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- “Chi-Town Smackdown! Reverse Auctioning, Common-Fund Haggling, and other Ethical Dilemmas Challenging Class Action Litigation and Settlements,” American Bar Association’s 14th Annual National Institute on Class Actions (October 2010)
- “Evaluating the Impact of Financial Institution Litigation on the D&O Market,” American Conference Institute’s 16th Annual Summit on D&O Liability (December 2010)
- “Hot Topics in Directors and Officers Liability,” PLUS Midwest Spring Education Event (June 2011)
- “What’s New in the Defense of Claims against Directors and Officers,” Crittenden Middle Market Accounts Insurance Conference (September 2011)
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CLAIMS AGAINST CHINA-BASED REVERSE MERGER COMPANIES: A TEMPEST IN A TEAPOT OF GUNPOWDER OR GREEN TEA?

INTRODUCTION

These days, nearly everything to do with China has grabbed the spotlight – not least of all the country’s extraordinary and seemingly unstoppable economic growth. Not surprisingly, many U.S. investors have been pouring millions of dollars into Chinese companies with the hopes of gaining super-sized returns. However, naysayers have long predicted a bursting of the China bubble. At least for investors in China-based issuers, perhaps that time is now. Not unlike the bursting of the Internet bubble in the 1990s fueled by explosive growth and investment in “dot.com” companies, investors and regulators may now have reason to fear the rapid rise and fall of Chinese companies that have accessed U.S. capital markets through reverse mergers. While short-sellers are publicly denouncing the purported fraud at these companies (and making big bucks shorting the stock), U.S. regulators are investigating the rash of accounting scandals at these companies, which have caused some auditors to abruptly resign. Meanwhile, directors and officers (D&O) insurers have to contend with the collateral damage resulting from the multitude of claims against China-based issuers and their directors and officers.

This article highlights the following topics involving Chinese reverse merger companies:

- Public Company Accounting Oversight Board (PCAOB) Research Note on Chinese reverse mergers
- Securities and Exchange Commission (SEC) investigation of China-based issuers and their auditors
- NASDAQ’s proposed new listing requirements for reverse merger companies
- SEC Investor Bulletin on reverse merger companies
- Moody’s “Red Flags” report on China-based companies
- D&O insurance coverage issues for claims against China-based issuers

PCAOB ISSUES A REPORT ON CHINA REVERSE MERGERS

On March 14, 2011, the PCAOB issued a report examining the audit implications for reverse mergers involving China-based companies.1 As explained in the PCAOB report, a reverse merger is an acquisition of a private operating company by a public shell company (a non-trading firm often listed on a stock exchange). While the public shell company is the surviving entity, the private company’s shareholders typically control the surviving company or hold publicly traded shares in the company. A perceived benefit of a reverse merger is that it enables a company to become an SEC reporting company with registered securities without having to file a registration statement under U.S. federal securities laws.

The PCAOB report identified 159 companies from China that accessed the U.S. capital markets in a reverse merger transaction from 2007 through March 2010, representing 26 percent of all reverse mergers during the period. Reportedly, the market capitalization of these companies was $12.8 billion as compared with a $27.2 billion market cap of the 56 Chinese companies that completed initial public offerings in the United States during that same period.

Reverse merger entities listed on U.S. exchanges are required to file audited financial statements with the SEC, and the auditors of the financial statements are required to be registered with the PCAOB. According to the PCAOB, U.S. firms audited 116 or 74 percent of the China-based reverse merger companies, while Chinese registered accounting firms audited 38 or 25 percent of these companies. The PCAOB report raises concerns that some U.S. firms are not conducting proper audits of China-based companies, including handing off the audit work to a local Chinese accounting firm without verifying the accuracy of the results. The PCAOB has identified various “key considerations” to determine the appropriate level of oversight of firms that perform audits of foreign companies with the aid of assistants outside the firm, including (1) the ability to supervise outside assistants, (2) whether the outside assistants have appropriate language skills and (3) whether the auditor would have the ability to comply with the PCAOB’s documentation requirements.

**SEC LAUNCHES INVESTIGATION OF CHINA-BASED ISSUERS AND AUDITORS**

In response to a congressional inquiry by House Representative Patrick T. McHenry, chairman of the Committee on Oversight and Government Reform, SEC Chairman Mary L. Schapiro issued a letter on April 27, 2011, seeking to assure Congress and the public that the SEC “has moved aggressively to protect investors from the risks that may be posed by certain foreign-based companies listed on U.S. exchanges” – particularly those companies based in China. As SEC Chairman Schapiro noted in her letter, there has been a recent marked increase in China-based companies listed on U.S. exchanges through the process of a reverse merger.

Last summer, the SEC reportedly launched a “proactive risk-based inquiry into U.S. audit firms” that have a significant number of issuer clients based outside the United States. Among other things, the SEC has requested that auditors provide information concerning the firms’ compliance with U.S. audit standards for foreign-based reverse merger companies based in China. Since the SEC launched its investigation, dozens of China-based companies have disclosed auditor resignations and accounting problems. Since February 2011, Big Four accounting firms have resigned or been dismissed from at least seven Chinese companies listed in the United States. These auditors have reportedly experienced difficulty obtaining independent bank confirmations of a company’s bank accounts, balances and transactions. In at least one case, the auditor purportedly received false information directly from the bank, prompting the auditor to resign.

In an effort to protect U.S. investors, the SEC has reportedly suspended trading in several China-based reverse merger entities. In addition, the SEC has revoked the securities registration of many other China-based reverse merger companies. In some instances, the SEC is also pursuing these companies’

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2 April 27, 2011, letter from SEC Chairman Mary L. Schapiro to the Honorable Patrick T. McHenry, Chairman, Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, and Committee on Oversight and Government Reform.
3 The Wall Street Journal, “Challenges Auditing Chinese Firms” by Dinny McMahon and Michael Rapoport (July 12, 2011).
5 Id.
auditors for improper audits. As the SEC Chairman observed, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) has enhanced the SEC’s ability to obtain audit documentation in connection with its investigations of issuers based in China and other countries.

**NASDAQ PROPOSES NEW LISTING REQUIREMENTS FOR REVERSE MERGERS**

On June 8, 2011, the NASDAQ filed proposed rules with the SEC to adopt additional listing requirements for companies that become public through a reverse merger. Under the proposed rules, a company that is formed by a reverse merger shall be eligible to submit an application for initial listing only if the combined entity can satisfy the following conditions:

- Traded for at least six months in the U.S. over-the-counter market, on another national securities exchange or on a foreign exchange following the filing of all audited financial statements.
- Maintained a bid price of $4 or more per share for at least 30 of the most recent 60 trading days.
- In the case of a U.S. domestic issuer, the company has timely filed its two most recent financial statements (i.e., Form 10-Q or 10-K).
- In the case of a foreign-based issuer, the company timely files a comparable financial statement (i.e., Form 6-K, 20-F or 40-F) that includes an interim balance sheet and an income statement presented “in English.”

In support of its proposed enhanced listing requirements, the NASDAQ cited the “extraordinary level of public attention to listed companies that went public via a reverse merger” and “allegations of widespread fraudulent behavior by these companies, leading to concerns that their financial statements cannot be relied upon.” The NASDAQ believes that these new listing requirements will protect investors and “discourage inappropriate behavior” by companies.

**SEC ISSUES AN INVESTOR BULLETIN ON REVERSE MERGERS**

On June 9, 2011, the SEC issued a bulletin cautioning investors of the potential pitfalls of investing in reverse merger companies. Among other things, the SEC observed that many reverse merger companies (RMCs) “either fail or struggle to remain viable following a reverse merger”; there have been instances of fraud and other abuses involving RMCs; and some RMCs have been using smaller U.S. auditing firms that may not have sufficient resources to conduct adequate overseas audits. The SEC bulletin also cited recent examples where it suspended trading of RMCs due to accounting irregularities and/or revoked the securities registrations of RMCs due to the companies’ failure to timely file required periodic financial statements.

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To address investors’ increasing concerns with the quality of financial reporting from publicly listed Chinese companies, on July 11, 2011, Moody’s credit rating agency issued a “Red Flags” report for China-based companies. The report examines 20 red flags grouped into five categories that identify possible governance or accounting risks for China-based companies, including:

1. Weaknesses in corporate governance: short track record of operations and listing history, murky shareholders' background, large and frequent related-party transactions.
2. Riskier or more opaque business models: unusually high margins compared with peers, concentration of customers, complicated business structures.
3. Fast-growing-business strategies: very rapid expansion, big capital investments resulting in large negative free cash flow and intangible assets.
4. Poorer quality of earnings or cash flow: discrepancy between cash flows and accounting profits, disjointed relationship between growth in assets and revenues, large swings in working capital, insufficient tax paid compared with reported profits.
5. Concerns over auditors and quality of financial statements: a switch in auditing firm or legal jurisdiction of auditor’s office, delay in reporting, adverse comments from auditors.

Moody’s applied its red flags analytical framework to 61 rated Chinese companies. According to Moody’s report, due to the rapid growth of Chinese companies, nearly all Chinese high-yield issuers tripped red flags related to aggressive business and financial strategies and quality of earnings. Moody’s observed that fast-growing companies put pressure on managerial and financial resources. Additionally, these companies may make large capital investments that could negatively impact cash flow for a prolonged period of time. Also, due to the prevalence of strong founding families, many Chinese companies tripped the red flag for concentration of family ownership, which may reflect weaknesses in corporate governance. Moody’s also noted the so-called arm’s-length related-party transactions were not always transparent. Interestingly, according to Moody’s report, concerns over auditors arose less frequently compared with other red flags.

Meanwhile, short-sellers are wreaking havoc on China-based issuers’ stock and publicly accusing these companies of fraud. In several instances, detailed reports issued by short-sellers have triggered a wave of internal investigations, investigations by regulators and shareholder litigation against companies. While some companies have gone to lengths to deny the often unsubstantiated accusations by short-sellers, the damage is done when the investors get spooked and the company’s stock price spirals downward.

All of the negative publicity has impacted Chinese companies across the board, regardless of whether specific allegations of fraud have been asserted. Where investors were once rushing to dump huge sums of money into any business with ties to China, they are now rushing to liquidate their stock holdings at the slightest sign of trouble. The fallout has had a devastating impact on the number of reverse merger
transactions of Chinese companies. Not surprisingly, some Chinese companies have postponed plans to sell shares in the United States, either through reverse mergers or initial public offerings. Compared with 47 reverse merger transactions in the first half of 2010, there have been only 29 for the first half of 2011. At least for now, Chinese companies are no longer the darlings of Wall Street.

