BAILEY CAVALIERI LLC
ATTORNEYS AT LAW

One Columbus 10 West Broad Street, Suite 2100 Columbus, Ohio 43215-3422
telephone 614.221.3155 facsimile 614.221.0479
www.baileycavalieri.com

Corporate Counsel Insurance: Important Coverage for Exposed Lawyers

By Dan A. Bailey

It is now widely recognized that the liability exposures for companies and their directors and officers are continuing to increase in a variety of areas. Unfortunately, this heightened liability exposure now also extends to in-house corporate counsel, who advise management on critical legal issues and who to a large extent can influence, if not control, conduct of the company and its directors and officers. In the wake of numerous highly-publicized recent corporate debacles, courts, legislators and regulators are imposing more rigorous standards on these in-house advisors, based on the premise that corporate counsel can serve an important role in detecting and preventing corporate wrongdoing if properly incentivized.

Not surprisingly, this environment has spawned more claims against in-house counsel and unprecedented liability exposure from a wide variety of potential claimants. For example, shareholder lawsuits arising out of the Enron collapse named as defendants several of Enron's in-house counsel and the bankruptcy examiner concluded there was sufficient evidence to support claims against in-house counsel on behalf of the Debtor. The causes of action against the in-house counsel included malpractice and breach of fiduciary duty, and alleged the counsel negotiated and documented improper transactions without investigating or properly advising directors or shareholders of the true nature of the transactions.

The following discussion summarizes some of the legal bases for this growing liability exposure and insurance issues relating to coverage for in-house counsel.

A. Liability Exposures

Like directors and officers, the most severe liability exposure for in-house counsel relates to violations of the federal securities laws. This exposure can arise in two contexts, both of which are briefly discussed below.

1. Direct Violator of Securities Laws

Prior to 1994, lawyers, accountants and other advisors could be liable if they aided and abetted directors' and officers' violations of the federal securities laws. However, the U.S. Supreme Court in 1994 ruled that attorneys and other secondary actors could not be held liable as an aider and abettor for money damages in connection with another person's violations of the securities laws. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). Instead of abandoning their efforts to hold attorneys liable for securities laws following that ruling, plaintiff lawyers have continued to name counsel as defendants in some securities class actions based on the allegation that the attorney was a primary violator of the securities laws even though the attorney did not sign or issue the allegedly false public statements and even though investors were never aware of the attorney's role in the disclosure process. The notion that an attorney can be a direct violator of the securities laws has received conflicting reactions from the courts. For example, the Third Circuit endorsed a very expansive view of attorney liability in *Klein v. Boyd*, Fed. Sec. L. Rep. (CCH) 90-136 (3d Cir. 1998). In that case, the court found attorneys liable as primary violators of the securities laws because they authored or co-authored documents which contained allegedly material misrepresentations and omissions. Although the lawyers did not have an obligation to blow the whistle on their client, they did have a duty to correct the client's false public statements.

In contrast, the Eleventh Circuit ruled that a law firm is not liable as a primary violator unless the plaintiffs can prove the law firm directly made material misrepresentations or omissions to investors. According to the court, attorneys cannot be held as primary violators of the securities laws if they merely draft, create, review or edit allegedly fraudulent disclosures by the corporation. *Ziemba v. Cascade International, Inc.*, 2001 U.S. App. LEXIS 15529 (11th Cir. 2001).

The most recent and most controversial interpretation arises out of the Enron litigation, where the Texas District Court created a new "scheme liability" test. The court adopted the position of the SEC in its amicus brief, ruling that "when a person, acting alone or with others, creates a misrepresentation, the person can be liable as a primary violator...if...he acts with the requisite scienter." *In re Enron Corp. Sec. Deriv. and ERISA Lit.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).

