Independent Directors Liability (IDL) Insurance

A Guide for Fund Independent Directors and Their Insurance Advisers

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Introduction

Today, more than 2000 independent directors and independent trustees serve on the boards of U.S. investment companies. By virtue of their experience, independence, and outside perspective, these directors and trustees (collectively referred to in this Guide as "fund independent directors" or "independent directors") play an integral role in the protection of funds and fund shareholders. Over the past decade—as the fund industry has experienced unprecedented scrutiny by the plaintiffs' bar and by regulatory enforcement authorities—fund independent directors have understandably shown an interest in securing appropriate protection, both for their funds and for themselves, against the financial exposures associated with shareholder lawsuits, regulatory investigations and regulatory proceedings. As a result, liability insurance for funds and fund independent directors has become an active topic for discussion in the boardroom.

Independent directors liability (IDL) insurance is a stand-alone liability insurance coverage that affords protection solely to fund independent directors, and is designed to supplement the liability protections afforded to them by fund indemnification and by directors and officers/errors and omissions liability (D&O/E&O) insurance. Unlike D&O/E&O insurance, IDL insurance is a relatively new liability coverage in the fund industry, having rarely been purchased by fund groups prior to the early 2000s. In recent years, however, IDL insurance has become a common feature of many liability insurance programs for management investment companies—i.e., open-end investment companies, including exchange-traded funds, and closed-end investment companies (collectively referred to in this Guide as "registered funds" or "funds"). ICI Mutual estimates that today, approximately sixty percent of fund groups purchase some form of IDL insurance, whether from ICI Mutual or from a commercial insurer.

Evaluating IDL insurance options involves the exercise of business judgment. Among the issues to be considered are these: Should a fund group utilize IDL insurance as a supplement to its D&O/E&O insurance program? If so, which of the two basic types of IDL insurance should be selected? From which insurer? And in what amount? Different fund groups can be expected to reach different determinations with regard to these issues. As with any business judgment, however, fund boards may find it useful to have access to resources that can assist them in determining what inquiries they may wish to make, and what information they may wish to consider, in reaching these determinations.

This Guide is designed to serve as such a resource. It provides a general introduction to IDL insurance, as well as commentary on specific IDL-related topics that may be of interest to fund directors, their insurance advisers, and others involved in the insurance decision-making process for fund groups. Towards this end, the Guide is divided into three parts:

- ***Fundamental Liability Protections for Independent Directors:*** Part I provides an overview of the two fundamental liability protections commonly provided to fund independent directors—fund indemnification and D&O/E&O insurance—and reviews the strengths and limitations of each.

- ***IDL Insurance—Supplementary Protection for Independent Directors:*** Part II provides an introduction to IDL insurance. It discusses the emergence of IDL insurance in the fund industry, and details how IDL policies are structured. Part II also describes the two basic types of IDL policies available in today's mutual fund insurance market, and how they differ.

- ***Questions for Fund Boards:*** Part III highlights some of the key questions that fund boards, and those who assist them in reaching insurance decisions, may wish to consider in evaluating IDL insurance options.

The Guide includes endnotes and two appendices. Although the endnotes and appendices may be of interest to some independent directors, they are designed primarily for the use of insurance advisers and counsel to fund boards. The endnotes and appendices provide additional information on, and backup support for, various statements and general observations set forth in the Guide.

The statements and observations in the Guide are derived from ICI Mutual's twenty-five years of experience in providing liability insurance to the fund industry and in addressing associated insurance claims; from ICI Mutual's discussions with attorneys, commercial insurance brokers and consultants involved in counseling fund groups on insurance issues; and from ICI Mutual's review of legal authorities and other information on IDL insurance, D&O/E&O insurance, and related concerns.

By necessity, the Guide generalizes as to the issues discussed, and does not include a full legal analysis of the matters presented. As such, it is designed simply to be informative, and should not be construed or relied upon as legal advice (for which interested parties should look to their own counsel). It is also important to note that the terms and conditions of individual IDL policies (including any special endorsements that may be added to insurers' standard policy forms during the course of the insurance underwriting process) will govern any coverage questions arising in a particular matter.

Portions of the Guide restate, update or otherwise reference, as relevant, material included in two previous ICI Mutual risk management studies: MUTUAL FUND D&O/E&O INSURANCE (2009), and INDEPENDENT DIRECTOR LITIGATION RISK (2006). Readers are directed to those two studies for additional information on the associated topics of D&O/E&O insurance and independent director liability risks.

Fundamental Liability Protections for Independent Directors

More than twenty-five years of fund industry claims experience evidences that the risk to fund independent directors of incurring personal financial exposure in fund industry claims is low, and is likely to remain so.[1] In part, this is because fund independent directors, as a legal matter, face a relatively low risk of personal financial exposure (for their legal defense costs or otherwise), where, as is typically the case, they (1) act with due care and independence (i.e., without conflicts of interest), and (2) devote appropriate time, attention, and oversight to reaching considered judgments on fund issues and concerns. In part, this is also because fund independent directors commonly enjoy the robust protections from personal financial exposure (including for legal defense costs) that are afforded by fund indemnification and by D&O/E&O insurance.

Fund Indemnification

Fund indemnification affords a strong first line of protection to independent directors against personal financial exposure in regulatory investigations, regulatory proceedings, and civil litigation. Indemnification allows independent directors to be paid from fund assets for legal expenses and other financial liabilities they may incur as defendants or non-party witnesses in fund-related proceedings.[2] Indemnification also allows independent directors to receive "advancements" from fund assets to cover their legal and associated expenses as those expenses are incurred by them during the course of the underlying proceedings.[3] From a practical perspective, indemnification is essential for attracting qualified persons to serve as directors.[4]

Under relevant provisions of state law, funds are typically *required* to indemnify their independent directors in certain circumstances (so-called "mandatory indemnification"), and are *permitted*—but not required—to indemnify them in other circumstances (so-called "permissive indemnification").[5] Provisions in fund charters and bylaws often grant fund independent directors the broadest indemnification rights available under applicable law, thus effectively converting permissive indemnification into mandatory indemnification. In some situations, independent directors and their funds may also enter into separate agreements with regard to indemnification, as part of an effort to assist directors in augmenting or preserving their indemnification rights.[6]

Fund independent directors tend to be at low risk of incurring loss that is non-indemnifiable—i.e., loss for which their funds cannot indemnify them. Although federal law places certain restrictions on the ability of funds to indemnify their directors and officers, these restrictions are unlikely to affect fund independent directors, for the reasons discussed in Appendix A. Fund independent directors are also unlikely to be affected by two other restrictions on indemnification that often concern directors and officers of operating companies:

- ***Corporate bankruptcy:*** Bankruptcies can limit or preclude the ability of corporations to indemnify their directors and officers.[7] As compared to operating companies (where bankruptcies can and do occur), registered funds—by reason of the nature and diversification of their assets, and their limitations on leverage—are generally viewed as having minimal risk of insolvency. Indeed, ICI Mutual is unaware of any registered funds filing for bankruptcy protection, and it is difficult to imagine how such an event could occur.[8]

  While funds are at minimal risk of insolvency, they may, of course, be merged into other funds or engage in orderly liquidations. In such cases, it is not uncommon for fund groups to make special insurance arrangements in advance of the mergers or liquidations, in order to protect the funds' former independent directors against potential exposures from post-merger or post-liquidation claims, particularly if indemnification will no longer be available.[9]

- ***Non-indemnifiable exposures in "derivative" litigation:*** Many states place restrictions on the ability of corporations to indemnify their directors and officers in "derivative" litigation—i.e., in shareholder lawsuits brought by and in the name of the corporation itself.[10] However, for the legal and practical reasons detailed in Appendix B, fund independent directors tend to be at low risk of incurring non-indemnifiable loss (in the form of non-indemnifiable defense costs or otherwise) in this type of litigation.[11]

Fund D&O/E&O Insurance

D&O/E&O insurance affords a second line of protection to fund independent directors against the direct financial impact of regulatory investigations, regulatory proceedings, and civil litigation. Although there is no legal requirement that they do so, funds generally arrange to purchase professional liability insurance, in the form of both directors and officers (D&O) insurance and errors and omissions (E&O) insurance, with these two forms typically combined into a single D&O/E&O policy. Today virtually all funds purchase D&O/E&O insurance, either from ICI Mutual or from commercial insurers. D&O/E&O insurance, like indemnification, is widely regarded as essential for attracting qualified persons to serve as directors.[12]

As with indemnification, D&O/E&O insurance—through its built-in "D&O" coverage—commonly protects fund independent directors against personal financial exposure to legal expenses and other financial liabilities incurred by them both as defendants in fund-related civil litigation, and as respondents in administrative proceedings initiated by the U.S. Securities and Exchange Commission (SEC) or other regulators.[13] D&O/E&O insurance may also be structured—as is the case with ICI Mutual's standard form of policy—to protect fund independent directors against financial exposure (e.g., in the form of legal and associated expenses) that may incur (1) in *regulatory investigations* (both formal and informal), and (2) as *non-party witnesses* in fund-related claims (e.g., "excess fee" lawsuits under section 36(b) of the Investment Company Act of 1940). In addition, D&O/E&O insurance typically allows fund independent directors to receive "advancements" of insurance proceeds to cover their legal and associated expenses, as those expenses are incurred by them during the course of covered claims.[14]

D&O/E&O insurance provides the above-described protection to fund independent directors in two ways—directly, through what is often referred to as "Side A" coverage (also commonly referred to as "direct" coverage); and indirectly, through what is often referred to as "Side B" coverage (also commonly referred to as "company reimbursement" coverage).

- ***Side A coverage:*** Side A coverage allows independent directors to be paid directly from D&O/E&O insurance for losses they incur (e.g., legal expenses or other covered liabilities) where fund indemnification is otherwise unavailable to them. As noted above, it is uncommon for financial or legal restrictions to prevent funds from indemnifying their independent directors. Accordingly, this direct (Side A) coverage is rarely implicated in actual fund industry claims involving fund independent directors.

- ***Side B coverage:*** Side B coverage allows funds to be paid from D&O/E&O insurance for amounts payable by the funds to indemnify their independent directors for losses that these directors themselves incur (e.g., legal expenses or other covered liabilities). Because funds are customarily in a position to indemnify their independent directors, it is this indirect (Side B) coverage that commonly responds in actual fund industry claims involving fund independent directors.[15]

As noted, the Side B coverage feature of D&O/E&O insurance compensates the fund for the indemnification amounts payable by the fund to its independent directors. Such indemnification amounts are a fund expense. Side B coverage thereby serves to eliminate the immediate impact on *fund assets*—and, by extension, the immediate impact on *fund shareholders*—of indemnifiable losses incurred by fund independent directors in underlying claim matters. Instead, the impact on fund assets is absorbed over time through the fund's payment of annual premiums for D&O/E&O insurance.

