UNDERSTANDING D&O EXPOSURES

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Introduction

This course is designed to give a moderately experienced insurance person a detailed look at the legal liability exposures faced by the directors and officers of for-profit, publicly held corporations. The major areas this course addresses include (1) the common law and statutory legal liability exposures to which the directors and officers of publicly held corporations are subject, (2) legal defenses available to directors and officers when a claim is made against them, (3) the types of situations that give rise to these claims, (4) the factors that insurers consider when underwriting directors and officers (D&O) policies for publicly held companies, and (5) the most effective methods of preventing and controlling claims against corporate directors and officers.

The course is arranged as follows.

- Chapter 1 describes the general nature of corporations and discusses the functions that directors and officers perform within corporations.
- Chapter 2 sets forth the common law duties owed by directors and officers to the corporations they serve. These duties, collectively known as "fiduciary duties," include loyalty, obedience, and due care.
- Chapter 3 discusses the liability exposures of directors and officers under federal securities laws—the single greatest exposure faced by directors and officers of publicly traded corporations.
- Chapter 4 discusses the numerous federal statutes that are not related to securities liability laws that can also form the basis for claims against corporate directors and officers.
- Chapter 5 sets forth the most common defenses available to corporate directors and officers when claims are made against them.
- Chapter 6 explains the nature of securities class action claims, which are by far the costliest type of litigation to which corporate directors and officers are exposed.
- Chapter 7 examines four major sources of securities class action claims commonly brought against corporate directors and officers. These include claims from financial restatements, initial public offerings (IPOs), change-of-control situations, and stock option backdating.
- Chapter 8 explains the nature of what are known as "parallel proceedings." Such claims are related to, but legally separate from, the class action claims from which they originated. These proceedings include (1) derivative claims, (2) opt-out claims, (3) Employee Retirement Income Security Act (ERISA) stock-drop claims, and (4) regulatory and criminal proceedings.
- Chapter 9 looks at two of the four major factors that D&O underwriters consider when evaluating and pricing a D&O policy: the corporation's financial situation, and its competitive position within the particular industry in which it does business.
- Chapter 10 examines the next two critical areas considered by D&O underwriters: factors particular to the individual corporation being evaluated, and the composition and operation of its board of directors.
- Chapter 11 is the first of two chapters that discusses methods of preventing and controlling claims against corporate directors and officers. This chapter provides what can be considered "general" methods of loss control.

- Chapter 12, the second of two chapters addressing D&O loss control and prevention, focuses on corporate governance, explaining how the actual composition and functioning of a corporate board can be improved, which will ultimately reduce a company's exposure to claims.
- Chapter 13 addresses the D&O liability exposures of private companies as opposed to public companies, describes the specific types of claims made against these firms, and explains why private companies purchase D&O insurance.
- Chapter 14 similarly deals with the exposures of nonprofit organizations, the types of claims made against nonprofit organizations, statutory protections against liability, and underwriting considerations.

Course Objectives

Upon successful completion of this course, you should be able to

- identify the general nature and purpose of corporations, and identify the functions served by directors and officers within corporations;
- identify the three key common law duties that directors and officers owe to corporations;
- identify the major federal securities laws that can give rise to D&O liability;
- identify the most important statutes (other than those pertaining to securities liability) that can subject directors and officers to claims;
- recognize the most important legal defenses that directors and officers have available to them when claims are asserted against them;
- recognize the essential nature of securities class action claims;
- recognize the major sources of securities class action claims against directors and officers, including claims from financial restatements, IPOs, change-of-control situations, stock option backdating, and private equity operations;
- recognize the various types of parallel proceedings, including derivative, op-out, ERISA stock-drop claims, and regulatory/criminal proceedings;
- identify reasons behind the four major underwriting factors considered by insurers in underwriting and pricing D&O coverage;
- identify the so-called general methods of preventing D&O claims;
- identify appropriate methods of controlling D&O losses that pertain to corporate governance, given relevant information;
- recognize the distinctive features of private companies and the types of claims commonly made against these companies; and
- identify the distinctive features of nonprofit organizations, and recognize the types of claims these organizations typically face.

Chapter 1
The Corporation and the Functions of Directors and Officers

Overview

This chapter analyzes the general nature of corporations, discusses the roles that directors and officers play within them, and explains the nature of the duties that they owe to the corporation.

Chapter Objectives

On completion of this chapter you should be able to

- identify the characteristics of a corporation,
- distinguish between public and private corporations,
- identify the functions and responsibilities of corporate directors and officers,
- distinguish between inside and outside directors, and
- recognize the nature and role of common board committees.

What Is a Corporation?

A corporation is an "artificial person" created under the laws of a given state. This means that a corporation has an identity and existence distinct and independent from that of its individual owners.

Corporations have the power to (1) act; (2) contract; (3) sue/be sued; and (4) own, manage, and buy/sell property.

The profits (and losses) of the corporation are distributed according to the ownership interest (i.e., the percentage of total shares) owned by each shareholder.

The Defining Feature of a Corporation: Limited Liability of Individual Shareholders

The defining feature of a corporation is its legal independence from the people who create it—meaning that if a corporation fails, shareholders only stand to lose their investment in the company (i.e., the amount of money they paid for shares of stock in the company), but they will not be liable for any remaining debts owed to the corporation's creditors. For example, an investor purchases $100,000 of stock in XYZ Company. A year later, XYZ Company declares bankruptcy. After the bankruptcy court liquidates all of XYZ's assets, it is determined that XYZ still owes its creditors a total of $5 million. Although the investor's $100,000 investment is now worthless, he is not liable for any of XYZ's remaining $5 million in debts.

Chartering of Corporations

Corporations are chartered by all 50 of the United States and by the federal government in certain instances. For example, national banks and thrifts (i.e., savings and loan institutions) are federally chartered.

Public versus Private Corporations

Public corporations are corporations whose shares of stock are held by and can be purchased by members of the public. In contrast, privately held corporations are those whose shares the public cannot purchase. Rather, the shares of private companies tend to be held by a small group of persons who are often, although not always, family members. As a result, public companies are generally much larger than private companies.

The shares of public companies can be bought or sold on one of the major stock exchanges, such as the New York Stock Exchange (NYSE) or the National Association of Securities Dealers Automated Quotations (NASDAQ). Conversely, the shares of private corporations are not traded on any of the major stock exchanges because they are not available for sale to the public.

The directors and officers of private corporations are exposed to liability for their actions on behalf of the corporations they serve. However, the extent of such liability is considerably less than that of persons who serve as directors and officers of public corporations. Therefore, this course will focus on the distinctive liability exposure aspects of public—rather than private company—directors and officers. However, private company and nonprofit directors and officers (D&O) exposures will also be discussed.

The Functions of Directors and Officers

Management of a corporation is entrusted to its board of directors, the members of which the shareholders elect. The shareholders' responsibility for the corporation's management is limited to (1) electing the directors who serve on the board and (2) approving extraordinary matters put before them by the board, such as a proposal to sell the corporation's assets to another corporation.

Specific Functions of Corporate Directors

Corporate directors must ensure that the corporation is managed in the shareholders' best interest. The directors are responsible for determining the corporation's business strategy and for appointing and supervising officers to execute that strategy.

Corporate Directors: The Link between Shareholders and Management

Because they appoint and supervise the corporate officers who carry out the day-to-day management of the corporation, the directors serve as a link between shareholders and management.

Specific Responsibilities

In supervising the management of the corporation's business, directors are responsible for the following specific items.

- Establishing and reviewing major policies and procedures
- Evaluating management's performance
- Determining appropriate compensation for management
- Identifying and recruiting potential board members and management personnel
- Reviewing the financial status of the corporation

- Preparing and submitting information about the corporation and its financial condition to shareholders and government regulators
- Monitoring and authorizing securities (i.e., stock) transactions, including public offerings of the company's stock
- Ensuring that the corporation is in compliance with the numerous federal and state laws and regulations that govern various aspects of the corporation's activities

Inside versus Outside Directors

Most publicly traded corporations have a board of directors that includes some (but not necessarily all) of the corporation's top executive officers (known as "inside directors"). For example, a corporation's chief executive officer (CEO), chief operating officer (COO), and chief financial officer (CFO) are nearly always members of the corporation's board of directors. However, the corporation's chief counsel (i.e., chief legal officer) and comptroller (i.e., chief accounting officer), while almost always officers of the company, are not always members of its board of directors.

In addition to these "inside" directors are persons who are not otherwise affiliated with or employed by the corporation but may have special qualifications and expertise that is valuable in managing the company. Such persons are known as "outside directors."

Board Committees

Boards of directors usually form a handful of what are known as "committees." These committees, each of which normally consists of two to four members of the board, are formed for the purpose of addressing a particular aspect or feature of the corporation. Like the entire board of directors, such committees also meet periodically to discuss matters relevant to the particular subject of their committee. Three of the most common board committees and their responsibilities are as follows.

- Auditing (overseeing the company's financial, accounting, internal, and external audit functions)
- Nominating (identifying and recruiting new/additional board members and officers)
- Compensating (recommending appropriate compensation levels for the company's management, as well as compensation for members of the board)

Other examples of board committees include those related to corporate governance, human resources, and community/charity purposes.

Chapter 1 Review Questions

1. Burr owns 48 percent of the shares of Workers Corporation's outstanding stock, for which he paid $480,000. Workers Corporation goes bankrupt. After all assets are liquidated, Workers Corporation still has $100,000 in debts. Burr is obligated to pay these creditors
   A. $0.
   B. $24,000.
   C. $48,000.
   D. $100,000.
2. All of the following are differences between public and private corporations EXCEPT:
   A. Shares of public company stock are held by and can be purchased by members of the public; shares of private company stock are held by a small group of persons.
   B. Public companies are generally much larger than private companies.
   C. Share of public companies can be bought or sold on one of the major stock exchanges; shares of private companies are not traded on the major stock exchanges.
   D. The liabilities faced by directors and officers of public companies and private companies are the same.
3. Lawson has been invited to serve on the Duck Corporation board of directors. If he agrees to serve in this role, he will become responsible for all the following EXCEPT:
   A. appointing and supervising corporate officers.
   B. determining corporate business strategy.
   C. electing the board of directors.
   D. serving as a link between shareholders and management.
4. All of the following are possible board committees EXCEPT:
   A. nominating.
   B. corporate governance.
   C. audit.
   D. wellness.
5. The Flat Corporation board of directors has a typical committee structure. Which committee is most likely responsible for board member compensation?
   A. Audit committee
   B. Compensation committee
   C. Nominating committee
   D. Shareholders committee

Answers to Chapter 1 Review Questions

1.

   A. That's correct! If a corporation fails, shareholders are not liable for any remaining debts owed to the corporation's creditors.

   B. This answer is incorrect. If a corporation fails, shareholders only stand to lose their investment in the company.

   C. This answer is incorrect. As a 48-percent shareholder, Burr is not obligated to pay 48 percent of the corporation's debt.

   D. This answer is incorrect. As a shareholder, Burr is not responsible for the corporation's $100,000 debt.

2.

   A. This answer is incorrect. Shares of public company stock are held by member of the public; shares of private company stock are held by a small group of people, often family members.

   B. This answer is incorrect. Because the stock of public companies can be purchased by members of the public, public companies tend to be larger.

   C. This answer is incorrect. Shares of public company stock are traded on the major stock exchanges; shares of private company stock are not available for sale to the public.

   D. That's correct! While directors and officers of public and private companies are exposed to the same liabilities, the extent to which private company directors and officers are exposed is considerably less.

3.

   A. This answer is incorrect. Directors are responsible for appointing and supervising officers to execute the corporation's strategy.

   B. This answer is incorrect. Directors are responsible for determining the corporation's business strategy.

   C. That's correct! Shareholders elect directors.

   D. This answer is incorrect. Because they appoint the people who carry out the corporation's day-to-day management, directors serve as a link between shareholders and management.

4.

   A. This answer is incorrect. The nominating committee is a common board committee that identifies and recruits new/additional board members.

   B. This answer is incorrect. Many corporations have a corporate governance committee.

   C. This answer is incorrect. The audit committee is a common board committee that oversees the company's financial, accounting, internal, and external audit functions.

   D. That's correct! A wellness committee would not be a typical board committee.

5.

   A. This answer is incorrect. The audit committee oversees the company's financial, accounting, internal, and external audit functions.

   B. That's correct! Recommending compensation levels for company management and board member compensation is a responsibility of the compensation committee.

   C. This answer is incorrect. The nominating committee identifies and recruits new/additional board members and officers.

   D. This answer is incorrect. Corporate boards do not necessarily have a shareholders committee.

Chapter 2
Common Law Duties of Directors and Officers

Overview

The legal principles enunciated in opinions written by judges and issued by the courts (as distinct from laws contained in legislative enactments known as statutory law) are often referred to collectively as "case law" or the "common law." Many of the claims made against directors and officers are based on legal principles embodied in the common law, especially as respects the four key duties of (1) loyalty, (2) obedience, (3) due care, and (4) good faith, all of which are owed by directors and officers to the corporations they serve. These are collectively known as directors' and officers' "fiduciary duties" and are discussed in this chapter.

Chapter Objectives

On completion of this chapter you should be able to

- list the four fiduciary duties owed by directors and officers;
- recognize the implications of these duties;
- identify the penalties for breaching these duties; and
- determine whether or how directors and officers fiduciary duties have been breached, given relevant information.

The Four Fiduciary Duties

Four of the key fiduciary duties owed by directors and officers are the duties of loyalty, obedience, due care, and good faith.

The Duty of Loyalty

According to the *Corporate Director's Guidebook*, the duty of loyalty requires that directors and officers act with "an undivided and unselfish loyalty to the corporation."

Although the courts recognize that there may be a certain degree of self-interest involved in board decisions, the duty of loyalty requires that directors' self-interest be minimal and that the interests of the corporation and its shareholders take precedence over the directors' desire to maintain their positions. Therefore, directors must ensure that board actions are designed to benefit the corporation as a whole—rather than themselves.

Examples of Breaches of the Duty of Loyalty

Examples of conduct by directors and officers that has been found to constitute a breach of the duty of loyalty are noted in Exhibit 2.1.

Exhibit 2.1
Breaches of the Duty of Loyalty

- **Revealing inside information or disclosing trade secrets of the corporation to outsiders** (e.g., advising a stock trader that the company will be announcing the introduction of a major new drug, knowing that the firm's share price is likely to rise when such information becomes public knowledge)
- **Appropriating a corporate opportunity for personal gain or competing with the corporation** (e.g., obtaining a "fire sale" price on assets that the corporation is selling, rather than offering such assets on the open market)
- **Soliciting the corporation's business or customers after the director or officer leaves the service of the corporation** (e.g., after retiring from the board, a director, who by means of his or her association with the company, makes sales calls on behalf of his or her own company, to all of the corporation's purchasing managers)
- **Authorizing loans of corporate funds to themselves or to associates on preferential terms** (e.g., having a bank director obtain a home mortgage loan at a rate that is 3 percent below the bank's regular rate for that type of loan)
- **Authorizing or receiving improper payments or gratuities from persons engaged in business transactions with the corporation** (e.g., arranging for the corporation to pay bribes to foreign officials as a condition of doing business in their country).
- **Using corporate assets to entrench the board in control of the corporation, such as where corporate funds are used to purchase stock to maintain a voting majority** (e.g., convincing the company's CEO to raise funds for the organization by selling shares of stock to the company's directors, rather than through a public offering of stock)

Directors and officers who seek to benefit themselves at the corporation's expense have breached their duty of loyalty to the corporation and may be held personally liable for any damage suffered by the corporation as a result. For example, in *Guth v. Loft, Inc.,* 5 A.2d 503 (Del. 1939), the president of a corporation that manufactured syrups was found to have breached his duty of loyalty to the corporation when he *personally* acquired the trademark and formula of Pepsi Cola and a 91 percent interest in the Pepsi Cola Company by using corporate funds, facilities, and labor to operate the acquired business. The president's use of corporate assets to personally acquire a corporate business opportunity violated his duty of loyalty to the corporation.

The Duty of Obedience

Adherence to the duty of obedience obligates directors to limit their corporation's conduct to the powers granted by the corporation's charter and within the law. "Law" includes not only the common law and statutes of the state that a company is incorporated in, but also federal and state statutes, rules, and regulations that control a corporation's duties and activities.

Ultra Vires Acts

Acts that are beyond the powers conferred upon a corporation by its charter or by the laws of its state of incorporation are termed *ultra vires*. (A charter is a document filed with the state by the founders of a corporation that describes the purpose, location, and other details pertaining to the organization.)

Directors are not only liable for their own *ultra vires* acts, but they are also liable for *ultra vires* acts authorized by the board as a whole. (For example, if the corporation's charter bans loans to directors and officers, the granting of such a loan would constitute an *ultra vires* act.) Moreover, directors and officers do not enjoy immunity simply because their conduct is in the capacity as a director or officer; if their conduct is illegal, they can also be personally accountable, meaning that their personal assets can be appropriated in a lawsuit.

Personal Exposures to D&O Liability

Claims against directors and officers for breaching the duty of obedience have received increased attention as the business environment in which they work has evolved. Historically, these claims have not typically implicated the personal assets of the defendant directors and officers. In virtually all cases, either the company's insurer or the corporation indemnified the defendant directors and officers. However, more recently, there have been cases where insurance coverage and corporate indemnification (i.e., the corporation paying on the director's behalf for liability the director incurred while serving the company) were unavailable. In such cases, especially where the alleged wrongdoing was abnormally egregious, directors and officers were forced to personally pay settlements or judgments from their own assets.

Important Settlements and Developments

Directors and officers can no longer feel safe from threats of personal liability exposure, even under the most comprehensive insurance program. As evidenced by many well-publicized settlements, institutional plaintiffs (e.g., pension funds, banks) and, in some cases, government regulators are demanding unprecedented personal contributions from directors to settle certain large securities claims. In a hallmark example, the directors of Enron paid a total of $13 million from their own assets, and the directors of WorldCom paid a total of $24.75 million out of their own assets to claims against them and their corporations.

In other cases, plaintiffs have settled with only some of the individual defendant directors/officers for the entire amount of the available insurance, thereby leaving the remaining defendant directors/officers uninsured. When combined with the explosion in the size of claim settlements in recent years, these developments are extremely alarming, even for the most scrupulous director or officer.

The Yates Memo: Individual Accountability for Corporate Wrongdoing

Another development that increased the potential liability exposure for individual directors and officers came in the form of a September 2015 directive from the United States Department of Justice. Released under the subject line of "Individual Accountability for Corporate Wrongdoing," but more commonly referred to as the Yates Memo, the directive emphasized the focus on individual directors and officers with regard to corporate misconduct.

More specifically, the Yates Memo affords added incentive for a company to provide the Department of Justice with "all relevant facts about the individuals involved in corporate misconduct" in the event of an investigation. The Yates Memo incentivizes the release of such information by making it a requirement in order for the company that is being investigated to be eligible for any sort of cooperation credit. This requirement in turn provides an increased likelihood that individual directors and officers will be involved in investigations.

The Duty of Due Care (Also Known as the Duty of "Due Diligence")

The duty of due care requires that directors and officers make decisions based upon reasonably adequate information and deliberation.

What Constitutes "Due Care"?

Directors and officers must discharge their duties with the care that an ordinarily prudent person, in a like position, would exercise under similar circumstances and in a manner they reasonably believe is in the best interest of the corporation. The duty of due care also requires that directors attend board meetings, obtain and adequately review information concerning actions taken by the board, and carefully supervise the corporation's business and its major policies.

The Two Settings Involving the Duty of Due Care

Director/officer liability for a breach of the duty to exercise due care typically arises in one of two settings.

Poor Decision-Making

With respect to a board decision that leads to a corporate loss, compliance with a director's duty of due care focuses on the good faith or rationality of the process employed in making the challenged board decision, not the result of the decision. For instance, Corporation A decides to purchase Corporation B. The decision was made following extensive discussions at three board meetings and was a product of 500 hours of analysis by Corporation A's internal staff. In addition, the board hired an investment banking firm to determine a fair price for the acquisition. If, a year later, it turns out to have been a bad decision because Corporation B's operations are unprofitable, the directors will most likely not be held liable for violating the duty of due care because they took reasonable measures and performed a thorough evaluation prior to making the decision to purchase Corporation B. On the other hand, a decision made after one board meeting that involved no consultation with outside experts would be much more likely to result in a perceived violation of the duty of due care.

Failure To Make a Decision

With respect to board inaction that leads to a corporate loss, compliance with a director's duty of due care largely focuses on whether the director attempted in good faith to assure that the corporation had in place an effective information and reporting system to ensure corporate compliance with legal requirements. For instance, assume that Corporation A offered Corporation B an opportunity to purchase certain assets of Corporation A, and Corporation B did not even bother to evaluate or respond to the offer. In this instance, the directors and officers of Corporation B could be held liable for breaching the duty of due care, given their lack of effort in failing to even review the potential benefits of Corporation B's offer.

The Duty of Good Faith

The fourth common law duty, known as the duty of good faith, has emerged and developed more recently than the prior three duties discussed. This duty requires that directors and officers act honestly and sincerely in their business dealings with the corporation's best interests in mind. This doctrine was advanced in a case known as *In re Walt Disney Co. Derivative Litig.,* 907 A.2d 693 (Del. Ch. 2005), and is discussed later in this course under "A Notable Derivative Claim" in Chapter 8. In this case, the court found that, in addition to the three traditional duties, directors and officers also have a duty to act in good faith. In the court's opinion, the failure to act in good faith can create liability for directors and officers in conjunction with their service to the corporation. However, in this case, the judges ultimately ruled that despite the plaintiffs' allegations to the contrary, the directors and officers had, in fact, acted in good faith and were therefore not liable for the damages claimed by the plaintiffs.

Chapter 2 Review Questions

1. Directors' and officers' four key common law fiduciary duties are
    A. due care, honesty, good faith, and loyalty.
    B. honesty, loyalty, due care, and obedience.
    C. loyalty, obedience, due care, and good faith.
    D. obedience, honesty, good faith, and loyalty.
2. Due to financial difficulties, Planet Motors, Inc., decided to discontinue its sale of Jupiter automobiles and concentrate on other brands. One board member suggested Planet liquidate its Jupiter inventory by holding an auction, but Bill, an outside board member who needs a fleet of cars for his own business, convinces other board members to let him purchase the entire inventory for 50 percent of the dealer invoice price. Bill’s actions as a board member probably breach his duty of
    A. due care.
    B. honesty.
    C. loyalty.
    D. obedience.
3. Hurst Corporation’s CEO arranged for a prostitute to seduce a competitor and take pictures of the tryst. The plot backfired when the prostitute demanded $100,000 from Hurst to buy her silence. The board authorized the $100,000 payment, but a zealous reporter found out about it and published a story in the trade press. Angry shareholders demanded compensation from the board. Based on this information, it appears that
    A. because the directors made reasonable attempts to protect the corporation’s reputation, their personal assets are safe.
    B. because the directors have met their duty of obedience, their personal assets are safe.
    C. the directors are guilty of an ultra vires act, and their personal assets could be appropriated.
    D. the directors are guilty of an ultra vires act, but their personal assets are not at risk.
4. A September 2015 directive from the United States Department of Justice, released under the subject line of “Individual Accountability for Corporate Wrongdoing,” emphasized the focus on individual directors and officers with regard to corporate misconduct and increased the potential liability exposure for individual directors and officers. This directive is known as the
    A. Ultra Vires Act.
    B. Yates Memo.
    C. Department of Justice Directive 104.6.
    D. Individual Accountability Act of 2015.

5. Squire Properties offered Metro Enterprises an opportunity to purchase certain assets of Squire. The directors of Metro had a number of initiatives underway and, being aware of Squire's reputation, did not even bother to evaluate or respond to the offer. In this instance, the directors and officers of Metro could be held liable for

    A. breaching the duty of due care.

    B. breaching the duty of good faith.

    C. breaching the duty of ethical behavior.

    D. breaching the duty of obedience.

Answers to Chapter 2 Review Questions

1.

   A. This answer is incorrect. Honesty is not one of the key common law duties.

   B. This answer is incorrect. The key common law fiduciary duties are loyalty, obedience, good faith, and due care.

   C. That's correct! The four key common law fiduciary duties are loyalty, obedience, due care, and good faith.

   D. This answer is incorrect. Honesty is expected of a director, so it is not one of the common law duties.

2.

   A. This answer is incorrect. The duty of due care requires that directors and officers discharge their duties with the care that an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner they reasonably believe is in the best interest of the corporation. Bill may have believed he was doing the company a favor by efficiently disposing of its orphaned autos.

   B. This answer is incorrect. No evidence has been given that Bill was less than honest with his fellow board members in proposing this bailout offer.

   C. That's correct! Appropriating a corporate opportunity for personal gain or competing with the corporation, such as by obtaining a fire-sale price on assets the corporation is selling rather than offering such assets on the open market, has been found to constitute a breach of the duty of loyalty.

   D. This answer is incorrect. There is no evidence that Bill's conduct was illegal or that the proposed action was outside the board's authority.

3.

   A. This answer is incorrect. Directors can be held personally liable for illegal conduct.

   B. This answer is incorrect. The duty of obedience requires compliance with applicable law, and several laws appear to have been breached in this case.

   C. That's correct! Paying blackmail is beyond the powers conferred upon a corporation, and directors and officers can be held personally accountable for illegal conduct, meaning their personal assets can be appropriated in a lawsuit.

   D. This answer is incorrect. The directors' personal assets can be appropriated in a lawsuit.

4.

   A. This answer is incorrect. Ultra vires acts are acts that are beyond the powers conferred upon a corporation by its charter or by the laws of its state of incorporation.

   B. That's correct! The Yates Memo focused on individual accountability and added incentive for a company to provide the Department of Justice with "all relevant facts about the individuals involved in corporate misconduct" in the event of an investigation.

   C. This answer is incorrect. There is no such directive. The directive is known as the Yates Memo.

   D. This answer is incorrect. This Act does not exist. The Yates Memo is the name by which this directive is known.

5.

A. That’s correct! The duty of due care requires that directors discharge their duties with the care that an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner he or she reasonably believes is in the best interest of the corporation. Failing to even evaluate the offer would violate that duty.

B. This answer is incorrect. The duty of good faith requires that directors and officers act honestly and sincerely in their business dealings. Their failure to respond did not relate to honesty and sincerity.

C. This answer is incorrect. The duty of ethical behavior is not one of the common law fiduciary duties. Directors are expected to act ethically.

D. This answer is incorrect. The duty of obedience obligates directors to limit their corporation’s conduct to the powers granted by the corporation’s charter and within the law. Failure to respond to an offer does not fall within this duty.

Chapter 3
Federal Securities Liability

Overview

Chapter 3 discusses the liability exposures of directors and officers under federal securities laws—the single greatest exposure faced by directors and officers of publicly traded corporations.

Chapter Objectives

On completion of this chapter, you should be able to do the following.

- Identify the primary goals and accomplishments of each of the following Acts.
    - The Securities Act of 1933
    - The Securities Exchange Act of 1934
    - The Sarbanes-Oxley Act of 2002
- Recognize the directors and officers liability exposures created by these Acts.

The Securities Act of 1933

The purpose of the Securities Act of 1933 is to ensure the availability of complete and reliable information about securities being sold to the public. The two most important components of the Act are Sections 5 and 11.

Liability under Section 5: The Obligation To Register a New Security

Section 5 makes it illegal to offer or sell securities to the public unless they have first been registered with the Securities and Exchange Commission (SEC). For example, if a corporation seeks to sell stock to the public, it must first register the stock with the SEC. The purpose of this requirement is to assure that the corporation and its securities will be evaluated by a neutral party that can determine whether the corporation is worthy of an investment.

Liability under Section 11: The Obligation To Make Truthful Statements about Securities

Section 11 imposes civil liability for material misstatements in registration statements. (A "material" misstatement refers to a falsification that would have an impact on a reasonable investor's judgment of a company's financial position. For example, intentionally inflating a company's quarterly earnings by 25 percent would be a material misstatement; doing so by 1 percent would not.) Failure to comply with the Act's technical or substantive requirements in connection with a public offering of stock can result in liability of the corporation and its directors and officers. For example, assume that a corporation issues a prospectus to induce investors to buy stock in the organization. If it is determined that the prospectus contained deliberately false information, the corporation and its directors and officers could be held liable for violating Section 11 of the Securities Act of 1933.

The Securities Exchange Act of 1934

In contrast to the Securities Act of 1933, which applies to the issuance of *new shares* of stock in a corporation, the Securities Exchange Act of 1934 was enacted to protect investors in connection with the trading of securities *already* issued and outstanding. The primary goal of the Securities Exchange Act of 1934 is to ensure that persons involved in securities transactions have reasonably equal access to material information about the transactions and the securities. The most important components of the Act are Section 10(b) and SEC Rule 10(b)–5, known as the *anti-fraud provisions.*

Liability under Section 10(b): The Prohibition against Deceptive Acts/Statements

This section of the law prohibits manipulative or deceptive acts in connection with the purchase or sale of a security. Such provisions would apply in the following situation. Assume a corporation issues financial statements that materially misrepresent the true financial condition of the company. Such statements indicate that the company earned a substantial profit in the just-ended fiscal year, yet in reality, it sustained a severe loss. As a result of such statements, investors claim that they were induced to buy stock in the corporation. The shares of stock plummet in value during the next month. Under this scenario, the corporation and its directors and officers could be held liable for violating Section 10(b) of the Securities Exchange Act of 1934.

Liability under SEC Rule 10(b)–5: The Prohibition against "Insider Trading"

This section of the SEC rules applies to what is known as "insider trading" in the shares of stock in a corporation. Insider trading is the trading of a corporation's stock or other securities, such as bonds, by persons with access to nonpublic information (also referred to as *asymmetric information*) about the company.

Here is an example of insider trading, which would be prohibited under SEC Rule 10(b)–5. Assume that a corporate director or officer knew that the company was about to announce a substantial loss for the just-concluded fiscal quarter. Prior to a public announcement of these financial results, the director sold the 500,000 shares of stock that he owned in the company. This pre-announcement sale allowed the director to avoid a considerable personal loss, given the fact that prior to the announcement, the company's stock was selling at $30 per share, yet following the disclosure, the market price plunged to $10 per share.

The Sarbanes-Oxley Act of 2002

Following the revelation of massive corporate improprieties, including accounting irregularities, scandals, and fraud of unprecedented scale and severity, Congress passed the Sarbanes-Oxley Act of 2002. More specifically, the Act was a response to the excesses associated with the Enron, WorldCom, Adelphia, and Global Crossing bankruptcies (among others), as well as from the implosion of the stocks in a number of high-tech companies during the period of 2000 to 2002.

The Act addresses several areas of national concern regarding corporate accounting and auditing, fraud, corporate transparency, and officer liability. The most important provisions are noted in Exhibit 3.1.

Exhibit 3.1
Key Provisions of the Sarbanes-Oxley Act of 2002

- **Independent accounting board**. The Act created an *independent accounting board* to oversee corporate accounting and auditing practices.
- **Personal certification of financial statements**. The Act included a requirement that CEOs and CFOs of public companies *personally participate* in preparing the firm's financial statements and *personally certify* the accuracy of such statements.
- **Internal control report**. The Act requires that an *internal control report* be included in a public company's annual report and that the company's public accountant must attest to management's assessment of the company's internal control structures.
- **Ban on loans**. The Act bans *corporate loans* to directors and officers, except in certain limited circumstances.
- **Insider trading**. The Act requires that *insider trades* (i.e., those by directors and officers) be reported to the SEC more quickly than was previously required.
- **Audit committee reform**. The Act requires that *audit committees* be composed entirely of *independent* directors and that members of audit committees be experienced and well versed on financial issues.
- **Penalties for material misstatements**. The Act requires CEOs and CFOs to *forfeit bonus and equity compensation* in the event of a material restatement of a company's financial statements. (A financial restatement is issued when a corporation must provide to the public and the SEC a completely new set of financial data because there has been a substantial error in the original statements.)
- **Whistleblower protection.** The Act provides for criminal penalties against corporations that retaliate against whistleblowers who reveal conduct by officials at the company. Such penalties apply regardless of whether the company's stock is publicly traded.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was signed into federal law in response to the United States recession, which took place from late 2007 through mid-2009. As stated in the law itself, the chief goals of the legislation include promoting financial stability by improving accountability and transparency, ending "too big to fail" treatment of banks, ending bank and corporate bailouts, and protecting consumers from abusive financial services practices. Exhibit 3.2 shows each of the sixteen Titles contained within Dodd-Frank, the names of which provide a glimpse of the range of issues that are addressed in more detail within the Act.

Exhibit 3.2
Titles within the Dodd-Frank Wall Street Reform and Consumer Protection Act

- **Title I—Financial Stability**
- **Title II—Orderly Liquidation Authority**
- **Title III—Transfer of Powers to the Comptroller of the Currency, the Corporation, and the Board of Governors**
- **Title IV—Regulation of Advisers to Hedge Funds and Others**
- **Title V—Insurance**
- **Title VI—Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions**
- **Title VII—Wall Street Transparency and Accountability**
- **Title VIII—Payment, Clearing, and Settlement Supervision**
- **Title IX—Investor Protections and Improvements to the Regulation of Securities**
- **Title X—Bureau of Consumer Financial Protection**
- **Title XI—Federal Reserve System Provisions**
- **Title XII—Improving Access to Mainstream Financial Institutions**
- **Title XIII—Pay It Back Act**
- **Title XIV—Mortgage Reform and Anti-Predatory Lending Act**
- **Title XV—Miscellaneous Provisions**
- **Title XVI—Section 1256 Contracts**

As reported by K. Alan Parry and Eric G. Barber for the American Bar Association ("Dodd-Frank's Impact on D&O Insurance," November/December 2011), the Act's whistleblower "bounty" provision and executive compensation "claw-back" provision are each particularly noteworthy in terms of their impact on directors and officers liability.

Dodd-Frank effectively incentivized corporate whistleblowing activity by amending the Securities Exchange Act of 1934 and providing for monetary awards for whistleblowers who provide information to the SEC that results in successful enforcement actions. By providing this potential "bounty" for those who report corporate wrongdoings, the Act increased director and officer exposure to liability significantly. In the SEC's Office of the Whistleblower report released in November 2015 ("The 2015 Annual Report to Congress: Dodd-Frank Whistleblower Program"), it was noted that the number of whistleblower reports to the agency had increased every year since the program's inception in 2011. As reported by Alan Farnham of ABC News in September 2012 ("7 Richest Snitches: Time to Rat Out Your Boss?"), companies like UBS, Pfizer, GlaxoSmithKline, and Bank of America have all been involved in whistleblower lawsuits that resulted in multi-million dollar rewards for the employee whistleblowers.