2. <u>Sarbanes Oxley Act</u>

Pursuant to Section 307 of the Sarbanes Oxley Act, the SEC was required to issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the commission. On January 23, 2003 after prolonged and heated public debate, the SEC adopted final rules to implement this congressional mandate. The new rules, which became effective August 5, 2003, impose an "up the ladder" reporting requirement on all lawyers who appear and practice before the SEC and become aware of evidence of a material violation of any securities laws, breaches of any fiduciary duties, or similar violation of any other laws. The new rules apply to lawyers providing legal services to an issuer corporation, who have an attorney/client relationship with the issuer, and who have noticed that documents they are preparing or are assisting in preparing will be filed with or submitted to the SEC. In-house corporate counsel are clearly subject to the new rules.

If the lawyer discovers such a material violation or breach, the lawyer must report the matter to a Qualified Legal Compliance Committee ("QLCC") of the board if the board has such a committee, or if not to either the corporation's chief legal officer or CEO. Interestingly, the SEC left for further debate the highly controversial proposal that the lawyer must disclose to regulators the violation or breach if the QLCC, chief legal officer and CEO do not reasonably respond to the information disclosed to them by the lawyer and withdraw from the representation (i.e., "noisy withdrawal").

In addition, the Sarbanes Oxley Act requires the CEO and CFO of the corporation to certify the truth and accuracy of the corporation's financial statements to the best of their knowledge. It is now common practice for the CEO and CFO to obtain sub-certifications from various people within the organization in order to support the certification by the CEO and the CFO. In-house counsel frequently are required to provide those sub-certifications. Obviously, such sub-certification can be the basis for claims against the attorney. Since those certifications are clearly intended to be relied upon in making public disclosures, the sub-certifications may increase the likelihood that the attorney providing the sub-certification is a direct violator of the securities law if it is later determined that the attorney acted recklessly in providing false information in the sub-certification.

B. Insurance

In response to this environment of heightened exposure for and concern by in-house counsel, more companies are now examining the extent and appropriate form of financial protection for their in-house counsel. Typically, this analysis reveals that the in-house counsel has very little if any reliable financial protection. Most companies provide in their bylaws or certificates of incorporation mandatory indemnification only for their directors and officers, not other employees. As a result, non-officer employees (including in-house counsel) are at the mercy of the company's directors to decide whether and to what extent indemnification will be available if a claim is made against the employee. Even if mandatory indemnification exists, there would be no protection if the company becomes insolvent or files bankruptcy.

Similarly, most directors and officers liability insurance policies ("D&O Policy") afford limited if any coverage for non-officer employees. If the coverage exists at all, it is usually only for Securities Claims or only when the employee is a co-defendant with a director or officer. Also, an issue may arise whether the counsel's alleged wrongdoing was committed as an employee or in some other uninsured capacity.

A company that recognizes this deficiency in its risk management program generally has two potential insurance options. First, the company may be able to purchase an endorsement to its D&O Policy that extends coverage under that policy to its in-house counsel. Second, the company can purchase a separate professional liability insurance policy specifically designed for in-house counsel. Such a policy would be subject to its own separate limit of liability and would cover both the in-house counsel for non-indemnifiable claims and the company to the extent it indemnifies the in-house counsel.

A separate professional liability insurance policy for in-house counsel affords to the Insureds a number of advantages over a D&O Policy which is endorsed to include in-house counsel as Insureds. The following summarizes many of those advantages:

1. Specifically Tailored Policy. A professional liability insurance policy for corporate counsel contemplates and addresses many of the unique issues that may arise in professional liability claims against in-house counsel. As a result, the Insureds under that type of policy have less risk of coverage surprises or uncertainties than under an endorsed D&O Policy.

2. Preserve D&O Coverage. If in-house counsel are added as Insureds to the D&O Policy, any payment under that policy of losses incurred by in-house counsel will reduce the remaining available limit of liability for claims against directors and officers. Since the D&O Policy is primarily designed and purchased to provide quality and predictable insurance coverage for directors and officers, the expansion of coverage to include in-house counsel as additional Insureds may ultimately harm the directors and officers. Conversely, if coverage under the D&O Policy is eroded or exhausted by losses incurred by the directors and officers, the in-house counsel who are additional Insureds under that policy will lose much if not all of their insurance coverage. A separate professional liability policy with a separate limit of liability protects against this type of potentially dangerous erosion of the D&O Policy's limit of liability.

