

# DM EXTRA!

January 3, 2005

## Caution—D&Os Working: Reducing Liability Exposure in 2005

**It's the dawn of a new year, and already directors and officers (D&Os) are scanning the horizon for liability risks.**

### Director Summary >

• This month (January 2005) the **Delaware Chancery Court** continues to hear arguments in the most recent case involving the **Walt Disney Company**<sup>1</sup>, to examine the process directors used to decide the compensation of the company's former CEO **Michael Ovitz**. Courts rarely second-guess directors' decisions, out of deference to their business judgment (the so-called "business judgment rule"), but this hallowed legal principle could be in for a challenge. The last time a court really challenged the decisions of a board was 30 years ago in the 1985 case of *Smith v. Van Gorkom*, which involved a merger decision made without adequate care.

• Directors and board advisors are bracing for the upcoming sequel to **WorldCom** litigation. On February 28, 2005, nearly three years after the giant company's bankruptcy sparked a plethora of cases (some already decided), the

gavel will bang for *In Re WorldCom, Inc. Securities Litigation*. **Judge Denise Cote** of the **United States District Court, Southern District of New York** will preside over this historic federal class-action suit, which pits WorldCom bondholders and shareholders (led by the **New York State Common Retirement Fund**) against the company's former directors, officers, auditors, and underwriters. The fines or settlement amounts could go to 10 figures, based on recent statements and precedents.<sup>2</sup>

These two historic cases should spark renewed interest in longstanding D&O trends.

> **This DMX explains who has been suing directors how often, for how much, why, and where—and how courts and insurers are responding to these lawsuits. It also gives tips for reducing the likelihood and impact of successful D&O litigation.**

### About NACD

**National Association of Corporate Directors (NACD)**, an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.



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## Who Is Suing Directors—and How Often

The sources of D&O lawsuits vary by type of organization—public, private, or nonprofit—and by industry. Here are the trends, based on the most recent annual D&O insurance survey (reporting a 10-year average through 2004) from **Tillinghast**, a **Towers Perrin** subsidiary:

### *Public vs. Private vs. Nonprofit Trends*

- **Public companies.** The most frequent source of litigation against public company directors and officers is shareholders (57 percent), as in the WorldCom case just mentioned, followed by employees (23 percent), competitors (6 percent), customers (5 percent), and the government (3 percent)—the remainder being miscellaneous third parties (5 percent).
- **Private companies.** Nearly half of all lawsuits against private company directors and officers are from employees (48 percent), followed by shareholders (31 percent). Next in frequency are competitors (10 percent) and customers (8 percent), plus miscellaneous sources (3 percent).
- **Nonprofits.** Employees are the source of nearly all recent lawsuits (96 percent) against nonprofit boards, with the remainder of lawsuits coming from customers (2 percent) or competitors (1 percent), plus miscellaneous sources (1 percent).

For more details, see [http://www.towersperrin.com/tillinghast/publications/reports/2004\\_D\\_O/2004\\_DO\\_Exec\\_Sum.pdf](http://www.towersperrin.com/tillinghast/publications/reports/2004_D_O/2004_DO_Exec_Sum.pdf).

More than one in four (27 percent) of public companies have filed at least one insurance claim related to a lawsuit or settlement in the past 10 years. For private companies, the figure is one in 10 (8 percent), and for nonprofits, the rate is one in 20 (5 percent). The larger a company is, the more likely it is to get sued (the “deep pockets” syndrome). More than half of companies with sales over \$10 billion reported at least one lawsuit in the past 10 years—while only a minority of smaller companies did.

### *Industry Trends*

In terms of industry, the most susceptible ones in the recent past have been *financial services*, *education*, and *energy/utilities*, which have experienced a higher than average number of lawsuits over the past 10 years. Not surprisingly, these are industries where insurance premiums have been the highest (as explained at the end of this *DMX*). *Healthcare* has also been a recent litigation magnet.

