January 2016 • Vol. XXIX • Number 1

PLUS Journal *Reprint*
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As Department of Justice Takes Aim at Board Members, How Can Companies and Their Insurers Mitigate Risks?

By Stephanie Resnick & John C. Fuller

In recent years, companies in a variety of industries have reported an increase in the number of potential directors who are declining invitations to join their corporate boards. Although many of the reports are anecdotal, they are numerous and widespread, and raise issues of why potential board members are now turning down once prestigious positions. Will this trend continue, and what can companies do to attract top candidates and invigorate or re-invigorate their boards?

The answers are that personal liability is the strongest disincentive, new government enforcement initiatives are bound to dissuade even more candidates, and adaptive insurance policies offer one of few realistic solutions for companies seeking to attract board members. Companies must set in motion plans to attract new board members and ensure indemnification even if such indemnification may not be covered under traditional directors' and officers' insurance policies.

After years of general concern over the decline of board membership, the specter of catastrophic personal liability has reached unprecedented levels following the recent release of the U.S. Department of Justice, Office of the Deputy Attorney General's Memorandum from Sally Quillian Yates dated September 9, 2015 (the "Yates Memo"), which announces new directives for holding individual directors and officers liable for corporate acts. With personal liability for board members poised to reach an all-time high, companies, their insurers and underwriters need to have a dialogue about their existing policies in an effort to offer appropriate protections to board members. Most likely, the ramifications of the Yates Memo will result in increased premiums to cover the increased incidents of potential board member liability and will be a challenge to insurers and underwriters in view of the Department of Justice's aggressive new stance.

The Yates Memo

On September 9, 2015, Deputy Attorney General Sally Quillian Yates released the Yates Memo—a memorandum to all federal investigators and prosecutors—outlining new procedures for investigating and prosecuting board members and other individuals involved with acts of alleged corporate wrongdoing.[1] Set forth as six directives, the core goals of the Yates Memo are to harmonize civil and criminal investigations, to ensure that directors and officers are the focus of the government's efforts, and to heighten the difficulty for directors and officers to evade personal liability when their specific role in corporate misconduct is identified.

First, a company must mitigate the charges against the entity by identifying all relevant facts about the potentially responsible directors and officers in order to receive "cooperation credit." If a company refuses to divulge information, or only provides minimal information about the individual directors and officers, the company will not receive any consideration for its cooperation in an investigation. The Yates Memo specifically instructs prosecutors to proactively scrutinize board members' roles and review all disclosures from companies in great detail to ensure that no officer's or director's role has been minimized or obscured. This directive clearly has ramifications for the insurer, which will need to retain separate counsel for the company and individuals in light of the potential inherent conflicts of interest.

Second, investigators and prosecutors are directed to focus on the officers and board members from the outset of their investigations. This directive is designed to increase prosecutorial pressure on officers and board members, but is also a strategic method of uncovering the full extent of alleged corporate misconduct by focusing on the acts (i.e., individual communications and decisions) of the officers and directors rather than the narrative told by the board minutes and corporate financial disclosures.

Third, criminal and civil prosecutors are instructed to stay in close contact with each other. This directive similarly has a multi-faceted goal of guaranteeing that the full breadth of remedies are available in each case of corporate wrongdoing and ensuring that directors and officers are pursued by the proper prosecutorial authorities if and when their involvement is uncovered by investigators.

Fourth, prosecutors are now expressly required to seek written approval from the Attorney General's Office or United States Attorney's Office to release officers and directors as part of the resolution of corporate matters. Moreover, absent "extraordinary" circumstances, individual liability is not to be released as part of settlement with the subject entity and prosecutors are instructed to ensure that all individual claims are preserved.

Fifth, cases are also not to be resolved without an articulated plan to pursue potential claims and charges against the directors and officers. Such plans are to set forth the status of the action, what investigative work remains, and a plan to complete the investigation before the applicable statute of limitations runs. In addition, if a decision is made not to pursue charges or claims against related directors and officers, the investigative office must memorialize, in writing, why further charges were not pursued.

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Sixth, a director's or officer's ability to pay potential fines or penalties is no longer to be considered when deciding whether to pursue claims or charges against them. Prosecutors have long balanced the "twin aims" of returning funds to public coffers and punishing wrongdoers. As part of their determination of whether the level of financial penalty assessed to a director or officer would be sufficient to benefit the public and deter future conduct, prosecutors have, historically, also considered whether such a penalty would be disproportionate or even recoverable in light of the director's or officer's personal means. Under this directive, prosecutors are to be guided by the seriousness of the crime and the ability to secure a criminal conviction or civil judgment, rather than the concerns as to whether the director or officer has funds worth pursuing.

Only over the course of the coming months and years will the effect of these directives on officers and directors in connection with criminal and civil investigations and prosecutions be fully known. Perhaps most concerning for potential board members, however, are the definitive requirements with regard to cooperation credit and approval for release of liability. These directives go beyond aspirational increases in cooperation and changes in decision making rubrics and require prosecutors and agencies to take affirmative actions to comply with their obligations under the directives. Therefore, the Department of Justice's enforcement of the Yates Memo directives will likely first be visible in denials of cooperation credit and refusals by the government to release individual directors and officers from liability. This will result in new levels of personal risk for board members and increased costs for companies and their insurers.

What Will the Yates Memo Mean for D&O Insurance?

