JONES WALKER

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corporateandsecurities@joneswalker.com

IN RE HEALTHSOUTH: ELEVENTH CIRCUIT RULES THAT A BAR ORDER IN CONNECTION WITH A SECURITIES SETTLEMENT CAN EXTINGUISH A NON-SETTLING FORMER CEO'S RIGHT TO INDEMNIFICATION AND ADVANCEMENT OF DEFENSE COSTS

In a June 17, 2009, opinion, the Eleventh Circuit affirmed the district court's order approving the partial settlement of the $445 million HealthSouth securities fraud class action, highlighting the relationship between director indemnification rights and the Private Securities Litigation Reform Act (the "PSLRA"). The court held that the PSLRA did not preclude a bar order that extinguished contractual claims by the former CEO of HealthSouth, Richard Scrushy, both for indemnification of any settlement in the case and for advancement of legal defense costs. *In re HealthSouth Corp. Sec. Litig.*, 572 F.3d 854, 2009 WL 1675398, *1 (11th Cir. June 17, 2009).

Scrushy was a non-settling defendant in the class action who had prior contractual agreements with HealthSouth for indemnification and advancement of attorneys' fees. The court found that the district court had not abused its discretion in approving a PSLRA bar order that extinguished those contractual claims against HealthSouth.

Background

In 1994, Scrushy and HealthSouth had entered into a typical agreement, governed by Delaware law, requiring HealthSouth to indemnify Scrushy to the fullest extent permitted by law with respect to any action in which he was sued in his capacity as a director and officer, provided "he acted in good faith and reasonably believed he was acting in the best interests of the company." Additionally, the agreement entitled Scrushy to advancement of attorneys' fees as they became due, provided he agreed to repay the amount advanced if it were later determined that he was not entitled to be indemnified.

In 2003, HealthSouth admitted it had materially misstated its income and assets in prior public financial statements. Subsequently, Scrushy and other HealthSouth officers were sued in a series of securities class action lawsuits that were consolidated in the Northern District of Alabama. In 2006, HealthSouth and several of the officers reached a partial settlement agreement with the plaintiffs for $445 million, of which $215 million was paid by HealthSouth and $230 million was paid by its insurance carriers. Scrushy was a non-settling defendant.

The PSLRA expressly requires securities class action settlement agreements to contain a bar order extinguishing contribution claims against the settling parties that arise out of the underlying securities action. Such bar orders are reciprocal, extinguishing claims by the settling defendants against the non-settling defendants as well. Additionally, such bar orders are also balanced by a judgment credit, under which a non-settling party is credited with the greater of (a) the amount actually paid in the settlement, or (b) the settling defendant's proportionate liability, which meant Scrushy could not be personally liable unless an adverse judgment against him, or settlement, was for more than the $445 million partial settlement.

The Eleventh Circuit's Opinion

Scrushy challenged the bar order on several counts, arguing that: (1) the mandatory contribution bar in the PSLRA is exclusive and prohibits the settlement from barring non-contribution claims, (2) his indemnity and advancement claims were an independent contract right not based on any liability he might have to plaintiffs, and (3) if he were to be deprived of valuable rights in a contribution bar order, he is entitled under case law and the PSLRA to compensation.

Indemnification Claims

The Eleventh Circuit upheld the bar order in its entirety. The court first addressed Scrushy's claim that the PSLRA's "mandatory contribution bar" is "exclusive." The court held that the mandatory contribution bar does not preclude a bar order extinguishing an indemnification right, reasoning that (a) no provision in the PSLRA limits or prohibits a bar of indemnification claims, (b) PSLRA case law supports a bar on indemnification, and (c) the PSLRA was "enacted against a backdrop of cases allowing indemnification bars."

Second, the court rejected Scrushy's argument that the bar order should not apply because his claims were "truly independent." In rejecting this argument as "almost … frivolous," the court followed *Denney v. Deutsche Bank AG*, 443 F.3d 253 (2d Cir. 2006), in which the court held that amounts paid in future settlements (by Scrushy) "would be nonetheless on account of liability or the risk thereof" to the plaintiffs and hence subject to the bar order.

Finally, the court also rejected Scrushy's argument that the bar order was inappropriate because it extinguished his right to indemnification without providing compensation. The court held that the judgment credit required by the PSLRA was adequate compensation. Scrushy's argument that the credit was inadequate since it only comes into play if there is an adverse settlement or judgment against him was rejected. The court noted that the judgment credit would be a "very significant bargaining chip in negotiating a [future] settlement [by Scrushy] with the underlying plaintiffs."

Advancement Claims

The Eleventh Circuit next turned to the bar order's extinguishment of the contractual claim for the advancement of attorneys fees in the securities fraud class action. The court rejected Scrushy's claim that bar orders may only "preclude claims by non-settling defendants against settling defendants where the injury to the non-settling defendant was its liability to the underlying plaintiffs." Here, Scrushy argued that his is "a truly independent claim" because it is unrelated to liability to the plaintiffs in the class action in that it is a claim by his attorneys against him. The Eleventh Circuit rejected this argument, concluding that while it is true the advancement of attorneys fees is not paid directly to the underlying plaintiffs, the advancement claim is not truly independent because the attorneys fees are paid "on account of liability to the underlying plaintiffs or the risk thereof."

Public Policy

In both his claims for indemnification of settlement amounts and those for advancement of attorneys' fees, Scrushy argued that Delaware public policy favors the indemnification of liabilities and advancement of attorneys' fees for corporate officers and directors in order to encourage qualified individuals to serve in those capacities. The court also

rejected this argument. While conceding that it may be difficult for an innocent officer or director to prove innocence without the advancement of attorneys' fees, the court held that "policy arguments supporting advancement of legal fees must be balanced against countervailing policies in favor of settlements and against indemnification in the securities litigation context."

