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Directors and Officers Insurance Digest

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Litigation Developments and Mega Settlements

Dole Food, Inc. Derivative Action – Delaware Chancery Court Finds D&Os Engaged in Fraud
Dole Food, Inc. shareholders sued Dole Chairman and CEO David Murdock and Dole President Michael Carter in connection with Murdock's buy-out (or "freeze out") of the company for $13.50 per share. Plaintiffs filed suit in Delaware Chancery Court alleging that defendants intentionally drove down the price of Dole's stock and misled the board committee, which comprised independent directors, regarding Dole's financial outlook so that Murdock could acquire the company for less money.

On August 27, 2015, the Delaware Chancery Court (Vice Chancellor Laster) issued a scathing decision in the case following a nine-day trial finding that Murdock and Carter engaged in "fraud" to gain approval of the deal at a reduced price, and that their conduct was "intentional and in bad faith." The court held that Murdock and Carter breached their duty of loyalty and were personally liable for $148 million, representing damages of $2.74 per share.

In re Activision Blizzard – Largest Cash Recovery Ever in Derivative Action
Plaintiffs challenged a transaction in which Vivendi divested its controlling equity position in Activision Blizzard, Inc. (Activision). The transaction restructured Activision's governance profile and stockholder base. Shortly before trial the parties entered into a settlement whereby defendants agreed to pay $275 million to Activision. The Delaware Chancery Court (Vice Chancellor Laster) approved the settlement. The court observed that the "monetary consideration of $275 million is the largest cash recovery ever achieved on stockholder derivative claims." The settlement represented the 10 percent spread between Activision's stock price on the open market and sale price in the transaction. The court also awarded plaintiff's counsel $72.5 million pursuant to the common fund doctrine "founded on the equitable principle that those who have profited from litigation should share its costs."

Duke Energy – M&A Dispute in the Guise of a Section 11 Claim
A securities class action was filed against Duke Energy and its directors and officers in connection with its $26 billion merger with Progress Energy. When the merger was proposed, it was announced that the head of Progress Energy (Bill Johnson) would become the CEO of the merged entity. However, shortly after the merger closed, the Board of the combined company voted to make the CEO of Duke Energy (Jim Rogers) the head of the combined company. Shareholders filed a

securities class action lawsuit alleging that the merger registration statement and prospectus contained materially untrue and misleading information regarding Johnson's anticipated role as CEO of the newly combined entity. On March 10, 2015, Duke Energy announced that it had reached an agreement to pay $146.25 million to settle the class action claims.

Freeport-McMoRan – Settlement Paid as a Special Dividend to Shareholders
Freeport's shareholders filed a derivative action in Delaware Chancery Court alleging that the company overpaid when it bought two companies, McMoRan Exploration and Plains Exploration & Production, for a combined $9 billion. Plaintiffs alleged that the Freeport Board had conflicts of interest while negotiating the acquisition due to overlapping boards and ownership interests of the three companies involved in the transaction. The parties agreed to settle the lawsuit for a payment of $137.5 million plus corporate governance reforms. The settlement is to be paid out in the form of a "special dividend" to Freeport shareholders, net of attorney's fees and costs.

Developments in Delaware D&O Law

Anti-Fee-Shifting Law
On June 24, 2015, Delaware's Governor signed a bill containing various amendments to the Delaware General Corporation Law (DGCL), which became effective August 1, 2015. Under the anti-fee-shifting provision, Delaware stock corporations are prohibited from adopting bylaws that force shareholders to pay legal fees if they do not prevail in lawsuits asserting internal corporate claims against directors and officers, Del. Code tit. 8 § 102(f). The legislation creates new Section 115 in the DGCL that defines "internal corporate claims" as claims (1) that are based on a violation of a duty by a current or former director or officer or stockholder in such capacity, or (2) as to which the title confers jurisdiction upon the Court of Chancery.

Anti-Forum-Shopping Provision
The new amendments to the DGCL also permit Delaware corporations to designate Delaware, but not any other state, as the exclusive forum for "internal corporate claims" (*see supra*). The law also invalidates any provisions that would prohibit litigation of intra-corporate claims in Delaware courts.

D&O Advancement Rights
On May 28, 2015, in *Blankenship v. Alpha Appalachia Holdings, Inc.*, the Delaware Chancery Court issued an opinion clarifying and strengthening the rights of a former director and officer to receive "mandatory advancement" of defense costs under a corporation's charter. The *Blankenship* case concerned the right to indemnification and advancement by Donald Blankenship, the former CEO and chairman of Massey Energy Company (Massey).

