 (February 28, 2014) ***

* Creation documents in the above include: Business Corporations, Limited Liability Companies, Limited Liability Partnerships, Limited Partnerships, Nonprofit Community Trusts, Nonprofit Corporations, Professional Corporations, Professional LLCs, and RLLLPs.
** N.C. State Fiscal Year runs July 1 to June 30.
*** The December 31, 2013 number published was in error. The correct number of creation filings at the end of December 31, 2013 was 28,533.

By the Numbers, continued from page 36

Current Processing Times

- The normal processing time for the Corporations Division is approx. 1-5 business days. Due to the severe weather experienced in January and February, the Document Compliance Unit experienced up to a 10-business day turnaround on filing documents. We are working diligently to bring the turnaround time back to 3-4 days. If you have time sensitive filing requirements, you may want to consider an expedited filing.
- Statutory mandate for processing UCC-1 financing statements: 3 business days, presently the performance rate is 2 business days on average.

Online Submission of Documents

Submission of documents over the Internet began June 1, 2013.

TIP: Before you start to submit a document, make sure you are using a version of Adobe which allows you to save both the information you enter and the form itself.

Online Submissions

Month	# of Online Submissions	% of Creation Documents
July – Sept 2013	3,803	70%
Oct- Dec 2013	4,583	59%
Jan – Feb 2014	3,687	67%

Email Notification Subscription Service

The free "Phase 3" subscription service is gaining in popularity as the numbers below indicate. The Secretary of State's office is marketing the use of the subscription service to CPAs, Registered Agents, and other state agencies, e.g., the Purchase and Contract Division, DHHS, and licensing boards. As you may know, the subscription service allows you to subscribe and receive email notifications about changes to the profiles of entities you select in our Corporations database. The chart below shows how many people have subscribed within the last two months, the number of entities monitored by those subscribers, as well as the total numbers since the subscription service became available in April of 2013.

Email Notification Subscriptions

Date	# of New Subscribers	# of New Entities being monitored
1/31/2014	125	308
2/28/2014	100	656
Total	1357	17,163

Myers is Corporations Director of the office of the North Carolina Secretary of State. ***Wall*** is General Counsel of the office of the North Carolina Secretary of State.

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