Within financial services, *mutual fund* boards have faced a high level of litigation. In early December 2004, a panel of six federal judges consolidated and transferred 96 individual investor lawsuits filed against some of the coun-

try’s most prominent mutual funds to the federal courts’ **District of Maryland** (in the **Fourth Circuit**). The lawsuits were from a variety of courts, but half of them had resided in Wall Street, at the **New York Southern District Court** (in the **Second Circuit**). Another 176 mutual fund lawsuits could be added later as the case progresses. These consolidated cases are from private litigants (customers of the mutual funds) suing in federal court. In addition, the government is suing the funds. In the past half year or so, the **Securities and Exchange Commission (SEC)** has obtained orders for almost \$2 billion in penalties and forfeitures.

## How Much Do D&O Lawsuits Cost?

### *Claim costs*

Claim costs for *employee* lawsuits (for judgment or settlement amounts alone, excluding legal defense costs) are averaging a half a million (\$506,226) per claim, based on the most recent 10 years. *Competitors’* lawsuits cost over \$1 million (\$1,029,167 per claim), and the average payment for *shareholder* lawsuits exceeds \$11 million—\$11,443,250. That is high in relation to employees and the government, but it represents a decline from much higher levels just after Sarbanes-Oxley (the Public Accounting Reform and Investor Protection Act of 2002, or SOX)—when it looked as though \$24 million would be the new round number to fret over. The costliest litigators now are *customers*. Traditionally, the average claim amount for lawsuits from this constituency has been only a few million, but a rise in lawsuits alleging fraud has increased the average to \$12,771,460. Many of these have been in the financial services area, which has experienced heavy claims related to stock or fund brokerage customers. Last but not least, there are *government* lawsuits—including lawsuits on behalf of all the groups just mentioned (employees, competitors, shareholders, and customers). These average more than \$5 million (\$5,577,500). The level is pushed up by the fact that one of the government’s litigators is the SEC, on behalf of shareholders in corporations and the customers of mutual funds. In the 12 months ending on November 1, 2004, the SEC levied 18 fines in excess of \$50 million. (Source: [http://www.towersperrin.com/tillinghast/publications/reports/2004\\_D\\_O/2004\\_DO\\_Exec\\_Sum.pdf](http://www.towersperrin.com/tillinghast/publications/reports/2004_D_O/2004_DO_Exec_Sum.pdf); and **Willis North America, Inc.**)

### *The Cost of Legal Defense*

Added to the cost of claims were the legal defense costs—now averaging a half million (\$494,141) per claim. Amounts vary by status: closed by litigation (\$198,989 on average), closed by settlement (\$840,507), or dropped by claimant (\$398,161). Claims dragging on as “open” in 2004 have been the most expensive

## 27% of public companies have filed at least one claim in the past 10 years.

(\$880,932 to date per claim). The least expensive lawsuit to defend is an employee lawsuit (\$106,960 on average per claim), while the most expensive is the shareholder lawsuit (\$1,641,328). (These figures exclude claims that were closed with no defense costs.)

In a comprehensive study of class-action case data from 1993 to 2002, “Attorney Fees in Class Action Settlements: An Empirical Study,” **Theodore Eisenberg** of **Cornell Law School** and **Geoffrey P. Miller** of **New York University School of Law** found that the average cost of defense, adjusted for inflation, has not risen significantly over time. They also found that the larger the award or settlement amount, the smaller the percentage taken by attorneys. The 10-year average they found for the period they studied was 21 percent. (Source: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=456600](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=456600))

## Why Litigants Are Suing Directors

In the for-profit company world, especially in public companies, there is a natural focus on lawsuits from shareholders, in part because the claim payment amounts, as mentioned, are relatively large for these lawsuits. Shareholders may base their lawsuits on a variety of issues (22 types of shareholder grievances are tracked by Tillinghast—see below). By far the most common issue is *inadequate disclosure*, but there are others. The two hottest topics in securities litigation in the past two years (since passage of major governance reforms) have been *accounting fraud* based on inappropriate revenue recognition, and *insider trading* that centers around the frauds—such as buying inflated stock and selling it before disclosures make its price drop. *M&A activity* aggravates the situation. Directors involved in mergers or joint ventures are three times as likely to be sued, and experience five times the number of claims. The legal complications around mergers have become extremely complex. In considering the legal battle between **PeopleSoft** and **Oracle**, **Vice Chancellor Leo Strine, Jr.**, of the **Delaware Court of Chancery**, stated on December 13, 2004, that their merger was the only way to resolve their dispute.