The executive compensation "claw-back" provision, a provision that expands the range of potential scenarios in which a director or officer would be required to forfeit incentive-based compensation that was earned based on erroneous financial filings, also increased liability exposure. The provision encompasses (a) any current or former executive; (b) a 3-year claw-back period predating financial restatements; and (c) strict liability, as opposed to liability only for misconduct. Each of the preceding aspects constitute a broadening of application (and therefore an increased exposure) compared to similar claw-back provisions that were previously included in the Sarbanes-Oxley Act of 2002.

Chapter 3 Review Questions

1. The biggest liability exposure of directors and officers involves federal securities laws such as the Securities Act of 1933, which was designed to

   A. determine which securities are listed on the New York Stock Exchange.

   B. ensure that the Treasury Department receives all revenues to which it is entitled as the result of securities sales and purchases.

   C. ensure the availability of complete and reliable information about securities being sold to the public.

   D. encourage insider trading, thereby enhancing stock prices and maintaining a healthy market.

2. Although it was not yet public knowledge, Apple Juice Corporation was about to announce an expensive product recall. Because a defective preservative was used, a large batch of its product had spoiled, fermented, or become toxic. Just before the recall, board member John sold most of his company stock. Two days later, the stock was worth much less than it was at the time of the sale. John appears to be guilty of

   A. an ultra vires act.

   B. asymmetrical knowledge.

   C. breaching his fiduciary duty of honesty.

   D. insider trading.

3. Mississippi Steak Corporation needed to issue a new set of financial data to the public and the Securities and Exchange Commission (SEC) after the firm, better known as "Miss Steak," discovered a substantial error in its original statements. This new set of financial data is referred to as a(n)

   A. audit report.

   B. consumer protection alert.

   C. financial restatement.

   D. Form 990.

4. Tamino, a quality control supervisor at the Magic Flute Company, received a monetary award from the SEC after Tamino reported corporate wrongdoings by Papageno, the company's CEO. This whistleblowing reward was authorized by

   A. the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

   B. the Sarbanes-Oxley Act of 2002.

   C. the Securities Act of 1933.

   D. the Securities Interchange Act of 1934.

5. Sokitumi Corporation's profits soared following its release of a financial report that grossly overstated its corporate earnings. Which one of the following is an example of applying Dodd-Frank's "claw-back" provision to this scenario?

    A. Noel Umber, Sokitumi's chairman of the board, was required to sell his shares of corporate stock at a loss.

    B. Sandy Klaus, a Sokitumi stockholder, received a bonus dividend.

    C. Claude Beck, Sokitumi's CEO, was required to forfeit incentive-based compensation based on the erroneous filings.

    D. Armand Ax, Sokitumi's treasurer, was incarcerated for 5 years.

Answers to Chapter 3 Review Questions

1.

   A. This answer is incorrect. Determining which securities are listed on the New York Stock Exchange is not the purpose of this Act.

   B. This answer is incorrect. Making sure taxes are paid is the role of the Internal Revenue Service.

   C. That's correct! The purpose of the 1933 Act is to ensure the availability of complete and reliable information about securities being sold to the public.

   D. This answer is incorrect. Insider trading is prohibited by the Securities Exchange Act of 1934.

2.

   A. This answer is incorrect. An ultra vires act is an act beyond the powers conferred upon a corporation.

   B. This answer is incorrect. As a director, John is expected to know more about the company than outsiders; knowing the recall was coming is not the problem here.

   C. This answer is incorrect. Selling a director's stock is not, in itself, dishonest.

   D. That's correct! Insider trading is the trading of stock by a person with access to nonpublic information.

3.

   A. This answer is incorrect. An audit report might have led to the restatement.

   B. This answer is incorrect. The new set of data would not be referred to as a consumer protection alert.

   C. That's correct! A financial restatement is issued when a corporation must provide to the public and the SEC a completely new set of financial data because there has been a substantial error in the original statements.

   D. This answer is incorrect. Form 990 is an IRS form for income tax exempt organizations.

4.

   A. That's correct! Dodd-Frank effectively incentivized corporate whistleblowing activity by amending the Securities Exchange Act of 1934 and providing for monetary awards for whistleblowers who provide information to the SEC that results in successful enforcement actions.

   B. This answer is incorrect. The Sarbanes-Oxley Act of 2002 provided for criminal penalties against corporations that retaliate against whistleblowers.

   C. This answer is incorrect. The Securities Act of 1933 dealt with the information that is provided about securities sold to the public.

   D. This answer is incorrect. There is no such act.

5.

   A. This answer is incorrect. The claw-back provision does not specifically require a board member to dispose of his or her stock.

   B. This answer is incorrect. The claw-back provision does not directly affect shareholders.

   C. That's correct! The claw-back provision expands the range of potential scenarios in which a director or officer would be required to forfeit incentive-based compensation that was earned based on erroneous financial filings.

   D. This answer is incorrect. Armand's incarceration was not based on the claw-back provision.

Chapter 4
Liability under Other Types of Statutes

Overview

While a considerable proportion of all claims against directors and officers are based on violations of securities laws, a substantial number of claims against directors and officers are also brought under statutes prohibiting various other types of conduct.

Chapter Objectives

On completion of this chapter, you should be able to do the following.

- Identify statutes that deal with each of the following.
    - Anticompetitive and unfair business practices
    - Infringement of patents, copyrights, and trademarks
    - Racketeering
    - Mismanagement of investment company funds
    - Failure to withhold and remit federal taxes
    - Direct corporate contributions to candidates for office in federal elections
    - Hazardous workplace conditions
    - Environmental pollution
    - Fraud in connection with government contracts
    - Bribery of foreign officials
    - Employment practices
- Recognize how these acts create liability exposures for corporate directors and officers.

Many of the statutes creating liability exposures for directors and officers are listed in Exhibit 4.1. The more important ones are discussed in this chapter.

Exhibit 4.1
Statutes Giving Rise to Directors and Officers (D&O) Liability

Anticompetitive and Unfair Business Practices

- The Sherman Antitrust Act
- The Clayton Antitrust Act
- The Robinson-Patman Act of 1936
- The Uniform Trade Secrets Act
- The Federal Trade Commission Act of 1914

Infringement of Patents, Copyrights, and Trademarks

- The Lanham Act

Racketeering

- The Racketeer Influenced and Corrupt Organizations (RICO) Act

Mismanagement of Investment Company Funds

- The Investment Company Act of 1940

Mismanagement of Employee Benefit Plans

- The Employee Retirement Income Security Act of 1974 (ERISA)

Failure To Withhold and Remit Federal Taxes

- The Internal Revenue Code

Hazardous Workplace Conditions

- The Occupational Safety and Health Act of 1970 (OSH Act)

Environmental Pollution

- The Clean Air Act
- The Clean Water Act
- The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)
- The Resource Conservation and Recovery Act (RCRA)

Exhibit 4.1
Statutes Giving Rise to Directors and Officers (D&O) Liability

Fraud in Connection with Government Contracts

- The False Claims Act

Bribery of Foreign Officials

- The Foreign Corrupt Practices Act of 1977

Employment Practices

- The Equal Pay Act of 1963
- Title VII of the Civil Rights Act of 1964
- The Age Discrimination in Employment Act of 1967
- The Pregnancy Discrimination Act of 1978
- The Older Workers Benefit Protection Act of 1990
- The Civil Rights Act of 1871 (as amended by the Civil Rights Act of 1991)
- The Americans with Disabilities Act of 1990
- The Family and Medical Leave Act of 1993
- The Lilly Ledbetter Fair Pay Act of 2009

Liability for Anticompetitive and Unfair Business Practices

The federal prohibition against anticompetitive business practices is principally embodied in two "antitrust" statutes—the Sherman Antitrust Act (Sherman) and the Clayton Antitrust Act (Clayton)—violations of which can subject corporate directors and officers to liability. Sherman prohibits contracts, combinations (i.e., groups of companies, also sometimes referred to as cartels), and conspiracies in restraint of trade, monopolies, and attempts and conspiracies to monopolize. Clayton prohibits price discrimination among purchasers of goods, exclusive dealing arrangements, and corporate mergers and acquisitions that may substantially lessen competition or tend to create a monopoly in any line of commerce. Notably, the medical sector has a significant antitrust exposure.

Predatory Price-Cutting Activities

The Robinson-Patman Act of 1936 imposes both civil and criminal penalties for predatory price-cutting and other actions taken to eliminate competition. The Federal Trade Commission Act of 1914 also prohibits other unfair or deceptive methods of competition.

Disclosure of Trade Secrets

Common law and federal statutes protect trade secrets. The Uniform Trade Secrets Act codifies common law principles of liability for improper disclosure of trade secrets. This Act prohibits misappropriation of confidential business or technological information by any means, including hiring another company's employee with the expectation that the employee will divulge or use the trade secrets of the former company in his or her new position.

Liability for Copyright/Patent/Trademark Infringement

Federal registration requirements protect owners of copyrights, patents, and trademarks from infringement by others.

Copyright/Patent Infringement

The owner of a copyright has the exclusive right to reproduce the work, prepare derivative (i.e., similar) works, distribute copies of the work, and perform and display the work. Violation of such rights may result in liability for infringement. Similarly, anyone who makes, uses, or sells a patented product without authorization from the patent holder may be held liable in damages for infringement of the patent.

Trademark Infringement

Federal (i.e., the Lanham Act) and state statutes and common law protect trademarks from unauthorized use. A trademark is infringed upon when there is a likelihood of confusion between two products caused by similar marks, such that a typical consumer exercising ordinary caution would think that the products derive from the same source.

To illustrate, a director or officer may be held personally liable for patent, copyright, or trademark infringement by a corporation. For example, in a patent infringement suit brought in 2004, *Bennett Marine, Inc. v. Lenco Marine, Inc., et al*, (Florida Southern District Court, Case No. 0:04-cv-60326), the court found Lenco Marine's president personally liable for the company's infringement, making him responsible for nearly $340,000 in damages jointly and severally with the company itself. Although the case was successfully appealed by Lenco in 2013, this example still illustrates the court's willingness to impose personal liability in certain cases of infringement.

Liability for Racketeering Activities

The Racketeer Influenced and Corrupt Organizations (RICO) Act prohibits any person, including corporations and their individual directors and officers, from conducting the affairs of any enterprise through a "pattern of racketeering activity" or from acquiring an enterprise through conduct constituting such activity. A "pattern of racketeering activity" is established by showing the commission of at least two enumerated acts within a 10-year period. Examples of acts that would constitute racketeering include securities fraud; mail fraud; bankruptcy fraud; obstruction of justice; and embezzlement from pension, welfare, and union funds, among others.

Treble Damage Provisions

In addition to its criminal penalties, RICO creates a civil cause of action that enables a person injured by a RICO violation to recover treble damages as well as costs and attorney fees. For example, if a plaintiff suffered $1 million in losses that qualified as a "pattern of racketeering," under the treble damages provision, he or she could potentially collect three times this amount—$3 million.

Liability for Mismanagement of Investment Company Funds

The Investment Company Act of 1940 protects holders of shares in investment companies (i.e., corporations formed to invest in the securities of other corporations, such as mutual funds) by imposing fiduciary duties on the managers and advisers of investment companies. Investment companies are organized and managed by an investment adviser that provides services to the company in exchange for fees. This Act imposes a fiduciary duty on both the investment adviser and the investment company, requiring that they charge reasonable compensation for their services. The Securities and Exchange Commission (SEC) and mutual fund shareholders may sue investment company directors for damages if they breach this duty by charging excessive fees.

Liability for Mismanagement of Employee Benefit Plans

"Fiduciaries" under the Employee Retirement Income Security Act (ERISA) of 1974 are defined as "any person who exercises any discretionary authority or control with respect to the management or administration of the plan or its assets." In this instance, "the plan" refers to employee benefit programs such as pension plans, 401(k) programs, or group health insurance coverage offered by an employer.

Directors and officers, even though they may have no day-to-day responsibilities for managing employee benefit programs, can be held liable for mismanagement of such plans. The bases for asserting liability are that directors/officers (1) negligently selected the fiduciaries who do have that responsibility and (2) had an ongoing responsibility to monitor the fiduciaries they selected, which they failed to do. So-called ERISA stock-drop litigation (discussed later in this course) is an example of the claims to which directors and officers are subject to in conjunction with employee benefit programs.

Liability for Failure To Collect and Remit Payroll Taxes

The Internal Revenue Code (the Code) requires employers to withhold federal income and social security taxes from their employees' wages. The Code imposes personal liability on "responsible persons" if the business does not collect or pay over these taxes to the Internal Revenue Service. Most cases against individual directors and officers turn on whether such individual is a "responsible person" under the Code—usually defined as someone who has significant control over the company's finances.

Liability for Safety Violations

Under certain circumstances, directors and officers may be held liable, as "employers," for violations of the Occupational Safety and Health Act of 1970 (OSH Act). The OSH Act imposes two important duties on "employers." First, employers have a general duty to provide a working environment that is free from hazards likely to cause serious harm, or even death, to employees. Second, employers must comply with specific occupational safety and health standards promulgated under the OSH Act.

In April of 2016, Don Blankenship, the former Massey Energy Company CEO, was convicted of willfully conspiring to violate federal safety standards, which led to the death of 29 coal miners at Massey Energy's Upper Big Branch mine in 2010. Situations like this, especially in similar industries with increased hazards, exemplify the vast extent of liability that can be inherent in safety violations.

Environmental Liability

Another area of potential liability for corporate directors and officers relates to compliance with increasingly comprehensive environmental laws. Corporations have long been held liable for improper dispersal, handling, or disposal of materials harmful to the environment. Now, directors and officers may also be subject to personal liability.

The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)

CERCLA affects owners or operators of facilities that have released hazardous substances into the environment. Also known as the Superfund Act, CERCLA establishes the means by which the government and private parties may bring suit to recover cleanup costs from those responsible for environmental damage. In *United States v. Northeastern Pharm. & Chem. Co.,* 810 F.2d 726 (8th Cir. Mo. 1986), *cert. denied*, 484 U.S. 848 (1987), the Eighth Circuit found individual officers liable for a corporation's release of pollutants where the officers had the power to control and direct the disposal of the pollutants. The individuals were held personally liable for cleanup costs not because of their status as corporate officers, but because of their personal involvement with the CERCLA violations, including the arrangement for transportation and disposal of hazardous substances on behalf of the corporation.

The Resource Conservation and Recovery Act (RCRA)

RCRA establishes a comprehensive hazardous waste management system. This Act imposes "cradle to grave" regulation over the generation, transportation, and disposal of hazardous waste. Therefore, owners and operators that treat, store, and dispose of hazardous waste must keep and maintain detailed records regarding handling of the waste. The government may institute criminal actions for violations of this law, and both the government and private citizens may bring civil actions.

Liability in Connection with Government Contracts

In 1986, the False Claims Act was amended to create a new directors and officers (D&O) exposure for treble damages in claims against directors and officers, as well as permit private citizens to bring what are known as qui tam suits on behalf of the U.S. government against anyone defrauding the U.S. government. Additionally, the 1986 amendments provide for (1) the reimbursement to the private citizen of reasonable attorney fees and costs and (2) the guaranteed payment to the private citizen of at least 15 percent of any judgment or settlement recovered by the government if the Department of Justice (DOJ) participates in the case (or 25–30 percent if the DOJ does not participate).

This Act was further amended in 2009, by the enactment of the Fraud Enforcement and Recovery Act, and in 2010, due to changes brought about by the Patient Protection and Affordable Care Act. These sets of changes had the general effect of expanding potential liability, broadening the definition of “claim,” and further equipping plaintiffs to overcome potential dismissals in court.

Any company doing business (or even loosely associated) with the U.S. government has potential exposure under the Act. Case in point, in March 2016, a multistate oncology firm agreed to pay upwards of $34 million to settle a qui tam suit brought by a former physicist who alleged that the company had defrauded the Medicare trust fund and taxpayers by utilizing a Gamma test that physicians were not properly trained to interpret.

Liability in Connection with Bribery of Foreign Officials

The Foreign Corrupt Practices Act of 1977 imposes criminal liability on directors and officers for illegal payments to foreign officials. For example, the Minister of Trade in Country A may demand an annual $50,000 payment from Corporation X in return for allowing Corporation X to ship its products into Country A. In the 1970s, an SEC investigation uncovered about 400 companies that had paid a combined $300 million on foreign bribes, with Lockheed Aircraft Corporation amongst the biggest offenders (Whistleblower Justice Network, “Birth of the FCPA: This Bribery is Positively Bananas”).

The law also mandates that corporations maintain detailed records of payments to foreign officials. Accordingly, courts have held directors and officers liable for the corporation’s failure to properly maintain such records.

The Walmart Case

In April 2012, *The* New York Times reported that a former Walmart executive alleged that the firm had paid millions of dollars to Mexican government officials in return for expediting the opening of new stores there ("With Wal-Mart Claims, Greater Attention on a Law," April 25, 2012). Although an internal investigation at Walmart was ongoing, a derivative claim was filed, which sought monetary damages, along with changes in the company's management controls and corporate governance procedures. The United States District Court for the Western District of Arkansas dismissed the claim in March of 2015.

Liability in Connection with Employment Laws

Employment-related claims are one of the fastest growing areas of litigation and an increasing source of claims against corporate directors and officers. Such claims include allegations that directors and officers violated laws prohibiting discrimination, wrongful termination, sexual harassment, retaliation, and other employment-specific acts. Employment-related claims do, however, constitute a much smaller exposure from a severity standpoint, comprising a far lower amount than, for example, claims alleging financial misconduct or acts involving mergers and acquisitions.

Coverage for Employment-Related Claims under Stand-Alone Policies

Employment-related claims are excluded under the vast majority of directors and officers liability policy forms. Therefore, most corporations purchase coverage for this exposure under either stand-alone employment practices liability (EPLI) policies or by means of what are known as management liability package policies. The latter policies cover employment-related exposures within a separate insuring agreement and also contain separate insuring agreements for directors and officers and fiduciary liability exposures, and sometimes for cyber and privacy claims. Accordingly, this course will not examine employment-related director/officer claim exposures in detail, since these types of claims are more often covered by EPLI rather than D&O liability policy forms. For more information on employment-related claims, refer to the “Employment Practices Liability Exposures and Insurance Coverage” course within the MLIS program, which treats this subject in depth.

Chapter 4 Review Questions

1. An unfair and anticompetitive business practice may violate any of the following federal acts EXCEPT:
   A. the Clayton Antitrust Act.
   B. the Federal Trade Commission Act of 1914.
   C. the Occupational Safety and Health Act.
   D. the Robinson-Patman Act of 1936.
2. None of the three pharmaceutical companies making zeta blocker pills have been profitable due to competition from the other two companies, and their shareholders are all angry. CEOs from these three companies hold a secret meeting at which they conspire to stop competing and hold their prices at a much higher and more profitable level. An agreement of this type violates the
   A. Foreign Corrupt Practices Act of 1977.
   B. Older Workers Benefit Protection Act of 1990.
   C. Racketeer Influenced and Corrupt Organizations Act.
   D. Sherman Antitrust Act.
3. Because the Metropolis Beavers were involved in a major athletic competition, the CEO of Tee Shirt, Inc., ordered his design staff to create a line of merchandise featuring the Beavers' logo. When the chief designer said she thought the Beavers' official logo could not be used without permission, the CEO said, "I just gave you permission." As a result of his decision,
   A. Tee Shirt, Inc., could be held liable for trademark infringement, but the CEO is shielded from liability.
   B. Tee Shirt, Inc., could be held liable for a copyright violation, but the CEO is shielded from liability.
   C. Tee Shirt, Inc., is protected by the Lanham Act, but the CEO is not.
   D. The CEO could be held personally liable for Tee Shirt, Inc.'s, trademark infringement.
4. To help attract and retain good workers, the directors and officers of Calvary Publishing Company provide a number of employee benefits. Which of the following benefits is not subject to regulation under the Employee Retirement Income Security Act of 1974 (ERISA)?
   A. 401(k) program
   B. Group health insurance
   C. Vacation policy
   D. Pension plan

5. Tucknip Plastic Surgery Clinic performs many liposuctions in which fat is suctioned from clients' waistlines. Tucknip always flushed the removed fat and other bodily tissue down the toilet until one of the doctor's daughters, an environmental engineering student, pointed out that bodily tissues are considered hazardous waste and are therefore subject to Resource Conservation and Recovery Act (RCRA) regulation. RCRA requires the clinic to keep and maintain detailed records concerning all the following EXCEPT:

    A. the disposal of hazardous waste.

    B. whose waists the material was removed from.

    C. the generation of hazardous waste.

    D. the transportation of hazardous waste.

Answers to Chapter 4 Review Questions

1.

   A. This answer is incorrect. The Clayton Antitrust Act prohibits anticompetitive business practices.

   B. This answer is incorrect. The Federal Trade Commission Act protects trade secrets.

   C. That's correct! The Occupational Safety and Health Act deals with hazardous workplace conditions.

   D. This answer is incorrect. The Robinson-Patman Act imposes penalties for predatory price-cutting and other actions taken to eliminate competition.

2.

   A. This answer is incorrect. The Foreign Corrupt Practices Act deals with the bribery of public officials.

   B. This answer is incorrect. It might be true that older workers are more likely than the young ones to take zeta blocker pills, but the Older Workers Benefit Protection Act deals with employment practices.

   C. This answer is incorrect. The Racketeer Influenced and Corrupt Organizations Act deals with matters such as securities fraud, mail fraud, bankruptcy fraud, obstruction of justice, and embezzlement.

   D. That's correct! The Sherman Antitrust Act prohibits conspiracies in restraint of trade.

3.

   A. This answer is incorrect. The CEO is not shielded.

   B. This answer is incorrect. This involves a trademark, not a copyright.

   C. This answer is incorrect. The Lanham Act protects the trademark owner, not a party that uses it without authorization.

   D. That's correct! The CEO was the moving force behind the sales of merchandise that infringed the Beavers' copyright.

4.

   A. This answer is incorrect. Fiduciaries who manage 401(k) plans are subject to ERISA.

   B. This answer is incorrect. Fiduciaries who manage group health plans are subject to ERISA.

   C. That's correct! Under ERISA, "the plan" over which directors and officers exercise discretionary authority or control refers to pension plans, 401(k) programs, and group health insurance. A typical vacation policy has no financial assets.

   D. This answer is incorrect. Fiduciaries who manage pension plans are subject to ERISA.

5.

   A. This answer is incorrect. RCRA requires detailed records regarding the disposal of hazardous waste.

   B. That's correct! RCRA imposes "cradle to grave" regulation requiring detailed records regarding the generation, transportation, and disposal of hazardous waste.

   C. This answer is incorrect. RCRA requires detailed records regarding the generation of hazardous waste.

   D. This answer is incorrect. RCRA requires detailed records regarding the transportation of hazardous waste.

Chapter 5
Primary Defenses to Directors and Officers and Corporate Liability

Overview

Chapter 5 sets forth the most common defenses when claims are made against directors and officers. These defenses can often reduce the extent of their liability and, depending upon the circumstances, completely absolve them of liability for damages sought by a plaintiff. These defenses include detailed, accurate minutes of board meetings; the business judgment rule; dissent; reliance; and ratification.

Chapter Objectives

On completion of this chapter, you should be able to

- recognize defenses a director can employ when charged with directors and officers (D&O) claims;
- recognize the effect of the business judgment rule; and
- identify preemptive steps a director or officer can take to prevent and/or defend against potential D&O claims, given appropriate information.

The Importance of Minutes at Board Meetings

The best defense to any claim of wrongdoing is that the director or officer did nothing wrong. Performance of a director's three basic duties of diligence, loyalty, and obedience will generally avoid claims of wrongdoing. To establish such performance, the directors will frequently need documentation or other proof of what was done, considered, reviewed, or rejected at board meetings. Accordingly, properly kept corporate minutes—documents that record the events taking place at board meetings—have high value. The careful, accurate, and complete preparation of such minutes can provide effective defenses against allegations of liability. On the other hand, board minutes that do not disclose what the directors knew or actually did are of little defensive value.

The Business Judgment Rule

The business judgment rule is a rule of evidence that is used as a defense when claims are made against corporate directors and officers. It creates a presumption that when the directors and officers made a business decision, they acted on an informed basis, in good faith, within their authority, and with the honest belief that the action taken was in the best interest of the company.

The Essence of the Business Judgment Rule: The Decision-Making Process

In a 2005 decision made in response to a claim against the directors and officers of the Walt Disney Company, the Delaware Chancery Court reaffirmed the court's reluctance to question corporate decisions in the absence of obvious malfeasance when it stated the following.

> … Should the Court apportion liability based on the *ultimate outcome* (emphasis added) of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimized risk, not maximized value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike.…

As evidenced by the court's statement, the essence of the business judgment rule is its attempt to encourage informed risk-taking by persons in charge of a corporation. Thus, unless it can be shown that the directors and officers clearly failed to exercise reasonable due diligence, they will generally not be held liable for the outcomes—even if unfavorable—of their decisions.

Preconditions for the Business Judgment Rule To Apply

Five preconditions must be present for the business judgment rule to be applicable and, thus, absolve directors and officers in the event it is alleged that a decision they made caused a loss to the corporation or to one or more shareholders. These preconditions are as follows.

- The directors made a *business decision* (i.e., the rule does not apply where directors either abdicate their functions or simply fail to act).
- The directors were *disinterested* (i.e., they had no personal stake) in the transaction or subject matter being decided.
- The directors were *informed* in making their decision.
- The directors acted in *good faith*.
- The directors' conduct was *not an abuse of discretion*.

Smith v. Van Gorkom: When the Business Judgment Rule Did Not Apply

The case of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), which was decided by the Delaware Supreme Court and also referred to as the TransUnion Case, provides a counter-example to the above-noted case study. The importance of the case lies in the fact that it offers a real-world illustration in which a court found that the business judgment rule did not apply to a decision made by a corporate board of directors.

The case involved a leveraged buyout of TransUnion by the Marmon Group, in which TransUnion's CEO, Jerome Van Gorkom, requested a per-share price of $55 for the company. However, in arriving at this price, Mr. Van Gorkom consulted only with TransUnion's CFO. In addition, during a 2-hour meeting, at which the offer was discussed, TransUnion's board of directors was not presented with any documents that explained the transaction and also did not receive a calculation as to how the valuation of the company was arrived at. (The merger was approved at a second board meeting.)

In a subsequent lawsuit brought by the plaintiff (Smith), who objected to the transaction, the Delaware Supreme Court ruled that the board had violated its duty of due care. The Court concluded that based on the CEO's failure to engage expert advice as to the organization's value, coupled with the board's hasty and less-than-fully-informed approval of the transaction, board members were therefore not entitled to the protection afforded by the business judgment rule in absolving it of liability for ratifying the merger.

Dissent

A director present at a board meeting usually will be presumed to have voted in favor of the board's action unless his or her dissent from the action is recorded in the minutes or is filed with the corporate secretary either during the meeting or within a reasonable time after its adjournment. On the other hand, absence from a meeting or abstaining from voting is generally not recognized as a defense.

If a director is uncomfortable with a board decision, the director should affirmatively dissent (if at the meeting) or express a dissent at the next meeting (if absent from the first meeting) and should be sure the dissent is recorded in the board minutes by name.

Reliance

Reliance upon qualified persons, such as officers, experts, consultants, board committees, and legal counsel, may be a defense if the reliance is in good faith and with the proper degree of care. In performing their duties, directors may rely on information, opinions, reports, or statements, including financial statements and other financial data prepared or presented by officers or employees of the corporation, legal counsel, public accountants, or other professionals, or a committee of the board. In relying on such sources, directors must act in good faith. However, they will not be considered to be acting in good faith if they have knowledge that would cause their reliance to be unwarranted. (For example, if they have knowledge that the conclusions of an expert, in his report, are erroneous, the directors and officers cannot rely on that report.) Moreover, directors may not abdicate their responsibilities and seek exoneration from liability merely by delegating authority to board committees or subordinates.

Ratification

Ratification by shareholders of board decisions, if made with full disclosure, may constitute a defense to an action against the directors. (For example, ratification may involve a vote by shareholders to accept a buy-out offer from another corporation at a specific price per share.)

Chapter 5 Review Questions

1. Noah Count, a director of the Endrun Corporation, has been accused of misusing corporate resources. Noah can best defend himself against this claim of wrongdoing by

    A. demonstrating bias on the part of Noah's accusers.

    B. demonstrating malicious intent on the part of his accusers.

    C. pleading guilty and accepting the consequences.

    D. proving that he did nothing wrong.

2. At a Magazine Corporation board meeting, outside director Bill Board strenuously protested a decision to do something that he considered illegal and unethical. However, he was overruled. Subsequently, the entire board is sued for breaching its duty of obedience. Bill Board can best prove he has done nothing wrong

    A. by disputing the corporate minutes of the board meeting.

    B. by establishing that the other directors exercised bad business judgment.

    C. if careful, complete, and accurate corporate minutes have been kept.

    D. if the duration of the relevant board meeting was accurately recorded in hours and minutes.

3. For months, the Barrier Corporation board had been exploring a proposal to move the company's manufacturing operation to Mexico. Some directors raised a concern that the tax treatment of offshore operations could become less favorable depending on the outcome of an upcoming national election. The directors discussed this concern at length and decided to accept the risks and proceed with the move. Less than a year later, a new administration took office and Barrier was penalized for its decision. In applying the business judgment rule to this situation, a court will likely find that

    A. The Barrier board exercised due judgment despite the unfavorable outcome of its decision.

    B. The Barrier board failed to exercise due judgment by underestimating the risks its decision involved.

    C. The Barrier board should have delayed acting on the offshoring proposal until after the election's results were known.

    D. The unfavorable outcome of its decision is ample evidence that the Barrier board acted inappropriately.

4. One of the directors at a Goldfish Corporation board meeting proposed that Goldfish purchase Guppy Company, a smaller company in the same industry that had just begun looking for a buyer. Another director immediately seconded the motion, and the purchase was approved without further discussion. After completing the deal, Goldfish discovered that it had also acquired Guppy's sizable debt. If a Goldfish shareholder makes a complaint against the board, a court is likely to find that the board violated its duty of

    A. due care.

    B. good faith.

    C. loyalty.

    D. obedience.

5. Bagel Bakery, Inc., finds it difficult to meet retailers' increasing demand for its product with its present baking facility, so corporate officers present a plan to increase capacity by buying another building and opening a second bakery. Most board members are in favor of the growth plan. Director Ida Noh, however, believes Bagel should instead raise its prices to maximize profits and limit demand to the capacity of its current facility. As a board member, she is concerned that she could be held accountable for contributing to a bad decision if the proposal is acted upon. The best way for Ida to defend herself against any such allegations is to

    A. attend the meeting but abstain from voting on the proposal.

    B. insist that minutes explicitly state that Ida Noh voted against the proposal.

    C. raise her hand and politely say "nay" when the vote is taken.

    D. stay away from the meeting at which the board will vote on the proposal.

Answers to Chapter 5 Review Questions

1.

   A. This answer is incorrect. This defense does not address the question whether the accusers' claims are valid.

   B. This answer is incorrect. Noah cannot vindicate himself by blaming his accusers.

   C. This answer is incorrect. An admission of wrongdoing is not a defense, but it might be the best strategy if Noah is guilty of the charges.

   D. That's correct! The best defense to any claim of wrongdoing is that the director or officer did nothing wrong.

2.

   A. This answer is incorrect. If the minutes accurately reflect Bill's position, there is no need for a dispute.

   B. This answer is incorrect. Bill's objective should be to establish his own good judgment.

   C. That's correct! Complete and accurate minutes would record not only the board's final decision, but also the directors' personal positions relative to the decision.

   D. This answer is incorrect. Minutes of a board meeting should record the events that take place at a meeting as well as the opening and closing time of the formal meeting.

3.

   A. That's correct! The business judgment rule attempts to encourage informed risk-taking. Unless it can be shown that the directors clearly failed to exercise reasonable due diligence, they will generally not be held liable for the outcomes—even if unfavorable—of their decisions.

   B. This answer is incorrect. The board identified the concern and discussed it at length.

   C. This answer is incorrect. The court is unlikely to second-guess the decision to proceed on a timely basis.

   D. This answer is incorrect. Any decision that involves risks faces the possibility of an unfavorable outcome, but that does not necessarily make it a bad decision.

4.

   A. That's correct! As in Smith v. Van Gorkom, the court is likely to conclude that the Goldfish board was not entitled to the protection afforded by the business judgment rule due to the board's hasty and uninformed approval of the transaction.

   B. This answer is incorrect. Though uninformed, the Goldfish board may have had the corporation's best interests in mind.

   C. This answer is incorrect. No evidence was given that the Goldfish directors failed to act with an undivided and unselfish loyalty to the corporation.

   D. This answer is incorrect. The Goldfish board presumably had authority to approve the acquisition.

5.

A. This answer is incorrect. If Ida is opposed to the proposition, she should vote against it, not abstain.

B. That's correct! A director is usually presumed to have voted in favor of a board action unless his or her dissent is recorded by name in the minutes or promptly recorded soon thereafter.

C. This answer is incorrect. Voting against the proposal is a good first step, but it will serve as a defense only if Ida's vote is recorded by name in the meeting's records.

D. This answer is incorrect. By absenting herself from the meeting at which she could have cast an opposing vote, Ida would, in effect, contribute to what she considers a bad decision.

Chapter 6
Securities Class Action Claims

Overview

Securities class actions are, by far, the type of claim in which the largest amount of damages is asserted against and paid by public company directors and officers. This chapter will describe the nature of these claims.

Chapter Objectives

On completion of this chapter you should be able to do the following.

- Distinguish between securities class action claims and other types of claims.
- Recognize factors that trigger securities class action claims.
- Identify legislation aimed at reducing or controlling class action abuses.
- Summarize relevant data concerning class action claims.

What Are Securities Class Action Claims?

Securities class action claims are brought by a publicly held corporation's shareholders. They are claims in which a large group of people collectively bring a claim to court. Such claims allege that specific actions (stated in lawsuit papers as "allegations") by a firm's directors and officers caused a loss in market value of the firm's securities.

