

INDIVIDUAL ACCOUNTABILITY

ISSUE

In the midst of the financial crisis in 2008, Bank of America agreed to acquire a troubled Merrill Lynch. Bank of America told its investors that year-end bonuses would not be paid to Merrill employees without Bank of America's consent. However, despite losing \$27.6 billion in 2008, Merrill paid employee bonuses totaling \$3.6 billion before year end.

In a complaint filed in early August in the U.S. District Court in Manhattan, the Securities and Exchange Commission (SEC) alleged that Bank of America had in fact agreed that Merrill could pay up to \$5.8 billion in discretionary year-end and other bonuses to Merrill executives for 2008. This side agreement was omitted from the general merger agreement attached to the proxy and was not disclosed to shareholders prior to the vote on the merger. The SEC concluded that this omission rendered the proxy materially false and misleading.

A \$33 million settlement was proposed by the parties to the litigation. In an unexpected move, the judge refused to accept the settlement between the SEC and Bank of America, stating that he didn't know why neither the *executives* nor their lawyers were sued. The judge ordered that the case proceed to trial in early 2010.

In support of the judge's view that the individuals should be held accountable, New York's attorney general issued subpoenas to five outside directors of Bank of America in an attempt to put further pressure on the bank to answer questions about the Merrill takeover. Additionally, pre-trial litigation may be brewing over the bank's reliance on the advice of its outside attorneys regarding the proxy issuance.

IMPACT

The judge in this case refused to accept a settlement that did not impose individual liability on corporate executives and outside counsel for merger-related SEC violations. Taken with other cases we have seen, there seems to be a movement afoot to focus on individual, rather than entity, liability. This could be the start of a trend where regulatory agencies, such as the SEC, and the plaintiffs' bar place more emphasis on the knowledge and actions of individuals.

It remains to be seen whether this decision will result in more cases proceeding to trial rather than settlement. If so, the effect may be a dramatic rise in the average costs of defense, as well as a detrimental impact upon insurance coverage and indemnification. Additionally, an increase in the number of cases going to trial could spell big trouble for defendant insureds. In fact, at a recent panel, one defense attorney noted that defendants lost all three securities cases that went to trial this year.

Another issue is whether fees and costs incurred in response to subpoenas issued by regulatory agencies such as the SEC are covered under a Directors & Officers (D&O) policy. The answer could depend on the policy's definition of *claim*.



ACTION

Take out your D&O policy (primary and lead A-Side) and have a close look. Minor variations in policy language can be coverage determinative. Carefully examine the personal conduct exclusions. While the majority of personal conduct cases result in settlements as opposed to trials, the reversal of this trend could impact coverage in a manner not typically contemplated. These exclusions, which often contain “final adjudication” triggers, could render an insured exposed if a court refuses to accept a settlement and orders the parties to proceed to trial.

Adequate consideration should also be given to defense counsel’s trial experience, as well as potential conflicts that could arise between the entity and the individuals. Furthermore, in the event that the entity refuses or is unable to indemnify the individuals, it is essential to have in place broad A-Side coverage, which can drop down and act as primary coverage.

The question of whether a subpoena is a covered claim under a D&O policy hinges not only on how the term claim is defined in the policy but how it is interpreted by the courts. Most courts have interpreted the term broadly to include subpoenas. For example, in *Minuteman International, Inc. v. Great American Ins. Co.*, 2004 U.S. Dist. Lexis 4660 (N.D. Ill. March 18, 2004), the court held that a subpoena issued by the SEC constituted a “...demand for compliance by a federal agency with the ability to enforce its demand,” and therefore was equivalent to a demand for relief. There, the definition of claim included a written demand or civil, criminal, administrative or arbitration proceeding seeking monetary or non-monetary relief. However, in a recent case, the U.S. District Court in Manhattan, rejected the holding in *Minuteman*, finding that a grand jury subpoena did not constitute a claim under a D&O policy. See *Diamond Glass Co. v. Twin City Fire Ins. Co.*, 2008 U.S. Dist. Lexis 86752 (S.D.N.Y. Aug. 18, 2008). The court found that subpoenas did not fall within the plain meaning of relief or within the use of this term in the policy’s definition of claim.

The takeaway is to make sure that your D&O broker is an expert in this highly technical and complex coverage. He/she should perform a thorough analysis and comparison of policy language prior to binding coverage, and should obtain the broadest coverage available in the marketplace.

CONTACTS

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