## 50+ Reasons Directors and Officers Get Sued

*Customers* have sued over the following issues:

- antitrust law violation
- contract disputes
- cost/quality of product or service
- debt collection
- deceptive trade practices
- dishonesty/fraud
- extension/refusal of credit
- lender liability

*Employees*—including current, past, or prospective employees or unions—have sued over:

- breach of employment/contract
- defamation
- discrimination
- employment conditions/safety
- failure to hire or promote
- harassment/humiliation
- pension, welfare, or other employee benefits
- retaliation/whistle-blowing
- salary, wage, or compensation disputes
- wrongful termination

*Shareholders* have sued over:

- accounting fraud
- breach of duty to minority shareholders
- challenge to takeover defense measures
- contract disputes (with shareholders)
- dishonesty/fraud (not accounting)
- divestitures or spin-offs
- dividend declaration or change
- duties to minority shareholders
- executive compensation (such as golden parachutes)
- financial performance/bankruptcy
- financial transactions (such as derivatives)
- fraudulent conveyance
- general breach of fiduciary duty
- inadequate disclosure
- inadequate employee supervision
- inside information use/trading
- investment or loan decisions
- loss or bankruptcy (financial performance)
- merger/acquisition (including both hostile takeovers and negotiated transactions)
- proxy contests

- recapitalization
- share repurchase
- stock or other public offering

*Competitors, suppliers, and other contractors* have sued over:

- antitrust law violation
- business interference
- contract disputes
- deceptive trade practices
- intellectual property—copyright/patent/trademark infringement

*Regulators* have sued over alleged violations of laws involving:

- antitrust
- civil rights/human rights
- consumer protection
- dishonesty/fraud
- environment
- loss or bankruptcy
- worker health, safety, and working conditions
- securities
- taxes

Source: Tillinghast/Towers Perrin, December 2004.

### *Using Shareholder Suits to Leverage Other Reforms*

Sometimes shareholders threaten lawsuits on disclosure or other issues in order to leverage settlements that include governance changes such as direct access to nominate directors. The newsletter of the well-known securities litigation firm **Lerach Coughlin Stoia Geller Rudman Robbins LLP**, known as “Lerach Coughlin,” recently conceded that the SEC was proving an “inadequate instrument” to bring about direct proxy access for shareholders, but said institutional shareholders are using securities litigation to accomplish this goal. (Source: [http://www.lerachlaw.com/pdf/newsletters/2004\\_4th\\_Qtr\\_Corp\\_Gov.pdf](http://www.lerachlaw.com/pdf/newsletters/2004_4th_Qtr_Corp_Gov.pdf)) A case in point involves **Hanover Compressor**. In *Pirelli Armstrong Tire Corp. Retiree Medical Benefits v. Hanover Compressor Company, et al.* (2004), plaintiffs accused Hanover of failing to disclose certain financial developments. Hanover settled the case without admitting or denying fault. As part of the settlement, Hanover agreed to several governance changes, including changes that would give its institutional investors an automatic say in the nomination of directors. Similar lawsuit-leveraging has occurred at **Cendant, Citrix, Enterasys, MCI, Sprint, and Siebel Systems**.

**Richard Koppes**, of counsel with **Jones Day** and the legal reviewer for *DMX*, has flagged this use of litigation to prompt governance reforms as a “growing trend” (*Compliance Week*, June 15, 2004). With some institutional investors such as the **California Public Employees Retirement System (CalPERS)** and the **State of Wisconsin Investment Board (SWIB)** becoming less active in shareholder resolutions at annual meetings, the courtroom may become their new outlet.

