

# THE NEW FRONTIER: CRIMINAL ACTIONS INVOLVING CORPORATE DIRECTORS AND OFFICERS

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*"Now we'll all close our eyes and cover our ears, and the person who took the four hundred and twenty-eight million dollars will put it back."*

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## **INTRODUCTION**

Recent news has been dominated by the flurry of criminal indictments against corporate directors and officers (“D&Os”).<sup>1</sup> This paper examines those actions in three different ways:

- (1) by providing an overview of the investigators, the investigatory and indictment process, and some of the significant criminal counts that can result from same;
- (2) by summarizing the current state of affairs in the corporate indemnification and advancement context; and
- (3) by reviewing the caselaw on some of the most common coverage and litigation management issues those actions present for D&O liability insurance carriers.<sup>2</sup>

## **CRIMINAL INVESTIGATIONS, PROCEEDINGS AND SOURCES OF LAW**

### **I. The Investigators**

#### **(A) Federal Government**

By and large, the federal government takes the lead in investigating and prosecuting alleged corporate crimes. The following is a non-exhaustive list of various federal agencies which may be involved in this process.

- Department of Justice

The DOJ is the federal government’s lead law investigation and enforcement agency; its ambit includes well-known agencies like the Federal Bureau of Investigation (“FBI”) and the Bureau of Alcohol, Tobacco and Firearms. One industry source estimates that the FBI handles the investigation of roughly nine (9) out of every (10) corporate fraud cases.<sup>3</sup>

The Fraud Section of the DOJ’s Criminal Division directs the investigation of such crimes as securities and financial institution fraud (among others), and takes direct responsibility for conducting grand jury investigations and prosecutions in certain cases that require centralized treatment because of their complex nature.<sup>4</sup> The Fraud Section also provides litigation support to U.S. Attorneys’ offices when requested.<sup>5</sup>

Working with the DOJ is the President’s Corporate Fraud Task Force, established by Executive Order on July 9, 2002.<sup>6</sup> The CFTF includes the FBI’s Director and selected Assistant Attorneys General and U.S. Attorneys who constitute both a DOJ group focused on enhancing its criminal

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enforcement activities and an inter-agency group charged with maximizing cooperation and joint regulatory and enforcement efforts throughout the federal law enforcement community.<sup>7</sup>

- Internal Revenue Service

The Criminal Investigation unit of the IRS investigates and prosecutes tax-related offenses such as filing false income tax returns, tax evasion and bank fraud.<sup>8</sup> With regard to corporate fraud matters, as of June 30, 2004, the IRS had conducted 86 investigations, filed 40 indictments, and reached the sentencing stage in 15 cases during FY2004.<sup>9</sup> Nine (9) of the fifteen (15) convicted defendants were incarcerated, with an average sentence of 30 months.<sup>10</sup>

- Department of Labor

The DOL, through the Employee Benefits Security Administration, is responsible for deterring and correcting corporate violations of various pension-related statutes, including the Employee Retirement Income Security Act (ERISA), through administrative, civil and criminal enforcement efforts.<sup>11</sup> One recent example of the DOL's work is the investigation into Tyco International, Ltd. involving losses in employee retirement funds.<sup>12</sup>

- Defense Criminal Investigative Service

The DCIS is the criminal investigation arm of the Inspector General's Office of the Department of Defense ("DoD").<sup>13</sup> While the DCIS primarily handles investigations of criminal conduct in connection with military operations, it also investigates D&Os' conduct involving contracts between the DoD and private corporations, such as where allegations of bribery, corruption or fraud are present.<sup>14</sup> For example, the DCIS is currently investigating allegations of overpricing by a Halliburton Co. subsidiary in connection with the delivery of fuel to Iraq.<sup>15</sup>

- Postal Inspection Service

Postal Inspectors enforce over 200 federal laws in investigations of crimes that may adversely affect or fraudulently use the U.S. Mail, the postal system or postal employees, including crimes such as mail fraud and money laundering.<sup>16</sup> Postal Inspectors are fact-finding and investigative agents only, but assist U.S. Attorneys, other law enforcement agencies and local prosecutors to prepare postal cases for court.<sup>17</sup>

**(B) State Agencies**

In addition to the aforementioned federal agencies, there are a number of state agencies that can investigate and/or prosecute D&Os for criminal conduct. Because laws and organizational structures vary among states, there is no set agency assigned to perform these functions.

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However, state-level investigations into corporate fraud are almost certain to involve the state attorney general's office or a subsidiary investigative wing.<sup>18</sup> State counterparts to the federal agencies listed above may also investigate D&Os' conduct, either apart from, or in tandem with, the state attorney general's office.

**(C) Other Important Entities**

The above-listed agencies may be assisted by any number of other investigative bodies that lack the authority to bring criminal charges on their own, including:

- (1) the Securities and Exchange Commission;
- (2) the Commodity Futures Trading Commission;
- (3) the Federal Energy Regulatory Commission; and/or
- (4) the National Association of Securities Dealers.

These organizations often file civil suits against D&Os to recoup money lost for fraudulent conduct and/or fine and bar defendants from the securities industry, and their investigations sometimes lead to referrals for prosecutions.

**II. Filing Charges**

The Fifth Amendment grand jury approval for the filing of federal criminal charges.<sup>19</sup> Federal grand juries may have anywhere from 16 to 23 individuals, and can be either regular or special in nature.<sup>20</sup> Regular grand juries focus mostly on hearing evidence and determining whether probable cause exists for an indictment.<sup>21</sup> They sit for up to 18 months, with the possibility of a six-month extension.<sup>22</sup> Special grand juries spend more time investigating possible criminal activity.<sup>23</sup> While they also sit for an initial period of up to 18 months, there is the possibility of an extension of another 18 months.<sup>24</sup> Both forms of grand juries have subpoena power, and testifying witnesses may not be accompanied into the grand jury room by counsel.<sup>25</sup>

In certain states, prosecutors may file less serious charges without approval (or even review) by a grand jury through other charging documents like informations<sup>26</sup> or complaints.<sup>27</sup> There are clear cost and time savings to filing these documents rather than indictments, in addition to eliminating the risk that a grand jury may destroy a strong prosecution case by simply refusing to indict.

**III. The Counts**

Of central focus in any discussion about D&O criminal liability are the criminal counts themselves. What charges are assessed against corporate D&Os? What are the elements needed to prove those charges? What sentences do convicted D&Os face? We focus on three types of corporate criminal law violations: (1) older federal provisions, most of which have been on the

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books for decades; (2) more recent provisions contained in the Sarbanes-Oxley Act of 2002; and (3) certain state law causes of action, with an emphasis on the law of New York, where many of the recent and well-publicized prosecutions have taken place. We examine these areas by reference to the recent trials of high profile executives such as Martha Stewart and Tyco's former CEO, L. Dennis Kozlowski.

**(A) Established Federal Counts**

1. Criminal Conspiracy

Conspiracy charges are, of course, brought in all kinds of non-corporate contexts, such as gang or mob allegations, terrorism and pyramid schemes. In a corporate context, prosecutors often charge the existence of a conspiracy to commit another offense or to defraud the United States, a violation of 18 U.S.C. § 371.<sup>28</sup> Charges under §371 must be brought within a five-year statute of limitations,<sup>29</sup> and violators are subject to up to a five-year prison sentence and a range of fines.<sup>30</sup>

In the recent Rite Aid trial, prosecutors alleged that the object of the D&Os' alleged accounting fraud was to defraud Rite Aid, its board, shareholders, lenders and third party vendors. The government claimed that this had been accomplished via a massive accounting fraud scheme that included the submission of falsified financial statements to the SEC.<sup>31</sup> Prosecutors used both documents and live witness testimony (including that from plea-bargaining defendants) to show the required agreement among the defendants. In the end, only former Rite Aid Chief Legal Counsel Franklin Brown pursued the case to trial where he was convicted of accounting fraud and recently sentenced to ten (10) years in prison.<sup>32</sup>

2. Fraud

Like its civil cousin, a charge of criminal fraud alleges that the defendant has received money or property through deception, whether by: (1) creating or reinforcing a false impression; (2) preventing the victim from obtaining correct information; or (3) failing to correct a false impression created by the defendant.<sup>33</sup> Fraud-style counts are subject to the same five-year statute of limitations that applies to conspiracy charges.<sup>34</sup> Because the central allegation of any fraud-based count is that the defendant received illicit monetary or other gains, courts can always require that a convicted defendant forfeit "any property constituting, or derived from, proceeds the person obtained directly or indirectly, as the result of such violation," in addition to the statute-specific penalties detailed below.<sup>35</sup>

• Securities Fraud

Federal law precludes the use or employment of "any manipulative or deceptive device" in connection with "the purchase or sale of securities."<sup>36</sup> For instance, federal prosecutors in the

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Rite Aid action charged that the defendants disseminated false information regarding Rite Aid's financial health through false SEC filings and press releases, and during various telephone conference calls and meetings.<sup>37</sup>

The dividing line between criminal and civil securities fraud is typically viewed in terms of *who* brings the charges (government vs. private party<sup>38</sup>) and the *potential penalties* that accompany each (imprisonment being available only for a criminal conviction). There are two other important distinctions, however. First, in a criminal case, the prosecutor must show that the defendant acted *willfully*, that is, that he or she had some "evil purpose."<sup>39</sup> In a civil action, on the other hand, plaintiff must show that the defendant acted with scienter, *i.e.* with the intent to deceive, manipulate or defraud.<sup>40</sup> It is not clear exactly *how* "willfully" differs from "scienter," as no court has yet interpreted the meaning of "willfully" in this context.<sup>41</sup> Second, unlike civil actions, criminal actions do not require proof of reliance on the defendant's misstatements. Instead, prosecutors must prove "the impact of the scheme on the investor."<sup>42</sup> Criminal securities fraud convictions can bring fines of up to \$5 million and/or twenty (20) years' imprisonment.<sup>43</sup>

Importantly, prosecutors need not allege that a defendant blatantly lied to hide a financial manipulation, as an individual may be charged with criminal securities fraud simply for declaring his or her innocence in the face of *other* charges, if the declaration is meant to influence stock prices. The Martha Stewart case is a classic example of this prosecutorial strategy. After the SEC's investigation into her alleged insider trading of ImClone stock was revealed, Stewart loudly and publicly proclaimed her innocence on the insider trading charges. Prosecutors used Stewart's statements to charge her with securities fraud, alleging that the statements were made to defraud and deceive purchasers and sellers of her own company's stock and prevent a decline in the market price of same.<sup>44</sup> Stewart was later convicted on this count.<sup>45</sup>

- Mail and Wire Fraud

The federal mail and wire fraud statutes, 18 U.S.C. §§ 1341 and 1343, prohibit the use of the mails or other communication mediums for the purpose of executing any scheme or artifice to defraud.<sup>46</sup> These statutes collectively cover any dispersion of false and misleading information through the mails, television, radio, telephone or internet.<sup>47</sup> Violators under either section face up to twenty (20) years in prison and fines of up to \$1 million.<sup>48</sup>

As an example of these sections' practical application, the Rite Aid prosecutors alleged that their defendants' wire transfers of company funds for bonuses or to pay off loans violated § 1343, and requested that the defendants forfeit the monies transferred to them if convicted.<sup>49</sup>

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- Making False Statements to the Federal Government

Individuals may not make false and misleading statements “in any matter within the jurisdiction of the executive, legislative or judicial branch of the Government of the United States.”<sup>50</sup> Defendants convicted under this section face fines and up to five (5) years in prison.<sup>51</sup>

The recent accounting-based criminal D&O trials have focused on this section as applied to false or misleading SEC filings. For example, the Rite Aid prosecutors identified several proxy statements and an 8-K report that contained false and misleading information regarding the company’s accounting.<sup>52</sup> Martha Stewart was alleged to have made false statements to the SEC (as well as the FBI) when she claimed that she had sold her ImClone shares under a standing agreement with her broker, rather than because she had received inside information.<sup>53</sup>