THE RISE OF SHAREHOLDER LITIGATION

Approximately 30 shareholder suits were filed in the first half of 2011 against China-based companies listed on U.S. exchanges and the companies’ directors and officers. On the surface, many of these suits are classic securities class actions alleging securities fraud and violations of section 10(b) of the Securities Exchange Act of 1934 for materially false and misleading financial statements and related derivative actions. However, suits against China-based companies may pose unique hurdles and added expense for the defense of shareholder claims in the United States. For one thing, many or most of the individual defendants, corporate documents and key witnesses may reside in China. Moreover, testimony and documents may need to be translated from Chinese to English. These circumstances can cause defense costs to escalate rapidly. Also, given the current regulatory climate and increased suspicion of China-based issuers, a company may also be the subject of parallel proceedings or investigations by the SEC and other regulators. In some situations, a company's board may simultaneously launch an internal investigation – particularly if the company's outside auditor abruptly resigns without issuing a clean audit opinion. That could trigger a wave of management departures, putting added strain on the company's already stretched resources.

DIRECTORS AND OFFICERS INSURANCE COVERAGE ISSUES

Claims against China-based issuers and their directors and officers may raise a host of coverage issues under traditional D&O liability insurance policies, including, but not limited to:

- Reasonable and necessary defense costs
- Coverage for parallel proceedings and investigations
- Rescission
- Known claim exclusion
- Fraud and personal profit exclusions
- Severability of the policy exclusions and application.

D&O policy limits for public companies are typically eroded by defense costs. This may occur more rapidly in suits against Chinese companies in light of the complexities of transnational discovery. Therefore, it is in the interests of D&O insurers and insureds alike to make certain that these claims are being defended with maximum efficiency to minimize the possibility that the D&O insurance is significantly impaired or even exhausted by defense costs alone. While many large defense firms now have outposts in China, it is still imperative to gain an understanding of the anticipated division of labor between the U.S.-based lead defense attorneys and their colleagues in China with respect to discovery,

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document collection, witness interviews and other matters. Additionally, there should be an objective assessment to determine whether it is cheaper and more efficient to outsource certain discovery-related tasks such as collection and translation of documents.

Shareholder litigation against Chinese companies may spawn multiple parallel proceedings and investigations by the government, regulators, the board, a special litigation committee and others. A key issue is whether such investigations constitute covered claims or securities claims under the D&O policy. Historically, many D&O policies narrowly limited the availability of coverage for investigations, such as formal investigations by the SEC commenced by service of a subpoena on a director or officer. However, in the past few years, some D&O policies began to offer enhanced coverage, including coverage for both formal and informal investigations by regulators. Now, the definition of a securities claim is less standard and may contain many subtle, yet critical nuances impacting coverage. Not surprisingly, there has been a significant amount of litigation and reported decisions with respect to coverage for investigations under D&O policies. However, many of these decisions are fact-specific and driven by now-obsolete D&O policy language and definitions that continue to evolve.

On July 1, 2011, the Second Circuit Court of Appeals issued an opinion in MBIA, Inc. v. Federal Ins. Co., 2011 U.S. App. LEXIS 13402 (Second Cir.) that sets forth a comprehensive analysis of coverage for various investigations under a D&O policy. In that case, the policy definition of a covered securities claim included “a formal or informal administrative or regulatory proceeding or inquiry commenced by the filing of a notice of charges, formal or informal investigative order or similar document.”

First, the Second Circuit held that investigations commenced by the SEC and the New York Attorney General (NYAG) were covered under the policy definition of a securities claim. The Court observed that the issuance of a subpoena by the NYAG was, at a minimum, a “similar document” related to a “formal or informal investigative order.” The court also opined that requests for information by the SEC pursuant to oral requests and subpoenas were covered because they were connected to the SEC’s formal order of investigation. The court also concluded that fees incurred by an independent consultant retained by MBIA in the context of negotiating a settlement with the SEC and NYAG were also covered.

Second, the Second Circuit concluded that legal fees incurred by MBIA's Special Litigation Committee (SLC) to determine whether to pursue or terminate pending shareholder derivative actions were covered and did not clearly fall within the policy's sub-limit of liability for shareholder derivative demands. Prior to the filing of the derivative actions, a shareholder demand on MBIA's board had been made and ultimately rejected. After the shareholder derivative suits were filed, the SLC sought and obtained dismissal of the lawsuits. The Second Circuit determined that the legal fees incurred by the SLC arguably fell within the policy's coverage for “costs ‘incurred in...investigating’ ‘Claims’ or ‘Securities Claims,’ respectively, each of which is defined to expressly include lawsuits.” The Second Circuit also determined that the insurer had failed to carry its burden of proving that the SLC's legal fees were not covered under the policy definition of loss, which excluded “any amount incurred by [MBIA] (including its board of directors or any committee of the board of directors) in connection with the investigation or evaluation of any Claim or potential Claim by or on behalf of [MBIA].”
To the extent claims against China-based issuers and their directors and officers allege accounting improprieties and false and misleading financial statements, D&O insurers might have a potential rescission argument if the policy were issued in reliance on these false financials. In some instances, D&O policies and/or applications contain a known-claim exclusion, which might serve as a basis for denying coverage if an insured knew and/or failed to disclose a fact, circumstance, act, error or omission that might give rise to a claim under the policy. Also, standard D&O policies contain fraud and personal profit exclusions that might apply; however, these exclusions are usually restricted to a finding “in fact” or “final adjudication” that the insured committed fraud or unlawfully profited. In addition, both the application and the exclusions might be “severable,” such that the knowledge or wrongful acts of one insured cannot automatically be imputed to other insureds except in limited situations.

CONCLUSION

Some might conclude that the spotlight on China-based reverse merger companies is merely a tempest in a teapot, as compared to the global financial crisis precipitated by the subprime market meltdown and collapse of numerous financial institutions at home and abroad. Nonetheless, the reality is that many China-based issuers have been targeted by regulators and investors alike for purported securities and accounting fraud that could ultimately cost D&O insurers millions in losses. At least for now, this trend seems to be gaining traction. Until the pot is done brewing and the tea leaves are read, D&O insurers should tread carefully in handling claims against their China-based issuers.
D&O INSURERS BE AWARE: U.K. BRIBERY ACT TAKES EFFECT ON JULY 1

On March 30, 2011, the U.K. Ministry of Justice (MOJ) issued long-anticipated Guidance on the Bribery Act, providing an overview of the four key offenses under the statute and six guiding principles to prevent bribery in violation of the Act.

This article discusses the following issues related to the Bribery Act:

- Four key offenses under the Act
- Imputation of bribery offenses by persons associated with the company
- Six guiding principles for implementing effective anti-bribery policies and procedures
- Potential coverage issues under D&O policies for investigations and proceedings under the Act

FOUR KEY OFFENSES UNDER THE ACT

As discussed below, the key offenses under the Bribery Act include (1) active bribery or offering bribes (Section 1), (2) passive bribery or accepting bribes (Section 2), (3) bribery of a foreign public official (Section 6) and (4) a company’s failure to prevent bribery (Section 7).

Sections 1, 2 and 6 apply with respect to acts of bribery that take place in the U.K., or if the person committing the offense has a “close connection” to the U.K., such as a British citizen, resident of the U.K. or entity incorporated under the laws of any part of the U.K. A company may also be liable under Sections 1, 2 or 6 if the offense was committed by or with the consent of a company’s senior officer. Section 7 applies to companies that are incorporated or formed in the U.K. or “carry on business” in the U.K., regardless of whether the bribery occurred in the U.K. or elsewhere.

ACTIVE AND PASSIVE BRIBERY

Section 1 of the Bribery Act prohibits “active bribery” and makes it an offense for a person to offer, promise or give “financial or other advantage” to another person with the intent to induce “improper performance” of a relevant function or activity. Section 2 of the Bribery Act is the flip side of Section 1 and prohibits “passive bribery.” Section 2 makes it an offense for a person to accept or receive a financial or other advantage intended to induce or reward improper performance by the recipient or some other person. According to the MOJ’s Guidance, improper performance means “performance which amounts to a breach of an expectation that a person will act in good faith, impartially, or in accordance with a position of trust.”

In the introduction to the MOJ’s Guidance, Kenneth Clarke, U.K. Secretary State for Justice, seeks to assuage businesses that the parameters of the Act are not intended to prohibit reasonable client development activities: “Rest assured...no one wants to stop firms getting to know their clients by taking them to events like Wimbledon or the Grand Prix.” Moreover, the Guidance itself suggests that “an invitation to attend a Six Nations match at Twickenham as part of a public relations exercise designed to cement good relations or enhance knowledge in the organisation’s field is extremely unlikely to engage section 1.” However, more lavish hospitality intended as a *quid pro quo* to induce favorable treatment in a pending business deal (i.e., to get new business, keep business or get some other business
advantage) could be subject to greater scrutiny under the Act. The test is what a “reasonable person” in the U.K. would expect under the circumstances, and whether the prosecution can demonstrate evidence of intent to induce improper performance as defined by the Act.

BRIBERY OF FOREIGN OFFICIALS

Section 6 of the Bribery Act, which resembles the anti-bribery provisions in the FCPA (Foreign Corrupt Practices Act), prohibits the bribery of a foreign public official. As explained in the MOJ’s Guidance, an offense is committed when a person offers, promises or gives a foreign public official a financial or other advantage with the intent of (1) influencing the official in the performance of his or her official duties and (2) obtaining or retaining business or other advantage in the conduct of business by offering the bribe. A foreign official includes any person who performs public functions in any branch of national, local or municipal government in any country or territory outside the U.K. An example in the MOJ’s Guidance of a permissible transaction with foreign officials is a U.K. mining company’s offer to pay for reasonable travel and accommodation to enable the foreign officials to inspect the standard and safety of the company’s distant mining operations. In contrast, an offer to pay the foreign officials’ “five-star holiday” in an unrelated destination is questionable.

FAILURE TO PREVENT BRIBERY

Section 7 of the Bribery Act creates a new offense for corporate liability for failing to prevent bribery in the first instance. Under this section of the Act, a company will be liable if a person associated with it bribes another person with the intention of obtaining or retaining business or other advantage. Liability under this section applies to “relevant commercial organizations,” which include (1) entities incorporated or formed in the U.K., regardless of whether the entity conducts business in the U.K., and (2) entities that “carry on business” in the U.K., regardless of the place of incorporation or formation. The Act does not define the term “carry on business,” and the MOJ’s Guidance merely states that this interpretation is subject to a “common sense approach.” While the MOJ notes that the courts are the final arbiter of this determination, the government does not expect that companies merely listed on the London Stock Exchange without a “demonstrable business presence” in the U.K. are subject to liability under Section 7 of the Act.

IMPUTATION OF ACTS BY ASSOCIATED PERSONS

Corporate liability under Section 7 of the Act may be established through bribery conducted by “associated persons,” which broadly encompasses any person or entity that “performs services” for the company. An associated person may include the company’s employees, agents, subsidiaries or any other party that performs services for or on behalf of the company regardless of the “capacity” in which such services are performed. Significantly, this may include the company’s suppliers (that do more than merely sell goods) and direct contractors (as opposed to subcontractors). As a result, there is an increased burden on companies to examine their supply chain and external business relationships with third parties for potential risk of bribery and imputation of corporate liability under the Act.
SIX GUIDING PRINCIPLES

The MOJ has identified six “guiding principles” to assist companies in adopting effective policies and procedures to prevent bribery. If a company can demonstrate that it has adequate anti-bribery procedures in place, this could be a complete defense to violation of Section 7 of the Bribery Act. These guiding principles are as follows.

