

Indemnification Risks: Dodd-Frank Ups The Ante

by David Woodcock and Nicki Glauser

The power of companies to indemnify their directors and officers for legal penalties has narrowed through Sarbanes-Oxley rules and tougher SEC policies. Now, the clawback provision in the new Dodd-Frank Act could further limit top executives' indemnification claims.

The Securities and Exchange Commission has made no secret of the fact that its increased enforcement activity will target individuals. Corporate officers and directors may be at increased personal financial risk as a result of the SEC's historic antipathy towards indemnification, which may be even stronger in light of new Commission enforcement initiatives, judicial decisions supporting those initiatives, and at least one element of the recently enacted Dodd-Frank Act. Both companies and their directors should assess whether an SEC enforcement action against a director implicates the company's assets, the individual's assets, or both.

Over the years, the SEC has used a variety of methods to put teeth into its anti-indemnification stance, with varying levels of success.

Most corporations, in accordance with state laws, corporate charter documents, and employment contracts, agree to indemnify their directors. This covers judgments, settlement payments, and reasonable defense costs for actions brought against the individual in his or her corporate capacity.

Further, most corporations agree to advance defense costs (including attorneys' fees) through a final determination that a director is not entitled to indemnification. Although these provisions may require the company to pay millions of dollars to its directors, many corporations view them as necessary to encourage capable people to accept corporate

leadership positions despite the ever-increasing risk that they will be named as a party to litigation by reason of that position.

For decades the SEC has taken the position that corporate indemnification of directors for violation of federal securities laws is against public policy and unenforceable. The SEC has used a variety of methods to put teeth into its anti-indemnification stance, with varying levels of success. Until recently, judicial decisions in favor of the SEC's policy created only a narrow prohibition on corporate indemnification that is rarely applicable. The SEC has attempted to advance indemnification reform through its administrative enforcement powers or through settlements; it historically has done so inconsistently.

Recently, the SEC has launched an initiative, under section 304 of the Sarbanes-Oxley Act (SOX), to aggressively recover or "clawback" bonuses and other compensation received by top officers of companies that have to make financial restatements due to misconduct. In light of decisions interpreting section 304, this may constitute a significant (if targeted) limitation on company indemnification, and put CEOs and CFOs at risk for significant financial liability. The Dodd-Frank Act may have raised the ante on indemnification risks.

□ *SEC's anti-indemnification stance.* The SEC has based its anti-indemnification position on the view that corporate indemnification thwarts the deterrent effect of federal securities laws. This position has received consistent judicial support with regard to the anti-fraud provisions of federal securities laws.

Although the judicial prohibition theoretically bolsters the SEC's position, the practical effect has been tempered by two facts. First, the company rather than the individual may still bear the defense costs incurred because the company often advances

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the legal expense. Second, the judicial prohibition is rarely applicable.

Most state corporate laws allow a corporation to advance expenses (including attorneys' fees) upon execution of an undertaking agreeing to repay the advancements if it is ultimately determined that the officer is not entitled to indemnification. Further, most companies enact corporate charter documents or indemnification agreements making expense advancement contractually mandatory. Advancement and indemnification are treated as distinct rights. As such, a corporation's obligation to advance defense costs is not dependent on the officer's or director's ultimate entitlement to indemnification.

This obligation continues until the final outcome of the litigation, usually after the officer or director has incurred significant attorneys' fees. Additionally, the obligation exists regardless of whether the person is likely to repay the advancements and regardless of whether the director is accused of even serious misconduct.

As a result, even where indemnification is ultimately prohibited because the executive is actually found guilty or liable, the company may have already advanced significant attorneys' fees—with no realistic hope for repayment. The legal fees incurred may total millions of dollars and, in some cases, actually exceed the amount of the penalty or liability incurred.

In addition to advancing defense costs, corporations have historically indemnified directors and officers for other amounts in actions brought by the SEC. Under federal case law, corporate indemnification is prohibited only where the subject is found guilty of or liable for certain securities law violations. In other words, the prohibition requires a judicial finding of an actual securities law violation. Most securities cases, however, settle before trial without an admission of guilt or liability. Indeed, this is often a primary motivation for settlement.

It is the SEC's unwritten policy to require settling parties to agree not to seek or accept indemnification or reimbursement for any penalties.

□ *SEC settlement policy.* Although SEC settlement agreements may require directors to pay penalties to the SEC, directors typically avoid full financial responsibility. Under most indemnification provisions, directors are entitled (or at least eligible) for amounts paid in settlement, in addition to legal fees, so long as the case is settled without an admission of guilt. As a result, in most cases, personal assets are not implicated and instead the corporation must pay the losses incurred.

Since at least 2003, however, the SEC has sought to end this practice by including provisions in settlement agreements that prevent officers (or corporations) from using corporate indemnification to shift the costs of settlement. It is the SEC's unwritten policy to require, as a condition to settling claims, that the settling party agree not to seek or accept indemnification or reimbursement from any source (including a D&O insurance policy) for any penalties or other amounts paid in settlement of the SEC action.

Pursuant to this policy, subjects may be required to agree to personally pay settlement amounts as a condition to settlement, even though the corporation may have otherwise indemnified all or part of those amounts. The SEC's prohibition almost always applies to the indemnification of penalties, but the SEC on occasion has insisted that defendants also relinquish rights to all amounts paid, including, for example, disgorgement.

In the 2003 settlement of the SEC's research analyst conflict-of-interest case with Merrill Lynch, the individual defendants (Jack Grubman and Henry Blodget) agreed not to "seek or accept, directly or indirectly, reimbursement or indemnification, including but not limited to payment made pursuant to any insurance policy, with regard to all amounts that defendant shall pay..."