Advantages of Class Action for Plaintiffs

Whenever more than a single person or organization suffers a loss associated with the acts of a corporation's directors and officers, there is a strong likelihood that they will file their claim in the form of a class action. The advantages of class action claims, from the standpoint of a plaintiff, include the fact that they (1) increase the efficiency of the legal process because they bring together many plaintiffs, all of whom have alleged the same wrongdoings, against the same persons/organizations; (2) lower the cost of litigation (on a per-defendant basis); and (3) provide incentive for people to seek legal redress in situations where their damages would otherwise have been too small to have brought a lawsuit. For example, an investor whose shares lost $10,000 in value probably could not find a lawyer to represent him or her. However, if 1,000 investors with similar losses banded together to file a class action, it would be easier to secure legal representation as a "class."

What Triggers a Securities Class Action Claim?

The immediate cause of most class action claims is the release to the public of negative financial data pertaining to a corporation's operations. These releases then produce heavy selling of the company's stock, which, in turn, causes a precipitous drop in the share price, ultimately resulting in a loss that is sustained by the organization's stockholders.

Securities Class Action Claims: A Typical Scenario

The following scenario depicts a typical sequence of events leading up to a securities class action claim. Assume that securities analysts have estimated that the XYZ Corporation will earn $2 per share during the quarter ending on March 31, 2016. When XYZ reports its actual earnings to the Securities and Exchange Commission (SEC) on April 21, instead of a $2 per share profit, it reveals a loss of $1 per share. This announcement of an "earnings miss" causes the company's share price to drop from $42 to $28 that day. As a result, a group of XYZ's shareholders file a class action lawsuit. The shareholders allege that the company's directors and officers have mismanaged the firm, a fact that is responsible for the $1 per share earnings loss. Based on the fact that 50 million shares of stock are outstanding, the lawsuit alleges a loss of $700 million, which represents the diminution in market value of all outstanding shares (50 million x $14 ($42 – $28)). Given this calculation, the magnitude of damages claimed in securities litigation becomes apparent. The damages computed here are quite typical of those claimed in class action claims involving the shares of large publicly traded companies.

What Specific Actions Give Rise to Securities Class Action Claims?

The *immediate trigger* to most securities class action claims is a precipitous drop in a firm's stock price, as illustrated above. However, it is important to understand that securities class actions are the *legal form* in which many claims, and by far the *largest* ones, are made against corporate directors and officers, rather than the *cause of action* (i.e., the specific action or circumstance that gives rise to the claim). Chapter 7 of this course lists and describes five specific circumstances that most commonly give rise to securities class action claims.

The Private Securities Litigation Reform Act: Reducing Class Action Abuses

The Private Securities Litigation Reform Act (PSLRA) of 1995 was intended to eliminate many of the abusive practices associated with securities class action lawsuits. As will be explained below, starting around 1990, a number of plaintiffs' lawyers began devising and using highly questionable methods of bringing securities class action claims against major corporations.

Anatomy of a "Shakedown": How Many Class Action Lawsuits Originated

Among the most prominent of such abuses involved securities class action lawsuits instigated by a handful of law firms—most notably the law firm of Milberg Weiss. Such firms arranged for various individuals (often referred to as "professional plaintiffs") to purchase small amounts of shares in a number of large, publicly traded corporations. The firms then set up special departments that closely tracked the hour-by-hour fluctuations in the share prices of these companies' stocks. Whenever a share price dropped significantly (e.g., more than 10 percent) during a short period of time (e.g., less than a week), the professional plaintiffs brought securities class action lawsuits against the directors and officers of the affected corporations. The plaintiffs asserted that specific acts of the directors and officers caused the stocks of these companies to lose value, a loss that was ultimately sustained by the company's shareholders.

The essence of the scheme was to quickly bring suit immediately after a drop in a company's stock. This is because the individual who was first to file such a securities class action lawsuit was designated as the "lead plaintiff," and the law firm representing the lead plaintiff was legally entitled to represent the entire "class" of shareholders in the claim. This ruse allowed Milberg Weiss to collect huge fees when claims were settled against major corporations, despite the fact that its group of professional plaintiffs represented a tiny fraction of the corporations' actual shareholders.

Eventually, it was revealed that Milberg Weiss illegally paid significant sums to certain individuals to serve as "professional plaintiffs" so that Milberg Weiss would have the "inside track" in being able to serve as lead counsel when a class action claim was brought. Several former partners in the firm received jail sentences for their offenses.

Specific PSLRA Reforms

The most important change implemented by the PSLRA was that it limited the frequency with which "professional plaintiffs" could serve as "lead plaintiff" to no more than 5 times in 3 years. The law also placed restrictions on the extent to which law firms that were the first to file claims received the right to represent the entire class of shareholders merely because they won the so-called race to the courthouse, as the Milberg Weiss law firm so often did.

Results of PSLRA

Unfortunately, abuses associated with securities class action lawsuits still remain. Furthermore, the PSLRA has generally not reduced either the long-term frequency or severity of such claims. Rather, it has unexpectedly produced even higher *settlement amounts* in securities class action claims.

The Class Action Fairness Act of 2005: Another Attempt To Control Class Actions

The Class Action Fairness Act (CAFA) of 2005, which expanded federal jurisdiction over securities and other class action lawsuits, represented a second attempt to control the abuses associated with these types of claims. Business groups and tort reform advocates lobbied for the legislation, asserting that it was essential to prevent class action lawsuit abuse.

Goals of CAFA

CAFA attempted to achieve three key goals, as discussed below.

Reduction in the Number of Claims

By requiring most class actions to be heard in federal rather than state courts, CAFA advocates foresaw a reduction in the number of securities class actions. This is because federal courts have historically been much more stringent than state courts in granting plaintiffs' class certification motions.

Reduction of Forum Shopping

Proponents of CAFA argue that in certain problematic jurisdictions, juries were accustomed to awarding astronomical sums that far exceeded actual damages.

Greater Federal Scrutiny over Settlements

CAFA advocates sought to reign in what they considered the excessive fees often garnered by plaintiff's attorneys. In some cases, these fees exceeded the amount of the actual monetary relief received by the class action plaintiffs themselves.

Basic Provisions

CAFA gives federal courts, rather than state courts, jurisdiction over certain class actions.

- in which the amount in controversy exceeds $5 million
- where any of the members of a class of plaintiffs is a citizen of a state different from any defendant

The practical effect of these provisions was that as a result of CAFA's enactment, the vast majority of securities class action claims are now tried in federal, rather than state, courts. This is because virtually all such claims involve damages far exceeding $5 million, and because it is rare for such claims not to involve at least one plaintiff whose state of residence differs from the state of incorporation of the corporation being sued.

CAFA also contains a provision giving courts greater scrutiny over class action settlements, especially coupon settlements. This provision was important because prior to CAFA, many settlements resulted in the distribution of product "coupons," entitling plaintiffs to receive free merchandise produced by the corporation being sued rather than cash. In contrast, the attorneys who brought such claims received substantial cash fees. For example, there have been incidences where the attorneys' fees exceeded the monetary award to class members. The class members actually lost money because their attorney's fees were paid from the monies the plaintiffs received from the settlement! (Coupons are not prohibited as a result of CAFA, although it does indicate that the value of such coupons must be reasonable, given the facts of the case and the losses sustained by the investors.)

Impact

As reported in April 2008 by the Federal Judicial Center, in the last of four interim reports on CAFA's impact, the Act quickly resulted in a 72 percent increase in class action activity at the district court level ("Impact of CAFA on the Federal Courts: Fourth Interim Report," Federal Judicial Center, April 2008). Moreover, online legal solution provider WORLD Law Direct has reported that many plaintiffs now attempt to engage in forum shopping at the federal circuit level by asking courts to "apply the laws of a single state to a diversity class action lawsuit" ("Class Action Fairness Act's Impact Internationally," Daniela Levett). Additionally, plaintiffs have utilized creative "class splitting" methods to remain at the state level, thereby countering some of CAFA's intended effects.

The years following the above reports have continued to highlight the difficulty of limiting securities class actions. According to a January 2016 report from NERA Economic Consulting titled "Recent Trends in Securities Class Action Litigation: 2015 Full-Year Review," securities class action lawsuit filings in 2015 reached their highest level since 2008.

Securities Class Action Claim Data

This section provides a brief recap of securities class action claim and settlement data since 1997.

The Correlation between Claim Filings and the Industry Sector

Exhibit 6.1 indicates the extent to which securities class action claims are correlated with specific industries. For example, in 2008, over one-half of all new claim filings were made against firms in the financial sector. In 2013, telecommunication and information technology companies faced significantly more new filings than other industries. Contrast this with 2002, a year in which utilities firms were the most prominent securities class action target, a fact indicating that not only Enron, but more than one-third of the companies operating within this sector were also sued.

Exhibit 6.1
Securities Class Action Claims Correlated to Specific Industries

	Average 2000–2013	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Consumer Discretionary	**6.4%**	6.5%	1.3%	24.7%	2.0%	7.9%	5.7%	8.9%	4.4%	7.2%	1.9%	4.9%	4.6%	1.6%	4.4%	2.5%
Consumer Staples	**5.0%**	34.5%	6.3%	0.3%	2.3%	0.1%	11.4%	0.8%	0.0%	2.6%	3.9%	0.0%	0.8%	14.0%	0.0%	3.4%
Energy/Materials	**2.3%**	3.0%	0.0%	1.2%	0.4%	29.7%	1.6%	0.0%	0.0%	0.0%	0.8%	5.5%	0.0%	0.9%	0.0%	0.2%
Financials	**20.4%**	3.3%	0.8%	29.2%	19.9%	46.1%	22.2%	8.2%	18.1%	55.0%	38.3%	31.1%	6.9%	11.0%	0.0%	0.3%
Health Care	**14.9%**	11.0%	5.4%	35.2%	16.3%	24.1%	10.1%	18.1%	22.5%	20.0%	1.7%	33.7%	0.7%	3.8%	4.4%	3.0%
Industrials	**6.4%**	3.9%	0.0%	13.3%	4.6%	8.8%	5.6%	0.0%	2.2%	26.4%	23.2%	0.0%	2.1%	1.2%	0.0%	1.7%
Telecommunications/ Information Tech	**10.0%**	15.0%	32.6%	9.1%	1.7%	1.2%	10.3%	8.3%	3.4%	1.4%	0.3%	5.9%	13.4%	2.2%	16.6%	0.0%
Utilities	**7.6%**	5.6%	17.4%	51.0%	4.3%	4.8%	5.6%	0.0%	5.5%	4.0%	0.0%	0.0%	5.6%	6.8%	0.0%	0.7%
All S&P 500 Companies	**10.1%**	**11.1%**	**10.9%**	**18.8%**	**8.0%**	**17.7%**	**10.7%**	**6.7%**	**8.2%**	**16.2%**	**8.6%**	**11.2%**	**5.1%**	**4.9%**	**4.7%**	**1.3%**

Legend 0% 0–5% 5–15% 15–25% 25%+

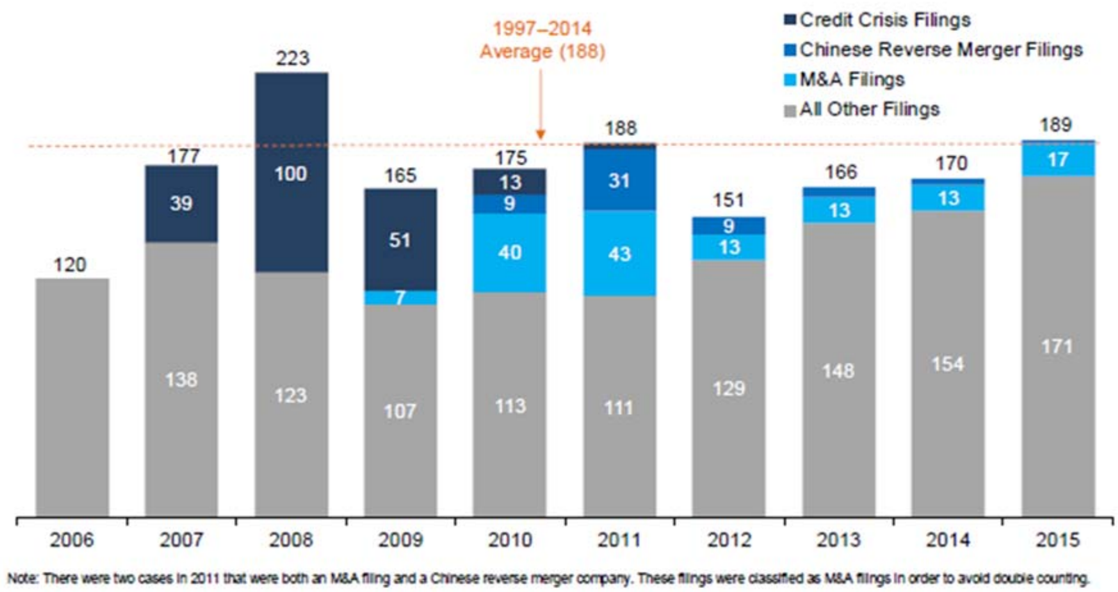
Note:
1. The chart is based on the market capitalizations of the S&P 500 companies as of the last trading day of the previous year. If the market capitalization on the last trading day is not available, the average fourth-quarter market capitalization is used.
2. Sectors are based on the Global Industry Classification Standard (GICS). The Energy and Materials sectors and the Telecommunications and Information Technology sectors appear separately but are combined for the purposes of this analysis.
3. Percentage of Market Capitalization Subject to New Filings equals the total market capitalization of companies subject to new securities class action filings in federal courts in each sector divided by the total market capitalization of all companies in that sector.

Source: Cornerstone Research, "Securities Class Action Filings: 2014 Year in Review."

Historical Class Action Claim Filing Data

Exhibit 6.2 below provides a recap of overall class action claim filings from 2006 through 2015. In 2008, as expected, there was a huge spike in filings against companies in the finance sector. Specifically, nearly 50 percent of all filings were against a company in the finance sector. Also of note is the decrease in mergers and acquisitions filings in the period between 2010 and 2015.

Exhibit 6.2
Securities Class Action Claim Filings Since 1996



Class Action Filings Index (CAF IndexTM) is the count of class action filings during a period.

Source: Cornerstone Research, "Securities Class Action Filings: 2015 Year in Review."

Exhibit 6.3 below contains a list of the 10 largest class action claims of all time, as of the end of 2013.

Exhibit 6.3
Top 10 Shareholder Class Action Settlements

Ranking	Company	Year	Total Settlement (in millions)
1.	Enron Corp.	2010	$7,242
2.	WorldCom, Inc.	2005	$6,196
3.	Cendant Corp.	2000	$3,692
4.	Tyco International, Ltd.	2007	$3,200
5.	In re AOL Time Warner, Inc.	2006	$2,650
6.	Bank of America Corp.	2013	$2,425
7.	Nortel Networks (I)	2006	$1,143
8.	Royal Ahold, NV	2006	$1,100
9.	Nortel Networks (II)	2006	$1,074
10.	McKesson HBOC, Inc.	2008	$1,043

Source: NERA Economic Consulting, "Recent Trends in Securities Class Action Litigation: 2013 Full-Year Review."

Chapter 6 Review Questions

1. Domino Corporation directors and officers have just learned that they are the defendants in a securities class action claim, which alleges that the directors' and officers' recent actions

   A. caused the market value of their publicly held securities to drop.

   B. contributed to global warming.

   C. violated federal law.

   D. were unnecessarily risky and increased the possibility of an uninsured loss.

2. With the aid of her attorney, Sue Sallot became adept at buying stocks whose value was likely to decrease. Following a major drop in the price per share, Sue would then become the lead plaintiff in a class action lawsuit against directors and officers of the firm that issued the stock. When she attempted to file her sixth such suit within a 2-year period, she learned that her suit was prohibited by the

   A. Bar Association Code of Professional Conduct.

   B. Marlborough-Newport Act of 2002.

   C. Milberg-Weiss Act.

   D. Private Securities Litigation Reform Act (PSLRA) of 1995.

3. To date, 10 gladiators in Rome, Georgia, and Rome, New York, have been injured by swords produced by King Arthur Swords, Inc., which is located in Las Vegas, Nevada. Alleging that King Arthur Swords's directors and officers had approved the swords' unsafe design, the gladiators decide to file a class action suit against King Arthur's directors and officers seeking $10 million in damages. The Class Action Fairness Act of 2005 requires that this suit be filed in

   A. either Georgia or New York.

   B. federal court.

   C. Las Vegas.

   D. Nevada state court.

4. Over the past dozen or so years, the largest number of class action claim filings took place in

   A. 2008.

   B. 2010.

   C. 2012.

   D. 2014.

5. As of 2013, which of the following companies had experienced the largest total shareholder class settlement to date?

   A. AOL Time Warner, Inc.

   B. Cendant Corp.

   C. Enron Corp.

   D. WorldCom, Inc.

Answers to Chapter 6 Review Questions

1.

   A. That's correct! Securities class action claims allege that specific actions by a firm's directors and officers caused a loss in market value of the firm's securities.

   B. This answer is incorrect. A securities class action suit is concerned with financial matters.

   C. This answer is incorrect. A violation of federal law would not lead to a class action suit, per se.

   D. This answer is incorrect. Taking risks does not harm shareholders unless there are consequences. In fact, shareholders often benefit from the rewards that accompany risky ventures.

2.

   A. This answer is incorrect. The bar association would be interested in the conduct of Sue's attorney.

   B. This answer is incorrect. This cigarette act does not exist.

   C. This answer is incorrect. Milberg Weiss is a law firm.

   D. That's correct! By limiting the frequency with which "professional plaintiffs" could serve as lead plaintiffs, among other provisions, PSLRA was intended to eliminate many abuses associated with securities class action lawsuits.

3.

   A. This answer is incorrect. Filing the claim in one of the gladiator's states might not well serve the interests of King Arthur Swords, which is located in Nevada.

   B. That's correct! For class action claims over $5 million where any plaintiff is a citizen of a different state from the defendant, the claim must be filed in a federal court.

   C. This answer is incorrect. By filing the claim in Las Vegas, King Arthur Swords might gamble that courts might be favorable to a home-town business; this would be against the plaintiffs' best interests.

   D. This answer is incorrect. None of the plaintiffs are from Nevada.

4.

   A. That's correct! In 2008, more than half of the 223 class action claim filings were made against the financial sector.

   B. This answer is incorrect. 175 filings were made in 2010.

   C. This answer is incorrect. 151 filings were made in 2012.

   D. This answer is incorrect. 170 filings were made in 2014.

5.

   A. This answer is incorrect. AOL Time Warner's settlement was the 5th largest.

   B. This answer is incorrect. Cendant's settlement was the 3rd largest.

   C. That's correct! Enron's total settlement, exceeding $7.2 billion, has the dubious honor of being the largest to date.

   D. This answer is incorrect. With a more than $6 billion settlement, WorldCom, Inc., had the questionable privilege of coming in second.

Chapter 7
Specific Situations Giving Rise to Securities Class Action Claims

Overview

Chapter 7 will discuss four specific situations that can give rise to claims against corporate directors and officers. These include claims from (1) financial restatements, (2) initial public offerings (IPOs), (3) change-of-control situations, and (4) stock option backdating.

Chapter Objectives

On completion of this chapter, you should be able to do the following.

1. Recognize the meaning of terms and phrases such as financial reinstatement, IPO, change-of-control situations, and stock option backdating
2. Recognize the exposures associated with financial reinstatements, IPOs, change-of-control situations, and stock option backdating

Financial Restatement Claims

Claims associated with financial restatements are a substantial exposure faced by corporate directors and officers. Such claims typically result when there is material adjustment to a corporate financial statement that affects the cumulative results of operations during past years. Usually, a financial restatement takes the form of a revision to a corporation's past operating results that are significantly less favorable than those originally reported (e.g., a company might reveal that instead of making $22 million in the just-ended fiscal year, as originally reported, it actually lost $12 million). Most often, the announcement of a restatement triggers a massive sell-off of the company's stock, thereby causing investors to suffer a severe loss. The investors then bring a claim against the company's directors and officers.

Notable Financial Restatements

A number of major public corporations have issued restatements, which have, in turn, prompted dramatic sell-offs of the organizations' shares of stock, ultimately triggering claims against the firms' directors and officers in many cases.

- In February 2006, the Securities and Exchange Commission (SEC) announced that American International Group, Inc. (AIG), would pay $800 million to settle securities fraud charges, in which it was alleged that various reinsurance transactions (among other types of transactions) had falsely inflated AIG's loss reserves by $500 million. As a result of AIG's restatement in 2004 (due to the investigation), shareholder equity was reduced by $2.26 billion.
- In the case of WorldCom, routine business expenses were hidden by improperly claiming them as long-term investments. According to experts who later examined WorldCom's books, even a routine audit would have uncovered such practices, which inflated the firm's profits by $4 billion in 2001 and part of 2002.

- In early 2016, shares of Valeant Pharmaceuticals International, Inc., lost more than half of their value when the company announced that it would be restating revenues from fiscal year 2014, which had been exaggerated by about $58 million (with a subsequent impact of $0.09 on earnings per share).
- In the case of Enron, which filed for bankruptcy protection in December 2001, its regular auditors at Arthur Andersen were aware of possible fraudulent practices but failed to act aggressively on such information.

Two key questions should be asked in conjunction with any financial restatement.

- What events caused the need for a restatement?
- What kinds of accounting errors and irregularities caused the restatement?

What Events Cause the Need for Restatements?

A number of specific events have most often given rise to corporate financial restatements, including the following. It is important to note that the frequency of these circumstances typically has an inverse relationship with overall stock market performance. A down market produces more of these events, while a bullish market will typically produce less.

- Audit exceptions revealed by independent auditors (An "exception" in an audit occurs when an auditor disagrees with the accounting treatment of a certain item, such as when a company has booked merchandise shipped to dealers as "final sales" even though unsold merchandise can be returned for full credit.)
- Incumbent or, in some instances, new management's discovery of financial improprieties
- Whistleblower's reporting (internal or external) of major financial irregularities
- SEC inquiry, either by the Division of Corporation Finance or the Division of Enforcement
- Due diligence review, usually conducted in conjunction with mergers or acquisitions
- Internal corporate investigations (often associated with one or more of the foregoing situations)

What Kinds of Accounting Errors and Irregularities Cause Restatements?

The following categories of accounting errors and irregularities cause restatements.

Revenue Recognition

A majority of restatement claims involve matters of revenue recognition. Such issues can range from the intentional, fraudulent recording of fictitious sales to more subtle situations involving the timing of sales bookings.

Asset Overstatement

Such situations involve the overvaluing of inventory, fixed assets, and often intangibles, which are inherently difficult to value, such as goodwill, trademarks, and patents.

Restructuring Charges

When a company closes a division of its business, such as a large manufacturing plant, there will ordinarily be significant costs associated with such actions, including (but not limited to) severance payments to workers. However, the extent of such charges is sometimes either deliberately or negligently understated, thus increasing a corporation's earnings (or reducing its losses).

Accounting for Business Combinations

This often occurs when a company purchases another company and the buyer either overvalues the assets of the entity it has purchased or understates the extent of the new liabilities, such as potential payments that the new company may be obligated to make in conjunction with lawsuits that have been filed against the newly acquired entity.

Understatement of Liabilities or Asset Impairments

Most often, this takes the form of failure to record contingencies that are both likely to occur and relatively easy to value, such as uninsured litigation in which a settlement date is near. Understatement of liabilities can also take the form of failure to reflect the impairment of assets, such as overvaluing uncollectible receivables, failing to write off obsolete inventory, or neglecting to report an upcoming federal or state tax payment.

Creation and Misuse of Impermissible Reserves

These are also known as "cookie jar reserves," the sole purpose of which is to "manage" or "smooth" earnings so that a corporation will be able to report steady quarter-to-quarter growth, despite the lack of profit from genuine business operations.

IPO-Related Claims

IPO-related claims allege various types of wrongdoing in conjunction with the way in which investment bankers or securities underwriters sold shares of stock in the IPO to investors. Such claims were prevalent during the late 1990s and early 2000s when the demand for shares in companies making IPOs was especially strong, mainly because the U.S. economy was growing rapidly. This environment, combined with a rising stock market, made IPOs a ready source of profit for investors. While IPO-related claims experienced a downturn from about 2008 to 2012, the subsequent period from 2013 to 2015 saw a rise both in number of completed IPOs and IPO-related lawsuits, as reported in Kevin LaCroix's December 2, 2015, article in *The D&O Diary* ("2015 YTD Securities Suit Filings Reflect Increased Numbers of IPO-Related Lawsuits").

How Does an IPO Work?

Assume that Company X seeks to raise $100 million to expand its operations. One means of doing so is to sell shares of Company X to the public. To accomplish this, Company X could retain the services of an investment banker. The banker would make the arrangements required to sell the firm's shares to the public, in return for which the investment banker receives a commission of 10–20 percent of the proceeds that were raised in the process. Buyers in the open market typically include a variety of mutual funds, banks, pension funds, insurance companies, brokerage houses, corporations, and individual investors.

Claims from "Change-of-Control" Situations

Directors and officers are exposed to claims in change-of-control situations (e.g., when one company is purchased by another company) because there is generally an inherent conflict of interest between and among (1) their duty to shareholders to ensure that they receive a fair and maximum price for their shares, (2) their duty to the corporation to protect its best interests as a corporate entity, and (3) their self-serving interest of preserving their own personal jobs and security.

The Typical Change-of-Control Claim Scenario

When one or more offers are made to acquire a corporation, directors have the obligation of seeking the transaction offering the highest available price to the shareholders. But given these inherent conflicts, virtually any decision reached by corporate managers involving a change-of-control situation may be subject to attack as an alleged violation of the fiduciary duties of the directors. This is because the corporate directors and officers will be inclined to reject all offers, no matter how favorable for stockholders, because they are likely to lose their jobs as a result of the buyout.

Frequent Claimants

Accordingly, directors and officers frequently become targets of litigation when someone becomes dissatisfied with his or her response to a bid. Depending on the nature of the bid and the board's reaction to it, potential plaintiffs may include shareholders of the corporation, the persons or entity making the bid, creditors, and regulatory agencies. According to some estimates, 1 out of 3 directors and officers liability claims are related to mergers and acquisitions.

Types of Claims Made against Directors and Officers in Change-of-Control Situations

The primary allegations against directors of the target company (i.e., the company being acquired) and, to a lesser extent, directors of the acquiring company, include the following.

Resistance to Hostile Takeovers

Directors of a target company who resist a hostile takeover attempt can still be quite vulnerable to legal attack. Disgruntled shareholders often allege that the directors breached their fiduciary duty by resisting the takeover proposal, thereby denying the shareholders the opportunity to sell their shares at the offer price, which is almost always significantly higher than the price at which the stock is trading on the various exchanges. The amount of recoverable damages and/or settlement amount in such a claim can be enormous.

Approval of Friendly Takeovers

Shareholders frequently sue the directors of the company being acquired, alleging that the directors failed to make an informed decision regarding the adequacy of the purchase price. Similarly, it can be alleged that the directors failed to "shop" the company to other potential buyers who would have offered an even higher per-share price. These cases are typically less severe than the hostile takeover case (above), since the potential recoverable damages are usually much less. Shareholders in this type of litigation frequently seek a "bump-up" in the purchase price.

For example, Company A was sold to Company B for $80 per share. However, A's shareholders allege that A is really worth $100 per share. Thus, A's shareholders would seek damages of $20 per share in this case: the difference between their own $100 per share opinion as to the share's value and the actual $80 sale price.

Preacquisition Mismanagement

After a company is acquired, the new owners and their appointed managers may determine that the directors and officers of the acquired company mismanaged the company prior to the acquisition. As a result, they may sue the prior directors and officers for the injury caused to the company. For example, after acquiring Company A, Company B may discover that Company A's customer base is highly dissatisfied with A's product or service, a fact that Company A deliberately concealed during acquisition negotiations. As a result, four major accounts, comprising 25 percent of A's sales, cease to do business with A within 6 months after the acquisition.

These claims are not common because the acquiring company typically conducts a thorough due diligence investigation before agreeing to purchase the company. However, this type of claim is brought occasionally and is particularly problematic for the defendant directors and officers since they no longer control the company, its indemnification policies, or its insurance programs.

Failure To Disclose

Change-of-control activity can result in class action securities lawsuits against the directors and officers of the acquired company, alleging that they did not accurately, completely, or timely disclose the existence of their negotiations or other related material information about the transaction. Courts have refused to articulate a bright-line rule for determining when such negotiations must be publicly disclosed. Directors and officers are thus placed in a dilemma of not wanting to disclose the existence and terms of the negotiations either prematurely or delinquently.

Early Disclosure

If disclosure is too early and the transaction does not occur as disclosed, shareholders who purchased stock after the disclosure will allege they were injured because the defendants artificially inflated the stock price by the premature disclosure.

Late Disclosure

If disclosure is too late, shareholders who sold their stock prior to the disclosure will allege that they were injured because they sold their stock prior to the large price increase following the merger announcement.

The disclosure exposure exists with respect to directors and officers of both the target company and the acquiring company.

Disclosure-Only Settlements

Another issue related to disclosures is that of disclosure-only settlements, in which a lawsuit accompanying a merger and acquisition transaction is settled by way of the defendant board of directors agreeing to amend its proxy statement and/or tender offer disclosures with additional disclosures. In exchange for providing these additional disclosures, the defendant board of directors is released from any claims.

The Harvard Law School Forum on Corporate Governance and Financial Regulation has described this tactic as “nuisance litigation” and as a way for plaintiff attorneys to receive “attorneys’ fees for minimal effort,” with the strategy playing a significant role in the vast majority of change-of-control transactions resulting in litigation (“Top M&A Developments and Trends for 2016”, Barbara L. Borden, February 11, 2016). Beginning in 2015, the Delaware Court of Chancery took steps towards abating the disclosure-only settlement trend by applying greater scrutiny to attorneys’ fees resulting from these types of settlements, but the potential for these types of settlements and other creative plaintiff strategies remains, especially in other jurisdictions.

Mismanagement (Following the Acquisition)

Directors and officers of the acquiring company can also incur liability in connection with their management after the acquisition. This exposure has proven particularly problematic when the acquisition is part of a diversification program of the acquiring company, since directors and officers of the acquiring company frequently have little experience in managing a company in a completely new industry or market.

Claims from “Option Backdating”

During the spring of 2006 and continuing through the remainder of the year, a number of claims alleging illegal backdating of stock options were made against the directors and officers of numerous corporations. Like IPO-related claims discussed earlier in this chapter, a large number of claims produced by illegal stock option backdating practices were made in a relatively brief period of time (i.e., the second half of 2006 and early 2007), a phenomenon that has not been repeated since. As of February 1, 2009, approximately 33 option backdating–related claims have been made. However, an abundance of such claims, given the prevalence of option-related compensation of directors and officers, might reemerge at some point, and for that reason, the subject merits discussion.

What Are "Stock Options"?

Stock options give an individual the right to purchase shares of stock in a corporation at a specified price usually, but not always, on or before a specified date. Stock options are routinely offered as part of a compensation package to corporate officers and directors (and sometimes to employees) as a means of providing them with added incentive to improve the firm's profitability, which, in theory at least, will boost the market price of the corporation's stock.

An Example

Typically, a board of directors will "price" an option at the market price of the stock on the day the option is granted. For example, a CEO receives a 2-year grant of 100,000 options on January 1, 2020, a date on which the company's shares are selling for $25 per share. This gives the CEO the right to purchase 100,000 shares of the company's stock on or before January 1, 2022, for $25 per share. If the CEO exercises the option when the shares are selling for $35 per share, he or she will realize a per-share profit of $10 ($35 market price minus $25 option price) and a total profit of $1 million (100,000 shares multiplied by $10).

The purpose of such arrangements is to incentivize the CEO to increase the company's share price. Conversely, it also lays the foundation for earnings manipulation in an attempt to inflate the company's stock price.

What Is "Backdating"?

Backdating occurs when the grant date for an award is set at an earlier date and at a lower exercise price than the one on which the option is actually granted. So in the above example, backdating would occur if, on January 1, 2020, the CEO was given a 4-year option grant that covered the period from January 1, 2018, to January 1, 2022. But in this situation, the market price of the stock was $15 on January 1, 2018, a fact that would allow the CEO to purchase the stock at $15, rather than the current $25 share price. As a result, the CEO's profit, assuming he or she exercised the option on January 1, 2022, when the stock was selling for $35, would be $2 million ($35 share price - $15 exercise price x 100,000 shares), as opposed to $1 million as in the above example.

Backdating "Per Se" Is Not Illegal

One key point regarding backdating is that, by itself, the type of option backdating noted in the above example is not against the law. Rather, what *is* illegal and what has triggered investigations and lawsuits was the fact that a number of companies (1) did not disclose such practices to shareholders and the general public and, in some instances, (2) director and officer recipients of options did not pay the requisite taxes on them.

In contrast, the kinds of option practices noted below are clearly illegal.

"Spring-loading": A Controversial and Illegal Form of Option Backdating

An even more controversial and usually illegal form of backdating is known as "spring-loading." There are two types of spring-loading.

Granting an Option Just Prior to Favorable News

One type of spring-loading occurs when an option is granted just prior to the announcement of positive corporate news. The expectation under such circumstances is that the news will boost the company's share price and, therefore, the value of the option grant. For example, assume that Company X is expected to announce its first quarter earnings on April 20. Although securities analysts expect Company X to earn $1 per share, on April 18, Company X's comptroller tells Company X's CEO, "This was a blow-out quarter. We're looking at earnings of $2.50 per share." With this knowledge, Company X's CEO calls an emergency meeting of the firm's board of directors, at which he requests the company's directors to grant him an option to sell 1 million shares of stock, exercisable any time within the next year. On April 20, immediately after the earnings announcement, Company X's share price soars to from $25 to $45, and the next day, the CEO exercises his option, selling his shares at $45 each and garnering a 1-day profit of $20 million ($45 – $25 = $20 share price rise x 1 million shares owned = $20 million).

Granting an Option Just after Negative News

Another type of spring-loading is to make an option grant immediately after the release of especially negative news that has adversely impacted a company's share price. This has the effect of issuing the grant at an artificially low price from which the stock is expected to bounce back relatively quickly, ultimately increasing the total profit that can be realized. For example, assume the reverse of the above situation, whereby quarterly earnings are expected to be $2.50, yet company insiders know that they will report earnings of just $1. In this instance, the expectation is that the earnings "miss" will cause the stock to drop, but since there are no other negative issues facing the company, the share price is expected to recover relatively quickly. So in this case, assuming the negative announcement causes Company X's stock to drop from $25 to $15, after the announcement, the CEO could seek an options grant of 1 million shares at a price of $15, knowing that the stock will rebound within the next year or so, therefore increasing his chances of realizing a profit on the eventual sale.