PROPORTIONALITY

The company's anti-bribery policies and procedures should be “proportionate” to the size of the company and the perceived risks it faces. The procedures should be designed to mitigate identified risks and prevent deliberate unethical conduct on the part of associated persons.

TOP-LEVEL COMMITMENT

The message of zero tolerance for bribery should be adopted, implemented and communicated by individuals at the highest levels of the organization, such as the board of directors.

RISK ASSESSMENT

The company should periodically assess and document its perceived exposure to internal and external risks of bribery, including an analysis of bribery risk in the markets in which it conducts business (for country risk, sector risk, transaction risk and business opportunity risk) and risk presented by various business partners/associates.

DUE DILIGENCE

The company should conduct appropriate due diligence either internally or by external consultants prior to hiring and engaging other persons, third-party intermediaries, agents or business partners/associates to represent the company in its business dealings.

COMMUNICATION

The company's anti-bribery policies and procedures should be communicated internally to staff and employees and externally to all business partners/associates that perform services for the company. Such communications may be made orally, in writing and/or through training sessions.

MONITORING AND REVIEW

The company should periodically evaluate its anti-bribery policies and procedures for effectiveness in light of changing business or political environments that may increase the company's bribery risk in certain markets. These periodic reviews may be conducted through special internal systems, such as internal financial control mechanisms, staff surveys, formal reviews by top-level management and/or external verification of the effectiveness of the company’s anti-bribery procedures.

It is important to recognize that the MOJ’s guidelines for anti-bribery policies and procedures are not “prescriptive” and there is no “one size fits all” approach that applies to all companies.
POTENTIAL COVERAGE ISSUES UNDER D&O POLICIES

These days, D&O policies routinely afford “worldwide” coverage, including coverage for foreign (non-U.S.) proceedings against a company’s foreign subsidiaries and directors and officers of these subsidiaries. Therefore, U.S. companies that do business in the U.K. and have subsidiaries, directors and officers, employees or agents in the U.K. may be subject to violations of the Bribery Act. D&O insurers would be well advised to consider the potential coverage implications under their policies for claims and investigations under the Bribery Act.

Potential coverage issues that might arise under D&O policies for Bribery Act violations, investigations and proceedings – some of which are discussed here – include, but are not necessarily limited to:

- Coverage for investigations
- Covered claims against a D&O policy versus uncovered claims against the company
- Identifying the insured subsidiaries and their directors and officers
- Allocation of defense costs
- Coverage for collateral litigation arising from Bribery Act violations
- Dishonesty and personal profit exclusions
- Coverage for fines and penalties

COVERAGE FOR INVESTIGATIONS

Initially, it is important to consider whether a government investigation for potential violations of the Bribery Act gives rise to an insurer’s obligation to pay or advance the insured’s legal fees and expenses under a D&O policy. Like FCPA investigations, investigation costs for Bribery Act violations could be substantial – potentially exceeding millions of dollars. Consider, for example, an ongoing FCPA investigation of the world’s largest direct seller of products to women in more than 100 countries. The company reportedly spent $96 million in 2010 and $35 million in 2009 for legal fees related to its FCPA investigation.

COVERED CLAIMS AGAINST A D&O POLICY

Coverage for investigations under D&O policies has evolved dramatically in recent years. In some instances, the D&O policy definition of a claim has expanded to encompass investigations of directors and officers by various government or regulatory authorities. Some D&O policies only afford coverage for formal investigations if a director or officer is served with a “subpoena” or identified as a “target” of an investigation by a governmental investigative authority. More recently, some insurers have expanded coverage to include informal investigations of directors and officers, which do not require the issuance of a subpoena. Such informal investigations may include a voluntary request for production of documents, interviews or testimony. This year, for the first time, a new generation of D&O coverage affords entity coverage for investigations “of the company.” However, entity coverage for investigations under these newest policies may be limited to claims for violations of securities laws and/or expressly exclude FCPA and Bribery Act claims. Thus, it is critical to analyze the specific policy wording to determine the scope of coverage for investigations.
Undoubtedly, there are numerous cases finding both in favor of and against coverage for investigations under D&O policies. This is a fact-sensitive analysis dictated in part by the precise policy wording and the circumstances surrounding the investigation.

For instance, a number of courts have held that subpoenas and/or Civil Investigative Orders issued by the SEC, DOJ or other government authorities are covered claims under a D&O policy – particularly where the definition of a claim expressly includes an “investigative order.” In *MBIA, Inc. v. Federal Ins. Co.*, 2009 U.S. Dist. LEXIS 124335 (S.D.N.Y. 2009), the court held that subpoenas issued by the SEC and New York Attorney General in connection with their investigations of MBIA constituted a Securities Claim, which was defined as “a formal or informal administrative or regulatory proceeding or inquiry commenced by the filing of a notice of charges, formal or informal investigative order or similar document.” The court rejected the insurer’s argument that a subpoena was not an investigative “order.” At a minimum, the subpoenas were “similar documents” that triggered coverage under the policies.

In *Ace American Ins. Co. v. Ascend One Corp.*, 570 F.Supp.2d 789 (D. Maryland 2008), the court held that an administrative subpoena issued by the Maryland Attorney General and a Civil Investigative Demand issued by the Texas Attorney General constituted a Claim, which was defined by the policy as “a civil, administrative or regulatory investigation against any Insured commenced by the filing of a notice of charges, investigative order or similar document.” The court also rejected the Insured’s argument that the subpoena and Investigative Demand failed to allege a Wrongful Act. The Court observed that the offices of the Maryland and Texas Attorneys General were investigating violations of their respective state Consumer Protection Acts in connection with the company’s business activities.

In *National Stock Exchange v. Federal Ins. Co.*, 2007 U.S. Dist. LEXIS 23876 (N.D. Ill. 2007), the court held that an SEC investigation commenced by a formal order of investigation was a Claim under the policy. In that case, the definition of a Claim included “a formal administrative or regulatory proceeding commenced by the filing of a notice of charges, formal investigative order or similar document.” It was undisputed that the SEC issued an order directing a private investigation and designating officers to take testimony. The court rejected the insurer’s argument that the SEC investigation was not a Claim “against an Insured Person for a Wrongful Act.” The court observed that the scope of the SEC’s investigation included the company and its directors and officers for possible violations of securities laws.

In contrast, other cases have held that government investigations are not a Claim under a D&O policy. In *Office Depot, Inc. v. National Union Fire Ins. Co.*, 734 F. Supp. 2d 1304 (S.D. Fla. 2010), the court held that the D&O insurer was not liable to pay legal fees and costs incurred by the company in connection with (1) the SEC’s investigation or (2) the company’s internal investigation by its audit committee. *First*, the court opined that the SEC investigation was not a covered Securities Claim against the company since the definition expressly excluded “an administrative or regulatory proceeding against...or investigation” of the company. *Second*, the court concluded that the SEC investigation was not a Claim against an Insured Person (D&O). The definition of a Claim included “a civil, criminal, administrative or regulatory proceeding” or “investigation...commenced by service of a subpoena” or identifying an Insured Person in writing as the target of an investigation. Here, however, the SEC investigation was
directed to the company – not to an Insured Person. The SEC’s formal order of investigation did not identify any specific D&Os or any specific wrongdoing by any of the D&Os. Third, the court found that the insurer was not liable for the company’s internal investigation because they were not a covered “loss” “arising from” a Claim or Securities Claim. Instead, the internal investigation, which preceded subsequent shareholder suits, was triggered by a whistleblower complaint regarding various accounting irregularities. Fourth, the court observed that the internal investigation costs did not “result solely from investigation or defense” of a covered Claim as contemplated by the policy definition of Defense Costs. The court held that the insurer was not liable for the legal fees and costs incurred by the company in response to (1) the SEC informal inquiry, (2) SEC formal investigation prior to the issuance of a subpoena or Wells Notice (a notification from a regulator that it intends to recommend that enforcement proceedings be commenced) on an Insured Person or (3) internal investigation by the audit committee.

In *Diamond Glass Companies, Inc. v. Twin City Fire Ins. Co.*, 2008 U.S. Dist. LEXIS 86752 (S.D.N.Y. 2008), the court held that expenses incurred by the insured in responding to a federal grand jury investigation were not covered under the insured’s D&O policy. In that case, the court opined that the investigation was not a “criminal proceeding...commenced by the return of an indictment, filing of a notice of charges, or similar document” as defined by the policy. The court observed that there was no claim against an individual insured because the policy expressly stated that the individual must receive “written notice from an investigating authority specifically identifying such Insured Person as a target against whom formal charges may be commenced.”

Of course, if prosecutors ultimately sue any directors or officers for violations of the Bribery Act, such a legal proceeding might be covered if the D&O policy broadly defines a Claim to include any civil, criminal, administrative or regulatory proceeding. On the other hand, if the company alone is the subject of a legal proceeding for violation of Section 7 of the Bribery Act, this may not constitute a covered Claim. Under many D&O policies, entity coverage is limited to a Securities Claim against the company, such as a lawsuit by shareholders in connection with the purchase or sale of the company’s securities. Such a narrow definition of Securities Claim may not apply to a company sued for violations of the Bribery Act to the extent the bribery does not involve a violation of securities laws, does not arise out of the purchase or sale of a company’s securities or is not brought by a company’s shareholders.

**IDENTIFYING THE INSURED**

It is also critical to determine whether an “insured” is the subject of an investigation. Many D&O policies offer worldwide coverage for a company, its subsidiaries and their directors and officers. However, a subsidiary is a defined term that may be limited to entities in which the company owns a specified percentage of the subsidiary’s stock. Consider, for example, a company that has an overseas U.K. affiliate in which it owns 40 percent of the voting stock. That affiliate and its directors and officers are the subject of an investigation or proceeding for violations of the Bribery Act. However, if the D&O policy only affords coverage to subsidiaries in which the company owns 50 percent or more of the voting stock, then the affiliate and its directors and officers are not insureds.
**ALLOCATION OF DEFENSE COSTS**

However, if both a covered subsidiary and one of its officers are sued for violations of the Bribery Act, this could give rise to a covered claim against the subsidiary’s officer and an uncovered claim against the company (assuming the policy does not afford entity coverage for investigations). In that event, the insurer may need to seek an allocation of covered defense costs (for the officer) versus uncovered defense costs (for the company). Some D&O policies contain express allocation language that states that the parties will make a reasonable effort to arrive at a fair allocation for covered versus uncovered defense costs; and, in the event of a dispute, the insurer will advance those amounts it determines are covered until the coverage dispute is ultimately resolved by negotiation, arbitration, litigation, mediation or otherwise.