D&O/E&O insurance can thus be viewed, in a sense, as a *hedge* against the fund's risk of a sudden and substantial reduction in fund assets as a result of the fund's own "indemnification risk." Viewed in this light, the Side B coverage feature of D&O/E&O insurance protects not only fund independent directors, but also their funds, and the fund shareholders whose interests they serve.

IDL Insurance—Supplemental Protection for Independent Directors

As discussed above, fund indemnification and D&O/E&O insurance provide robust liability protection for fund independent directors. Yet the protection they afford is not absolute. Although the odds of fund independent directors incurring *non*-indemnifiable losses in fund industry claims are quite low, this possibility cannot be entirely discounted. Similarly, while D&O/E&O insurance can be expected to respond to many financial exposures of independent directors in fund industry claims, such insurance may be unavailable to respond under certain circumstances (as, for example, where a fund's D&O/E&O insurance is "exhausted" through payments made by the D&O/E&O insurer on other claims made under the insurance).

Since the early 2000s, in response to developments both inside and outside the fund industry, a third form of liability protection for fund independent directors has emerged.[16] This protection, commonly referred to as independent director liability (IDL) insurance, is designed to supplement the liability protections afforded to fund independent directors by fund indemnification and by D&O/E&O insurance. The subparts below (1) detail how IDL policies are commonly structured to afford this supplementary protection, and (2) describe the two basic types of IDL insurance that are commonly available to fund independent directors in today's insurance market, and how they differ.

Use of IDL insurance by fund groups has grown significantly since the early 2000s. ICI Mutual estimates that on an industry-wide basis, approximately sixty percent of fund groups now purchase IDL insurance, either from ICI Mutual or from one of the relatively small number of commercial insurers who, along with ICI Mutual, provide most of the IDL policies in the fund insurance market.

How IDL Policies Are Structured

IDL policies are usually provided on a stand-alone basis, as insurance contracts separate from D&O/E&O insurance policies. D&O/E&O policies in the fund industry insure entities and persons in addition to fund independent directors (i.e., the fund itself, the fund's "inside" directors and officers, and frequently, other affiliated funds, fund advisers and/or other affiliated fund service providers, along with their directors and officers). In contrast, IDL policies in the fund industry are typically structured to insure only fund independent directors. IDL insurance thus serves as dedicated coverage for fund independent directors, and no other individuals (e.g., fund "inside" directors, fund officers) customarily have rights to collect under such insurance.[17]

IDL insurance mitigates the exposure of fund independent directors to various risks associated with indemnification and D&O/E&O insurance, including (1) *indemnification risk* (i.e., the risk that a fund will be financially unable or legally prohibited from paying indemnification to its independent directors), (2) *erosion risk* (i.e., the risk that the underlying D&O/E&O insurance otherwise available for use by independent directors will be fully depleted through payments made by the D&O/E&O insurer on other covered claims), and (3) *coverage risk* (i.e., the risk that a D&O/E&O insurer will decline to pay a particular claim). More specifically:

- ***Indemnification risk:*** IDL insurance can respond to certain *non*-indemnifiable exposures to which fund independent directors could, at least in theory, be subject (e.g., judgments in "derivative" lawsuits[18])—thereby mitigating indemnification risk. As discussed in the following subpart of the Guide, there are two basic types of IDL insurance. One type limits coverage to non-indemnifiable exposures only, whereas the other type extends coverage to both non-indemnifiable and indemnifiable exposures. Regardless of which type is involved, IDL insurance is structured so that it can respond to a claim *only* where a fund's underlying D&O/E&O insurance does not.

- ***Erosion risk:*** IDL insurance provides additional (i.e., "excess") insurance for fund independent directors above and beyond the insurance available under their fund's D&O/E&O insurance—thereby mitigating erosion risk. Thus, where payments made by a D&O/E&O insurer on claims made against an adviser or other insureds exhaust the maximum dollar amount of insurance proceeds available under a fund's D&O/E&O policy (i.e., the D&O/E&O policy's "limit of liability"), IDL insurance would be available to respond to remaining (or additional) insurable exposures that may attach to fund independent directors.[19]

- ***Coverage risk:*** IDL insurance is typically structured to "drop down," so as to provide first level (primary) insurance coverage for fund independent directors, where a fund's D&O/E&O insurer determines that the claim at issue is not covered under the fund's D&O/E&O insurance—thereby mitigating coverage risk. Through what are commonly referred to as *difference-in-conditions* (DIC) provisions, IDL insurance may provide coverage that is intentionally broader, in certain respects, than the coverage provided in a fund's underlying D&O/E&O insurance. As a result, IDL insurance can drop down to respond, as first level insurance, to certain exposures that are outside the scope of coverage afforded by a fund's D&O/E&O insurance. Thus, for example, if an IDL insurance policy provides coverage for non-party witness costs of independent directors and the fund's D&O/E&O insurance does not, the IDL insurance could drop down to respond to such costs.

- ***Other risks:*** IDL insurance is also frequently structured to drop down, so as to provide first level (primary) insurance coverage for fund independent directors, where a fund's underlying

D&O/E&O coverage is "unavailable" by reason of the materialization of certain other risks. These risks include: (1) *cancellation risk* (i.e., the risk that underlying D&O/E&O insurance may be terminated or cancelled by insureds other than the fund independent directors); (2) *rescission risk* (i.e., the risk that underlying D&O/E&O insurance may be voided, or "rescinded," by the D&O/E&O insurer); and (3) *insurer insolvency risk* (i.e., the risk that underlying D&O/E&O insurance may be uncollectible by reason of the D&O/E&O insurer's insolvency). In today's insurance market, these three risks tend to be viewed as more remote than the other risks discussed above.

As with a D&O/E&O insurance policy, an IDL policy constitutes an enforceable agreement between the insureds and the insurer. The nature and scope of an insurer's reimbursement obligations under an IDL policy are governed by the terms and conditions of the particular IDL insurance policy at issue. Typically, no deductible (i.e., self-retention amount) is imposed on fund independent directors under an IDL policy.[20] The dollar amount of the insurer's maximum potential financial obligation under an IDL policy is set forth in the policy's limit of liability, which is agreed upon between the insurer and insureds before the IDL policy goes into effect. The limit of liability represents the maximum amount payable by the insurer on any and all claims first made against fund independent directors during the period (typically, one year) that the IDL policy is in force.

The Two Basic Types of IDL Insurance

Two basic types of IDL insurance are commonly available in today's insurance market:

- ***Safety Net IDL insurance:*** This first type of IDL insurance is sometimes referred to as "Side A&B" or "Broad Form" IDL insurance (although neither of these descriptions is entirely accurate[21]), and is branded "Safety Net" IDL insurance by ICI Mutual. It is designed to respond, subject to its terms, to *both* non-indemnifiable *and* indemnifiable exposures of fund independent directors, where a fund's underlying D&O/E&O insurance does not respond. For the reasons discussed below, Safety Net IDL is the standard type of IDL insurance offered by ICI Mutual (although ICI Mutual is willing to provide its own version of the Side A-Only IDL insurance discussed below for those fund groups who may prefer such an approach).

- ***Side A-Only IDL insurance:*** This second type of IDL insurance is designed to respond, subject to its terms, *solely* to *non*-indemnifiable exposures of fund independent directors, where a fund's underlying D&O/E&O insurance does not respond. This is the standard type of IDL insurance offered by commercial insurers (although some commercial insurers are willing to provide their own versions of Safety Net IDL insurance for those fund groups who may prefer such an approach).[22] Side A-Only IDL insurance, as utilized in the fund industry, is patterned after a stand-alone insurance product—known as "Side A" D&O insurance—that is often used in the broader corporate sector, where it is promoted as protecting directors (both inside and outside) and officers of operating companies against non-indemnifiable exposures they may incur.[23]

Both types of IDL insurance—Safety Net and Side A-Only—have their proponents. It is not uncommon for insurance professionals to engage in debates over such issues as (1) which of the two types of IDL insurance offers more value for the dollar,[24] (2) the extent to which difference-in-conditions (DIC) protections in Side A-Only IDL insurance have "real world" relevance for fund independent directors,[25] and (3) which of the two types of IDL insurance best serves the interests of fund directors, funds, and fund shareholders.[26] ICI Mutual participates in these debates, and recognizes that arguments can be made on both sides.

Ultimately, choosing between these two types of IDL insurance involves a business judgment. ICI Mutual believes that Safety Net IDL is, on balance, a better choice, for two reasons:

- ***Breadth of coverage:*** Safety Net IDL greatly enhances the practical value of IDL insurance in the fund sector. It expands IDL protection beyond rare "Side A" exposures, and encompasses the very kinds of exposures (e.g., indemnifiable defense costs) that fund independent directors are most likely to face.

- ***Protection of fund assets:*** Through its coverage for indemnifiable losses, Safety Net IDL insurance assists fund directors in preserving fund assets that might otherwise be called upon to indemnify them. Safety Net IDL insurance thus permits independent directors to protect not only themselves, but also the funds and fund shareholders whose interests they serve.

Questions for Fund Boards

When evaluating IDL insurance options, fund boards may wish to consider a number of questions. The following questions are illustrative only, and all of them may not be relevant for every fund group. Moreover, directors in different fund groups may view different questions as being of greater or lesser importance.

* * *

Fund boards assessing their need for IDL insurance may wish to consider the following questions, among others:

- ***What are our rights to fund indemnification and advancements?:*** How strong are the rights to indemnification that our funds provide us as independent directors? Are our funds obligated to indemnify us to the fullest extent permitted by applicable law? Should we consider asking for separate indemnification agreements with our funds? As fund independent directors, are we entitled to advancements from fund assets of our legal fees and other expenses, and if so, how do we exercise this right? When would indemnification and advancements *not* be available to us? How immediate or remote is this risk?

- ***What is the nature and amount of our fund's D&O/E&O insurance?:*** What is the nature of the D&O/E&O insurance coverage purchased by our funds? What is the overall dollar limit of this coverage? How many funds and fund boards share this coverage? Do advisers or other fund service providers also share this coverage? If so, does coverage extend to claims made against them for their "non-fund" activities (e.g., services to private advisory accounts)?

- ***What scope of coverage is provided to independent directors under our funds' D&O/E&O insurance?:*** What basic coverages does our D&O/E&O insurance provide to us as independent directors? Does our D&O/E&O insurance extend coverage to expenses incurred by us in both formal and informal regulatory investigations? As non-party witnesses in lawsuits against our funds' adviser or in other fund-related claims? In shareholder derivative demand investigations?

