

ROBERTO SCALESE: Good afternoon. The Association of Corporate Counsel and SmartPros Legal and Ethics welcome you to today's webcast, What In-House Litigators Need to Know about Indemnification on D and O Insurance and Disclosure Issues.

[The instructions provided here were intended for attendees of the live webcast when it was originally broadcast.]

Our presentation today will be moderated by Monica Palko, the ACC Litigation Committee Chair, and now I'll turn it over to Monica. Take it away.

MONICA PALKO: Great! Welcome everyone. Thank you so much for joining us. This is the third presentation in the Litigation Master Series, which is sponsored by the ACC Litigation Committee and Lex Mundi.

As Roberto mentioned, I'm Monica Palko, and I chair the Litigation Committee. This will be my plug for you all to become actively involved, so you can find our contact information at the ACC site, and we welcome you. We do webcasts, info packs, and otherwise exchange information.

The Litigation Master Series is a four-part series and it focuses on areas of importance to the in-house litigation community. Each presentation focuses on two related issues, and we hope that the in-depth knowledge of our presenters will make a difference in your day-to-day very practical experience. So, please plan to join us for the final webcast in our series which will be on December 10, Arbitration and Global Legal Issues.

The two earlier presentations in the Master Series are also archived on the ACC Web site. They are Litigation Assessments and Maximizing Strategic Relationships with Outside Counsel and Establishing Procedures for Internal Investigation and Litigation Holds.

I really want to take a minute to thank Lex Mundi, which has been a terrific sponsor. In particular, its Litigation, Arbitration and Dispute Resolution Practice Group has generously sponsored the Litigation Master Series. Many of you are familiar with Lex Mundi, but just to review briefly, Lex Mundi has 160 law firms worldwide and a longstanding relationship with the ACC for providing legal expertise for the ACC members.

[The CLE code and instructions provided here were for use only by attendees of the live webcast.]

MONICA PALKO: Great. So, let's get started. Today's Master Series is: What In-House Litigators Need to Know about Indemnification, D and O Insurance, and Disclosure Issues. I am going to take the first section along with Wally Dietz and then we'll turn things over to Ron Davis and Mark Rogers.

Very briefly for my background, I'm currently a special consultant to Rosetta Stone. Many of you may have seen that they have IP litigation against Google now, and I'm assisting with that. Prior to that, I was with BearingPoint, and that's where I gained most of the experience we'll be discussing today. Some of you familiar, they had an SEC investigation, some securities fraud class actions; those are the classic types of issues that tend to involve multiple [people], whether

its executives or other witnesses, where it might be appropriate for them to have separate counsel. Prior to being with BearingPoint, I was with the United States Department of Justice in Washington D.C., a trial attorney in the Commercial Litigation Branch. And before that, I was in private practice at Bracewell & Patterson, now Bracewell & Giuliani.

So, let's get started. Indemnification: What is it? I hear indemnification used as shorthand all the time. And it's fine; I don't object to that. But the practical reality is that almost never is an executive going to come to you and say, "I want you to indemnify me." What he's really saying is, "Wow, I've been named along with the company in a lawsuit. It's appropriate for me to have separate counsel, or, in any event, I may be entitled to it"—and we'll get to that shortly—"I want you to advance my legal fees as they come due."

That's different from indemnification, which would be that same executive coming back and saying, "All right I've got this hairy judgment against me. It relates to my work for the company, or for whatever reason and I understand I'm entitled to it. Please reimburse me for that judgment." Of course, they want you to pay it up front, but technically, that's the indemnification. It's a look back. Fee advancement is: Are we going to pay your fees as they come due? As a practical matter, that's what the individuals who are looking for separate counsel want to know. They want to know, "Are you going to pay my fees so that I can represent myself fairly?"

Where are you going to find out? Someone walks in your office and they say, "Look, I've been named in this lawsuit. What the heck is going on?" More than likely they're going to look to you as in-house counsel and say, "Are you going to represent me?" Of course, you have to tell them, "No, I represent the company." How are you going to find out if the company is going to incur this expense of separate counsel for this individual?

Well, the first thing you need to look to is your basic corporate documents. You will usually find a provision in your bylaws, but it could also be in the corporate charter. Read it and see what it says about this. It may be merely a reiteration of Delaware law, which is exactly what many companies do and that works just fine. They'll lift a statute from Delaware, put it in the corporate documents, and say usually something along the lines of: Members of the board—so directors and officers of the company, usually defined to be the very senior officers—are entitled—usually it's mandatory—to have their fees be paid if they are named in litigation relating to the company. That sums it up.

Now, ordinarily—and this is how Delaware law works—it will say that they must provide an undertaking. The undertaking will include a few primary matters, if it's a typical one. It will say, "I tell you that I'm familiar with the claim that's been brought against me sufficiently to tell you that I was acting in the best interest of the company. And with regard to any potential criminal activity, I had no reason to believe my actions were criminal." If they can't verify that to you and sign the undertaking, then they're likely not entitled [to it]. Most people are going to go ahead and sign the undertaking. The undertaking says if it's later determined that that's not true, then I'm going to reimburse you for these legal fees. That's basically how it works.