Discussion

The *HealthSouth* Bar Order decision may alarm some corporate directors and counsel, because in certain situations the decision has the effect of undermining not only the contractual indemnification and advancement rights of directors and officers but also their coverage under D&O insurance policies maintained by their corporations. For that reason, it is worthwhile to place the HealthSouth decision in an appropriate context.

First, the *HealthSouth* decision does not adversely affect advancement or D&O insurance rights in *derivative shareholder* litigation, i.e., suits brought in state court (most commonly Delaware courts) by minority shareholders in the right of the corporation against directors (and sometimes officers) for alleged breach of their fiduciary duties of care and loyalty. The PSLRA would not normally be implicated in such cases. Accordingly, no bar order would be involved in a derivative suit that could prevent a defendant director from enforcing his contractual right against the corporation for advancement of legal fees. Although in derivative litigation Delaware law does not permit a corporation to indemnify its directors against costs of settlement, as distinguished from legal fees, almost all D&O insurance policies do insure directors against the costs of settling derivative litigation.

Second, the *HealthSouth* decision also does not adversely affect indemnification, advancement, or D&O insurance rights in class action suits or other third-party litigation against directors *not involving securities fraud*. For example, in a class action suit against directors for alleged breach of their fiduciary duty to a class of shareholders in connection with a merger negotiation, or in a third-party or governmental action against officers for alleged breach of the antitrust laws, the *HealthSouth* decision could not be used as a basis for denying advancement, indemnification, or D&O insurance rights to a defendant director or officer.

Third, as the *HealthSouth* court pointed out, the PSLRA expressly precludes a settlement bar order in a securities fraud class action from adversely affecting the contractual rights of a non-settling director or officer *who is later successful in defending himself in that action* to be indemnified by the corporation for attorneys' fees incurred in his defense. A successful defendant is always entitled to indemnification.

Fourth, in practice it is rare that the settlement of a securities fraud class action under the PSLRA does not include all of the defendant directors and officers, as well as the corporation itself, as protected settling defendants. In those cases, no costs of either settlement or defense would typically be borne by the defendant directors and officers. In the *HealthSouth* case, Scrushy was not a protected settling defendant—and therefore lost his indemnification, advancement, and D&O insurance rights— because the corporation took the position that he personally was the principal wrongdoer responsible for committing the acts of securities fraud alleged in the complaint. Accordingly, the only directors and officers likely to be placed at risk by the *HealthSouth* decision are those personally responsible for committing alleged acts of securities fraud *who are not ultimately successful in defending the claims against them*.

Fifth, as the court also pointed out in *HealthSouth*, at 572 F.3d 867, there are "situations in which the equities would indicate that a [nonsettling] corporate officer should be permitted [under a PSLRA bar order] to enforce a contractual right to advancement of attorneys' fees", an issue that "will be left to the sound discretion of district courts." For example, where a defendant director or officer offers evidence that he was not personally involved in any affirmative acts of securities fraud or concealment, but was nevertheless excluded over his objection from the settlement, the Eleventh Circuit suggested that most courts would be sympathetic to a carveout in the bar order entitling that individual to enforce his contractual right to the advancement of attorneys' fees incurred in defending the claims against him.

Sixth, insofar as the court of appeals affirmed the bar order's extinguishment of Scrushy's contractual right to indemnification for the costs of a future settlement by or judgment against him, the court merely followed existing case law and broke no new ground. It has long been the position of the U.S. Securities and Exchange Commission, as well as of federal courts generally, that indemnification of directors and officers for liabilities arising under the Securities Act is against public policy, and therefore unenforceable, except for the expenses of a successful defense. For that reason, what may at first appear a draconian evisceration by the *HealthSouth* court of contractual indemnification rights via a PSLRA bar order is really no more unfavorable to corporate directors and officers than existing case law precluding the enforceability of indemnification rights generally in securities fraud cases.

Finally, after eliminating the chaff described above, the kernel of wheat in the *HealthSouth* decision is the court's ruling that the district court did not abuse its discretion in issuing a bar order that extinguished Scrushy's contractual right to *advancement* of attorneys' fees, as distinguished from his contractual right to *indemnification*. This issue is of paramount concern in a case such as *HealthSouth*, because by hypothesis the corporation's D&O insurance coverage has been exhausted by the court-approved settlement. Accordingly, unless the director or officer who has been excluded from the settlement is able to enforce his contractual right to advancement, he must finance the costs of his legal defense out of his pocket. Existing case law on this issue is exceedingly sparse, and there is no reason why it may not be successfully litigated by excluded directors and officers in future cases, given that entitlement to contractual advancement is within the discretion of the trial court.

—*Richard P. Wolfe*, *Robert B. Bieck, Jr.*, *R. Troy Van Orman*

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

Curtis R. Hearn
Jones Walker
201 St. Charles Avenue
New Orleans, LA 70170-5100
504.582.8308 *tel*
504.589.8308 *fax*
chearn@joneswalker.com

Corporate & Securities Attorneys

Dana L. Bandera
Allison C. Bell
Sarah B. Belter
Robert B. Bieck, Jr.
William R. Bishop
John C. Blackman, IV
Robert L. Carothers, Jr.
Robert R. Casey
Monique A. Cenac
Scott D. Chenevert
Alexandra L. Clark
Edward B. Crosland
Eric J. Dyas
Allen E. Frederic, III
Asher J. Friend
Kristin S. Gardner
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Charles W. Lane, III
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H. Gary Pannell
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Myla R. Reizen
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Hope M. Spencer
R. Troy Van Orman
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Richard P. Wolfe