At times, the SEC has gone to great lengths to discourage corporate indemnification and even imposed significant fines on companies that do not follow the SEC's policy. In 2004, Lucent Technologies and the SEC had agreed, in principal, to settle the SEC's investigation of improper recognition of revenue. When Lucent subsequently indemnified several former employees not covered by indemni-

fication obligations, the SEC imposed a \$25 million penalty on Lucent for lack of cooperation in an SEC investigation.

Two recent examples of where the SEC has required defendants to give up their indemnification rights are its settlements with the former CEOs of i2 Technologies and Countrywide Financial. This settlement policy, however, may create a perverse incentive. Corporate officers might be unwilling to settle if they are personally liable for the settlement amounts. As a result, the SEC's policy might incentivize them to take their chances at trial, causing the company to incur significantly more defense costs under customary expense advancement provisions, sometimes with little hope of recouping the costs.

The SEC has not yet attempted to restrict indemnification of attorneys' fees, and has indicated that it is unlikely to do so in the future. Furthermore, any attempt to do so might be blocked by the courts or result in significant public backlash.

□ *SEC clawback initiative.* The SEC has recently begun more aggressively using the clawback provision in section 304 of the Sarbanes-Oxley Act. This allows enforcement proceedings against executives without accusing them of any personal wrongdoing. Under section 304, the SEC can recover restatement-related pay and stock profits if the restatement involved misconduct.

Although SOX was passed in July 2002, the SEC initially did not use its power under section 304 aggressively. In July 2009, however, the SEC sounded alarm bells when, for the first time, it brought an enforcement action to recoup more than \$4 million in bonuses and profits received by the former CEO of CSK Auto Corporation, Maynard Jenkins. The company had committed accounting fraud, but Jenkins was not accused of any personal wrongdoing.

Expect SEC enforcement actions seeking the return of pay from CEOs and CFOs not alleged to have engaged in misconduct to continue, at least so long as the current commissioners remain in office. In June 2010, the SEC obtained its first judicial sanction for such actions. The United States District Court in Arizona ruled in the SEC case against Jenkins that specific misconduct of an individual is

not required for liability under SOX 304, and denied the CEO's motion to dismiss. Although that case is still in litigation, it may result in the first verdict holding an executive liable without knowledge of underlying fraud.

The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act expands upon SOX 304. Section 954 of Dodd-Frank requires that an issuer "develop and implement a policy" for disclosure of its policy on incentive-based pay, and, in the event of an accounting restatement, the recovery of excessive incentive-based pay paid in the three years prior to the restatement.

The exact details of the clawback provision will not be known until the SEC adopts final rules implementing Dodd-Frank section 954, but Dodd-Frank clawbacks will go beyond SOX clawbacks. Further, the SEC may view the Dodd-Frank Act and its instruction to the SEC as a call to more aggressively pursue SOX 304 actions. Directors and officers should not expect indemnification in these cases.

The SEC has already stated that SOX 304 indemnification is against public policy, and the Second Circuit's 2010 decision in *Cohen v. Viray* bolsters that position. *Cohen* arose out of a proposed settlement against DHB Industries' former CEO and CFO. DHB manufactures body armor used by the military. The derivative action was filed after DHB's stock price plummeted following news that its manufacturing materials caused the armor to rapidly deteriorate.

The parties in the action reached a settlement agreement. As part of the settlement, the company agreed to release the executives from any SOX 304 liability and to indemnify them in any SOX 304 action brought by a third party. The Department of Justice, in conjunction with the SEC, objected to the release and indemnification provisions. They argued that it "limited the remedies" available to the United States and "undermined efforts by the SEC" to pursue clawback claims. The district court rejected the objections and approved the settlement.

Reversing the district court, however, the Second Circuit held that a corporation cannot release or indemnify its CEO or CFO against SOX 304 liability. The court first concluded that SOX 304 gives only the

Executive Compensation Clawbacks

SOX vs. Dodd-Frank

	SOX 304	Dodd-Frank Act Section 954
Who is at risk?	CEOs and CFOs only.	All current or former executive officers.
What is clawed back?	All incentive-based and equity-based compensation.	Excessive incentive-based compensation only.
When?	One year following issuance of misstated financial statements.	Three years preceding the date on which the company was required to restate financials.
Misconduct required?	Yes, but not necessarily misconduct by CEO or CFO forced to repay clawed back amounts.	No requirement of any misconduct.
Private right of action?	No.	Undetermined.
Right to indemnification for clawed back amounts?	No.	Undecided, but probably not.
Who is primarily responsible for clawback?	SEC	Company

SEC the right to “enforce” clawbacks or to “exempt” its application (i.e., there is no private right of action). The court then concluded that the settlement’s release and indemnification provision constituted an “end-run” around section 304 that would effectively bar any clawback claims by the SEC.

Passing the clawback claim to the company such that the executive suffered no penalty, the court described, “[flew] in the face of Congress’s efforts” and “frustrate[d] the power” of the SEC. Accordingly, the court held that the release and indemnification provisions were void. It seems likely that the courts would apply the same reasoning to conclude that a corporation cannot release or indemnify its executive officers against Dodd-Frank clawbacks.

While *Cohen* does insulate CEOs and CFOs from private clawback claims by the company or its

shareholders, this protection may be undercut by the Dodd-Frank Act. Additionally, *Cohen* implicates the personal assets of executive directors by prohibiting indemnification. Even those who are not accused of wrongdoing may now face significant personal liability when a company issues a restatement.

Directors and officers facing the SEC’s current vigorous enforcement stance need to be aware of the risks to their personal assets. The SEC has long desired to hold those who violate the securities laws personally accountable. While the Commission recognizes the importance of indemnification in ensuring that high caliber people are willing to serve public companies, it has shown an intent to aggressively pursue enforcement actions against individuals and to hold them personally accountable. ■

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