3. Obstruction Counts

D&Os may also be prosecuted for *post hoc* attempts to conceal their fraud through a variety of obstruction-based counts. As above, a five-year statute of limitations applies to these charges.<sup>54</sup>

- Obstruction of Justice

In federal court, obstruction of justice counts are typically couched in terms of a larger conspiracy under 18 U.S.C. § 371, discussed above, especially when the prosecutor has a comparatively weak case on the underlying behavior (*e.g.*, securities fraud). An obstruction of justice count allows the prosecution to focus on the cover-up of the questionable behavior rather than on the behavior itself.<sup>55</sup> Penalties for obstruction of justice include a range of fines and up to five (5) years in prison.<sup>56</sup>

- Obstruction of Proceedings

Federal law also prohibits a defendant from “endeavor[ing] to influence, intimidate or impede any grand or petit jury” using “threats or force” or “any threatening letter or communication.”<sup>57</sup> Prosecutors must prove that there was a specific intent to obstruct.<sup>58</sup> Significant prison time may be imposed, depending on the method of interference.<sup>59</sup> Similar protection is afforded to proceedings pending “before any department or agency of the United States.”<sup>60</sup> Penalties here include fines and up to five (5) years imprisonment.<sup>61</sup>

- Witness and Evidence Tampering

Defendants may not “knowingly use[] intimidation or physical force, threaten[], or corruptly persuade[]” another in order to cause or attempt to cause them to withhold their testimony, or take any action to alter or destroy a record to be used in a legal proceeding.<sup>62</sup> A similar intent

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must be shown to prove evidence tampering.<sup>63</sup> Penalties for tampering are severe, with a defendant facing up to ten (10) years imprisonment for witness tampering<sup>64</sup> and up to twenty (20) years incarceration for evidence tampering.<sup>65</sup> Furthermore, if the offense occurs in connection with a criminal trial, the maximum penalty is “the higher of that otherwise provided by law or the maximum term that could have been imposed for any offense charged in such case.”<sup>66</sup>

Tampering charges played a role in the Rite Aid case, as two defendants allegedly “threatened” and persuaded a grand jury witness to withhold information and provide false information to the FBI, prosecutors and a grand jury regarding a Rite Aid real estate acquisition.<sup>67</sup>

- False Declarations Before the Grand Jury

Finally, federal law prohibits a defendant from making a false material declaration under oath in any proceeding “before or ancillary to any court or grand jury of the United States.”<sup>68</sup> Convictions can result in fines and/or imprisonment for up to five (5) years.

This statute is usually applied where defendants misrepresent their improper conduct to the investigating grand jury. For example, the Rite Aid prosecutors alleged that one defendant lied to the grand jury about when he received a severance letter so that it appeared that his receipt occurred before another defendant’s resignation as CEO.<sup>69</sup>

**(B) Sarbanes-Oxley**

In response to growing public outrage over the numerous business scandals revealed in 2001 and 2002, Congress enacted the Sarbanes-Oxley Act of 2002 (“the Act”), which criminalized certain corporate malfeasance and strengthened the penalties for violations of existing criminal and civil statutes.<sup>70</sup> Like the established federal counts detailed above, a five-year statute of limitations applies to all of the foregoing charges.<sup>71</sup> This statute’s relative newness makes tracking its practical application difficult, as few cases have been brought under its parameters.

1. Criminal Securities Fraud Provisions

Corporate executives may not knowingly execute, attempt to execute, or conspire to execute or attempt to execute “a scheme or artifice” to defraud or to obtain by “false or fraudulent pretenses ... any money or property in connection with the purchase or sale of any security.”<sup>72</sup> Importantly, these provisions do not require that the fraud actually occur in order for a prosecution to take place. Violators may be fined and/or imprisoned for up to twenty-five (25) years.<sup>73</sup>

2. False Certification of a Financial Statement

The Act also makes it a crime to falsely certify a periodic SEC report, such as a 10-Q.<sup>74</sup>

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Violators who “knowingly” submit a false certification face up to \$1 million in fines and ten (10) years prison time.<sup>75</sup> Violators who “willfully” certify false statements face more severe penalties, including fines of up to \$5 million and incarceration of up to twenty (20) years.<sup>76</sup>

3. Record Destruction or Falsification

Anyone who knowingly alters, destroys or falsifies a record or other document with the intent to impede, obstruct or influence any matter within a government department or agency’s jurisdiction, or in a Chapter 11 bankruptcy, can be fined and/or imprisoned for up to twenty (20) years.<sup>77</sup> This provision is a significant strengthening of previous statutes, which required that: (1) there be an actual ongoing proceeding and (2) “corrupt” intent.<sup>78</sup>

(C) **State Counts**

Although the federal government has pursued more high-profile criminal prosecutions of D&Os in recent months, states have played and will continue to play a significant role in this area. Several states – most notably, New York – have been more aggressive about enforcing existing criminal laws governing corporate conduct. Other states, such as Illinois, have followed the federal government’s lead and enacted their own versions of the Act, criminalizing conduct that was previously punishable only through civil litigation.

1. New York

As home to numerous corporate headquarters, New York always has played a significant role in the corporate criminal law arena. Aggressive enforcement efforts by current state attorney general Eliot Spitzer have confirmed New York’s status as a – if not *the* – focal point for D&O prosecutions. Perhaps the most high-profile criminal D&O trial in the state’s recent history – the prosecution of Tyco’s former CEO, L. Dennis Kozlowski, and former CFO, Mark Swartz – resulted in a mistrial. We parse two of the counts brought against Kozlowski and Swartz below.

• Grand Larceny

One of the more interesting developments in the Tyco trial was the inclusion of a grand larceny charge, defined in New York as the theft of \$1 million or more in property.<sup>79</sup> Grand larceny in New York is a Class B felony that is subject to a five-year statute of limitations,<sup>80</sup> and it carries a penalty of up to twenty-five (25) years in prison.<sup>81</sup> The Tyco prosecutors argued that Kozlowski and Swartz’s granting of tens of millions of dollars in corporate funds to themselves through various loan forgiveness and executive relocation loan programs constituted grand larceny. It remains to be seen whether Kozlowski and Swartz will be re-tried on these counts.

(b) Falsifying Business Records

The more traditional counts against Kozlowski and Swartz involved the falsification of various corporate records on file with the state. New York law prohibits the falsifying of business records with “an intent to commit another crime or to aid or conceal the commission thereof.”<sup>82</sup> Violation of this statute is a Class E felony, also subject to a five-year statute of limitations<sup>83</sup> and punishable by up to four (4) years’ prison time.<sup>84</sup> The Tyco prosecutors asserted that Kozlowski and Swartz had falsified certain business records (the loan forgiveness agreements providing millions to them and other Tyco employees) with the intent to commit another crime (the grand larceny). Again, it remains to be seen whether these charges will be pursued upon re-trial.

2. Illinois

Illinois is one of the states that has responded to recent scandals with a new corporate fraud statute. The Illinois statute both criminalizes some formerly non-criminal behavior and toughens existing penalties. Importantly, the subject corporation need not be of a specific size to trigger this section’s application (or even be publicly-owned), as D&Os of small private companies are covered with equal force.

Penalties for the new corporate malfeasance crimes<sup>85</sup> vary according to the benefit received. If the D&O receives a benefit greater than \$500,000, the conduct is deemed a Class 2 felony subject to up to seven (7) years’ imprisonment whereas a benefit less than \$500,000 is a Class 3 felony subject to up to five (5) years imprisonment.<sup>86</sup> Consistent with other Illinois felonies, violations of the new provisions must be brought within a three-year statute of limitations.<sup>87</sup> Another notable provision of the new statute is its establishment of a new corporate crime fund into which guilty D&Os may be required to contribute an amount equal to up to three times the value of all property involved in the criminal activity.<sup>88</sup>

**IV. Conclusion**

The criminal D&O landscape has seen radical changes in a relatively short time frame. Not only are there new statutes aimed at curbing corporate abuses, there are innovative applications of existing statutes as well. These trends are certain to continue as state and federal prosecutors seek to assuage public concerns about the explosion of corporate scandals.

**CORPORATE INDEMNIFICATION AND ADVANCEMENT**

**I. Pertinent Statutory Authority**

**(A) Delaware General Corporation Law § 145**

Without question, the single most important statute addressing corporate indemnification and advancement is § 145 of the Delaware General Corporation Law. In short, § 145 authorizes (*i.e.*, permits) corporations to indemnify and advance their D&Os' defense expenses (and *requires* indemnification, in certain cases) and, in the absence of more specific corporate authority, provides a general framework for administering that process. A Westlaw KeyCite of § 145 illustrates its continuing relevance; of the more than 150 reported caselaw and administrative decisions involving § 145, one-third have been issued within the last four years.

1. Indemnification Under § 145

Section 145 is designed to “induce capable and responsible businessmen to accept positions in corporate management.”<sup>89</sup> Cognizant of this purpose, courts have interpreted § 145's terms liberally and enforced corporate obligations under it stringently.

- What Proceedings Are Covered

“[T]he first requirement for indemnification under Section 145 is that the expenses in question be incurred in connection with a covered proceeding.”<sup>90</sup> This hurdle is relatively easy to clear, as corporations are authorized to provide indemnification in connection with *any* civil, criminal, administrative or investigative action, including derivative actions to a certain extent.<sup>91</sup>

- Who May Claim Indemnification

Subject to its other provisions, § 145 authorizes indemnification for “any person who was or is a party *or is threatened to be* made a party to” a covered proceeding (see above) by reason of the person's status as: (1) a current or former director, officer, employee or agent of the corporation or (2) a director, officer, employee or agent of another corporation or related enterprise, if done at the corporation's request.<sup>92</sup> (Italicized emphasis added.) Indemnification also is available to a D&O's “heirs, executors and administrators” for actions taken in these positions, unless the corporation specifies otherwise.<sup>93</sup>

Capacity questions abound under this language, and there are no easy answers.<sup>94</sup> For instance, Delaware courts have found that the agency relationship under § 145 “logically extends to only those situations when an outside contractor – such as an attorney – could be said to be acting as an arm of the corporation vis-a-vis the outside world.”<sup>95</sup> Resolving indemnification requests by

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D&Os of corporate subsidiaries is an even more complicated and fact-intensive inquiry.<sup>96</sup>

- Mandatory vs. Permissive Indemnification

Section 145 provides for both mandatory and permissive indemnification.<sup>97</sup>

Mandatory indemnification is only available to D&Os, not to employees and agents, and then only when the D or O has been “successful on the merits or otherwise” in a suit.<sup>98</sup> Citing this clause’s “or otherwise” language, Delaware courts have found that even a dismissal with prejudice or the equivalent result based on a technicality is sufficient.<sup>99</sup> Courts also have found that complete and total success is not required, as “Claimants are... entitled to partial indemnification if successful on [one] count of an indictment...even if unsuccessful on another, related count.”<sup>100</sup> This logic, however, applies only on a count-by-count basis, not an allegation-by-allegation basis.<sup>101</sup>

The rules for permissive indemnification, by contrast, vary with the type of suit involved. To receive permissive indemnification for a *third-party action*, the claimant must have:

acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person’s conduct was unlawful.<sup>102</sup>

Any one of the following four groups can make this determination:

- (1) a majority vote of the directors who are not parties to the subject action, even if less than a quorum;
- (2) a committee of such directors designated by such directors’ majority vote, again, even if less than a quorum of the entire board;
- (3) written opinion of an independent legal counsel, if there are no such directors or if such directors so direct; or
- (4) the stockholders.<sup>103</sup>

In making this determination, “the termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act” appropriately.<sup>104</sup>