In order to discourage the two types of spring-loading discussed above, many companies limit directors and officers to a period of time known as a "trading window" (e.g. a 10-day period shortly following the release of earnings for a given fiscal period) during which they are able to trade company securities. While some companies restrict both purchases and sales outside of the trading window, others restrict only sales and permit purchases.

Chapter 7 Review Questions

1. After Kreisler Corporation closed its Neon Lite plant, its financial records understated the costs of providing the severance pay to which Kreisler's laid-off workers were entitled. This understatement
   A. caused Kreisler to overstate its actual earnings (or understate its actual losses).
   B. is an example of asset overstatement.
   C. is appropriate because severance benefits will be paid over time.
   D. is unlikely to lead to a financial restatement.
2. Buff Warrant, a wealthy investor, purchased the maximum number of shares of Ytech's initial public offering (IPO) that the investment banker would permit. He later learned that other investors who paid the banker an additional "commission" under the table had been permitted to purchase larger stakes in Ytech. Warrant's suit against Ytech's directors and officers will most likely allege that
   A. a conflict of interest existed between corporate directors and officers and the investment banker.
   B. the board had engaged in an illegal laddering arrangement.
   C. the IPO involved an inappropriate tie-in agreement.
   D. the IPO prospectus was misleading because it failed to accurately disclose the investment banker's true commissions.
3. Because the directors and officers of Puddle Company resist a Sponge Corporation offer to absorb Puddle Company, the directors and officers may find themselves defendants in a lawsuit brought by any of the following plaintiffs EXCEPT:
   A. Pond Corporation, Puddle's main competitor.
   B. Puddle Company's bondholders.
   C. Puddle Company's stockholders.
   D. Sponge Corporation.
4. Old Woman, Inc., thoroughly investigated Fly Company before proceeding to acquire it. Problems ensued after Old Woman swallowed Fly and discovered a number of previously concealed management issues. Old Woman contacts its law firm, Spider and Bird, who initiate legal action against Fly's former directors and officers for their alleged mismanagement. This claim is problematic for the defendants for all the following reasons EXCEPT:
   A. they no longer control the company.
   B. they no longer control the company's indemnification policies.
   C. they no longer control the company's insurance program.
   D. they no longer mismanage the company.

5. Candy-Barr Company sweetened its officer compensation package and encouraged the officers' efforts to increase shareholder value by granting each officer a right to purchase 1,000 shares of stock at $200/share (the market price 2 years ago) at any time during the next 3 years. The stock currently trades at $250/share. In connection with this package, which of the following activities is illegal?

   A. Backdating stock options

   B. Exercising a stock option and paying tax on the income

   C. Concealing this option from shareholders or the general public

   D. Offering stock options as a performance incentive

Answers to Chapter 7 Review Questions

1.

   A. That's correct! Accurate reporting of this liability would result in lower reported earnings or a higher reported loss for the period.

   B. This answer is incorrect. Severance pay owed to workers is not an asset.

   C. This answer is incorrect. Although benefits will be paid in the future, they are still a liability.

   D. This answer is incorrect. A restructuring charge of this type is likely to lead to a financial restatement.

2.

   A. This answer is incorrect. This is not a conflict of interest situation.

   B. This answer is incorrect. Laddering agreements involve an agreement for the aftermarket purchase of additional chairs.

   C. This answer is incorrect. Tie-in agreements are the same as laddering agreements.

   D. That's correct! IPO-related claims in cases like this typically allege that the investment bankers received larger compensation from investors than the IPO prospectus revealed, rendering the prospectus false and misleading.

3.

   A. That's correct! Potential plaintiffs include shareholders of the corporation, the persons or entity making the bid, creditors, and regulatory agencies.

   B. This answer is incorrect. As creditors of the corporation, bondholders are likely to be among the plaintiffs.

   C. This answer is incorrect. As shareholders of the corporation, Puddle's stockholders are potential claimants.

   D. This answer is incorrect. As the company that made the bid, Sponge is likely to be a plaintiff.

4.

   A. This answer is incorrect. The claim alleges past mismanagement of a company the defendants no longer control.

   B. This answer is incorrect. Old Woman's due diligence should have uncovered any problems before the acquisition took place.

   C. This answer is incorrect. The defendants are in no position at present to correct problems that occurred in the past.

   D. That's correct! Their current management status is irrelevant, as the claim alleges their prior mismanagement.

5.

   A. This answer is incorrect. Backdating per se is not illegal.

   B. This answer is incorrect. Until the option holder exercises his or her option, it produces no taxable income.

   C. That's correct! Failure to disclose stock option backdating practices to shareholders and the general public is illegal.

   D. This answer is incorrect. Stock options are routinely offered to corporate officers, directors, and even employees to incent them to improve the firm's profitability.

Chapter 8
Parallel Proceedings

Overview

As noted at length, the size of settlements in securities class action claims against directors and officers has increased significantly compared to years past. Less publicized, and yet no less important, is a similar increase in the frequency of proceedings against directors and officers that are separate from but related to (i.e. parallel to) securities class action lawsuits. This chapter sets forth an overview of four types of "parallel proceedings": (1) derivative claims, (2) opt-out lawsuits, (3) ERISA stock drop claims, and (4) regulatory and criminal proceedings.

Chapter Objectives

On completion of this chapter you should be able to do the following.

1. Recognize the general characteristics of derivative claims, opt-out lawsuits, ERISA stock drop claims, and regulatory and criminal proceedings.
2. Identify common bases for derivative claims, opt-out lawsuits, ERISA stock drop claims, and regulatory and criminal proceedings.

Derivative Claims

A derivative claim is a type of lawsuit brought by one or more stockholders on behalf of the corporation, rather than on their own behalf. The alleged harm must be to the corporation as a whole, rather than to one or more shareholders. Therefore, any recovery in derivative suits inures to the benefit of the corporation and is paid to the corporation, rather than to the shareholder(s) who institutes the action. Although less frequent than securities class action lawsuits, the personal liability associated with derivative claims can be substantial, and claims of this type have increased in frequency over time.

Common Breaches of Duty Alleged in Derivative Claims

The breaches of duty most commonly alleged in derivative actions against directors and officers are listed in Exhibit 8.1.

Exhibit 8.1
Most Common Allegations in Derivative Lawsuits

- Transactions involving undisclosed conflicts of interest, self-dealing, or personal appropriation of corporate opportunities
- Approval of improper or excessive corporate expenditures
- Imprudent investment procedures
- Self-interested, improper, or inadequate consideration of takeover offers
- Improper payment of dividends
- Improper payment of executive compensation
- General neglect and mismanagement of the corporation

Although the practice of filing a derivative lawsuit in conjunction with a securities class action lawsuit is not new, the practice has become more common. Increasingly, sophisticated and highly experienced plaintiff law firms are handling (and effectively controlling) securities class action lawsuits. Consequently, other law firms that are sometimes excluded from these class action lawsuits will often file a derivative suit in an attempt to obtain a fee award when the class action case settles. As Judy Greenwald noted in a January 2014 article in *Business Insurance* ("Derivative shareholder lawsuits are on the rise and bring D&O liability risks"), the focus of derivative lawsuits has shifted from options backdating to merger and acquisition activity, executive compensation, and regulatory exposures.

A Notable Derivative Claim

In what became a record shareholder derivative lawsuit settlement at the time, video game maker Activision settled for $275 million in 2014 in response to shareholder objections to an $8 billion transfer of control deal ("Activision settles investor suit for record $275 mln," Reuters, Nov. 19, 2014). In the disputed transaction, Activision and an investor group bought approximately 600 million of Activision's shares from Vivendi, a French conglomerate. The lawsuit alleged that both the CEO and co-chairman at Activision breached their fiduciary duties and "negotiated a transfer of control from Vivendi to themselves, rather than a repurchase of control by Activision." More specifically, as reported by Reuters, the CEO and co-chairman of Activision negotiated their own receipt of 25 percent of the investor group's gains in Activision's stock price once certain thresholds were met, despite only contributing 6 percent of the equity for the investor group. In addition to the monetary cost, the settlement required two unaffiliated directors to be added to Activision's board, as well as a reduction in the voting rights percentage of the investor group.

As reported by Kevin LaCroix in *The D&O Diary* on December 5, 2014 ("Largest Derivative Lawsuit Settlements"), the nine largest derivative lawsuit settlements at the time included the following.

- Activision Blizzard: $275 million
- News Corp.: $139 million
- Freeport-McMoRan: $137.5 million
- Oracle: $122 million
- Broadcom Corp.: $118 million
- AIG: $115 million
- Del Monte Foods: $89.4 million

- Pfizer: $75 million
- Bank of America: $62.5 million

Opt-Out Lawsuits

In addition to derivative lawsuits, plaintiff law firms also file what are termed individual "opt-out" claims on behalf of a single institutional investor (e.g., a bank, an insurance company, a pension fund), rather than being part of a class action.

Why "Opt Out"?

By bringing a lawsuit that is separate from the larger class action lawsuit, these individual plaintiffs can sometimes negotiate a larger settlement recovery than if the plaintiffs were passive beneficiaries of the larger class action lawsuit.

Advantages for Directors and Officers

Opt-out suits may, under certain circumstances, be beneficial for corporate defendants.

First, such settlements could be especially beneficial when one (or more) claimants is a large institutional plaintiff. For example, assume that a major pension fund is seeking substantial damages from a corporation. After the corporation settles separately with the pension fund, the corporation may only have to deal with the relatively small (individually, at least) investors who comprise the members of the class action lawsuit. In effect, it may be ridding itself of a major plaintiff by making a separate settlement and, thus, reducing the bulk, or at least a major portion, of its total dollar exposure in the process.

Second, when faced simultaneously with a class action claim and an opt-out claim, corporate defendants may be required to respond to multiple motions and discovery requests in each of the separate lawsuits, which may be filed in different courts throughout the country. Given the rapid accumulation of defense costs necessitated by such activities, it is often in the directors' and officers' best interests to settle the opt-out claim expeditiously. This allows the directors and officers to conserve policy limits available under their directors and officers (D&O) policy so that funds will be available to settle the class action claim.

Advantages for Opt-Out Plaintiffs

From the standpoint of a plaintiff, a separate opt-out settlement affords two advantages. First, it provides a greater chance for an accelerated recovery of damages. This is preferable to waiting as long as a decade, the period of time sometimes required to settle a class action lawsuit.

Second, by settling on an accelerated basis, an opt-out plaintiff can obtain earlier access to the D&O insurance proceeds that remain available. Often, the protracted litigation process characteristic of class action claims will rapidly deplete D&O policy limits (through the expenditure of defense costs) before claim settlements have even been made. Therefore, settling on an accelerated basis is often beneficial for plaintiffs.

ERISA "Stock Drop" Litigation

The proliferation and popularity of 401(k) retirement plans has created yet another substantial liability exposure for corporate directors and officers. Given the fact that such plans are governed by the Employee Retirement Income Security Act of 1974 (ERISA), what are termed "ERISA stock drops" (or less commonly referred to as "ERISA tag-along" suits) rose in frequency around the early 2000s.

401(k) Monies Invested in Company Stock: The Trigger for ERISA Stock Drop Litigation

Many corporations' 401(k) plans include the option to purchase company stock as an investment choice. ERISA stock drop claims arise when the market price of company stock drops substantially, an event causing 401(k) employee plan holders to suffer losses in their individual accounts. Such losses, if they are large enough, can result in class action lawsuits against the directors and officers of the organizations that sponsor the plans. In these lawsuits, employee-plaintiffs allege that the directors and officers were fiduciaries of the 401(k) plans and that the conduct required to administer such plans is governed by the provisions found within ERISA.

Coverage for claims alleging that the acts of directors and officers caused employee 401(k) plan holders to suffer losses is generally not available within directors and officers liability insurance policies (a topic discussed in the Management Liability Insurance Specialist (MLIS) course "Directors and Officers Liability Insurance Coverage"). This is because the policies almost always contain exclusions for losses involving ERISA, as well as claims pertaining to employee benefit programs. Nevertheless, it is important to examine the exposure of directors and officers to ERISA stock drop litigation, since claims usually result from the same acts that also trigger securities claims brought by shareholders of the corporation.

Concentration of Employer Stock in 401(k) Plans

In the period from 1999 to 2014, the percentage of 401(k) accounts invested in company stock fell to about 7 percent, a decrease of 62 percent. Notably, though, 53 percent of participants in plans with more than 5,000 participants were offered company stock as an option as of 2013. These statistics are according to a December 2014 brief from Employee Benefit Research Institute titled "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2013." Given this prevalence of company stock as an investment option among *large* plans, the exposure to litigation, settlements, and legal fees remains significant, despite an *overall* downward trend in the relative percentage of plan assets consisting of company stock since the early 2000s.

Specific Allegations against Directors and Officers in ERISA Stock Drop Cases

Following are the most common breaches of duties alleged against directors and officers in conjunction with ERISA "stock drop" claims. In the past, employee-plaintiffs typically asserted that directors and officers did the following.

- Deceived plan participants and beneficiaries by providing false and misleading information about the company's finances, which induced the employees to buy shares of the company's stock
- Failed to disclose material information about the company and its financial condition and performance, either in statements to the general public, to shareholders, or to employees
- Failed to disclose such information to other plan fiduciaries (such as investment advisors and brokers) who had responsibility for investing plan assets
- Failed to correct misleading statements made by other officers and plan fiduciaries and failed to adequately monitor wrongdoing by other plan fiduciaries

Securities Class Action Litigation versus ERISA Stock Drop Litigation

The following example will illustrate the difference between the losses sustained by shareholders in a securities class action and those suffered by employee 401(k) plan holders in the "parallel" ERISA stock drop litigation.

The Scenario

Assume that a company's 1,000 employees hold a total of 1 million shares of the company's stock within their 401(k) plans. Also assume that in addition to these shareholders, an additional 5,000 shareholders own a total of 5 million shares of the company's stock. Both groups—the employee shareholders and the nonemployee shareholders—allege that the directors and officers of the company had been hiding losses for a 2-year period and that when the true condition of the firm was announced, it was required to restate its financials. The day of the announcement, the stock dropped from $75 per share to $45 per share.

The Securities Class Action Claim

In this lawsuit, the class of 5,000 shareholders will allege that they suffered a loss of $150 million (i.e., $75 – $45 = $30 per share loss x 5 million shares = $150 million loss).

The ERISA Stock Drop Claim

In this lawsuit, the class of 1,000 employee 401(k) plan participants will allege that they suffered a loss of $30 million (i.e., $75 – $45 = $30 per share loss x 1 million shares = $30 million loss).

Regulatory and Criminal Proceedings

Claims against directors and officers brought by the Securities Exchange Commission (SEC), the Department of Justice (DOJ), and other regulators have increased significantly over time. In fiscal year 2016, the SEC budget surpassed $1.6 billion, an increase of over 68 percent since just 2009, when the budget was still below the $1 billion mark. Similarly, the number of enforcement proceedings brought by the SEC has increased dramatically. In fact, in fiscal year 2015, the SEC filed a record 807 enforcement actions, resulting in approximately $4.2 billion ordered in disgorgement and penalties, according to a JD Supra Business Advisor article written in December 2015 by Michael Dicke and Catherine Kevane of Fenwick & West LLP ("And the Winner is…The SEC Touts Record Number of Cases for Its FY2015, and Highlights Innovative Firsts").

Other regulators have likewise become much more active in bringing civil proceedings against companies and their directors and officers. Internationally, and particularly in Latin America, the phenomenon of civil litigation following corruption investigations has been a specific area of growth, as discussed by Kevin LaCroix in a September 2015 article in *The D&O Diary* ("What to Watch Now in the World of D&O"). The frequency of criminal proceedings against directors and officers has also continued to increase in recent years. As a result, individual defendants in securities class action lawsuits are also frequently the subjects of "parallel" regulatory or criminal investigations and proceedings. In effect, a "garden variety" class action claim against directors and officers often morphs into a regulatory investigation and/or criminal proceeding against them.

Regulatory Investigations and Class Action Claims

What begins as an investigation by a regulatory agency frequently has the potential to evolve into a class action lawsuit by a firm's shareholders. For example, at one point, the DOJ and the SEC were conducting investigations of more than 100 corporations in conjunction with illegal option backdating practices (as discussed earlier in this course). The vast majority of these investigations did not result in criminal charges or fines and penalties against the companies being investigated. (Although in one notable case, former UnitedHealth Group, Inc., CEO William McGuire was required to pay back $418 million in option-related compensation that he had obtained illegally.) In addition, approximately 33 of the firms that were investigated eventually had class action lawsuits brought against them by shareholders in conjunction with their option backdating practices.

Criminal Prosecutions and Class Action Claims

Just as regulatory proceedings and investigations are frequently conducted on a parallel basis with class action lawsuits, such actions are frequently intertwined with criminal indictments and prosecutions. Again, as in many instances throughout this course, the case of Enron provides a landmark example of the subject at hand. In addition to the wave of class action lawsuits brought against the directors and officers of Enron, criminal indictments and prosecutions were conducted against numerous Enron executives, most notably Kenneth Lay, Jeffrey Skilling, and Andrew Fastow, the company's former CEO, COO, and CFO, respectively. (These three and others were convicted.)

Special Issues Associated with Parallel Proceedings

These parallel regulatory and criminal matters create unique problems for the defendants.

Discovery Issues

Regulators frequently have extremely broad discovery rights (much more so than do plaintiffs' attorneys in class action litigation). In addition, regulators tend to conduct their investigations more rapidly than do class action attorneys. In some instances, courts have required defendant directors and officers to share with the securities class action plaintiffs' attorneys documents given to the government in connection with its investigation or proceeding. Unfortunately, the fact that such parties now have access to this often damaging information heightens the directors' and officers' liability exposure in the class action case. As a result, the evidentiary "road map" developed by regulators can sometimes be effectively followed by class action attorneys in prosecuting their case against corporate directors and officers. This puts these defendants at a tremendous disadvantage in the securities class action case, compared to situations where regulatory/criminal investigations are not being conducted.

Burdensome Defense Procedures

In addition, since the regulatory proceedings are rarely consolidated or coordinated with the class action litigation, director and officer defendants must often engage in duplicate and overlapping discovery activities (i.e., taking the time to provide depositions *both* to regulatory agencies and to attorneys who bring class action lawsuits).

Defense Coverage Issues: The Shrinking Limits Problem

Yet another difficulty associated with parallel proceedings is the fact that defense costs necessitated by criminal indictments and regulatory investigations can rapidly deplete D&O policy limits. This is because under D&O policies, insurers are obligated to defend insureds when they are criminally indicted and/or when a regulatory agency investigates the directors and officers or the corporation. The monies expended for providing defense in these situations might otherwise be needed to defend and settle class action claims against directors and officers.

"White Hats" versus "Black Hats"

The "competition" for D&O policy limits between so-called "white hats" (directors and officers who were merely negligent) and "black hats" (directors and officers who were also guilty of criminal conduct) is especially problematic in securities class action claims that also involve parallel proceedings. To continue with the Enron example, a number of officers were convicted of criminal conduct, and the monies required to defend them exhausted Enron's D&O policy limits. This left nothing to defend the directors whose conduct, while negligent, was not criminal—a fact that probably explains why these "white hat" directors were ultimately required to contribute to the class action securities settlement with personal funds.

Chapter 8 Review Questions

1. Sensing a growing opportunity, lawyers working at the law firm Manny, Moe, and Curly (MM&C) would like to participate in securities class action lawsuits. However, nearly all of these suits are handled by law firms with a proven track record. MM&C might still be able to obtain fee awards when the class action cases are settled if MM&C files

   A. derivative suits.

   B. single-plaintiff suits.

   C. secondary suits.

   D. tertiary suits.

2. Monica, who personally owns 20 percent of the outstanding shares of Blue Dress Company, has just learned of a class action securities suit being brought against Blue Dress directors and officers on behalf of all shareholders. Monica agrees shareholders have grounds for a claim, but she decides to negotiate her own settlement by filing an opt-out claim. Why might Monica be better off with the opt-out claim than she would be by participating in a class-action lawsuit?

   A. An opt-out claim will not reduce remaining directors and officers (D&O) policy limits.

   B. As a large institutional investor, Monica will receive red-carpet treatment.

   C. Monica is likely to recover damages sooner.

   D. Monica will need to hire her own legal counsel.

3. A combination of two major stockholders' opt-out lawsuits and a shareholder class action lawsuit against Alphabet Soup Company directors and officers could exhaust the firm's D&O liability insurance limits and leave the corporation in hot water. The plaintiffs most likely to recover D&O insurance proceeds are

   A. opt-out plaintiffs because major shareholders who settle on an accelerated basis generally have earlier access to insurance proceeds.

   B. opt-out plaintiffs because their claims will probably be settled faster than the class action claim.

   C. shareholders participating in the class action lawsuit because their claims will probably be settled faster than the opt-out plaintiffs' claim.

   D. shareholders participating in the class action lawsuit because they always have better lawyers.

4. Last Chance Company employees hold 100,000 shares of Last Chance stock within their 401(k) plans. When Last Chance announces a financial restatement, its stock drops from \$50 per share to \$30 per share. Alleging that Last Chance directors and officers had concealed the company's true financial condition prior to the financial restatement, employees bring an Employee Retirement Income Security Act (ERISA) stock drop claim alleging that they suffered a loss of

   A. \$2 million.

   B. \$3 million.

   C. \$5 million.

   D. confidence in company management.

5. Some directors and officers of the Stepson Hat Company were found to be guilty of criminal conduct while others were merely negligent. However, Sue Ellen, the 50-year-old vice president of human resources, was acquitted of all criminal charges against her but found to be negligent. Sue Ellen would be considered one of the

   A. black hats.

   B. blue hats.

   C. red hats.

   D. white hats.

Answers to Chapter 8 Review Questions

1.

   A. That's correct! Law firms that are excluded from a class action lawsuit often file a derivative suit in an attempt to obtain a fee award when the class action case settles.

   B. This answer is incorrect. The type of suit this refers to involves a single claimant, but these are not referred to as single-plaintiff suits.

   C. This answer is incorrect. Suits filed in an attempt to obtain a fee award when the class action suit settles are not referred to as secondary suits.

   D. This answer is incorrect. A third (tertiary) layer of lawsuits is not involved.

2.

   A. This answer is incorrect. All paid claims will reduce the remaining aggregate policy limits.

   B. This answer is incorrect. Monica is an individual investor.

   C. That's correct! Opt-out claims often receive accelerated treatment.

   D. This answer is incorrect. Separate legal counsel might be expensive.

3.

   A. This answer is incorrect. The opt-out plaintiffs can settle on an accelerated basis.

   B. That's correct! Opt-out claims handled on an accelerated basis can recover D&O proceeds before the policy's aggregate limit is completely eroded.

   C. This answer is incorrect. Opt-out plaintiffs will probably settle on an accelerated basis.

   D. This answer is incorrect. The issue here is one of timing, not of lawyer quality.

4.

   A. That's correct! $50 – $30 = $20 per share loss x 100,000 shares = $2 million loss.

   B. This answer is incorrect. The shares are still worth $3 million.

   C. This answer is incorrect. Employees did not lose the entire value of their stock.

   D. This answer is incorrect. The employees probably have lost confidence in company management, but they will express their claim in terms of a monetary loss and seek money damages.

5.

   A. This answer is incorrect. Black hats refers to the directors and officers who were guilty of criminal charges.

   B. This answer is incorrect. This term is sometimes used to refer to computer security professionals.

   C. This answer is incorrect. Sue Ellen might be a member of the Red Hat Society, which used to admit only women over the age of 50 but is now open to women of any age. (Those under 50 wear pink hats.) However, that is not relevant to the D&O claim against her.

   D. That's correct! White hats refers to the directors and officers who were merely negligent.

Chapter 9
Underwriting D&O Liability Insurance: Part 1

Overview

This chapter begins with a discussion of the data sources underwriters use to evaluate and price a directors and officers (D&O) risk. Next, it addresses the first two of the four major D&O underwriting factors that underwriters consider: (1) financial situation and (2) industry/competitive position. Chapter 10 examines the next two factors that D&O underwriters also evaluate when pricing a D&O risk: (3) internal company issues and (4) composition/operation of the board of directors.

Chapter Objectives

On completion of this chapter, you should be able to do the following.

1. Identify the types of data used in underwriting a D&O policy, and recognize the relevance of each.
2. Recognize favorable and unfavorable underwriting characteristics of a corporation's financial situation and its competitive situation.

Underwriting Data

Much of the key data required to underwrite a D&O policy is provided in the application form. In addition to a completed application, organizations must usually provide a number of other items, several of which are listed in Exhibit 9.1, during the process of being evaluated for D&O liability coverage.

Exhibit 9.1 Items Typically Necessary To Underwrite a D&O Policy
• Copies of the corporation's latest annual report • Copies of all proxy material • Corporate bylaws • A list of directors and officers (including subsidiary organizations) • Copies of the most recent financial information filed with the Securities Exchange Commission (SEC) (normally 10-K and 10-Q reports) • A summary of litigation that the corporation has been involved in

Annual Report

The annual report is the most important piece of information used by underwriters because no single document conveys as broad an overview of the company. A company's annual report sets forth a general description of a company's business, discusses current issues and conditions affecting the business, and contains detailed financial data that explains how the company achieved its earnings during the most current fiscal year. The majority of publicly traded companies release annual reports in the spring because their fiscal years usually run from January 1, 20XX, through December 31, 20XX. An annual report contains financial data covering this period.

Annual Report Contents

Annual reports usually contain (1) a chairman's report, (2) detailed financial data, (3) an auditor's report on corporate governance, (4) the corporate mission statement, (5) the corporate governance statement of compliance, (6) a roster of and statement of directors' responsibilities, and (7) an invitation to the company's annual meeting.

Financial Data

The financial section of an annual report normally contains (1) an auditor's report on the firm's financial statements, (2) a balance sheet, (3) a statement of retained earnings, (4) an income statement, (5) a cash flow statement, (6) notes to the financial statements, and (7) a statement of the company's accounting policies.

Proxy Material

A proxy statement is a statement required when a corporation solicits the votes of its shareholders on a particular issue. Such statements most often concern mergers and acquisitions, the election of board members, and matters relating to director/executive compensation. Proxy statements must be filed with the SEC.

The statement generally includes (1) voting procedures and information on the issue being decided, (2) background information about the company's nominated directors, (3) details of director/executive compensation, and (4) a breakdown of audit and nonaudit fees paid to the auditor. Such material is important from an underwriting standpoint because it indicates the manner and extent to which the board communicates critical information to its shareholders.

Corporate Bylaws

A company's corporate bylaws describe the internal rules that govern its management. They provide particular insight into the frequency of board meetings, types of board committees, number of board members, and criteria for board membership. A key aspect of a corporation's bylaws concerns the procedures for and conditions under which the company will indemnify directors/officers for claims incurred in conjunction with their service to the organization. These kinds of details assist an underwriter in evaluating the effectiveness with which the board will be able to operate.

Roster of Directors and Officers

The essence of any D&O risk is the integrity, knowledge, and experience possessed by those who occupy the roles of directors and officers. The roster of directors and officers (which also includes their committee assignments) provides an underwriter with the information required to analyze the backgrounds of the people who occupy these important positions.

SEC Reports

Public companies are required to make regular filings with the SEC, which underwriters also review carefully. The filings consist of the company's key financial statements, which must be submitted each quarter. Underwriters are especially interested in such filings because, compared to the financial data in the company's annual report, they provide a more current picture of a company's finances.

Financial Situation

The actual pricing of a D&O policy is related to—although not strictly a function of—the dollar amount of a firm's total assets. A number of other important factors are also considered in developing a premium for a D&O policy. Accordingly, pricing D&O liability insurance is a highly subjective process. In arriving at premiums, D&O underwriters begin by analyzing a company's financial position.

A firm's key financial areas include the following.

- Profitability
- Leverage
- Accounting and financial reporting practices
- Liquidity
- Stock price volatility

Profitability

Profitability is a concern to D&O underwriters given the strong correlation between lack of profit and the incidence of claims against directors and officers. Thus, the ability of a firm to generate acceptable levels of profits for its investors is the single most important financial indicator evaluated by underwriters.

Profitability: The Double-Edged Sword of D&O Underwriting

Despite the fact that profitability is generally recognized as a key D&O underwriting factor, it should be remembered that many companies, like Enron, are "profitable" right up to the moment they declare bankruptcy.

Profit: An Elusive Concept

"Profit" has, in many instances, become an accounting construct rather than an infallible indicator of a company's long- or short-term viability. Accordingly, what is most important from an underwriting standpoint is to understand exactly where profit is coming from and how it is derived. In fact, certain companies are excellent D&O risks despite the fact that they report losses year after year (e.g., development-stage biotech firms that have products on the drawing board but haven't sold them yet). Profit alone may—or may not—say very much about a particular company's propensity to have a claim made against its directors and officers.

One leading underwriter captured this dilemma best when he commented that "companies managing to report ever-increasing profits and consistently exceed Wall Street's expectations by wide margins are arguably the scariest companies out there!"

Countrywide Financial: A Case Study in the Sometimes-Illusory Nature of "Profit"

In an October 1, 2007, *The New York Times* op-ed piece titled " Enron's Second Coming?," Nobel Prize-winning economist Paul Krugman described the problems faced by Countrywide Financial, the nation's largest subprime lender, comparing them to the Enron situation. A one-time darling of growth-enamored Wall Street analysts, Countrywide's shares fell by more than 50 percent during the prior year. The company was technically insolvent when Bank of America acquired it in January 2008.

The op-ed noted similarities between both Enron and Countrywide in terms of (1) stellar earnings immediately prior to announced internal problems, (2) high CEO compensation relative to competitors, (3) CEO stock sales just prior to large share price drops, and (4) radiant business press coverage in which both Enron's CEO, Kenneth Lay, and Countrywide's CEO, Angelo Mozilo, were lauded not only as great businessmen, but also as great human beings.

Quality of Earnings versus Quantity of Earnings

Countrywide was a textbook case of how the *quality* of a company's earnings—in this case, from mortgage loans made to people lacking the financial wherewithal to repay them—took a back seat to the *quantity* of those earnings in Wall Street's assessment of the company. If a company consistently reports sales and profit growth far above industry averages and receives exuberant write-ups in the financial press, underwriters must look more deeply into the true nature of the company's operations. Problems could, and often do, lie ahead.

Leverage

A debt to equity ratio provides an underwriter with insight into a firm's financial structure. This ratio indicates the relationship of debt to equity financing and the degree to which a company is leveraged (i.e., the portion of debt used to finance the business). Many companies utilize greater leverage (i.e., debt) to increase performance results or stretch limited resources. Heightened leverage creates heightened risks.

Interpret Debt to Equity Ratios Carefully

A company's debt to equity ratio must be interpreted carefully. From a creditor's standpoint, a high proportion of owners' equity is desirable. This is because equity provides a substantial protective buffer of owners' investment for creditors in the event the company suffers a loss. However, from an owner's standpoint, a high proportion of owners' equity may or may not be desirable. If borrowed funds can be used by a business to generate earnings in excess of the after-tax cost of the interest on such borrowed funds, a lower percentage of owners' equity may be desirable.

Conversely, too low an equity ratio (i.e., too much debt) may be hazardous from the owner's standpoint. Underwriters should be leery of firms that appear heavily dependent on debt and whose ability to meet debt repayment requirements is suspect. For such firms, a business recession could result in operating losses and shrinkages in the values of assets (such as receivables and inventories). This, in turn, could lead to an inability to meet fixed payments for interest and principal on debt. Similarly, underwriters should avoid firms that are especially vulnerable to changes in interest rates, such as companies that maintain a high percentage of "floating rate" debt, the cost of which could increase substantially.

Accounting and Financial Reporting Practices

Accounting and financial reporting practices are a key component for underwriters to evaluate in developing an understanding of the company's financial picture. The five examples noted in Exhibit 9.2 illustrate the kinds of accounting and financial reporting practices that can be especially problematic.

Exhibit 9.2 Problematic Accounting and Financial Reporting Practices
• Complex business arrangements that are difficult to understand and appear to serve little purpose from a practical standpoint (e.g., Enron had numerous “off-balance-sheet partnerships” that were used to hide excessive debt) • Changes in auditors over accounting or auditing disagreements (i.e., the new auditors agree with management, and the old auditors did not, which is why they were replaced) • Unusually rapid growth and profitability that is significantly better than competitors, despite a lack of substantive difference in the nature of operations (e.g., Countrywide Financial generated outsize returns compared to its competitors, despite essentially identical business practices) • Inability to generate cash flows from operations while reporting significant earnings growth (a sign of earnings manipulation) • A consistently close or exact match between the reported results and planned results (e.g., results that are always exactly on budget or managers who always achieve 100 percent of bonus opportunities, which is yet another sign that earnings are being “managed”)

Liquidity

Adequate liquidity (i.e., current assets less current liabilities) is important to a company, given the possibility of unforeseen emergencies (e.g., a sharp downturn in sales during a recession), as well as unanticipated business opportunities (e.g., the opportunity to expand into a new product line). In addition, a firm’s inability to accumulate sufficient working capital could indicate poor financial management. Lastly, what constitutes a reasonable amount of liquidity varies with the degree of uncertainty inherent in a given industry group. For example, a high-tech company would need considerable working capital, given continuous innovation in that industry and the need for the rapid introduction of new products.

Liquidity and Lines of Credit

Existing lines of credit are an important component of a firm’s liquidity position. Companies must have adequate lines of credit in place in the event that profitable business opportunities emerge or, alternatively, unforeseen problems arise. The inability to establish and maintain adequate lines of credit may indicate poor relationships with the banking industry and/or deeper rooted financial issues.

Stock Price Volatility

Companies whose share prices have historically been significantly impacted by even minor events have a tendency to produce shareholder class action claims. Thus, firms with volatile stock prices produce a “caution flag” for many underwriters. There is, however, some disagreement on this point because many businesses that exhibit volatile stock prices have not had a history of class action claims made against them. Conversely, numerous companies with relatively stable share prices have been frequently involved in such litigation. In addition, volatility is related to a firm’s particular industry group. Therefore, stock price volatility/stability should be viewed as one of several important finance-related underwriting factors and not in isolation.

Industry/Competitive Position

A firm’s competitive position in a given industry encompasses four significant factors: market share, competitive structure of the industry, revenue sources, and industry group.