- ***Do we believe it necessary or appropriate to obtain IDL insurance?:*** In light of the rights to indemnification and advancement afforded to us as independent directors, and in light of the amount and scope of D&O/E&O insurance coverage available to us and our funds, should we consider obtaining special insurance protection dedicated solely for our use? If so, should this protection take the form of IDL insurance? Are there other options we should consider?

In addition to the questions set forth above, ***fund boards planning to purchase IDL insurance*** may wish to consider the following questions, among others:

- ***What options do we have with regard to IDL insurance?:*** What basic types of IDL insurance are available for purchase? How do these types of IDL insurance differ with regard to the risks they address? How immediate or remote do we consider these risks to be?

- ***How important are DIC provisions?:*** What importance do we assign to particular difference-in-conditions (DIC) provisions that may be available in IDL policies? To what extent are the protections they afford already included in our funds' D&O/E&O insurance?

- ***Which type of IDL insurance do we prefer?:*** Do we want our IDL insurance to respond solely to non-indemnifiable exposures (Side A-Only IDL)? Or do we want our IDL insurance to be available to respond to both non-indemnifiable and indemnifiable exposures (Safety Net IDL)? What considerations (e.g., expense, scope of coverage provided, impact on fund shareholders) should we take into account in making this judgment?

- ***How much IDL insurance is enough?:*** What factors should we consider when determining how much IDL insurance to purchase? Should we look at peer data (available from ICI Mutual or elsewhere) on this question?

- ***Who can advise us on IDL insurance issues?*** : With whom can we consult on IDL insurance issues (e.g., brokers, ICI Mutual or other insurance company representatives, outside counsel)? Should we consult more than one insurance adviser? How do the perspectives of these insurance advisers differ, and how are they compensated?

Endnotes

[1] Historical experience supports this conclusion. Over the long history of the fund industry, there appear to be few, if any, examples of civil judgments for damages (i.e., formal court determinations of liability) against fund independent directors. Similarly, there appear to be few, if any, known instances of fund independent directors being individually responsible for amounts paid in civil settlements (i.e., resolutions of litigation by the parties, without a formal determination of liability by the court). There have, however, been some regulatory settlements and regulatory actions involving fund independent directors. *See, e.g.*, In the Matter of Jon D. Hammes, Investment Company Act of 1940 (ICA) Rel. No. 26290 (Dec. 11, 2003) (while no monetary payment was involved, independent directors of an investment company consented to an order of the U.S. Securities and Exchange Commission (SEC) requiring them to cease and desist from committing or causing certain violations of the Securities Act of 1933 (1933 Act) and the ICA); In re The Rockies Fund, Inc., Admin. Proc. No. 3-9615, ICA Rel. No. 27593 (Dec. 7, 2006) (in SEC action involving a business development company, two independent directors received cease and desist orders, prohibitions on associating with investment companies for a period of three years, and civil monetary penalties of $20,000 each); In the Matter of Parnassus Investments, Admin. Proc. No. 3-9317, Initial Decision Rel. No. 131 (Sept. 3, 1998) (initial decision) and Securities Exchange Act of 1934 (1934 Act) Rel. No. 40534 (Oct. 8, 1998) (final decision) (in SEC action involving an open-end fund, two independent directors received cease and desist orders, but no civil monetary penalties).

Recent months have witnessed two additional regulatory proceedings involving fund independent directors. In late 2012, in a highly publicized development, the SEC instituted an administrative enforcement proceeding against eight former fund directors (including former fund independent directors), alleging that the directors "failed to satisfy their fair valuation obligations" with respect to securities held by their funds, and thereby caused the funds to violate certain rules adopted under the ICA. *See* In the Matter of J. Kenneth Alderman, Admin. Proc. No. 3-15127, ICA Rel. No. 30300 (Dec. 10, 2012). By March 2013, the SEC staff and the former fund independent directors reportedly had reached an agreement in principle to settle the action. *See* In re J. Kenneth Alderman, Admin. Proc. No. 3-15127 (SEC Mar. 27, 2013) (in filing joint motion for stay, parties stated that they "have agreed in principle to a settlement on all major terms"); Joe Morris, *SEC, Morgan Keegan Directors Reach Settlement*, IGNITES (Mar. 28, 2013); Jean Eaglesham & Kirsten Grind, *Former Morgan Keegan Fund Directors to Settle With SEC*, WALL ST. J. (Mar. 28, 2013). In May 2013, the SEC reached a settlement in a second proceeding involving fund directors, in which fund independent directors (among others) were alleged to have caused misleading or untrue disclosures regarding their review of the advisory contracts of certain "turnkey" open-end funds, and to have failed to follow appropriate procedures in approving compliance programs of the funds' service providers. *See* In the Matter of Northern Lights Compliance Services, LLC, Admin. Proc. No. 3-15313, ICA Rel. No. 30502 (SEC May 2, 2013) (fund independent directors received cease and desist orders, but no civil monetary penalties).

[2] *See generally* ICI MUTUAL INSURANCE COMPANY, INDEPENDENT DIRECTOR LITIGATION RISK 20-21 (2006); JAMES HAMILTON, ANNE SHERRY & TED TRAUTMANN, RESPONSIBILITIES OF CORPORATE OFFICERS AND DIRECTORS UNDER FEDERAL SECURITIES LAW ch. 14 (2012); 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS ch. 20 (8th ed. 2012).

[3] Although the term "indemnification" is sometimes used to encompass the concept of "advancement," the two terms are conceptually distinct. *See, e.g.,* Miller v. Miller, 132 Ohio St.3d 424, 2012-Ohio-2928 ("Although advancement and indemnification are corollaries, they are not one and the same."); MD Acquisition, L.L.C. v. Myers, 173 Ohio App.3d 247, 2007-Ohio-3521, 878 N.E.2d 37, ¶ 6 (10th Dist.) ("Advancement of litigation expenses for corporate officers and directors, while related to (and often a precursor of) indemnification, is a distinct remedy."); United States v. Stein, 452 F. Supp. 2d 230, 271 (S.D.N.Y. 2006) ("[T]he critical point about advancement of defense costs—as distinguished from, among other things, claims for indemnification after the fact—is that its value 'is that it is granted or denied while the underlying action is pending.'"[citation omitted]); *see generally* J. Weston Peterson & Anthony W. Rodgers, *Protecting the Protectors: Indemnification of Trustees of Delaware Statutory Trusts*, THE INVESTMENT LAWYER (July 2011) ("Typically, the right to indemnification is granted by statute, contract or via an entity's organization documents and often only accrues once the indemnitee has made payment to a third party and the dispute with that party is final. The ability to receive funds in advance of such a judgment for defense costs is referred to as 'advancement.'").

[4] *See, e.g.*, Hermelin v. K-V Pharm. Co., 54 A.3d 1093 (Del. Ch. Feb. 7, 2012) ("No corporation can be a success unless led by competent and energetic officers and directors. Such individuals would be unwilling to serve if exposed to the broad range of potential liability and legal costs inherent in such service despite the most scrupulous regard for the interests of stockholders. This is the rationale behind the indemnification and advancement provisions of Delaware corporate law."); Homestore, Inc. v. Tafeen, 888 A.2d 204, 211 (Del. 2005) ("Indemnification encourages corporate service by capable individuals by protecting their personal financial resources from depletion by the expenses they incur during an investigation or litigation that results by reason of that service."); Miller v. Miller, 132 Ohio St.3d 424, 2012-Ohio-2928 (quoting *Homestore, Inc.*).

[5] As an example of mandatory indemnification, *see* MD. CODE ANN., CORPS. & ASS'NS § 2-418(d)(1) ("Unless limited by the charter … [a] director who has been successful, on the merits or otherwise, in the defense of any proceeding . . . shall be indemnified against reasonable expenses incurred by the director in connection with the proceeding."). As an example of permissive indemnification, see MD. CODE ANN., CORPS. & ASS'NS § 2-418(b)(1) ("A corporation may indemnify any director made a party to any proceeding by reason of service in that capacity unless it is established [that the director engaged in certain disqualifying conduct as defined in the statute]."). As discussed in Appendix B, most funds are organized as Maryland corporations, Massachusetts business trusts or Delaware statutory trusts. *See* Appendix B (nn. 13-22, and accompanying text) for a more detailed discussion of the state law provisions that govern indemnification of directors (trustees) of these types of funds.

[6] Such agreements are sometimes considered, for example, when a fund's governing documents do not in fact grant fund independent directors full indemnification rights available under applicable law, or as a "belt and suspenders" supplement to the indemnification rights contained in the fund's governing documents. *See generally* David A. Sturms, Vedder Price PC, *The Basics of Indemnification and Insurance for Investment Company Directors*, Investment Company Institute, Investment Company Director's Conference 3-4 (Oct. 2003), *available at* http://www.vedderprice.com/files/Publication/639b0969-0f2a-4006-9d7b-1b8b5ebc0d18/Presentation/PublicationAttachment/c9553c6b-47f2-48b7-b29c-6e7c2074f2b5/The%20Basics%20of%20Indemnification%20and%20Insurance%20for%20Investment%20Company%20Directors.pdf ("In addition to the traditional manner of including indemnification provisions in a fund's charter or bylaws, most state laws also permit directors to enter into indemnity agreements with the fund. Such an agreement may be desirable because it gives the directors an additional contractual basis to make a claim against the fund, secures indemnity rights in the event the board determines to change the bylaws, and clarifies and amplifies the directors' indemnification rights.").

[7] *See, e.g.*, Michael R. Nestor, William D. Johnston & Kristen Salvatore DePalma, Young Conaway Stargatt & Taylor, LLP, *Bankruptcy: The Game-Changer for Directors and Officers Who May Face Claims By Shareholders or Others*, THE METROPOLITAN CORPORATE COUNSEL (June 2, 2010), *available at* http://www.metrocorpcounsel.com/pdf/2010/June/43.pdf ("[A]dvancement or indemnification claims will be subjected to *enhanced scrutiny* not imposed pre-petition…. [E]ven allowed claims for advancement or indemnification ultimately may be worth little or nothing."); Marla H. Kanemitsu, Dickstein Shapiro LLP, *Under Siege: The Effect of Bankruptcy on D&O Protections*, BLOOMBERG LAW CORPORATE COUNSEL LAW REPORT (Feb. 23, 2012), http://www.dicksteinshapiro.com/files/Publication/1c8b85d1-92c4-4f18-885e-29f276185a17/Presentation/PublicationAttachment/83a26c5e-4bd1-453d-a145-34056a3f889b/Bankruptcy_DO_Protections.pdf ("Once a corporation files for bankruptcy, a director or officer who is otherwise entitled to indemnification has nothing more than a claim against the bankruptcy estate, and must attempt to obtain payment for that claim as would any other creditor. … Given these [previously described] challenges, indemnification from the corporation ultimately may have limited value to directors and officers.").