**COVERAGE FOR COLLATERAL LITIGATION**

It is possible that Bribery Act violations may spur collateral litigation against a company and/or its directors and officers by shareholders, employees, customers, competitors or other third parties. By comparison, FCPA violations have prompted a number of shareholder suits in the U.S. that may give rise to a covered Securities Claim. In addition, in the case of multinational corporations, Bribery Act investigations by U.K. authorities might provoke similar investigations or legal proceedings by foreign governments or U.S. authorities under the FCPA or other anti-bribery laws. Many D&O policies are “claims made and reported policies,” which means a claim is covered if it is first made during the policy period and timely reported to the insurer. When there is a chain of bribery-related investigations or legal proceedings, potential coverage issues include the date the initial bribery claim was first made (and reported) and whether subsequent bribery claims are deemed to be related to the initial claim, such that they are all covered under a single policy period.

**DISHONESTY AND PERSONAL PROFIT EXCLUSIONS**

Common exclusions in D&O policies include the fraud, dishonesty and personal profit exclusions. These exclusions might be implicated if an insured is found to have engaged in intentional misconduct or unlawfully profited from his wrongdoing. Often, however, such exclusions are subject to a final adverse adjudication establishing that the insured engaged in such wrongdoing. In addition, such exclusions may be “severable,” such that the wrongful acts of one insured cannot be imputed to another for purposes of triggering an exclusion.

**COVERAGE FOR FINES AND PenALTIES**

Companies and individuals may be subject to imprisonment and/or fines for violations of the Bribery Act. As a general rule, most D&O policies do not afford coverage for fines or penalties. However, some D&O policies now afford very limited coverage for fines imposed under the FCPA. Thus, it is possible that similar coverage for limited fines or penalties might be offered for Bribery Act violations in the future.
BUSINESS PLANNING IN THE NEW ENVIRONMENT

Without a doubt, governments are demonstrating increasing intolerance of bribery in the corporate world by both individuals and companies. To date, the Bribery Act far surpasses other anti-bribery laws, including the FCPA, in identifying the breadth of unacceptable business practices that are subject to prosecution in both the private and public sectors. U.K. enforcement authorities have emphasized the strong public policy rationale for adopting the Act’s stringent measures, which are designed to encourage “free and fair competition,” and have outright rejected the notion of greasing the wheels of commerce by so-called facilitation payments, which are considered commonplace in some parts of the world. If the rigorous enforcement and prosecution of FCPA violations in the U.S. has caused companies concern, the Bribery Act might possibly signal just cause for companies to scrutinize and re-think their transnational business activities to avoid future claims, prosecution and legal expenses for potential violations of the Bribery Act.
NEW FDIC LAWSUITS ATTACK FORMER BANK D&OS

Many financial industry insiders and their insurers have been wondering where the Federal Deposit Insurance Corporation (FDIC) has been during the recent financial industry meltdown. As the appointed receiver of failed banks that are federally insured, the FDIC is expected to be at the forefront of litigation against the directors and officers (D&Os) of failed financial institutions.

A recent spate of lawsuits against bank D&Os suggests that the FDIC might be back in lawsuit mode. This is not surprising, since the FDIC has already paid out nearly $9 billion to cover losses for failed banks and expects to pay out $21.5 billion more in the next few years. Clearly, the FDIC will be looking for sources to defray this expense in light of the negative $7.4 billion balance for the FDIC’s deposit-insurance fund.1

Now that the FDIC has captured the limelight once again, more lawsuits are expected to follow, resulting in increased liability exposure for bank D&Os and possibly their insurers. Given the high stakes, banks and D&O insurers should be aware of:

- The FDIC’s role as receiver of failed banks
- The current state of FDIC lawsuits and the nature of claims against bank D&Os
- Potential insurance coverage issues for FDIC claims against bank D&Os
- FDIC’s Oversight and Investigation of Failed Banks
- As receiver, the FDIC has broad statutory powers to investigate and bring claims on behalf of the failed bank against its former D&Os for civil monetary damages based on breaches of fiduciary duty, gross negligence and/or negligence.

THE FDIC APPOINTED RECEIVER

When a federally insured bank fails, the FDIC is appointed as the bank’s receiver by the appropriate state or federal regulatory agency determined by the bank’s charter.2 Because the FDIC proceedings are not governed by U.S. bankruptcy laws, a bankruptcy court does not appoint the FDIC as a receiver of a failed bank.

The FDIC’s role as a receiver of failed banks is prescribed by federal statute, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Under FIRREA, the FDIC, acting as a receiver, “succeeds to all rights, titles, powers, and privileges of the insured depository institution.”3 FIRREA expressly authorizes the FDIC, acting as a receiver, to prosecute claims on behalf of a failed bank against the bank’s directors and officers seeking monetary damages. “A director or officer of an insured

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1 The Wall Street Journal article, Tab Nears $9 Billion for Bank Failures (March 17, 2011).
2 The FDIC Resolutions Handbook may be viewed on the FDIC’s website at www.FDIC.gov. A depository institution’s charter determines which state or federal regulatory agency will appoint a conservator or receiver for a failing institution. For federal savings associations and national banks, the Office of Thrift Supervision and the Office of the Comptroller of the Currency, respectively, are the chartering authorities responsible for determining when the appointment of a receiver is necessary. The FDIC must be appointed as receiver for insured federal savings associations and national banks. For state chartered savings and loan associations or banks, the FDIC may accept appointment as receiver by the appropriate state regulatory authority, but it is not required to do so. In the case of state chartered banks that are members of the Federal Reserve System, the state banking authority may appoint the FDIC as receiver. In certain limited circumstances, the FDIC may appoint itself as receiver for a state chartered insured depository institution.
depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of the [FDIC], which action is prosecuted wholly or partially for the benefit of the [FDIC] acting as conservator or receiver of such institution.”

FDIC’S PRE-LAWSUIT INVESTIGATIONS

The FDIC typically conducts a pre-lawsuit investigation of the failed bank to evaluate whether it can bring a claim against the bank’s D&Os. Among other things, the FDIC looks for evidence of dishonest conduct, abusive insider transactions, violations of the bank’s internal policies and failure to establish, monitor or follow underwriting guidelines. Like the SEC, the FDIC has broad investigatory powers. It can subpoena documents and take depositions of D&Os. If the FDIC determines there is evidence of wrongdoing, the FDIC can issue a Demand Letter to a D&O for civil monetary damages. Often, the Demand Letter will contain allegations that the D&O breached his or her fiduciary duties to the bank. Savvy insurance coverage counsel for the FDIC may word Demand Letters in an effort to trigger coverage under a bank’s D&O policy, which may include an expanded definition of “claim” to include a “demand for monetary or non-monetary relief.”

Prior to filing suit against a bank’s D&Os, the FDIC must make two threshold determinations: First, the claim must be deemed “sound on its merits” and the receiver must be more than likely to succeed in any litigation to collect on the claim. Second, the litigation must be “cost effective” when taking into account liability insurance coverage and the personal assets of the D&Os. In other words, the aggressiveness of the FDIC in pursuing claims may be tempered by the economic realities of recovery.

According to the FDIC, most of its investigations are completed within 18 months from the time the institution is closed. The FDIC may attempt to settle, and likely prefers to settle, D&O claims prior to filing suit. This is not surprising given the time and expense of litigating such claims, not to mention the uncertain recovery. Absent a settlement, the statute of limitations on FDIC claims is typically three years for tort claims and six years for breach of contract claims, measured from the date a bank is closed. These deadlines could be extended if the state statute is longer.

FDIC CLAIMS AGAINST BANK D&OS

FIRREA authorizes the FDIC to assert claims against a bank’s directors and officers for “gross negligence,” including any similar conduct or conduct that demonstrates a greater disregard of the duty of care. To establish a claim against officers and directors of the bank under section 1821(k) of FIRREA, the FDIC must prove that: (1) each of the individual officers or directors was grossly negligent in approving the specific loans at issue; (2) these grossly negligent decisions were the proximate cause of

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4 12 U.S.C. §1821(k)(1)
5 Source: Review of Banking & Financial Services, Vol. 26, No. 7 (July 2010).
6 Id.
8 Id.
10 Id.
11 12 U.S.C. §1821(k)
losses to the bank without any intervening cause, and such losses were foreseeable at the time that the loans were made; and (3) the bank experienced actual losses (not simply an accounting write-off) as a result.\(^{12}\)

The FDIC has explained the “duty of care” of bank directors and officers to act as “prudent and diligent business persons”:

This means that directors are responsible for selecting, monitoring, and evaluating competent management; establishing business strategies and policies; monitoring and assessing the progress of business operations; establishing and monitoring adherence to policies and procedures required by statute, regulation, and principles of safety and soundness; and for making business decisions on the basis of fully informed and meaningful deliberation.

Officers are responsible for running the day to day operations of the institution in compliance with applicable laws, rules, and regulations and the principles of safety and soundness. This responsibility includes implementing appropriate policies and business objectives.

Directors must require and management must provide the directors with timely and ample information to discharge board responsibilities. Directors also are responsible for requiring management to respond promptly to supervisory criticism. Open and honest communication between the board and management of the bank and the regulators is extremely important.\(^{13}\)

The FDIC also has acknowledged the distinction between “inside” and “outside” directors for purposes of bringing suit. Unlike an outside director, the FDIC notes that an “inside director is generally an officer of the institution, or a member of the control group. An inside director generally has greater knowledge of and direct day to day responsibility for the management of the institution” than an outside director.\(^{14}\) This distinction between inside and outside directors is not lost on the D&O insurance market, which now affords separate coverage for outside directors so their policy limits are not eroded by insider directors or officers, who often face greater liability exposure.

Notwithstanding the “gross negligence” standard under FIRREA, the FDIC also may assert claims for simple negligence where state law permits. As the U.S. Supreme Court has explained, the federal statute’s gross negligence standard only provides a “floor” for liability of directors and officers and “does not stand in the way of a stricter standard that the laws of some states provide.”\(^{15}\)

Bank officers and directors may also be subject to claims for statutory violations and/or administrative actions under section 1818 of FIRREA.\(^{16}\) Under this section, the FDIC may seek to impose civil monetary penalties, as distinct from civil money damages, on officers and directors of a bank.

\(^{12}\) 12 U.S.C. §1821(k)
\(^{13}\) See FDIC’s Statement of Policy Concerning the Responsibilities of Bank Directors and Officers found at www.fdic.gov/regulations/laws/rules/5000-3300.html.
\(^{14}\) Id.
CURRENT FDIC LAWSUITS AGAINST BANK D&OS

From July 2010 through March 2011, the FDIC filed five lawsuits against former bank D&Os for breaches of fiduciary duty and other common law claims, collectively seeking millions of dollars in monetary damages for bank loan losses. Two emerging trends in the recent FDIC lawsuits include (1) a focus on imprudent commercial (versus residential) real estate loans and (2) cases in which regulators previously warned bank D&Os of risky lending practices, as reflected in written Reports of Examination issued by bank examiners.