Now, another thing that you have to consider is if someone's been named as a witness versus a target or a defendant. Most clauses are only going to speak to someone who's actually been named as a defendant in a lawsuit or who is the target of an investigation. Well, a lot of these cases that come about and nobody's really telling you if you're a target. "Hi, we're the SEC, we're concerned that you haven't been able to make your filings on time. We'd like to speak to someone." Right? Are they entitled or not? Maybe they're just a witness. What's the company going to do?

If they don't speak to it, there ordinarily is a provision that will state that "Any other indemnification or fee advancement lies with the discretion of the board of directors." And that can be handled in a host of ways. I know that we're just trying to get a snapshot in here in today, but it is possible to go to the board and say, for example, "We see this litigation coming up and we think there are going to be a host of witnesses. We want you to authorize reasonable fees for independent counsel for these individuals." So, there are ways to not have to go to the board of directors every single time. But beware not to take steps to retain separate counsel if in fact the company's authorization to pay that lies with the board of directors and not with the legal department.

Another place you have to look is the employment agreement. Let me tell you, these guys all have their special employment agreements. Many of them are represented by very sharp outside counsel and they're going to try to get special deals. I have found that this can turn into a cottage industry for the company. If you permit everybody to have a separate clause, everybody to have a separate deal, you will do nothing but spend your time interpreting these various agreements and negotiating them. So, I would encourage you to have a consistent clause. I would make it available so that everybody can read it and knows what the same one is, but you really have to read an individual's employment agreement to see what it says.

Some of these guys actually have special termination agreements or the like drawn up, which is to say, let's say they're concerned about some issues, whether they think they're going to be named in a lawsuit or not. Maybe the company moves them along and hires somebody else, some of whom will say, "Look, you don't have the right to diminish my rights under these agreements, and if anybody turns around and challenges them later, you're going to have to provide me XYZ legal support." So, you want to read any unique employment agreements.

And then, of course, you've got to read your applicable law. It will likely be the state of incorporation, but this is a fascinating issue to me. What if you're incorporated in Delaware and the individual resides in California? What if California's indemnification laws are more favorable? What if their employment agreement says that it needs to be interpreted consistent with the laws of Virginia, which is where the headquarters office is? You want to check to see which statutes apply, but hopefully it will be laid out and not be a major issue.

[There are] fascinating differences internationally. I'll just say that the U.S. probably has the most developed law in this area, and that in many countries all that a director or officer would be entitled to would be a look back after they've paid their own fees, gotten their own way along, and a judgment has been issued. Then everybody turns around and looks at it and says, "Well, were you really acting in good faith? Is it appropriate for the corporation to reimburse you for

legal fees or any judgment?” So, pay attention to your international officers and directors. That’s an interesting issue.

Now, why do we need fee advancement and indemnification? I think we all understand it, but there is often a misperception that it really is to protect the bad guys. And it’s not. It’s because we have seen an increase in lawsuits where they name not only the company, but the individual officers and directors. We’ve seen increased liability to the board of directors. And it’s fair to say that if you’re going to move in and take on substantial responsibility at a company, [with] Sarbanes-Oxley and all these other certifications, a lot of individual plaintiffs may turn around and say, “I think it’s beneficial to name the corporate governance. Whoever is responsible for corporate governance, I’m going to name.” It really just needs to be there for a reassurance, even for the good guys.

But frankly you can see a lot of abuse in it. Some of it is simply prejudging who’s entitled. Who is entitled is in the corporate documents in the employment agreements. Somebody runs in and say, “I know this guy. He’s not a good guy, he’s a bad apple. We’re letting him go. Don’t pay his fees.” You may have to stand your ground and say, “Whatever you think, this guy has an agreement.” If that individual has to sue in order to receive his fees, it’s called fees-on-fees. You have to pay his fees for suing you about paying his fees, so be careful.

There is a corporate waste factor, which is to say that if you don’t impose a reasonableness parameter on the bills—if you let them overflow—that could be a problem. It could also be a problem if you have conducted an internal investigation and you have what you consider to be very reliable proof that the person acted badly. Now, you are really going to be at risk because ordinarily you need a full and final determination on the merits before you can decline to advance someone’s legal fees. So, read your documents and see what they say, or you’re going to have to make a judgment call depending upon the evidence that is available to you as to whether you could be subject to a corporate waste argument.

All right, wholly owned subsidiaries [and] the directors and officers of those: Are they entitled? It really does depend. I think we’ve all seen this. We’re global companies. You have a subsidiary in Ireland. It requires three members on the board of directors, so you say, “Let’s take a couple of lawyers in the legal department and suddenly they’re the directors. Let’s take our infrastructure lawyer and let’s make him a director.” If they’re acting at the request of the parent company as a director, they’re going to be entitled to Delaware law. There’s case law out there that says that, basically, merely having the parent company control them, authorize them, vote them in means that they have been requested to serve in that capacity. That’s how they can get the advantage of Delaware law.

It is an interesting question I find whether the parent is obligated to inform the individual that they have these rights. The answer may be no, but it’d be interesting to see if you have someone overseas who’s behaved in a certain manner and they’re perfectly comfortable taking their country’s indemnification look-back, and they’re not aware that they might be entitled to Delaware coverage if they would just ask for it. So, that’s a question I’ll leave to you all.