[8] For example, when the Reserve Primary Fund "broke the buck" in September 2008 and its net asset value fell below $1 per share, the fund did not enter into a bankruptcy, but rather engaged in a liquidation under the supervision of the SEC and pursuant to court order. In January 2010, the Reserve Primary Fund completed the distribution of the bulk of its remaining assets, representing a recovery by investors of more than 98 cents on the dollar. *See* Press Release, SEC, *Reserve Primary Fund Distributes Assets to Investors* (Jan. 29, 2010), http://www.sec.gov/news/press/2010/2010-16.htm.

[9] *See generally* ICI MUTUAL INSURANCE COMPANY, MUTUAL FUND D&O/E&O INSURANCE 51-52 (2009) (discussing insurance protections associated with fund acquisitions, mergers and liquidations).

[10] *See* Appendix B at n.11 and accompanying text.

[11] In contrast, the risk to directors of operating companies of incurring non-indemnifiable loss in derivative litigation may have increased in recent years, due both to (1) a reported "upsurge in the number of derivative suit settlements [involving operating companies] that include a significant cash component …," *see D&O Insurance to Fund Entire "Largest Ever" $139 Million News Corp. Derivative Suit Settlement* (Apr. 23, 2013), www.dandodiary.com; and (2) the fact that many operating companies are Delaware corporations, and as such are generally viewed to be prohibited (as discussed at Appendix B) from indemnifying their directors for derivative suit settlements.

[12] *See, e.g.,* Staff Report to the SEC, Exemptive Rule Amendments of 2004: The Independent Chair Condition 25 n.75 (Apr. 2005), http://www.sec.gov/news/studies/indchair.pdf ("Such insurance policies … are purchased by funds, in large part, to attract the services of qualified directors and officers.").

[13] *See generally* ICI MUTUAL INSURANCE COMPANY, MUTUAL FUND D&O/E&O INSURANCE 5-6 (2009) (discussing the "direct coverage" and "company reimbursement" components of D&O insurance) and at 21-22 (discussing meaning of "claim" in mutual fund D&O/E&O policies).

[14] Separate and apart from "advancements" that may be paid by an insurer from insurance proceeds, the fact that insurance is in place and available may also facilitate the ability of fund independent directors to receive "advancements" of defense costs directly from their funds (as discussed at p. 3 of the Guide). *See* Indemnification by Investment Companies, ICA Rel. No. 11330 (Sept. 4, 1980) (SEC staff states its belief that "advancements" from fund assets of defense costs to fund directors are permissible upon receipt of an undertaking from them to repay the defense costs unless it is ultimately determined that they are entitled to indemnification, provided that (1) the directors provide security for their undertaking, *or* (2) the fund is insured against losses arising by reason of any lawful advances, *or* (3) a majority of a quorum of disinterested, non-party directors, or an independent legal counsel in a written opinion, determine that there is reason to believe that the directors ultimately will be found entitled to indemnification.).

[15] *See* ICI MUTUAL INSURANCE COMPANY, MUTUAL FUND D&O/E&O INSURANCE 5-6 (2009) (discussing Side B coverage, also referred to as "company reimbursement" D&O coverage).

[16] Before the early 2000s, insurers and insureds recognized that erosion risk, rescission risk, and certain other risks described at pp. 7-8 of the Guide existed, and could, at least in theory, impact fund independent directors. Mechanisms were also available to mitigate the impact of certain of these risks. Thus, for example, in 1999, ICI Mutual institutionalized "reserved limits" as an optional feature in its D&O/E&O insurance policies. The option permitted fund groups to set aside (or "reserve") a portion of the overall limits of their D&O/E&O liability policies for the sole use of their funds' independent directors. The option, which is still used by some fund groups, takes advantage of the lower pricing accorded a "shared" policy (i.e., a D&O/E&O policy whose limit is "shared" by funds and fund directors and officers, and, in some cases, by affiliated service providers), while at the same preserving a portion of the "shared" policy's overall aggregate limit for the sole use of fund independent directors.

Various developments in the late 1990s and early 2000s contributed to the emergence of IDL insurance as a separate, stand-alone product for fund independent directors:

- *Two Notable Lawsuits in the Mutual Fund Sector:* In the late 1990s, in an unusual turn of events, two investment advisers initiated lawsuits against fund independent directors. These lawsuits highlighted the importance to fund independent directors of having appropriate liability insurance and indemnification protections in place. *See generally* Sturms, *supra* n.6, at 16-20 (discussing the background of the two lawsuits and the lawsuits themselves); Paul H. Dykstra & Paulita Pike-Bokhari, *The Yacktman Battle: Manager Bites Watchdogs*, THE INVESTMENT LAWYER (Nov./Dec. 1998) (reviewing one of the lawsuits).

- *High Profile Events and Settlements involving Operating Company Directors:* In the early 2000s, events outside the fund industry—most notably, the corporate meltdowns at Enron, WorldCom and other public companies, along with several high-profile settlements of civil litigation involving the directors of some of these companies—heightened concerns on the part of corporate directors generally (as well on the part of fund independent directors) over their potential risk for personal financial liability. *See generally* ICI MUTUAL INSURANCE COMPANY, INDEPENDENT DIRECTOR LITIGATION RISK 4-5 (2006) (discussing the WorldCom and Enron settlements). These concerns, in turn, helped to popularize, in the broader corporate sector, a previously underutilized stand-alone insurance product, frequently referred to as "Side A D&O" coverage. *See generally* 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 27.01 (8th ed. 2012) (discussing history of Side A D&O policies). As noted at pp. 8-9 of the Guide, Side A-Only IDL insurance, as utilized in the fund industry, was patterned closely after this corporate sector Side A D&O insurance product.

- *The Mutual Fund Market Timing Scandal:* A third development contributing to the emergence of IDL coverage was the mutual fund market timing scandal of 2003-2004. During the scandal period, the fund industry witnessed unprecedented frequency and severity of claims, and unprecedented allegations of misconduct on the part of fund industry personnel. These claims and allegations raised concerns on the part of fund independent directors and their insurance advisers over erosion risk, rescission risk, and certain other risks discussed at pp. 7-8 of the Guide. Whereas various of these risks had once seemed to be relatively remote—and, in any event, too remote to support a viable insurance market in stand-alone liability coverage for fund independent directors—the risks began to appear more plausible during the scandal period. As a result, fund groups, their insurance advisers, and insurers themselves gave increased consideration to what additional insurance protections, if any, might be appropriate to mitigate the potential impact of these risks on fund independent directors. Thus, the market timing scandal itself helped to fuel interest in IDL coverage on the part of insurers, fund independent directors, and their insurance advisers.

[17] In this regard, it is important to distinguish between IDL insurance, on the one hand, and a separate insurance product—commonly referred to as "Side A D&O" insurance—on the other. As discussed at pp. 8-9 of the Guide, Side A D&O insurance, in the broader corporate insurance market, is generally designed to protect *all* directors and officers of an operating company (including both inside and outside directors) against non-indemnifiable liability exposures. While "Side A D&O" insurance is sometimes purchased in the mutual fund sector, it does not appear to be a common practice.

[18] *See* Appendix B of the Guide for a discussion of the availability of indemnification for judgments in derivative lawsuits.

[19] The 2008 collapse of the Reserve Primary Fund (referenced at n.8 *supra*) affords a recent example of how funds and fund directors may be subject to erosion risk. The fund's collapse spawned both SEC and shareholder litigation. In September 2012, the court overseeing the SEC litigation ruled that all insurance proceeds from the fund's $10 million D&O/E&O policy (which the fund shared with its adviser and certain other entities) be distributed to the adviser and other "insider" defendants, as reimbursement for defense costs incurred by them. *See* SEC v. Reserve Mgmt. Co., Inc., No. 09 Civ. 4346 (S.D.N.Y.) (Order, filed Sept. 10, 2012). The D&O/E&O policy had thus been exhausted when, in January 2013, the fund's adviser and other defendants filed a third-party complaint in the shareholder litigation against the fund's independent directors, seeking contribution and indemnification from them. *See* Third Avenue Institutional Int'l Value Fund, L.P. v. Reserve Mgmt. Co., Inc., No. 08 Civ. 8060 (S.D.N.Y.) (Defendants' Answer to Consolidated Class Action Complaint and Defendants' Third Party Complaint, filed Jan. 22, 2013). By March 2013, the parties had reportedly reached an agreement in principle to settle the litigation. *See* Third Avenue Institutional Int'l Value Fund, L.P. v. Reserve Mgmt. Co., Inc., No. 08 Civ. 8060 (S.D.N.Y.) (Stipulation and Order Adjourning Deadline to Respond to Third Party Complaint, filed March 5, 2013).

[20] As discussed at pp. 8-9 of the Guide, there are two basic types of IDL insurance—i.e., "Safety Net" IDL insurance and "Side A-Only" IDL insurance. Under both types, there is typically no deductible applied to any *non*-indemnifiable exposures covered under the insurance. Unlike Side A-Only IDL insurance, Safety Net IDL insurance can also respond to *indemnifiable* exposures. For exposures that are indemnifiable, Safety Net IDL insurance, like D&O/E&O insurance, typically provides for an "indemnifiable loss deductible" to be paid by the fund. Under the terms of Safety Net IDL insurance policies, this "indemnifiable loss deductible" is typically waived if the fund refuses to indemnify, thereby protecting fund independent directors against the risk that they might be required to use personal assets to pay a deductible.

[21] Referring to Safety Net IDL insurance as "Side A&B" coverage is not entirely accurate, because (1) Safety Net IDL insurance directly insures *independent directors themselves* for their losses (both indemnifiable and non-indemnifiable), such that the fund itself is not an insured, whereas (2) "Side B" coverage, as a formal matter, insures the *entity itself* (i.e., the fund) for amounts that the entity pays to its directors as indemnification. *See generally* ICI MUTUAL INSURANCE COMPANY, MUTUAL FUND D&O/E&O INSURANCE 5-6 (2009) (discussing the difference between Side A (also referred to as "direct") coverage and Side B (also referred to as "company reimbursement") coverage in D&O insurance).

Referring to Safety Net IDL insurance as "broad form" coverage is also not entirely accurate. This is because the "broad form" reference, in the D&O insurance market, is commonly applied to distinguish Side A-Only D&O policies that contain difference-in-conditions (DIC) provisions (described at p. 7 of the Guide) from Side A-Only D&O policies that do not contain DIC provisions. As discussed in the text, Safety Net IDL insurance is not a Side A-Only product, because Safety Net IDL insurance provides coverage for *both* non-indemnifiable (Side A) loss *and* indemnifiable loss. That being said, Safety Net IDL insurance can also contain coverage provisions that may be broader than the coverage available in a fund's underlying insurance (e.g., for non-party witness costs of fund independent directors), and in this sense may also accurately be viewed as "broad form" coverage.

