



FEDERAL CIVIL ENFORCEMENT

Expert Analysis

Collateral Consequences Of Individual Liability

More and more, individual corporate officers and directors are threatened with potentially life-altering consequences when they are caught up in government civil fraud investigations. Reaching agreement to settle these matters without admitting liability—as had been the standard practice followed by many individuals in the past—is now under fire. Preet Bharara, the U.S. Attorney for the Southern District of New York, has been forthright about this change, explaining: “When we’re talking about vindicating interests related to fraud, companies *and individuals* whenever possible should have to admit that they engaged in bad conduct for all the world to see.”¹

Where CEOs, CFOs, and other executives frequently find themselves as named defendants in federal civil enforcement actions, requiring admissions of wrongdoing in settlement may have broad-reaching consequences, very much akin to a finding of liability after trial in any civil fraud action. This article explores the personal financial and professional consequences inherent in such a finding of individual liability.

Legal Fees and Judgments

Perhaps the most uncertain and potentially devastating consequence of a liability finding against an individual is the risk that he may be responsible for a substantial financial penalty.

Companies often attempt to mitigate this risk to their officers and directors by providing a right of indemnification for any monetary damages or penalties resulting from litigation. In the event of a finding of liability for intentional fraud, however,



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indemnification likely will not be available. But the financial risks do not end there. A finding of fraud can also trigger an obligation to repay any legal fees that may have been advanced on the defendant’s behalf by a corporate employer. The combination of these two risks, especially in the context of a long investigation typical of many complex financial fraud cases, could be financially overwhelming.

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In examining issues of advancement and indemnification, we turn to Delaware law, the corporate home to many public companies. As a general matter, Delaware law permits, but does not require, the advancement of legal fees incurred by an individual in defending against a civil enforcement action.² Further, Delaware law broadly permits, but does not require, a company to provide indemnification in circumstances where an individual is found liable, but otherwise “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.”³ Indemnification is only required under Delaware law if a current or former director or officer has actually “been

successful on the merits or otherwise in defense of any action, suit, or proceeding.”⁴

Many companies seek to offer additional protection to their directors, officers, or other employees by adopting bylaws that require the company to provide advancement and indemnification to the maximum extent permitted by Delaware law. Under such mandatory provisions, the individual will be entitled to advancement of fees and indemnification from liability arising out of an enforcement action unless or until the “final disposition,” that is the final, non-appealable conclusion of the proceeding.⁵

If the individual admits to, or is otherwise found liable for intentional fraud, however, the court will likely find that individual did not act with good faith and is therefore not entitled to indemnification.⁶ Federal law may similarly prohibit a company from indemnifying such conduct, including “reckless, willful or criminal conduct” in violation of the securities laws.⁷ Under these circumstances, not only may the company be unable to indemnify the individual employee, but it may seek to recoup the legal fees that were previously advanced to him. Indeed, under Delaware law, “[i]f it is subsequently determined that a corporate official is not entitled to indemnification, he or she will have to repay the funds advanced.”⁸

Even if the company continues to stand behind the employee despite the liability finding, if the company relied upon insurance proceeds to fund the advancement of legal costs, the individual is again at risk of a lawsuit seeking to recoup legal fees by the insurance carrier. A fraud liability finding will often result in a conduct-based exclusion under a company’s typical Director & Officer Insurance Policy.

A final adjudication of intentional misconduct will allow the insurer to seek not only to terminate insurance coverage, but also to exercise its subrogation rights to stand in the shoes of the company and seek repayment of the advancement of legal fees. While the likelihood of this result is

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dependent on the precise wording of the underlying policy and practical considerations regarding the insurer's assessment of the defendant's ability to repay such funds, the risk that the insurer may have the right to claw back advances made for litigation costs is a disturbing one.

Risk of Negative Impacts

In addition to financial consequences, other significant collateral consequences may flow from a finding or admission of civil fraud, including the destruction of the individual's reputation, career and future job prospects. While the SEC enforcement mechanism of a "director and officer bar"⁹ is generally unavailable in civil enforcement actions or cases brought by private plaintiffs, a liability finding of fraud may nevertheless severely impact an individual's ability to retain his employment or board positions. For example, as with any negative news, a public company should reasonably anticipate extensive negative press coverage following a settlement or jury verdict finding liability for fraud.

If current company management is found to have committed intentional wrongdoing—even in the context of a settlement that is arguably beneficial for the company by allowing it to put the enforcement matter behind it—the outcry from shareholders may cause the board to feel it has to change leadership. Further, even for former directors and officers, a liability finding will implicate complicated disclosure issues at their new place of employment,¹⁰ and may present challenges to their ability to continue to remain employed.

In the case of *Jaffe Pension Plan v. Household Int'l*,¹¹ for example, a former chairman/CEO was found liable at trial for having acted recklessly with respect to public statements by the company concerning its lending practices. Following the jury verdict, the press questioned whether this individual should relinquish his director positions at other public companies.¹² The press reasoned that "[t]his sort of governance question rarely surfaces because class-action securities suits usually are dismissed or settled with no admission of liability. The judgment does not automatically disqualify him from serving on a public company board, but it is something the board would have to consider before he came up for re-election....At a minimum, the companies will have to disclose the violation to shareholders."¹³ While there is no mandate that an individual resign from his employment following a liability finding of fraud, the reputational damage and resultant public pressure may have that practical consequence.