### **Legal Sources of Litigation: Federal and State**

There are two main sources of litigation against directors: federal law and state law.

#### *D&O Liability Based on Federal Law*

As the highest decision-makers in the corporation, directors may be sued along with corporate officers for violation of federal laws intended to protect various corporation stakeholders, including customers, employees, and shareholders. In federal cases, judges use guidelines from the **Federal Sentencing Guidelines Commission** to determine sentences. These guidelines, first issued 15 years ago and most recently amended effective November 1, 2004, give a hierarchy of sentences based on mitigating factors. The press release announcing the latest changes explains them as follows:

As a fundamental proposition, organizations must promote an organizational culture that encourages

ethical conduct and a commitment to compliance with the law. In particular, the amendment requires *boards of directors and executives to assume responsibility for the oversight and management of compliance and ethics programs*. Effective oversight and management presumes *active leadership in defining the content and operation of the program*. At a minimum, the amendment explicitly requires organizations to identify areas of risk where criminal violations may occur, train high-level officials as well as employees in relevant legal standards and obligations, and give their compliance and ethics officers sufficient authority and resources to carry out their responsibilities.<sup>3</sup>

Of all the federal laws on the books, the ones of most concern to directors (as detailed in the earlier section on litigation trends) are securities laws. Under federal securities laws, directors are responsible for oversight of disclosure and reporting, namely:

- Ensuring absence of material inaccuracy or omission in a registration statement.
- Ensuring absence of material inaccuracy or omission in Form 10-K and proxy statement.
- Reporting on the rationale for executive and board compensation (under Regulation S-K).
- Ensuring that the company keeps reasonably detailed financial records.

As mentioned, the Tillinghast surveys show *disclosure, fraud, and insider trading* as key litigation triggers.

#### *D&O Liability Based on State and Common Law*

State laws protecting stakeholders parallel federal laws. In addition, states have corporation laws. One of the leading causes of shareholder litigation, other than disclosure, fraud, and insider trading, is general breach of directors’ “fiduciary duties” under state corporation law. (Such law is based in part on common law, which also has a separate existence through legal precedent. It is enshrined in judicial decisions, but is not always written down as a law passed by state legislators.)

So what exactly are the fiduciary duties of directors? Under most state corporation laws, corporations are “managed by or under the direction of a board.” Certain key duties must be performed by the board, and cannot be delegated to management:

- Amending the corporate charter and adopting/amending bylaws.
- Electing officers, hiring/firing the CEO.
- Indemnifying officers, directors, and others.
- Declaring dividends.
- Approving sale, lease, or exchange of assets; transactions by interested parties; and mergers.

- Compensating directors, including the CEO.
- Issuing stock, stock options, and stock rights; and retiring stock or reducing legal capital.
- Filing for bankruptcy; dissolving the corporation.

In fulfilling these duties and any others imposed by state corporation law or by the corporation's charter or bylaws, directors must exercise *care* (exercising the degree of care that an ordinary person would under similar circumstances), *loyalty* (acting in the best interests of the corporation, rather than their own personal interests), and act in *good faith*.<sup>4</sup> Many state cases are based on allegations that directors failed to act with due care, loyalty, and/or good faith. The **Disney** case in the **Delaware Court of Chancery** is an example.

### Where Litigants Are Suing

So much for why shareholders and others are suing. Now—*where* do they sue? Lawsuits from shareholders are commonly filed in *federal court* as class actions, with a lead plaintiff representing a group of shareholders. Over the past 10 years, the number of federal securities class-action lawsuits has been relatively flat—hovering around 200 and fluctuating up or down by no more than 10 percent,<sup>5</sup> according to the **Stanford Securities Class Action Clearing Center** at **Stanford University** (<http://securities.stanford.edu/>). This steady stream has occurred despite federal laws aimed at either reducing such lawsuits (e.g., The Private Securities Litigation Reform Act of 1995) or empowering them (e.g., SOX). The year 2004, however, is likely to show a slight rise in the level of federal class-action securities lawsuits. As of early December, reports the Stanford group, there had been 216 federal class-action suits against directors and officers in the first 11 months of 2004—the same as in all of 2003.