Now, what can you do? Here we are; it's a real life situation. You're not going to rewrite your bylaws. You're not going to rewrite your charter. I think you can do a few things. One is: Create an internal program for processing the requests that come in, so that every time a request comes in it is treated consistently. You say, "Look, if you want your fees, here's what I need. I need for you to provide me with any and all of your employment agreements. I'm going to look at the charter. I'm going to figure out if fee advancement is mandatory or discretionary in this situation, and I'm going to handle it in the same manner every time."

You don't want to call it a policy, frankly. You don't want to create a policy. You may not have the rights to do that. They're set out in the corporate documents. The discretion lies with the board of directors; then you put something out there that you call a policy. If it does anything other than exactly mimic what's in the other documents, I think you're at risk of arguments that you've created more or additional or different rights. You want to be careful. What you say is, "The rights are as laid out in these other agreements. Here's how we process these requests."

The interplay with insurance coverage is another very interesting issue, because your D and O insurance may very well state that they will advance legal fees, but only if the company is either unable to pay or has declined to pay. So, you could wind up with a dispute with the insurance company, which is to say, "We're not required to pay this guy's fees. We're not going to pay this guy's fees." He goes to the insurance carrier and the carrier says, "Ha! Yes, you are. The company's required to pay these fees." So, just be aware of that.

The other thing is that the individuals are likely focused on the rights they believe are in the available corporate documents, their individual employment agreements, which, again, I would argue should not differ from the corporate documents, but it may. And that could look very different from what the insurance carrier is willing to cover. It's something to be aware of. Often with the carriers, they give no leeway essentially in terms of what they're willing to cover.

And here's the most unfortunate of all: If a company files for bankruptcy and is actually unable to pay the fees and declines, that individual may have very few options. If the insurance coverage doesn't kick in, the company is simply not available to meet any obligations for fee advancement or indemnification.

So, with that, I believe I've used my 15 minutes and I'd like to turn things over to Wally.

WALLY DIETZ: Thank you, Monica, and hello everybody. My name is Wally Dietz. I am a member of the law firm Bass, Berry & Sims. I work in our national office. Bass, Berry & Sims is the Tennessee Lex Mundi firm.

I just wanted to follow up with some case analysis of some of the principals that Monica touched on briefly. The first one I wanted to look into is: What happens with these indemnification provisions when the government is investigating the conduct of a company as a whole or the conduct of individuals who may be entitled to advancement of fees under an indemnification provision? This scenario could come up in various ways. It could come up as part of a Department of Justice investigation or an SEC investigation. It could come up with an OIG

investigation. And now many of the state's Attorney Generals are more and more active in pursuing their own investigation, so this comes up in lots of different dynamics.

And when it does, there is a certain tension here that often develops between the company as a whole and perhaps the interests of some of the individual officers and directors. In many cases, the company's primary objective is to figure out whether or not there is any exposure to the government, do an internal investigation, and then identify how they want to go forward with the government. I see this a lot in my practice. I do a lot of corporate governance cases [and] shareholder class action defense work, but also a fair number of internal investigations.

The company may start quickly going to the government to say, "Look, we want to cooperate. It'll be an open kimono. We'll tell you what we know." That may or may not be the company's position. But you may have individuals who might be in a slightly different posture [and] they may or may not wish to cooperate.

In terms of dealing with the Department of Justice, in particular the Department of Justice will issue a memorandum from time to time telling the corporations out there under what circumstances and what factors will be considered for a corporate entity to be indicted, as opposed to a prosecution of individuals. And again, these different memoranda have had different names, but one version of this DOJ memorandum was called the Thompson Memorandum, where part of it indicated that the government would look at whether or not the company was cooperating by looking at whether or not the company was advancing fees for individual targets or potential targets of the government investigation. It was the government's position that if the company helped these individuals "lawyer up," then that might be used against the company in terms of whether or not the company was, in fact, cooperating with a government investigation.

The case that we have referenced is the leading case on this, which is the *United States versus Stein*. That case involved an indictment of 13 partners at KPMG who allegedly were creating fraudulent tax shelters for clients of the company. Well, obviously, if you're KPMG, especially after what happened to Arthur Anderson, the last thing KPMG needed would be to have a corporate indictment. So, the government leaned heavily on KPMG not to advance fees or to limit fees. And in fact, KPMG did put a cap of \$400,000 on fees and other limitations. For instance, if an individual defendant was going to not cooperate or to take the Fifth Amendment, then it would potentially not advance fees. The partners filed a lawsuit saying that that was a violation of their constitutional rights.

In fact, the District Court in New York, Judge Kaplan, agreed that it was a violation of the Sixth Amendment and Fifth Amendment right; the Sixth Amendment right to counsel, the Fifth Amendment right of due process. That opinion was affirmed on appeal by the Second Circuit, where the court did not address the Fifth Amendment issue but did say that, essentially, the government was putting so much pressure on KPMG that these individuals were being deprived of their right of counsel. And part of that was determining, obviously, what sort of advancement and indemnification provisions were in effect. But the core ruling of the court is that prosecutors should not take into account whether or not corporation is advancing or reimbursing attorneys' fees to officers and directors who may be under investigation, and it's inappropriate for the

government even to make that request. And so, I think the aggressive government activity that many people thought was, frankly, egregious; we're in a different place than we were just a few years ago.