FDIC v. INDYMAC BANK D&OS

The first of the FDIC lawsuits was filed on July 2, 2010, in California federal court against the former D&Os of IndyMac Bank (IndyMac). The IndyMac complaint is unique in light of the sheer volume of the allegations, which comprise more than 300 pages focused on the bank’s Homebuilder Division (HBD). The IndyMac complaint contains 68 separate counts against the D&Os for negligence and breaches of duty in connection with the underwriting, administration, extension and modification of numerous HBD loans that resulted in losses exceeding $500 million. Each count of the complaint sets forth in great detail the specific terms of the loans at issue. The FDIC claims that IndyMac's losses stem from two significant departures from safe and sound banking practices. First, HBD’s management allegedly disregarded the division's credit policies and approved loans to borrowers who were not creditworthy and/or for projects that provided insufficient collateral. Second, HBD’s management purportedly continued to follow a strategy of growth in loan production with little regard for credit quality and with knowledge that a significant downturn in the market was imminent.

FDIC v. HERITAGE COMMUNITY BANK D&OS

On November 1, 2010, the FDIC filed suit in Illinois federal court against the former D&Os of Heritage Community Bank (Heritage) in connection with the bank's commercial real estate loan losses. The FDIC asserts claims against the Heritage D&Os for gross negligence under section 1821(k) of FIRREA and common law claims under Illinois law for negligence, gross negligence and breach of fiduciary duty. By way of relief, the FDIC seeks to recover losses of at least $20 million, including $11.075 million paid in dividends and incentive compensation.

According to the FDIC, Heritage and its D&Os:

- Had virtually no experience in commercial real estate lending
- Did not understand the risks inherent in such loans
- Failed to implement the most basic controls to mitigate risk
- Did not undertake meaningful underwriting and analysis of the economic viability of the underlying commercial projects

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17 FDIC v. Scott Van Dellen, et al., Case No. 10-cv-4915 in the United States District Court for the Central District of California.
18 The IndyMac D&Os have since answered the FDIC’s complaint, essentially denying the allegations contained therein.
20 The Heritage Bank D&Os have filed various motions to dismiss the FDIC’s claims, which are pending.
• Extended loans with excessive loan-to-value ratios
• Failed to monitor the progress of the commercial project
• Hired entry-level credit analysts with little or no banking experience
• Failed to set aside sufficient loan loss reserves
• Failed to heed warnings by regulators

In addition, the FDIC charged the D&Os with concealing from regulators and the public the rapidly deteriorating performance of commercial real estate loans on the bank's books. Meanwhile, the D&Os continued to approve generous dividends that were "upstreamed" to the bank's holding company and incentive compensation payments to themselves and others.

FDIC v. Integrity Bank D&Os

On January 14, 2011, the FDIC filed a complaint in Georgia federal court against former D&Os of Integrity Bank (Integrity), seeking money damages in excess of $70 million for the bank's commercial and residential loan losses that allegedly were caused by the D&Os’ breaches of fiduciary duties and negligence. The defendants include eight former Integrity D&Os who were also members of the bank's Director Loan Committee (DLC), which was specifically charged with maintaining responsibility for the bank’s overall credit function and setting lending limits. The FDIC alleges that the defendants delegated virtually all of their responsibilities over lending to low-level bank loan officers who had financial incentive to maximize loan volume at the risk of loan quality. The complaint also alleges that the D&Os ignored numerous warnings by bank regulators between 2003 and 2007 with respect to Integrity’s excessive concentration of commercial and residential acquisition, development and construction loans; lending limit violations; deficient underwriting practices; and negligent credit administration, as reflected in various Reports of Examination by regulators.

FDIC v. 1st Centennial Bank D&Os

Also on January 14, 2011, the FDIC filed suit against 14 former D&Os of 1st Centennial Bank (1st Centennial), seeking recovery of at least $26.8 million against defendants for common law negligence, breaches of fiduciary duty, breach of the duty to supervise and gross negligence under FIRREA. The FDIC contends that the D&Os recklessly implemented an unsustainable business model, pursuing rapid asset growth concentrated in high-risk loans in commercial real estate without having adequate credit administration and loan underwriting policies and practices to manage the risk. The FDIC claims that it previously warned that 1st Centennial’s exceedingly high levels of commercial loans for acquisition, development and construction posed potentially serious risk to the bank, but that these warnings went unheeded. In May 2004, the FDIC issued a Report of Examination recommending that 1st Centennial’s board and management undertake steps to mitigate the bank’s commercial real estate concentration risk. In April 2006 and again in February 2007, the FDIC issued subsequent reports, again warning that the high concentration of 1st Centennial’s real estate construction lending posed a serious risk.

21 FDIC v. Steven M. Skow, et al., Case No. 1:11-cv-00111 in the United States District Court for the Northern District of Georgia, Atlanta Division.
22 FDIC v. James R. Appleton, et. al., Case No. 2:11-cv-00476 in the United States District Court for the Central District of California, Western Division.
to the bank’s financial health. Purportedly, by mid-2007, the D&O’s knew that 1st Centennial’s high concentration of commercial real estate loans was unsustainable. Nonetheless, the D&Os allegedly continued to mask the bank’s mounting problems instead of curtailing lending, monitoring the existing loan portfolio, working out troubled loans and preserving the bank’s capital. Between February 2, 2006, and February 25, 2008, defendants supposedly approved 16 additional risky commercial loans that resulted in losses of $26.8 million.

**FDIC v. Corn Belt Bank & Trust D&Os**

On March 1, 2011, the FDIC filed suit in Illinois federal court against four former D&Os of Corn Belt Bank and Trust Company (Corn Belt), seeking to recover at least $10.4 million for defendants’ alleged negligence and gross negligence in connection with five risky commercial loans made to out-of-state, start-up businesses that were improperly underwritten and inadequately secured.\(^{23}\) The complaint alleges that the D&Os, who were members of the bank’s Loan Committee, failed to adequately inform themselves of the relevant risks and acted recklessly in approving the loans. The FDIC also contends that the D&O’s conduct was particularly egregious because they approved the loans after the bank’s examiners warned Corn Belt that it suffered from weak loan administration, faced risks posed by highly leveraged loan-to-value loans and faced excessive exposure from its concentrated loan portfolio. Allegedly, various Reports of Examination issued from 2003 through 2008 reflect that defendants failed to address recurring criticisms by Corn Belt’s examiners regarding imprudent lending.

**FDIC v. Washington Mutual Bank D&Os**

Most recently, on March 16, 2011, the FDIC filed suit in Washington federal court against three former officers of Washington Mutual Bank (WaMu), including its former chief executive officer, chief operating officer and president of the bank’s Home Loans Division. WaMu is cited as the largest multibillion-dollar bank failure in U.S. history. The FDIC’s complaint accuses the officers of negligence, gross negligence and breaches of fiduciary duties that purportedly caused the bank to lose billions of dollars. Defendants allegedly adopted an aggressive five-year plan dubbed the Higher Risk Lending Strategy to pursue growth through high-risk consumer home loans, including subprime loans and loans concentrated in two overheated housing markets: California and Florida. Defendants purportedly ignored repeated warnings from the bank’s risk managers of “payment shock” to borrowers resulting from adjustable-rate mortgages, the bank’s woefully inadequate technological infrastructure to monitor the growing volume of risky loans and the imminent bursting of the housing bubble. Instead of ramping up the bank’s risk management in light of its high-risk lending strategy, defendants allegedly marginalized the bank’s risk department and hired a chief risk officer with no experience in risk management for a bank.

According to the complaint, the bank’s central risk management function became little more than an advisory group without the ability to impose restraints on lending practices. Meanwhile, despite growing evidence of mounting losses attributed to these risky loans, defendants allegedly continued to pursue the aggressive lending strategy until the bank was placed into receivership. The FDIC also has sued

two of the bank defendants’ spouses for fraudulent transfer of personal assets purportedly intended to defraud creditors.\textsuperscript{24}

In reciting the FDIC’s allegations in these cases, we do not presume their accuracy, but they are illustrative of the FDIC’s theories of liability in the recent spate of bank D&O lawsuits.

**THE CONFINES OF D&O COVERAGE FOR FDIC CLAIMS**

FDIC investigations and lawsuits may give rise to a host of coverage issues under D&O policies, depending upon the given policy’s terms. Some common policy provisions include:

- Definition of “claim”
- Regulatory exclusion
- Professional liability/E&O exclusion
- Other insurance
- Insured v. insured exclusion
- Prior knowledge
- Prior notice

While other coverage issues may arise, these tend to be the most frequently litigated policy provisions.

**INVESTIGATION OR CLAIM?**

Initially, it is important to determine the extent to which coverage is afforded for “investigations,” since this can vary greatly from policy to policy, depending on the definition of a claim. Typical limitations on coverage for investigations may include investigations by certain regulators such as the U.S. Securities and Exchange Commission, company investigations resulting from a shareholder derivative demand, sub-limits of liability for pre-lawsuit investigations, service of a subpoena on a director or officer and written notice that a director or officer is a “target” of an investigation. Recognizing the potential need for coverage for investigations, some insurers have begun to offer special policies that are specifically designed to afford coverage for pre-lawsuit investigations. Some such policies are limited to costs incurred by the bank for any investigation, as opposed to legal fees incurred by individuals who are not indemnified by the bank. The latter situation might implicate A-side D&O policies specifically drafted to cover non-indemnifiable loss of directors and officers. Once again, however, this depends on the extent of coverage afforded for pre-lawsuit investigations and the definition of a covered “claim.”

**REGULATORY EXCLUSIONS**

During the savings and loan (S&L) crisis of the 1980s and 1990s, courts often upheld regulatory exclusions in D&O policies for claims by regulators against D&Os of failed banks and S&Ls. Since that time, regulatory exclusions have been less commonplace in D&O policies. It is possible that the recent

\textsuperscript{24} See FDIC v. Kerry K. Killinger, et. al., Case No. 2:11-cv-00459 in the United States District Court for the Western District of Washington.
global financial crisis triggered by residential and commercial subprime mortgage loans might cause resurgence in such regulatory exclusions, which can, of course, be drafted to specifically exclude from coverage claims by the FDIC.

**E&O COVERAGE**

It is not uncommon for banks and financial institutions to procure multiline coverages, including D&O and professional errors and omissions (E&O) coverage. While the allegations in the complaint are the starting point of a coverage analysis under such multiline policies, the broad definition of “wrongful acts” found in many D&O and E&O policies may overlap. Sometimes these coverages are afforded in a single policy with a single aggregate limit of liability underwritten by the same insurer(s). It is also possible that different retentions or deductibles apply to each type of claim. In other instances, the D&O and E&O coverages may consist of separate towers of insurance with separate policy limits underwritten by different insurance companies. In that case, a claim by the FDIC might theoretically implicate both the D&O and E&O insurance towers, which could lead to coverage disputes between the D&O and E&O carriers with respect to the availability of “other insurance” and possible allocation of loss and defense costs. Of course, the availability of coverage under either or both policies depends on the precise policy wording and the nature of the allegations asserted by the FDIC.

