BUSINESS LAW TODAY

The Spring Meeting Confronts the Yates Memo: Execs in the Front Lines of Corporate Criminal Responsibility; Presentation of the Business Law Section's Director and Officer Liability Committee

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The Business Law Section's Director and Officer Liability Committee conducted a program at the Section's Spring Meeting in Montréal. The program focused on the recent Yates memorandum of the U.S. Department of Justice (DOJ), and its implications for practitioners and executives. The Yates memo, of course, further intensifies the DOJ's emphasis on director and officer personal criminal liability as an enforcement priority. Practicing lawyers and a representative from the insurance industry were panelists. A summary of the session follows.

Historic Role of the Committee in Assessing Criminal Law Risk of Innocent Directors and Officers

The Business Law Section's Directors and Officers Liability Committee was created as a task force in the wake of Sarbanes-Oxley in 2002. Early on, the committee became concerned with the increased exposure of executives, many of whom are innocent, to criminal prosecution. These concerns intensified as the DOJ developed the principles of "cooperation" during the 2000s in a series of DOJ memoranda known by the names of their authors—Holder/Thompson/McNulty/Filip and now Yates. The committee and its members have authored articles and held numerous programs over the years reporting on these developments. The committee has consistently supported amendments of statutes and has recommended improvements to take better account of the increased exposure of innocent executives to criminal risk. Its efforts have been met with some success, but work remains to be done.

Origins of the DOJ Memoranda; the Development of "Cooperation" as the Central Technique of White-Collar Criminal Law Enforcement; Yates Memorandum as Most Mature Reflection of Emphasis on Individual Criminal Responsibility

The Thompson/McNulty/Filip/Yates memoranda were greatly influenced by the DOJ's experience in investigating and prosecuting major accounting firms for promoting what the government viewed as illegal tax shelters. In addition, one of the country's largest and most visible former "Big 5" firms, Arthur Andersen, had imploded just before Sarbanes-Oxley's enactment as the direct result of an indictment arising out of the Enron failure. Thus, accounting firms saw themselves as particularly exposed to threats of criminal indictment for whatever reason. The concept of "cooperation" thus evolved in the environment of prosecutions of accounting firms and their partners where the stakes were very high, indeed. Litigation in this area still continues.

The Holder/Thompson/McNulty/Filip/Yates memoranda all deal with the standards that prosecutors are to apply in deciding to criminally charge corporations and other legal entities. Over time, it became the practice of the DOJ that given sufficient "cooperation" by the entity, it could avoid being criminally charged and instead receive a "deferred" or "non-prosecution" agreement. One of the principal means by which an entity could earn sufficient "cooperation credit" to obtain such an agreement on favorable terms was by investigating its own personnel and executives and reporting the results of the investigation to enforcement authorities. The availability of this option operated to drive a wedge between the in-

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terests of an entity's officers, directors, and employees, on the one hand, and the entity itself. Nothing in the corporate statutes, partnership and LLC acts, insurance policies, or historic practices in corporate drafting anticipated this development.

The Yates memorandum is the latest and most severe manifestation of the DOJ's emphasis on individual criminal responsibility:

It expressly states that it will use both the civil and criminal law to further the government's enforcement objectives against corporate executives: "The guidance in this memo will also apply to civil corporate matters. . . . [C]ivil enforcement actions serve to redress misconduct and deter future wrongdoing."

The fact that an executive may not have sufficient assets to satisfy a civil judgment is not determinative of whether the executive should be pursued civilly: "Pursuit of civil actions against culpable individuals should not be governed solely by those individuals' ability to pay."

For the first time, it expressly conditions any consideration of an entity's cooperation on its identification and reporting of potential criminal conduct of individuals from the outset of negotiations: "To be eligible for *any* cooperation credit, corporations must provide to the Department all relevant facts about the individuals involved in corporate misconduct."

And no corporation may hope to resolve an enforcement action by a settlement that protect its executives: "Department lawyers should not agree to a corporate resolution that includes an agreement to dismiss charges against, or provide immunity for, individual officers or employees The same principle hold true in civil corporate matters. . . ."

Central Themes and Issues that Arose in the Development of the Doctrine of "Cooperation" as They Impact Innocent Investigated Individuals

A number of central themes emerged as the DOJ's practices were litigated in the context of tax shelter prosecutions. The first was the development of the "corporate internal investigation" as a principal tool by which criminal investigations of white-collar crime were to proceed. It came to be accepted that before the entity could obtain leniency and avoid indictment, it would have to agree to carry out an internal investigation of its own personnel's conduct at the entity's expense. Indeed, entities often carried out investigations on their own initiative as an exercise in "self-reporting" before the questionable conduct had even reached the attention of an enforcement authority. This greatly expanded the number and depth of investigations because enforcement agencies' budgets were freed of most of the expense of the investigation. The Yates memorandum continues to emphasize the internal investigation as a key tool of law enforcement.

A second major theme became the ethics and privilege issues faced by counsel tasked with conducting the investigation. State ethics rules govern communications between an entity's counsel and individuals serving or employed by the entity. The ethics literature refers to such individuals as entity "constituents." The fact that counsel for the entity may at some point investigate the conduct of the entity's directors, officers, and employees for possible reporting to enforcement authorities gives rise to stark conflicts of interest and difficult privilege issues. The Yates memorandum has only served to intensify these concerns and bring their application forward in time.

