Technicolor Hats: The Danger of Relying Solely on D&O Insurance to Protect In-House Counsel in Securities Litigation

by Erik A. Christiansen

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Since passage of Section 307 of the Sarbanes Oxley Act of 2002, and the Securities & Exchange Commission's ("SEC") adoption of its Final Rule: Implementation of Standards of Professional Conduct for Attorneys,[1] there has been an increased focus on the conduct of attorneys representing issuers of securities, including in-house counsel of issuers, and the potential culpability of such counsel in corporate securities scandals. As a result, in this environment of increased scrutiny, it is critical that in-house counsel not only be aware of potential liability in SEC enforcement actions, but also in private securities class actions and derivative actions. In this context, many in-house counsel have mistakenly assumed that they are fully protected by traditional directors and officers liability insurance policies in the event of an SEC enforcement action, or a private securities class action. This article discusses some of the pitfalls of blind reliance by in-house counsel on traditional D&O policies, and recommends additional steps in-house counsel might wish to consider to protect themselves against an uncovered loss. Given the many hats warn by in-house counsel, it is important for in-house counsel to understand and appreciate which of his or her many hats likely will be afforded protection under a corporation's D&O policy.

How Real is the Risk to In-House Counsel?

In a post-Enron world, Congress and the SEC have a renewed focus not only the role accountants have played in corporate securities scandals, but also on the role lawyers have played as well. As former SEC Chairman Harvey L. Pitt stated in 2002:

> The public cannot be served if professionals who serve as gatekeepers merely follow the letter of the law, but not necessarily its spirit. We need to move away from wooden, rigid, literalism, and encourage all upon whom the present system depends to adopt a bias in favor of the needs of the investing public . . . Corporate lawyers represent the corporation and its shareholders, even though management may hire or fire them; they must be satisfied that objectives management asks them to pursue truly are intended to, and do, further the interests of the company and its shareholders.[2]
>
> Confidence in our capital markets cannot be maintained if the public believes everything is game to enable corporations to rely on lawyers and other professionals, who in turn rely on a literal reading of the law or governing principles . . . A core issue arising in Enron's wake is enhancing existing and planned legal standards with ethical and competency standards not only for accountants but also for lawyers, officers and directors and others.[3]

Within this regulatory context, President Bush on July 30, 2002 signed into law the Sarbanes-Oxley Act of 2002 (the "Act").[4] In Section 307 of the Act, Congress directed the SEC to promulgate rules of practice to require attorneys appearing before the SEC to report evidence of material securities law violations, including up-the-ladder to a company's chief legal officer, chief executive officer, audit committee, independent directors, and/or board of directors.[5] The SEC, in

fact, then decided to federalize ethical standards for lawyers appearing before the Commission and ultimately adopted its Final Rule: Implementation of Standards of Professional Conduct for Attorneys, which took effect on August 5, 2003.[6]

These SEC rules require lawyers "appearing and practicing before the Commission" to report "evidence of a material violation" "up-the-ladder" within the company to the chief legal officer, or the CEO.[7] The reporting attorney also may report directly to the audit committee, or the company's board of directors, if he or she reasonably believes that it would be futile to first report to the chief legal officer or CEO.[8]

Within this context, in-house and general counsel of issuers have more frequently been named as defendants in SEC and securities class actions.[9] As a result, this changed regulatory and litigation climate has left "in-house counsel worried about their exposure to lawsuits and penalties if their corporate employers run afoul of securities regulations."[10]

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In-house counsel who simply assume that they are covered under D&O policies, however, can be in for an unpleasant surprise if and when a corporate scandal comes home to roost. Many such policies cover only directors and officers.[11] If an in-house counsel is not also an officer or director, coverage could be denied. Moreover, insurers often argue that coverage is afforded for in-house counsel who are officers or directors, but only if the in-house lawyer was expressly acting in his or her capacity as a director or officer at the time of the suspect conduct, and not as counsel.[12]

This distinction — as to whether the insured was acting as an officer or director, on the one hand, or as an in-house counsel providing legal advice, on the other—is a factual and legal morass, as in-house counsel as a practical matter frequently wear many hats on a daily basis. Typically, the "general counsel archetype performs multiple roles, including legal counselor; business adviser; corporate cop; problem solver; and cost center manager," among others.[13] In-house counsel making a claim under a D&O policy thus will face the difficult task of proving that counsel was acting as an officer at the time, rather than as a legal advisor, with respect to the suspect conduct at issue.[14] Thus, even if an in-house counsel is an officer or director, or even a named insured under a D&O policy,[15] coverage may be at risk if counsel's actions at issue are deemed legal advice, as opposed to management or business actions.