The process for permissive indemnification in *derivative actions* is much different. While a corporation’s disinterested directors or shareholders may grant indemnification for a *pending or settled* derivative action (subject to the “good faith” test described above), in actions where the person *has been adjudged liable to the corporation*, indemnification can only be granted if, and

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to the extent that, there is a judicial finding that the person is “fairly and reasonably entitled” to indemnity, and that the requested indemnification is for “proper” expenses.<sup>105</sup>

- Recoverable Expenses

Eligible individuals may be indemnified for virtually any expense, including attorneys’ fees, judgments, fines and amounts paid in settlement “actually and reasonably incurred” by the person in connection with a covered proceeding, subject to certain exceptions for derivative actions.<sup>106</sup> Indemnification in derivative actions is limited to a claimant’s *expenses and attorneys’ fees*, and cannot include amounts that the claimant owes the corporation.<sup>107</sup>

The judicial analysis of whether a particular expense has been “reasonably incurred” typically tracks the factors set out by Rule 1.5 of the American Bar Association’s Model Rules of Professional Conduct, which include:

- (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
- (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
- (3) the fee customarily charged in the locality for similar legal services;
- (4) the amount involved and the results obtained;
- (5) the time limitations imposed by the client or by the circumstances;
- (6) the nature and length of the professional relationship with the client;
- (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
- (8) whether the fee is fixed or contingent.<sup>108</sup>

After some initial reluctance,<sup>109</sup> Delaware courts now also allow claimants to recover their costs of bringing indemnification litigation (a/k/a “fees on fees”) under § 145, so long those costs as not specifically precluded by a corporate bylaw or other resolution.<sup>110</sup>

## 2. Advancement Under § 145

Section 145 also provides that D&Os may seek advancement of their defense expenses. Delaware courts have made clear that there is no right to *mandatory* advancement under § 145.<sup>111</sup>

The key difference between advancement and indemnification is that advancement is not conditioned on the underlying action’s merits. Instead, § 145(e) contemplates only that the claimant will provide “a written undertaking to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation as authorized in this section.”<sup>112</sup> Delaware courts have noted that because advancement is essentially a line of

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credit, only the corporation, using its business judgment, can determine “whether the undertaking proffered in all of the circumstances is sufficient to protect the corporation’s interest in repayment and whether, ultimately, advancement of expenses would on balance be likely to promote the corporation’s interests.”<sup>113</sup> One court went so far as to say that corporations may choose not to require any undertaking from the D&O under § 145(e).<sup>114</sup>

**(B) New York Business Corporation Law §§ 721-726**

New York law on indemnification and advancement closely tracks that of Delaware, with a few notable exceptions:

First, there is *no* statutory indemnification for *administrative or investigative actions*.

Second, there are *no* statutory indemnification rights for *corporate employees or agents*.

Third, under New York law, the “good faith” test required for permissive indemnification may not be delegated to a committee of the board of directors.

Fourth, judicial approval is required for all indemnification requested in connection with: (a) “threatened” derivative actions; (b) “pending” derivative actions that are “settled or otherwise disposed of”; and (c) “any claim, issue or matter” where the claimant has been adjudged to be liable to the corporation.<sup>115</sup>

Fifth, claimants in New York generally may be indemnified for all “judgments, fines, amounts paid in settlement and reasonable expenses, including attorneys’ fees” in all actions, including derivative actions, subject to certain limited exceptions.<sup>116</sup>

Sixth, “fees on fees” may not be recovered in statutory-based indemnification actions, although a claimant may be able to seek such fees under a private indemnification agreement.<sup>117</sup>

Finally, a claimant may seek a *judicial order of advancement* where, “by his pleadings or during the course of the litigation, [he has] raised genuine issues of fact or law” even if the alleged harm is to the corporation itself.<sup>118</sup>

**II. Indemnification and Advancement By Agreement**

In addition to the statutory rights afforded above, Delaware and New York law alike authorize corporations to provide indemnification to their D&Os through supplementary means such as corporate bylaws, resolutions and private indemnification agreements.<sup>119</sup> Corporate indemnification agreements usually state that the company “shall indemnify [the indemnitee] to

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the fullest extent permitted by applicable law in effect on the date hereof or as such laws may from time to time be amended.”<sup>120</sup> As a result, many of these agreements’ provisions closely track the language of Delaware § 145 or other statutory authority.<sup>121</sup>

**III. Current Battleground: Advancement**

Without question, the current dispute over these rights focuses on a corporation’s obligation to advance defense expenses. Simply put, most corporations that have been economically crippled by the malfeasance of their former executives find it objectionable (to put it mildly) that they then should have to pay to defend those individuals.

The problem most companies face is that the statutory language used as a shield for limiting indemnification (*i.e.*, “to the extent permitted by applicable law”) unwittingly becomes a sword when applied to advancement. As discussed above, Delaware § 145 and New York § 722 generally require claimants to prove that they acted in good faith to receive indemnification. Advancement has no comparable “good faith” requirement, only the requirement that one provide a written undertaking to repay. Understandably, many corporations are skeptical about advancing significant sums of money (which ordinarily will be in the six or seven figures, if not higher, when civil, criminal and regulatory actions are involved) in exchange for a promise from the executive – an accused liar – to repay. Further complicating matters is the fact that in many cases, the executive is likely to exhaust his personal assets to satisfy any settlement or judgment reached against him. In the corporation’s view, then, the situation amounts to throwing good money after bad. As such, many corporations have refused to advance defense expenses, arguing that D&Os accused of acting in their own interest to the corporation’s detriment have placed themselves outside the shelter of indemnification. The following two cases, both based in Delaware, illustrate the courts’ hostility to these arguments.

**(A) Bergonzi v. Rite Aid**

The first case stemmed from what, at the time, was the largest financial restatement by a public company in American history – Rite Aid Corporation’s restatement of over \$2.3 billion in cumulative pretax income and \$1.6 billion in cumulative net income during the latter half of 2000.<sup>122</sup> A slew of civil, criminal and administrative actions followed against Rite Aid’s former executives, including former Chief Financial Officer Franklyn M. Bergonzi.<sup>123</sup> Rite Aid initially advanced Bergonzi’s defense expenses for various litigation, but following his June 5, 2003 guilty plea to participation in a criminal conspiracy to defraud Rite Aid, the company’s Board:

- (1) decided that Bergonzi was not entitled to indemnification;
- (2) notified Bergonzi that it would no longer advance the costs of his defense; and
- (3) demanded repayment (pursuant to Bergonzi’s written undertaking to repay) of money previously advanced on his behalf.<sup>124</sup>

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On July 28, 2003, pursuant to Delaware § 145(k), Bergonzi filed an action in Delaware Chancery Court for advancement of his unpaid defense expenses.<sup>125</sup> Rite Aid answered Bergonzi's complaint and filed a counterclaim seeking repayment of the amounts previously advanced.<sup>126</sup> Bergonzi filed a motion to dismiss Rite Aid's counterclaim as unripe, arguing that Rite Aid's by-laws, which tracked § 145(e), afforded him a right to advancement until a "final adjudication" established otherwise.<sup>127</sup> Rite Aid, in response, argued that Bergonzi's guilty plea presented "a unique circumstance and should constitute an 'ultimate determination' that Bergonzi is not entitled to indemnification – triggering the obligation to repay the advanced expenses (and cutting off the right to future advancements)."<sup>128</sup>

In granting Bergonzi's motion to dismiss the counterclaim, the court noted that he: (1) had yet to testify in a related proceeding, as called for by his plea agreement and (2) had not yet been sentenced.<sup>129</sup> In light of these contingencies, the court could not say that there had been a "final adjudication" such that Bergonzi was precluded from receiving further advancement under the specific terms for advancement in Rite Aid's by-laws.<sup>130</sup> The court noted that "Rite Aid could have easily drafted this provision differently, but it did not and must now maintain its bargain with its former officer."<sup>131</sup>

**(B) Tafeen v. Homestore, Inc.**

A second significant decision also involves massive accounting chicanery – this time involving online real estate service provider Homestore, Inc., which, in late 2002, restated \$192 million in revenues for fiscal 2000 and 2001.<sup>132</sup> Homestore's restatement resulted in Securities & Exchange Commission and Department of Justice investigations as well as ten (10) civil actions, all of which involved, to various degrees, allegations of illegal actions by and excessive profits received by former Homestore VP Peter Tafeen.<sup>133</sup> After Homestore failed to advance Tafeen's expenses in defending the various actions, he sued the company.<sup>134</sup>

In its motion for summary judgment, Homestore raised nine (9) different defenses<sup>135</sup> to advancement, all of which boiled down to, as the court put it, "that [Tafeen] is not entitled to advancement because he has offered a hollow, worthless promise to repay if he is ultimately found not to be entitled to indemnification."<sup>136</sup> In denying eight of Homestore's asserted defenses as a matter of law, the court noted that the company:

reminds one of a sinner who suddenly finds religion – the conversion is breathtaking. Content to adopt advancement and indemnification bylaws drafted with holes large enough to drive a truck through, [Homestore] (like so many others in this Court of late) suddenly "finds religion" – insisting on a rigorous interpretation of its loosely written bylaws.<sup>137</sup>

Consistent with the view expressed in Bergonzi, the court noted that, "Homestore had the right to

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lessen the credit risk posed by its advancement bylaw. It did not do so.”<sup>138</sup>

A significant point lay in the court’s ruling on Homestore’s “unclean hands” defense, which it left open pending additional factual development. Homestore had claimed that in order to shelter assets otherwise available to repay Homestore in the event of an adverse finding, Tafeen had purchased an expensive home in Florida, a state with an extremely generous ‘homestead’ exemption for creditor claims.<sup>139</sup>

While acknowledging that Delaware public policy (as seen in § 145(e)) weighed in favor of advancement, the court concluded that:

Allowing an unclean hands defense based on alleged affirmative actions taken to shelter assets does not undermine this public policy. Corporate officials ought to continue to be secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve. They are simply now on notice that they will not be permitted to use *the statute itself* after taking improper actions at the expense of the corporation’s stockholders.<sup>140</sup>

Because the unclean hands defense would require additional factual development, the court denied summary judgment on it as well, but ordered that the matter continue to trial on those issues.<sup>141</sup> The court has since denied Tafeen’s motion for re-argument on the denial of summary judgment for that issue.<sup>142</sup>

#### **IV. Conclusion**

The current balance stands in favor of D&Os on several important indemnification-related issues, including advancement and, in the case of Delaware, “fees on fees.” Corporations are not entirely without hope, as the Homestore decision indicates that there still may be *some* limits on the judicial predisposition for granting advancement. How this area of law continues to develop will be important, as the glut of corporate scandals continues to work its way through the judicial process.

### **LITIGATION MANAGEMENT AND COVERAGE ISSUES**

#### **I. Litigation Management Issues**

When one learns that he or she is under investigation for possible criminal wrongdoing, a natural reaction is to seek out the advice of counsel. Because D&O policies typically provide coverage for the costs of defending criminal matters, sometimes including formal investigations (even

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though they do not indemnify insureds for their criminal acts), litigation management issues are often of immediate concern to a carrier receiving notice of such a proceeding.

**(A) Choice of Counsel and Conflicts**

D&O policies generally offer indemnification-only coverage (*i.e.*, the insured selects the counsel) though an increasing number are written on a duty-to-defend basis (*i.e.*, the insurer selects the counsel). In either case, the insurer has *some* input into the selection of counsel, because indemnification policies usually include a provision requiring the insurer's prior consent to the insured's choice of counsel, with such consent not to be unreasonably withheld.<sup>143</sup> Because criminal convictions can result in the defendant's loss of liberty, this decision carries extreme importance, and insurers ordinarily should accede to an insured's choice of counsel in the absence of a compelling reason to object.