Market Share

As has been emphasized throughout this course, merger and acquisition activity frequently gives rise to claims. Therefore, firms with a relatively small market share (e.g., 5 percent or less in a given industry or product type) are attractive takeover candidates, and such companies should be carefully underwritten. However, even industry leaders are not immune to takeover attempts, given the emergence of creative financing techniques in the 1980s, such as leveraged buyouts, whereby takeovers of multibillion-dollar corporations have been almost completely financed by debt.

Competitive Structure of the Industry

The degree of competition within an industry is another factor that underwriters must assess. Firms engaged in highly competitive industries where markets are saturated with products and are characterized by overcapacity are especially risky. Such problems are exacerbated when the industry's products are subject to rapid obsolescence, as was the case with most high-tech firms during the 1999–2002 period in which firms in this industry were subject to chaotic earnings fluctuation.

Revenue Sources

Companies dependent on a few large customers for a significant portion of their revenues are generally poor D&O risks. (This is especially true when profit margins are declining within the entire industry.) For such firms, the loss of only a handful of key customers can cause earnings to plunge, thereby increasing the firm's susceptibility to claims.

Consumer versus Business-Dependent Companies

In addition, firms who sell their products largely to other businesses—rather than to consumers—are much more vulnerable to wide swings in earnings and, ultimately, claims against their directors and officers. Many of the bankruptcies and financial difficulties experienced by high-tech firms from 2000 to 2002, an especially volatile period for that specific industry, can be explained by the overall lack of investment spending by corporations during this period. Accordingly, firms whose customers are principally other businesses are riskier from a D&O standpoint because consumer spending is considerably less volatile than spending by corporations. For example, the 2007–2009 stock market plunge did not impact the share prices of consumer products manufacturers such as Kraft, Procter & Gamble, and Johnson & Johnson as severely as it impacted heavy equipment manufacturers that sell almost exclusively to other businesses, like Caterpillar and John Deere.

Industry Group

The industry group in which a company operates correlates significantly with D&O claim activity. Historically, patterns have emerged in which a particular industry group bears the brunt of numerous claims during a certain time period, as discussed below.

1999–2002: The High-Tech Claim Wave

From the end of the 1990s and early 2000s, approximately 56 percent of all federal class action securities claims were filed against companies involved in three broad industry groups: computer services, telecommunications, and electronics.

2007–2009: The Banking/Financial Services/Real Estate Wave

Just as technology companies were the most susceptible to claims during the 1999–2002 period, during the years 2007–early 2009, banks, brokerages, and real estate/construction-related industries bore the brunt of the claims onslaught. The Stanford Law School's Securities Class Action Clearinghouse (SCAC) and Cornerstone Research for the year ending 2008 indicated the extent to which claims were heavily concentrated by industry group. Specifically, approximately half of the suits involved some aspect of the credit meltdown, since 103 such suits named firms in the financial industry as defendants, including 55 percent of the financial companies in the S&P 500 Index.

As was pointed out by Kevin LaCroix in *The D&O Diary,* of the 152 subprime and credit crisis–related securities lawsuits that have been filed as of February 4, 2009, 117 of them have involved companies or other entities with standard industrial classification codes (SIC) in the 6000 series (finance, insurance, and real estate). And of the 18 entities that have been sued but that have no SIC code designated, these entities are heavily populated by mutual funds, private equity firms, hedge funds, and foreign firms whose shares are not traded on U.S. exchanges.

2013–2015: The Biotechnology/Pharmaceuticals/Healthcare Wave

As shown in another Stanford Law School SCAC and Cornerstone Research report, "Securities Class Action Filings: 2015 Year in Review," the "Consumer Non-Cyclical" sector became an especially prominent arena for securities class action filings between 2013 and 2015. This industry classification encompasses biotechnology, pharmaceuticals, and healthcare, as well as an "other" category (primarily agriculture, beverage, commercial services, and food subsectors). Claims from this sector constituted approximately 32 percent of all filings from 2013 to 2015 (the next highest industry, communications, amounted to less than 13 percent during the same period).

More specifically, the report also showed that filings against biotechnology, healthcare, and pharmaceutical companies (ignoring the "other" class) increased in each year during the 3-year period, with pharmaceutical companies accounting for the most filings of any subsector.

Given such data, underwriters will add a significant premium loading to firms whose businesses are concentrated within an industry or industry group that is part of a D&O securities litigation "wave."

Chapter 9 Review Questions

1. In applying for directors and officers liability insurance, Firetower's corporate risk manager will probably need to submit a completed application and submit originals or copies of all the following documents EXCEPT:
   A. corporate bylaws.
   B. directors' and officers' passports.
   C. a summary of litigation that the corporation has been involved in.
   D. Firetower's annual report.
2. George is curious as to the financial wellbeing of Jungle Company, Inc, where he works. George obtained a copy of Jungle's current financial report and is currently looking at the financial section, where he can expect to find all of the following EXCEPT:
   A. a balance sheet.
   B. monthly bank statements.
   C. a statement of Jungle's accounting policies.
   D. an auditor's report on Jungle's financial statements.
3. In reviewing the roster of directors and officers of Tony's Debt Collection Agency, Inc., a directors and officers underwriter is least likely to consider the directors' and officers'
   A. ethnicity.
   B. experience.
   C. integrity.
   D. knowledge.
4. From a directors and officers (D&O) underwriter's viewpoint, which of the following is the most important financial indicator in Razor Blade Corporation's D&O application?
   A. Razor Blade consistently generates a profit, and this trend seems likely to continue.
   B. Razor Blade promptly dropped its double-edged product line once it became unprofitable.
   C. Razor Blade's board had a close shave several years ago but successfully defended its only D&O claim.
   D. Razor Blade's experienced and mature board members are all more than 70 years old.
5. In reviewing Furniture Factory's (FF) financial records, a D&O underwriter notices that FF is reporting both unusually rapid growth and profitability that is significantly better than its competitors. However, the underwriter sees no evidence that FF's operations are significantly different from those of the competitors. The underwriter is rightfully concerned that this suggests that
   A. FF bookkeepers are lax in recording sales as they are made.
   B. FF has a bonus program for officers who make the numbers.
   C. FF is not accurately reporting its financial results.
   D. FF uses outdated accounting practices.

Answers to Chapter 9 Review Questions

1.

   A. This answer is incorrect. Underwriters usually want to see corporate bylaws.

   B. That's correct! A complete list of directors and officers, along with biographical information, is usually sufficient.

   C. This answer is incorrect. A summary of the firm's litigation activities should normally accompany a D&O application.

   D. This answer is incorrect. The annual report is the most important piece of information an underwriter uses.

2.

   A. This answer is incorrect. The financial section of an annual report generally includes a balance sheet.

   B. That's correct! George will have to look elsewhere for his bank statements.

   C. This answer is incorrect. The financial section of an annual report generally includes a statement of the firm's accounting policies.

   D. This answer is incorrect. The financial section of the annual report should include an auditor's report on the firm's financial statements.

3.

   A. That's correct! The essence of any director and officer (D&O) risk is the integrity, knowledge, and experience of its directors and officers. Moreover, since racial discrimination in underwriting is prohibited, underwriters should ignore the applicants' ethnicity.

   B. This answer is incorrect. The essence of any D&O risk includes its officers' experience.

   C. This answer is incorrect. The essence of any D&O risk includes its officers' integrity.

   D. This answer is incorrect. The essence of any D&O risk includes its officers' knowledge.

4.

   A. That's correct! A firm's ability to generate acceptable levels of profits for its investors is the single most important financial indicator evaluated by underwriters.

   B. This answer is incorrect. This action suggests that Razor Blade is willing to make changes to maintain profitability, but it doesn't indicate whether the firm is profitable.

   C. This answer is incorrect. Loss history is important, but it is not a financial indicator.

   D. This answer is incorrect. Age is not a financial indicator.

5.

   A. This answer is incorrect. This may be the case, but it is not an underwriting concern.

   B. This answer is incorrect. A bonus program might provide an incentive to manipulate the numbers, but there is not necessarily a link between the reported numbers and a bonus program.

   C. That's correct! FF may be reporting sales figures higher than actual sales.

   D. This answer is incorrect. Assuming accounting practices are consistent, the underwriter would be more concerned about the accuracy of the numbers.

Chapter 10
Underwriting D&O Liability Insurance: Part 2

Overview

This chapter will examine the other two broad areas considered by directors and officers (D&O) underwriters: internal company factors and composition/operation of the board of directors.

Chapter Objectives

On completion of this chapter, you should be able to do the following.

1. Identify the internal company factors a typical D&O underwriter considers important distinguish between positive and negative underwriting characteristics.
2. Recognize favorable and unfavorable underwriting characteristics of a corporate board of directors.

Internal Company Factors

The third general area evaluated by underwriters involves the specific circumstances particular to an individual company. The following paragraphs discuss these areas.

Merger and Acquisition Activity

As stated often within this course, D&O claim susceptibility is related to the frequency of a company's involvement in merger and acquisition activity. Merger and acquisition activity presents a number of problematic issues, all of which can lead to claims, as follows.

- **Acquiring companies** are always vulnerable to criticism that the purchase price paid for the company it acquired was excessive.
- **Acquired companies'** directors and officers have a vested interest in preserving their own positions and are naturally predisposed to rejecting a takeover offer, even those clearly in the best interest of the stockholders. Moreover, when they accept such an offer, the directors and officers are vulnerable to criticism that the offer was inadequate.

As a result, underwriters usually perceive a company with a proclivity for merger and acquisition activity as a higher-than-average claim risk. According to publishing house Raconteur Media's report "M&A Outlook 2016," five sectors in particular were leading the way in merger and acquisition activity at the time of the report: financial services, telecommunications, pharmaceuticals, computer manufacturing, and oil and gas.

Breadth/Concentration of Stock Ownership

The more widely held a stock, the greater the chance that some party owning it will bring suit against the organization. For this reason, closely held public companies have a dramatically lower level of claim frequency, compared to those with more diffused, public stock ownership. A closely held public company is one in which a high percentage of the firm's stock (e.g., 50 percent or more) is owned by the firm's directors and officers or other so-called insiders, yet is also held by members of the public and is traded on one or more of the large national stock exchanges. (This is distinct from a privately held company in which directors/officers/other insiders own all of a company's shares and the company's shares are not traded on a public exchange.)

Underwriters are leery of publicly held companies in which one or more outsiders hold large blocks of a firm's stock. Such persons (or institutions, in some cases) have a great deal at stake in the firm's fortunes and are therefore prime candidates for suing at the first sign of a business downturn. (D&O liability policies do, however, often contain exclusions that bar coverage for suits brought by individuals owning more than 10 percent, and in some cases, more than 5 percent, of a company's outstanding shares. Fortunately for insureds, this is one provision within D&O policies that is typically negotiable to some degree.)

Future Company-Specific Risks

A key underwriting factor for any individual company is whether the firm is susceptible to a single event or change that could substantially alter the company's fortunes. Examples of such vulnerabilities include (1) dependence on a single customer, contract, product, or supplier (often typical of manufacturers of industrial equipment); (2) a company holding a patent on a major product (e.g., a pharmaceutical manufacturer) that is about to expire; (3) a company dependent upon a natural resource that is in short supply and/or whose price can fluctuate wildly (e.g., an airline's dependence upon fuel prices; an oil exploration firm); or (4) a company awaiting the outcome of pending high-stakes litigation.

Service Provider Relationships

Underwriters are alert for high turnover rates in the firm's associations with key outside service organizations. Changes in major (1) banking relationships, (2) independent auditors, (3) law firms, (4) investment bankers, (5) pension fund/investment managers, and (6) insurance brokers could indicate potential difficulties.

Company Size

As already mentioned in this section, claims against a firm's directors and officers are related to the organization's asset size. For this reason, premium for a D&O policy correlates closely with a company's total assets. The larger the firm, the more vulnerable it is to suits, mainly as a result of wider public visibility, coupled with more diversified stock ownership.

Company Age

Underwriters generally prefer older, more established organizations to relatively newer firms. Accordingly, it is more difficult to secure D&O coverage for companies that have been in business less than 5 years. Start-ups and firms that have only been in business for brief periods of time pose added risks associated with so-called "growth companies" (e.g., suits arising out of initial public offerings) and also must buck the odds implicit in the high failure rate for all new businesses. Absent the longevity required to demonstrate a track record of sustained profits, relatively new companies are less desirable D&O risks, and their premium rates reflect this.

Degree of Diversification

Diversified conglomerates produce a higher incidence of claims than do companies with business activities confined to more limited sectors and product lines. Risks of financial loss tend to increase as firms begin to depart from their core businesses and diversify into unrelated endeavors where senior management has relatively little experience. Clearly, the organization's inclination to integrate vertically or horizontally appears to augment its risk of lawsuits against the firm's directors and officers.

Degree of Centralization

Highly centralized organizations pose reduced risks of D&O claims because they are easier to control and manage compared to firms operating on a more decentralized basis. Accordingly, companies with subsidiaries and divisions that function on a relatively autonomous basis, especially in financial matters (e.g., subsidiaries having separate banking, insurance, and outside auditing relationships), are carefully underwritten. Similarly, underwriters must closely examine firms with overly complex organizational structures, especially those operating in tax-haven jurisdictions for which there appears to be no clear business purpose.

Public Perception

Studies and surveys by major business publications have proven conclusively that the public holds certain firms in higher esteem than it does others (e.g., *Fortune* magazine's annual survey of the "World's Most Admired Companies"). Those held in lesser esteem are somewhat more vulnerable to D&O claims than companies that are highly regarded.

A firm's risk management program can often provide valuable insight to a D&O underwriter. Adverse loss experience in major property and casualty lines might suggest management problems. Stability of relationships with insurers and brokers also offers clues about the organization. Finally, management's involvement with and support of property and liability loss control programs often indicate its willingness to minimize D&O claim exposures.

Loss History

Underwriters also consider a company's prior claim record in evaluating a D&O risk. Most important is whether and to what extent an organization implemented procedural changes to avoid future claims from a similar source.

Certainly, a firm's previous loss experience influences the likelihood of future claim activity. Nevertheless, that record must be analyzed in light of changes within management and the board of directors.

Composition and Operation of the Board of Directors

Although underwriters carefully evaluate financial, industry/competitive, and internal company factors, the essence of any D&O risk is the quality of the individuals who serve as directors and officers. According to Dan Bailey, a noted authority on D&O liability,

> [T]he single most important underwriting consideration is the quality of the people involved in the management of the corporation. Any future claim under the policy will relate to the alleged actions or omissions of these people. Therefore, the more experienced, capable, honest, knowledgeable and forthright is the management, the less risk of valid claims being asserted.

Degree of Control by the Chairman or Other Individuals

Underwriters should be wary of boards on which a single individual, usually the chairman of the board, appears to exercise a disproportionate degree of control over the organization. Such control sometimes leads to a "groupthink" mentality in which other directors and officers merely rubber-stamp the initiatives proposed by the chairman of the board without carefully examining the details and assumptions underlying his or her ideas.

Conversely, and although this is less often the case, problems can arise when the board chairman is relatively weak. Board chairmen who are too easily influenced by others are sometimes coerced into making unwise decisions. Firms that have chairmen with good ideas—but little influence—are prone to ill-advised actions that sometimes produce claims.

Board Selection Criteria and Composition

In addition to evaluating the board chairman, underwriters must also assess the individuals comprising a company's board of directors. Although no consistent criteria exist for being selected as a director, such persons should possess integrity, an inquiring mind, ample experience, good business judgment, and an understanding of business fundamentals (e.g., finance, law, marketing, accounting, and investing). Perhaps most important is the fact that board members should not be selected purely on the basis of friendship or politics.

Specific Selection Criteria

Underwriters consider three specific factors in evaluating the individuals who make up a firm's board of directors: size of the board, diversity of experience, and independence.

Size of the Board

The typical board of directors of the average publicly held corporation numbers around 12 persons. Yet it is debatable whether this is really an optimal number. Often, detailed questioning and extended discussion is impossible in a group of this size, so in some instances, a smaller number of persons, perhaps as few as 6, would function more effectively while still offering a diversity of backgrounds and experience. Accordingly, a board size of at least 6, but no more than 12, is the optimal range for a public company.

Diversity of Experience

Directors should possess experience in areas not solely confined to the company's core business. For example, the outside directors of a bank should come from several different industry backgrounds rather than being restricted to persons with banking as their principal business experience. This diversity of perspectives will be beneficial for decision-making processes that extend beyond a company's typical operational comfort zone.

Independence

Underwriters must carefully examine the relationships between board members and the companies they have been asked to serve. Some degree of detachment from the organization is desirable. Close connections sometimes produce conflicts of interest. Moreover, underwriters should question the boards of firms when all or most of the members are inside (i.e., an employee of the company), rather than outside (i.e., a nonemployee of the company), directors. Unless a firm has a number of board members who have no connection to the firm, the objectivity of the board's decision-making process is likely to be compromised.

Compensation Method of Management

Underwriters should also carefully consider the manner in which operating management is compensated. Some industry observers go so far as to assert that "outsized" executive compensation is the single most reliable risk marker, as it usually invites a host of dangerous (and sometimes destructive) behaviors. Certainly, many of the most egregious corporate scandals have involved excessive executive compensation. Accordingly, underwriters will consider the details surrounding executive compensation as an important component of the risk analysis.

Analyze the Effect of "Nonsalary" Items

Underwriters should be especially wary of firms in which compensation of management is heavily dependent on nonsalary items, such as bonuses, stock options, and similar incentives. One problem with these types of arrangements is that they often encourage excessive risk taking, promote the implementation of overly aggressive accounting methods, or, in the worst-case scenario, provide incentive to commit fraud by boosting reported earnings. Another problem is that these nonsalary items are also more easily hidden from public disclosure—yet another factor that creates incentive for excessive risk taking.

The Greatest Danger: When CEOs "Manage" Earnings

Many observers agree that there is great danger inherent in management compensation plans that heavily utilize stock options. Under these conditions, CEOs have particular incentive to maximize the company's stock price, which, in turn, encourages earnings manipulation. Accordingly, CEOs will be more likely to artificially increase earnings by means of questionable, if not fraudulent, accounting practices. One example of this would be a sudden increase in company stock buy-backs. Since more buy-backs means fewer shares outstanding, which in turn means higher earnings per share, CEOs may be tempted to utilize this tactic to positively influence their compensation packages.

This link between incentive-based compensation plans and "managed" earnings was the conclusion of a study by Lin Peng and Ailsa Röell, and published by the *Oxford Journals*, titled "Executive Pay and Shareholder Litigation" (December 2005), noting that "there is a significant relationship between option-based executive compensation and shareholder class litigation" and that "incentive pay in the form of options significantly increases the probability of a shareholder class action lawsuit."

Earnings and Auditors

Another related problem is the fact that there is an inherently "incestuous" relationship between companies and their supposedly independent auditing firms. In the case of Enron (and other corporations as well), Enron pressured its auditing firm, Arthur Andersen, to certify financial statements that Andersen knew were highly inaccurate, if not fraudulent. Andersen's incentive to comply was that Enron also provided Andersen with lucrative consulting engagements that, in reality, were much more profitable for Andersen than was the standard audit work. This allowed Enron to pressure Andersen into certifying Enron's blatantly misstated earnings. Ultimately, such deception helped to maintain a high share price and increase the extent of earnings-driven compensation plans for top management.

CEO Compensation Packages: What To Look for

Given the frequency of compensation-related D&O claims coupled with the correlation between options-driven compensation packages and securities litigation (as already noted in this course), underwriters carefully scrutinize the details of the CEO's employment contract. Questions to be posed include the following.

- Are the compensation levels realistic?
- Are the compensation levels in line with other CEOs in the same industry?
- Does the nature of the compensation plan provide more incentive to manage the stock price than to manage the company itself?
- Does the compensation package achieve the right mix of both short- and long-term performance incentives?

Analyzing Board Turnover

Frequent turnover among a firm's officer/director group indicates the possible presence of inherent conflicts and problems that could only be resolved by resignations—voluntary or otherwise. When evaluating a prospective insured, underwriters should request additional information concerning the reasons for such turnover.

Assessing the Board's Knowledge of the Organization

It is important for an underwriter to assess the extent to which the directors are knowledgeable about the organization. Absent such knowledge, a director will be unable to render sound advice when the organization is presented with various options or courses of action in specific situations.

Preliminary study, prior to joining a board, should include reviews of the corporate charter or bylaws and recent board and committee meeting minutes. Additionally, a new director should be aware of the immediate political, legal, and competitive environment in which the organization operates.

A number of authorities recommend that new directors meet privately with the firm's independent auditors, as well as with its outside counsel. These meetings can provide a somewhat less biased view of the organization than would be obtained from inside directors and will assist the new director in formulating a more objective opinion about the company. Not only must new directors receive a thorough orientation, but existing directors should also continually update their knowledge of the important areas that affect the company. Corporate governance experts also recommend that the board should communicate frequently with the company's CFO, particularly if a director is on the audit committee.

Assessing the Board's Knowledge of Nonindustry—Yet Essential—Areas

Underwriters must also evaluate whether and to what extent the board has expertise in areas that, while not directly involving the organization's core business, are nevertheless critical to the company's success—and perhaps even its survival. A particular noteworthy example (yet by no means the sole specialized area in which a board requires expertise) involves knowledge of electronic data security. Given the demonstrated threats to businesses posed by electronic hacking and data breach activity, it is imperative that corporate boards have at least one member who possesses deep knowledge in this functional discipline.

Conducting Face-to-Face Meetings with Management

In an effort to more carefully evaluate the all-important people factor, underwriters should request face-to-face meetings with top management personnel when plausible. Many of the questions raised in this discussion of D&O underwriting are more easily answered by the impressions obtained from such meetings rather than simply relying on data submitted with an application or acquired from online sources.

Underwriter meetings with an insured's CFO can help an underwriter develop a "comfort level" with a prospective insured's financial data. Alternatively, these meetings may reveal problems indicating that financial statements cannot be taken at face value and that potential claim issues lurk beneath an otherwise rosy picture presented by the insured. Whichever the case, face-to-face meetings can sometimes afford the underwriter the opportunity to obtain clarification and ask questions that may assist in developing a clearer picture of a given D&O risk.

Conclusion: The Art of D&O Underwriting

Underwriting D&O insurance is as much an art as a science. There are innumerable different types of businesses, the details of which uniquely affect a D&O risk from an underwriting standpoint. In addition, it should be apparent that most of the factors discussed above are not subject to exact quantification. Thus, successful underwriters use their experience, judgment, and well-honed instincts—rather than a strict set of rules—to determine the premium level and the scope of coverage they will offer in response to a request for D&O insurance. Of course, in addition to determining appropriate premiums and scopes of coverage, underwriters must also make impactful decisions regarding limits, sublimits, and retentions, depending on the insured.

Chapter 10 Review Questions

1. National Acquirer Company's market share is on the rise since it has gradually been buying out its major competitors. Directors and officers (D&O) underwriters would probably consider National Acquirer a higher-than-average claim risk because

   A. National Acquirer's directors and officers might be more interested in preserving their own positions than in protecting the company.

   B. National Acquirer's shareholders might accuse directors and officers of paying too little to acquire another company.

   C. National Acquirer's shareholders might accuse directors and officers of paying too much to acquire another company.

   D. buying out smaller competitors is illegal.

2. Vista Corporation stock is traded on the New York Stock Exchange. Hank was Vista Corporation's chairman of the board until his ouster a few years ago. He still owns 40 percent of Vista's stock, a much larger share than any other individual or organization. Current directors and officers collectively own only 12 percent of Vista's outstanding stock. In reviewing Vista's D&O application, underwriters would most likely

   A. be leery because Hank is likely to sue at the first sign of a business downturn.

   B. exclude coverage for claims brought by shareholders other than Hank.

   C. reduce the premium because concentration in stock ownership tends to reduce claim frequency.

   D. view Vista favorably because closely held public companies have a relatively low claim frequency.

3. All else being equal, D&O underwriters tend to prefer a firm that is

   A. relatively large but older and well established.

   B. relatively small but older and well established.

   C. a relatively large start-up firm.

   D. a relatively small start-up firm.

4. Because Frank Sonata, Chairman of the Blue Eyes Company board of directors, selected nearly all of the firm's directors and officers, he also believes he can terminate any board member who disagrees with him. Consequently, there is little disagreement among board members. Whenever a board decision produces favorable results, Frank loudly proclaims, "They did it my way!" Unfavorable results are not discussed. In evaluating these circumstances, a D&O underwriter would

   A. be wary because Frank appears to exercise a disproportionate degree of control.

   B. suspend judgment pending more detailed analysis of the results of Frank's decisions.

   C. view Frank's strong leadership favorably.

   D. view the board's lack of dissent favorably, since dissent tends to generate claims.

5. Jack and Jill have just been elected as new outside directors of Well Company. In order to get a somewhat unbiased view of Well Company, it would be a good idea for Jack and Jill to

    A. hold one-on-one meetings with top corporate officers.

    B. meet privately with the board chairman and inside counsel.

    C. meet privately with the firm's independent auditors and outside counsel.

    D. review the corporation's annual report to stockholders, press releases, and other public documents.

Answers to Chapter 10 Review Questions

1.

A. This answer is incorrect. Self-preservation can always be a problem, but it is not specific to corporate acquisitions.

B. This answer is incorrect. Shareholders would not be likely to complain that their interests were damaged by National Acquirer's bargain purchase.

C. That's correct! An acquiring company is always vulnerable to criticism that the purchase price paid for a company it acquired was excessive.

D. This answer is incorrect. Buying out competitors is not by itself illegal.

2.

A. That's correct! One person or organization with a great deal at stake is a prime candidate for suing at the first sign of a business downturn.

B. This answer is incorrect. Claims brought by Hank are a bigger concern.

C. This answer is incorrect. This sort of concentration in stock ownership can lead to a claim.

D. This answer is incorrect. In general, closely held public companies have a relatively low claim frequency, but Vista's case presents another underwriting concern.

3.

A. This answer is incorrect. Larger firms are more vulnerable to suits.

B. That's correct! The larger the firm, the more vulnerable it is to suits. Underwriters also prefer older, more-established organizations to relatively new firms.

C. This answer is incorrect. A larger firm that is not well-established is considered especially vulnerable to suits.

D. This answer is incorrect. A start-up firm is vulnerable because it is not well-established.

4.

A. That's correct! Frank's dominance likely creates a groupthink mentality in which other board members do not carefully examine his proposals.

B. This answer is incorrect. The underwriter can evaluate the decision-making process independently of its results.

C. This answer is incorrect. Frank seems to have too big a voice in corporate decisions.

D. This answer is incorrect. Evaluation of dissenting viewpoints generally leads to well-reasoned decisions.

5.

A. This answer is incorrect. Corporate officers are likely to highlight positive aspects of their work and downplay the negatives.

B. This answer is incorrect. People in these positions are not unbiased.

C. That's correct! As outsiders who also deal with other organizations, these individuals are likely to have a broader, more objective perspective than corporate insiders.

D. This answer is incorrect. Public documents usually have some degree of "spin" intended to cast the company in a favorable light.

Chapter 11
Controlling D&O Liability Claims Part 1: General Suggestions

Overview

Chapter 11 provides a number of general suggestions on how to prevent directors and officers (D&O) claims. Insured companies can implement these suggestions themselves and, in addition, underwriters can recommend that insureds apply such loss control practices. Chapter 12 offers various loss control techniques that apply to the area of corporate governance.

Chapter Objectives

On completion of this chapter, you should be able to do the following.

1. Identify D&O loss control techniques.
2. Select D&O loss control techniques applicable to a particular situation, given relevant information.
3. Recognize problems that can result from inadequate D&O loss control.

Exhibit 11.1 lists these general techniques, which are discussed in the pages that follow.

Exhibit 11.1 D&O Loss Control Techniques
• Encourage active questioning and appropriate dissent • Consult with legal counsel and outside experts • Maintain contact with operating managers (insist on a sufficient flow of information) • Avoid embarrassing corporate actions • Require review of the D&O policy and application • Monitor insider trading • Investigate warning signs • Do not manage to artificial indicators

Encourage Active Questioning and Appropriate Dissent

The chairman of the board should conduct meetings in as unbiased a fashion as possible. The purpose of having a board is not necessarily to achieve unanimity of opinion, but to encourage frank, open discussion and the airing of alternative courses of action and viewpoints. The board chairman must not discourage dissent among board members and challenge board members to put forth out-of-the-ordinary viewpoints. By discouraging a "yes man" culture within corporate boardrooms, the kinds of wrongdoing that have led to some of the largest corporate scandals would have been more difficult to carry out.

The Problem with Board Appointments: Too Often a Function of Friendship

Unfortunately, directorships are far too often given to those who are close personal friends of the company's chairman. As a result, board members' general business philosophies tend to mesh closely with the CEO. For this reason, there is an inherent tendency of board members to agree with the chairman rather than question his or her ideas and initiatives. The airing of differing viewpoints tends to be the exception rather than the rule. To the extent possible, boards should guard against the dangers inherent in "groupthink" based upon personal affinity, relying instead upon true expertise and objectivity.

Avoiding Groupthink by Appointing an "Out of the Box" Director

New York-based Signature Bank provides an example of how one corporation actively sought a board member who (likely) possesses viewpoints that differ significantly from most other executives working within its particular industry. In June 2015, the bank asked former United States Congressman Barney Frank to join its board of directors. Previously, in July 2009, Congressman Frank introduced and was instrumental in helping to pass landmark legislation that bears his name ("The Dodd-Frank Wall Street Reform and Consumer Protection Act"), which imposed a variety of operational requirements on banks and other financial institutions. Given his background, it is probable that with respect to matters pertaining to banking regulation, the congressman holds opinions unlike those of his Signature Bank board colleagues.

Consult with Legal Counsel and Outside Experts

In situations where actions must be taken (e.g., responding to a takeover bid) but where there is potential for claims arising from such actions, reliance on outside investment banking and/or legal counsel is perhaps the best method of reducing exposure and developing a sound defense to allegations of wrongdoing.

For example, if another firm makes an offer to buy the company, an independent investment banking firm can provide objective input as to its fair market value. Acceptance or rejection of the offer—based on an unbiased party's assessment—can then be used to justify management's final decision when confronted by a lawsuit alleging that directors and officers agreed to sell the company at too low a price or, alternatively, that it mistakenly rejected a buyout proposal because, in the board of directors' view, the offering price was too low.

Maintain Contact with Operating Managers

Directors must guard against being insulated from the actions and decisions of operating managers. This is an admittedly difficult task, given the distance between an outside director and the company's day-to-day operations. There should be no hesitation in questioning members of operating management about actions that have been taken or regarding current conditions. While only directors have the legal right to attend board meetings, operating managers should be questioned at such meetings, where appropriate.

"Management by Walking Around"

In addition to their other oversight work, directors should also thoroughly examine the company's day-to-day "ground level" operations. In effect, "management by walking around" is important for directors to do on a periodic basis. Board members should be curious and should occasionally visit stores, factories, and other company offices. Simply observing how work is done, what the typical workplace interactions are like, and even asking questions of regular employees and mid-level management can prove to be very insightful for directors that are typically more detached from the actual workplace.

Avoid Embarrassing Corporate Actions

Management experts frequently advise that businesses "never do anything in private that would be embarrassing if revealed to the public." For example, at one time it was revealed that American International Group (AIG) had spent nearly a half-million dollars to send a number of its sales executives to an outing at a high-end resort. Normally, this would not have triggered a public outcry. However, only a month earlier, AIG had received more than $100 billion in U.S. government funding as a means of saving the company from bankruptcy. This was a classic example of how a seemingly private action fanned the flames of public resentment—an action that encouraged investors to file claims against the company's directors and officers in addition to the ones that had been already made at the time of the revelation about the resort event. An example like this shows the effect that bad timing can have by amplifying an otherwise unremarkable event or action.

Require Review of the D&O Policy and Application

By studying both the application for D&O coverage and the policy itself, directors and officers will have a better idea of the scope of acts covered by the insurance contract. Reviews of this kind can provide a heightened awareness of the types of conduct that could give rise to claims—regardless of whether coverage applies. In addition, the organization's risk manager or insurance representative should be called upon annually to make a detailed presentation about the firm's D&O insurance program. This provides an ideal forum to address difficult points of coverage as well as to update directors and officers on the current state of the market for coverage.

The Importance of the Application

Special attention should be focused on two items within the application. First, directors and officers should study the documents attached to the application. This is because insurers have increasingly used inaccuracies or outright misrepresentations in such documents as the basis of rescission (i.e., an action that voids the entire policy). If need be, these documents should be reviewed by a professional in the appropriate area of expertise before submission to the insurer.

Second, board members should review the claim warranty statement, in which the signer of the application is asked to assert that he or she knows of no incidents that could produce a future claim. Discussions concerning this item could reveal problematic situations that should be immediately reported to the firm's current insurer, an action that might prevent a claim denial under a future policy.

Monitor Insider Trading

One of the most dangerous components of a serious securities class action lawsuit is the presence of significant insider trading at a suspicious time and in suspicious amounts. Referring to the classic Enron example, COO Jeffrey Skilling sold massive amounts of the company's stock during the summer of 2001, immediately prior to the implosion of the company's stock in the fall of that year. The same is true of former Countrywide CEO Angelo Mozilo, who also unloaded suspicious amounts of the stock he owned in the company immediately before it experienced a similar plunge.

Given the high correlation between heavy insider trading and securities class action claims, underwriters often insist that the company's insider trading policy has well-established trading "blackouts" (e.g., no trading is allowed for the 60 days immediately prior to or after a quarterly earnings announcement) and "windows" (e.g., trading is only allowed during the first 60 days of each fiscal year). Lastly, an effective compliance officer who strictly enforces such rules should oversee these policies.

Investigate Warning Signs

In most instances of corporate financial or operational problems, warning signs are visible to senior management and directors long before the problem fully develops. Directors and officers should be vigilant in identifying those warning signs and should adequately respond on a timely basis.

Such warning signs include (1) a company entering into numerous transactions designed for financial reporting purposes rather than those containing real economic substance; (2) an excessive number of related-party transactions, such as large-dollar-volume sales to subsidiaries; and (3) highly complex transactions of which some senior managers and the directors did not understand the structure, purpose, terms, and effect.

Enron: A Case Study in Financial Manipulation

A high percentage of Enron's revenues were generated by "sales" of assets to nonconsolidated "special purpose entities." These kinds of complex, off-balance sheet transactions are completely lacking in economic substance yet create the appearance of actual revenue. They are often a sign of intentional financial mismanagement and ultimately produce claims. Such activity requires thorough investigation. These and similar transactions should be approved by knowledgeable, informed, and truly independent boards of directors, based on the advice of qualified outside advisers where appropriate.