Massey's charter required it to advance costs to the maximum extent provided by Delaware law. Massey's advancement of expenses to Blankenship was contingent on him making certain representations, including a representation that he "had no reasonable cause to believe that his conduct was ever unlawful." After a criminal indictment of Blankenship, the company determined that Blankenship had breached his representation in the undertaking and ceased advancing the costs of his defense. Chancellor Bouchard observed that when a Delaware corporation adopts broad, mandatory advancement rights, it cannot condition its advancement obligation on anything other than an undertaking to repay the expenses if it is later determined that indemnification is not available because an individual has not met the Delaware law standard of conduct.

Section 102(b)(7) Charter Exculpation Clause
On May 14, 2015, in *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, the Delaware

Supreme Court issued important guidance regarding the pleading requirements to overcome an exculpatory provision, such as those authorized under Section 102(b)(7) of the Delaware General Corporation law. Section 102(b)(7) authorizes stockholders of a Delaware corporation to adopt a charter provision exculpating directors from paying monetary damages that are attributable solely to a violation of the duty of care – as opposed to violations of the duty of loyalty and/or acts of bad faith. If a director is protected by an exculpatory charter provision, in order to survive a motion to dismiss, a plaintiff must plead facts "supporting a rational inference that the director harbored self-interest adverse to the stockholders' interest, acted to advance the self-interest of an interested party from whom the director could not be presumed to act independently, or acted in bad faith."

D&O Cyber Liability

The Home Depot Derivative Action
On September 2, 2015, shareholders of The Home Depot, Inc. (Home Depot) filed a derivative action in Georgia federal court against the company's directors and officers for breach of their fiduciary duties in connection with its 2014 data breach impacting 56 million credit cards. The complaint alleges that defendants failed to ensure that Home Depot safeguarded its customers' personal and financial information. Among other things, the suit claims that Home Depot failed to comply with Payment Card Industry Data Security Standards (PCI DSS) that apply to all entities that store, process or transmit payment card data. The complaint also alleges that certain of the individual defendants, including Home Depot's chief information officer, were aware that the company's security systems were outdated based on reports by employees and independent security consultants. The defendants allegedly breached their duties by failing to oversee and manage the risks posed by Home Depot's data security systems and failing to oversee the inadequate internal controls that failed to protect customers' personal and financial information.

SEC's Cybersecurity Risk Alert
On September 15, 2015, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert in connection with its Cybersecurity Examination Initiative (Initiative), which is available on the SEC's website. The Initiative is designed to assess cybersecurity preparedness in the securities industry, including Wall Street broker-dealers and investment advisers. While the Initiative focuses on the securities industry, it provides all companies with a road map of action items identified by the SEC that may reduce cyber liability exposure. The OCIE Risk Alert identifies the following areas for examination to gauge firms' cybersecurity preparedness and resilience – including the role of the board of directors in cybersecurity governance, controls and risk assessment.

- Governance and Risk Assessment: OCIE examiners may assess whether registrants have in place cybersecurity governance and risk assessment procedures relative to the key areas of focus noted below. Examiners also may assess whether firms are periodically evaluating cybersecurity risks and whether their controls and risk assessment processes are tailored to their businesses. Examiners also may review the level of communications to senior management and boards of directors and the level of involvement by those entities.

- Access Rights and Controls: *As noted by the OCIE, firms may be particularly at risk of a data breach from a failure to implement basic controls to prevent unauthorized access to systems or information*, such as multifactor authentication or updating access rights based on personnel or system changes. Examiners may review how firms control access to various systems and data via management of user credentials, authentication and authorization methods. This may include a review of controls associated with remote access, customer logins, passwords, firm protocols to address customer login problems, network segmentation and tiered access.

- Data Loss Prevention: *The OCIE indicated that some data breaches may have resulted from the absence of robust controls in the areas of patch management and system configuration*. Examiners may assess how firms monitor the volume of content transferred outside of the firm by its employees or through third parties, such as by email attachments or uploads. Examiners also may assess how firms monitor for potentially unauthorized data transfers and may review how firms verify the authenticity of a customer request to transfer funds.

- Vendor Management: *The OCIE observed that some of the largest data breaches over the past few years may have resulted from the hacking of third-party vendor platforms*. As a result, examiners may focus on firm practices and controls related to vendor management, such as due diligence with regard to vendor selection, monitoring and oversight of vendors, and contract terms. Examiners also may assess how vendor relationships are considered as part of the firm's ongoing risk assessment process as well as how the firm determines the appropriate level of due diligence to conduct on a vendor.