A few mega-settlements in federal class-action shareholder suits have made this a particularly lucrative field for the plaintiff's bar. Since SOX, not counting the aftermath of the **Cendant** settlement (see note 2), there have been at least four settlements in excess of \$200 million: the **Bank of America** litigation settled for \$490 million; **Waste Management** settled two separate class actions for \$457 million and \$220 million; and **3Com** settled a class-action proceeding for \$259 million.

The 11 federal circuit courts have different attitudes toward securities law, according to experts. For example, with respect to the standard of *scienter* (how much intent is required for a guilty finding) the most pro-plaintiff courts are the **Second Circuit** (which includes **New York**) and the **Third Circuit** (which includes **Delaware**). For these courts, a finding of *scienter* requires only a mix of motive and opportunity, or else circumstantial evidence. That is,

## Many state cases are based on allegations that directors failed to act with care, loyalty, and/or good faith.

a director can be accused of doing some harm “knowingly” even if the director only had a plausible motive and the opportunity for doing so. At the other extreme, the **Ninth Circuit** (which includes **California**) has a more pro-defense standard that would require “strong evidence of deliberately reckless conduct.”<sup>6</sup>

Currently, some observers see a movement to litigate cases in *state* courts rather than federal courts. The **Retirement System of Alabama (RSA)** got underwriters of WorldCom to agree to a \$111 million settlement in November 2004, after the **U.S. Court of Appeals** for the **Second Circuit** overturned Judge Cote's decision to block the RSA. Now at least one source (*Securities Class Action Services Alert*, a publication of **Institutional Shareholder Services**) predicts that “more pension funds may pursue their securities claims in state court and opt out of federal class actions.” Already pension funds in Ohio and California opted out of a federal class action against **AOL Time Warner** to bring claims in state court. And some states are known for having “jackpot” courts where litigants can easily prevail.

From the defendants' point of view, tort reforms in some states have made them appealing places to select as a venue for legal action. In June 2004, a tort-reform bill passed in **Mississippi**, known for “jackpot” courts (at least in the realm of asbestos cases). The new law includes new limitations on venues where plaintiffs can sue (they can't shop for courts), a \$1 million cap on non-economic damages, lower caps on punitive damages for smaller companies, elimination of joint liability (liability to be apportioned according to percentage of fault), and immunity for innocent sellers.<sup>7</sup>

But despite some advantages of state courts, the trend to litigate there may not last. Instead, it may be like the temporary migration from federal courts to state courts that happened 10 years ago after **Congress** passed a tort reform law making federal cases more difficult to pursue (the above-mentioned Private Securities Litigation Reform Act of 1995). In the end, the number of federal cases remained about the same per year. There are reasons that most institutional investors litigate their claims in federal court, rather than state court. Plaintiff lawyers believe that they have a better chance of winning there—

## D&O insurance premiums have been rising for some time. This past year, however, they dropped for the first time in five years.

and fees as a percent of class recovery tend to be higher in federal court than in state court, according to the Eisenberg-Miller study. Defense lawyers prefer to negotiate a single federal class settlement than deal with a variety of state courts. Also, plaintiff attorneys do not want to settle with state plaintiffs before resolving a federal class action because that can set a minimum for (and so inflate) the federal claim settlement amounts.<sup>8</sup>

### How Courts Are Ruling in D&O Cases

A few key themes are emerging in current D&O litigation.

#### *Business Judgment Rule*

The business judgment rule is withstanding some new challenges. The current Disney case (mentioned earlier) is predicated on the court's right to review the appropriateness of a board decision. The business judgment rule says that a decision made by independent, well-informed directors in good faith will be protected from liability, even if in retrospect the decisions turns out to be an incorrect decision. Also, directors are not protected by the business judgment rule if they had a personal financial interest in the decision, or if they failed to act independently.

