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The Perils of Adjudicated Fraud

6 Min Read

By: Geoffrey B. Fehling, Brian T.M. Mammarella | October 21, 2024

Directors and officers of Delaware corporations often benefit from a robust suite of liability protections that generally include exculpation rights, indemnification rights, rights to recoup expenses incurred while defending a proceeding in advance of its final disposition (or "advancement" rights), and rights under director and officer (D&O) liability insurance policies. While each aspect of this so-called three-legged stool[1] of executive protection—exculpation, indemnification/advancement, and insurance—often has different exclusions and exceptions, personal, monetary liability of individual directors and officers is exceedingly rare. For example, even if a company becomes insolvent or is prohibited from or unwilling to indemnify or advance legal fees on behalf of the executive, the executive may nonetheless be entitled to D&O insurance coverage for nonindemnified losses, protecting the individual from personal exposure.

But as the Delaware Court of Chancery's recent post-trial opinion in *InterMune v. Harkonen*[2] illustrates, these protections are not bulletproof. There, the Court of Chancery ordered the CEO and director of InterMune, Inc. to repay almost $6 million of advanced funds where the executive had been convicted of wire fraud and exhausted all appeals. As such, *Harkonen* serves as a reminder that, while only possible under an increasingly uncommon set of facts, "advanced sums sometimes must be repaid."

BACKGROUND

The proceedings central to the *Harkonen* dispute were criminal and administrative fraud disputes waged for over twenty years. In 2002, Dr. Scott Harkonen, InterMune's CEO and board member, issued a press release that (per the opinion) "misrepresented . . . clinical study results" for an InterMune drug product candidate. The U.S. Department of Justice launched an investigation into the press release in 2004, which led to criminal indictments for felony misbranding and felony wire fraud. In 2009, a federal jury found Harkonen guilty of wire fraud but not misbranding.

Harkonen challenged that finding through an extensive series of motions, petitions, and appeals at the U.S. district court, U.S. circuit court, and U.S. Supreme Court levels. His campaign in the courts ultimately proved unsuccessful and the verdict stood. All the while, Harkonen retained a "sophisticated and well-resourced" defense team and accrued expenses—advanced on his behalf by both the company and its D&O insurers—that exhausted the applicable D&O policy's $10 million primary policy, $5 million first excess policy, and $5 million second excess policy.

Several ancillary proceedings unfolded in parallel. Between 2011 and 2015, Harkonen defended himself in professional misconduct proceedings brought by the Medical Board of California, which culminated in a finding of cause for discipline and resultant punishments. And perhaps more relevant for Harkonen's future recoupment battles, two of InterMune's D&O insurance carriers filed an arbitration action to recover the $10 million advanced to Harkonen under the two $5 million excess policies.

The insurers succeeded in those efforts, demanding repayment in arbitration proceedings based on the D&O policies' so-called fraud exclusion—common in most modern D&O policies—barring coverage for loss arising out of deliberate criminal or fraudulent acts if established by a final adjudication. The arbitration panel concluded on dispositive motions that the insurers could recoup millions of dollars in defense costs advanced to defend the wire fraud count and fees and costs incurred to defend against allegations relating to the offending press release. Eventually, the D&O insurance claims were settled, with InterMune repaying all excluded loss, subject to a reservation of rights against Harkonen.

After advancing the full settlement amount, InterMune sued Harkonen to claw it back. As is common, InterMune's bylaws and indemnification agreements required all executives seeking advancement to undertake to repay any funds ultimately determined not indemnifiable. And while both instruments guaranteed Harkonen indemnification to the fullest extent permitted by law, Section 145 of the Delaware General Corporation Law only empowers corporations to indemnify directors and officers if the indemnitee "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful." Failure to satisfy that standard of conduct—by, for example, acting in bad faith—forecloses indemnification and can trigger an obligation to repay advanced funds.