- Training: *The OCIE cautioned that without proper training employees and vendors may put a firm's data at risk*. Some data breaches result from unintentional employee actions such as a misplaced laptop, accessing a client account through an unsecured Internet connection, or opening messages or downloading attachments from an unknown source. With proper training, employees and vendors can be the firm's first line of defense, for example, by alerting firm IT professional to suspicious activity and understanding and following firm protocols with respect to technology. Examiners may focus on how training is tailored to specific job functions and how training is designed to encourage responsible employee and vendor behavior. Examiners also may review how procedures for responding to cyber incidents under an incident response plan are integrated into regular personnel and vendor training.

- Incident Response: *Finally, the OCIE noted that firms generally acknowledge the increased risks related to cybersecurity attacks and potential future breaches*. Examiners may assess whether firms have established policies, assigned roles, assessed system vulnerabilities and developed plans to address possible future events. This includes determining which firm data, assets and services warrant the most protection to help prevent attacks from causing significant harm.

Recent D&O Insurance Coverage Decisions

Professional Services Exclusion
Darryn Begun v. Scottsdale Ins. Co., Case No. 13-16211 in the U.S. Court of Appeals, Ninth Circuit (August 18, 2015). The court (applying California law) upheld the Professional Services Exclusion in a management liability insurance policy. The Ninth Circuit affirmed the district court's ruling, finding that the Professional Services Exclusion barred coverage, and held that the "district court properly found Scottsdale [the insurer] had no duty to defend … because the underlying action centered on Appellants' personal failure, of their failure as the alter egos of Clickbooks, to render payroll services which qualify as professional services under California law."

Michael I. Goldberg v. National Union, Case No. 13-21653 in the U.S. District Court for the Southern District of Florida (May 18, 2015). The court (applying Florida law) upheld a Professional Services

Exclusion in a D&O policy. The policy did not define the term "professional services." However, in interpreting this phrase, Florida courts have considered several factors, including whether the services involve specialized skill or training. The court concluded that banking "is a learned profession which requires specialized skill, training, and knowledge, and which is regulated by the state and federal governments." In addition, the court rejected the insured's position that the application of the exclusion would render coverage "illusory" under the policy.

Reimbursement of Unreasonable Fees by Cumis *Counsel*
Hartford Casualty Ins. Co. v. J.R. Marketing, LLC, et al., Case No. S211645 in the Supreme Court of California (August 10, 2015). The California Supreme Court (applying California law) held that an insurer may seek reimbursement for unreasonable legal fees directly from independent *Cumis* counsel. The court observed that "principles of restitution and unjust enrichment dictate that [the law firm] should be directly responsible for reimbursement to Hartford for counsel's excessive legal bills." The court also rejected counsel's argument that the insurer should only be permitted to seek reimbursement from the insured. As the court observed, requiring the insureds to mount a separate lawsuit against their counsel to recover funds the insured is required to reimburse its insurer would give rise to a "circuitous, complex, and expensive procedure [that] serves neither fairness nor any other policy interest."

Capacity Exclusion
The Langdale Co. v. National Union, Case No. 14-12723 in the U.S. Court of Appeals, Eleventh Circuit (June 22, 2015). The Eleventh Circuit (applying Georgia law) held that the Capacity Exclusion in the insured's D&O policy barred coverage for claims asserted against the individual insureds in their dual capacities as trustees and as directors and officers. The policy barred coverage for any claim made against any insured "alleging, arising out of, based upon or attributable to any actual or alleged act or omission of an Individual Insured serving in any capacity other than as Executive or Employee of [The Langdale Company]." In upholding the exclusion, the Eleventh Circuit noted that to the extent "that [the Individual Insureds] were allegedly acting as directors and officers, that misconduct was so inextricably intertwined with their alleged misconduct as trustees that the duty to advance defense costs was not triggered."

Fraud Exclusion
Rodney Watts v. Scottsdale Ins. Co., Index 653412/11 New York Supreme Court, Appellate Division, First Department (June 23, 2015). A New York intermediate appellate court (applying New York law) held that the insurer was relieved from defending the insured under a D&O policy after he was sentenced in a criminal proceeding. The court observed that in the context of "a criminal prosecution, it is well settled that the imposition of the sentence constitutes the final judgment against the accused." The court further noted that the "finality of it is not changed by the pendency of the appeal." On a separate note, the court also held that the insurer was entitled to reimbursement from the insured for defense costs in light of the sentencing.

Insured v. Insured Exclusion
Robert D. Redmond v. ACE American Ins. Co., Case No. 14-3864 in the U.S. Court of Appeals, Third Circuit (June 5, 2015). The Third Circuit (applying New York law) held that the Insured v. Insured Exclusion in a D&O policy barred coverage for claims initially brought by the insured entity as a debtor-in-possession (DIP), even though the same claims were subsequently prosecuted by a Chapter 11 bankruptcy trustee. The Third Circuit observed that the trustee's substitution for the DIP "does not change the fact that IEAM [the debtor] 'brought' [the suit]" in the first instance. Thus, the plain language of the exclusion applied.

