Supplement to the Los Angeles and San Francisco

Daily Journal

AUGUST 13, 2008

Corporate Counsel

On A Tightrope

A Company's Careful Course in Extracting Bad Guys at the Top

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You are in-house counsel for a large public company headquartered in California. For months, the company has been the subject of an investigation by the Securities and Exchange Commission into allegations of audit irregularities related to subprime mortgage instruments. The media has publicized disturbing facts indicating that the CEO and other officers "cooked" the books to disguise the extent subprime mortgage transactions adversely affected financial statements.

Six months after the initial disclosures and just prior to a complaint being filed by the SEC and another by shareholders, the CEO and other members of management agreed to resign, effective immediately, pursuant to a termination agreement being negotiated with the company. Based on a privileged report you just received from outside counsel retained by a special committee appointed by the board of directors to investigate the allegations, it is clear to you that former management did cook the books and then attempted to cover up their conduct.

Now, the new CEO wants your advice on separating the company from former management and transforming the company from "wrongdoer" to "victim." In view of the fact that the special committee's investigation revealed that former management did engage in illegal activities, the new CEO wants to know if the company can: refuse to advance legal fees to former management; refuse to honor stock options granted to former management; and most importantly, sue former management for damages suffered by the company because of their conduct without jeopardizing insurance coverage.

With respect to whether the company can refuse to advance fees for former management's legal defense, the bottom line in most cases is probably not. Many corporations provide for the right to advancement of legal fees in their articles of incorporation and in their bylaws. If neither the articles of incorporation nor the bylaws have such a provision, it may exist in former management's employment agreements.

Former management's legal fees with respect to defending against an SEC complaint as well as a shareholder lawsuit could easily amount to millions of dollars. Such advancements must continue until all appeals have been exhausted. Also, it is likely that each member of former management will require separate counsel because of potential conflicts. Worse still, the company will likely find itself in the unenviable position of having to pay legal fees for former management's opposition to the company's efforts to reduce or eliminate fee advancements.

With respect to advancement and indemnification issues, the company will need to consider its position as to whether the applicable state law should be California, the state where the company is headquartered, or the state of incorporation, usually Delaware. It is important in every case to assess the specific facts and determine whether one state's laws offer some unique advantage to the company.

The company can achieve some success by challenging the amount of former management's legal fees and by requiring that they provide undertakings. Courts have allowed challenges to advancement of legal fees based on allegations that the recipient sought to shelter assets and thereby avoid having to repay the advancements if the claims were found to be nonindemnifiable. A related issue worth raising is whether the company is entitled to receive some form of "security" to protect itself should former management refuse to repay advances that are determined to have been paid for nonindemnifiable claims.

The standard for challenging legal fees is whether the fees were "reasonable." Sometimes, just knowing that the company is closely monitoring legal fee invoices can be a powerful incentive causing counsel hired by former management to avoid work and expenses that cannot be justified.

As to whether the company must honor stock options awarded to former management, it will be necessary to look to their employment agreements, the stock option agreement, the company employee manual and the company bylaws. Each of these agreements might contain specific language dealing with voiding stock options or some general language that the company can claim allows it to void the stock options, such as language requiring the optionee to render "faithful services," or services "in the best interests" of the company.

Accordingly, in negotiating a termination agreement with former management, the best course of action is to include a clause stating that in order to receive their stock options, former management must represent in writing that they at all times acted in accord with the best interests of the company and they must specifically deny the allegations being made against them. The termination agreement should also specify that it supersedes any other agreements.

Former management might refuse to provide such assurances. In that case, the company has a number of alternatives. One is not to enter into the termination agreement. The problem with this strategy is that it usually is in the best interests of the company for former management to resign sooner rather than later. Any decision that delays the execution of the termination agreement or that leads to an all-out battle to oust former management will probably be detrimental to the company.

Even without such general language in the stock-option agreement or the employment agreements, and without representations from former management that they did not engage in any improprieties, the company can still withhold stock options if it can prove that former management failed to fulfill their duties with respect to affirmatively protecting the interests of the company, or refraining from doing anything that would work injury to the company or deprive it of profit or advantage. *Bancroft-Whitney Co. v. Glen,* 64 Cal. 2d 327 (1966).

While there is no way to know whether the company will prevail if former management sues it for withholding stock options, withholding options may achieve most of the company's objectives. Should former management choose to challenge the withholding of stock options, they risk forcing the company to come forward with documents and witnesses who will provide evidence that at best would be embarrassing to former management and at worst could provide the basis for a civil or criminal prosecution. Win or lose, the company, by raising such objections, has staked out its position as a victim of its former management's illegal acts rather than a willing participant.

The final question relates to whether the company should file a complaint against former management to recover damages for their illegal conduct. While such a complaint will make it clear that the company was a victim and not a perpetrator, there are disadvantages. One potential problem involves insurance coverage. The company already has been sued by shareholders. It is likely that the insurance policy contains a "deliberate fraud" exclusion that bars insurance coverage for the company if former management engaged in deliberate fraud. Should the company prove that former management did commit fraud, it runs the risk that the carrier will use that verdict to void its coverage responsibilities. Whatever damages the company can actually recover from former management may be far less than what it will lose in the way of insurance coverage. At the least, if the company pursues litigation against former management, it should avoid making explicit allegations of fraud.

Second, it is possible that former management will defend themselves by claiming that the company was well aware — and implicitly sanctioned — their conduct. Regardless of whether such allegations are false, the company's efforts to disassociate itself from former management may suffer a setback. Even if the complaint is heard by an arbitrator in a "private" proceeding rather than in court, there is nothing to stop the SEC or the Justice Department from subpoenaing the transcript. Should that occur, testimony and evidence from the arbitration could become publicly available.

The company should also consider the extent to which it should try to help the SEC by providing privileged documents prepared by outside counsel during the course of its investigation on behalf of the special committee. This dilemma occurs if the SEC, which the company wants to impress by being as candid and helpful as possible, requests these documents. This very issue came before the 9th U.S. Circuit Court of Appeals in *McKesson HBOC Inc. v. The Superior Court of San Francisco County,* 115 Cal. App. 4th 1229 (2004). The appellate panel held that McKesson waived the attorney client and work product privileges when it shared with the SEC and the U.S. attorney a report prepared by outside counsel that had been retained to perform an internal investigation involving alleged securities fraud. While there are cases where other circuit courts have accepted a "selective waiver" theory under which a company can disclose privileged documents to the government without waiving the privilege, that is not the law in the 9th Circuit.

A related issue is whether a carrier might successfully argue that close cooperation between the company and the SEC with respect to a civil lawsuit brought by the SEC against former management is tantamount to the company suing former management, thereby triggering the "insured vs. insured" exclusion in the directors and officers policy.

There is no correct answer as to whether the company should provide privileged investigative reports to the SEC. However, it is important that the company understands that if such documents are provided to the SEC, then they may also have to be provided to former management as well as to shareholder plaintiffs who could use such documents in a manner detrimental to the company's interests.

The bottom line is that the road the company will travel in the aftermath of the resignation of former management contains minefields at every turn. Strategies that might be successful — not to mention satisfying — such as suing former management, might have adverse consequences that far outweigh their benefits. The best advice is to make sure that new management fully understands the advantages and disadvantages of such strategies.

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