[22] Safety Net-like IDL coverage available in the commercial insurance market may take the form of modifications (via endorsement) to "standard form" commercial Side A-Only D&O policies, and/or to "standard form" commercial mutual fund D&O/E&O policies. In such cases, fund independent directors requesting Safety Net-like IDL coverage from commercial insurers may wish to carefully review the wording of the commercial forms and endorsements being utilized, to ensure that the coverage being provided accords with their coverage expectations.

[23] In the broader corporate sector, Side A D&O insurance is often promoted as protection for directors and officers of operating companies against non-indemnifiable exposures they may incur in connection with claims arising from company bankruptcies (as discussed above at p. 4 of the Guide, a highly remote risk in the mutual fund industry) and/or derivative lawsuits (discussed at Appendix B of the Guide). *See, e.g.*, *A-Side D&O FAQ*, WillisHRH, Executive Risks Alert, June 2009, http:// www.willis.com/documents/publications/services/executive_risks/2009/Executive_Risks_Alert_-_0609_-_A-side_FAQs.pdf (highlighting risk to corporate directors and officers of non-indemnifiable loss in derivative claims); Whitepaper: *Side A D&O: Why company directors need this coverage*, Zurich, 2010, http://hpd.zurich.com/whitepaper/zurich-DO-Side-A.pdf (highlighting potential personal exposure for directors and officers where their company is bankrupt and in settlements of derivative actions).

[24] Some insurance professionals favor Side A-Only IDL insurance because it tends to be available at a lower cost. Others view Safety Net IDL insurance as a better overall value, given the increased scope of coverage that it affords (i.e., for both non-indemnifiable *and* indemnifiable loss), and the rarity in the fund industry of Side A exposures for fund independent directors.

[25] Some insurance professionals favor Side A-Only IDL insurance for its DIC protections. Those who favor Safety Net IDL insurance question the value of DIC protections in Side-A Only IDL insurance. They reason that in today's insurance market, many of the DIC protections with "real world" relevance for fund independent directors (e.g., coverage for non-party witness costs) are already available in underlying mutual fund D&O/E&O insurance policies (such that their "drop down" value is limited), and that many of these DIC protections are likewise provided in Safety Net IDL policies. They also question the practical value of a number of the DIC protections in Side A-Only IDL policies, given that DIC protections in Side A-Only policies cover only *non*-indemnifiable exposures.

[26] Some insurance professionals favor Side A-Only IDL insurance, based on their view that IDL insurance should serve *solely* as "pocketbook" protection for fund independent directors, and should therefore be structured *solely* to mitigate the risk—as remote as it may be—that fund independent directors could incur a loss that is neither indemnifiable nor payable under their funds' D&O/E&O insurance. Other insurance professionals favor Safety Net IDL insurance, based on their view that in the *fund industry,* where the risk of non-indemnifiable exposures for fund independent directors is low, IDL insurance can and should serve a dual purpose: first, to provide "pocketbook" protection for fund independent directors; and second, to mitigate the risk that shareholder (i.e., fund) assets could be called upon to indemnify fund independent directors in claims made against them.

Appendix A – Restrictions Imposed on Indemnification by Federal Law

As stated in the Guide (at page 3), although federal law places certain restrictions on the ability of funds to indemnify their directors and officers, these restrictions are unlikely to affect fund independent directors, for the reasons discussed below. This Appendix A is designed primarily for the use of insurance advisers, counsel to fund boards, and others who may have a particular interest in these federally-imposed restrictions.

Section 17(h) of the Investment Company Act of 1940

Section 17(h) of the Investment Company Act of 1940 (ICA) provides:

> Neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.

Such conduct is often referred to as "disabling conduct." As interpreted by the U.S. Securities and Exchange Commission (SEC) and some courts, section 17(h) prohibits not only the inclusion of exculpatory provisions in the designated fund documents, but further prohibits indemnification by funds for "disabling conduct" itself.[1]

Absent unusual circumstances, however, the section 17(h) prohibition is unlikely to preclude indemnification of independent directors. Fund independent directors—by reason of their position, responsibilities, and independence—

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[1] *See generally* Indemnification under Sections 17(h) and 17(i) of the Investment Company Act of 1940 and Related Policies of the Securities Act of 1933 and the Securities Exchange Act of 1934, ICA Rel. No. 13181 (Apr. 21, 1983) ("… Congress intended to prohibit the indemnification of persons whose conduct violates these statutory standards, and not merely to ensure that the language of disabling conduct is included in appropriate investment company documents …."); Indemnification by Investment Companies, ICA Rel. No. 11330 (Sept. 4, 1980) (stating SEC staff's view "that an indemnification provision does not violate section 17(h) or (i) of the Investment Company Act of 1940 … if it precludes indemnification for any liability, whether or not there is an adjudication of liability, arising by reason of … [disabling conduct] and sets forth reasonable and fair means for determining whether indemnification should be made"); In re Nuveen Fund Litig., 1996 U.S. Dist. LEXIS 8077, at *12 (N.D. Ill. 1996) ("Under [Section 17(h) of] the ICA, the Funds may not exonerate their directors for gross negligence, bad faith or a breach of the duty of loyalty."); Steadman Sec. Corp. v. Steadman Associated Fund, 1982 U.S. Dist. LEXIS 16558, at *3-6 (D. D.C. 1982) (court refuses to conclude as a matter of law that adviser's conduct was not "disabling" so as to permit indemnification of the adviser under section 17(i), a section which "essentially applies the same restrictions on indemnification to agreements between a fund and its investment advisor [as does section 17(h) with respect to fund directors and officers]"); Interpretive Matters Concerning Independent Directors of Investment Companies, ICA Rel. No. 24083 (Oct. 14, 1999) ("Section 17(h) is intended to balance the need to ensure that funds have the ability to indemnify directors for liability arising out of actions that they took in good faith with the need for funds and their shareholders to be able to hold fund directors personally accountable for their actions as directors."); ROBERT A. ROBERTSON, FUND GOVERNANCE: LEGAL DUTIES OF INVESTMENT COMPANY DIRECTORS § 5.02[4][a] (Law Journal Press 2012) (discussing section 17(h)).

have little opportunity, and even less incentive, to engage in actual "disabling conduct," so as to implicate the prohibition.[2]

"Public Policy" Prohibition on Indemnification

The federal courts have long recognized a "public policy" prohibition on corporate indemnification of directors or other parties for violations of various provisions of the federal securities laws.[3] Absent unusual circumstances,

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[2] *Cf.* Interpretive Matters Concerning Independent Directors of Investment Companies, ICA Rel. No. 24083 (Oct. 14, 1999) ("Independent directors are presumed by the nature of their qualifications to be free of many of the kinds of conflicts that may color their judgment and affect their actions as directors.").

The SEC staff has also stated that it views section 17(h) as precluding a fund from using insurance paid for by the fund to indirectly indemnify fund directors and officers for "disabling conduct," although it has noted that "[t]here would be no objection … to insurance policies which were paid for by the directors or officers themselves covering liabilities arising from [disabling conduct]." *See* Exemption of Certain Joint Purchases of Liability Insurance Policies*,* ICA Rel. No. 10700, at n.8 (May 16, 1979) (citing to Item 19 of the guidelines for the preparation of Form N-8B-1). Although Form N-8B-1 was subsequently replaced, the guidelines to the form were not withdrawn by the SEC. *See* Indemnification by Investment Companies, ICA Rel. No. 11330, n.1 (Sept. 4, 1980) (in referring to Item 19, the release notes that "[a]lthough Form N-8B-1 has been replaced …, the guidelines have not been withdrawn by the Commission since they contain regulatory positions which are applicable to the new forms.").

The SEC staff's view is more restrictive than most state laws, which allow insurance for conduct that would not be indemnifiable, subject to certain limitations. *See, e.g.*, MD. CODE ANN. CORPS. & ASS'NS §2-418(k); MASS. GEN. LAWS ch. 156D §8.51; DEL. C. §145(g). No significant court has decided whether the SEC staff is in correct in its view as to the applicability of Section 17(h) to the purchase of insurance, and the staff's view has been subject to criticism. *See, e.g.,* Israel Investors Corp., 1987 SEC No-Act. LEXIS 2278, at *19-20 (Jul. 27, 1987) ("We suggest there is a substantial difference between an investment company's agreeing to indemnify a director or officer and the same company's paying for someone else's (the insurance company's) agreeing to do such…. That the company may not itself legally indemnify a director or officer under certain circumstances does not mean that the company as a business matter may not provide for someone else to do so.").

Separate and apart from section 17(h), in certain situations (e.g., settlements of lawsuits), consideration may also need to be given as to whether section 17(d) of the ICA and rule 17d-1 thereunder could be implicated. *See, e.g.,* The Brazilian Equity Fund, Inc., ICA Rel. No. 26781 (March 9, 2005) (application requesting an SEC order permitting a proposed settlement of a derivative and class action lawsuit naming an adviser, a fund, and certain of the fund's current and former directors as defendants); ICA Rel. No. 26826 (March 31, 2005) (SEC order granting application). Section 17(d) and rule 17d-1 thereunder generally prohibit affiliated persons of funds from participating in any "joint arrangement" with their funds, unless an application regarding the joint arrangement has been filed with the SEC and the SEC has granted an order authorizing the transaction. However the SEC staff has expressed the view that "the fact that fund expenditures may benefit the directors in some way is not sufficient to render them 'joint arrangements' among the fund and the directors for purposes of [Section 17(d) and] Rule 17d-1." *See* Matters Concerning Independent Directors of Investment Companies, ICA Rel. No. 24083 (Oct. 14, 1999). The SEC staff has also indicated that the "joint arrangement" prohibition should not be interpreted to encompass such common actions as the use of fund assets to pay legal fees of counsel to fund independent directors. *Id.*