The Disney case is interesting in part because it could weaken the protection of the rule. **University of Illinois** law professor **Larry Ribstein**, quoted in the *New York Post* December 12, 2004, called it the "case of the decade." He elaborated: "Maybe that's overstating it, but just in terms of pure corporate law, it involves the very tricky legal issues that go to the heart of how much should the law trust boards of directors." (This issue was the essence of the classic *Van Gorkom* case against directors.)

#### *Challenging the Constitutionality of SOX and the Federal Sentencing Guidelines*

Is SOX constitutionally sound? On November 23, 2004, **Judge Karon Bowdre**, of the **U.S. District Court in Birmingham, Alabama**, upheld the constitutionality of SOX against a legal challenge. The decision enabled litigants to go forward in a case against **HealthSouth** CEO **Richard Scrushy**. Scrushy, who faces fraud charges stemming from

accusations he overstated HealthSouth's earnings by \$2.7 billion, was the first company executive to be charged under SOX (for alleged fraud in overstating earnings at the company).

Courts are also reviewing the constitutionality of the Federal Sentencing Guidelines mentioned earlier. On June 24, 2004, the **U.S. Supreme Court** in *Blakely v. Washington*<sup>9</sup> found that a court cannot let an exacerbating factor count against a defendant unless the defendant has admitted the factor, or a jury has found it to be true beyond a reasonable doubt. The Blakely case may have implications for corporate defense.

#### *Raising the Bar on Director Independence*

Courts are raising the bar on independence. Legal experts note that in *Beam v. Stewart*<sup>10</sup> (2004), a case against some directors and officers of Martha Stewart's Omnimedia, and in *In Re Oracle Corp. Derivative Litigation* (2003)<sup>11</sup> involving Oracle directors and officers, "the courts found that in addition to the traditional inquiry into a director's financial connections with the individuals whose conduct they are evaluating, the current trend of the Court appears to be more willing to consider whether non-financial ties, such as personal friendships, might unconsciously affect a director's ability to remain impartial" in certain matters. (Source: [http://library.lp.findlaw.com/articles/file/00151/009759/title/Subject/topic/Civil\\_percent20Procedure\\_Derivative\\_percent20Suits/filename/civilprocedure\\_2\\_737](http://library.lp.findlaw.com/articles/file/00151/009759/title/Subject/topic/Civil_percent20Procedure_Derivative_percent20Suits/filename/civilprocedure_2_737)) Similarly, *In re eBay, Inc. Shareholders Litigation* (2004)<sup>12</sup> extended the idea of a financial conflict of interest to directors' options to purchase shares.

#### *Lengthening the Statute of Limitations*

Another recent D&O theme concerns timing of cases. One of the reforms passed in SOX was an extension of the time litigants have to sue for alleged fraud. The old statute of limitations was one year from the time the fraud was discovered and three years from when it happened. SOX gave litigants more time—two years from discovery and five years from occurrence. On December 6, 2004, the **2nd U.S. Circuit Court of Appeals** (in **New York**) ruled that investors may not apply that provision retroactively, meaning that if the deadline had passed before Sarbanes-Oxley took effect, the suit may not be filed.

#### **How Insurers Are Responding**

In response to the increasing size of settlements and claims, D&O insurance premiums have been rising for some time. This past year, however, they dropped for the first time in five years, according to **Tillinghast**. The decline—by 10 percent—came because insurance companies are competing for D&O business, not because of

any improvement on the odds for insurers. Although this competition has temporarily created a buyer's market, the fundamental economics of the situation—e.g., the recent increase in the number and size of settlements and claims—will no doubt put pressure on insurers to raise premiums again. Right now, the average insurance premium across the board is \$296,956, according to Tillinghast. For the smallest companies (under \$10 million in sales) it is \$27,344, and for the largest companies (over \$10 billion) it is \$5,321,869.

### Tips for Reducing D&O Liability (and Insurance Premiums)

**1. Know your litigants.** Considering the stakeholders of the corporation you serve, which ones have sued before? Which ones are likely to sue? Where is the company vulnerable? Make a special effort to anticipate and meet the needs of these potential litigants.