Turning again to follow up on a topic that Monica presented [which] is some issues that come up when you've got insurance coverage, and I suspect that's the case for most of you who are attending this webinar. It's been my experience with clients that there are issues that arise after the fact, after there has been, for instance, a lawsuit filed where individual officers or directors are named as defendants where the company, for the first time, figures out that, for instance, the insurance company may be able to approve or essentially call the shots on who was going to be representing the insured. Some insurance companies are more lenient than others, but that's something that, if you're representing a corporation, it's much better to figure out what your insurance company will do in those situations before you get in that situation. Some insurance companies require that, for instance, one of their panel counsel be approved. In other instances, that's not the case.

This is especially difficult in those cases where it may be possible for one law firm to represent if the company is named and you have individuals named as well. In certain situations, it may be determined that there's no conflict, at least at the beginning, and one counsel can be involved. Sometimes, it will involve the company not being able to use its normal counsel, based on who is on the insurance company's list. So, that's just something that a lot of companies do not focus on when they are negotiating policies because, frankly, where the strength of the insurance company and the cost of the premiums is a more important topic, but that is something that I would encourage you to look in to.

You also get into situations with the insurance policies where, depending on the policy, the advancement of fees may in fact erode your coverage. So that, if you have, for instance, a \$10 million policy and you have a lot of individual defendants, some of whom may need separate counsel, you can quickly begin to erode your policy limits, where obviously it's more beneficial to be able to use the policy limits in terms of trying to settle or resolve any claim than it is for it to be set up where the lawyers come in and take all the money.

Part of this situation involves lawyers who represent some of these individuals may feel like they've got essentially a green light to do whatever they need to do, even beyond what they might do for a typical client. It's like a cash cow. I've got this indemnification provision. I've got the insurance company backing it up. So, there is a tension that comes up which is why you have a lot of litigation over reasonableness fees incurred. Typically the only obligation for a company is to advance reasonable defense costs and you have a fair bit of litigation about that.

We wanted to highlight some recent Delaware cases. One is the *Under Break* case in Delaware, where the attorneys representing the individuals came in with a fee application for 63% of the fees they had incurred to date. The company said, "No, we only want to pay you 10%. We think your fees are too high, but also we only want to pay you 10% reserving until the end of the matter, whether or not all the fees are appropriate or whether or not the indemnified party is entitled to actual indemnification." In that case, the Delaware court said, "We do not want to get involved in monthly or quarterly fee disputes." They referred it to a special master and they

ended up “splitting the baby” a little bit by instead of paying the \$750,000 or \$795,000 that was requested, they paid \$375,000 and said, “We’re going to let you move on with the case.” So, the courts will look at reasonableness, but they really do not want to micromanage it on a monthly or quarterly basis.

One interesting thing of note: I think in the current economic crisis there are fewer people flying around first class, but the court specifically did not approve \$19,000 for first class airline tickets.

Now, if you look on the next slide, we talk about another couple of cases. One is the *Martinez versus Regent’s Financial Corp.* In that case, there was a very broad advancement provision, which essentially said that the indemnified individual was entitled to advancement as a result of any contest regardless of the outcome pertaining to an employment agreement or any other dispute in which the individual was a defendant. There was a change of control provision, where the executive was trying to collect benefits under a change of control provision, and the company in that case won summary judgment on several of the claims and said, “It’s not reasonable”—which is the standard they applied—“it’s not reasonable to reimburse all of these fees because we won summary judgment on several of the claims.” The court said, “As long as the claims were brought in good faith and you have such a broad indemnification clause, the fees were permissible.”

The next case is the *Duthie* case, which really stands for the proposition that you may have to change circumstances in the middle of a lawsuit, where claims that are subject to indemnification, such as claims for the individual who is on the defensive are subject to indemnification, but the court down the road said there were some changed circumstances due to the procedural posture. I won’t go into that detail, but under changed circumstances, you may lose your advancement right or your indemnification rights.

I want to quickly touch on some cases that deal with companies where there is a private equity owner or partial owner. The next slide addresses those. Essentially, where you have a private equity owner and an individual is entitled to indemnification, it may be that their portfolio company will be obligated to indemnify the directors, and there may be some sort of cost sharing benefit of that. I don’t want to dwell on that because that may not be your situation, but there are three cases that are in the materials; recent Delaware decisions dealing with private equity considerations.

And then, turning to the last point before I turn it back to Monica, in terms of litigation concerning reasonableness of fees, which is the next slide. Obviously, under the Delaware code, you’re only obligated as a company to advance or indemnify fees that are reasonably incurred. That’s for the ultimate indemnification. There is no similar limitation on advancement, but the courts really treat it as the same. The courts in Delaware are going to impose a reasonably incurred standard on advancement, as well as indemnification, figuring it’s essentially the same thing. There are guidelines in the Delaware rules for what’s reasonable.

And then, my last slide, which I will not go over but is in your materials, is the courts have developed a list of nonexclusive factors to be considered, and they are factors that you would

typically see in any fee award about the reasonableness of a fee. And all of those factors are highlighted in the next two slides. Now, I'll turn it back over to Monica.