When the insured proposes counsel to handle the defense, insurers should consider whether:

- counsel can properly represent multiple defendants;
- counsel has sufficient expertise in defending criminal matters to effectively handle the representation;
- the prosecution involves corporate transactions negotiated by or approved by the counsel or his/her law firm, creating a conflict;
- any pre-existing business relationship might create pressure on counsel (either from the entity's new management or the law firm's leadership) to place the entity's interests before those of the individual;
- counsel's relationship with the insured entity or persons may influence counsel to structure the defense in such a way as to maximize insurance coverage, lessen the chances for corporate indemnification, or advance the defense of any associated regulatory or criminal investigations of the entity to the detriment of any other individual client; and
- geographic location of counsel.

As a general rule of thumb, it is advisable for individual insureds to retain independent, well-experienced counsel for the defense of criminal D&O matters to avoid any potential conflict of interest, and insurers should advise them of as much.

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**(B) “Reasonable and Necessary” Fees and Costs**

1. The Engagement

It should be noted at the outset that defense counsel may decline to provide full versions of their bills based on privilege grounds. Although the strength of those objections can vary according to the laws of each state, by and large these types of objections have a reasonable basis. In such cases, insurers may need to reserve their rights as to issues of “reasonableness” until the matter has concluded and privilege issues are no longer present.

Given that the insurer may have less information with which to manage the defense and associated costs, the best way for it to protect its interests is by working with the proposed counsel at the engagement’s outset to negotiate an appropriate rate and expense structure for the defense. As part of this process, insurers should obtain the following information:

- How many timekeepers will be utilized

Some firms assume that complicated litigation grants them *carte blanche* with respect to staffing decisions. Overstaffing is one of the most wasteful litigation billing practices, as oftentimes it costs more to have a newly-enlisted paralegal educate himself with the file for purposes of completing a discrete task than to have the attorney already familiar with the file perform the task. Our own experience provides a prime example of these problems, as one of our assignments involved opining on the fees and costs incurred in defending a major criminal D&O matter where a firm employed in excess of one-hundred twenty (120) timekeepers, including forty-four (44) paralegals, to defend a single individual who later agreed to enter a guilty plea.

- Who are those timekeepers and what are their qualifications

Insurers should ask for all pertinent background information about the proposed timekeepers, including paralegals and any proposed consultants or defense experts. With many large firms now billing lead counsel at over \$500 an hour, and even paralegals at over \$150 an hour, insurers should ensure that the timekeepers’ professional qualifications support the proposed rates. In addition, when dealing with firms who operate nationwide, insurers should verify that the appropriate office will handle the representation. For instance, the firm referenced above also thought that having timekeepers from their Los Angeles, San Diego and Washington, D.C. offices coordinate on a matter pending in Pennsylvania was a cost-effective defense strategy.

- What will be each timekeeper’s role in the defense

Insurers should ask counsel to identify the attorneys with primary responsibility for the file, and verify that counsel’s duties are not only independent of those of their colleagues, but also those

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of any outside assistance, including experts. If a “relationship” or “rainmaker” partner is proposed for supervisory or client coordination purposes (often at rates exceeding \$500 per hour), consider whether that involvement is necessary, or if it can be limited to a maximum number of hours per month or to certain defined tasks (*e.g.*, communication with the client).

- What charges will apply for services and disbursements

Insurers also should request information regarding scheduled charges, such as photocopying. As explained above, “overhead” costs such as local travel, office supplies and employee meals should not be billed. In a similar vein, charges that are billed to the file should come with a sufficient degree of detail to be readily identified.

- If necessary, who will serve as local counsel

In civil litigation, local counsel oftentimes serves as little more than a person who signs and files pleadings and makes appearances at insubstantial hearings. By contrast, criminal local counsel can be a valuable addition to the defense team, as effective local counsel can obviate the need for lead out-of-town counsel to appear before the court on short notice and perform local-based tasks in a more efficient and cost-effective manner. As an example, the nationwide firm referenced above selected a sole practitioner as its local counsel but, for unspecified reasons, charged him with completing only menial tasks. Lead counsel then decided to establish a temporary local office of its own solely for purposes of the matter, at a cost of over \$34,000.

Insurers should also review counsel’s bills on a monthly basis to ensure that the billings are within the agreed parameters and constitute defined Defense Costs; even heavily redacted bills can be useful in identifying costs and fees that may be unreasonable.

## 2. The Evaluation

The typical definition of Defense Costs includes:

reasonable costs, charges, fees (including but not limited to attorneys’ fees and experts’ fees) and expenses (other than regular or overtime wages, salaries or fees of the directors, officers or employees of the Company) incurred in defending or investigating Claims and the premium for appeal, attachment or similar bonds.<sup>144</sup>

“Reasonable” fees are defined on a state-by-state basis, but an overwhelming majority<sup>145</sup> follow the non-exhaustive list of factors contained in Model Rule 1.5.<sup>146</sup> Expenses face similar scrutiny, with courts distinguishing between overhead (*i.e.*, non-billable) costs and out-of-pocket (*i.e.*, billable) costs primarily by looking to see if the cost in question is a day-to-day operating cost or whether it can be clearly traced to a particular client.<sup>147</sup>

## **II. Major Coverage Issues**

Despite their procedural and semantical differences, civil and criminal litigation have at their core an identical goal: to enforce an individual's responsibilities under a particular source of obligations. Similarly, the process for evaluating coverage in connection with a criminal action tracks that employed when examining civil litigation.

### **(A) Rescission**

Without question, the most prominent coverage issue associated with criminal D&O actions is rescission. Before asserting a rescission defense, insurers should be able to conclusively answer two questions in the affirmative: (1) Was the alleged misrepresentation or omission "material"? and (2) Can the material misrepresentation or omission be attributed to the insured?

The answer to the first question largely depends on the law of the particular jurisdiction. Virtually all states have statutes defining materiality; for example, the California Insurance Code provides that:

Materiality is to be determined not by the event, but solely by the probable and reasonable influence of the facts upon the party to whom the communication is due, in forming his estimate of the disadvantages of the proposed contract, or in making his inquiries.<sup>148</sup>

Many jurisdictions hold that allegedly inaccurate financial information disseminated to the public, which many criminal D&O matters focus on, is "material," under the theory that such information is "patently critical to the insurer's decision to provide coverage."<sup>149</sup> There is some law suggesting that, in the context of omissions, the insured has no duty to volunteer potentially harmful information if not otherwise requested by the carrier.<sup>150</sup> Insurers also should take care to note what *level of intent*, if any, will be required by the court considering rescission.<sup>151</sup>

The answer to the second question, by comparison, depends largely on the language of the particular policy or application form at issue, and many policies now contain language noting that the misrepresentations or omissions of one insured in connection with the application for insurance may not be imputed to the other insureds for rescission purposes in the absence of specific knowledge by those individuals regarding the information misrepresented or omitted.<sup>152</sup>

Beyond the legal issues, insurers must also consider the additional costs associated with pursuing a rescission. The one obvious cost of rescission comes in the form of return premium for the policy. This can be a not insignificant proposition, especially for carriers who charge millions of dollars to provide healthy layers of primary coverage to companies having annual revenues in the hundreds of millions or even billions. Another consideration is the expense of pursuing a

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declaratory or interpleader coverage action. Because D&O criminal defendants are unlikely to willingly part with insurance funds that might be used to pay for their defense and/or satisfy potential settlements of related civil actions, pursuing a rescission can be a long and costly process for the insurer, and one that is not absorbed by the policy's limits. Finally, even if the insurer believes that it stands on solid legal ground and eventually will prevail, emerging authority consistently compels it to provide or pay for the defense of its insureds in the interim. As discussed in greater detail *infra*, recent decisions involving attempted rescissions of the Tyco and Adelphia D&O policies make clear that a pending rescission does not absolve a carrier of these obligations.

For all of these reasons – both legal and practical – carriers should carefully think through the issues before pursuing rescission in connection with criminal D&O matters.

**(B) The Insuring Agreement**

Outside of considerations regarding rescission, an insurer's typical initial inquiry will be whether the tendered action falls within the governing policy's insuring clause; that is, whether the criminal action is a defined Claim first made during the policy period that alleges Wrongful Acts committed by an Insured.

1. Claims-Made Issues

Whether the criminal investigation or action constitutes a defined Claim depends on the specific policy language at issue. Some older policy forms require that criminal proceedings be brought by indictment in order for them to constitute a Claim.<sup>153</sup> Newer policy forms include virtually *all* criminal investigations and proceedings – brought by indictment, information<sup>154</sup> or otherwise – as Claims.<sup>155</sup>

A concurrent inquiry should be whether the Claim is one first made during the policy period. In making this determination it may be worthwhile to examine whether the criminal action “relates back” to any pre-policy Claims, especially civil suits, which are easier to file and more often than not predate criminal proceedings. While this inquiry also depends on the specifics of the particular situation, there are some helpful rules of thumb, including:

- When interpreting the phrase “interrelated,” courts usually take a pro-insured approach and hold that “legally distinct claims that allege different wrongs to different people” are not interrelated.<sup>156</sup> Under this test, a civil action alleging accounting fraud resulting in substantial gain to the executive likely would not be “related” to a criminal action to recover unpaid taxes on those gains.
- Given an appropriate factual record, however, courts *may* accept the argument that

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there was a “unitary scheme” common to all pieces of the litigation.<sup>157</sup> There are no reported cases of an insurer using this theory to link civil and criminal litigation for coverage purposes.

- Even where insurers attempt to define “interrelatedness” by imposing a “factual nexus” requirement or, going even farther, by excluding coverage whenever *any* part of a claim is in *any* manner related to the prior Wrongful Act, courts still require that at least “but for” causation be shown.<sup>158</sup>

As these general rules show, insurers arguing that criminal litigation is “related to” civil litigation for coverage purposes face an uphill battle. Absent broadly worded and particularly helpful policy language, most criminal actions will be deemed “unrelated” to civil litigation and treated as separate claims, usually with the intent of maximizing available coverage.

2. Capacity Issues

The second half of an inquiry under the insuring agreement deals with whether the alleged criminal acts were committed in the D&O’s insured capacity. Most policies include this prerequisite to coverage in their definition of “Wrongful Acts,” although some policies define the term separately.<sup>159</sup> Because most D&Os are also significant shareholders of the company and may serve in various capacities with corporate subsidiaries or outside entities, an insurer may be able to negotiate a significant allocation for those actions taken in uninsured capacities, which can be common in the criminal context.<sup>160</sup> For instance, a securities fraud prosecution may involve acts taken both in insured (*e.g.*, making false and misleading statements regarding the company’s financial outlook) and uninsured (*e.g.*, voting one’s shares in favor of an action that furthers the scheme) capacities. When all of the charges in a particular prosecution are stated against the D&O in his or her *individual* capacity, like those against Tyco’s Dennis Kozlowski for failing to pay sales tax on his personal art purchases or the obstruction charges against Martha Stewart relating to her insider trading of ImClone shares, there should be no coverage for the proceedings.

**(C) Limitations on Coverage**

As noted above, while D&O policies are not designed to indemnify insureds for their criminal acts, they do typically cover defense expenses. As explained below, while most policies afford insurers sufficient protection against exposure via fines, penalties and the like, similar protections are unavailable for the exposure presented by the obligation to advance costs of defense.

1. Definition of Loss

A policy’s definition of Loss is one of its most important provisions, as a definition that is both

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clear and comprehensive will eliminate much of an insurer's exposure for Loss in the criminal context other than advancement of Costs of Defense. In fact, most definitions of Loss specifically carve out fines, penalties and taxes.<sup>161</sup> In addition to those express limitations, actions (1) brought to enforce an existing statutory obligation, like taxes,<sup>162</sup> or (2) for disgorgement of ill-gotten gains<sup>163</sup> arguably can result in no Loss other than Costs of Defense.