**2. Know your litigation hot buttons.** As mentioned, the most active D&O litigation areas for shareholders are disclosure, fraud, and insider trading.

- *To prevent inadequate disclosure*, avoid creating unreasonable investor expectations. Carefully review disclosure documents to ensure that all material information reasonably available is disclosed to the relevant audience. A key regulation here is Regulation FD, requiring immediate public disclosure of information following any selective disclosures. (Norman E. Veasey of Weil, Gotshal & Manges, suggested this as a key imperative for directors when he was Chief Justice of the Delaware Supreme Court.) Also exercise caution when talking to securities analysts.
- *To prevent fraud*, establish a strong internal control function that reports directly to a qualified, independent audit committee. Also, establish an employee hotline and create and enforce a code of ethics. (All of these are required of public companies under Sarbanes-Oxley anyway.)
- *To prevent insider trading*, discourage directors from engaging in the sale and purchase of company stock. Instead, set and enforce a policy requiring stock ownership and retention.

In addition to these three areas from securities litigation, directors and officers should develop a reasonable familiarity with general principles in the laws of antitrust, consumer protection, environment, labor, intellectual property, and taxes. After all, boards serve many constituents, and there are laws protecting those constituents' interests—directors need to do their legal homework. Working with competent legal counsel, internal and/or

external, you can anticipate and prepare for litigation trends.

**3. Know your courts.** What circuit court has jurisdiction over the company you serve? What are the legal trends in that court? Consider your type of company (private, public, nonprofit), your industry, and your jurisdiction, and create a risk profile for litigation judgment.

**4. Ensure good corporate leadership and management.** Several points are key:

- Select experienced and trustworthy managers, and adopt a *management succession plan*.
- To lessen the changes of lawsuits from employees, strengthen/centralize *employee relations* functions. Private companies and nonprofits need to keep an especially close watch on this issue, given the frequency of this type of lawsuit in these organizations. In particular, they should be alert to discrimination and wrongful employee dismissal or termination—the two leading causes of employee lawsuits.
- Pay similar heed to *customer relations*. Since customers drive revenues, this has always been a favorite focus for directors and officers. The recent large spike in the average claim values in this area makes it more imperative than ever.

**5. Practice good governance.** As stated earlier, some plaintiffs are suing boards over alleged securities violations (failure to make adequate disclosures, for example), but the real reason they are suing may be a desire to negotiate governance changes as part of their settlement. Here are some general tips that can lessen the chances of successful litigation:<sup>13</sup>

- Select board members who have the necessary time and interest to perform their jobs, and who lack conflicts of interest.
- Establish corporate governance guidelines that are ahead of the governance curve, and adhere to them. Guidance is available from NACD Blue Ribbon Commission reports and other publications on various topics.
- Retain and rely upon only experienced and qualified advisors.
- Issue corporate policy statements that define ethical standards and set guidelines for legal compliance.
- Institute effective programs for internal control and legal compliance.
- Follow the dictates of your corporate governance guidelines and committee charter mandates. Conduct an annual review of how the board and committees are addressing these points.

## To limit your liability as a director, track liability trends, and take warnings from them. As always, good governance is the best—although not the only—insurance.

**6. Buy or request D&O insurance and read your policy.** Good insurance coverage is a must.<sup>14</sup> Request a copy of the policy and ask these questions. What are the liability limits *per occurrence* and *in total*? Are *punitive damages* excluded by the policy or by state law? Does the policy contain *regulatory* or other exclusions? Another consideration when reviewing insurance policies is whether the policies are for *claims incurred* or for *claims made*.<sup>15</sup> In addition, under some policies, coverage will continue only if a “tail” is purchased. (A tail policy continues coverage that would otherwise be terminated.)

Another safety measure is a *non-rescindability* clause, providing that the insurer cannot rescind the policy based on alleged misrepresentations in the application process. Such clauses are usually not included in standard policies and do cost extra, but the price is worth it. In addition, look for a *severability clause*, which generally provides that no knowledge or statement of one person buying insurance can be imputed to any other insured person.