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A recent example of the distinction between legal advice and business actions is found in *Hunt v. National Union Fire Insurance Company of Pittsburgh, PA.*[16] In *Hunt*, plaintiff John Frazier Hunt, an officer, director and attorney for Lifetime Corporation ("Lifetime") filed suit against National Union Fire Insurance Company of Pittsburgh, PA ("NUFIC") seeking a declaratory judgment that NUFIC had a duty to defend and indemnify him in an underlying lawsuit. In response, NUFIC filed a motion for judgment on the pleadings, and argued that Hunt was sued as an attorney in the underlying action, and not in his capacity as a director of Lifetime. NUFIC argued that because claims against Hunt as a director earlier had been dismissed in the underlying lawsuit, and the only remaining claims related to his actions as counsel, no coverage was afforded under the policy. After examination of the Malpractice Exclusion in the D&O policy, the Court granted NUFIC's motion and held:

> Even if NUFIC may have had a duty to pay some defense costs early in the proceedings, that does not mean that NUFIC has a duty to continue to do so. Nor does it mean that NUFIC has a duty to indemnify Hunt in the Underlying Action. Once the claims made against Hunt in his capacity as a director of Lifetime were dismissed, so that the only counts remaining against him involved acts he undertook in his capacity as an attorney, any duty NUFIC had to pay defense costs and to indemnify Hunt evaporated. That stage was reached in the Underlying Action some time ago. The only claims remaining against Hunt in the Underlying Action are for legal malpractice and possibly also for breach of fiduciary duty. Coverage for such claims is excluded under the Malpractice Exclusion in the Policy, so NUFIC has no duty to indemnify Hunt in the event that a judgment is entered against him in the Underlying Action.[17]

The *Hunt* case thus illustrates the very real risks in-house counsel face when named as both an officer and director, as well as in their capacity as counsel, in a securities class action. *Hunt* shows that courts are willing to parse the particular claims made against counsel, and to decide which claims do or do not relate to their actions as counsel, as opposed to an officer or director, even in the midst of on-going underlying litigation. D&O policies thus do not provide a blanket protection for in-house counsel, but at best, provide some moderate level of protection to those in-house counsel who are officers or directors, and who are sued for their actions as officers or directors, as opposed to those in-house counsel who are sued for their actions as corporate counsel.

"It is critical that in-house counsel become involved in the procurement of their company's D&O policy, closely monitor and participate in the negotiation of policy terms, and if needed, hire and retain professions who can assist in the procurement and negotiation of such policies."

In addition to coverage risks, there also may be practical reasons why a company may affirmatively decide to exclude in-house counsel from D&O coverage. For example, the addition of in-house counsel as an insured under the D&O policy may dilute the coverage available for the corporation's other officers and directors, who are the primary beneficiaries of such policies.[18] A corporation thus may decide for policy reasons that coverage should only be afforded to the officers and directors involved primarily in management, as opposed to in-house counsel who provides more legal, as opposed to business advice, to ensure that officers and directors have the maximum benefit of the coverage amounts available under the policy.

Given these multiple risks, it is critical that in-house counsel become involved in the procurement of their company's D&O policy, closely monitor and participate in the negotiation of policy terms, and if needed, hire and retain professions who can assist in the procurement and negotiation of such policies.

Practical Steps In-House Counsel Should Take to Maximize their Insurance Protection:

An obvious first step in-house counsel should take to protect themselves is to advocate that the company obtain a D&O policy that includes "in-house counsel" in the definition of officers and directors. If there are multiple in-house lawyers who report to a single general counsel, in-house counsel also might want to negotiate policy language that includes all in-house counsel, not just the general counsel who may be the only in-house counsel that is an officer of the corporation. For example, subordinate in-house counsel potentially might be identified in a corporation's by-laws as assistant officers of the corporation. If the D&O policy definitions are then negotiated to afford coverage to assistant officers as well as officers, such subordinate in-house counsel potentially might also be afforded coverage under the policy.

Another approach is to amend the corporation's by-laws to define the corporation's officers to include the general counsel, or all in-house counsel. Such a change not only has the benefit of picking up the benefits of D&O policies that afford coverage to a corporation's

"officers", but also may result in statutory indemnification for in-house counsel under state law indemnification statutes if coverage under the D&O policy is not available. Such state-law based indemnification statutes typically allow for advancement of defense costs and for settlement payments under certain defined circumstances.[19] Indeed, in-house counsel may want to negotiate a written indemnification agreement with the company to define specifically what types of acts the corporation will or will not indemnify counsel for within the context of applicable state law. In such cases, in-house counsel may want to negotiate for indemnification even after the date counsel ceases employment with a company, if claims relate to acts committed while counsel was with the corporation, particularly given the fact that in times of corporate crisis, officer and directors frequently lose their jobs.