**INSURED V. INSURED**

The S&L crisis also brought about much coverage litigation over the Insured v. Insured (I v. I) exclusion typically found in D&O policies. Some courts held that the I v. I exclusion applies to claims by bank regulators, standing in the shoes of or on behalf of the bank, suing the bank’s D&Os. Other courts rejected this position, finding instead that claims by the FDIC fell squarely within the I v. I exclusion. A related coverage issue was whether claims by the FDIC fell within an exception (or carveout) to some I v. I exclusions for shareholder derivative claims. The rationale behind this argument was that the FDIC had the ability to pursue claims not only on behalf of the failed bank but also on behalf of the bank’s shareholders, creditors and depositors. Once again, there were S&L crisis cases on both sides on this issue.

Many modern D&O policies also have I v. I exclusions with broad carveouts that permit coverage for claims by a trustee, receiver, liquidator or other party; however, the wording can vary significantly from policy to policy. If, for example, the I v. I exclusion solely carves out (or allows) coverage for claims by a bankruptcy trustee, it would not literally apply to a claim by the FDIC. Ultimately, the application of the I v. I exclusion depends on the precise wording of that provision.

Another argument sometimes made by the FDIC and insureds is that the I v. I exclusion only applies to “collusive” lawsuits and does not apply to claims asserted by a bank’s regulators. The collusion argument is not black letter law and has been rejected by some courts.

**KNOWLEDGE AND NOTICE**

Other potential coverage defenses are “prior notice” and “prior knowledge” exclusions. D&O policies are typically claims-made and reported policies, and often contain prior-notice exclusion for matters
reported under a predecessor policy. In other words, if the insured gives an insurer notice of a claim or potential claim during a predecessor policy period, coverage is not afforded under the successor policy due to its “prior notice” clause.

The insurer could also deny coverage and/or seek to rescind the policy as to claims emanating from known wrongful acts that were not disclosed by the insured when applying for the policy. It is possible that more carriers might choose to scrutinize potential defenses based on the bank’s application for insurance, particularly if the FDIC alleges that it has previously warned the bank’s senior management of potential claims or losses due to risky underwriting and lending practices.

MORE FDIC LAWSUITS TO FOLLOW

While the FDIC has filed only a handful of D&O lawsuits during the current financial crisis, these might be the tip of the iceberg. More FDIC lawsuits seem certain to follow. Indeed, as of April 12, 2011, the FDIC had authorized suits against 187 directors and officers, with damage claims of approximately $3.77 billion. The FDIC also has authorized 11 fidelity bond, attorney malpractice and appraiser malpractice lawsuits. 25

On March 15, 2011, the board of directors for the FDIC approved a Notice of Proposed Rulemaking (NPR) to clarify its liquidation authority over failed banks and other financial companies under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act. 26 The NPR permits the FDIC as receiver to recoup or “claw back” compensation from those individuals deemed to be “substantially responsible” for the company’s financial condition. There is a presumption that a bank’s senior executives — including its chairman of the board, CEO, CFO and COO — are substantially responsible for the bank’s failure and could be forced to disgorge up to two years of compensation. 27

Without a doubt, the FDIC has many arrows in its quiver to attack D&Os of failed banks and will likely hone in on specific targets as the clock continues to run on the statute of limitations for claims against former bank executives.

27 Id.
A TICKING TIME BOMB: MORE FDIC LAWSUITS FILED AGAINST BANK D&OS AS THE STATUTE OF LIMITATIONS BEGINS TO RUN

In the past few months, the Federal Deposit Insurance Corporation (FDIC) has filed a host of new lawsuits against former directors and officers of banks seeking recovery of hundreds of millions of dollars. As of August 23, 2011, the FDIC reported that the number of financial institutions on its “problem list” was 865. In the six months of 2011, 48 FDIC-insured financial institutions failed. Twenty-two of these banks failed during the second quarter of 2011.1 As of August 4, 2011, the FDIC had authorized suits in connection with 30 failed banks against 266 individuals for D&O liability, with damage claims of at least $6.8 billion.2

This might be the tip of the iceberg. More FDIC lawsuits are likely to follow as the statute of limitations begins to run on the FDIC’s claims in its capacity as Receiver of countless failed financial institutions in the wake of the global financial credit crisis. As Receiver, the FDIC can assert claims against directors and officers for gross negligence under federal statute, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), breach of fiduciary duty, and simple negligence if state law permits. The FDIC has three years to assert tort claims and six years for breach of contract claims to file suit from the date a bank is closed. In most claims, the three-year statute likely applies.

Since May 2011, the FDIC has filed nearly half a dozen new lawsuits in Illinois, Georgia, California, and Arizona federal courts against former directors and officers of various failed banks, including Wheatland Bank, IndyMac, Haven Trust Bank, Silverton Bank, and First National Bank of Nevada.

As discussed below, all but one of these lawsuits assert claims against the directors and officers for negligence, gross negligence, and breach of fiduciary duty in connection with losses attributed to risky commercial real estate loans and/or non-traditional single family residential “Alt-A” loans. The complaints focus on individuals who served on the banks’ Loan Committee with ultimate authority to approve loans in excess of a certain dollar amount. In addition, some of the complaints allege that the individual defendants ignored repeated warnings by bank regulators regarding these risky loans that ultimately caused significant losses for the bank. In two instances, the FDIC has asserted or threatened claims against the banks’ D&O insurers for wrongful denial of coverage of the FDIC’s claims against the former bank directors and officers.

On May 5, 2011, the FDIC filed a First Amended Complaint in Illinois federal court against 10 former directors and officers of Wheatland Bank to recover over $22 million in losses the Bank suffered on certain commercial real estate (CRE) loans, including acquisition, developments, and construction (ADC) loans.3 The amended complaint asserts claims against each of these individuals for gross negligence, negligence, breach of fiduciary duty, and failure to supervise. Several of the named defendants were members of the bank’s Loan Committee which was responsible for approving loans.

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2 FDIC’s Professional Liability Lawsuits Update found at www.fdic.gov/bank/individual/failed/pls.
The FDIC alleges that the defendants recklessly implemented an unsustainable business model pursuing rapid asset growth concentrated on high-risk CRE loans without having adequate loan underwriting and credit administration practices to manage the risk. The FDIC also accuses defendants of routinely violating the bank’s loan policies and approving loans that had little chance of repayment. The bank also purportedly made loans to its favored shareholders and borrowers on preferential terms; and, after default, defendants failed to pursue the borrowers. Finally, the FDIC contends that the defendants repeatedly ignored warnings by bank regulators about the bank’s reckless lending practices.

On July 6, 2011, the FDIC as Receiver for IndyMac Bank filed a complaint in California asserting a single cause of action for negligence against IndyMac’s former CEO. This is the second lawsuit filed by the FDIC against IndyMac directors and officers. In this new lawsuit, the FDIC alleges that between April and October 2007, the CEO negligently permitted, presided over, and failed to suspend, limit, or stop the production of a pool of more than $10 billion in risky residential mortgage loans intended for sale by the bank into the secondary market. Purportedly, even while IndyMac continued to make these risky loans, the CEO knew that the secondary market for these types of loans was increasingly unstable, unpredictable, and illiquid due to the market’s increasing concerns about the credit quality of the loans. Eventually, when IndyMac was unable to offload these loans into the secondary market by the end of 2007, Indy Mac was allegedly forced to transfer these loans to its own investment portfolio and ultimately suffered losses in excess of $600 million.

On July 14, 2011, the FDIC as Receiver for Haven Trust Bank filed a complaint in Georgia against the bank’s former directors and officers. The complaint alleges that the defendants failed to engage in safe and sound banking practices. Instead, defendants purportedly implemented an unsustainable business model that pursued rapid asset growth concentrated in risky commercial real estate (CRE) loans without adequate internal controls, loan underwriting policies, and credit administration procedures. The complaint asserts claims against the individual defendants for negligence, statutory gross negligence, and breach of fiduciary duty. The FDIC seeks recovery in the amount of $40 million for losses that the bank allegedly suffered in connection with (i) high risk acquisition, development and construction (“ADC”) loans and other types of CRE loans; (ii) improper loans to insiders, and (iii) imprudent dividend payments upstreamed to the bank’s parent holding company.

On August 22, 2011, the FDIC as Receiver of Silverton Bank filed suit in Georgia federal court against the bank’s former directors and officers, including members of the bank’s Executive Loan Committee. The complaint asserts claims against the individual defendants for negligence, gross negligence, and breach of fiduciary duty. The FDIC’s suit seeks to recover damages in excess of $71 million for losses incurred by the bank. The FDIC characterizes the case as a “text book example of officers and directors of a

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4 FDIC, as Receiver for IndyMac Bank v. Michael Perry, Case No. 2:11-cv-05561 in the United States District Court for the Central District of California.
5 FDIC, as Receiver for Haven Trust Bank v. Edward Briscoe, et al., Case No. 1:11-cv-02303 in the United States District Court for the Northern District of Georgia.
financial institution being asleep at the wheel and robotically voting for approval of transactions without exercising any business judgment in doing so.” The FDIC further notes that the bank's directors were not merely “ordinary businessmen.” To the contrary, they allegedly possessed superior knowledge and skills since they were all CEOs and presidents of other community banks.

Interestingly, the FDIC has also named the bank’s D&O insurers as defendants in the same lawsuit, and asserts a claim against them for declaratory relief with respect to coverage under the D&O policies. The FDIC argues that the insurers have wrongfully denied coverage for the FDIC’s claims against Silverton Bank’s directors and officers pursuant to the Insured v. Insured Exclusion and the Regulatory Exclusion in the D&O policies.

Most recently, on August 23, 2011, the FDIC as Receiver for the First National Bank of Nevada filed suit in Arizona against the bank’s former president and CEO and one of its directors.7 Like the other FDIC suits, the complaint asserts causes of action for negligence, gross negligence and breach of fiduciary duty by the individual defendants and seeks to recover $193 million in damages suffered by the bank. According to the complaint, the FDIC’s claims are based on the creation of a Wholesale Mortgage Division within the bank. This division was allegedly formed for the express purpose of purchasing and marketing billions of dollars of non-traditional single family residence mortgage loans commonly referred to as “Alt-A loans.” The FDIC claims that the bank sacrificed safety and soundness in favor of specializing in non-traditional loans characterized by a lack of proper underwriting, no verification of income or assets by the borrowers, and terms that effectively guaranteed high default rates. While these risky Alt-A loans returned near-term record profits for the bank, the FDIC contends that these same loans produced losses once the real estate market softened and ultimately caused the bank to fail. The FDIC accuses the defendants of promoting the growth of the Wholesale Mortgage Division long after they knew or should have known that the Alt-A loans made by the bank created a substantial risk of harm to the bank.