MONICA PALKO: Thank you so much, Wally. For reasons of timing, let's go ahead and hold questions to the end. And I'll turn things over to Ron Davis and Mark Rogers.

RON DAVIS: This is Ron Davis, and Mark Rogers and I will be presenting the second half of the program, which deals with disclosure issues concerning the indemnification and D and O subjects that Monica and Wally have been talking about. I think they've done a great job of covering a lot of the issues that come up.

You might be wondering why is disclosure included in this Masters Litigation Series. I will tell you a little bit about me in terms of Womble Carlisle. We have a firm that stretches from Atlanta to Baltimore. I've been involved in different places within the firm for securities class action litigation and shareholder derivative actions.

With public companies, disclosure is a huge issue. You're in the middle of a very significant war, as I'm sure Monica could probably talk at more length about, but typically in this kind of situation what you have is you have an event, whatever the event is; [inaudible] EPS or there's something that has to be disclosed, and somehow that will get reported to the SEC, which starts the investigation, which leads to all of the class actions that are securities class actions that are filed. And under the former law, it was very important to file first in order for the plaintiffs to be lead counsel. Now it's sort of a different test, but you're probably going to get copycat or follow-on shareholder derivative actions, both in state and federal court. It can be in different forums while you're fighting let's say 16 class actions going on. Then, if there's any company stock in retirement plans or other benefit plans, you'll have a companion ERISA class action going on. And in the meantime, you've got the U.S. Attorney, probably in the background, who's taking notes or conducting an investigation, and then another regulatory body, like the Department of Labor, so you've got all of this going on at the same time. I don't call it death to the company litigation; it's really kill the company litigation. The issue is when you have all those different moving pieces and you're trying to coordinate it all as in-house counsel, how do you also manage what you have to disclose and when, pursuant to the securities laws?

Mark is going to address that right now. Mark?

MARK ROGERS: I am associate general counsel for Insight Enterprises. We're a Fortune 500 provider of IT hardware and software services in Tempe, Arizona. I've been practicing in-house for 10 years. Before that, I was a securities lawyer in private practice and had to bridge that gap between the securities and litigation management in practice over the last decade. So, as Ron said, we're trying to show that the disclosure of these items can be critically important, too, and how to work on them and work them through the disclosure process.

The first thing I'd say is that you want to work this issue through your disclosure process like any other disclosure that you've got to deal with. So, you probably have a disclosure committee, you'll have finance involved and maybe internal audit, legal compliance, tax, other members of

management that have a good view of the business, and you want to run that through that mill. We're going to show you how it comes out of the mill here in just a second.

The other thing that you want to keep in mind as you go through this is that you'll be working with your outside counsel for sure, but don't discount the importance of keeping your auditors up to date in understanding the disclosure and where you're going with it.

So, the first thing that we were going to do on the slide is say, from the securities lawyer point of view, just call out where these things are going to come up. Right? So, you will have seen from the slides there that in the 10-K, in the 10-Q, you'll have these under what's called "legal proceedings sections." There are different sections in the K and the Q, but they're all going to be based on the same item of regulation—that's K—which is the backbone for the integrator disclosure system. What item 103 calls for are disclosure of material legal procedures. These are material, so we'll pass on that. But then the required items are really fairly basic: the court or the agency, the date instituted, the principal parties, what's actually alleged, and the relief sought. But as you'll see—we'll go through a couple more slides about where it'll be and where it'll look—but some of the decisions get harder to make as you go along.

Turning to the next slide, you'll see the other places where this topic is going to come up and kind of populate your document are in management's discussion and analysis of the financial results. You'll see it sometimes in the risk factor. And again, in terms of working with the auditors and the financial people, it's going to come up in the notes to financial statements. And of course, some of these things are going to be exhibits to your filings as well. We'll also mention that, in terms of reporting, you have your annual reports, you have your quarterly reports, but there are times when you have to file an 8K, and that's a current report. That is going to come up one of two ways: When a director is coming or going, and when officers come and go as well, and then there's just a general category in item 8.01, and those are just other events. In the other events, we'll just look at a couple of things that come up in that context, but those are things that are material that you can't wait for your next quarterly or annual filing to cover.

Moving on, then, to the next slide, where we talk about what we call just overarching considerations and obligations. Of course, what you're trying to do here is meet the SEC's requirements: materiality in general, both in the terms of whether or not to disclose in the first instance and then in terms of deciding of well, what is it I've got to disclose? So, if you don't have something that really meets one of those items of required disclosure under Reg SK Item 103, you still may have an obligation to disclose it if it's material.

You also need to pay attention to the exchange rules where your stock is listed. You could have a series of events that trigger disclosure, and you're going to want to do that quickly. Technically speaking, the 8K won't be due for as much as four days after the occurrence of an event, but the exchanges are going to want you to get out there with information more quickly. And you probably want to in most cases as well, because if you do have material information and you sit on it for a couple of days and something further happens with the stock, then those two-day periods or three-day periods of nondisclosure can be revisited and questioned as well.