[3] *See, e.g.*, Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288 (2d Cir. 1969) (holding that indemnification by an issuer of an underwriter for liabilities arising out of material misstatements of which the underwriter had actual knowledge "would encourage flouting the policy of the common law and the Securities Act"); Heizer Corp. v. Ross, 601 F.2d 330, 334 (7th Cir. 1979) ("Whereas contribution supports the policy of securities legislation, indemnification tends to frustrate and defeat it. A securities wrongdoer should not be permitted to escape loss by shifting his entire responsibility to another party."); Baker, Watts & Co. v. Miles & Stockbridge, 876 F.2d 1101, 1108 (4th Cir. 1989) (en banc) (where dealer-manager sought indemnification from law firm following court determination that dealer-manager had violated §12(2) of the Securities Act of 1933 (1933 Act), court holds that "[a]lthough a right to indemnification may not be preempted in each and every circumstance … [h]ere, [the

however, the prohibition, as interpreted by the courts, is unlikely to preclude indemnification by funds of their independent directors. This is because court decisions suggest that in order for the "public policy" prohibition to be triggered, "a judicial finding of an actual securities law violation" may be required.[4] But such judicial findings are uncommon, particularly in lawsuits against fund independent directors, since such lawsuits are nearly always resolved either (i) through dismissal of the lawsuits (either by the courts or voluntarily by the parties), or (ii) through settlements that do not involve findings (or admissions) of liability by fund independent directors, or payments (other than defense costs) made by them or on their behalf. Even where lawsuits are ultimately settled (rather than dismissed), the "public policy" prohibition, as interpreted by the federal courts, appears unlikely to preclude indemnification of fund independent directors.[5] This being said, the issue of directors' eligibility for indemnification in the case of a settlement is one that, depending on the circumstances, may ultimately need to be determined by a court.[6]

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dealer-manager's] wrongdoing has been plainly adjudicated, and a state action for indemnification would frustrate the basic enforcement of federal securities law."); In re Healthsouth Corp. Secs. Litig., 572 F.3d 854, 862 (11th Cir. 2009) ("[P]recedent indicates that indemnification of participants in the context of securities violations is inconsistent with the policies underlying the securities laws."); *cf.* McLean v. Alexander, 449 F. Supp. 1251, 1265-67 (D. Del. 1978) (discussing and contrasting "contribution" and "indemnification").

[4] *See* David Woodcock and Nicki Glauser, *Indemnification Risks: Dodd-Frank Ups the Ante*, THE CORPORATE BOARD (Mar./Apr. 2011) at 19, *available at* http://www.velaw.com/uploadedFiles/VEsite/1103WoodcockGlauser.pdf.

[5] *See, e.g.,* In re Cendant Corp. Secs. Litig., 109 F. Supp. 2d 273, 284 (D. N.J. 2000) (in rejecting the argument that a settlement was an "illegal indemnification" by a corporation of its directors, court notes that the directors had not admitted liability and that "courts have ruled that corporate indemnification of individual directors is permitted under the federal securities laws where 'defendants did not admit liability in settling the underlying suit.' [citations omitted]"); Rachem Corp. v. Federal Ins. Co., 853 F. Supp. 1170, 1177 (N.D. Cal. 1994) (court notes that indemnification of corporate officers and directors for settlement payments and defense costs supports "two competing public policies," and concludes that "federal law does not prohibit [the corporation's] indemnification of its officers and directors for settlement payments and defense costs"); *cf.* Wisener v. Air Express Int'l Corp., 583 F.2d 579, 583 (2d Cir. 1978) (where actions alleging violations of federal securities laws were settled, court finds that neither corporate bylaws nor "public policy" of the relevant state precluded claim by a former officer and director for indemnification for his defense costs); *see generally* ROBERTSON, *supra* n.1 at §5.02[4][b][i][C][vi] ("Indemnifying a director for settlement payments and associated defense costs in a federal securities action does not, as a general matter, violate public policy." [citations omitted]).

[6] As discussed at n.5 *supra*, a number of courts do not appear to view the "public policy" prohibition as applicable either to dismissals or settlements. Some courts, however, seem to have drawn a distinction between the two, and have suggested that a party seeking indemnification in a settlement context must demonstrate that it was without fault. *See, e.g.*, Goldstein v. Alodex Corp., 409 F. Supp. 1201, 1205 (E.D. Pa. 1976) (following the settlement of class actions alleging violations of the 1933 Act, court finds that "public policy as expressed in the Securities Act of 1933" did not preclude the issuing company from indemnifying two of its outside directors for their defense costs, where the court found "that the directors … acted in good faith in connection with the registration statement"); Credit Suisse First Boston, LLC v. Intershop Commc'n., 407 F. Supp. 2d 541, 547-48 (S.D.N.Y. 2006) (court discusses the rationale for requiring a "no fault" demonstration, and relevant cases).

In addition, it should be noted that in the case of a lawsuit alleging violations of the 1933 Act, a registered fund may be obliged, under certain circumstances, to submit to a court the issue of whether indemnification of its directors or officers accords with "public policy." More specifically, if fund directors or officers seek indemnification in such a lawsuit (other than for expenses incurred by them in their "successful defense" of the lawsuit), the fund may find itself required, by reason of an undertaking included in the fund's registration statement, to submit the issue of indemnification to a court. *See, e.g.,* 17 C.F.R. § 230.484 (requiring, under certain circumstances, registered funds to include in their registration statements an undertaking in

Separate and apart from the "public policy" prohibition recognized by the federal courts, it should be noted that the SEC has itself "[f]or decades … taken the position that corporate indemnification of directors for violation of federal securities laws is against public policy and unenforceable."[7] Whereas the courts, as discussed above, have often limited application of the "public policy" prohibition on indemnification to cases involving judicial findings of actual securities law violations, the SEC, by contrast, reportedly has an "unwritten policy" of seeking to preclude parties in SEC proceedings from seeking or accepting indemnification for amounts, other than defense costs, that may be paid by them in settlements (e.g., penalties, and in some cases, disgorgement).[8]

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substantially the following form: "Insofar as indemnification for liability arising under the Securities Act of 1933 may be permitted to directors [or] officers …, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director [or] officer … in the successful defense of any action, suit or proceeding) is asserted by such director [or] officer …, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.").

[7] Woodcock and Glauser, *supra* n.4 at 18; David B. Schultz, Comment, *Indemnification of Directors and Officers Against Liabilities Imposed Under Federal Securities Laws,* 78 MARQ. L. REV. 1043, 1051 (1995) (noting that "[t]he SEC's position that indemnification undermines the deterrent policies of the Securities Acts is not in itself law, but is the policy opinion of a federal agency"); J. OLSON & J. HATCH, DIRECTOR AND OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE § 6.05[1] (1991); *see also* 17 C.F.R. §§ 230.484, supra n.6.

[8] *See* David Woodcock and Nicki Glauser, *Emboldened SEC and Indemnification: Corporate Officials Face Greater Risk of Personal Liability,* SECURITIES LITIGATION INSIGHTS (Fall 2010), *available at* http://www.velaw.com/uploadedFiles/VEsite/Resources/SecuritiesLitigationInsights_Fall2010.pdf; *see also* Woodcock and Glauser, *supra* n.4 at 19-21.

Appendix B - Non-Indemnifiable Loss in Fund Derivative Litigation

As stated in the Guide (at page 4), fund independent directors tend to be at low risk of incurring non-indemnifiable loss (in the form of non-indemnifiable defense costs or otherwise) in derivative litigation—i.e., in shareholder lawsuits brought by and in the name of the fund itself. The legal and practical reasons for this conclusion are discussed below. This Appendix B is designed primarily for the use of insurance advisers, counsel to fund boards, and others who may have a particular interest in this issue.

Legal Protections Available to Fund Independent Directors

The strength of the legal protections that are generally available to fund directors in derivative litigation places them at low risk of incurring non-indemnifiable loss. State law typically requires that a plaintiff shareholder, in order to proceed with a derivative lawsuit on behalf of a fund (or any other company), must first make demand on the company's board of directors to take action or else to explain why demand on the board would be futile. At least in the fund context, where a plaintiff shareholder fails to make such a demand, courts rarely excuse the demand requirement as futile, and courts often dismiss such cases as a matter of law.[1] Moreover, even when a demand is made, the fund itself—through appropriate fund representatives, such as a committee of directors whose conduct is not at issue—typically makes a determination as to whether the lawsuit should be pursued. If these representatives reach a considered judgment that prosecution of the lawsuit is not in the best interests of the fund (i.e., if the shareholder's demand is "refused"), the shareholder may seek to persuade a court that the derivative lawsuit should nevertheless proceed. In such a case, if the judgment of the representatives not to proceed with the lawsuit was "made in good faith by independent decision makers after reasonable inquiry,"[2] courts are generally predisposed to terminate the litigation.[3]

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[1] *See, e.g.*, Hartsel v. Vanguard Group, Inc., 2011 Del. Ch. LEXIS 89 (2011), *aff'd* 38 A.3d 1254 (Del. 2012); Seidl v. Am. Cent. Cos., Inc., 713 F. Supp. 2d 249, 257-262 (S.D.N.Y. 2010), *aff'd* 427 Fed. Appx. 35 (2d Cir. 2011); In re Eaton Vance Mut. Funds Fee Litig., 380 F. Supp. 2d 222 (S.D.N.Y. 2005), *aff'd* Bellikoff v. Eaton Vance Corp., 481 F.3d 110 (2d Cir. 2007); Benak v. Alliance Capital Mgmt. L.P., No. 01-CV-5734, 2005 WL 1285652 (D.N.J. May 23, 2005), *aff'd* 435 F.3d 396 (3d Cir. 2006); *but cf.* Union de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Fin. Servs. Inc. of Puerto Rico, 2013 WL 49818 (1st Cir. Jan. 4, 2013) (in lawsuit involving a demand made on the board of an investment company organized in Puerto Rico that was not a registered investment company, court rules that demand was excused because a majority of the board was not "independent" under applicable law).

[2] Halebian v. Berv, 644 F.3d 122, 127 (2d Cir. 2011); *see generally* Mark Holland, Goodwin Procter LLP, *Recent Developments in Shareholder Derivative Litigation Involving Investment Companies*, Investment Company Institute, Mutual Funds and Investment Management Conference (Mar. 2013) (conference outline on file with ICI Mutual).

[3] *See, e.g.*, Gamoran v. Neuberger Berman LLC, No. 1:11-cv-7957 (S.D.N.Y. Mar. 29, 2013) (in granting motion to dismiss amended complaint, the court determined that the plaintiff's allegations did "not implicate the reasonableness of the board's investigation and fail[ed] to demonstrate that the board's refusal was made in bad faith"); Halebian v. Berv, 869 F. Supp. 2d 420,

It is rare, in the fund context, for a derivative lawsuit to proceed beyond the foregoing stages. Even in such an instance, however, the plaintiff shareholder could still be called upon to "prove her case"—that is, the plaintiff shareholder could still be required to demonstrate that the underlying board decision being challenged in the derivative lawsuit was made in breach of directors' fiduciary duties or was otherwise illegal. In this regard, courts may accord broad deference to challenged board decisions under a long-standing legal doctrine known as the "business judgment rule." Under this doctrine, directors are presumed to have exercised their judgment on an informed basis, in good faith and in a rational belief that their actions were taken in the best interests of the fund.[4]

As a result of the foregoing, financial losses incurred by fund independent directors in derivative litigation are generally limited to their legal defense costs. Such defense costs, as discussed later in this Appendix, are typically indemnifiable by their funds.