Notably, on September 2, 2011, the parties in the First National Bank case filed a Joint Motion for Entry of Judgment whereby the two individual defendants have each stipulated to an entry of judgment against them in the amount of $20 million (per defendant). The director and officer defendants have also agreed to assign their rights under their D&O policies to the FDIC to collect on the stipulated judgments. The motion states in part that the bank’s D&O insurer wrongfully denied coverage for the FDIC’s claims and refused to defend the lawsuit against the bank’s directors and officers. In Arizona, if an insurer has refused to defend a claim, it has no right to contest the stipulated damages on the basis of “reasonableness.” Instead, the insurer can only contest the settlement on the basis of fraud or collusion. In other words, there is a presumption of reasonableness with respect to any underlying settlement by the insured when the insurer refuses to defend the claim. This type of settlement is commonly referred to as a “Damron Agreement” in Arizona.8 It remains to be seen whether the bank's D&O insurer is successful in its coverage defenses and/or overturning the settlement on the basis of fraud or collusion.

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Given the number of failed FDIC-insured banks and the sizeable aggregate losses in the billions of dollars, more lawsuits against former bank directors and officers are certain to follow as the statute of limitations continues to run on the FDIC’s claims. The parties in several of the FDIC’s earlier lawsuits have filed motions to dismiss, many of which have been fully briefed and awaiting decisions by the courts. Meanwhile, it appears that the FDIC lawsuits may also give rise to coverage litigation under bank D&O policies, particularly with respect to the application of the Insured v. Insured Exclusion and the Regulatory Exclusion – both of which were heavily litigated during the prior Savings & Loan crisis of 1980s and early 1990s. For now, however, it is too earlier to tell who will be the winners.
IMPACT OF DODD-FRANK ACT ON D&O LIABILITY: CORPORATE GOVERNANCE, COMPENSATION, CLAW-BACKS AND MORE

Recently enacted sweeping financial legislation embodied in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) creates new concerns for directors and officers of all public companies – not just financial institutions. D&Os will be subject to heightened public and regulatory scrutiny in connection with corporate governance and executive compensation. Broad disclosure requirements regarding executive pay, coupled with potentially enormous financial incentives to corporate whistleblowers, could lead to increased liability exposure for D&Os and their insurers.

Key provisions in the Act that D&O insurers should be aware of include:

- Accountability and executive compensation
- Whistle-blower protections
- Enhanced aiding and abetting liability

SHAREHOLDERS’ SAY ON EXECUTIVE PAY

The provisions in the Act likely to cause the most angst among D&Os of publicly traded companies are Sections 951 and 953, which set new requirements regarding executive compensation. Section 951 of the Act states that executive compensation must be disclosed in a separate resolution subject to shareholder vote. Section 953 of the Act requires companies to disclose the relationship between executive compensation actually paid and the financial performance of the company. Moreover, in the context of a merger or acquisition, companies are required to disclose in the proxy or consent solicitation materials for the transaction all executive compensation in the form of “golden parachutes” that are also subject to shareholder vote. This includes all agreements with executive officers concerning any type of compensation (whether current, deferred, or contingent) that relates to the merger, acquisition, consolidation, sale, or other disposition of assets of the company. The disclosures must also include all conditions under which the so-called golden parachutes may be paid or become payable to the executive officer.

Section 951 of the Act also imposes new requirements for establishing an Independent Compensation Committee of a company’s board of directors. The Act identifies various factors to consider in determining a board member’s “independence,” including: (1) any sources of compensation the board member receives from the company – including any consulting, advisory, or other compensatory fees; and (2) whether the board member is affiliated with the company, a subsidiary of the company, or any affiliates of a subsidiary. The Act authorizes the Independent Compensation Committee to retain the services of an independent compensation consultant, legal counsel, or other adviser to advise the committee on compensation matters.

Undoubtedly, the so-called “claw-back” provision in Section 953 of the Act is the most detrimental, from a D&O’s personal liability standpoint. In the event of a company’s accounting restatement, this provision requires the company to recoup or “claw back” incentive-based compensation (including stock options) received by any executive officer based on the company’s erroneous financial statements. The amount
of the claw-back only applies to the excess compensation the executive received due to the false financials. The claw-back period for compensation is up to three years preceding the date the company is required to restate its financials. Significantly, there is no requirement under the claw-back provision that the executive officer be found to have personally engaged in any wrongdoing.

WHISTLEBLOWER COULD BE REWARDED BY THE SEC

Occasionally referred to as the corporate “bounty hunter” provision, Section 922 of the Act authorizes the United States Securities and Exchange Commission (SEC) to pay a whistle-blower up to 30 percent of any monetary sanctions imposed on a company for violations of federal securities laws. The Act defines “whistle-blower” as any individual or group of individuals acting jointly in providing information to the SEC. To qualify for an award, the whistle-blower must: (1) “voluntarily provide” the SEC (2) with “original information” (3) that leads to the “successful enforcement” of (4) a covered judicial, administrative or related action by the SEC under the securities laws (5) that results in monetary sanctions exceeding $1 million.

Under these circumstances, the SEC can pay the whistle-blower an award between 10 percent and 30 percent of the total monetary sanctions collected by the SEC. The actual amount of the award is discretionary, and the SEC may consider various factors including: (i) the extent to which the information provided by the whistle-blower was useful in the SEC’s successful prosecution of the action; (ii) the degree of assistance the whistle-blower or its counsel provided the SEC in prosecuting the action; and (iii) the SEC’s interest in deterring similar violations by other offenders.

If a company is considering retaliating against a whistle-blower, it had better think twice, since the Act contains an express prohibition on retaliation:

   In general – No employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistle-blower in the terms and conditions of employment because of any lawful act done by the whistle-blower –

   (i) in providing information to the Commission in accordance with this section;

   (ii) in initiating, testifying in, or assisting in any investigation or judicial or administrative action of the Commission based upon or related to such information; or

   (iii) in making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002, the Securities Exchange Act of 1934. . . .

Not surprisingly, the whistle-blower provisions in the Act have generated much dissent by public companies. Companies fear that the potential for a sizeable SEC award will cause employees to bypass internal corporate reporting procedures and undermine corporate compliance efforts and investigations. Instead, employees may be financially motivated to go straight to the SEC. Companies and their D&Os may very well find themselves embroiled in more SEC investigations that are not only expensive, but could also lead to more enforcement actions and private shareholder suits.
SEC RECORDS SUBJECT TO PUBLIC DISCLOSURE

As a corollary, President Obama recently signed a bill that repeals a provision in the Act that had made it easier for the SEC to deny public requests for information under the Freedom of Information Act. The SEC was previously exempted from disclosing information obtained from “surveillance, risk assessments, or other regulatory or oversight activities.” With the repeal of this provision, it will be easier for the public to obtain SEC records that could aid plaintiffs’ counsel in pursuing private litigation against companies and their D&Os.

“RECKLESS” STANDARD FOR AIDERS AND ABBETTORS

The SEC has always had the ability to pursue “aiders and abettors” for “knowing” violations of the federal securities laws. However, Section 929 of the Act expands the SEC's ability to prosecute persons who “recklessly” provide substantial assistance in violating securities laws – regardless of whether the individual had actual knowledge of the wrongdoing. Reckless aiders and abettors can be prosecuted by the SEC to the same extent that they would be if they had committed a primary violation of the securities laws. As such, D&Os might be the target of more actions by the SEC for aiding and abetting liability.

PROPOSED SEC RULES FOR WHISTLEBLOWER AWARDS UNDER DODD-FRANK

On November 3, 2010, the SEC issued for public comment proposed rules for implementing the whistle-blower provisions in the Dodd-Frank Act. To be eligible for a whistle-blower award under the SEC’s proposed rules:

- Information must be “voluntarily” provided by a whistle-blower before receiving any formal or informal request, inquiry, or demand from the SEC;
- Information is not voluntary if an employee provides information in response to an SEC request on his/her employer;
- “Original information” must be derived from the whistle-blower’s independent knowledge or analysis, and must not already be known to the SEC;
- Information obtained from the media, the Internet, SEC filings, court documents and other public sources is not “original;”
- Persons not eligible for an award include attorneys and independent auditors who obtain information during the course of their representation of clients;
- Information provided by the whistle-blower must “significantly contribute” to the success of any SEC enforcement action;
- “Monetary sanctions” may include any penalties, disgorgement and interest paid as a result of a successful action;
- Maximum award is 30 percent of monetary sanctions in the aggregate for all whistleblowers who provide information in connection with a single action;
- A whistle-blower would be required to provide a sworn declaration attesting to the veracity of the information provided to the SEC; and
- Counsel representing anonymous whistleblowers must certify that the attorney has verified the identity of the whistle-blower.
The Dodd-Frank Act creates substantial financial incentives for whistleblowers to provide the SEC with information regarding potential violations of federal securities laws. The SEC has acknowledged the potential downside and unintended consequences of the Act, including: (i) financial incentive for attorneys to breach the attorney-client privilege; (ii) financial incentive for employees to report violations directly to the SEC first, which could undermine companies’ internal compliance and reporting programs; and (iii) a possible increase in spurious allegations, causing innocent companies and individuals to incur substantial investigation costs. Nonetheless, on the whole, the SEC believes that the enhanced whistle-blower incentives will result in greater deterrence of securities law violations and effective enforcement by the SEC. However, only time will tell if the perceived benefits of the Dodd-Frank Act whistle-blower provisions outweigh the costs.

**WHAT THE FUTURE HOLDS FOR D&OS UNDER DODD-FRANK**

While it is too early to predict all of the consequences of the sweeping financial and corporate legislative reform under the Dodd-Frank Act, it seems that D&Os and their insurers should be wary of a potential rise in claims against D&Os (1) relating to executive compensation, (2) brought by an increasing number of financially motivated whistleblowers, (3) alleging aiding and abetting liability, and/or (4) arising from greater public access of SEC records.
SEC'S FINAL WHISTLEBLOWER RULES ENCOURAGE (BUT DO NOT REQUIRE) INTERNAL REPORTING

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act) authorizes the United States Securities and Exchange Commission (SEC) to pay a whistleblower between 10 percent and 30 percent of any monetary sanctions imposed on a company for violations of federal securities laws. To qualify for an award under this so-called bounty hunter provision, an individual whistleblower must “voluntarily provide” the SEC with “original information” that leads to the SEC’s “successful enforcement” of a federal court or administrative action resulting in monetary sanctions exceeding $1 million (that are actually collected by the SEC).