So Ron, if I set those kind of overall concerns aside, I want to turn it back to you for a second, and say I've been covering the securities lawyer perspective; what does a litigator want to see or what does a litigator not want to see if they're defending one of these things in disclosure?

RON DAVIS: What I want to see is as little as possible. What you said and was contained on slide 22: Just the facts, ma'am. The court, the date instituted, the allegations, and the complaint, the relief sought. What I do not want to see is an opinion from you as a securities lawyer that a loss is probable, because that's going to give me a lot of heartburn. I'm going to get that waved in my face a lot, and I may even get a motion for partial summary judgment based on what you filed.

When we were looking through different examples, Mark and I found, unfortunately, an example where something like that had happened. Not only had the disclosure been indicated that a loss was probable, the disclosure indicated that the company had evaluated the amount of the loss and had created a reserve on the books for that loss, typically on the defense side. If I was a plaintiff's lawyer, I would look at that and start salivating.

MARK ROGERS: You'd probably want to take some additional depositions too.

RON DAVIS: I think I would notice up deposition pretty quickly and find out what the reserve was.

MARK ROGERS: Back to 10-K and 10-Q, the legal proceedings section. One of the things that I think will be material—we had just looked back to slide 22 for the required items and Ron has just told us that we want to see as little as possible—but we still have this materiality obligation. I think we need to figure out: Is there coverage? Has the claim been tendered to carriers? Is there a response from the carrier? What kind of position are they taking on the matter?

Ron, it occurs to me here that one of the things that often is not disclosed in great detail, but what is sort of buried in the information or implicit in it, is that there's actually different types of coverage. In some of the examples we'll look at later, we'll talk about that in more detail. If you could take a minute on the types of coverage, I think that would be helpful.

RON DAVIS: Sure. This is not on slide 24, but it basically deals with the information that we're talking about—coverage—and when we see later slides, we'll see examples of disclosure of some of these types of problems. I know that we have people listening who are probably D and O experts and know these policies inside and out, but I want to take about three minutes and just give the people who are not as familiar with D and O insurance just a little primer on that.

If you hear about D and O policies, first of all, they're very negotiable. When you go out on the market, you're going to find that it's not like a homeowner's policy or an auto policy that's regulated by the state. In North Carolina, for example, we have a standard policy for a homeowner's policy. For a D and O it's going to be whatever you negotiate with that particular carrier. But you will typically see three types of coverage: You'll hear the words side A, side B, side C, and when you really get into it with the brokers and the insurance guys and they start throwing these things around, it sort of makes your head spin. But just to boil it down: side A is

coverage that directly benefits the directors and officers individually for a loss that is made for a claim. You know, they have those little extended definitions of claim, extended definitions of loss, but it directly benefits the directors and officers.

You do have the issue that Monica brought up of is the obligation on the part of the carrier to advance the fees and pay the fees as they go along, or do they have to wait until the final adjudication. You might wonder: Why is there this need for a direct benefit to the directors and officers when there may already be significant indemnification protection for those Ds and Os? For example, there are some states that limit or even historically had invalidated the indemnification of Ds and Os by the company. In addition, the company may go into bankruptcy. It may not be available to indemnify the Ds and Os. Or, if the company is small and has limited resources, it may not be able to provide the coverage to attract the Ds and Os that it wants. Finally, I think Monica alluded to this: The coverage under the policy may be broader than the bylaws or the other corporate documents allow for. Side A is obviously the most important to the Ds and Os.

Side B ensures the company for monies it has to pay or is required to pay or chooses to pay to defend or indemnify the Ds and Os for alleged wrongdoing. That is a benefit to the company. You get in the same issue of: Is it advancing fees or is it a reimbursement after the company has already paid the money to the Ds and Os? This was added in the 1970s, because before D and O insurance really didn't benefit the company. It just benefited the Ds and Os directly.

Side C coverage—you'll hear us call it entity coverage—it insures the company. It typically covers securities claim, and that's broadly defined. It may include even broader coverage than that, for example, things like employment claims. D and O policies are claims-made policies. As Wally pointed out, they're typically wasting policy, so that any defense costs are defined as loss to produce the amount of coverage.

There are a lot of different exceptions, exclusions, and limitations on coverage. I wanted to just talk about a few real quick. There's an insurer versus insured exception. You'll hear about that, which has been coming more into play because plaintiffs under the Reform Act will use confidential witnesses and if one of those witnesses is a former director or officer, then there's been arguments by carriers that that constitutes an insurer versus insured exception.

There is deliberate fraud. For example, if there is fraud in the application, then a carrier might try to rescind the coverage. In North Carolina, for example, our law is that a fault material misrepresentation is enough for a rescission. It doesn't even have to be intentional. You would think fraud would require intent, but it can be an unintentional representation.

One of the practice pointers I think is to have as many people as you can review that application—CEO, CFO, risk manager, or GC—to make sure that it's correct, because if there is an issue down the road and an attempt by the carrier to rescind, you want to make sure that everything in the application is correct.

There are some D and O policies that do not cover regulatory proceedings, like Wally talked about SEC proceedings. There are severability issues, where obviously you want severability

because you want coverage for the CEO if he didn't know about something that the CFO did know about.

