

## U.S. COURT RELIEVES SETTLING CORPORATION OF ITS OBLIGATION TO ADVANCE DEFENSE COSTS OF NON-SETTLING DIRECTOR/OFFICER IN SECURITIES CLASS ACTION

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To Our Clients and Friends:

Public company directors and officers, whose personal assets are increasingly at risk, suffered another potentially significant setback in a recent securities class action ruling.

In *In Re HealthSouth Corporation Securities Litigation*, 2009 WL 1675398 (11th Cir. 2009), the U.S. Court of Appeals for the Eleventh Circuit approved an order barring Richard Scrusby, the former HealthSouth Chairman and CEO, from enforcing his contractual right to advancement of his defense costs in the class action. The decision—if followed by other courts—could profoundly affect directors and officers who are named as defendants in securities class actions.

### Background

HealthSouth, a Delaware corporation, was founded by Scrusby in 1984 and grew into one of the country's largest providers of healthcare services. HealthSouth provided Scrusby with a customary indemnification agreement pursuant to which HealthSouth indemnified Scrusby to the fullest extent permitted by Delaware law and agreed to advance his defense costs in any litigation, subject to a standard undertaking by Scrusby to repay HealthSouth if he later was determined not to be entitled to indemnification.

In 2003, HealthSouth announced that it had overstated earnings in prior periods. SEC investigations, criminal and civil enforcement suits and class actions against HealthSouth and Scrusby ensued. In 2006, HealthSouth and its insurers agreed to pay \$445 million to settle the class action (as to HealthSouth). Though a co-defendant, Scrusby was not permitted to participate in the settlement discussions and was not a party to the settlement.

As required by the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), the settlement included a "bar order" extinguishing rights of contribution among the settling and non-settling defendants. In this case, however, the bar order also prohibited Scrusby from asserting any claim against HealthSouth for indemnification for losses that he incurred in the class action *or* for advancement of the costs or expenses of defending the class action. Although the bar order preserved Scrusby's ability to seek reimbursement of his defense

costs to the extent his defense was successful, it forced him to pay those costs for as long as he continued to fight the case.

### THE COURT'S RULING

Citing precedent in several circuits, the Eleventh Circuit held that extinguishment of Scrusby's contractual indemnification rights (except to the extent that Scrusby was ultimately successful in his defense) was proper under the PSLRA.

However, the court went beyond existing law and also permitted the extinguishment of Scrusby's advancement rights. The court noted the PSLRA policy favoring settlements and, in furtherance of that policy, the importance of allowing settling defendants to buy complete peace. It also placed considerable weight on Scrusby's alleged role in the HealthSouth fraud, noting that he failed to back up his objection to the extinguishment of his advancement rights with evidence of his lack of responsibility. The court specifically distinguished the Scrusby case from that of an "outside director who the evidence suggested was excusably ignorant of the violations, . . . an innocent bystander." Finally, the court also made clear its view that public policy did not favor indemnification of directors or officers who are accused of violating federal securities laws.

### IMPLICATIONS

The cost of defending securities class actions can be very high—easily in the millions of dollars. Most directors and officers do not lose much sleep over the possibility that they will lose a securities fraud case, because they are conscientious about doing their job and about engaging competent professional advisers to help them do it. However, no amount of diligence or caution can ensure that a director or officer will not be sued. Accordingly, the right to have the corporation advance defense costs (subject to the indemnitee's obligation to return amounts advanced if he or she turns out not to be entitled to be indemnified, as required by Delaware's and most other states' indemnification statutes) is a key factor in attracting qualified directors and officers.

If the *HealthSouth* ruling is followed in other circuits, settling class action plaintiffs and corporate defendants will be able to extinguish the corporation's advancement obligations. Even where the defendant corporations would otherwise be disposed to honor their advancement obligations, they will have to seriously consider taking the same money-saving step as HealthSouth, at least with respect to former executives. Plaintiffs will be able to use the threat of extinguished advancement rights to increase their leverage in settlement negotiations with individual director and officer defendants. As a result, directors and

officers will feel greater pressure to settle and pay damages out of their own pockets, rather than risk paying potentially even more in legal fees in an effort to vindicate themselves.

#### WHAT CAN BE DONE?

The Eleventh Circuit's ruling raises many questions that will be answered only after other courts consider applications for bar orders similar to that issued in *HealthSouth*.

Nevertheless, there are practical steps that directors and officers can and should consider taking now to address this development.

First, in new or existing indemnification agreements, directors and officers should request a covenant by the indemnifying corporation not to seek or agree to a bar order that extinguishes the director's or officer's contractual right to advancement (or indemnification). Such a covenant may not influence the Eleventh Circuit, which has already shown willingness to rewrite an indemnification agreement valid under Delaware law, but it could have a deterrent effect on a defendant corporation.

Second, a defendant director or officer may, at the first sign that the corporate defendant may not honor its advancement obligations, use the expedited procedures available in Delaware Chancery Court to obtain an order directing advancement. The existence of a state court order requiring advancement may give pause to the federal court presiding over the class action before it blesses a conflicting bar order.

We will be monitoring developments as other courts begin to consider requests for *HealthSouth*-type bar orders in securities class action settlements. If you have any questions, please feel free to contact either of the undersigned.

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