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432 (S.D.N.Y. 2012), *appeal docketed* Halebian v. Berv, 12-3360 (2d Cir. Aug. 17, 2012) (in reviewing challenge to determination by special committee of fund trustees that "the balance of the [fund's] interests weighed against taking the action that the demand letter requested," district court grants summary judgment dismissing plaintiff's derivative lawsuit); Safier v. Nuveen Asset Mgmt., No. 10-CH-32166 (Ill. Cir. Ct. filed Jul. 27, 2010) (slip op.) (court grants motion by funds to dismiss derivative lawsuit, finding that a majority of the board was independent, that the board's investigation was "reasonable and in good faith," and that the board's demand committee had conducted a "comprehensive inquiry"); *see also* Richelson v. John Hancock Advisers, LLC, No. 10-3355A (Mass. Super. Ct., filed Aug. 24, 2010) (court orders dismissal of derivative lawsuits where special committee of fund independent trustees determined that legal action was not in their funds' best interests and where plaintiffs and defendants agreed to a dismissal).

Among the issues that may arise where plaintiffs challenge the judgments of fund representatives in "demand refused" derivative lawsuits are (1) the extent to which plaintiffs should be entitled to conduct "factual discovery" (or otherwise to receive information from fund representatives) regarding the representatives' independence and the scope and content of their investigation into the plaintiffs' demands; and (2) the appropriate stage of the litigation process at which the court may make a determination to terminate the derivative lawsuit. *See, e.g.*, Ryskamp v. Looney, No. 10-cv-00842 (D. Colo., filed April 15, 2011) (in denying, without prejudice, fund's motion to dismiss derivative lawsuit, court orders defendants to produce certain information to the plaintiff); Seidl v. Am. Cent. Cos., Inc., No. 10-cv-4152 (W.D. Mo., filed Oct. 31, 2012) (after discussing approaches taken by courts "in addressing how rigorously to review a [special litigation committee's] recommendation to dismiss a derivative lawsuit," the court determines that the issue should be addressed at summary judgment, rather than on the defendants' motion to dismiss).

[4] *See generally* In re Citigroup, Inc. Shareholder Derivative Litig., 964 A.2d 106, 124 (Del. Ch. 2009) ("The business judgment rule 'is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.' [citation omitted]"); Anne Tucker Nees, *Who's The Boss? Unmasking Oversight Liability within the Corporate Power Puzzle*, 35 DEL. J. CORP. L., 199, 226 (2010) ("The business judgment rule prevents a court from second-guessing the decisions made in the board room by presuming them to be undertaken in compliance with the directors' fiduciary duties. This presumption can be rebutted if a plaintiff pleads with particularity that the directors' actions were fraudulent, illegal, wasteful, or that the directors likely breached a fiduciary duty. But directors and their decisions will be protected by the business judgment rule if the plaintiff fails to rebut the presumption." [citations omitted]); Douglas M. Branson, *The Rule That Isn't a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV., 631, 634-47 (discussing formulations and components of the business judgment rule); ICI MUTUAL INSURANCE COMPANY, INDEPENDENT DIRECTOR LITIGATION RISK 7-8 & Appendix A (2006).

Affiliated Entities as "Deep Pocket" Defendants

A derivative lawsuit "permits an individual shareholder to bring 'suit to enforce a *corporate* cause of action against officers, directors, and third parties,"' and thereby "to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'"[5] In the operating company context, because corporate management is typically *internalized*, it is common for defendants in derivative lawsuits to be limited to corporate directors and officers (with the corporation itself named as a "nominal" defendant).[6] By contrast, in the fund context, because management is typically *externalized*, defendants in derivative lawsuits tend to include, in addition to fund directors and/or officers, one or more of the affiliated "deep pocket" entities who provide services to the funds—e.g., affiliated fund advisers, distributors and/or administrators (and, in some cases, their parent companies).[7] While it is not unheard of for derivative lawsuits in the fund context to name only fund directors and/or fund officers as defendants, this appears to be an infrequent exception.[8]

In securities-related derivative lawsuits, as in securities class action lawsuits, monetary settlements may be funded by available insurance.[9] The plaintiffs' bar typically recognizes that securing monetary settlements in amounts beyond available insurance limits can be challenging, even where corporate entities (as opposed to natural persons) are involved as defendants.[10] That being said, the presence of entity defendants in most fund derivative lawsuits provides

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[5] Kamen v. Kemper Fin. Serv., 500 U.S. 90, 95 (U.S. 1991) (citations omitted).

[6] *See, e.g.*, Louisiana Mun. Police Employees Ret. Sys. v. Dimon, No. 11-cv-6231 (S.D.N.Y. filed Sept. 6, 2011) (in derivative lawsuit following a $88.3 million settlement by JP Morgan Chase & Co. (JPMC) with the U.S. Department of the Treasury's Office of Foreign Assets Control, complaint names JPMC's directors as defendants); In re HP Derivative Litig., No. 10-cv-03608 (Consolidated Action) (N.D. Cal. filed Aug. 16, 2010) (in derivative lawsuit following resignation of the chief executive officer of Hewlett-Packard Company (HP), complaint names HP's directors and former chief executive officer as defendants); *see generally* Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis,* 51 WM. & MARY L. REV. 1749, 1772 (2010) (in study of shareholder derivative lawsuits filed in federal courts, author notes that only 16 of 141 public company derivative complaints named individuals or entities with no corporate relationship to the public company).

[7] *See, e.g.*, Rotz v. Van Kampen Asset Mgmt., Inc., No. 651060-2010 (N.Y. Sup. Ct. filed July 22, 2010) (in derivative lawsuit challenging the redemption by funds of auction rate preferred securities, the complaint names the funds' adviser and the adviser's parent company, in addition to fund trustees and executive officers); Verified Shareholders' First Amended Derivative Complaint, In re Regions Morgan Keegan Secs., Derivative and ERISA Litig., Docket No. 2:09-md-2009 (W.D. Tenn. Oct. 13, 2009) (in derivative lawsuit alleging "mismanagement" of fund assets, the complaint names the funds' investment adviser and distributor, among other entities, in addition to fund directors and officers).

[8] *See, e.g.*, Halebian v. Berv, No. 06-cv-4099 (S.D.N.Y. filed May 30, 2006) (in derivative lawsuit challenging approval of new advisory contracts following an adviser's sale of its asset management business, the complaint names only fund trustees as defendants).

[9] *See generally* Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PENN. L. REV. 755, 821 (2009) ("[S]ettlements are funded largely, and often entirely, by D&O insurance."); Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006) (discussing the factors that incentivize the plaintiffs' bar to settle within insurance limits, regardless of their view of the "value" of the lawsuit); *D&O Insurers Fund $118 Million Partial Settlement of Broadcom Options Backdating Derivative Suit* (Sept. 1, 2009), www.dandodiary.com; John D. Hughes, Gregory D. Pendleton & Jonathan Toren, *Shareholder Derivative Litigation—A Primer for Insurance Coverage Counsel,* (Dec. 2012), www.edwardswildman.com (discussing insurance and insurance coverage issues in the context of derivative litigation).

[10] *See* TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT 141-143 (The University of Chicago Press 2010).

the plaintiffs' bar with another source of potential "deep pocket" recovery beyond insurance. The presence of these "deep pockets" further insulates fund independent directors against the risk that they might be called upon to contribute, as individuals, if a derivative lawsuit should ultimately result in a monetary settlement.

Breadth of Indemnification Permitted Under State Law

As noted in the Guide (at page 4), many states place restrictions on the ability of corporations to indemnify their directors and officers in derivative litigation. The restrictions can be traced, in part, to concerns over the "circularity" that would result if directors and officers in derivative litigation were to be permitted to receive corporate assets (in the form of indemnification) in order to fund settlement amounts or judgments payable by them to the corporation itself.[11] These state restrictions do not, however, generally preclude corporate indemnification for defense costs incurred by directors and officers in their successful defense of derivative litigation.

For fund independent directors, of course, the relevant issue is *not* the restrictions on indemnification that are imposed by "most states," but rather the restrictions that are imposed by those particular states where mutual funds are organized. Nearly 90% of mutual funds are organized as Maryland corporations (14%), as Massachusetts business trusts (40%), or as Delaware statutory trusts (35%).[12] The breadth of indemnification permitted by these three jurisdictions provides additional support for the conclusion that fund independent directors tend to be at low risk of incurring non-indemnifiable loss in derivative litigation.

The three jurisdictions address indemnification of fund directors in derivative litigation as follows:

- **Maryland:** Subject to certain provisos, Maryland law permits directors of funds organized as Maryland corporations to be indemnified for amounts paid by them in settlements of derivative lawsuits, as well as for their expenses (including attorneys' fees).[13]

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[11] *See* Dan A. Bailey, *Understanding Side-A Only D&O Insurance*, RISKVUE (Aug. 2007), http://www.riskvue.com/articles/fs/fs0708b.htm ("The ability to indemnify for derivative suit judgments or settlements is severely limited or prohibited by most state indemnification statutes.… This limitation is intended to avoid the circularity which would result if funds received by the corporation were simply returned to the person who paid them."); R. Franklin Balotti & Jesse A Finkelstein, 1 DELAWARE LAW OF CORPS. AND BUS. ORGS. §4.19 at 4/359 (Supp. 1996) ("Amending [the relevant section of the Delaware Code] to allow indemnification of judgments or amounts paid in settlement in derivative suits was rejected as circular since the corporation would simply be paying itself for injury caused to it by the very directors being indemnified by the corporation."). Some commentators have been critical of "circularity" as a reason to prohibit indemnification in derivative litigation, particularly in the case of settlements. *See, e.g.*, Mae Kuykendall, *A Neglected Policy Option: Indemnification of Directors for Amounts Paid to Settle Derivative Suits—Looking Past "Circularity" to Context and Reform,* 32 SAN DIEGO L. REV. 1063, 1110-11 (1995) ("This pairing [of indemnification of amounts paid in settlement with amounts paid to satisfy judgments] erases a critical distinction between the two types of indemnification.… The term circularity of recovery lacks an animating meaning when transposed from the context of an adverse judgment to the context of a settlement.").

[12] *See* INVESTMENT COMPANY INSTITUTE, 2013 INVESTMENT COMPANY FACT BOOK 207 (2013).