And then, perhaps most important to this audience, there is a fairly typical exception for in-house attorneys. Maybe you'd be surprised, [but] if you have an in-house counsel who is also a director or officer, there are lots of issues about whether there is D and O coverage. The reason is because of the dual roles that in-house counsel play both in the business setting and then also in the professional legal setting. And so, there's typically a professional services liability exception, and you may even have your professional malpractice carrier and your D and O carrier pointing fingers at each other saying, "No, the lawyer was acting as a lawyer," and the other one saying, "No, he was acting in his role as a director." There are some good articles in *Corporate Counsel* if you want to read about that. They have entertaining titles like "Naked and Nervous" and "Cover Me," but that is an area that I would say you need to pay particular attention to when you're negotiating your D and O coverage. Make sure that there is specific coverage for the in-house counsel if he is serving as a director or officer, regardless of whether he is also rendering professional services to the company.

MARK ROGERS: Thanks, Ron. On the slide you've all got up now, you'll see how, in the ordinary course—this is an example of disclosure when there is not anything pending. This is just stuff that's going to come up in the ordinary course. If we go on to slide 26, the first example is an example pulled from notes to a company's financial statements. This is an area where the disclosure really brings together the finance and the legal team, because these kinds of notes are what [are] required for the financial statements. It's outside the regular text of the disclosure document. It's more with the numbers folks, generally.

This one is calling out I think something interesting, and it goes to what Ron was just talking about in terms of what kind of coverage is being discussed here, again, without calling out the side A, side B, side C language. So, Ron, what does it look what we've got here?

RON DAVIS: We figured this was a side B example. What's going on is this is called an interim funding agreement. It's basically the carrier and the company insurers are sort of postponing their fights over coverage for a later date. You can see that the company is disclosing that they are entitled to recover these fees and they have already been paid over \$2 million, but they enter into this agreement with the carrier, so that, depending on a final determination later down the road, if it's not a loss, then they're going to repay the money to the carrier. Btu, for now, they're going to fight the current fight and they're going to postpone the issue of coverage. It's basically like a huge reservation of rights agreement just so that the funds can keep rolling to fight the war.

MARK ROGERS: Yeah. I think Monica covered slide 27, really, with her comments, so Monica, if you wouldn't mind advancing us all the way to slide 28. This is where we kind of make our transition from where you're going to find this disclosure to what it's going to look like. These are both pulled from 8Ks, item 801 of 8K. These are things that have come up between periods, between the quarterly and annual reporting period, which were material enough to call out here on the interim thing. Again, this was put together at least within four days, so you really need to be ready for that because you can't do that quickly with all the people that you've got to get signed off on this.

Ron, why don't we take a quick look at the second bullet on the partial settlement here? What's the carrier trying to point out?

RON DAVIS: I think what we wanted to point out there to everybody was that if you're settling, in this situation where this disclosure shows that they are settling, the carrier is getting out. They're going to pay the money; they're going to get out. They don't want to have any continuing obligations. And if you happen to be representing a D or an O in this kind of situation—we're the only one with in-house counsel so that's probably not the situation—but you're going to be supervising and paying or at least dealing with counsel for the Ds and Os. The carrier is going to be expected and the company is going to be expecting the Ds and Os to relinquish their rights under insurance policies or under their indemnification rights. And that's what they're trying to reflect in this disclosure.

MARK ROGERS: Good. Thanks. The first item that we call one of the harder decisions to make relates to derivative litigation. On slide 29 on the bottom, there's one thing that I wanted to call out actually. I'll take one of Ron's points for him. He talked about the insured versus insured exclusion. That is actually not raised necessarily by the derivative-style setting. The other thing that I wanted to call out here is this language in red, where the company believes that the suits are without merit and will vigorously defend against it.

This was curious disclosure for me because, again, these are derivative actions; these are the company's claims. You here have the company, presumably with in-house counsel, saying that they believe the suits are without merit and will vigorously defend against it. And, I think, if that were to have continued, again, you'll see this settled, that could have had odd implications and not good ones for a demand futility motion. I also questioned if they hadn't done some big investigation and had more to say about it, how they really could have known that the suits didn't have any merit. Usually, you'd say, "Oh, well, we'll form a committee. We'll look into it," etc. The other thing to note here is that it was a pretty small case. They were able to get out early and really get out for just reimbursement of fees.

If we turn now to [slide] 30, we'll go through the example in the classic litigation very quickly because we'll just call up that sometimes your disclosure is going to need to refer to your auditors, or former auditors, as the case may be, and that can be uncomfortable, but if they're part of the case, they're part of the case. The interesting thing to me here is that the auditors have appeared not to have settled yet on this one. Otherwise, I'd say this is a good summary, good disclosure and really just called out the basics pretty nicely without making a tough situation more difficult by disclosing too little or too much.

If we jump on to [slide] 31, this is an interesting one, actually. It's litigation regarding indemnification. Most of the slides were anonymized, but if I told you about a \$2.9 billion judgment against a former director in the health care industry, I think you would have gotten it anyway. But this one traces nicely the arbitration, the result, and it just puts fees aside in escrow pending the decision, which goes back to one of the topics earlier in the deck about the need to keep advancing the defense counsel along the way. The other thing that it does a really good job of, I think, is that, once it's determined that they don't have to continue covering these, they walked that all the way through the financial segments. Ron, anything there?