Most definitions of Loss also exclude "amounts for matters uninsurable under the governing law."<sup>164</sup> Many states preclude insurance coverage for criminal acts on the grounds that it such coverage would violate public policy.<sup>165</sup> California has codified its public policy in this regard, stating that "an insurer is not liable for a loss caused by the wilful act of the insured; but he is not exonerated by the negligence of the insured, or of the insured's agents or others."<sup>166</sup>

2. Exclusions

Defined Loss may be excluded under other policy provisions. Those most commonly implicated in the criminal context are a policy's personal conduct exclusions. The typical policy language excludes coverage for Claims:

- a. for any deliberately fraudulent act or omission or any willful violation of any statute or regulation if a judgment or other final adjudication adverse to such Insured Person establishes that such Insured Person committed such an act, omission or willful violation; [or]<sup>167</sup>
- b. based upon, arising out of, or attributable to such Insured Person gaining in fact any personal profit, remuneration, or financial advantage to which such Insured Person was not legally entitled.<sup>168</sup>

A subtle difference in these exclusions lies in their triggering events. As the above-quoted language illustrates, while fraud and dishonesty exclusions usually require that there be a "judgment or other final adjudication," personal profit exclusions typically only require an "in fact" finding.<sup>169</sup> According to a leading treatise, the "final adjudication" language is "viewed as being more favorable to the insured because it implies that the claim has reached a definite conclusion," whereas the "in fact" language suggests that the exclusion might apply simply after hearing testimony given at trial, before any resolution is reached.<sup>170</sup>

Recent caselaw has revisited what constitutes a "final adjudication" in the criminal context. In former Rite Aid CFO Franklyn Bergonzi's action for indemnification under a corporate by-law with similar language, the court declined to find that the requisite "final adjudication" had yet occurred, stating as follows:

Bergonzi has pled guilty, but he still must testify in a related proceeding pursuant

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to his plea agreement. Bergonzi's use as a witness will impact whether the government gives him a favorable sentencing recommendation. It appears, as a practical matter, that the proceedings have not reached their final disposition.<sup>171</sup>

Although it is the most recent decision (and from perhaps the most influential jurisdiction), Bergonzi is not necessarily the law of the land, as other courts have found that a "final adjudication" occurs as soon as the insured enters a guilty plea.<sup>172</sup> An interesting related question is whether a plea of *nolo contendere* would trigger either personal conduct exclusion. By its very nature, a plea of *nolo contendere* contains no admission of guilt, and is often viewed as a favorable alternative to a guilty plea that could be used against a defendant in related civil or regulatory proceedings.<sup>173</sup> Under current authority, it is not entirely clear whether a carrier could effectively deny coverage based on such a plea.

Similar interpretive questions have arisen with respect to the "personal profit" required under those exclusions. Generally speaking, courts have found that personal profit exclusions require the presence of: (1) an illegal profit or gain that (2) is directly received by the insured. Benefits received *derivatively* by the insured or as a by-product of an illegal act are not sufficient to trigger the exclusion.<sup>174</sup>

One significant issue for insurers to keep in mind as the backlog of criminal D&O matters plays out is the potential that a D&O could be convicted of a crime falling outside the scope of *both* exclusions. The public outrage over Enron-style collapses resulted in the enactment of legislation that both increased the category of punishable offenses and reduced the intent requirements for existing offenses, effectively creating a class of general intent<sup>175</sup> corporate crimes.<sup>176</sup> With no convictions under these provisions reported as of yet, it is difficult to predict how the associated coverage issues would be resolved. However, because a conviction on some of these offenses arguably would not require proof of specific intent or illicit profit, a court theoretically could find that the fraud & dishonesty and personal profit exclusions do not apply to these cases, and require an insurer to cover all Loss for same unless another policy term or exclusion precluded that result. This will be an issue for insurers to keep a close eye on as more cases are brought under these relatively untested statutes.

### **III. Advancement Issues**

While the foregoing limitations typically afford insurers sufficient protection *after* the criminal action's resolution, the same protections generally are not available with respect to advancement of defense expenses. In two recent significant cases, courts affirmed that D&O insurers generally must provide advancement of D&Os' criminal defense expenses until the requisite factual finding is made regarding the D&Os' conduct.

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**(A) Federal v. Tyco**

The first case is Federal Insurance Company v. Tyco International Ltd., et al., which involves a rescission action against manufacturing conglomerate Tyco by its D&O insurer. After returning the premium it had received for the policies issued to Tyco between 1999 and 2003, Federal filed an action seeking a declaration that those policies were void *ab initio* or, in the alternative, a declaration that certain exclusions barred coverage for the defendants, including former Tyco CEO Dennis Kozlowski.<sup>177</sup> Federal claimed that Tyco had made a number of misrepresentations during the application process for the Federal policies, such as by failing to disclose an alleged misappropriation of over \$750 million by Kozlowski and other former Tyco executives.<sup>178</sup> Kozlowski moved for partial summary judgment, claiming (among other things) that Federal had a duty to advance his defense expenses for (among other things) the criminal actions pending against him in New York state court.<sup>179</sup>

While acknowledging the dearth of New York law on the subject, the court granted Kozlowski's motion, concluding that:

[U]ntil Federal's rescission claims are litigated in its favor and the Policies are declared void *ab initio*, they remain in effect and bind the parties ... Accordingly, Federal's unproven rescission claim does not affect its present obligation to defend Kozlowski or pay his defense costs under the Policies. However, if Federal ultimately prevails in this action and the Policies are declared to be void *ab initio*, Federal may be able to recover its costs for the defense it has provided Kozlowski.<sup>180</sup>

The court also addressed Federal's personal profit exclusion as a grounds for avoiding its advancement obligation. According to the court:

The "personal profit" exclusion does not excuse Federal from covering Kozlowski in his criminal trial. While the Indictment alleges that Kozlowski obtained money illegally through the criminal enterprise, it also accuses him of crimes from which he did not directly profit ... Since [these counts] do not fall within the coverage exclusion, Federal's duty to provide defense costs extends to the entire Criminal Action.<sup>181</sup>

While the court arguably reached the proper result on this point, its logic in doing so is confusing and ignores the most compelling reason why the personal profit exclusion should not apply – because Kozlowski has not yet been found "in fact" to have received those profits.

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**(B) AEGIS v. Rigas**

Some two weeks later, the Eastern District of Pennsylvania also sided with the insureds in a similar dispute over advancement of defense expenses for pending civil and criminal litigation. The case of Associated Electric & Gas Insurance Services, Ltd., et al. v. John J. Rigas, et al. involved a rescission action brought by the former D&O insurers of now-bankrupt Adelphia Communications Corporation. As in Tyco, Adelphia's D&O insurers (led by primary carrier AEGIS) claimed misrepresentations regarding the company's financial health as their grounds for rescission.<sup>182</sup> Also as in Tyco, the former executives claimed that, until the rescission was definitively entered, AEGIS had a duty to advance their defense expenses for other civil and criminal litigation arising from Adelphia's collapse.<sup>183</sup>

The court found that a decision on rescission was barred by the automatic bankruptcy stay, but noted that, even if it were to consider the issue, and even if AEGIS's failure to return the policy premiums (which it claimed the bankruptcy court had prevented) was excused, the validity of the rescission was far from settled.<sup>184</sup> Citing Tyco and others, the court found that "until the issue of rescission is adjudicated, an insurer is bound by the obligations in that contract to advance defense costs[.]"<sup>185</sup> This result, the court observed, was supported not only by the policy language but by several public policy factors as well, most notable of which was the presumption that an individual is innocent until proven guilty.<sup>186</sup>

**(C) Advancement Agreements**

As the Tyco and Adelphia decisions make clear, courts are clearly inclined to require advancement by D&O carriers absent a final and preclusive factual finding that negates coverage or triggers an applicable exclusion. Problematic from the insurer's perspective is that there is no assurance the *significant* sums of money (*i.e.*, in the six or seven figures) it is likely to advance for the criminal defense will be repaid. The most obvious hurdle to repayment is that a criminal finding sufficient to trigger repayment almost certainly will lock in significant civil liability that, except for the independently wealthy, will exhaust the D&O's personal assets. Another potential roadblock to repayment is where the corrupt D&O shelters assets (either through legal or illegal means) in order to protect them from creditor claims.

So what can insurers do to enhance their chances of being repaid? One strategy they might consider is asking the D&O to execute a separate written undertaking to repay, similar to that contemplated by 8 Del. Code Ann. § 145(e), assuming the policy language conditions advancement on same or makes advancement discretionary. Such an advancement agreement would be a way to ensure that the individual D&O affirmatively and individually recognizes his or her obligation in this regard. Any agreement should, of course, provide that its terms and conditions only control as to the limited issue for which it is designed, and that in all other respects the policy controls, consistent with most policies' language regarding alteration and

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assignment.<sup>187</sup> While such an agreement cannot entirely eliminate the risk that the insured cannot or will not repay the monies advanced, it is a step in the right direction.

**IV. Conclusion**

As the foregoing makes clear, while criminal litigation presents many of the same general coverage issues as civil litigation, it does so with a twist, as in the case of “final adjudications.” Current caselaw makes clear that issues of advancement will continue to be of the utmost importance to insurers in the short-term, and that proffered rescissions will not preempt an insurer’s obligations in that regard. With criminal indictments of corporate executives becoming both more frequent and higher-profile in recent months, how the law in these cases develops is certain to have a profound impact on the D&O landscape for years to come.

**ENDNOTES**  
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1. While corporations can be indicted as well, that scenario is outside the intended scope of this paper.
2. While other coverages also might be implicated by these actions (e.g., fiduciary or fidelity bond), those coverages are outside the scope of this paper.
3. Rick Telberg, *A Joint Effort to Fight Corporate Fraud*, 197 J. ACCT. 4 (Apr. 2004), available at <http://www.aicpa.org/pubs/jofa/apr2004/telberg.htm>.
4. *Fraud Section homepage*, at <http://www.usdoj.gov/criminal/fraud.html>.
5. *Id.*
6. Exec. Order No. 13271 (July 9, 2002), available at <http://www.usdoj.gov/dag/cftf/execorder.htm>.
7. *Members of the President's Corporate Fraud Task Force*, at <http://www.usdoj.gov/dag/cftf/membership.htm>.
8. *Criminal Investigation (CI) At-a-Glance*, at <http://www.irs.gov/irs/article/0,,id=98398,00.html>.
9. *Statistical Data – Corporate Fraud*, at <http://www.irs.gov/irs/article/0,,id=121471,00.html>.
10. *Id.* The IRS defines “incarcerated” as including confinement to federal prison, halfway house, home detention, or some combination thereof.
11. *EBSA Organization Chart / Mission Statement*, at [http://www.dol.gov/ebsa/aboutebsa/org\\_chart.html](http://www.dol.gov/ebsa/aboutebsa/org_chart.html).
12. *Tyco Gets Subpoenaed on Retirement Plans*, Reuters, Aug. 14, 2003, found at [http://www.yourlawyer.com/practice/news.htm?story\\_id=6466&topic=Tyco%20%20Stock%20Fraud](http://www.yourlawyer.com/practice/news.htm?story_id=6466&topic=Tyco%20%20Stock%20Fraud)
13. *DCIS Home Page*, at <http://www.dodig.osd.mil/INV/DCIS/dcismain.html>
14. *DCIS Mission*, at <http://www.dodig.osd.mil/INV/DCIS/dcismis2.html>
15. *Criminal Probe of Halliburton Unit Begun*, MSNBC News (Reuters), Feb. 23, 2004, at <http://www.msnbc.msn.com/id/4355528>.
16. *U.S. Postal Inspection Service – Jurisdiction and Laws*, at <http://www.usps.com/postalinspectors/jurislaw.htm>.
17. *U.S. Postal Inspection Service – Who We Are*, at <http://www.usps.com/postalinspectors/missmore.htm>.
18. For example, in New York the Investment Protection Bureau (under the state attorney general’s control) conducts civil and criminal investigations as well as criminal prosecutions of violations of the New York State Securities Law. *Investors and Securities – Office of New York State Attorney General Eliot Spitzer*, at <http://www.oag.state.ny.us/investors/investors.html>.
19. U.S. CONST., amend. V.
20. 18 U.S.C. § 3321.