Do Not Manage to Artificial Indicators

Public companies routinely focus on meeting analysts' expectations of quarterly earnings. Regrettably, meeting these expectations can become an end in itself, rather than managing the company to achieve long-run growth and profitability. As a result, an environment can be created in which personnel at all levels of the company are pressured to do whatever it takes to meet these short-term artificial indicators. Such a mindset may encourage the kinds of deceptive accounting practices described above. Instead, companies should strive to build long-term credibility and seek to avoid unreasonable expectations by company constituents such as stockholders and securities analysts.

Chapter 11 Review Questions

1. Jack, a major stockholder, often pops up at Cobblers Bench stockholder meetings to express an opinion contrary to what the board of directors is proposing. Jack's outside-the-box opinions are annoying, but they have also led the board to take another look at some important issues. Why might it be a good idea to appoint Jack to Cobblers Bench's board of directors?

   A. As a member of the board, Jack will be less likely to disrupt stockholder meetings.

   B. Jack might be less cranky as a board insider.

   C. Jack's outside-the-box viewpoints would help the board avoid the dangers inherent in groupthink.

   D. Other members of the board could shoot down Jack's ideas before he pops up to make public statements.

2. Only-a-Dollar Stores, Inc., approaches the board of Dime Stores, Inc., with an offer to buy the company. Whether accepted or rejected, a takeover bid can lead to a claim against Dime's directors and officers. Which of the following presents the best method for Dime's board to develop a sound defense against any allegations of wrongdoing in its response to Only-a-Dollar's offer?

   A. Accept the offer without further negotiation if the price seems fair.

   B. Obtain input from an independent investment banking firm concerning Dime's fair market value.

   C. Obtain the minutes of Only-a-Dollar's board meeting that preceded its buyout offer.

   D. Reject the offer without further negotiation if the price seems too low.

3. When Bill completed the warranty statement in the application for directors and officers (D&O) insurance on his charitable foundation, he conveniently forgot to mention a previous incident involving secret payoffs of foundation money to an intern that had the potential to produce a future D&O claim. If the insurer discovers this inaccuracy in the application after the policy goes into effect, it might be used as the basis for a(n)

   A. additional premium.

   B. audit premium.

   C. exclusionary endorsement.

   D. rescission.

4. Why is it important for board members to review the claim warranty statement in an application for directors and officers insurance?

   A. Directors should be aware of any exclusions in the warranty.

   B. Directors should know how long the warranty is good.

   C. Failure to identify a situation likely to produce a claim might give the insurer grounds for denying a subsequent claim.

   D. Failure to list any incidents could raise underwriters' suspicions and lead to a denial of coverage.

5. When Clementine joined the board of Citrus Company, she was surprised to discover that Citrus has a policy that will only permit her to buy or sell Citrus Company securities during the months of January and February. What is the most likely reason for this policy?

   A. Blackouts commonly take place during those 2 months due to ice storms.

   B. During those 2 months of the calendar year, Citrus Company's inventory is frozen.

   C. The trading window is open during those 2 months to encourage insider trading.

   D. This short trading window limits inappropriate insider trading.

Answers to Chapter 11 Review Questions

1.

A. This answer is incorrect. To some extent, at least, Jack's disruptions have been healthy.

B. This answer is incorrect. Jack might pop up with his outside-the-box ideas because he is cranky, but his cranky ideas have been helpful, in at least some cases.

C. That's correct! Exploring alternative viewpoints helps the board avoid the "yes man" culture that leads to groupthink.

D. This answer is incorrect. Other board members will have a better opportunity to listen to and evaluate Jack's ideas rather than being forced to react on the spur of the moment. The board might choose to adopt some of Jack's ideas or at least present them to stockholders as an alternative idea that was carefully considered.

2.

A. This answer is incorrect. Lack of any due diligence could easily lead to allegations of wrongdoing.

B. That's correct! An independent investment firm can provide objective input on the firm's value.

C. This answer is incorrect. The minutes might or might not include any relevant information.

D. This answer is incorrect. Upon further investigation, the board might find that a price that subjectively seemed too low might actually be a generous offer.

3.

A. This answer is incorrect. The insurer would not change the premium on a policy already in force.

B. This answer is incorrect. Any audit premium would be based on exposures during the policy term.

C. This answer is incorrect. An endorsement would not be necessary to give the insurer grounds for denying a claim.

D. That's correct! Insurers have increasingly used inaccuracies or outright misrepresentations in application documents as the basis of rescission—an action that voids the entire policy.

4.

A. This answer is incorrect. The warranty does not contain exclusions.

B. This answer is incorrect. It's not that type of a warranty.

C. That's correct! The person(s) signing the application asserts that they know of no incidents that could produce a future claim. Failure to report such an incident provides grounds for denying a claim that results from that incident.

D. This answer is incorrect. If indeed there were no incidents to report, that is a favorable underwriting sign.

5.

A. This answer is incorrect. The issue here is not electrical blackouts, but trading blackouts.

B. This answer is incorrect. During those months, Citrus can concentrate on frozen orange juice and similar products.

C. This answer is incorrect. The short trading window discourages insider trading.

D. That's correct! Because heavy insider trading often leads to securities class action claims, underwriters probably insist that Citrus Company's insider trading policy has well-established trading "blackouts" such as this one that are strictly enforced by an effective compliance officer.

Chapter 12
Controlling D&O Liability Claims: Effective Corporate Governance

Overview

This chapter provides a detailed review of a company's corporate governance practices, an important part of public company underwriting.

Chapter Objectives

On completion of this chapter, you should be able to do the following.

1. Recognize what is meant by "corporate governance."
2. Identify best practices associated with corporate governance.
3. Recognize why certain practices are considered best practices.

What Is "Corporate Governance"?

Corporate governance is a system specifying the division of duties, rights, and responsibilities among various participants in a corporation, typically the board of directors, various committees within the board of directors, operating managers, and shareholders. Corporate governance enumerates the rules, guidelines, and procedures for making decisions affecting corporate affairs.

Although adoption of a "best practices" approach to corporate governance provides no guarantee that a company will not be involved in a claim, firms that are actively implementing such practices are less likely to have problems and will be better able to defend themselves if a claim does arise. Exhibit 12.1 lists these "best practices," which are discussed in this chapter.

Exhibit 12.1 Corporate Governance "Best Practices"
• Assure independent decision-making on the board • Require a minimum level of stock ownership • Reform option-related compensation practices • Separate the roles of board chairman and CEO • Conduct CEO-free board meetings • Periodically evaluate director performance • Improve audit committee effectiveness • Provide directors with relevant and timely information • Limit time devoted to board service • Avoid conflicts of interest • Eliminate corporate board "interlock"

Assure Independent Decision-Making on the Board

The following actions can assure the independence of a corporate board.

Limit Corporate Boards to No More than Three Insiders

If a board consists of only three insiders (typically the CEO, COO, and CFO), there will be a higher probability of independent decision-making (assuming there are at least four outside directors). This is true because when operating executives are in the minority, they will, of course, have a minority of votes on any given issue or proposal.

Assign Only Independent, Outside Directors to the Three Key Committees

The audit, compensation, and nominating committees are the three key board committees. By assigning only independent directors to them, the board will be better able to render unbiased decisions.

Set Mandatory Term Limits

Directors should be required to resign after 10 years on the board or at age 70, whichever comes first. These benchmarks help to ensure that a board member does not become so entrenched that he or she begins to rubber stamp a CEO's initiatives rather than evaluating each major proposal with healthy skepticism. A number of corporate governance experts refer to planned, periodic turnover as maintaining a "refreshed board."

Ban (or at Least Limit) Stock Sales by Directors for the Duration of Their Service

If directors are banned (or at least limited) from selling their shares during their tenure, they will have more incentive to reveal inappropriate conduct by operating management. This will allow them to divulge such improprieties without fear of the consequences associated with short-term price declines in the company's stock that may follow.

For example, if a director feels that a company is engaging in "aggressive accounting" in an effort to bump up earnings, an announcement to that effect would probably cause a drop in the company's share price, at least in the short-term. However, if a rule was in effect that banned sales of the company's stock during a director's tenure, the share price would likely recover, and the director would not be hurt financially. (Alternatively, limiting such sales to perhaps $250,000 each year would have essentially the same effect while allowing for the fact that directors may have personal emergencies requiring them to raise cash by selling stock in the company.)

Require a Minimum Level of Stock Ownership

On a number of high-profile corporate boards, directors hold only small equity positions. As a result, they are virtually immune to the financial consequences of their own poor decisions. However, by requiring a minimum equity stake (e.g. $250,000), there is greater assurance that the interests of stockholders and board members will be aligned. The only exception to this rule should be for relatively new directors who have not served on the board long enough to build up the requisite equity stake. (This is, in essence, the converse of the situation noted above, in which board members have too much of a stake in the company's fortunes, in the short-term, at least.)

Reform Option-Related Compensation Practices

As already explained in this course, option grants are a significant source of claims against corporate directors and officers. So by bringing increased discipline to the process of option grants, there will be reduced temptation for directors and officers to artificially inflate the prices of their stocks through short-term earnings maneuvers in hopes of cashing in outsize option gains.

FASB Impact on Option Grant Abuses

Under previous accounting rules, stock option grants were not treated as an expense on a corporation's income statement. This had the effect of encouraging options grants as part of CEO pay packages, as well as director and officer pay packages. (Instead, if such grants were treated as current expenses, it would have the effect of lowering a corporation's short-term earnings, something that few corporations prefer.)

The rule, in turn, supplied corporate executives with incentive—perhaps too much so—to manipulate the price of the corporation's stock. Such incentive, as has been apparent in a number of high-profile corporate meltdowns and subsequent directors and officers (D&O) litigation, resulted in questionable, if not fraudulent, accounting practices.

In 2004, the Financial Accounting Standards Board (FASB) issued a revised statement (Statement No. 123) that mandated that employee option grants be accounted for at fair value. As the statement details, the change in accounting treatment was aimed at addressing the concern that failing to expense these grants may result in "financial statements that do not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for equity instruments."

The effect of Statement No. 123 was significant. As reported by Steven Balsam, Sebastian O'Keefe, and Mark M. Wiedemer in the Journal of Accountancy ("Frontline Reaction to FASB 123(R)," April 1, 2007), approximately 61 percent of surveyed companies had eliminated or decreased their use of options at all levels in just over 2 years after the revised FASB standard. These changes have been accompanied by a decreased incentive (and increased transparency of financial consequences) for abusing stock option grants.

Another advantage of "expensing" options is that this practice will produce more accurate earnings in the short-run.

Specific Option-Related "Best Practices"

The following specific procedures have been suggested to change the system of option granting.

- Barring exercise of options for a relatively long period, such as 3, 5, or even 7 years

- Prohibiting the exercise of options unless the stock meets or exceeds some specific benchmark, such as equaling the annual return of the S&P 500 index
- Awarding stock to executives that must be held for a number of years so CEOs can "win big or lose big" along with stockholders
- Requiring shareholders—not simply the board of directors—to vote on all stock option grants

Separate the Roles of Board Chairman and CEO

Since the wave of high-profile corporate failures in the early 2000s, one area of corporate governance that has received particular attention is the question of whether the roles of chairman of the board and CEO should be split. Some argue that such an arrangement provides greater oversight of corporations and, in extreme cases, serves to rein in CEOs tempted to bend the rules or even break the law.

Split of Board Chairman and CEO Roles

As of 2015, approximately 52 percent of S&P 500 CEOs also served as board chairmen, representing a decline of nearly 20 percent compared to 10 years earlier, according to Spencer Stuart's *2015 Spencer Stuart Board Index*. This rapid trend towards a split of the board chairman and CEO roles points towards what has already been standard practice in places like Canada and England, where a small percentage of CEOs also hold the position of board chairman. A continued switch to this system represents a sea change in American corporate governance. In light of investor skepticism and heightened demand for added scrutiny of corporate actions, an argument can be made for improved corporate governance when CEOs relinquish their title of "board chairman." Splitting the CEO and board chairman's roles might help assure D&O underwriters that financial restatements and similar liability-producing events are more likely to be prevented.

Better Monitoring of CEO Performance

Another argument in favor of dividing these roles is that there is an inherent conflict when the CEO is also chairman of the board and the board must monitor the CEO's performance and hold him or her accountable for results. Indeed, the theoretical roles of chairman of the board and CEO call for two separate individuals to handle each of the two distinct roles required by these positions. More specifically, the CEO is charged with creating overall strategies and running the company, whereas the chairman of the board is chiefly responsible for leading the board in overseeing the company's top management. When the chairman of the board and the CEO are the same person, the board's oversight role is compromised. Accordingly, a number of experts believe that effective governance is impossible if the same person is responsible for developing the firm's overall strategy and managing the business on a day-to-day basis *and* charged with evaluating and, at times, challenging those strategies on behalf of the company's owners. In their view, unless these two roles are separated, corporate governance will be an illusion.

Board Chairman and CEO: Too Demanding for One Person?

A number of observers feel it has become nearly impossible to effectively run a major corporate entity while, at the same time, performing all of the duties of a board chairman. Since the chairman's role includes setting the board agenda, providing the board members with the highest-quality information, and facilitating communication among board members and with management, it is often believed that all of these duties, in addition to running a major corporation, are simply too much for one person.

Appoint an Independent Lead Director: An Alternative To Splitting the Roles

Another variation on the approach of splitting the jobs of board chairman and CEO is to have an independent "lead" director who, after each board meeting, meets with the other independent directors.

This approach provides greater oversight of the CEO and of the entire board, yet is admittedly not as effective as having separate individuals serving in these two positions.

Conduct CEO-Free Board Meetings

Yet another effective corporate governance practice is to periodically hold board meetings, but without the presence of the company's CEO.

Facilitating Frank Discussions

The value of CEO-free board meetings is that they allow board members, who will not often confront hard issues with the CEO in the room, to be more open in his or her absence. Clearly, "executive sessions," as CEO-free board meetings are sometimes called, can promote the kind of candid, open discussions that may not otherwise have been possible.

Periodically Evaluate Director Performance

The board of directors should periodically evaluate director and officer performance and assess the extent to which these persons have met the standards set forth for them.

Areas To Evaluate

The following are among the most important areas in which performance should be evaluated.

- Regularity of attendance at both board and committee meetings
- General level of preparedness
- Capacity for asking challenging questions
- Ability to offer creative suggestions
- Willingness to make and take constructive criticism

Peer performance reviews of this type are essential in assuring that those serving in director and officer capacities are putting forth their best efforts. Although this process will sometimes hurt feelings, the stakes are too high for an organization not to receive anything less than top performance from its directors and officers.

Improve Audit Committee Effectiveness

The audit committee is perhaps the most important committee of the board of directors. Its key duties include monitoring and oversight of the following.

1. Financial reporting and disclosure
2. The choice of accounting policies and principles
3. Hiring and performance evaluation of external auditors
4. Regulatory compliance, ethics, and whistleblower hotlines
5. The internal control process
6. The internal audit function
7. Risk management policies and practices

Suggestions to enhance the committee's effectiveness include the following.

- **Financial literacy.** Audit committees should be composed of at least financially literate members (and preferably those with financial expertise) who can fully understand and critique the company's financial statements. In particular, the chairperson of the audit committee should be well steeped in financial and accounting knowledge and experience.

- **Independence.** Audit committee members should be truly independent from management and the auditors. Business, social, or other relationships that may impede the independent thinking and decision-making of committee members should be considered when evaluating a member's qualifications for service on the audit committee.
- **Frequent meetings.** Audit committees should meet regularly and frequently (i.e., each month), not just in connection with the annual audit.
- **Auditor selection.** The audit committee—not the CFO—should have full responsibility for selecting, hiring, and terminating outside auditors. A periodic turnover of auditors (or at least the partner in charge of the audit) is advisable.
- **Discussions with auditors.** The audit committee should discuss annual financial statements in one-on-one meetings with the company's auditors, senior management (e.g., the CFO), and internal accountants. In particular, the CFO should spend time with board members on the audit committee to verify that they are well versed on the unique financial aspects of the business.
- **Financial reporting policies.** The audit committee should examine very closely the financial reporting and accounting policies for significant transactions that can materially affect the company's earnings performance for a quarter or year. The audit committee should also verify that Generally Accepted Accounting Principles and any other relevant accounting rules have been followed.
- **Separate auditing and consulting services.** A vast majority of the major accounting firms now offer nonaccounting/consulting services, from which these firms derive substantial fee income, often far exceeding audit-based revenues. A number of observers feel that the combination of both an audit and a consulting relationship with the same client severely compromises an accounting firm's objectivity in performing the annual audit. Therefore, the only meaningful business relationship with a company's outside auditor should involve its annual audit.
- **Response to complaints.** The audit committee should establish procedures to receive, investigate, and respond to complaints or requests for confidential information from employees or others relating to the company's accounting or financial controls.

Provide Directors with Relevant and Timely Information

To facilitate their work, directors need to be given information that is both relevant and timely. A frequent complaint of directors is the increasing volume of reports being sent to them just prior to each meeting. Clearly, more is not better. An independent director who receives a 500-page file 3 days before the board meeting and who is to attend a discussion that management has structured around completely abstruse technical points is of no use in the decision-making process. Instead, companies should strive to supply their boards with information packets that are truly pertinent to the issues on the upcoming agenda and manageable from the standpoint of length. Moreover, this information should be made available well in advance (e.g., at least 2 weeks) of each board meeting.

Create an Adequate Support Structure

One way to assure the relevance and timeliness of information they receive is to provide directors with an adequate support structure. Despite the increasing demands placed on them, even directors of large, public corporations do not always have a dedicated staff available to assist them. And yet, given their significant and growing responsibilities (especially since passage of the Sarbanes-Oxley Act), a support structure can be valuable in assuring that directors have the necessary resources available to them.

Limit Time Devoted to Board Service

It has been estimated that approximately 278 hours per year are required to serve as a director of a major corporation. Accordingly, it is a generally accepted practice that a person should serve on no more than four corporate boards at the same time, a recommendation that tracks with Avon Products' Corporate Governance Guidelines, noted below as an example. Undoubtedly, staying abreast of the complete scope of a firm's activities is an extremely difficult task in any large organization. Therefore, underwriters should be alert for situations in which any member of a board of directors also sits on the boards of several other sizeable organizations or serves as an officer of such firms. Often, the demands that such activities have placed on a director make it difficult if not impossible to devote adequate time to preparing for board and committee meetings. An assertion that a board member had inadequate time to stay fully apprised of relevant corporate matters is not a valid defense to claims against directors and officers.

Semiretired Directors versus Directors with Full-Time Jobs

It is also important to distinguish board members who have full-time jobs with other corporations from those that are "semiretired." For example, Avon Products' Corporate Governance Guidelines (as of March 1, 2016) recommend that if a board member is the CEO of another public company, he or she should not sit on any more than two additional boards besides Avon. If not the CEO of another public company, he or she should sit on no more than four additional boards.

Limiting Board Service Is a Growing Trend

As of a 2006 survey by the executive search firm Heidrick & Struggles, in conjunction with the University of Southern California's Marshall School of Business, 40 percent of the corporations surveyed had mandated limits on the number of other boards on which outside directors can serve. This was up dramatically from 2001, a year in which just 3 percent of the corporations surveyed imposed such restrictions.

Furthermore, a December 2015 article by Todd Wallack and Sacha Pfeiffer of the *Boston Globe* ("Debate swirls on how many board directorships are enough") stated that the issue remains "a simmering debate across corporate America," citing concerns from the president of the National Association of Corporate Directors that his organization's recommended limits on the number of boards a director can serve may be outdated. At the time of the article, Institutional Shareholder Services and Glass Lewis, two of the largest shareholder advisory services, had both lowered their recommended limits on the number of boards a director can serve from six to five.

Avoid Conflicts of Interest

According to Roswell B. Perkins, a prominent New York attorney, the most effective test of a potential conflict of interest is for a board member to ask, "Do I have any reason to prefer corporate action A to action B, or vice versa, that is not a reason shared by all stockholders?" An affirmative answer reveals a conflict of interest.

Conflicts of Interest: An Example

John Smith, a director of the ABC property and casualty insurance company, is also the CEO of XYZ, a leading independent claims adjusting firm. At a recent board meeting, ABC is discussing the need to hire an independent adjusting firm. A deluge of claims caused by a recent hurricane in South Florida (where ABC writes most of its business) has created this situation. Given these circumstances, Smith has a clear conflict of interest. Although hiring his firm, XYZ, would obviously benefit Smith, the firm may not necessarily be the one best suited to ABC's needs. Consequently, Smith can and should avoid this conflict of interest by, first, not being present during any of the board's discussions pertaining to the hiring of an adjusting firm. Second, he should recuse himself from voting after the discussions have concluded and a single firm has been chosen.

"Side Deals": A Frequent Source of Conflicts

So-called "side deals," in which directors are frequently involved, are another source of conflicts of interest. According to Executive Compensation Advisory Services, one out of four U.S. firms is involved in such conflicts, the likes of which frequently include the following by board members, in conjunction with the companies on whose boards they sit.

- Receipt of consulting or legal fees
- Participation in lease agreements
- Involvement in contracts to purchase or supply goods

Obviously, such deals cast serious doubt on a director's independence. In addition, these types of arrangements reflect poorly on the company's CEO because they create the perception that such consulting contracts are a means of quelling opposition on the board. Obviously, board members should not also function as consultants, suppliers, or providers of legal, brokerage, or investment banking services.

Eliminate Corporate Board "Interlock"

Related to the issue of conflicts of interest is the fact that there is a high percentage of "overlap" between the board members of many major corporations. Such overlap, also known as "interlock," occurs when two (or more) board members also sit together on another corporate board.

Board Interlock: Potential for Quid Pro Quo Deals

The problem with board interlock is the potential for quid pro quo deals, especially when CEOs serve on each other's boards. According to New York University professor Lawrence White, "Anytime you have two guys sitting on at least two boards, there's room for horse trading." While corporate interlock does not necessarily create conflicts of interest, it does increase the potential for the kinds of acts that could encourage claims against directors and officers.

Proving direct damage to shareholders from board interlock is difficult. Yet, if a board member rubber stamps a business decision that turns out to be a bad move and costs the company money, the question arises as to whether the directors made a mistake or whether they had ulterior motives.

The Dangers of Board Interlock: An Example

John Smith, who is the CEO of the Ajax Corporation, sits on both the board and compensation committee of the National Motors Corporation. Mary Jones, National Motors' CEO, sits on both Ajax's board and compensation committee. In this situation, it is quite obvious that each can assist the other in garnering maximum pay packages as CEO's of their respective organizations.

Exhibit 12.2 provides a case study of how the structure of one board of directors appeared to be burdened with (1) conflicts of interest, (2) board interlock, and (3) excessive time commitment to other boards.

Exhibit 12.2
American Airlines: A Case Study in Board Interlock

On May 9–15, 2003, the *Dallas Business Journal* reported that Anne McNamara, who retired in January as general counsel for American Airlines (AMR), is married to board member Philip Purcell, chairman and CEO of Morgan Stanley. As indicated in AMR's 2002 proxy statement, Morgan Stanley supplied financial services to AMR. According to Gavin Anderson of New York-based Governance Metrics International, Inc., "We wouldn't regard Mr. Purcell as independent."

Another potential problem is that eight AMR directors sit on four or more boards. This exceeds the rule of thumb that a person who is employed on a full-time basis should sit on only one other board, while those not employed should serve on a maximum of four boards. (One member, Michael Miles, serves on seven boards in addition to AMR.)

A third potential problem is the degree of interlock between board members. Specifically, Miles and ex-AMR CEO Don Carty sit on Sears Roebuck's board; Miles, Purcell, and Edward Brennan work together on Morgan Stanley's; Miles and Carty are on Dell Computer's; Brennan and Miles are part of Allstate Insurance Company's; and Earl Graves and Judith Rodin serve on Aetna Insurance Company's board.

Chapter 12 Review Questions

1. CERF Company's board of directors is adopting a "best practices" approach to corporate governance. By doing so, the CERF board
   - A. can guarantee that the company will not be involved in a directors and officers (D&O) claim.
   - B. is riding the wave of modern corporate cultures.
   - C. waives some of its defenses.
   - D. will better be able to defend itself if a D&O claim does arise.
2. The Black Corporation recently made all the following changes to its board of directors. Which of them is most likely to assure that Black board members make independent decisions?
   - A. Black's CEO became chairman of the board's nominating committee.
   - B. Directors were banned from selling their shares of corporate stock while serving on the Black board.
   - C. Four corporate insiders were added to the Black board.
   - D. Term limits were expanded to enable the current treasurer, who is completing 10 years of service, to remain on the Black board.
3. If only independent directors are assigned to a corporation's audit, compensation, and nominating committees,
   - A. inside directors are likely to resent their input.
   - B. it will be easier for committee members to meet at a convenient time and place.
   - C. the board will be better able to render unbiased decisions.
   - D. these committees lack sufficient insight to make effective decisions.
4. When Walker Corporation recruited Luke Sky to serve as its new CEO, his compensation package included substantial stock options. Luke Sky would benefit if Walker stock performed well. How, if at all, should Mr. Sky's stock option grants be treated on Walker's financial statements?
   - A. They should be acknowledged in a footnote.
   - B. They should be included since the options are a corporate asset.
   - C. They should be valued at fair value.
   - D. They should not be mentioned because they do not currently involve a cash transaction.
5. The performance of a board of director's auditing committee, perhaps its most important committee, is likely to be enhanced if
   - A. committee members are financially literate.
   - B. committee members maintain close personal or social relationships with managers and auditors.
   - C. committee meetings are infrequent and deal primarily with the annual audit.
   - D. the committee delegates primary responsibility for selecting outside auditors to the CFO.

Answers to Chapter 12 Review Questions

1.

A. This answer is incorrect. Adoption of a "best practices" approach to corporate governance provides no guarantee that a company will not be involved in a claim.

B. This answer is incorrect. What other companies are doing is not relevant.

C. This answer is incorrect. If anything, CERF strengthens its defenses.

D. That's correct! Firms that actively implement best practices are better able to defend themselves if a claim does arise.

2.

A. This answer is incorrect. If only independent directors were assigned to the nominating committee, the board would better be able to render unbiased decisions.

B. That's correct! This gives directors more incentive to reveal inappropriate conduct by operating management because the consequential short-term price declines in the company's stock will not adversely affect the directors.

C. This answer is incorrect. Assuming there are at least four outside directors, a corporate board should have no more than three insiders.

D. This answer is incorrect. Directors should be required to resign after 10 years on the board or at age 70, whichever comes first.

3.

A. This answer is incorrect. Inside directors should welcome their objectivity.

B. This answer is incorrect. It is more difficult to get outsiders to agree on a time and place when all can be available.

C. That's correct! Outside directors have less personal stake in the outcome of these committees' actions.

D. This answer is incorrect. Effective decision-making may be enhanced by these outsiders' objectivity.

4.

A. This answer is incorrect. They should be accounted for within financial statements.

B. This answer is incorrect. Stock options are an expense.

C. That's correct! Financial Accounting Standards Board Statement No. 123 mandates that employee option grants be accounted for at fair value.

D. This answer is incorrect. They should be mentioned in order to produce an accurate earnings report.

5.

A. That's correct! Audit committee members should be able to fully understand and critique the company's financial statements.

B. This answer is incorrect. Social relationships can impede independent thinking.

C. This answer is incorrect. Audit committees should meet frequently and regularly.

D. This answer is incorrect. The audit committee—not the CEO—should have full responsibility for selecting, hiring, and terminating outside auditors; a turnover of auditors is advisable.

Chapter 13
Private Company D&O Liability Exposures

Overview

This chapter provides an overview of the liability exposures faced by the directors and officers of private companies, the kinds of claims made against private companies, and the reasons that private companies purchase directors and officers (D&O) liability insurance.

Chapter Objectives

On completion of this chapter, you should be able to do the following.

- Recognize the distinctive features of private companies and identify three types of privately held companies.
- Identify the differences between private companies' financial reporting requirements and those of public companies.
- Recognize the types of claims commonly made against private companies.
- Identify sound reasons why a private company should purchase D&O insurance.

Types of Private Companies

There are three types of privately held companies.

- **Sole proprietorship.** This is a business owned by a single person. Sole proprietorships may be operated solely by the owner or may employ others. The owner of the business has total and unlimited personal liability for the debts incurred by the business. Sole proprietorships are frequently small businesses (i.e., those with less than $1 million a year in annual revenues).
- **Partnership.** A partnership is an unincorporated arrangement in which two or more people own a business. Each partner has total and unlimited personal liability for the debts incurred by the partnership. There are three types of partnerships: (1) general partnerships, (2) limited partnerships, and (3) limited liability partnerships.
- **Corporation.** A corporation is an entity having a legal existence separate from its owners. The owners have no personal liability for the debts and liabilities incurred by the corporation. A business corporation is owned by multiple shareholders and is overseen by a board of directors, which hires the firm's managerial staff. A corporation may be privately held or publicly traded.

Privately Held Corporations

A privately held corporation is one that (1) is owned by a relatively small number of shareholders and (2) does not offer its stock for trade on one of the major stock exchanges, such as the New York Stock Exchange (NYSE) or the National Association of Securities Dealers Automated Quotations (NASDAQ). Instead, the company's stock is offered for sale, owned, and traded privately, often by (1) family members; (2) a small group of investors; or (3) executives, managers, or employees at the company.

In 2015, Forbes' list of the 216 largest privately held companies generated $1.637 trillion in revenues (the U.S. economy's gross domestic product was roughly $17.42 trillion in 2014).

Largest Privately Held Companies

Some of the largest, most recognizable privately held companies in the United States include Koch Industries, Bechtel, Cargill, Dell, PricewaterhouseCoopers, Ernst & Young, Publix, Albertsons, Love's Travel Stops & Country Stores, H-E-B Grocery, and Mars.

Financial Reporting and Other Requirements

Privately held companies have fewer and generally less extensive reporting requirements (e.g., annual reports, quarterly financial reports that must be filed with the federal government) compared to publicly traded companies. The most important difference in reporting requirements is that in the United States, privately held companies—unlike publicly held companies—are not required to report or publish their financial statements.

Privately held companies also sometimes have restrictions on the total number of shareholders they may have. For example, Section 501 of the Jumpstart Our Business Startups Act of 2012 makes a privately held company subject to public company reporting requirements if it has total assets over $10 million and 2,000 or more shareholders.

Specific Types of Claims Made Against Private Companies

The following section describes some of the more common types of claims made against private companies, including shareholder claims and claims from miscellaneous entities.

Shareholder Claims

One of the great misconceptions surrounding private company D&O insurance coverage is that because private companies do not face the prospect of shareholder class action litigation, they do not have an exposure to claims involving shareholders.

The Three Myths of Private Company Securities and Securities Claims

The term "securities" refers to (1) equity securities, otherwise known as shares of stock in the company, and (2) debt securities, also called bonds issued by a company, which represent an obligation for the company to repay the purchasers of such bonds.

Three myths are associated with private company securities.

- Private companies do not issue securities to the public.
- Private companies are not subject to U.S. securities laws.
- Private company directors and officers are held to lower conduct standards compared to directors and officers in public companies and, therefore, would not even be liable for securities claims.

The following sections will explain—and explode—these myths.

Private Companies Do Issue Securities to the Public

Admittedly, private companies do not issue *equity* securities to the general public. However, they do issue equity securities to small groups of investors in what are known as *private placements* (typically to investment banks and wealthy individuals). In addition, larger private companies routinely issue *debt* securities (i.e., bonds) to the public. If, for example, such a company were to default on these bonds, it is likely that a class action lawsuit against the company would follow.

Private Companies Are Subject to U.S. Securities Laws

Private companies are indeed subject to such laws, despite the fact that private companies are generally exempt from having to *register* their securities with the Securities and Exchange Commission (SEC). These exemptions apply when debt securities are issued to the public. The exemptions also apply to *private placements* (i.e., equity securities offered to a limited number of investors but not to the public). But simply because the company is not required to *register* the private placement with the SEC does not exempt the company from having to *comply with* federal securities laws. If, for example, a prospectus describing an offer of a privately held company's shares contained fraudulent misrepresentations about the company (e.g., the prospectus vastly inflated the extent of the firm's profits during the preceding 5 years), the directors and officers of the company could be held liable because federal securities laws require that information contained in securities prospectuses be truthful.

Private Company Directors and Officers Are Held to the Same Conduct Standards as Directors and Officers in Public Companies

The case of *Pereira v. Farace*, 413 F.3d 330 (2d Cir. N.Y. 2005), which was decided in 2005, definitively established this principle. The case involved circumstances similar to those in Tyco International, where former CEO Dennis Kozlowski was convicted of looting the company. In *Pereira*, the judge found that the board of directors was derelict in its duties in failing to detect large-scale embezzlement by its own CEO. Because of the losses the company suffered, its shareholders sued the company's directors and officers. The latter were found liable for the loss the shareholders sustained, despite the board's contention that it was being held to standards of conduct required of public corporations (which the court deemed applicable).

Claims by Minority Shareholders

In reality, claims by minority shareholders pose an even greater threat to private company directors than do claims from common shareholders of a large public company. This is because, compared to common shareholders of a public company, minority shareholders often have better access to the inner workings of the business. Consequently, minority shareholders, many of whom are employees with day-to-day knowledge of the private company's daily activities, are better able to uncover director/officer malfeasance about which they often have more detailed information, thereby helping make such allegations "stick."

Claims Associated with Private Placements

As already mentioned, even if a company's securities are exempt from SEC registration, the company can still be sued for misrepresentation or other securities violations when it issues securities to investors by means of a private placement. Just like shares offered to the general public by a public company, private placements require the company to issue what is known as an *offering statement* or *prospectus,* a document setting forth the nature of the company's operations, as well as its financial statements, and the specific purpose for which the funds being raised will be used. Purchasers of private placements can use false statements in such documents as a "road map" for making claim allegations against the directors and officers of private companies.

Claims by Miscellaneous Entities

A number of nonshareholder/miscellaneous entities routinely bring claims against private company directors and officers. Such entities include competitors, government agencies and regulators, creditors, customers, and vendors.

Competitors

Allegations brought by a competitor against a private company's directors and officers can include (1) interference with contractual relationships, (2) misappropriation of trade secrets, (3) fraud/misrepresentation, and (4) unlawful access to stored information.

Government Agencies and Regulators

A common source of claims stemming from government agencies and regulators are those related to antitrust lawsuits and/or price fixing allegations. These claims may arise if it is perceived that a private company, along with its competitors, conspired to "set" prices for a given industry in a concentrated location.