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Another approach is to negotiate to broaden the definition of "wrongful act" to include any wrongful act committed by a covered officer or director (including an in-house counsel) to provide for coverage, regardless of whether such wrongful acts are intermingled with non-covered acts, i.e., the practice of law. In other words, to the extent feasible, in-house counsel negotiating the procurement of a D&O policy should attempt to narrow the scope of the malpractice exclusion, and to broaden the definition of wrongful acts to help reduce potential factual arguments about which hat in-house counsel was wearing at the time of an alleged bad act.

Finally, although beyond the scope of this article, there are numerous issues having to do with the negotiation of D&O policies in general with which in-house counsel should be familiar, including priority of payments provisions, severability, rescission, final adjudication language and other related issues.[20] If in-house counsel is not familiar with these issues, he or she should consult professionals who can assist counsel in negotiating such provisions.

An additional protection available for in-house counsel is an Employed Lawyers Professional Liability Insurance Policy ("ELP policy"). Such policies are designed for in-house counsel, and many include a separate limit of liability from that available under D&O policies, to afford coverage to in-house counsel for non-indemnifiable claims, as well as provide for coverage for the company to the extent it indemnifies its in-house counsel.[21] Many ELP policies cover defense costs for direct malpractice claims, which are typically excluded in D&O policies.[22] Such policies potentially also might cover claims arising out of moonlighting, pro bono, or other legal services provided by in-house counsel, as well as personal tort claims, such as false arrest, malicious prosecution, or defamation.[23]

Conclusion

While at first blush it might seem that in-house counsel who also is an officer of a corporation would be afforded coverage under his or her employer's D&O policy, the reality is that given the difficulty in separating out the lawyer's legal role from his or her business role, there is a substantial risk that an in-house counsel may wind up in a coverage battle with a D&O carrier about which hat the lawyer was wearing at the time of any alleged bad acts. Accordingly, when in-house counsel are negotiating and procuring D&O policies, they should carefully consider and evaluate specific policy language so that they can broaden coverage, and minimize the risk that they will be left without coverage in the event of a corporate crisis. In-house counsel also should consider the purchase of an ELP policy to fill in the gaps left uncovered by the company's D&O policy, as well as negotiating to be included as officers within a corporation's by-laws to maximize the potential for statutory

indemnification under state law indemnification statutes.

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[1] 17 CFR Part 205, Release Nos. 33-8185; 34-472276; IC 25919; File No. S7-45-02.

[2] Harvey L. Pitt, Public Statement by SEC Chairman: Remarks at the SEC Speaks Conference, at www.sec.gov/news/speech/spch540.htm (Feb. 22, 2002).

[3] Harvey L. Pitt, Public Statement by SEC Chairman: Remarks at SIA Compliance and Legal Division Seminar, at www.sec.gov/news/speech/spch544.htm (Mar. 11, 2002).

[4] Pub. L. No. 107-214, 116 Stat. 745.

[5] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 307, 116 Stat. 745, 784.

[6] 68 Fed. Reg. 6296 (Feb. 6, 2003); 17 CFR Part 205, Release Nos. 33-8185; 34-472276; IC 25919; File No. S7-45-02 (the "Final Release").

[7] See Final Release, *supra*, at 6306.

[8] 17 C.F.R. § 205.3(b)(4).

[9] *See, e.g.*, In re Tyson Foods, Inc., 2003 U.S. Dist. LEXIS 17904 (D. Del. Oct. 6, 2003) (Les Baledge, Tyson's Executive Vice President and General Counsel, named as defendant); Harris v. Intel Corp., 2002 U.S. Dist. LEXIS 13796 (N.D. Cal. July 8, 2002) (F. Thomas Dunlap, Jr., Vice President and General Counsel, named as defendant); In re Solv-Ex Corp. Sec. Litig., 198 F.Supp.2d 587 (S.D.N.Y. April 30, 2002) (Herbert M. Campbell, II, Senior Vice-President, Secretary and General Counsel, named as defendant); In re Envoy Corp. Sec. Litig., 133 F. Supp. 2d 647 (N.D. Tenn. 2001) (Jim D. Kever, Envoy's Executive Vice President, Secretary and General Counsel, named as defendant).