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21. U.S. Attorney's Manual, 9-11.101, at [http://www.usdoj.gov/usao/eousa/foia\\_reading\\_room/usam/title9/11mcrm.htm](http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/11mcrm.htm).
22. *Federal Grand Juries*, University of Dayton, at <http://www.udayton.edu/~grandjur/fedj/fedj.htm>.
23. U.S. Attorney's Criminal Resource Manual, Title 9, § 158, at [http://www.usdoj.gov/usao/eousa/foia\\_reading\\_room/usam/title9/crm00158.htm](http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/crm00158.htm).
24. 18 U.S.C. § 3331.
25. *Federal Grand Juries*, *supra* note 22.
26. An information is the filing of formal criminal charges by a prosecutor without the intervention of a grand jury. *See* BLACK'S LAW DICTIONARY 701 (5th ed. 1980).
27. In the criminal law context, "information" and "complaint" are often used interchangeably. *See* BLACK'S LAW DICTIONARY 258 (5th ed. 1980). For a good state-by-state breakdown on this topic, see *State Grand Jury Functions*, at <http://www.udayton.edu/~grandjur/stategj/funcsgj.htm>.
28. To prove a violation of § 371, prosecutors must show: (1) an object to be accomplished; (2) a plan or scheme embodying means to accomplish that object; and (3) an agreement or understanding between two or more defendants whereby they become definitely committed to cooperate for the accomplishment of the object by the means embodied in agreement, or by any effectual means. *U.S. v. Henley*, 360 F.3d 509, 513 (6th Cir. 2004) (citations omitted).
29. 18 U.S.C. § 3282.
30. Fines can be as much as \$250,000, depending on the nature of the conspiracy. *See* 18 U.S.C. §§ 371, 3571.
31. *U.S. v. Grass, et al.*, Case No. CR-02-146 filed in U.S. Dist. Ct. (M.D. Penn.), Complaint at p. 23.
32. Bloomberg News, *Rite Aid lawyer, 76, gets 10 years in jail*, N.Y. DAILY NEWS, October 15, 2004, available at <http://www.nydailynews.com/business/story/242429p-207873c.html>
33. Geraldine Szott Moohr, *The Federal Interest in Criminal Law*, 47 Syracuse L. Rev. 1127 (1997).
34. 18 U.S.C. § 3282.
35. 18 U.S.C. § 982(A)(2)(A).
36. 15 U.S.C. § 78j(b).
37. *U.S. v. Grass*, *supra* note 31 at p. 64.
38. As noted above, however, the SEC and other governmental agencies can also bring civil suits for securities fraud violations.
39. *See* Julia K. Cronin, *Securities Fraud*, 38 AM. CRIM. L. REV. 1277, 1288 (2001).
40. *Aaron v. SEC*, 446 U.S. 680 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

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41. Cronin, *supra* note 39 at 1288. Cronin suggests that this confusion may be due to the fact that the criminal willfulness provision (15 U.S.C. § 78ff(a)), was drafted *before* courts interpreted a requirement of scienter under the civil provision (15 U.S.C. § 78j).
42. *Id.* at 1289, quoting U.S. v. Schaefer, 299 F.2d 625, 629 (7th Cir. 1962).
43. 15 U.S.C. § 78ff.
44. U.S. v. Stewart, et al., Case No. 03 Cr. 717 filed in U.S. Dist. Ct. (S.D.N.Y.), Superseding Indictment ¶¶ 60-65.
45. *Stewart Found Guilty on All Counts*, CNN/Money, Mar. 5, 2004, at [http://money.cnn.com/2004/03/05/news/companies/martha\\_verdict/](http://money.cnn.com/2004/03/05/news/companies/martha_verdict/).
46. Compare Carter v. U.S., 530 U.S. 255, 261, 120 S.Ct. 2159, 147 L.Ed.2d 203 (2000) (mail fraud case) with U.S. v. Frank, 354 F.3d 910 (8th Cir. 2004) (wire fraud case).
47. For more information, see Ellen S. Podgor, *Criminal Fraud*, 48 Am.U.L.Rev. 729, 753 (Apr. 1999).
48. Incarceration time can increase to 30 years if the victim is a financial institution.
49. U.S. v. Grass, *supra* note 31 at p. 72.
50. 18 U.S.C. § 1001; see also U.S. v. Hart, 92 F.3d 1186 (6th Cir. 1996) (unpublished).
51. See 18 U.S.C. §§ 1001, 3571.
52. U.S. v. Grass, *supra* note 29 at p. 67.
53. U.S. v. Stewart, *supra* note 44 at pp. 25-28.
54. 18 U.S.C. § 3282.
55. The elements of an obstruction of justice count are that: (1) there was a pending judicial proceeding; (2) the defendant had knowledge or notice of the proceeding; (3) the defendant acted corruptly with the intent of influencing, obstructing, or impeding the proceeding in the due administration of justice; and (4) the defendant's action had the "natural and probable effect" of interfering with the due administration of justice. In re Impounded, 241 F.3d 308 (3rd Cir. 2001).
56. See 18 U.S.C. §§ 1510, 3571.
57. 18 U.S.C. § 1503.
58. U.S. v. Petzold, 788 F.2d 1478, 1485 (11th Cir. 1986).
59. 18 U.S.C. § 1503(b).
60. 18 U.S.C. § 1505.
61. See 18 U.S.C. §§ 1505, 3571.

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62. 18 U.S.C. § 1512(b); *see also* U.S. v. Vitagliano, 86 Fed.Appx. 470, 473 (2nd Cir. 2004).
63. 18 U.S.C. § 1512(b)(2).
64. 18 U.S.C. § 1512(b).
65. 18 U.S.C. § 1512(c).
66. 18 U.S.C. § 1512(I).
67. U.S. v. Grass, *supra* note 31 at pp. 90-91.
68. 18 U.S.C. § 1623; *see also* U.S. v. Santosuosso, 19 F.3d 1435 (table), \*8 (6th Cir. Feb. 25, 1994).
69. U.S. v. Grass, *supra* note 31 at pp. 92-96.
70. SOA also contains numerous new civil provisions, and makes several important changes in existing civil securities fraud statutes. While that is beyond the scope of this paper, any of a number of articles detail those provisions, including Michael B. Bixby, *The Sarbanes-Oxley Act: New Responsibilities for Business*, 46-NOV ADVOC (Idaho) 15 (Nov. 2003).
71. 18 U.S.C. § 3282.
72. 18 U.S.C. §§ 1348-1349.
73. 18 U.S.C. § 1348.
74. 18 U.S.C. § 1350.
75. 18 U.S.C. § 1350(c)(1).
76. 18 U.S.C. § 1350(c)(2).
77. 18 U.S.C. § 1519.
78. *See, e.g.*, 18 U.S.C. § 1505.
79. McKinney's Penal Law § 155.42.
80. McKinney's Criminal Procedure Law § 30.10.
81. McKinney's Penal Law § 60.05.
82. McKinney's Penal Law § 175.10.
83. McKinney's Criminal Procedure Law § 30.10.
84. McKinney's Penal Law § 60.12.

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85. For instance, directors can now be indicted for: (1) making unlawful dividends; (2) discounting notes or other debts that are required to be paid;(3) allowing withdrawal of any money paid for his or her stock by receiving or discounting a note or debt; (4) using any portion of the company's funds to purchase the stock of the company, except as permitted by law; (5) authorizing an issuance of capital stock beyond the authorized amount; (6) selling, or agreeing to sell, stock of which he or she is not the actual owner at the time of the sale or agreement; (7) executing, or attempting to execute, a scheme to obtain stock through false representation; and (8) causing, or attempting to cause, the company or its accountants to fail to file a required financial report, or file a report which contains a material omission or misstatement of fact. Anthony E. Cascino, Jr., *Corporate Crime & Punishment: New Illinois Law Goes After Officer and Director Wrongdoing*, 17 CBA Rec. 33, 34 (Oct. 2003) (citing 720 ILCS 5/17-26).
86. 730 ILCS 5/5-8-1.
87. 720 ILCS 5/3-5.
88. 720 ILCS 5/17-29A-4
89. Merritt-Chapman & Scott Corp. v. Wolfson (Merritt-Chapman I), 264 A.2d 358, 360 (Del. Super. 1970) (internal citations omitted).
90. Shearin v. E.F. Hutton Group, Inc., 652 A.2d 578, 593 (Del. Ch. 1994).
91. 8 Del. Code Ann. §§ 145(a), (b); *see also* Hibbert v. Hollywood Park, Inc., 457 A.2d 339 (Del. 1983) (former directors could be indemnified for expenses in proxy contest that, although couched in terms of board election, actually involved substantive differences about corporate policy).
92. 8 Del. Code Ann. §§ 145(a), (b); *see also* Hibbert, *supra* note 91 (recognizing that indemnity is not limited to only defendants).
93. 8 Del. Code Ann. § 145(j).
94. *See, e.g.*, Westphal v. U.S. Eagle Corp., No. Civ. A. 18540-NC, 2002 WL 31820973 (Del. Ch. Nov. 27, 2002) (summary judgment inappropriate where a factual issue existed as to whether the director acted in his corporate capacity or acted for personal gain); Perconti v. Thornton Oil Corp., No. Civ. A. 18630-NC, 2002 WL 982419 at \*7 (Del. Ch. May 3, 2002) (“The inquiry, in these circumstances, is into whether the criminal scheme is alleged to have employed the corporate powers (or, for example, confidential inside information acquired through the corporate status) conferred upon the officer by virtue of his status.”).
95. Fasciana v. Elec. Data Sys. Corp., 829 A.2d 160, 163 (Del. Ch. 2003).
96. *Compare* Merritt-Chapman & Scott Corp. v. Wolfson (Merritt-Chapman II), 321 A.2d 138 (Del. Super. 1974) (chairperson of the board and president of wholly owned subsidiary entitled to benefit of § 145) *with* Chamison v. Healthtrust, Inc., 735 A.2d 912 (Del. Ch. 1999), *aff'd*, 748 A.2d 407 (Del. 2000) (no indemnification for director of a subsidiary corporation where the parent corporation was not a successor-in-interest to the subsidiary’s obligations); *see also* VonFeldt v. Stifel Fin. Corp., 714 A.2d 79 (Del. 1998) (individual elected to subsidiary’s board by a 100 percent stockholder serves the subsidiary “at the request of” the stockholder, and is therefore eligible for indemnification under § 145(a)).
97. *See* 8 Del. Code Ann. §§ 145(a)-(b) (permissive), (c) (mandatory).