RON DAVIS: No, I thought that was exactly the point and it sort of reinforces what Monica was saying about once there's a final adjudication—if there is an adjudication like there was here of fraud or breach of fiduciary duties—then under those circumstances he's not going to get indemnified.

MARK ROGERS: We have a few more slides and wouldn't be able to get to all of them. I think if we call out what they are. Slide 33 would walk you through what it looks like when there is a rescission claim, and they're called the counterclaim or a separate suit for a declaration of coverage. It might be worth pausing, Ron, with last comments from you on the insurer action on the exclusion, which is slide 34. If you want to walk through that insured versus insured that was covered a little bit earlier.

RON DAVIS: I think we're just about through, but on 33 and 34, these are very interesting disclosures to us. This 33 is WorldCom, and the director here sued first, so even though the carrier tried to invalidate coverage, you see, at the end of the day, the preliminary injunction was granted requiring the insurer to go ahead and pay the defense costs as they were incurred. That's pretty much the state of the law right now, is that the carrier has to do that. They can try and get out of it, but they pretty much have to go ahead and do it for now until there's been a resolution.

This disclosure on 34, just real quick, is unusual in that it's a shareholder derivative action, but the thing is on this one, the plaintiffs included a former director. A lot of times on the D and O policies they cover current directors, former directors, current officers, former officers, so this is an example, if you look down at the bottom, the company insurance carriers denied coverage with respect to the claims contained in the Delaware Action based on the the insured vs. insured exclusion. That's because in this case the plaintiffs, who were suing on behalf of the company, included as a named plaintiff a former director, and he was covered as an insured under the policy. So, this is an example of the carrier going back to the company and saying, "Well, sorry you got sued, but one of your former directors who is insured is one of the plaintiffs, and you're on the other side of the V—the current directors—and so there's no coverage."

The last one we have is on page 35. It's called litigation with former auditors. If you get into the Adelphia, the Deloitte, the Rigas' family relationships, it's very complicated, but this involved bankruptcy issues too which brings into question whether the policy is actually owned by the bankruptcy trustee, and whether the trustee acting on behalf of the company is in sort of an insured versus insured if he's suing directors. In this case, it looks like the Rigas sort of cut a deal as they were exiting Adelphia that was fairly advantageous to them, and the company was sort of stuck trying to capture that in a disclosure.

I think that's all my comments on that slide and I think that's our last slide, Mark.

MARK ROGERS: Yes, it is, thanks.

RON DAVIS: So, Monica, back to you.

MONICA PALKO: It's about two minutes after three. I'm not sure if we have time for a short question. I've been advised that it's very important to CLE that we fill the full 60 minutes with

the subject matter. So, let's go ahead and pose a quick question to Ron and Mark regarding disclosure. Is there potential exposure if a company discloses a grim proposition? Everyone talks about where we're putting forth these rosy expectations. What if the company says, "Look, we think we may have to restate revenue," then in the next filing they say, "No, as it turns out we were just fine; we didn't have to do that." Is there exposure there?

MARK ROGERS: I think so. I think you'd be in to this suit by the time you had your next filing, because what usually happens is the 8K requirement for a decision that you may have to restate will have to be made very promptly. And again, that's a great example, in fact, of the difference between the 8K requirements, which give you up to four days, but the fact [is] that you don't actually even want one trading day to elapse between that decision and the release. I think the way companies try and manage that is to very carefully work up to a decision that there may have to be a statement which, in that careful work, would include the 8K requirement, but in all likelihood, if you're going to have any stock drop, you're going to have it as soon as that 8K goes out and you're going to want to do that in not more than a trading day in between the decision and the announcement, rather than taking the four days that 8K gives you. But Ron, tell me if you disagree, but I think you're in the soup already.

RON DAVIS: I think you're exactly right. I wouldn't want to ever be there. That's why I just like the facts. I'm not sure we're going to paint a rosy picture, we're just going to paint an accurate but as minimal-worded picture as possible.

MONICA PALKO: That's very helpful because I think many people have the impression that the disclosures need to sort of reveal all of the bad news, but I find that companies are starting to have issues with being over prudent in their disclosures and finding that an inaccurate grim prediction is just as bad as an inaccurate rosy one.

MARK ROGERS: I think that's good counsel.

MONICA PALKO: We need to go ahead and close. I want to thank everyone for signing on [and] remind everyone that there's another Master Series on December 10, Arbitration and Global Litigation Issues. I want to thank all of our speakers, Wally Dietz, Ron Davis, and Mark Rogers. I hope that you'll turn to Wally Dietz and Ron Davis of Bass, Berry & Sims and Womble Carlisle respectively as sponsors of this program should you have any future needs. With that, I'll send it back to Roberto for the second verification code.

[The CLE code and instructions provided here were for use only by attendees of the live webcast.]

ROBERTO SCALESE: On behalf of the Association of Corporate Counsel and SmartPros Legal and Ethics thank you again for listening to today's program. For those users who want to apply for CLE credit, please log back into your SmartPros account and click on the course listing in your My Courses page. Follow the directions there to enter the verification codes and print your certificates. This program is now concluded. Thank you again and have a great day.