Similarly, a liability finding may negatively impact the willingness of third parties, including

institutional investors like pension funds, endowments, and trusts, to continue investing in the company if a current director or officer has been found liable for fraud. A liability finding may also undermine a public company's outside auditor's assessment of that company's financial statements, requiring a reexamination of its prior audits if the auditor determines that its report would have been affected by the undisclosed information.¹⁴

And because a liability finding may affect the outside auditor's assessment of the reliability of representations of management, it will likely require the auditor to increase its level of work on the account, decrease its reliance on management's representations, or request remedial actions (including a change in leadership). Under such circumstances, an outside auditor may decide to withdraw if the company refuses to take the proposed remedial action.¹⁵ Such pressures may

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also have the practical result of foreclosing the individual's ability to remain employed at his current company.

A liability finding may further restrict an individual's opportunities for subsequent employment, including jobs involving government contracts, as the government has broad authority to debar contractors based on (inter alia) an "offense indicating a lack of business integrity or business honesty."¹⁶ There are similar collateral consequences for professionals like accountants¹⁷ and lawyers,¹⁸ who may face disciplinary actions and exclusion from practice if they admit to wrongdoing in a civil enforcement action. The repercussions of such disciplinary action cannot be overstated.

Risk of Additional Litigation

Finally, admissions of liability may result in exposure to further litigation, with potential criminal consequences. Indeed, if an individual admits to wrongdoing in a settlement agreement, the Department of Justice could use that information to prosecute the defendant, seeking to admit the information at trial for its truth as a

party admission.¹⁹ Similarly, individual admissions may embolden private litigants to bring securities class actions based on the underlying conduct, using the admissions to bolster the allegations in their complaint to satisfy the heightened pleading requirements of the Private Securities Litigation Reform Act. Hence, after admitting to misconduct in one proceeding—even as a condition of settlement—it will be difficult to avoid its use in these subsequent proceedings.

Conclusion

Federal law enforcement's increased focus on obtaining admissions from individuals and companies accused of fraud will fundamentally change the landscape of how such civil enforcement actions are litigated and how often they settle. From the perspective of individuals, there exists tremendous risk in the collateral consequences of agreeing to an admission of fraud liability.

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1. Gretchen Morgenson, "Making Them Pay (and Confess)," *N.Y. TIMES*, Jan. 26, 2013 (emphasis added). Similarly, the SEC, which has the power in addressing violations of the securities laws to require injunctions, cease and desist orders, director and offices bars, and collateral industry bars, has indicated that it will be seeking more admissions of wrongdoing from defendants as a condition of settling civil fraud cases.

2. DEL. CODE tit. 8 §145(e).

3. DEL. CODE tit. 8 §145(a).

4. DEL. CODE tit. 8 §145(c).

5. *Sun-Times Media Group v. Black*, 954 A.2d 380, 397 (Del. Ch. 2008).

6. See, e.g., *Stockman v. Heartland Indus. Partners*, Nos. 4227-VCS & 4427-VCS, 2009 WL 2096213, at *16 (Del. Ch. May 20, 2009) (finding that Sections 145(a) and (b) "seem best read as public policy limits designed to prevent corporations from indemnifying corporate officials...when the officials have...incurred liability as a result of culpable conduct and that liability was the result of conduct that involved a certain level of scienter.")

7. *Credit Suisse First Boston v. Intershop Commc'ns*, 407 F.Supp.2d 541, 547 (S.D.N.Y. 2006).

8. *Homestore v. Tafeen*, 888 A.2d 204, 214 (Del. 2005).

9. 15 U.S.C. §78u(d)(2).

10. See, e.g., Regulation S-K, 17 CFR 229.401(f)(5).

11. No. 02-C-5893 (N.D. Ill., filed Aug. 19, 2002).

12. Ameet Sachdev, "Judgment against William Aldinger raises issues about board seats," CHICAGO TRIBUNE, May 12, 2009.

13. Id.

14. PCAOB AU Standard 561.

15. PCAOB AU Standard 317.

16. 2 C.F.R. §180.800(a)(4); 48 C.F.R. § 9.406-2(a)(5).

17. In New York, for example, the Board of Regents exercises authority to revoke a public accountant's license for "unprofessional conduct." See Rules of the Board of Regents of the State of New York, §29.10, available at <http://www.op.nysesd.gov/title8/part29.htm#cpa> (last visited Feb. 20, 2015).

18. In New York, the Appellate Division has the authority to revoke an attorney's admission to practice if the individual is found "guilty of professional misconduct, malpractice, fraud, deceit, crime or misdemeanor, or any conduct prejudicial to the administration of justice." N.Y. JUD. LAW §90.2.

19. FED. R. EVID. 801(d)(2)(A). To avoid potential criminal liability, it may be advantageous for an individual to take an enforcement action to trial, rather than admit to liability in the context of settlement. Even if the individual were to lose at a civil trial, such a finding would have no preclusive effect in a subsequent criminal action, because of the higher standard of proof.