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98. 8 Del. Code Ann. § 145(c); *see also* Witco Corp. v. Beekhuis, 38 F.3d 682 (3d Cir. 1994) (interpreting § 145(c) as an absolute grant of indemnification).
99. *See, e.g., Galdi v. Berg*, 359 F. Supp. 698, 701-702 (D. Del. 1973) (discussing mandatory indemnification for victory on a “technical” defense).
100. Merritt-Chapman II, *supra* note 96, at 141; *see also* May v. Bigmar, Inc., 838 A.2d 285, 290-92 (Del. Ch. 2003) (recognizing the problems inherent in making awards of partial indemnification).
101. Merritt-Chapman I, *supra* note 89, at 360 (“The fact that one of the objects of the conspiracy is removed does not invalidate the entire conspiracy charge.”)
102. 8 Del. Code Ann. § 145(a).
103. 8 Del. Code Ann. § 145(d).
104. 8 Del. Code Ann. § 145(a).
105. 8 Del. Code Ann. § 145(b).
106. 8 Del. Code Ann. §§ 145(a), (b). Courts also may include interest in their indemnification award. *See, e.g., Merritt-Chapman II*, *supra* note 96, at 144 (“Without interest on expenses actually paid, indemnification would be incomplete.”).
107. 8 Del. Code Ann. § 145(b); *see also* Cochran v. Stifel Fin. Corp., No. Civ. A. 17350, 2000 WL 286722, at \*11 (Del. Ch. Mar. 8, 2000).
108. MODEL RULES OF PROF’L CONDUCT, R. 1.5(a) (2003); *see also* Galdi, *supra* note 99 at 700; Merritt-Chapman II, *supra* note 96, at 143-144 (finding a flat fee for each trial as “not inherently unreasonable”).
109. *See, e.g., Mayer v. Executive Telecard, Ltd.*, 705 A.2d 220 (Del. Ch. 1997).
110. *See, e.g., Weaver v. ZeniMax Media, Inc.*, No. Civ. A. 20439-NC, 2004 WL 243163 (Del. Ch. Jan. 30, 2004); Weinstock v. Lazard Debt Recovery GP, LLC, No. Civ. A. 20048, 2003 WL 21843254 (Del. Ch. Aug. 8, 2003); Fasciana, *supra* note 95; VonFeldt, *supra* note 96.
111. Gentile v. SinglePoint Fin., Inc., 788 A.2d 111, 113 (Del. 2001) (“The General Corporation Law of Delaware expressly allows a corporation to advance the costs of defending a suit to a director. The authority conferred is permissive, however. The corporation “may” pay an officer or director’s expenses in advance. Conversely, a corporation is free not to provide for advancement at all, or to provide it in limited situations.”) (internal citations omitted); *see also* VonFeldt, *supra* note 96; Advanced Mining Sys. v. Fricke, 623 A.2d 82, 84 (Del. Ch. 1992); Citadel Holding Corp. v. Roven, 603 A.2d 818, 823 (Del. 1992), *reh’g denied* Feb. 26, 1992.
112. 8 Del. Code Ann. § 145(e).
113. Fricke, *supra* note 111, at 84.
114. *See, e.g., Reddy v. Elec. Data Sys. Corp.*, No. Civ. A. 19467, 2002 WL 1358761 (Del. Ch. Jun. 18, 2002) (enforcing by-laws providing advancement without prior written undertaking to repay).

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115. N.Y. Bus. Corp. L. § 722(c).
116. N.Y. Bus. Corp. L. §§ 722(a), (c).
117. Baker v. Health Mgmt. Sys., Inc., 745 N.Y.S.2d 741 (2002), *answer to certified question conformed to* 298 F.3d 146, *reargument denied* 749 N.Y.S.2d 478.
118. N.Y. Bus. Corp. L. § 724(c); *see also* Sequa Corp. v. Gelmin, 828 F. Supp. 203 (S.D.N.Y. 1993) (finding that an executive's claims of innocence in a RICO case met this standard); U.S. v. Weissman, No. S2 94 CR. 760 CSH, 1997 WL 539774 (S.D.N.Y., Aug. 28, 1997) (alleged harm to corporation); Sierra Rutile, Ltd. v. Katz, No. 90 Civ. 4913 (JFK), 1997 WL 431119 (S.D.N.Y., July 31, 1997) (same).
119. 8 Del. Code Ann. § 145(f); N.Y. Bus. Corp. L. § 721; *see also* Biondi, *supra* note 119 (discussing public policy limitations on indemnification). Companies based in Bermuda are afforded similar powers under §§ 98 and 98A of the Bermuda Companies Act of 1981. Companies also remain free to purchase D&O insurance for these purposes. 8 Del. Code Ann. § 145(g); N.Y. Bus. Corp. L. § 726. The rights and obligations afforded under those policies is beyond the scope of this discussion.
120. *See, e.g.*, Compaq Computer Corp. Indemnity Agreement, ¶ 2 (Indemnification), *available at* <http://contracts.corporate.findlaw.com/agreements/hp/indemn.compaq.html>.
121. *See id.*
122. *SEC Settles Fraud Case Against Rite Aid's Former CEO*, U.S. Securities & Exchange Commission Litig. Rel. No. 18728, May 27, 2004, *available at* <http://www.sec.gov/litigation/litreleases/lr18728.htm>.
123. Bergonzi v. Rite Aid Corp., No. Civ. A. 20453-NC, 2003 WL 22407303, at \*1 (Del. Ch. Oct. 20, 2003).
124. Id.
125. Id.
126. Id.
127. Id. at \*2.
128. Id. at \*3.
129. Bergonzi, *supra* note 123, at \*2.
130. Id. at \*2-\*3.
131. Id. at \*3.
132. *AOL, Cendant, 14 Others Added To Homestore Class Action Lawsuit*, Realty Times, Nov. 18, 2002, *available at* [http://realtytimes.com/rtnews/rtapages/20021118\\_homsclassaction.htm](http://realtytimes.com/rtnews/rtapages/20021118_homsclassaction.htm).
133. Tafeen v. Homestore, Inc., No. Civ. A. 023-N, 2004 WL 556733, \*2 (Del. Ch. Mar. 22, 2004).
134. Id. at \*3.

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135. Homestore argued that: (1) the allegations of Tafeen’s conduct meant that he was not a party “by reason of the fact” that he was a Homestore officer; (2) Tafeen’s underlying misconduct had fraudulently induced Homestore to extend contractual advancement rights to him; (3) Tafeen, who was alleged to have profited handsomely through the accounting misdeeds, should be estopped from further profiting from his behavior; (4) because Tafeen ultimately would not be entitled to indemnification, he should not receive advancement; (5) Tafeen’s unclean hands precluded him from receiving advancement; (6) the doctrine of laches barred Tafeen’s claims; (7) Homestore’s bylaws, which precluded advancement in derivative actions, also should bar advancement for the claims stated directly by the company against Tafeen; (8) advancement would run afoul of the provisions in the Sarbanes-Oxley Act of 2002 prohibiting corporate loans to D&Os; and (9) advancement would place the company “in a position of severe financial hardship.” Id. at \*4-\*11.
136. Id. at \*1.
137. Id.
138. Id. at \*10 (internal citations omitted).
139. Tafeen, *supra* note 133, at \*6.
140. Id. at \*7.
141. Id. at \*11.
142. Tafeen v. Homestore, Inc., No. Civ. A. 023-N, 2004 WL 1043721 (Del. Ch. Apr. 27, 2004).
143. *See, e.g.*, St. Paul Directors & Officers and Company Liability Policy, Directors & Officers and Company Liability Coverage Section, Form FP095 Ed. 1/97, Section V.D.; *see also* Chubb Executive Protection Policy, Executive Liability and Indemnification Coverage Section, Form 14-02-0943 (Ed. 1/92), ¶ 18 (Defense and Settlement); Great American Insurance Companies ExecPro Management and Corporate Liability Protection, Policy Form D2100 (1/99), Section VII.A.; American International Companies, Executive & Organization Liability Insurance Policy Form 75010 (2/00), Section 8.
144. St. Paul D&O Policy, *supra* note 143, at Section III.D.; *see also* Chubb Executive Protection Policy, *supra* note 143, at ¶ 18 (Definitions, Defense Costs); Great American ExecPro Policy, *supra* note 143, at Section III.D. (also requiring that the fees be “necessary”); AIG Executive & Organization Liability Policy, *supra* note 143, at Section 2(f) (with identical “necessary” language).
145. Forty-three (43) states and the District of Columbia follow the ABA’s Model Rules, six (6) states (Iowa, Maine, Nebraska, New York, Ohio, Oregon) follow the ABA’s Model Code of Professional Responsibility, and California follows its own independent scheme.
146. *See supra* note 108 and accompanying text; *compare* CAL. R. PROF. CONDUCT R. 4-200(B); MODEL CODE OF PROF’L RESPONSIBILITY DR 2-106(B) (1980). In virtually every state, ethical considerations preclude an attorney from accepting contingent fees in criminal cases, making an hourly or flat fee structure necessary. MODEL RULES OF PROF’L CONDUCT R. 1.5(d)(2); MODEL CODE OF PROF’L RESPONSIBILITY DR 2-106(c); *cf.* CAL. R. PROF. CONDUCT R. 4-200 (containing no explicit restriction).
147. In re Leonard Jed Co., 103 B.R. 706, 711 (D. Md. 1989); *see also* In re Thacker, 48 B.R. 161, 164 (Bankr. N.D. Ill. 1985) (“overhead” includes library expense, rent and utility expense, secretarial and clerical expense, office supply expense, telephone expense, and employee local commuting and meal expense).

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148. CAL. INS. CODE § 334; *compare* N.Y. INS. LAW § 3105(b) (“No misrepresentation shall be deemed material unless knowledge would have led to a refusal by the insurer to make such contract.”).
149. National Union Fire Ins. Co. v. Sahlen, 999 F.2d 1532, 1536 (11th Cir. 1993) (applying Florida law); *see also* Cutter & Buck v. Genesis Ins. Co., 306 F. Supp.2d 988, 1004 (W.D. Wash. 2004) (noting that the materiality of revenue recognition and right of return policies was uncontested by the insured); American Int’l Specialty Lines Ins. Co. v. Towers Fin. Corp., No. 94Civ.2727 (WK)(AJP), 1997 WL 906427 (S.D.N.Y., Sept. 12, 1997) (New York law); National Union Fire Ins. Co. v. Federal Deposit Ins. Corp., No. 03A01-9405-CH-00179, 1995 WL 48462 (Tenn. Ct. App., Feb. 8, 1995); Jaunich v. National Union Fire Ins. Co., 647 F. Supp. 209 (N.D. Cal. 1986); Shapiro v. American Home Assur. Co., 584 F. Supp. 1245 (D. Mass. 1984); *cf.* Federal Ins. Co. v. Oak Industries, Inc., Civ. No. 85-985-G(M), 1986 WL 2699, Fed. Sec. L. Rep. P 92,519 (S.D. Cal. Feb. 3, 1986) (rescission not permitted for inaccurate financials when policy’s coverage extended to claims based on prior acts involving those financials).
150. *See, e.g.*, Home Ins. Co. v. Spectrum Info. Techs., Inc., 930 F. Supp. 825, 835-36 (E.D.N.Y. 1996) (finding that “An applicant for insurance is under no duty to volunteer information where no question plainly and directly requires it to be furnished.”) (internal citations omitted); Aguilera v. Pacific Ins. Co., No. 95 C 1163, 1996 WL 14043, at \*8 (N.D. Ill. Jan 10, 1996) (“Questions left unasked are impliedly immaterial.”); Oak Industries, *supra* note 149, 1986 WL 2699 at \*2 (“Where the insurer does not inquire into the insured’s knowledge of the allegedly concealed fact, that fact is not material and non-disclosure thereof does not violate the insured’s duty to disclose.”) (internal citations omitted).
151. *Compare, e.g.*, CAL INS. CODE § 331 (“Concealment, whether intentional or unintentional, entitles the injured party to rescind insurance”) and In re UFG Intl, Inc., 207 B.R. 793 (Bankr. S.D.N.Y., 1997) (intent not required under New York law) with Booker v. Blackburn, 942 F. Supp. 1005, 1010-11 (D.N.J. 1996) (finding that “knowing” misrepresentations were required to support a rescission, but noting that “an insurer need not show that the insured actually intended to deceive.”)
152. *See, e.g.*, St. Paul D&O Policy, *supra* note 143 at Section V.H.; Chubb Executive Protection Policy, *supra* note 143 at ¶ 17 (Representations and Severability); Great American ExecPro Proposal Form, Form D2211, at p.4; *cf.* In re HealthSouth Corp. Ins. Litig., 308 F. Supp.2d 1253 (N.D. Ala.2004) (partial summary judgment inappropriate where question of fact remained on severability issues).
153. *See, e.g.*, St. Paul D&O Policy, *supra* note 143, at Section III.B.3.; Chubb Executive Protection Policy, *supra* note 143, at ¶ 18 (Definitions, Claim (iii)).
154. An information is the filing of formal criminal charges by a prosecutor without the intervention of a grand jury. BLACK’S LAW DICTIONARY 314 (Pocket ed. 1996).
155. *See, e.g.*, AIG Executive & Organization Liability Policy, *supra* note 143, at Section 2(b) (Definitions - Claim); Great American ExecPro Policy, *supra* note 143, at Section III.A.(2).
156. *See, e.g.*, National Union Fire Ins. Co. v. Ambassador Group, Inc., 691 F. Supp. 618, 623 (E.D.N.Y. 1988); Home Ins. Co. v. Spectrum Info. Techs., Inc., 930 F. Supp. 825 (E.D.N.Y. 1996).
157. *See, e.g.*, Continental Cas. Co. v. Wendt, 205 F.3d 1258 (11th Cir. 2000) (finding interrelationship under a “common sense understanding” of the word ‘related’); Stauth v. National Union Fire Ins. Co., 185 F.3d 875 (Table), 1999 WL 4200401 (10th Cir. 1999) (unreported) (declining to accept this theory because of an insufficiently developed factual record).