Regulatory Exclusion
Certain Underwriters at Lloyd's London v. Huron Consulting Group, Inc., Index 650339/11, New York Supreme Court, Appellate Division, First Department (April 30, 2015). A New York intermediate appellate court held that the Regulatory Exclusion in a professional liability policy barred coverage for a *qui tam* action that was brought by a private party plaintiff. The exclusion applied to claims "brought by or on behalf of the Federal Trade Commission, the Federal Communications Commission, or any federal, state, local or foreign governmental entity, in such entity's regulatory or official capacity." The court held that the exclusion applied despite the fact that the *qui tam* action was brought by a private party instead of by a governmental entity operating in an official or regulatory capacity, because "the United States is the real party in interest in a *qui tam* action under the False Claims Act."

Consent to Settle and No Action Clause
Piedmont Office Realty Trust, Inc. v. XL Specialty Ins. Co., Supreme Court of Georgia (April 20, 2015). The Georgia Supreme Court (applying Georgia law) held that an insured cannot sue its insurer for bad faith when the insured failed to obtain the insurer's prior consent to settle a claim. The insurance policies contained a "consent to settle" provision and a "no action" clause. The Georgia Supreme Court observed that the plain language of the insurance policy at issue "does not allow the insured to settle a claim without the insurer's written consent." In addition, the court noted that the no action clause stated that the insured could not sue the insurer unless, as a condition precedent, the insured "complies with all of the terms of the policy and the amount of the insured's obligation to pay is determined by a judgment against the insured after a trial or [written] agreement between the claimant, the insured, and the insurer." The Georgia Supreme Court held that in light of "these unambiguous policy provisions, we hold that Piedmont is precluded from pursuing this action against XL [the insurer] because XL did not consent to the settlement and Piedmont failed to fulfill the contractually agreed upon condition precedent."

No Coverage for Civil Theft
Twin City Fire Ins. Co. v. CR Technologies, Inc., Case No. 9:13-cv-80998 in the U.S. District Court, Southern District of Florida (March 11, 2015). A Florida district court (applying Florida law) held that a D&O policy did not afford coverage for a final judgment entered against the insured for civil theft. The D&O insurer denied coverage for the judgment on the following grounds: (1) the policy definition of Loss does not include the restoration of an ill-gotten gain; (2) civil theft is not insurable as a matter of public policy; and (3) statutory treble damages awarded for civil theft constitute a multiplied damages award, which was expressly excluded from the definition of Loss. The court agreed that the D&O policy did not afford coverage for each of the reasons cited by the insurer.

Dishonesty Exclusion
J.P. Morgan Securities Inc., v. Vigilant Ins. Co., Index 600979/09 in the New York Supreme Court, Appellate Division, First Department (January 15, 2015). A New York intermediate appellate court held that an SEC Consent Order did not implicate the Dishonesty Exclusion in a D&O policy. Pursuant to a settlement agreement with Bear Stearns, the SEC issued an Order that included numerous factual findings explaining how Bear Stearns operated its late trading and market timing scheme. However, the SEC Order expressly stated that the "findings herein are made pursuant to [Bear Stearns's] Offer of Settlement and are not binding on any other person in this or any other proceeding." The exclusion only applied in the event of a final adverse adjudication against the insured. The court held that the exclusion did not apply because "[i]t can hardly be said that the SEC Order … put Bear [Stearns's] guilt 'beyond doubt,' when those very same documents expressly provided that Bear Stearns did not admit guilt, and reserved the right to profess its innocence in unrelated proceedings."

SEC Claim First Made Prior to Inception of Policy

BioChemics, Inc. v. AXIS Reinsurance Co., Case No. 13-10691-RWZ in the U.S. District Court, District of Massachusetts (January 6, 2015). A Massachusetts district court held that an SEC investigation and subsequent enforcement action constituted a Claim first made prior to the inception of a D&O policy. The definition of a Claim in the policy included a “civil, arbitration, administrative or regulatory proceeding against any Insured commenced by … the filing of a notice of charge, investigative order, or like document.” The court concluded that the SEC subpoenas and subsequent enforcement action constituted a Claim first made prior to the policy: “The Formal Order [was] issued on May 5, 2011. The policy went into effect on November 13, 2011. The investigation and enforcement action, the Claim at issue, was thus ‘first made’ before the policy period and is, therefore, not covered under the policy.”

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