On May 25, 2011, in a divided 3-2 vote, the SEC adopted final rules to implement the whistleblower rules of the Dodd-Frank Act (or Act). Prior to the adoption of the final rules, the SEC received many public comments from those who feared that the SEC’s proposed rules would encourage whistleblowers to circumvent a company’s internal reporting and compliance procedures and go straight to the SEC to report violations of securities laws. The SEC’s final rules do not require – but merely encourage – whistleblowers to first report violations pursuant to a company’s internal corporate compliance program before reporting the violation to the SEC under the Act’s whistleblower provision.

For instance, if an individual reports original information through a company’s internal whistleblower or compliance program and reports the same information to the SEC within 120 days, the SEC will consider that the information was first reported by the whistleblower when he or she initially reported the violation to the company:

If you provide information to the Congress, any other authority of the federal government, a state Attorney General or securities regulatory authority, any self-regulatory organization, or the Public Company Accounting Oversight Board, or to an entity’s internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law, and you, within 120 days, submit the same information to the Commission . . . as you must do in order for you to be eligible to be considered for any award, then, for purposes of evaluating your claim to an award . . . the Commission will consider that you provided information as of the date of your original disclosure, report of submission to one of these other authorities or persons. You must establish the effective date of any prior disclosure, report, or submission, to the Commission’s satisfaction.

Moreover, if an individual reports original information through a company’s internal whistleblower or compliance procedures, and the company later provides that same information to the SEC (or provides the SEC with the results of an audit or internal investigation initiated by the information provided by the individual), this whistleblower will receive credit for the information reported by the company to the SEC.

In determining the appropriate amount of a whistleblower award, the SEC will consider, among other factors, whether the whistleblower participated in or interfered with a company’s internal compliance and reporting systems. The award might be increased to the extent the whistleblower reported the securities
law violation through a company’s internal whistleblower, legal or compliance procedures before or at the same time he or she reported the violation to the SEC. Conversely, the reward might be decreased if the SEC determines that the whistleblower undermined the integrity of the company’s reporting systems by knowingly: (i) interfering with the company's established legal, compliance, or audit procedures to prevent or delay detection of the reported securities violation; (ii) making any material false, fictitious, or fraudulent statements or representations that hindered the company’s efforts to detect, investigate, or remediate the reported securities violations; and (iii) providing any false documentation knowing that it contained any false, fictitious or fraudulent statements that hindered the company’s efforts to detect, investigate, or remediate the reported securities law violations.

Nonetheless, since internal reporting under existing corporate compliance programs is not a requirement under the SEC’s final whistleblower rules, some critics fear that this will impede a company’s ability to perform its own investigation in response to an internal complaint before the SEC launches an investigation. Indeed, a company may very well be caught off guard and unprepared to promptly respond to any inquiries by the SEC triggered by a whistleblower complaint. In contrast, if the company has the initial opportunity to consider the whistleblower’s allegations, it might be able to effectively stem the tide and/or choose to self-report the incident to the SEC. Presumably, this would benefit the SEC, whose resources are already stretched thin, by obtaining critical information from the company up front based on the company’s own investigation. Otherwise, the SEC will have to start its investigation “from scratch” without the benefit of a report by the Board’s Audit Committee or its designated attorneys or consultants. For now, it remains to be seen whether the SEC’s newly created Office of the Whistleblower will be deluged with whistleblower complaints as some anticipate, and how efficiently and effectively the SEC is able to respond.
Our Firm

Wilson Elser is a full-service law firm with more than 800 attorneys representing a breadth of practices in 23 offices throughout the United States. Founded in 1978, Wilson Elser has grown to become one of the largest and most influential firms in the country. Wilson Elser ranks in the Am Law 200 and in the top 50 of the National Law Journal 250. With a full-service office in London and affiliate firms in France and Germany, Wilson Elser provides “on the ground” legal advice and representation on an international basis. Our large, loyal and expanding client base transacts business in every key global region.

With a proud heritage in insurance defense, our experience increasingly extends into commercial litigation and related areas. Our litigators, with arguably more “senior litigating partner years” than any other law firm in the country, routinely handle the most challenging and technical cases. Moreover, we apply the disciplines and high standards demanded of effective litigation to virtually all areas of the law. This transfer of experience is facilitated by a practice group model that successfully leverages the collective intelligence and abilities of multidisciplinary teams.

Wilson Elser attorneys bring to bear a consistently high level of rigor and innovation to all legal matters, whether simple and local or complex and multijurisdictional. Many have specialized undergraduate and graduate degrees in business, engineering and accounting as well as extensive practical experience in these and other fields. By combining this experience with the vast resources and technical capacity of a firm of our size and stature, we can provide clients with sound and uncompromising representation.

Wilson Elser has enjoyed considerable growth and will continue to rapidly expand in lockstep with where and how our clients transact business. Driven by a commitment to become nothing less than the leading and largest law firm in our core practice areas, Wilson Elser continues to make substantial strides toward advancing this ambitious objective.
The Practices

With depth of experience and a network of more than 800 attorneys across the nation, Wilson Elser helps clients respond to the ever-changing demands of the marketplace. For more than 30 years, we have provided our clients with varied and innovative legal assistance. We have successfully grown in response to the needs of a broad range of clients. Today, we are one of the premier litigation defense firms in the United States.

Our team of creative and resolution-oriented attorneys works collaboratively in a wide spectrum of practice areas. Our vast pool of legal knowledge and our nationwide resources allow us to evaluate risk exposure in advance for clients, thus freeing them to focus on their businesses.

Our practice areas include:

- Accountants
- Admiralty & Marine
- Alternative Dispute Resolution
- Appellate
- Aviation
- Bankruptcy & Creditors’ Rights
- Business Litigation
- Class Action Defense
- Construction
- Corporate
- Data Security & Cyber Liability
- e-Discovery
- Employment & Labor
- Financial Services
- General Liability & Casualty
- Government Relations
- Hotels & Resorts
- Insurance-Reinsurance Coverage
- Intellectual Property
- Land Use & Zoning
- Latin America
- Life, Health, Disability & ERISA
- Medical Malpractice
- Municipal
- Pharmaceuticals & Medical Devices
- Product Liability
- Professional Liability
- Program Management
- Railroad Industry
- Real Estate
- Securities Industry
- Toxic Tort, Environmental & Energy
- Trucking, Automobile, Transportation & Cargo
Directors & Officers

Wilson Elser’s Directors and Officers (D&O) practice is experienced with all aspects of D&O and corporate exposure. We have a national presence in this practice area, ranging from litigation defense to insurance coverage and bankruptcy issues. Our attorneys have long represented the world’s leading D&O insurers as special counsel, advising them on coverage, defense of complex litigation, and resolution strategies. We recognize the disruption that a company faces when senior management is targeted in litigation, as well as the concomitant public relations concerns. Our experience enables our D&O team to promptly evaluate strategic and cost issues and to defend or resolve disputes in a cost-effective and expeditious manner.

Employment

Employers face a growing set of legal challenges. These include new and often complex statutory regulations, increased potential exposure from the ever-expanding challenges of employment decisions, and increased oversight by the U.S. Department of Labor. Wilson Elser helps companies meet these and other challenges with a broad range of capabilities in employment law.

We assist our clients in all employment-related matters, including transactional and contract matters, restrictive covenants and non-compete disputes, labor force reductions as well as matters and grievances under collective bargaining agreements. We litigate claims of discrimination, defamation, wrongful termination and negligent hiring. Our attorneys are also well-versed in labor law issues.

Wilson Elser handles cases for both private and public-sector employers. Our attorneys are skilled in all aspects of federal and state discrimination employment laws, including issues arising under Title VII, the Age Discrimination in Employment Act, the Americans with Disabilities Act, Family and Medical Leave Act and Employee Retirement Income Security Act. We are fully prepared to defend our clients before all administrative and judicial tribunals, including the U.S. Equal Employment Opportunity Commission, the National Labor Relations Board, all state administrative agencies, the U.S. Department of Labor, as well as all state and federal courts.

We regularly “partner” with our clients, serving as counselors and advocates to anticipate and help prevent situations that could result in lawsuits or administrative actions. We coordinate our resolution strategies with our clients and often utilize alternate resolution options, including arbitration, conciliation and mediation. We advise on such matters as employee termination, preparing employment manuals, drug testing, and avoiding any and all discrimination claims.
The Team

The Wilson Elser Practices draw on the support, skills and experience of our offices across the nation and our affiliates across the sea.
Wilson Elser continually strives to exceed the expectations of its clients. In doing so, the firm is often recognized for its outstanding efforts. Domestically, we are ranked among the top law firms identified by The American Lawyer and listed in the top 50 of The National Law Journal 250. Our work has also been ranked among The National Law Journal’s “Top 10 Defense Verdicts of the Year.”

In the area of government relations, Wilson Elser has been named the leading lobbying law firm in New York state. These are just a few examples of how we surpass expectations and excel in the field of law.

As part of our commitment to outstanding service, our firm also participates in various pro bono activities. Our efforts provide benefits at the community level and allow our attorneys to grow as individuals. We encourage our attorneys to be active in organizations where they live and work and to lend our experience to endeavors that improve communities and institutions. Accordingly, members of our legal team volunteer with organizations that range from Little League to the boards of directors of libraries, universities and health care institutions. Our firm also has been recognized for work on the World Trade Center relief effort.

Wilson Elser attorneys also have gained recognition through professional awards. Recent examples include the Founders Award and the PLUS1 Award given to two of our attorneys by the Professional Liability Underwriting Society. The society recognized our attorneys’ accomplishments in the area of professional liability insurance defense.

In addition, our attorneys hold and have held leadership positions in the Korean American Coalition, the National Asian Pacific American Bar Association, the Japanese American Bar Association, the Korean American Bar Association and the Asian American Bar Association as well as the California State Bar, the Los Angeles County Bar Association, the Bronx Bar Association, the State Bar of Nevada, the Professional Liability Underwriting Society, the Coalition for Justice, the State of California Commission on Judicial Performance, the American Bar Association, the Federation of Defense and Corporate Counsel, the Association of Business Trial Lawyers and the Defense Research Institute.

These awards, honors and affiliations are proof of our ongoing commitment to our clients and to our consistent, unsurpassed legal services. We are proud of our preeminent standing in the legal industry and our contributions to the communities where we live and practice law.
Diversity

At Wilson Elser, we believe promoting diversity is critical to the success of our firm and key to the integrity and vitality of the legal field. Bringing together people of different backgrounds, with diverse perspectives, fosters the innovative and creative thinking that enhances our response to the needs of our clients.

We believe in creating a work environment free of barriers and bias, where individual outlooks and talents are fostered and valued. Our firm is committed to eliminating any impediment to hiring and professional growth based on race, marital status, citizenship, religion, ethnicity, gender, sexual orientation or preference, disability, or any other category protected by equal employment opportunity laws. We actively recruit candidates to promote diversity in our firm.

Our firm strives to mirror the rich diversity of our clients and of the communities in which we practice. We promote an atmosphere in which all members of the firm are given the chance to develop professionally, while contributing their own ideas and views. By doing these things, we believe that we will be better able to represent our clients in today’s diverse, multicultural society.