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158. *See, e.g., High Voltage Eng'g Corp. v. Federal Ins. Co.*, 981 F.2d 596, 601 (1st Cir. 1992); Zunenshine v. Executive Risk Indem., No. 97 Civ. 5525, 1998 WL 483475 (S.D.N.Y. 1998).
159. *See, e.g., St. Paul D&O Policy*, *supra* note 143, at Section III.S. (“Wrongful Act”); *AIG Executive & Organization Liability Policy*, *supra* note 143, at ¶ 2(aa) (“Wrongful Act”); *Great American ExecPro Policy*, *supra* note 143, at Section III.R. (“Wrongful Act”); *compare Chubb Executive Protection Policy*, *supra* note 143, at ¶ 18 (defining “Insured Capacity”).
160. *See, e.g., Continental Cas. Co. v. Adams*, No. 3:CV02-1122, 2003 WL 22162379, at \*10 (M.D. Pa. Sept. 12, 2003) (granting insurer’s motion for summary judgment as to no coverage, finding that the claims against insureds in their insured capacities were “inextricably intertwined” with those claims against them in their uninsured capacities); *but see D’Amelio v. Federal Ins. Co.*, No. 02-CV-12174, 2004 WL 937328 (D. Mass. Apr. 28, 2004) (“The duty to indemnify is not circumscribed by the formal nature of the pleadings. Rather, ‘the duty to indemnify depends upon the facts established at trial and the theory under which judgment is actually entered in the case.’[citation omitted]”); *compare Perconti v. Thornton Oil Corp.*, *supra* note 94, at \*7 (finding that, in situations where the D&O requests mandatory indemnification under 8 Del. Code Ann. § 145(c), “The inquiry ... is into whether the criminal scheme is alleged to have employed the corporate powers (or, for example, confidential inside information acquired through the corporate status) conferred upon the officer by virtue of his status.”).
161. *See St. Paul D&O Policy*, *supra* note 143, at Section III.J.; *Chubb Executive Protection Policy*, *supra* note 143, at ¶ 18 (“Loss”); *AIG Executive & Organization Liability Policy*, *supra* note 143, at ¶ 2(p); *Great American ExecPro Policy*, *supra* note 143, at Section III.L.
162. *See, e.g., St. Paul Fire & Marine Ins. Co. v. Briggs*, 464 N.W.2d 535, 539 (Minn. App. 1991) (“[I]nsurance coverage for nonpayment of taxes would be contrary to public policy. The officers of Briggs were under a legal obligation to ensure that Briggs’ taxes were paid.”).
163. *See, e.g., Hoyle v. Utica Mut. Ins. Co.*, 137 Idaho 367, 374, 48 P.3d 1256, 1263 (2002) (“[A]ny restitution the state may seek from Hoyle in the criminal action does not constitute damages ... under the policy’s coverage.”); *see also Conseco, Inc. v. National Union Fire Ins. Co.*, No. 49D130202CP000348, 2002 WL 31961447, at \*6 (Ind. Cir. Ct. Dec. 31, 2002) (“It is axiomatic that insurance cannot be used to pay an insured for amounts an insured wrongfully acquires and is forced to return, or to pay the corporate obligations of an insured.”); Level 3 Comm’n, Inc. v. Federal Ins. Co., 272 F.3d 908 (7th Cir. 2001) (same).
164. *See, e.g., St. Paul D&O Policy*, *supra* note 143, at Section III.J.; *Chubb Executive Protection Policy*, *supra* note 143, at ¶ 18 (“Loss”); *AIG Executive & Organization Liability Policy*, *supra* note 143, at ¶ 2(p); *Great American ExecPro Policy*, *supra* note 143, at Section III.L.
165. *See, e.g., Cubic Corp. v. Ins. Co. of N. Am.*, 33 F.3d 34 (9th Cir. 1994) (no coverage for or duty to defend a suit based on insured’s criminal bribery under California law); St. Paul Fire & Marine Ins. Co. v. Jacobsen, 826 F. Supp. 155, 162-63 (E.D. Va. 1993) (“To be sure, public policy generally bars coverage for an insured’s intentional wrongdoing or criminal misconduct.”) (internal citations omitted); Massena v. Healthcare Underwriters Mut. Ins. Co., 281 A.D.2d 107, 110, 724 N.Y.S.2d 107, 110 (2001) (“[P]ublic policy precludes indemnifying an insured for intentionally inflicted injuries.”); Briggs, *supra* note 162 at 539 (“[I]t would be contrary to public policy to require insurers to pay for losses occasioned by willful acts.”); *cf. Grinnell Mut. Reinsurance Co. v. Jungling*, 654 N.W.2d 530 (Iowa 2002) (public policy would not bar coverage for fraud under excess liability policy because the victims, and not the wrongdoers, would be primary beneficiaries).

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166. CAL. INS. CODE § 533 (2003).
167. St. Paul D&O Policy, *supra* note 143, at Section IV.B.2.; *see also* Chubb Executive Protection Policy, *supra* note 143, at ¶ 6(b) (same); *accord* AIG Executive & Organization Liability Policy, *supra* note 143, at ¶ 4(c) (lacking “willful violation of statute” language); Great American ExecPro Policy, *supra* note 143, at Section IV.A.(2) (same); *cf.* Westport Res. Inv. Servs., Inc. v. Chubb Custom Ins. Co., No. 04-0409-cv, 2004 WL 2166308, at \*2 (2nd Cir. Sept. 23, 2004) (where claims of negligence against insured entity were related to claims of fraud against insured individual and policy’s fraud and dishonesty exclusion was not contingent on a “final adjudication,” summary judgment for insurer in declaratory action was proper).
168. St. Paul D&O Policy, *supra* note 143, at Section IV.B.3.; *see also* Chubb Executive Protection Policy, *supra* note 143, at ¶ 6(c) (same); Great American ExecPro Policy, *supra* note 143, at Section IV.A.(1)(same); *accord* AIG Executive & Organization Liability Policy, *supra* note 143, at ¶ 4(a) (lacking “remuneration” language).
169. *See Stargatt v. Avenell*, 434 F. Supp. 234 (D. Del. 1977) (no coverage for *settlement* where exclusion contained no “in fact” requirement).
170. 1 INTERNATIONAL RISK MANAGEMENT INSTITUTE, PROFESSIONAL LIABILITY INSURANCE, § X (Directors and Officers), at X.E.43-.44 (3d reprint, Dec. 2003); *see also Gardner v. Cumis Ins. Soc’y, Inc.*, 582 So.2d 1094, 1096 (Ala. 1991) (insured’s acknowledgment at trial of bad conduct sufficient for “in fact” purposes).
171. Bergonzi v. Rite Aid Corp., No. Civ. A. 20453-NC, 2003 WL 22407303, at \*2 (Del.Ch. Oct. 20, 2003); *see also Weaver v. State*, 779 A.2d 254, 258 (Del. 2001) (“In Delaware, the benchmark of a “final judgment” in a criminal case is the pronouncement of sentence.”); U.S. v. Weissman, No. S2 94 CR. 760 CSH, 1997 WL 334966, at \*13 (S.D.N.Y. June 16, 1997) (jury verdict alone could not be a “final adjudication,” which would require decision of all post-trial motions and sentencing).
172. *See, e.g., First Nat’l Bank Holding Co. v. Fid. & Deposit Co. of Md.*, 885 F. Supp. 1533, 1537 (N.D. Fla. 1995); New England Ins. Co. v. Sylvia, 783 F. Supp. 6 (D.N.H. 1991) (rejecting the insured’s contention that all appellate proceedings must be completed before there would be a “final adjudication”); *cf. First Nat’l Bank v. First Fin. of La.*, 921 F. Supp. 1506, 1508 (E.D. La. 1996) (finding that FED. R. EVID. 410 bars an insurer from using a *nolo contendere* plea as grounds to trigger a dishonesty exclusion).
173. BLACK’S LAW DICTIONARY 437-38 (Pocket ed. 1996).
174. *See, e.g., Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 400 (D. Del. 2002); In re Donald Sheldon & Co., Inc., 186 B.R. 364, 369-370 (S.D.N.Y. 1995)
175. The distinction between general and specific intent can be summarized as follows:
- General intent:* The state of mind required for the commission of certain common-law crimes not requiring a specific intent or imposing strict liability; general intent usually takes the form of recklessness (involving actual awareness of a risk and the culpable taking of that risk) or negligence (involving blameworthy inadvertence).
- Specific intent:* The intent to accomplish the precise act with which one has been charged; at common law, the specific-intent crimes were robbery, assault, larceny, burglary, forgery, false pretenses, embezzlement, attempt, solicitation, and conspiracy.

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BLACK'S LAW DICTIONARY 328 (Pocket ed. 1996).

176. *Compare* 18 U.S.C. § 1350(c)(1) (making it a crime to certify a public company's financial statement knowing that it does not comport with the applicable accounting and publication guidelines) *with* 18 U.S.C. § 1350(c)(2) (imposing increased penalties if the certification is "wilful"); *accord* 18 U.S.C. § 1519 (making it a crime to "knowingly" destroy, alter or mutilate corporate records "with the intent" to impede, obstruct or interfere with a federal or regulatory investigation).
177. Federal Ins. Co. v. Tyco, Index No. 600507/03, 2004 WL 583829, at \*1 (N.Y. Sup. Mar. 5, 2004).
178. Id.
179. Id. at \*5.
180. Id. at \*6. The court cited a number of decisions from other jurisdictions in support of its conclusion, including Gon v. First. St. Ins. Co., 871 F.2d 863 (9th Cir. 1989); Independent Petrochem. Corp. v. Aetna Cas. & Sur. Co., 654 F. Supp. 1334 (D.D.C. 1986), *rev'd in part on other grounds*, 944 F.2d 940 (D.C. Cir.1991); Natl. Union Fire Ins. Co. v. Brown, 787 F. Supp. 1424 (S.D. Fla.1991); U.S. Fid. & Guar. Co. v. Thomas Solvent Co., 683 F. Supp. 1139 (W.D. Mich.1988); and Hoechst Celanese Corp. v. Natl. Union Fire Ins. Co., Civ. A. No. 89C-SE-35, 1994 WL 721618 (Del. Super. 1994).
181. Tyco, *supra* note 176, at \*7.
182. Associated Elec. & Gas Ins. Servs., Ltd. v. Rigas, No. Civ. A. 02-7444, 2004 WL 540451, at \*1 (E.D. Pa. Mar. 17, 2004).
183. Id. at \*3.
184. Id. at \*4.
185. Id. at \*5.
186. Id. at \*13-15.
187. *See, e.g.*, St. Paul D&O Policy, *supra* note 143, at Section V.N.; Great American ExecPro Policy, *supra* note 143, at Section IX.L.