[10] M. McDonough, *Ideas From The Front: Naked And Nervous*, 2 No. 49 A.B.A. J. E-Report 5, at 1 (2003).

[11] J. Tanner & D. Howard, *Blowing Whistles & Climbing Ladders*, ACC Docket, 23 No. 4 ACC Docket 32, at 7 (April 2005). The issue is further complicated if the lawyer involved is a subordinate lawyer, who reports to a general counsel, but who is not an officer or director of the company. Moreover, in recent years, there has been a considerable increase in litigation over who is and is not an "officer" under such policies. *See, e.g.*, J. Conder, *Who Is An 'Executive Officer' Of Insured Within Meaning Of Liability Insurance Policy*, 1 A.L.R. 5th 132 (2005).

[12] J. Tanner & D. Howard, *supra*, at 7.

[13] L. Nicholson, *Sarbox 307's Impact On Subordinate In-House Counsel: Between A Rock And A Hard Place*, 2004 Mich. St. L. Rev. 559, at 593 (Summer 2004).

[14] M. McDonough, *supra*, at 1 ("D&O insurance may only cover general counsel if they are acting as officers of the company and not in their role as lawyers."); E. Lenz, *Inside Track with Broc: Ethan Lenz on Coverage for In-House Counsel Under D&O Insurance Policies and Indemnification Provisions* (Jan. 31, 2005) ("For example, there is the potential that a D&O insurance carrier could assert that certain actions of a general counsel relate purely to the provision of legal advice to the corporation and others, versus acting in his or her capacity as a director and/or officer of the corporation.").

[15] Some D&O carriers allow in-house counsel to be covered as named insureds by endorsement, either by amending the policy definition of "Directors and Officers" to include in-house attorneys or by specifically listing the in-house attorneys by name. J. Tanner & D. Howard, *supra*, at 7. For example, "Executive Officers" in the policy can be defined as "Executive Officers, either in the singular or plural, means with respect to any Company its chairperson, president, chief executive officer, chief financial officer, in-house general counsel . . . ." ACE Illinois Union Insurance Company policy, ¶ 2(G).

[16] Hunt v. National Union Fire Ins. Co., 2005 Phil. Ct. Com. Pl. LEXIS 488 (Pa. Nov. 8, 2005); cf Raychem Corp. v. Federal Ins. Co., 853 F. Supp. 1170 (N.D. Cal. 1994) (insurer attempted to avoid coverage based on the position that actions taken by directors/officers were done in their capacities as shareholders, as opposed to capacity as directors and officers); Texlon Corp. v. Federal Ins. Co., 309 F.3d 386 (6th Cir. 2002) (D&O insurance only available to general counsel for litigation costs which the company was "legally obligated to pay").

[17] Hunt v. National Union Fire Ins. Co., 2005 Phil. Ct. Com. Pl. LEXIS 488 (Pa. Nov. 8, 2005).

[18] J. Tanner & D. Howard, *supra*, at 7.

[19] *See* W. Fletcher, Fletcher Cyclopedia of the Law of Private Corporations, Chapter 11. Directors, Other Officers And Agents, XXXIII. Practice And Procedure In Actions to Enforce Common-Law And Statutory Liability Of Directors And Other Officers (2005); Fasciana v. Electronic Data Systems Corp., 829 A.2d 160 (Del. 2003) (counsel was not acting as an agent of the corporation, for purposes of advancement statute, to the extent allegations against counsel did not involve dealings with third parties on behalf of corporation); Cohen v. Southbridge Park, Inc., 369 N.J. Super. 156, 848 A.2d 781 (2004) (counsel, who had provided legal advice to corporation, was not a "corporate agent" within the meaning of corporate agent indemnification statute).

[20] *See generally*, R. Shulman, A. Rediy, C. Davis and A. Buttry, *Hot Issues In D&O Insurance*, Practising Law Institute, 719 PLI/Lit 205 (February 22-23, 2005); J. Mathias, Jr., T. Burns, and T. Braun, *Misrepresentations in the Application as Grounds for Rescission of the D&O Policy, Coverage*, Vol. 11, No. 3, May/June 2001; J. Mathias, Jr. and T. Burns, *Conserving D&O Insurance Policies in Securities Fraud Litigation: A Common Interest of Policyholders and Institutional Shareholder Claimants, Coverage*, Vol. 14, No. 4, July/August 2004.

[21] J. Tanner & D. Howard, *supra*, at 7.

22 J. Tanner & D. Howard, *supra*, at 7; *see also* E. Lenz, *supra*, at 2.

23 E. Lenz, *supra*, at 2.

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