3. Claims by Company. A standard D&O Policy excludes from coverage any defense costs, settlement, judgment or other loss incurred in a claim by or on behalf of the company against an Insured. One of the purposes for this standard exclusion is to dissuade companies from asserting claims against their directors and officers. Although a professional liability insurance policy for corporate counsel similarly is not intended to encourage claims by the company against its in-house counsel, at least the AIG Corporate Counsel Premier℠ professional liability policy form affords defense costs coverage for such claims. This approach protects the in-house counsel defendant by providing a defense, without creating a financial incentive for the company to sue its in-house counsel.

4. Covered Claims. Unlike a standard D&O Policy, the AIG Corporate Counsel Premier professional liability insurance policy covers not only demands, suits or proceedings for monetary damages or other relief, but also ethics and licensure proceedings against the in-house counsel concerning the eligibility or license of the counsel to practice law or compliance with Section 307 of the Sarbanes-Oxley Act of 2002. Legal expenses incurred by counsel in such proceedings may not be indemnifiable by the company, and thus insurance coverage for those legal expenses can be critically important to the in-house counsel. A standard D&O Policy, even if endorsed to include in-house counsel as Insureds, does not provide this coverage.

5. Insured Persons. The AIG Corporate Counsel Premier professional liability insurance policy includes as Insureds not only past, present and future in-house counsel, but also paralegals, clerical staff and other employees of the company who support the counsel in the performance of legal services. Also, "contract" attorneys who perform services for the company under a written agreement with

an employment contractor or agency are covered. A standard D&O Policy which is endorsed to include in-house counsel as additional Insureds typically does not include coverage for these types of employees or contract attorneys. This expansion of coverage under the professional liability policy is not only important for the employees and contract attorneys, but also for the company to the extent the company indemnifies those employees or contract attorneys, since the professional liability policy insures the company to the extent it indemnifies an Insured Person for covered Loss.

6. Moonlighting. A D&O Policy which is endorsed to include in-house counsel as additional Insureds typically covers the in-house counsel only for claims made against the counsel in his or her capacity as counsel for the company. However, many corporate counsel professional liability insurance policies also afford coverage for moonlighting, pro bono and other legal services unrelated to the company if those services are rendered while the counsel is an employee of the company. In-house counsel frequently render these types of "external" legal services without realizing they may otherwise have little if any financial protection against claims arising out of those services. As a result, this expansive coverage can be highly valuable to counsel.

7. Officer Capacity. Even if the in-house counsel is designated an officer of the company, and therefore an Insured under the D&O Policy, some D&O insurers may contend that legal services performed by that officer are not performed in his or her insured capacity as an officer. For example, some insurers may contend that a person who holds the title "Vice President and General Counsel" is not insured under the D&O Policy for legal services rendered as general counsel (which may not be considered an officer capacity), but is insured only for services rendered as vice president. A professional liability insurance policy for corporate counsel eliminates this potential gap in coverage by expressly insuring legal services rendered as an employee, including as general counsel.

8. Duty to Defend. Some corporate counsel professional liability insurance policies impose upon the insurer the duty to defend any claim under the policy. D&O Policies typically require the Insureds to defend the claim, and the insurer is simply required to pay reasonable, necessary and covered defense costs. By requiring the insurer to defend the claim, the policy allows the Insureds to rely on the insurer and its vast claims experience to defend the claim. In addition, there is less risk that coverage disputes will arise regarding the amount or nature of the defense costs, or the need to allocate defense costs between covered and non-covered matters.

9. Personal Injury Coverage. Some corporate counsel professional liability insurance policies expressly cover claims for false arrest or imprisonment, malicious prosecution, defamation, violation of the right to privacy, and wrongful entry or eviction. Many of these types of claims are excluded under some D&O insurance policies. Because the rendering of legal services frequently can give

rise to these types of claims, express coverage for these claims in a professional liability policy can be quite valuable.

For these reasons, among others, a corporate counsel professional liability insurance policy can provide important and unique financial protection for companies, their in-house counsel and other employees involved in rendering legal services.