Creditors

Creditors, on the other hand, most often allege loan fraud in the claims that they have brought against privately held companies. Claims of this sort may arise, for example, if an executive of a privately held company falsified a loan application, resulting in a default that would have otherwise been more foreseeable.

Customers

A common example of a customer claim against a privately held company is the allegation that the company did not deliver its product on a timely basis and/or in accordance with a written delivery contract, causing the customer claimant to lose business from its own customers as a result.

Vendors

Vendor claims may arise when the privately-held organization purchases goods from a vendor despite being aware of its own poor financial condition, resulting in the privately held company's failure to honor its obligations when payment is eventually due.

Statistics Related to Private Company Director and Officer Liability

Chubb's "2013 Private Company Risk Survey" offers many insights into the type, frequency, and severity of litigation levied against private company directors and officers. Some of the particularly notable statistics from the survey are included below.

- In the 10 years prior to the survey, 27 percent of private companies were affected by directors and officers claims (only 6 percent less than public companies).
- In the same time period, the most common types of directors and officers claims against private companies were (1) employment-related, (2) derivative shareholder/investor suits, (3) direct shareholder/investor suits, (4) regulatory, and (5) fiduciary.
- The average total cost of a director and officer liability event to a private company was $697,902 (including judgments, settlements, fines, and legal fees).
- 25 percent of private companies were likely to be involved in a major acquisition/merger/sale in the year immediately following the survey (indicating the high degree to which private companies are exposed to claims).
- 60 percent of private companies lacked a published corporate governance program.
- Only 28 percent of private companies purchase D&O liability insurance.

Why Private Companies Purchase D&O Insurance

Private companies purchase D&O insurance for a variety of reasons, both similar to and different from the reasons that motivate public companies to do the same. Some of the more prominent reasons are discussed below.

Need To Attract Managerial/Board Talent and Expertise

Increasingly, people who are being asked to serve on the boards of privately held corporations have become aware of the threats to their personal assets that claims against them can pose. This is because claims against corporate directors and officers have received increasing amounts of publicity in the media—in addition to the fact that both their frequency as well as their severity have consistently risen.

Accordingly, if a private company has not purchased D&O insurance, otherwise qualified individuals may be reluctant to serve on the boards of directors at such firms.

Protection for Directors' and Officers' Personal Assets

Directors and officers liability insurance can protect the personal assets of private company directors and officers if they are sued during the course of their service.

Although corporate bylaws and state laws may appear to require that companies indemnify their directors and officers in the event of a lawsuit, this may not be the case in certain situations.

One reason that indemnification might not be available for private company directors and officers could be that the company is financially unable to provide such indemnification. Insolvency and/or bankruptcy, scenarios that are typically even more of a concern for private companies than public companies, frequently result in a company's financial inability to honor its legal obligations to indemnify its directors and officers.

Derivative lawsuits present another situation in which indemnification may not be available for private company directors and officers. These lawsuits, due to the fact that they are brought *on behalf of* the corporation, reward any damages to the corporation itself, meaning the damages are not indemnifiable under corporate bylaws.

In light of the above situations in which indemnification is not available, a private company D&O policy is important in order to protect the personal assets of directors and officers. This importance is underscored by the fact that virtually no personal umbrella liability policies will afford coverage for service on for-profit boards of directors, contrary to commonly held beliefs regarding the applicability of these policies. (Note, however, that coverage of nonprofit board service is often available by endorsement to personal umbrella policies.)

Protection for the Company's Balance Sheet

Unlike large public companies, in the absence of insurance coverage, most small businesses do not have the financial wherewithal to fund major litigation and/or cover large settlements and judgments out of their operating capital.

Even if a company *can* pay a settlement or judgment—along with the costs of defense—such payments are likely to leave the firm in an impaired financial condition.

For these reasons, having D&O coverage in place may mean the difference between survival and failure for many privately held organizations, much like having a property policy may determine whether a company is eventually able to resume operations after a major physical loss.

Advantages When an Insured Private Company Goes Public

Although the majority of privately held companies never go public, those that do enjoy the following benefits from having bought directors and officers coverage as a private company.

- The organization will be able to obtain broader coverage.
- Coverage will come at a lower price compared to a company that never had a D&O policy in place while it was privately held.

For the privately held firm that is considering going public, the time to develop a relationship with an underwriter is *while the organization is still a private company*. A competent D&O liability underwriter will or certainly should have doubts about a company that decides to go public but had never previously purchased coverage. The essence of any directors and officers risk is the extent of knowledge, ability, and business acumen possessed by the individuals who manage the company, and an omission of this sort should give underwriters pause about such a company's insurability.

New public companies also face higher-than-average potential for claims, yet another reason for an underwriter's reluctance to cover a first-time buyer of a directors and officers liability policy. One reason for this higher-than-average potential for claims is the variety of problems that can arise when filing an offering statement with the SEC. Since these statements reveal a significant amount of information about the company that is relevant to investors, claims may allege that the information presented was misleading or deliberately false, leading to an erroneous investment.

Another cause of increased claim potential is the elevated pressure for continuous earnings growth that has become almost a requirement for publicly held businesses. Since new public companies may not have faced this pressure from investors when they were still privately held, their directors and officers may now be more at risk of using questionable tactics (often accounting-based) to inflate earnings and relieve "earnings pressure," eventually resulting in shareholder claims.

For the preceding reasons, an already insured private company may be better suited to prove to an underwriter its awareness and management of directors and officers liability issues, therefore increasing the likelihood of securing broader coverage at a reasonable price.

Chapter 13 Review Questions

1. Fisher, who owns a small fishing boat, operates his seafood supply business as a sole proprietorship. He is slowly paying off the loans from Hillside Bank and from his mother that enabled Fisher to purchase the boat. Who is on the hook for any other debts incurred by Fisher's business?
    A. Fisher
    B. Fisher's mother
    C. Hillside Bank
    D. Hillside Bank and Fisher's mother
2. Manny, Moe, and Curly each contributed $10,000 in cash to purchase a truck that they use to operate a piano-moving business. Manny, Moe, and Curly are the sole owners of this business, which currently has no debt and no insurance. This business appears to be a
    A. corporation.
    B. failure.
    C. partnership.
    D. sole proprietorship.
3. Phantom, Inc., has 1,000 shares of outstanding stock that various shareholders purchased as an investment. Jack Schmitt, who owns 40 percent of the stock, is the majority shareholder and chairman of Phantom's board of directors. What person or entity is responsible for debts and liabilities incurred by the corporation?
    A. Each shareholder is personally liable for the corporation's debts and liabilities.
    B. Jack Schmitt is personally liable for the corporation's debts and liabilities because he is the chairman of the board.
    C. Jack Schmitt is personally liable for the corporation's debts and liabilities because he is the majority shareholder.
    D. Phantom, Inc., has a legal existence separate from its owners and is the entity responsible for the corporation's debts and liabilities.
4. Some of the stock in the Bloom Corporation, all of which three members of the Bloom family originally owned, has recently been inherited by an original stockholder's children. Now that the corporation has seven owners who are family members, Bloom Corporation is a(n)
    A. open corporation.
    B. privately held corporation.
    C. publicly held company.
    D. publicly traded corporation.

5. To make its initial public stock offering attractive to investors, Private Company prepares a prospectus that significantly understates the company's operating expenses during the past several years. In this scenario,

    A. federal security laws do not apply.

    B. Private need not register its securities with the Securities and Exchange Commission.

    C. Private will be permitted to issue equity securities to members of the general public, who first receive a prospectus.

    D. Private's directors and officers could be held liable for this wrongful act.

Answers to Chapter 13 Review Questions

1.

   A. That's correct! The owner of a sole proprietorship has total and unlimited personal liability for the debts incurred by the business.

   B. This answer is incorrect. Fisher's mother is off the hook.

   C. This answer is incorrect. Perhaps the bank did not carefully underwrite the loan, but that does not make the bank responsible for Fisher's other debts.

   D. This answer is incorrect. The bank and the mother did not incur the debt; Fisher did.

2.

   A. This answer is incorrect. The business is unincorporated.

   B. This answer is incorrect. The piano moving operation's lack of insurance suggests that the firm is out of tune with good management practice, but it might be lucky and succeed despite this ineptitude.

   C. That's correct! A partnership is an unincorporated arrangement in which two or more people own a business.

   D. This answer is incorrect. A sole proprietorship is owned by a single person.

3.

   A. This answer is incorrect. Corporate shareholders have no personal liability for the corporation's debts and liabilities.

   B. This answer is incorrect. The corporation doesn't owe Jack Schmitt and he is not personally responsible for paying the corporation's debts.

   C. This answer is incorrect. Jack's liabilities are no different from those of other shareholders.

   D. That's correct! The owners of a corporation have no personal liability for the corporation's debts and liabilities.

4.

   A. This answer is incorrect. Shares of an open corporation are available for exchange on the public market.

   B. That's correct! A privately held corporation is one that is owned by a relatively small number of shareholders and whose stock is privately traded.

   C. This answer is incorrect. Bloom stock is not publicly traded.

   D. This answer is incorrect. Bloom stock is not held by members of the public.

5.

   A. This answer is incorrect. Private companies are subject to U.S. securities laws.

   B. This answer is incorrect. Registration exemptions do not apply to securities offered to the public.

   C. This answer is incorrect. Exemptions exist when debt securities are issued to the public.

   D. That's correct! If, for example, a prospectus describing an offer of a privately held company's shares contains fraudulent misrepresentations about the company, the directors and officers of the company could be held liable because federal securities laws require that information contained in securities prospectuses be truthful.

Chapter 14
Nonprofit Organization D&O Liability Exposures

Overview

This chapter provides an overview of nonprofit organization exposures by discussing (1) the nature of nonprofit organizations, (2) the duties owed by directors and officers, (3) the types of claims against organizations of this type, (4) the statutory protections against liability, and (5) the underwriting considerations relevant to nonprofit organizations.

Chapter Objectives

On completion of this chapter, you should be able to do the following.

- Recognize how nonprofit organizations differ from for-profit businesses.
- Identify the distinctions among various types of nonprofits.
- Identify the duties owed by directors and officers of nonprofit organizations, and recognize situations in which those duties might have been breached.
- Identify the specific types of claims commonly made against nonprofit organizations.
- Identify the statutory provisions that protect nonprofits' directors and officers against liability.
- Recognize the criteria underwriters consider when insuring directors and officers (D&O) insurance on a nonprofit organization.

The Nature of Nonprofit Organizations

More than 1 million nonprofit corporations exist in the United States. There are numerous types of nonprofit organizations ranging in degree of size, sophistication, and purpose. Nonprofits run the gamut in size from large charities and foundations to little league organizations, in sophistication from universities to neighborhood associations, and in purpose from self-interested professional associations to philanthropic missionary societies.

Following is a representative list of some of the many types of nonprofit organizations (also termed not-for-profit organizations, trusts, cooperatives, foundations, or endowments) for whose directors and officers commercial insurance policies have provided liability coverage.

- Alumni associations
- Animal welfare/humane societies
- Arts organizations (e.g., galleries, art institutes, museums, performing arts, cultural centers, theaters)
- Big Brothers/Big Sisters Clubs
- Boys and Girls Clubs

- Chambers of commerce
- Churches and religious organizations
- Clubs (e.g., gun, sporting, dinner/social)
- Fairs and exhibitions
- Food banks/emergency shelters
- Foundations
- Historical/genealogical societies
- Home owners' organizations (e.g., associations for condominiums, co-ops)
- Libraries
- Nature conservation groups
- Private primary/secondary schools (K–12)
- Public broadcasting stations
- Social services agencies
- Trade and professional associations
- United Way agencies
- YMCAs/YWCAs
- Youth sports organizations (e.g., little leagues)
- Zoos, aquariums, botanical gardens

Source: Chubb Insurance Company

Nonprofit organizations are distinguished from for-profit corporations by virtue of the fact that the former do not distribute their surplus funds to owners or shareholders. Instead, nonprofits use such funds to achieve the organization's goals. Another distinctive feature of nonprofit organizations is that they are exempt from both income and property taxation.

The Lack of Ownership

Nonprofit organizations have no owners. Rather, they have boards of directors. As a result, persons who serve on such boards are unable to sell ownership shares of the nonprofit because none exist.

Executive and Employee Compensation

Some nonprofits pay their executives, middle management, and employees. Others employ unpaid volunteers. In some nonprofit organizations, even executives may work for no or limited compensation. However, executive compensation structures of large nonprofit organizations have increasingly mirrored those found within for-profit organizations.

Tax Treatment

Nonprofits are exempt from federal, state, and local taxation if they are organized and operated exclusively for religious, charitable, scientific, public safety, literary, educational, prevention of cruelty to children or animals, and/or developing national or international sports purposes.

Organized under State Law

Nonprofit organizations are organized under state law. A number of states give nonprofit organizations immunity from tort liability, and still other states limit tort liability by enactment of a damage cap.

Individual states define nonprofits differently. A common differentiation is found between organizations not operated for profit and without charitable goals (e.g. a sports or professional association), as opposed to charitable associations. This distinction is made in order to determine the specific legal rights and privileges the different types of nonprofit organizations will be given.

501(c): The Standard for Nonprofits

A significant number of nonprofit corporations in the United States are set up under Section 501(c) of the U.S. Internal Revenue Code. This law specifies 29 different types of nonprofit organizations that are exempt from some types of federal income taxes. Many state laws also specify the types of nonprofit organizations that are exempt from state taxes. Exhibit 14.1 notes the 29 different types of organizations enumerated in Section 501(c) of the U.S. Internal Revenue Code (26 U.S.C. 501(c)).

Exhibit 14.1
Types of 501(c) Nonprofit Organizations

The following types of nonprofit organizations are listed in Internal Revenue Service (IRS) Publication 557 in the Organization Reference Chart section.

- 501(c)(1)—Corporations Organized Under Act of Congress (including Federal Credit Unions)
- 501(c)(2)—Title Holding Corporation for Exempt Organization
- 501(c)(3)—Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, to Foster National or International Amateur Sports Competition, or Prevention of Cruelty to Children or Animals Organizations
- 501(c)(4)—Civic Leagues, Social Welfare Organizations, and Local Associations of Employees
- 501(c)(5)—Labor, Agricultural, and Horticultural Organizations
- 501(c)(6)—Business Leagues, Chambers of Commerce, Real Estate Boards, etc.
- 501(c)(7)—Social and Recreational Clubs
- 501(c)(8)—Fraternal Beneficiary Societies and Associations
- 501(c)(9)—Voluntary Employees Beneficiary Associations
- 501(c)(10)—Domestic Fraternal Societies and Associations
- 501(c)(11)—Teachers' Retirement Fund Associations
- 501(c)(12)—Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, Mutual or Cooperative Telephone Companies, etc.
- 501(c)(13)—Cemetery Companies
- 501(c)(14)—State-Chartered Credit Unions, Mutual Reserve Funds
- 501(c)(15)—Mutual Insurance Companies or Associations
- 501(c)(16)—Cooperative Organizations to Finance Crop Operations
- 501(c)(17)—Supplemental Unemployment Benefit Trusts
- 501(c)(18)—Employee Funded Pension Trust (created before June 25, 1959)
- 501(c)(19)—Post or Organization of Past or Present Members of the Armed Forces
- 501(c)(21)—Black Lung Benefit Trusts
- 501(c)(22)—Withdrawal Liability Payment Fund
- 501(c)(23)—Veterans' Organization (created before 1880)
- 501(c)(25)—Title Holding Corporations or Trusts with Multiple Parents
- 501(c)(26)—State-Sponsored Organization Providing Health Coverage for High-Risk Individuals
- 501(c)(27)—State-Sponsored Workers' Compensation Reinsurance Organization
- 501(c)(28)—National Railroad Retirement Investment Trust
- 501(c)(29)—Qualified Nonprofit Health Insurance Issuers

Three Common Types of Nonprofit Organizations

The Revised Model Nonprofit Corporation Act (1987), frequently used as a basis for classifying nonprofit organizations, defines three types of nonprofit "corporations": (1) public benefit corporations, (2) religious corporations, and (3) mutual benefit corporations.

The Public Benefit Corporation

The public benefit corporation is analogous to traditional charities formed for public or charitable purposes and includes colleges, universities, and private schools. A public benefit corporation is organized to benefit the general segment of society whether or not the members of the segment participate in controlling and maintaining the institution. A public benefit corporation may also be one that offers a service or product that is not offered by or for for-profit corporations (e.g. museums, libraries, civil groups, hospitals, and schools.

Public benefit corporations usually have no members (or members with limited voting rights). Therefore, directors and officers of such corporations generally are seen as serving the public as a matter of trust. Thus, such corporations are, to a certain degree, more regulated than other types of nonprofits.

The Religious Corporation

Religious corporations are organized primarily or exclusively for religious purposes and not for private inurement. Religious corporations are substantially less regulated than public benefit corporations, meaning directors and officers are held to a somewhat lower standard of loyalty than those of a public benefit corporation.

The Mutual Benefit Corporation

The hallmark of a mutual benefit corporation is that it is formed primarily to serve its members. These corporations tend to feature many attributes similar to for-profit corporations. In fact, other than laws prohibiting mutual benefit corporations from distributing profits to their members, a number of these corporations may operate almost identically to their for-profit counterparts.

Examples of mutual benefit corporations include professional and trade associations, condominium associations, and nursing homes.

Duties Owed by Directors and Officers of Nonprofit Organizations

In many instances, issues involving the duties of loyalty and care owed by nonprofit directors and officers are decided using trust principles, leading to a heightened standard of care and loyalty owed by directors and officers.

Duty of Care

In most states, directors and officers of nonprofits are subject to the same standard of care as directors and officers of for-profits, which is the duty of each to exercise his or her judgment as a reasonably prudent person in similar circumstances would. Examples of breaches of the duty of care include the following.

- A church secretary sued the members of the church's governing board, alleging that the minister had sexually imposed on her and that the trustees were negligent in selecting the minister and in failing to supervise his activities.
- Directors allegedly authorized an organization to become involved in attempts to influence legislation that was beneficial to the organization. However, such activities jeopardized the organization's tax-exempt status. Members sued the directors and officers as a result of such actions.

- Directors of a charitable organization failed to either invest $500,000 of contributions it received from donors or put them to actual use. Instead, the directors placed the contributions in a noninterest-bearing checking account for 5 years. The directors were required to pay the interest that should have been received from a relatively safe investment.

Duty of Loyalty

The duty of loyalty owed by directors and officers of nonprofit corporations includes the duty to avoid conflicts of interest, avoid interference with corporate opportunity, and keep the confidence of the corporation. Exhibit 14.2 shows examples of the types of claims that may arise from a breach of the duty of loyalty.

Exhibit 14.2
Representative Claims Resulting from a Breach of the Duty of Loyalty

- A trustee pledged assets of a charitable trust to obtain a personal loan. Under California law, trustees are strictly prohibited from self-dealing, and the trustee was held liable.
- A nonprofit organization was used as a business conduit through which the chairman of the board of the organization personally profited. A creditor of the organization was permitted to recover from the chairman.
- A charitable hospital corporation owned a parcel of land adjacent to the hospital. The hospital then sold the land to a corporation owned by one of the hospital's trustees. The trustee then used the land to build an apartment and office building. The court held that these facts constituted a conflict of interest and awarded damages to the hospital as a result.
- A former president of a nonprofit association attempted to purchase land on which the organization's clubhouse was located to build condominiums on the land. Members of the association successfully sued to block the sale.
- The trustee of a hospital corporation, who was also the corporation's attorney, was paid a finder's fee in connection with a hospital transaction. A lawsuit was successful in preventing the attorney from receiving the finder's fee.

Duty of Obedience

Directors and officers are required to perform their duties in accordance with applicable statutes and within the terms of the organization's charter. Directors and officers must also obey a variety of laws that may impose direct liability on them for wrongful conduct. Examples of suits from statutorily imposed liability on nonprofit directors and officers are shown in Exhibit 14.3.

Exhibit 14.3
Examples of Statutorily Imposed Liability

- EPL suits
- Antitrust suits
- Copyright/patent suits
- Employee Retirement Income Security Act (ERISA) suits
- Pollution suits
- Physician credentialing suits
- Securities lawsuits
- Suits under miscellaneous state statutes

Duties Owed to Members

Nonprofit corporations generally do not have a class of persons with a sufficiently significant financial interest in the operation of the corporation to bring a derivative or class action suit. However, where a nonprofit corporation *does* have members, the directors and officers do have duties to them and may be liable for breaches of those duties. These duties are generally encompassed within the general duties of loyalty and due care owed to the corporation itself.

Duties Owed to Employees

For directors and officers of nonprofit corporations, employee-related claims are the leading source of exposure, according to a 2011 report from Zurich American Insurance Company ("The Liability Exposures of Nonprofit Board Members"). In fact, according to Nonprofits Insurance Alliance Group's compilation of over 1,500 directors and officers claims against nonprofits from 2005 through 2014, 94 percent of all claims costs originated from employee-related claims. These claims may arise as a result of wrongful acts while hiring, promoting, or terminating employees.

It should be noted, however, that nonprofits with fewer than a certain number of employees and certain types of nonprofit organizations that are considered "private membership clubs" may be exempt from some federal employment statutes (e.g., the Americans with Disabilities Act of 1990 does not apply to employers with less than 15 employees or to private clubs, while the Age Discrimination in Employment Act of 1967 does not apply to employers with less than 20 employees).

Duties to the General Public

Nonprofit organizations must abide by the criminal and civil laws of the federal and state government regarding duties owed to the general public. Civil actions often directed against nonprofit corporations and their directors and officers include common law fraud, breach of contract, and all varieties of torts, including wrongful death or personal injury, negligent hiring and supervision, and interference with contract or prospective advantage of third parties.

Specific Types of Claims Made Against Nonprofit Organizations

Public benefit, religious, and mutual benefit corporations each face distinct types of claims to which they are susceptible.

Public Benefit Corporations

As discussed, directors of public benefit corporations are often held to a "trustee" standard, whereby the director/officer must exercise a degree of care that is higher than simply avoiding ordinary negligence. One reason for this is that many public benefit corporations operate in a "quasi-governmental" capacity and are therefore subject to special rules and procedures. Quasi-governmental organizations are partially, but not entirely, funded by government and are considered important in the functioning of society (e.g., Fannie Mae, or the Federal National Mortgage Association).

Another reason for the higher standard of care is that members of the corporation (if any) and members of the general public have traditionally had no standing to sue, and thus, only the state's attorney general can do so. Without a higher standard of care, and with a minimal threat of lawsuits, public benefit corporations would potentially lack the necessary incentive to act responsibly.

Denial/Termination of Tenure Claims

One troubling type of claim for public benefit nonprofit corporations, specifically colleges and universities, is one alleging that there was an unjust denial of tenure for a professor. This denial of tenure may be despite the fact that the professor has met certain stipulated requirements. Claims may also arise when a tenured professor is terminated and he or she alleges that the institution was not legally permitted to do so. Tenure is regarded as "permanent" employment, and tenured professors may only be terminated for adequate and limited causes.

University of Pa. v. EEOC, 493 U.S. 182 (1990), was an important case in terms of its impact on the potential for tenure-related claims. In short, the Equal Employment Opportunity Commission (EEOC) sought peer-review documents and materials regarding the disputed denial of tenure for a female Asian-American associate professor, which the Wharton School of Business refused to provide. In siding with the EEOC, the United States Supreme Court ruled that the university had no special privilege of "academic freedom" to prevent the EEOC from accessing the peer-review records. The decision lessened the difficulty of proof for professors alleging discriminatory tenure decisions. Nevertheless, claims of sexist or racist denial/termination of tenure have continually occurred since the ruling.

Religious Corporations

Religious corporations, like all corporations, face potentially serious liability in several areas. Although the exposures below have been increasingly covered by stand-alone policies unique to the exposure, the potential remains for parallel proceedings against directors of religious organizations; claims that could fall under a nonprofit directors and officers liability policy.

Liability from Donors

As with most nonprofits that rely on donations to fund their operations, religious organizations are exposed to liability from potential allegations of misappropriation of donor funds. This is especially true given the rise of "megachurches" (churches with average weekly attendance of 2,000 persons or more at their worship services) and other large religious facilities that feature high seating capacities, the ability to host a variety of recreational and social events, and often times multiple "campuses" with cutting-edge services provided for members. According to a September 2012 article by Thom S. Rainer in *The Christian Post*, "Seven Updated Trends on Megachurches in America", the number of megachurches in the United States had grown from 600 in 2000 to 1,600 in 2012. Often times, the lavish features that can be characteristic of religious facilities like these may lead to questions of whether donations are being used appropriately to fund the organization's actual religious mission.

Liability from Counseling and Potential Child Abuse

Religious organizations are uniquely situated to significantly impact the personal lives of their members. Unfortunately, activities like counseling and caring for children bring serious liability concerns to the forefront.

With increasing frequency, employees of religious corporations have been accused of negligent or abusive counseling. If a tort of negligent counseling is established, it is likely that suits against directors and officers alleging negligent hiring or failure to establish proper training programs will follow. Furthermore, potential liability for failure to report suspected abuse or danger to third parties that may become apparent during counseling sessions is another concern.

Additionally, religious organizations that undertake some form of child care services face exposures associated with alleged child abuse. Much like the liability associated with counseling, discussed above, negligent hiring leading to alleged child abuse is one of the primary exposures for directors and officers of religious organizations.

Notably, these exposures are often times specifically excluded from nonprofit directors and officers liability coverage, whether by definition of "bodily injury" or by endorsement. Religious organizations seeking coverage for their directors and officers should therefore make extensive efforts to determine whether coverage exists for these exposures, in addition to making efforts to minimize potential liability.

Mutual Benefit Corporations

Certain liability exposures are particularly relevant for directors and officers of mutual benefit corporations, particularly those exposures related to membership admission discrimination and antitrust liability.

Liability for Membership Admission Discrimination

Mutual benefit corporations can be susceptible to suits by those who wish to become members, but feel they are unable to do so due to discriminatory membership policies. Such lawsuits are expensive to defend and may be pleaded so as to involve directors and officers as the designers of the club's discriminatory policies. Given these circumstances, underwriters carefully examine membership qualifications when they analyze applications submitted by private clubs.

Antitrust Liability

Another area of exposure to the directors and officers of mutual benefit corporations is the antitrust lawsuit. Nonprofit corporations of this type, which include trade and professional societies and cooperatives, can be targets of antitrust claims, just as for-profit corporations may be. Suits often involve agreements regarding price-fixing through minimum or maximum fees or group boycotts, activities that are considered per se violations of federal antitrust laws and are punishable without proof of harm (in civil lawsuits) or proof of criminal intent (in criminal actions). Directors and officers may face both criminal and civil liability, and the combination of defense costs and damages can prove to be very serious.

Statutory Protections Against Liability

Because increased litigation against directors and officers of nonprofit corporations has affected the willingness of such persons to serve on boards or as officers of nonprofit corporations (particularly those directors and officers who serve without compensation), virtually every state has adopted legislation to limit legal liability of volunteer directors and officers under state law, reduce the threat of litigation, and promote the service of volunteers on nonprofits.

However, the limitation of liability for volunteer directors and officers is not without exception. According to Nonprofit Risk Management Center's "State Liability Laws for Charitable Organizations and Volunteers—4th Edition," updated in December 2009, some of the more notable exceptions to state volunteer immunity statutes include the following.

- Exceptions eliminating protection for volunteer conduct found to be willful or wanton
- Exceptions for gross negligence on the part of the volunteer
- Exceptions for wrongful acts committed while operating a motor vehicle
- Exceptions for fraud or fiduciary misconduct
- Exceptions for actions brought by an attorney general or other state official
- Exceptions for the delivery of certain professional services
- Exceptions for knowing violation of the law

There is little consistency or uniformity among state laws that provide protection for volunteers. However, the Volunteer Protection Act, signed into federal law in 1997, addressed the same issue of volunteer immunity and sought to provide additional consistency.

Volunteer Protection Act of 1997

The Volunteer Protection Act of 1997 provides immunity from tort claims that might be filed against volunteers of nonprofit organizations. Generally, the Act protects volunteers from liability if they are (1) volunteering for a nonprofit organization, school, or other government agency for little or no compensation; (2) acting in the scope of volunteer duties; and (3) negligent or accused of negligence. However, the Act does not provide immunity for the organization itself.

The Act also includes several qualifications that must be met in order for volunteers to maintain their immunity. Some examples of exceptions to the Act (i.e., situations in which immunity would *not* be provided to volunteers) include the following.

- Harm that took place because the volunteer acted in an extremely negligent or deliberately criminal manner
- A volunteer activity that required a license or certification in the state in question and for which the volunteer did not have the required credentials
- A volunteer under the influence of drugs or alcohol
- Harm due to the volunteer's operation of a motor vehicle

The above requirements and exceptions were reported in a July 2010 fact sheet from ChangeLab Solutions titled "Volunteers and Liability: The Federal Volunteer Protection Act." Given the numerous exceptions and qualifications to state and federal law that affect whether nonprofit organizations, their directors and officers, employees, and volunteers may be exempt from liability, nonprofits are well advised to purchase liability coverage, despite any appearance of "immunity."

Underwriting Nonprofit Organizations

The following list provides examples of some of the unique facets of various nonprofit organizations that underwriters examine when evaluating their directors and officers exposures.

- Finances

- Fund-raising activities and outside grants
- Advice-rendering/professional services
- Exchange of information
- Publishing
- Membership standards or admissions policies
- Nature and composition of professional staff
- Indemnification agreements
- Antitrust exposures
- Certification exposures
- Insurance program sponsorship

Finances

Underwriters must carefully assess the financial controls that are in place despite the fact that the organization is not strictly in the business of making a profit.

Fund-Raising

Underwriters must also assess the methods by which funds are secured from contributors, as well as the inducements that are associated with the funds solicitation process. This includes evaluating the extent to which funds are used for their intended purposes and whether such funds personally inure to the benefit of directors, officers, and employees of the organization.

A concern that has become particularly relevant is the percentage of donated funds that are used for administrative purposes rather than to directly further the aims of the nonprofit. For example, in late 2015 and early 2016, Wounded Warrior Project (a nonprofit organization supporting wounded veterans) was criticized for only spending 60 percent of donated funds specifically on veterans. Given situations such as this one, underwriters must consider whether the percentage of a nonprofit organization's actual expenditures on its core mission (as opposed to administrative costs) is in line with other similar organizations.

Advice-Rendering/Professional Services

Professional liability suits frequently arise from the advice-giving activities of nonprofit organizations. Examples include pastoral counseling, social services work, legal aid programs, credit counseling, and financial advice. However, such exposures are typically excluded, either by the directors and officers liability policy form or by endorsement, and separate policies (e.g., professional errors and omissions (E&O)) are usually needed.

Exchange of Information

Trade associations and education-oriented associations are especially engaged in disseminating information, either in written material or by other means. Libel, slander, and publishers liability (e.g., copyright violations) can be significant exposures, which may require a separate media liability policy.

Membership Standards/Admissions Policies

Educational institutions, fraternal organizations, and private clubs face an especially significant risk of lawsuits arising from membership standards or admissions policies. Race, sex, religion, national origin, and age are examples of factors that may allegedly play a role in an individual's denied membership.

Professional Staff

The extent to which a nonprofit organization's staff is managed by experienced executives is an important consideration for an underwriter. A large percentage of part-time/volunteer staff, as opposed to those on a full-time, compensated basis, may make an organization more vulnerable to lawsuits. Experience, time, motivation, and resources are more likely to be associated with full-time, compensated staff.

Indemnification Agreements

The extent to which the organization has agreed to indemnify its directors, officers, and employees (when they are sued in conjunction with their work on behalf of the nonprofit) is another important area that underwriters consider.

Antitrust Exposures

Antitrust litigation exposure is an especially important area because many nonprofit organizations (including trade associations and cooperatives) are composed of firms that compete against one another. Discussions of pricing policies, allocation of territories and customers, and the boycotting of certain suppliers are examples of practices that are prohibited by law and may be alleged against nonprofit organizations.

Especially since certain conduct constitutes a per se violation of the law, irrespective of the motives underlying such actions, underwriters must carefully investigate organizational practices that could be construed as violating antitrust statutes.

Product Certification Exposures

Some nonprofit organizations certify specific products. For example, an association of chemical manufacturers may certify that products produced by its members are safe and fit for certain uses. As a result, associations of this sort could be held liable for improper certification in the event of injury or poor performance.

Insurance Program Sponsorship

Nonprofit organizations are sometimes involved in sponsoring various kinds of insurance programs. For example, they may encourage participation in purchasing groups or risk retention groups for various lines of coverage. Professional associations may also sponsor captive insurance companies through which their members can obtain professional liability insurance. However, if the insurer or self-insurance program becomes insolvent or is unable to pay losses, claims may arise against the sponsoring organization.

It should be noted, though, that such programs are usually considered to be an "insurance company E&O exposure" and are therefore excluded by most nonprofit directors and officers liability policies.

Chapter 14 Review Questions

1. Because Yacht Club is a nonprofit organization, we can correctly assume that
    - A. it has a board of directors.
    - B. it might be privately owned.
    - C. it might be publicly owned.
    - D. its board members are also Yacht Club stockholders.
2. Because it was founded to promote the public safety of school children, the nonprofit National Crossing Guards Association is
    - A. exempt from federal income taxes but must pay state and local taxes.
    - B. exempt from federal, state, and local taxes.
    - C. exempt from property taxes but must pay federal, state, and local income taxes.
    - D. exempt from state tax in most states but must pay federal income taxes.
3. In the United States, nonprofit religious corporations are set up under what section of the Internal Revenue Code?
    - A. 401(k)
    - B. 403(b)
    - C. 501(b)(8)
    - D. 501(c)(3)
4. Because it legally qualifies as a private membership club, the not-for-profit Goodol Boys Club is exempted from
    - A. dividend requirements.
    - B. fire protection service charges.
    - C. the Americans with Disabilities Act of 1990.
    - D. zoning laws.
5. Because Smithville Civic League is a 501(c)(4) organization, the Volunteer Protection Act of 1997
    - A. does not apply, although it would apply if the League were a 501(c)(3) organization.
    - B. provides immunity from injury lawsuits to Smithville Civic League as an organization.
    - C. provides immunity from injury lawsuits to Smithville Civic League's paid employees.
    - D. provides immunity from injury lawsuits to Smithville Civic League's volunteers.

Answers to Chapter 14 Review Questions

1.