These conflicts are most apparent whenever an individual attempts to invoke his or her Fifth Amendment privilege in the course of an investigation. It is obvious to the committee that the function of the Fifth Amendment in the criminal justice system is often misunderstood. Thus, when an employee asserts this constitutional right, often the entity terminates the individual's employment, and the individual can lose his or her career, compensation, and benefits.. The damage to individuals can be severe. Indeed, the severity of the results on the individual is generally perceived as one of the reasons why internal investigations are so effective. Nevertheless, many of these adverse results are in many cases legally prohibited when the executive is a public employee, political office holder, or government contractor.

An individual's Hobson's choice between remaining employed in an industry versus waiving one's key constitutional rights is striking and stark, especially when the employee is innocent of any wrongdoing. Indeed, as a result of the Yates memorandum, the privilege and ethics issues that surround communications between corporate counsel and internal interviewees also infect the conversation between corporate counsel and corporate "constituents" whenever an executive protection program is created or renewed. The Yates memorandum highlights the unpleasantness of this issue and makes its resolution more difficult than ever.

The final major theme that developed from the corporate criminal litigation of the 2000s was the unsatisfactory and conflicting state of common law rules that govern the circumstances under which an executive can access funding from the entity for his or her criminal legal defense. In its most severe form (at least up to now as disclosed in reported cases), the DOJ had been deemed guilty of an invasion of some of KPMG's tax partners' constitutional rights when it was found that it had influenced KPMG to cut off defense cost funding on the eve of a criminal trial. This decision raises the more general question of how far an entity may go to "cooperate" with the government to avoid indictment itself, particularly when, unlike the situation in KPMG, its indemnitees have legally enforceable advancement or defense cost payment rights written into their corporate bylaws. The limits of the colloquial expression, "throwing [an executive] under the bus," remain still to be fleshed out in the case law.

In any case, the number of reported cases suggests that many entities continue to force executives to litigate clear contractual rights to advancement of defense costs. The inability to mount a successful defense can be the difference in whether or not the executive is found to have done anything improper (or indeed whether they are under undue pressure to agree to a plea bargain when he or she has not). Entities' efforts to frustrate or deny these rights are rarely successful in Delaware but are frequently successful in other jurisdictions because of the uncertain and conflicting state of the common law of advancement and indemnification.

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The Challenge of Creating an Adequate Executive Protection Program

All this cries out for a solution. Executives need prompt protection, and they need it at least as soon as they become subject to internal investigation. The boards and managements of most entities—at least on the proverbial "clear day," i.e., before a question of potential criminal misconduct by the entity has arisen—typically agree with the proposition that directors and other senior management of entities should have legally mandatory protection against having to pay what can be enormous legal costs to defend their stewardship of the entity, at least until they are found guilty of some form of reprehensible conduct. The law of almost all jurisdictions supports that view.

As a consequence, management and boards routinely direct entity counsel and risk managers to draft and procure protection "to the fullest extent permitted by law," and to back up that promise with "all risk" director and officer insurance cover. An entire industry of global insurance brokers and underwriters exists that is devoted to this enterprise. This industry each year collects millions of dollars of premiums. Sophisticated lawyers undertake to draft indemnification and advancement contracts and legally binding bylaws.

The Question Is, Do They Succeed? The Committee's Collective Answer Is "Not Always"

This brief report cannot outline the difficulties and legal vagaries that arise when a board or management committee directs counsel and a risk manager to obtain "all risk" insurance to protect the entity's covered executives "to the fullest extent permitted by law." (Copies of published materials are available in the Montreal program materials.) Nor can we here begin to outline the conflicts that corporate counsel and risk managers now face post–Yates memorandum. Simply put, when a corporate lawyer or risk manager is now tasked with creating a comprehensive executive protective program, that lawyer and risk manager must provide on the "clear day" for a later "stormy day" protection where the conflicts between the indemnified individuals and the entity itself have become exceedingly intense and considerations of prompt protection and preservation of legal privilege advance to the foreground.

The Problem Crosses Disciplines and Legal Silos

To be done properly, the lawyer creating the program must be conversant with at least four distinct legal specialties: white-collar criminal defense, corporate indemnity and advancement; civil litigation; and insurance law and markets. Practitioners' minds become focused once they realize that under the laws of many, if not most, jurisdictions, the entities' lawyer's undertaking to draft protections for the personal benefit of a group of executives means that he or she could have professional responsibility to them personally as a matter of third-party beneficiary tort law. This area is not for amateurs.

The Central Role of Insurance

The obvious answer is insurance. Insurance ought to be able to protect innocent executives from both the risk of legal harm and from the vagaries of the common law of advancement and defense cost payment. But can entities really procure an "all risk" policy that provides adequate protection? Insurers have taken the first steps in that direction through a Lloyd's of London offering marketed by global insurance brokerage Marsh LLC. This policy extends, for the first time, defense cost protection to executives involved in corporate internal investigations that are not prompted by inquiries of enforcement authorities and that explicitly addresses certain critical Fifth Amendment problems that have arisen in practice. But the market is by no means mature, nor universally responsive, and pitfalls abound.

In sum, the challenges of executive protection are receiving more visibility, and insurance solutions are emerging. But there is a long way to go before innocent executives and managers can feel that they have "all risk" insurance protection close to that enjoyed by professionals.

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