If the Yates Memo indeed brings about a new wave of enforcement, there is little doubt that insurance premiums for directors' and officers' insurance policies will rise. However, in order to provide effective coverage for board members without dramatically raising premiums, companies and their insurers need to anticipate how the specific Yates Memo directives may affect litigation. Among the issues that companies and insurers must consider when discussing coverage for board members and officer are the appropriate scope of conduct exclusions; heightened conflicts of interest; new demands for independent counsel; increases in early, in-depth discovery; higher defense costs; and, increases in judgments against individual directors and officers.

Conduct Exclusions

Perhaps the single largest concern for potential board members in light of the Department of Justice's new focus on individual accountability is whether directors' and officers' insurance will even cover the defense of the charges and claims against them. Although directors' and officers' insurance policies may still cover some or all of the defense, some policies may leave individual directors and officers vulnerable as a result of the new prosecutorial focus on board member accountability for acts that have long been attributed to the corporate entity only. Moreover, the barriers to negotiation and resolution, including the directive that directors and officers will not be released from liability absent extraordinary circumstances, may lead to additional individual charges which, in the past, may have been resolved as part of a company's settlement.

Conflicts of Interest

Directors will also need to re-examine their relationship with General Counsel on whom they have long relied. General Counsel and board members are no doubt aware of the potential conflicts of interests which arise when the interests of the company are at odds with those of the individual directors. Significantly, the new Department of Justice directives may put companies and their directors in conflict far sooner.

As a result, even in the earliest stages of investigation or litigation, the company must provide information about the individuals who made the corporate decisions at issue in order to "cooperate" with the authorities. The decision to seek cooperation will, almost necessarily, require identifying the directors or officers who were part of the decision-making process. In addition, targeted directors and officers may find themselves in a position where identifying other board members or disclosing additional information regarding the company may aid their own defense.

With these significant potential conflicts of interest now arising at almost the very moment when a company comes to anticipate litigation, directors and officers will almost certainly require independent counsel much sooner and more frequently than they have in the past. Not only will the extent of coverage for independent counsel be a concern for potential directors, it is one of the many additional costs insurers and companies must consider going forward in the underwriting process and premium assessment.

Litigation Costs

In addition to possible conduct exclusions and the potential for highly adverse boardroom situations, the Yates Memo directives undoubtedly create additional litigation costs which will require higher policy limits and higher premiums. Both companies and potential board members should be clear about their respective financial burdens if policy limits are exceeded.

The Department of Justice's pursuit of individual directors and officers from the outset of a given action may also add increased pressure to expedite discovery in the early stages of litigation. Rather than making massive disclosures on behalf of the company, targeted investigations could mean targeted discovery. While a streamlined process could theoretically decrease costs, the burden of distilling corporate documents to respond to specific requests regarding the involvement of individual directors and officers will fall heavily on defense counsel and significantly increase the cost of defense. Moreover, as prosecutors have been instructed to fully investigate any productions made, counsel may be required to engage additional discovery requests and more aggressive motion practice.

Additional costs will also arise if the government elects to pursue different civil and criminal cases against individual officers and directors. In addition to the potential need for independent counsel for individual board members, the scope of legal work that can be performed jointly on behalf of numerous directors and officers may be substantially diminished. Moreover, not only may the claims and respective courses of litigation diverge and require separate motion practice and trials, but tasks such as document productions may become segregated by individual defendant and a single corporate production may no longer suffice.

As is the trend with electronically stored information, using technology to increase efficiency with document production will be key to offset these additional costs and to minimize duplicative efforts on behalf of multiple defendants. One potential strategy may be to have counsel work with investigators to develop agreeable defendant-specific search terms. A robust production of documents responsive to these search terms will put the defense in an advantageous position should the government press for additional, duplicative disclosures.

Judgments

Beyond increased defense costs, larger judgments and added obstacles to negotiated resolutions may also push defense costs beyond current policy limits. The Yates Memo directive that an individual's ability to pay should not affect prosecution decisions may lead to unprecedented judgments against individual officers and directors.

The ability for board members, companies and their insurers to determine the ultimate range of potential judgments is further obscured by the directive that prosecutors are not to settle matters without an articulated plan for pursuing claims and charges against individual directors and officers. This directive creates the distinct possibility of multiple rounds of defenses and judgments all emanating from a single claim which can quickly exhaust defense funds. Moreover, the uncertainty of the future prosecution of directors and officers makes negotiation of a final resolution within policy limits significantly more difficult.

While the thought of increased defense costs are unpleasant, the potential financial liability for directors and officers if policy limits are reached is likely to dissuade even more potential board members. Insurance policy limits and corporate indemnification policies should be clearly communicated to board members so that they have a complete understanding of the risks they are assuming when they join the board—not when an issue arises. Companies will need to address difficult subjects such as liability policy limits, as well as the other heavy burdens created by the Yates Memo, if companies are attempting to recruit the best and brightest board members.

The Yates Memo represents a significant increase in the potential liability for individual board members. Companies that want to attract board members will need to offer means of mitigating individual risk and will need to work with their insurers to do so. While companies will need to prepare for increased premiums, insurers should also consider the structure of the policies they offer in light of the government's transition from corporate to individual targets.

Endnote

1 The Yates Memorandum is addressed to the Assistant Attorneys General of the Antitrust, Civil, Criminal, Environmental and Natural Resources, and Tax Divisions, the Director of the Federal Bureau of Investigation, the Director of the Executive Office for United States Trustees, and all United States Attorneys.