   A. That's correct! Nonprofit organizations have no owners; rather, they have boards of directors.

   B. This answer is incorrect. A nonprofit has no owners.

   C. This answer is incorrect. A nonprofit cannot be publicly owned.

   D. This answer is incorrect. A nonprofit does not issue shares of stock.

2.

   A. This answer is incorrect. The Association would be exempt from local taxes.

   B. That's correct! Nonprofits are exempt from federal, state, and local taxation if they are operated exclusively for public safety purposes.

   C. This answer is incorrect. The Association would not pay state income taxes.

   D. This answer is incorrect. The Association would be exempt from federal income taxes.

3.

   A. This answer is incorrect. Subsection 401(k) of the Internal Revenue Code defines a tax-qualified, defined-contribution pension account.

   B. This answer is incorrect. A 403(b) plan is a retirement plan for certain employees of public schools, employees of certain tax-exempt organizations, and certain ministers.

   C. This answer is incorrect. There is no Section 501(b)(8).

   D. That's correct! Section 501(c)(3) applies to religious organizations, among others.

4.

   A. This answer is incorrect. A nonprofit issues no stock and therefore pays no dividends.

   B. This answer is incorrect. The club would not be exempt from fire protection service charges by virtue of its status as a private membership club.

   C. That's correct! The Americans with Disabilities Act of 1990 does not apply to private clubs.

   D. This answer is incorrect. Zoning laws apply to nonprofits.

5.

   A. This answer is incorrect. The Act applies to nonprofit organizations.

   B. This answer is incorrect. No immunity is provided for the organization itself.

   C. This answer is incorrect. The Act protects volunteers; employees do not qualify.

   D. That's correct! The Act provides immunity from tort claims that might be filed against volunteers of nonprofit organizations.

Glossary

ADA—See Americans with Disabilities Act.

ADEA—See Age Discrimination in Employment Act of 1967.

Age Discrimination in Employment Act (ADEA) of 1967—A law that prohibits the making of employment decisions (e.g., hiring, promotion) based on age. It applies to employees or applicants who are 40 years or older and to companies with 20 or more employees. The ADEA specifies various remedies if a firm is found to have violated the law. Some of these include hiring an applicant who was discriminated against; reinstating a terminated employee; and paying of back wages, liquidated damages, "front" pay until an employee reaches the age of 70, court costs, and attorneys' fees.

Americans with Disabilities Act (ADA) of 1990—A federal statute passed in 1990, primarily aimed at preventing discrimination in hiring persons having a "disability" as defined by the Act. Under the ADA, employers must afford job applicants equal opportunity (i.e., evaluating an applicant solely on his or her ability to perform the essential functions of a job, regardless of disability) and make reasonable accommodations to allow disabled employees to perform job functions. However, employers are relieved from the reasonable accommodation requirement if it creates an "undue hardship," such as excessive costs or considerable work disruption. Alleged violations of the ADA are one of the leading perils covered by employment practices liability insurance (EPLI) policies. Title III of the ADA is concerned with making public and commercial buildings physically accessible for disabled persons. It imposes remodeling and reconstruction requirements on some organizations that vary depending on the primary use of each building. Some of the requirements apply regardless of whether the building in question must be remodeled or rebuilt for reasons other than ADA compliance. Accordingly, the ordinance or law exclusions in 1995 and later edition Insurance Services Office, Inc. (ISO), commercial property forms contain language intended to make it clear that there is no coverage for the cost of compliance with the ADA.

ARS—See auction rate security.

auction rate security (ARS)—A type of long-term bond issued by a corporation or a municipality. ARSs differ from traditional bonds in one crucial respect: rather than paying a fixed rate of interest for a long time (e.g., a minimum of 10, and sometimes as long as 30, years), the interest rate on an ARS "resets" frequently through a process known as a Dutch auction, which takes place every 7, 28, or 35 days. At each Dutch auction, ARS holders are given an opportunity to sell the ARS. Issuers/borrowers of an ARS benefit because ARSs can provide them with long-term financing, but at substantially lower rates, compared to traditional long-term bonds. Buyers of ARSs benefit because, given their short-term nature, an ARS offers the liquidity of a money market fund, yet with a higher rate of return. But in February of 2008, a number of Dutch auctions "failed" due to a lack of buyers, an event that caused ARS investors' money to be frozen in their accounts. As a result, many investors brought class action lawsuits against the banks and brokerages that induced them to invest in ARSs.

Bipartisan Campaign Reform Act of 2002—A federal law better known as the McCain-Feingold Act regulating the financing of political campaigns. Under this law, corporations may not make direct contributions (i.e., in the "name" of the corporation) to political candidates or parties in connection with federal elections. However, corporations may establish "political action committees" (PACs), which are permitted to raise voluntary contributions from a "restricted" class of individuals, such as executive and managerial employees, stockholders, and their families. Directors and officers of corporations have exposure to liability for violating the McCain-Feingold Act, resulting from the corporation's campaign financing activities.

board committees—Committees formed by members of a corporate board of directors that are created to address a particular aspect or feature of the corporation. Three of the most common board committees and their responsibilities include (1) audit (overseeing the company's financial, accounting, and internal and external audit functions), (2) nominating (identifying and recruiting new/additional board members and officers), and (3) compensation (recommending appropriate compensation levels for the company's management, as well as compensation for members of the board). Board committees normally consist of two to four members of a corporate board of directors.

business judgment rule—A common-law liability doctrine sometimes used to absolve the directors and officers of a corporation from liability, provided it can be shown that a loss resulted from a seemingly prudent, good faith business decision that simply turned out to be incorrect, rather than a grossly negligent or fraudulent act.

CAA—See Clean Air Act of 1970.

CAFA—See Class Action Fairness Act of 2005.

case law—See common law.

CERCLA—See Comprehensive Environmental Response, Compensation, and Liability Act of 1980.

Civil Rights Act of 1871 (as amended by the Civil Rights Act of 1991)—A federal act that amends the Age Discrimination in Employment Act of 1967 to clarify the protections given to older individuals in regard to employee benefit plans.

class action—A type of lawsuit that is brought by a single affected individual on behalf of a large group of similarly affected individuals. Class actions were created by the judicial system because frequently, the number of plaintiffs involved in a lawsuit is so numerous that it would be onerous to name and adjudicate the claims of all plaintiffs on an individual basis.

Class Action Fairness Act (CAFA) of 2005—A law intended to prevent abuses associated with class action lawsuits. The Act places class action cases under federal jurisdiction (previously, such cases were within the jurisdiction of state courts), provided the amount at issue is greater than $5 million. The Act also makes it more difficult for plaintiffs to go "forum shopping" in search of jurisdictions known for class action lawsuit abuses. Another important provision within the Act contains procedures for judicial review of attorneys' fees, which are often excessive relative to the recoveries received by plaintiffs. Opponents of the Act have asserted that these changes will deny aggrieved persons their day in court by making it much more difficult to bring class action suits and that taking such cases out of state court jurisdiction will clog the federal courts' dockets.

Clayton Act—A federal act that prohibits price discrimination among purchasers of goods, exclusive dealing arrangements, and corporate mergers and acquisitions that may substantially lessen competition or tend to create a monopoly in a line of commerce.

Clean Air Act (CAA) of 1970—A federal act regulating the emission of harmful pollutants into the air. It requires corporations to list pollutants that may adversely affect human health and establishes air quality standards. The CAA contains provisions for civil and criminal penalties and enforcement through citizen suits.

Clean Water Act (CWA) of 1972—A federal act that requires the monitoring of discharges into U.S. waters. The CWA contains provisions for abatement actions, penalties, fines, and imprisonment of responsible parties.

closely-held public company—A public company in which a high percentage of the firm's stock (e.g., 50 percent or more) is owned by the firm's directors and officers or other so-called insiders, yet is also held by members of the public and is traded on one or more of the large national stock exchanges.

common law—Unwritten law derived from court case decisions based on custom and precedent. It is contrasted to statutory law.

Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) of 1980—A federal act establishing a system for reporting facilities where hazardous wastes are or have been disposed of, treated, or stored. It also encompasses trust funds financed by certain taxes to be used for cleanup costs. CERCLA also establishes very broad liability standards for hazardous waste incidents that require liable parties to reimburse trust funds that finance cleanup operations.

copyright—An exclusive right to reproduce the work, prepare derivative (i.e., similar) works, distribute copies of the work, and perform and display the work. Violation of such rights may result in liability for infringement.

corporate governance—A system specifying the division of duties, rights, and responsibilities among various participants in a corporation, such as the board of directors, the various committees within the board of directors, operating managers, and shareholders. Corporate governance enumerates the rules, guidelines, and procedures for making decisions affecting corporate affairs. The term has received particular attention in recent years because of massive lawsuits against the directors and officers of a number of high-profile corporations that filed for bankruptcy. Many business commentators, as well as insurance industry observers, believe that a breakdown of corporate governance, especially in the area of financial and accounting controls, was largely responsible for such failures.

corporation—An "artificial person," created under the laws of a given state. A corporation has an identity and an existence distinct and independent from that of its individual owners. Corporations have the power to (1) act; (2) contract; (3) sue and be sued; and (4) own, manage, and buy/sell property. The profits (and losses) of the corporation are distributed according to the ownership interest (i.e., the percentage of total shares) held by each shareholder. The defining feature of a corporation is its legal independence from the people who create it. This means that if a corporation fails, shareholders only stand to lose their investment in the company (i.e., the amount of money they paid for shares of stock in the company) but will not be liable for any remaining debts owed to the corporation's creditors. Corporations are chartered by all 50 of the United States and by the federal government in certain instances (e.g., national banks and savings and loan institutions).

credit rating agencies—Privately owned agencies such as Standard & Poor's, Moody's, and Fitch that rate securities.

credit report—An underwriting tool used by insurers. Some individuals or companies with poor credit records may be more likely to have insurance claims. For example, a person with financial difficulties may not have the funds to repair or replace an aged roof, which increases the chance of a water damage loss. People with major financial problems may be more inclined to stage or exaggerate a loss in the effort to collect more money from the insurer. Research also indicates that a person who is less responsible about the use of credit is more prone to be less responsible while driving. For commercial lines accounts, credit reports such as Dun and Bradstreet are often ordered and can play an important role in the selection process and the pay plan offered.

CWA—See Clean Water Act of 1972.

D&B—See Dun and Bradstreet.

derivative—A financial instrument whose value depends, at least in part, on the value of a related asset or liability. In essence, its value is "derived" from the values of some underlying asset such as a commodity or stocks. For example, if an individual or business owns an option to purchase 1,000 shares of a particular stock at a set price, the value of the option will increase as the value of the stock increases. Risk managers and financial officers often deal in derivatives as a technique for managing their business risks.

derivative lawsuit—A type of lawsuit brought by one or more stockholders on behalf of the corporation, alleging financial loss to the organization. The alleged harm must be to the corporation as a whole, such as the diminishing of the corporation's assets, for shareholders to pursue an action derivatively. Any recovery in such suits inures to the benefit of the corporation itself as opposed to the shareholders who institute the action.

director—A member of a corporation's board of directors who is elected by the shareholders of a corporation to govern and manage the affairs of the company.

due care—See due diligence.

due diligence—Proper care and attention. This term is commonly used to refer to the review of financial and legal documents in a merger or acquisition but is equally applicable to virtually any decision-making process, including whether to insure or self-insure, whether to form a captive insurance company, and a host of other risk management decisions.

Dun and Bradstreet (D&B)—A company that provides credit information on businesses and corporations. The company's reports are referred to as "D&Bs."

Employee Retirement Income Security Act (ERISA) of 1974—Federal law that established rules and regulations to govern employer-provided pensions and other employee benefits provided to U.S. employees.

employment practices liability insurance (EPLI)—A type of liability insurance covering wrongful acts arising from the employment process. The most frequent types of claims covered under such policies include wrongful termination, discrimination, sexual harassment, and retaliation. In addition, the policies cover claims from a variety of other types of inappropriate workplace conduct, including (but not limited to) employment-related defamation, invasion of privacy, failure to promote, deprivation of a career opportunity, and negligent evaluation. The policies cover directors and officers, management personnel, and employees as insureds. The most common exclusions are for bodily injury (BI), property damage (PD), and intentional/dishonest acts. EPLI policies are written on a claims-made basis. The forms contain "shrinking limits" provisions, meaning that insurer payment of defense costs—which are often a substantial part of a claim—reduce the policy's limits. This approach contrasts with commercial general liability (CGL) policies, in which defense is covered in addition to policy limits. Although EPLI is available as a stand-alone coverage, it is also frequently sold as part of a management liability package policy. In addition to providing directors and officers (D&O) and fiduciary liability insurance, management liability package policies afford the option to cover employment practices liability (EPL).

EPLI—See employment practices liability insurance**.**

Equal Pay Act of 1963—A federal law prohibiting pay discrimination against employees because of their gender. The Act compels businesses to pay equal wages to employees performing substantially equal work, regardless of the sex of the individual employees. Pay differentials may be based on merit, seniority, or any lawful factor other than sex. The Equal Pay Act applies to all businesses regardless of the number of employees. Inequalities in pay between men and women for performance of "substantially equal jobs" are prohibited, unless the differences are due to a factor other than sex, such as a seniority system or merit system. Claims alleging violation of the Equal Pay Act are covered by employment practices liability insurance (EPLI) policies.

equity stripping—A type of home equity loan in which a disproportionate percentage of minority and elderly home owners were saddled with loans requiring high fees and high interest rates. Such loans, which were common from 2003 to 2008, effectively reduced borrowers' home equity positions to zero and were clearly unaffordable, given these borrowers' relatively limited incomes. In response to the widespread use of such loans, a number of consumer organizations, in conjunction with various state attorneys general, brought lawsuits against the major banks and their directors and officers who had perpetrated equity stripping. The suits were based on the theory that banks, along with their directors and officers, encouraged and assisted lenders in what amounted to predatory lending schemes, knowing they could package and sell these loans in the form of mortgage-backed bonds and, at the same time, remove such loans from their own financial statements. A number of these suits have been settled, with payments made to affected home owners. Other suits are ongoing.**ERISA**—See Employment Retirement Income Security Act of 1974.

False Claims Act—A federal act amended in 1986 to permit private citizens to bring what are known as qui tam suits on behalf of the U.S. government against anyone defrauding the U.S. government.

Family and Medical Leave Act of 1993—A law allowing employees to take up to 12 weeks annually of job-protected unpaid leave. Such leaves are permitted in the event of a serious illness of the employee or family member, or the birth or placement (through adoption or foster care) of a child. The law applies to employers having 50 or more employees and to employees who have worked for the employer for a minimum of 1,250 hours during the prior year. Charges of discrimination against those taking leave under the Act (or by those prevented from taking leave under the Act) can be filed with the Department of Labor, which investigates and enforces claims. In addition, an employee can sue his or her employer individually. Such claims are covered by employment practices liability (EPL) policies.

FCPA—See Foreign Corrupt Practices Act of 1977.

Federal Trade Commission Act—A federal act that established the Federal Trade Commission (FTC). This commission was authorized to issue “cease and desist” orders to large corporations to curb unfair trade practices. Unfair methods of competition include deceptive advertisements and pricing.

fiduciary—As defined by the Employee Retirement Income Security Act (ERISA), an individual or corporation that (1) exercises any discretionary authority or discretionary control in managing a pension or benefit plan, or exercises any authority or control in managing or disposing of its assets; (2) renders investment advice for a fee or other compensation, with respect to any monies or other property belonging to the plan; or (3) has any discretionary authority or responsibility in administering the plan. ERISA, which was passed in 1974, not only formalized the law associated with the administration of employee pension and benefit plans, but it also broadened the scope of such liability so that it became a "personal" rather than simply a "corporate" liability. The effect of this change was that soon after ERISA's enactment, insurance companies began offering fiduciary liability insurance policies, which were specifically designed to cover this newly legislated exposure.

Financial restatement—A material adjustment to a corporate financial statement that affects the cumulative results of operations during past years. Most often, a financial restatement takes the form of a revision to a corporation's past operating results when they are significantly less favorable than was originally noted. In recent years, a number of major public corporations have issued restatements, which have, in turn, prompted major sell-offs of the organizations' shares of stock. This ultimately has resulted in claims against the firms' directors and officers, alleging fraud and mismanagement. Such claims are covered by directors and officers (D&O) liability insurance policies.

Foreign Corrupt Practices Act (FCPA) of 1977—A law imposing criminal liability on corporate directors and officers for illegal payments made to foreign officials. For example, the minister of trade in Country A may demand an annual $50,000 payment from Corporation X in return for allowing the corporation to ship its products into Country A. Corporation X's payment of such monies would constitute a violation of the FCPA and could subject Corporation X and its directors and officers to liability in the United States. FCPA prosecutions have increased markedly in recent years. This, in part, resulted because the Sarbanes-Oxley Act requires that senior executives scrutinize their company's internal controls;

certify its financial statements; and report possible FCPA violations to the company's board of directors, its audit committee, or its chief legal officer. One high-profile FCPA case in 2012 involved a former Wal-Mart executive who alleged that his firm paid millions of dollars to Mexican government officials in return for expediting the opening of new stores there.

friendly takeover—A situation in which a target company's management and board of directors agree to a merger or acquisition by another company.

groupthink—A type of thought exhibited by group members who attempt to mitigate conflict and reach consensus without critically testing, analyzing, or evaluating ideas.

hostile takeover—A merger or acquisition situation where the company being acquired does not approve of the buyout and fights against the acquisition.

initial public offering (IPO)—The process of selling stock in a corporation for the first time to the general public. IPOs are handled by investment banking firms, which study the corporation's financial situation and then decide how many shares of stock should be sold and at what price. Individual investors are sometimes shut out of IPOs because investment bankers typically dole out IPO shares to institutional customers, such as mutual funds, pension funds, banks, and insurance companies. Accordingly, IPOs have received particular attention in recent years because class action lawsuits against corporate directors and officers have arisen in conjunction with the way in which the IPOs were allocated among various parties. Such claims are known as IPO laddering claims.

inside directors—Members of a corporate board of directors who are also employees of the corporation. Usually, a corporation's chief executive officer (CEO), chief operating officer (COO), and chief financial officer (CFO) are members of the corporation's board and are therefore considered inside directors because they are also employees. In contrast to inside directors are persons known as "outside directors," who are not employed by the corporation.

insider trading—The trading of a corporation's stock (or other securities, such as bonds) by corporate insiders. Corporate insiders include officers, directors, or persons holding substantial (e.g., more than 5 percent) blocks of the firm's stock. Insider trading is legal, provided the person making the trade did not do so on the basis of private information to which the public was not privy and reported the trade to the Securities and Exchange Commission (SEC). Conversely, trades by insiders are illegal when they are made with nonpublic knowledge. Directors and officers (D&O) liability insurance policies specifically exclude coverage for claims involving damages produced by illegal insider trading. However, the policies do cover the cost of defending against allegations of illegal insider trading.

interlock—A situation that occurs when two or more board members also sit together on another corporate board.

Internal Revenue Code—Federal code that, among other things, requires employers to withhold federal income and social security taxes from their employees' wages. The Code imposes personal liability on "responsible persons" if the business does not collect or pay over these taxes to the Internal Revenue Service.

Investment Company Act of 1940—A law requiring that mutual funds register with the federal government. The Act's original intent was to protect the public from many of the abuses engaged in by mutual funds during the 1920s, many of which were responsible for the Wall Street Crash of 1929. On a more contemporary basis, the Act has assumed particular importance because it affords individuals who serve as fiduciaries of employee benefits plans a layer of insulation from liability. Specifically, if it can be shown that a fiduciary selected an investment adviser who is registered under the Investment Company Act of 1940, the fiduciary cannot be held liable for the investment adviser's imprudent investment decisions. Rather, liability can only attach when it can be shown that the fiduciary failed to select an adviser who is registered under the Act.

IPO—See initial public offering.

Lanham Act—A federal act protecting trademarks from unauthorized use.

Lilly Ledbetter Fair Pay Act of 2009—A federal law amending the Civil Rights Act of 1964 and stating that the 180-day statute of limitations for filing an equal pay lawsuit begins to run with each new discriminatory paycheck. The law is intended to overturn the U.S. Supreme Court's ruling in *Ledbetter v. Goodyear Tire & Rubber Co.*, 550 U.S. 618, 127 S. Ct. 2162, 167 L. Ed. 982 (2007), in which the court held that the statute of limitations for presenting an equal pay lawsuit begins to run on the date on which the initial discriminatory pay level was agreed, not on the date of the most recent paycheck, as a lower court had ruled. The Act was intended to clarify the intent of Title VII as it pertains to discriminatory pay decisions. Accordingly, the new statute enables female workers to litigate allegedly discriminatory pay decisions that were made many years in the past, irrespective of the requirement that a claim be filed within 180 days of a discriminatory act.

McCain-Feingold Act—See Bipartisan Campaign Reform Act of 2002.

minutes—Documents that record the events taking place at a meeting.

nonsalary items—Compensation such as bonuses, stock options, and similar incentives.

Occupational Safety and Health Act (OSH Act)—A federal act that imposes on employers a general duty to provide a working environment that is free from hazards likely to cause serious harm or death to employees and requires employers to comply with specific occupational safety and health standards promulgated under the Act.

Older Workers Benefit Protection Act of 1990—A federal act amending the Age Discrimination in Employment Act of 1967 to clarify the protections given to older individuals in regard to employee benefit plans.

option backdating—Occurs when a stock option exercise date is set prior to the date on which the option was granted and at a lower exercise price than the current market price of the company's stock. For example, assume that on January 1, 2006, a company's stock is selling for $25 per share. Also assume that the company's chief executive officer (CEO) is given a 4-year option grant covering the period from January 1, 2004, to January 1, 2008, and that on January 1, 2004, the stock was selling for $15 per share. "Backdating" the option grant by 2 years in this instance allows the CEO to purchase the stock at $15, rather than at the current $25 per share price, thereby locking in an automatic profit. Option backdating is legal, provided the backdating is clearly communicated to stockholders and as long as the effect of the backdating is properly reflected in both earnings reports and tax payments. However, there have been a number of lawsuits against corporate directors and officers alleging illegal option backdating in which these conditions were not met.

opt-out lawsuits—A type of lawsuit in which an individual plaintiff "opts out" of the larger securities class action lawsuit that is also being brought against the same corporate defendant. Opt-out suits are most often filed by an institutional investor (e.g., a bank, insurer, or pension fund). By making a claim that is separate from the larger class action, an individual plaintiff can sometimes negotiate both a larger and more rapid settlement recovery than if the plaintiff was a more passive beneficiary of the class action lawsuit. In addition, by settling on an accelerated basis, an opt-out plaintiff gets "first dibs" at the defendant's directors and officers (D&O) liability insurance policy proceeds. This is important because the defense expenditures required by complex, protracted securities litigation rapidly depletes and frequently exhausts D&O policy limits, often before monies are available to make actual claim settlements.

OSH Act—See Occupational Safety and Health Act.

outside directors—Members of a corporate board of directors who are not employees of the corporation or otherwise affiliated with it. Outside directors usually have special qualifications and expertise that make them valuable in managing the company—hence their appointment to the company's board. In contrast to outside directors are inside directors, who are also employees of the corporation.

patent infringement—An encroachment on a right granted by a government to an inventor assuring the sole right to make, use, and sell an invention for a certain time period. Coverage for this exposure is normally not provided by liability policies.

PDA—See Pregnancy Discrimination Act of 1978.

Ponzi scheme—A scheme that operates by obtaining money from new investors that is then used to pay off existing investors when they seek to withdraw monies from the investment. Ponzi schemes eventually collapse when cash inflows from new investors cease or when withdrawal requests become so large that the available funds cannot meet them.

Pregnancy Discrimination Act (PDA) of 1978—An amendment to Title VII of the Civil Rights Act of 1964. The PDA brought "pregnancy, childbirth, or related medical conditions" within the purview of "sex" as a characteristic protected by Title VII. This legislation created a new "protected class"—pregnant women—and gave them the right to bring claims for discrimination. The PDA allows a pregnant woman to recover equitable relief (e.g., job reinstatement following termination), compensatory relief, and, at times, punitive damages to remedy acts of discrimination on the part of her employer. Coverage for such claims is available under employment practices liability insurance (EPLI) policies.

private equity firm—A company that raises money in private markets (i.e., from institutional investors such as pension funds or from wealthy individuals) rather than from public markets (such as major stock exchanges) and then uses these monies to make various types of investments. The most well-known private equity firms, such as Kohlberg Kravis Roberts and Blackstone, operate by buying all of the shares of a company listed on a public stock exchange (such as the New York Stock Exchange). Since it now owns the corporation, the private equity firm then brings in a new management team in an attempt to make the newly purchased company more profitable and, thus, more valuable. Ultimately, the private equity group resells the company later, hopefully for a higher price per share than the one for which it was originally acquired on the public market.

Private Securities Litigation Reform Act (PSLRA) of 1995—A law aimed at reducing the number of claims against corporate directors and officers that allege securities violations.

privately held corporation—A type of corporation whose shares are not for sale to the public. Rather, the shares of privately held companies are usually owned by a small group of persons—often, although not always, family members and/or senior executives and managers of the company. Unlike publicly held corporations, the shares of stock in privately held corporations are not listed on the major stock exchanges.

proxy statement—A statement required when a corporation solicits the votes of its shareholders on a particular issue. The statement generally includes (1) voting procedures and information on the issue being decided, (2) background information about the company's nominated directors, (3) details of director/executive compensation, and (4) a breakdown of audit and nonaudit fees paid to the auditor.

PSLRA—See Private Securities Litigation Reform Act of 1995.

publicly held corporation—A corporation whose shares of stock are held by and are available for purchase by members of the public. The shares of public corporations can be bought or sold on one of the major stock exchanges, such as the New York Stock Exchange (NYSE) or the National Association of Securities Dealers Automated Quotations (NASDAQ).

public offering—The public sale of a company's shares of stock.

Racketeer Influenced and Corrupt Organizations (RICO) Act of 1970—A law providing for treble damages against those engaged in "a pattern of racketeering activity." At one time, a number of liability policies excluded coverage for suits alleging RICO Act violations against insureds. Now, however, this exclusion is much less common.

RCRA—See Resource Conservation and Recovery Act of 1976.

repurchase—A company's purchase of stock in its own company.

Resource Conservation and Recovery Act (RCRA) of 1976—A federal act regulating the handling of hazardous waste from its generation to disposal. The Act defines "hazardous waste" and establishes standards and permit programs for waste generating, treatment, storage, and disposal. It implements detailed recordkeeping requirements and imposes civil and criminal penalties for noncompliance.

RICO—See Racketeer Influenced and Corrupt Organizations Act.

Robinson-Patman Act of 1936—A federal act that imposes both civil and criminal penalties for predatory price-cutting and other actions taken to eliminate competition.

Sarbanes-Oxley Act of 2002—A sweeping corporate financial reform bill passed by Congress and signed into law by President Bush in July 2002. The Act is a response to a number of accounting scandals involving several high-profile public corporations, including Enron and WorldCom. The reforms promulgated by the Act are an attempt to prevent similar abuses in the future and to restore investor confidence that suffered significantly as a result of these scandals. The key provisions include requirements that chief executive officers (CEOs) and chief financial officers (CFOs) certify their 10-Q and 10-K reports and that all audit committee members be independent. In addition, the law bans personal loans to executive officers and directors, prohibits insider trades during 401(k) blackout periods, requires accelerated reporting of stock trades by insiders, and mandates more detailed disclosure of off-balance-sheet transactions. Finally, the law requires that CEOs and CFOs return any profits they obtained as a result of material misstatements in financial documents and requires attorneys working with offending corporations to report violations of the Act.

SEC—See Securities and Exchange Commission.

Securities Act of 1933—An act to ensure the availability of complete and reliable information about securities being sold to the public. The most important components of the Act are Section 5, which makes it illegal to offer or sell securities to the public unless they have first been registered with the Securities and Exchange Commission (SEC), and Section 11, which imposes civil liability for material misstatements in registration statements. Failure to comply with the Act's technical or substantive requirements in connection with a public offering of a security can result in liability of the corporation and its directors and officers.

Securities and Exchange Commission (SEC)—The U.S. government agency primarily responsibility for enforcing federal securities laws and regulating the securities industry, the nation's stock and options exchanges, and other activities and organizations, including U.S. electronic securities markets.

securities class action claims—Claims brought by a publicly held corporation's shareholders alleging that actions by the firm's directors and officers caused a loss in market value of the firm's shares. Coverage for such claims is available under directors and officers (D&O) liability insurance policies.

Securities Exchange Act of 1934—The Act and its accompanying rules were enacted to protect investors in connection with the trading of securities already issued and outstanding. The most important components of the Act are Section 10(b) and Securities and Exchange Commission (SEC) Rule 10(b)–5, which prohibits manipulative or deceptive acts in connection with the purchase or sale of a security. Corporate directors and officers are frequently the targets of lawsuits brought under these antifraud provisions.

securitization—A process whereby periodic cash flows from a given source are pooled, packaged, and sold to investors, usually in the form of bonds. Between 2003 and 2006, large numbers of subprime mortgage loans were pooled in this manner and then sold to investors who, in return for paying an up-front principal amount, received periodic payments (usually quarterly) in the same manner as bondholders. By 2006, approximately 63 percent of all subprime loans were being sold and packaged in this fashion. When a wave of subprime mortgage loan defaults began in 2007, the value of the bonds began to plummet because the cash flows that "securitized" the bonds (i.e., the periodic monthly payments from the subprime loans) were substantially lower than anticipated, given massive numbers of loan defaults, and were therefore insufficient to pay the interest required by the bonds. This, in turn, triggered huge losses for the investors who bought these bonds. As a result, the investors brought literally hundreds of class action lawsuits against the directors and officers of both the banks that made the subprime loans and the investment bankers who packaged the loans into bonds.

Sherman Act—A federal act that prohibits contracts, combinations (i.e., groups of companies, also sometimes referred to as cartels), and conspiracies in restraint of trade, monopolies, and attempts and conspiracies to monopolize.

spring loading—A controversial and usually illegal form of backdating. There are two types: (1) granting an option just prior to favorable news, and (2) granting an option just after negative news.

stock drop litigation—Litigation brought against corporate directors and officers and trustees of corporate 401(k) plans. Such litigation, normally filed in the form of a class action lawsuit, arises when the market price of a company's stock drops sharply, and as a consequence, employee 401(k) plan holders lose substantial sums of money because they hold large amounts of company stock in their individual accounts. In these lawsuits, employee-plaintiffs allege that the directors and officers were fiduciaries of the 401(k) plans and that the conduct governing the administration of such plans is therefore governed by the provisions found within the Employee Retirement Income Security Act (ERISA). Among the most common allegations of negligence asserted in these claims include (1) intentional disclosure of false and misleading information about the company's finances, which induced the employees to buy shares of the company's stock; (2) failure to disclose material information about the company and its financial condition and performance in statements to the general public, to shareholders, or to employees; (3) failure to disclose such information to other plan fiduciaries (such as investment advisers and brokers) who had responsibility for investing plan assets; and (4) failure to correct misleading statements made by other officers and plan fiduciaries and to adequately monitor wrongdoing by other plan fiduciaries.

stock option—The right to purchase shares of stock in a corporation at a specified price usually, but not always, on or before a specified date. Stock options are routinely offered to corporate officers and directors (and sometimes to employees) as a means of providing them with added incentive to improve the firm's profitability, which, in theory at least, will boost the market price of the corporation's stock. In recent years, the granting of stock options has been the subject of litigation against a number of corporations and their directors and officers by plaintiffs who have alleged that these organizations engaged in the practice of illegally "backdating" option grants.

stock option claims—Allegations by current or former employees that they have been wrongfully deprived of monies due from stock option grants provided by the organization. The largest stock option claims involve those by high-level executives who, following termination or forced resignation, assert that they have been wrongfully deprived of the financial gain produced by stock option grants. Such claims are covered by employment practices liability insurance (EPLI) policy forms.

subprime loans—Loans on residential real estate carrying interest rates that are substantially above the prime mortgage loan rate. Subprime loans are made to borrowers who pose a high credit risk because they have either (1) a low credit score or (2) a high debt-to-income ratio. Often, subprime loans carry relatively low interest rates during the first 2–3 years of the agreement but then increase sharply thereafter, which, in some cases, causes the monthly payment to double or even triple. Beginning in 2006, falling national real estate prices combined with "resets" to higher monthly payment amounts triggered numerous subprime mortgage loan defaults by borrowers. This, in turn, caused huge earnings losses for the banks that made subprime loans. Ultimately, the directors and officers of these banks were hit with literally hundreds of class action lawsuits by investors, who alleged that the directors and officers had been negligent in making such loans.

tag along claims—A type of claim in which plaintiffs assert that, in addition to pension plan fiduciaries, corporate directors and officers are also liable for pension plan defaults and payment shortfalls and, therefore, must also "tag along" as named defendants in such lawsuits. The rationale for naming directors and officers as defendants in fiduciary claims is that they should also bear responsibility for losses sustained by pension and 401(k) plans because they are responsible for selecting fiduciaries and monitoring their decisions.

teaser rates—Initially low mortgage rates that later reset to a much higher rate, which, of course, produce a significantly higher monthly payment.

tie-in endorsement—An endorsement sometimes added to a directors and officers (D&O) liability insurance policy form. Tie-in endorsements state that if an insured's D&O and fiduciary liability policies are written by the same insurer, only one policy limit applies (or the higher of the two limits applies if the limits are different) when a claim arises from essentially the same set of acts or facts. Tie-in endorsements first appeared after Enron's 401(k) plan holders filed lawsuits, alleging almost the identical wrongful acts that were stated in shareholder class action suits against Enron and its directors and officers.

Title VII of the Civil Rights Act of 1964—See Civil Rights Act of 1964.

trademark—A trademark or service mark includes any word, name, symbol, device, or any combination used or intended to be used to identify and distinguish the goods/services of one seller or provider from those of others, and to indicate the source of the goods/services.

treble damages—Triple the amount of the actual/compensatory damages to be awarded to a prevailing plaintiff.

***ultra vires* acts**—Acts that are beyond the powers conferred upon a corporation by its charter or by the laws of its state of incorporation. Corporate directors are not only liable for their own *ultra vires* acts, but can also be held liable for *ultra vires* acts authorized by the board as a whole. For example, if a corporation's charter bans loans to directors and officers, the granting of such a loan by the board would constitute an *ultra vires* act for which all board members could be held legally liable. Coverage for *ultra vires* acts are excluded by directors and officers (D&O) liability policies if they are considered to have been dishonest, fraudulent, or malicious or if such acts violate criminal statutes.