THE COURT OF CHANCERY'S POST-TRIAL OPINION

So it was in *Harkonen*. At the summary judgment stage, the Court of Chancery had held that Harkonen's felony fraud conviction foreclosed his ability to satisfy Section 145's standard of conduct requirement because bad faith was a subsidiary element of the crime. That meant that the only issue left to decide in the follow-on advancement clawback trial was whether the roughly $6 million that InterMune had advanced to settle the insurance arbitration arose in connection with Harkonen's fraud conviction.

The Court of Chancery concluded that it did, as the settlement (which, the court highlighted, Harkonen himself agreed to) had been tailored to reflect only sums attributable to the wire fraud count. As such, indemnification was unavailable, and the court ordered Harkonen to repay the full amount advanced for the settlement.

TAKEAWAYS

In one sense, *Harkonen* is a reminder that "fullest extent permitted by law" indemnification protection does indeed have limits. In another sense, though, *Harkonen* is perhaps better understood as an exception that proves the rule. That is, proceedings against directors and officers in their corporate capacities rarely result in personal liability, a result only reached in *Harkonen* under extreme facts: (i) adjudicated criminal misconduct involving a specific finding that the executive acted in bad faith and (ii) a complete exhaustion of appeals.

Notwithstanding the uncommon set of facts giving rise to Harkonen's approximately $6 million repayment obligation, the result shows that D&O insurers can and will enforce available policy exclusions to support recoupment claims following an adverse, final adjudication. InterMune's D&O policies had strong final-adjudication exceptions to the standard conduct exclusion, but not all insurers and forms are created equal, and they require careful analysis at the time of placement or renewal, not after a claim arises. Negotiating robust limitations on exclusionary provisions, especially those based on fraudulent and criminal conduct, can help mitigate the risk of insurer recoupment in all but the most dire circumstances where fraud is actually and finally adjudicated.

The authors are co-chairs of the ABA Business Law Section Director and Officer Liability Committee. The views expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger, Hunton Andrews Kurth, or their respective clients.

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1. For more information on the issues presented in preparing and maintaining a comprehensive D&O liability protection program, *see* James Wing, Geoffrey B. Fehling & Brian T.M. Mammarella, *Training for Tomorrow: 2021 Checklist for Entity Counsel Supervising the Creation or Renewal of an Executive Protection Program in the Age of 'Cooperation,'* Bus. L. Today (Nov. 1, 2021).
2. No. 2021-0694-NAC, 2024 WL 3619692 (Del. Ch. Aug. 1, 2024).

ABOUT THE AUTHORS

Geoffrey B. Fehling
Hunton Andrews Kurth LLP

Geoffrey B. Fehling is a Boston-based partner in Hunton Andrews Kurth LLP's Insurance Coverage group. Geoff dedicates his practice to helping companies and their directors and officers maximize insurance recoveries, especially in the area of directors and officers (D&O), professional liability, and management liability insurance. He is Co-Chair of the ABA Business Law Section Director and Officer Liability Committee. Geoff can be reached at (617) 648-2806 or gfehling@HuntonAK.com.

Brian T.M. Mammarella
Richards, Layton & Finger, P.A.

Brian Mammarella is an associate at Richards, Layton & Finger, Delaware's largest law firm. He focuses his practice on counseling corporations, directors, officers, board committees, and stockholders on complex corporate governance, fiduciary duty, and transactional matters under Delaware law. Before joining Richards Layton, Brian clerked for Vice Chancellor John W. Noble and Vice Chancellor Joseph R. Slights III in the Delaware Court of Chancery. He has published several articles on issues of Delaware corporate law, and has been named among *The Best Lawyers in America* Ones to Watch. Brian earned a BA, *summa cum laude*, from the College of William & Mary and a JD from the University of Virginia School of Law, where he served on the managing board of the *Virginia Law Review*. Brian can be reached at (302) 651-7542 or mammarella@rlf.com.