[13] *See* MD. CODE ANN. CORPS. & ASS'NS § 2-418. Under the Maryland provision, as here relevant, a corporation may indemnify unless it is "established" that (1) the relevant act(s) or omission(s) of the director(s) were "material" and were committed in bad

- **Massachusetts:** Subject to certain provisos, Massachusetts law permits directors of Massachusetts *business corporation*s to be indemnified for amounts paid in both judgments and settlements of derivative lawsuits, as well as for their expenses (including attorneys' fees) in such lawsuits.[14] Massachusetts *business trusts* are subject to a different set of Massachusetts statutory provisions, and these provisions make no express reference to indemnification of persons serving as trustees.[15] It appears likely, however, that the courts would view the indemnification rights of trustees of funds organized as Massachusetts business trusts to be equally as broad as the indemnification rights of directors of Massachusetts business corporations, at least where, as is commonly the case, the applicable trust instruments contain express provisions for indemnification.[16]

- **Delaware:** Delaware law is generally viewed as prohibiting directors of Delaware *corporations* from being indemnified for amounts paid in judgments or settlements of derivative lawsuits,[17] but as permitting directors to be indemnified for their expenses (including attorneys' fees) in such lawsuits, subject to certain provisos.[18] Delaware *statutory trusts*, however, are subject to a different set of statutory provisions than are Delaware

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faith, or were the result of active and deliberate dishonesty, or (2) the director(s) actually received an improper personal benefit. However, a corporation is prohibited from indemnifying directors for *judgments* in derivative litigation. *Id.* at §2-418(b)(2)(ii).

[14] *See* MASS. GEN. LAWS ch. 156D § 8.51 (applicable to Massachusetts business corporations). Under the Massachusetts provision, as here relevant, a corporation may indemnify if the director (1) conducted himself in good faith, and (2) reasonably believed that his conduct was in the best interests of the fund or that his conduct was at least no opposed to the best interests of the corporation.

[15] *See* MASS. GEN. LAWS ch. 182 (governing "voluntary associations and certain trusts").

[16] *See* David A. Sturms, *The Basics of Indemnification and Insurance for Investment Company Directors*, Guide n. 6, at pp. A-3 & A-4 ("Based upon both Massachusetts law and the 1940 Act, it is likely that courts would permit indemnification and advancement of expenses for directors of a Massachusetts business trust, so long as the provisions of the 1940 Act were satisfied, and provided no bad faith was involved"); *see generally* Halebian v. Berv, 457 Mass. 620, 623, n.4, 931 N.E.2d 986, 988 n.4 (Mass. 2010) (state's highest court looks looks to the state's statutory provisions on business corporations to guide its analysis of a legal issue involving a fund organized as a business trust, noting that because a business trust 'in practical effect is in many respects similar to a corporation …,' the [Massachusetts] statute regulating [certain actions involving business corporations] applies to a shareholder bringing such a claim against a corporation or a business trust. [citations omitted.]"); Hull v. Tong, 14 Mass. App. Ct. 710, 712, 442 N.E.2d 427, 429 (1982) (noting that "[a] trustee 'has a right to reimbursement' from trust assets for obligations properly incurred for the benefit of the trust [citation omitted]"); Robert H. Sitkoff, *Trust as 'Uncorporation': A Research Agenda*, 2005 U. ILL. L. REV. 31, 39 (2005) (noting that "the common law of trusts permits indemnification and exculpation clauses," though not a "total exoneration from all fiduciary obligations").

[17] *See* 8 DEL. C. § 145(b); TLC Beatrice Int'l Holdings, Inc. v. Cigna Ins. Co., 1999 U.S. Dist. LEXIS 605, at *10 (S.D.N.Y. 1999) ("Section 145(a) permits a corporation to indemnify its officers and directors for attorneys' fees and other litigation expenses, as well as for judgments or settlement payments made in civil cases. In contrast, §145(b) permits indemnification only for expenses and does not authorize indemnification for amounts paid in settlement in derivative suits."); Kurt A. Mayr, II, *Note: Indemnification of Directors and Officers: The "Double Whammy" of Mandatory Indemnification Under Delaware Law in Waltuch v. Conticommodity Services, Inc.*, 42 VILL. L. REV. 223, 242-45 & n.90 (concluding that Section 145(b) "restricts indemnification exclusively to attorney fees and other expenses and does not permit indemnification for judgments or amounts paid in settlement of an action [brought by or in the right of the corporation]," but discussing, at n.90, arguments to the contrary).

[18] *See* 8 Del. C § 145(b). The Delaware provision requires director(s) to have "acted in good faith and in a manner the [director(s)] reasonably believed to be in or not opposed to the best interests of the corporation…", and imposes certain additional requirements if the director(s) has been adjudged liable to the corporation in the derivative litigation.

corporations. (These provisions are codified as the Delaware Statutory Trust Act (DSTA)).[19] The DSTA seems to suggest that funds organized as Delaware statutory trusts may indemnify their trustees against amounts paid in both judgments and settlements of derivative lawsuits, as well as for the trustees' expenses (including attorney's fees) in such lawsuits,[20] at least where (1) the funds' governing instruments include provisions authorizing such indemnification, and (2) the trustees have not otherwise engaged in disabling conduct (for which indemnification would be precluded by section 17(h) of the Investment Company Act of 1940 (ICA) in any event).[21]

Where fund independent directors are successful in their defense of derivative litigation, as is commonly the case, they are thus at low risk that relevant provisions of state law would preclude their indemnification for defense costs. Indeed, even in the unlikely event that a derivative lawsuit were ultimately to be resolved through a monetary settlement payable in whole or in part by fund independent directors, the foregoing suggests that relevant provisions of state law would not, at least in theory, preclude most funds from indemnifying their independent directors for such a settlement, assuming that the independent directors had acted in good faith and that they reasonably believed their conduct to have been in the best interests of their fund.[22]

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[19] *See* 12 DEL. C. §§ 3801-3826.

[20] In this regard, section 3817 of the DSTA expressly provides that "[s]ubject to such standards and restrictions, if any, as are set forth in the governing instrument of a statutory trust, a statutory trust shall have the power to indemnify and hold harmless any trustee … from and against any and all claims and demands whatsoever." To date, no Delaware court appears to have directly addressed the issue of the breadth of indemnification available to trustees of Delaware statutory trusts in derivative litigation. However, some support for a broad reading of section 3817 can be found in one of the few Delaware court decisions construing the DSTA. In Nakahara v. NS 1991 Am. Tr., 739 A.2d 770, 782-783 (Del. Ch. 1998), the court ruled that Delaware statutory trusts have the power to advance legal fees to their trustees; in so ruling, the court noted, as here relevant, that (1) "[t]he permissive language of §3817 itself suggests that the [Delaware] General Assembly intended the [DSTA's] indemnification provision to be interpreted broadly …," and (2) "[s]uch a general authorization of indemnification [in §3817] compels a permissive interpretation, with the language intended to authorize as much as possible and exclude only that which is expressly prohibited." *See generally* J. Weston Peterson & Anthony W. Rodgers, *Protecting the Protectors: Indemnification of Trustees of Delaware Statutory Trusts*, THE INVESTMENT LAWYER (July 2011) (discussing the DSTA and indemnification thereunder); J. Weston Peterson & Anthony W. Rodgers, *Delaware Statutory Trusts and Shareholder Derivative Actions: Recent Delaware Cases Provide First Rulings on the Law*, THE INVESTMENT LAWYER (Aug. 2012) (discussing recent Delaware case law addressing derivative actions involving registered funds organized as Delaware statutory trusts).

[21] Assuming that the DSTA does, in fact, permit funds organized as Delaware statutory trusts to indemnify their trustees for amounts paid in settlements and judgments of derivative lawsuits, it does not follow that the DSTA would necessarily permit indemnification in all instances. In this regard, for example, one commentator has suggested that there may be a "floor" on a Delaware statutory trust's ability to exculpate or indemnify its trustees—e.g., where trustees engage in "willful misconduct" (defined in Delaware's general trust law to mean "intentional wrongdoing, not mere negligence, gross negligence or recklessness"). *See* Richards Layton & Finger, *Beyond the Delaware Statutory Trust Act: Is Willful Misconduct the Floor for Liability?* (Feb. 2, 2012), http://www.rlf.com/knowledgecenter/ealertsnewsletters/4268. Of course, and as noted above, the question of a "floor" for indemnification under Delaware law is largely academic for fund independent directors, given the separate prohibition on indemnification for "disabling conduct" that is established by section 17(h) of the ICA.

[22] Indeed, it appears that for funds organized as Massachusetts business trusts or Delaware statutory trusts, relevant provisions of state law might even permit indemnification for judgments entered against fund independent directors in derivative litigation. Although interesting as an academic matter, this issue is of scant practical relevance, given that derivative lawsuits in the fund industry are rarely, if ever, litigated to final judgment. *See generally* Robert W. Helm, William K. Dodds, David M. Geffen & Jeanette Wingler, *When a Fund is Sued: An Independent Director's Guide to Fund Litigation—Part 2*, THE INVESTMENT LAWYER 6

It is not surprising that this issue—i.e., the scope of indemnification available to fund independent directors for amounts paid by them in settlements or judgments of fund derivative litigation—remains largely theoretical. As discussed in the preceding subsections of this Appendix, given the strength of the legal protections generally available to fund independent directors in derivative litigation, it is uncommon, in the real world, for such litigation to result in monetary settlements (and judgments are virtually unheard of). Moreover, even if monetary settlements are reached, it is far more likely, given the realities of litigation and the realities of the litigation settlement process, that the plaintiffs' bar will look to insurance (and/or to one or more "deep pocket" entity defendants) for payment, rather than to fund independent directors.

As theoretical as it may be, the risk that fund independent directors could be called upon to pay (in whole or in part) a monetary settlement in derivative litigation cannot be entirely discounted. Accordingly, in evaluating IDL options, insurance advisers and counsel to fund boards may wish to consider how the two different types of IDL insurance would respond to such a scenario if D&O/E&O insurance was unavailable to do so. Side A-Only IDL insurance, by its terms, could presumably respond only if the settlement payment was determined to be *non*-indemnifiable. In contrast, Safety Net IDL insurance could potentially respond regardless of whether the settlement payment was non-indemnifiable or indemnifiable.

(Aug. 2010) ("Due to a number of factors, such as the cost of litigation or the desire to avoid a protracted legal battle, the majority of fund lawsuits that are not dismissed are resolved by a settlement."); Erickson, *supra* n.6 at 1788 (in study of corporate shareholder derivative lawsuits filed in federal courts, author notes that of the 170 lawsuits examined in the study that had been resolved, only two ended with a judgment favorable to the plaintiff, while the remaining 168 were either settled or dismissed, voluntarily or involuntarily).

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