Finally, research your insurer. Have there been times that the insurer has refused to pay a claim? What were the reasons? How can you structure your policy to avoid such circumstances?

### Resources

For other recent developments in D&O liability see:

- “White Collar Crime Crackdown,” *DMX* November 5, 2004 (about recent federal prosecutions) <http://www.nacdonline.org/dm/NACD-DMXNov5-2004.pdf>
- “SOX is Still on a Roll,” *DMX* July 30, 2004 (about SOX developments affecting public companies, private companies, nonprofits, and mutual funds) <http://www.nacdonline.org/dm/NACD-DMXJuly2004.pdf>

### Conclusion

Most directors are covered by D&O insurance, and then try their best to fulfill their fiduciary responsibilities. But to be safe, directors should go beyond this “buy and try” approach to governance by developing a sense of “why.” To limit your liability as a director, track liability trends, and take warnings from them. As always, good governance is the best—although not the only—insurance.

### Endnotes

- 1 Past cases were *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003). The current case continues *In re Walt Disney*.
- 2 Wolf Haldenstein Adler Freeman & Herz LLP, the plaintiff’s law firm for this case states, on its website, “While the litigation against the non-settling defendants continues, New York State Comptroller Alan G. Hevesi, who represents lead plaintiff in the consolidated litigation, said he was pursuing similar agreements with 17 other investment banks that could result in a further \$2.8 billion for WorldCom stock and bond holders.” <http://www.whafh.com/modules/case/index.php?action=view&id=110>. There are precedents for this large number. In November 2003, to settle shareholder claims, WorldCom advisor Citigroup paid \$2.65 billion. This was the largest securities class action ever against an advisor, and the second largest overall—ranking just behind the Cendant settlement of \$3.2 billion paid out last year for a year 2000 case.
- 3 Source: <http://www.ussc.gov/PRESS/re10504.htm>
- 4 For an early warning about this duty, see the January 2003 issue of *DMX*, provided by Weil, Gotshal and Manges: <http://www.nacdonline.org/dm/NACD-Jan-14-2003-DMX.pdf>. Holly Gregory, a partner with Weil Gotshal, provided a memo used as the basis for the list of duties in this section.
- 5 The one exception was the year 2001, but this was an anomaly due to a one-time rise in lawsuits related to the distribution of shares in initial public offerings.
- 6 For this and other general litigation trends of this nature, see Joseph Allerhand and Paul Ferrillo, *Securities Litigator Survey 2003-2004*, Weil Gotshal & Manges, 2004.
- 7 Source: John H. Beisner, Melvyn & Meyers, “Recent Developments in Mississippi Vastly Improve Legal Climate for Defendant Companies,” client letter dated November 16, 2004.
- 8 Source: Jerome F. Birn Jr., a partner with Wilson Sonsini Goodrich & Rosati, speaking at a conference of Institutional Shareholder Services in early 2004.
- 9 For the full opinion see <http://a257.g.akamaitech.net/7/257/2422/24june20041200/www.supremecourtus.gov/opinions/03pdf/02-1632.pdf>
- 10 833 A.2d 961 (Del. Ch. 2003).
- 11 824 A.2d 917 (Del. Ch. 2003), *appeal refused* 2003 WL 21756131 (July 28, 2003).
- 12 C.A. No. 19988, Chandler, C. (Del. Ch. Jan. 23, 2004).
- 13 Based in part on an unpublished list from Aon insurance brokerage.
- 14 See Ty Sagalow, *D&O Liability Insurance: A Guide for Directors and Officers* (Washington, D.C.: National Association of Corporate Directors, 2000).
- 15 Coverage under a claims-incurred policy continues after the cancellation or termination of the policy and includes claims that arose during the period of insurance coverage, whether or not those claims are reported to the insurance company during that period. Claims-made policies cover only those claims actually made to the insurance company during the term of the policy.